REPORT #627

TAX SECTION

New York State Bar Association

Report on Certain Provisions
of the
Revenue Reconciliation Act of 1989

September 19, 1989

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION REPORT #608

LETTER DATED APRIL II, 1989 TO KENNETH W. GIDEON, ESQ., ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, AND OTHERS ENCLOSING REPORT ON THE APPLICATION OF THE CORPORATE ALTERNATIVE MINIMUM TAX IN BANKRUPTCY SETTINGS.

Tax Report #627

TAX SECTION
New York State Bar Association

September 19, 1989

The Honorable Dan Rostenkowski
Chairman
House Ways & Means Committee
211 Rayburn Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Act of 1989 as introduced in the House of Representatives on August 4, 1989. Portions of the Report were drafted by Wm. L. Burke, John A. Corry, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Mr. Reinhold coordinated its preparation.

The Report comments on the following provisions in the Bill:

(1) Section 11202 - Treatment of certain high yield original discount obligations

(2) Section 11203 - Treatment of certain transfers to controlled. corporations

(3) Section 11206 - Distributions on certain preferred stock treated as extraordinary dividends

(4) Section 11210 - Limitation on deduction for certain interest paid to related person

(5) Section 11404 - Disposition of stock in domestic corporations by 10-percent foreign Stockholders

(6) Section 11642 - Treatment of distribution by partnerships of contributed property

The Report notes that the changes proposed in Sections 11203, 11206 and 11642 address structural deficiencies in the tax system that warrant attention. It supports those provisions and suggests modifications intended to enhance effectiveness or administrability.

The other proposals are found to conflict with longstanding fundamental policies, tax and nontax, that should not be lightly disturbed. To minimize this conflict in the case of the Section 11202 provisions, the Report recommends allowing interest deductions for the targeted obligations only when the interest is actually paid (rather than treating the targeted obligation as preferred stock) if, on balance, action is in fact warranted. It opposes the interest limitation and stock sales provisions in Sections 11210 and 11404 of the Bill as fundamentally unsound. In the case of the interest limitation, it recommends that any concern be addressed directly through consideration of whether the tax-exempt payees should be taxed, rather than imposing the burden on the payor (and indirectly on any taxpaying shareholders of the payor).

Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
4568r-5
Enclosure

cc (w/ encl.): Robert J. Leonard, Esq.
Chief Counsel, Staff Director
House Ways & Means Committee
1102 Longworth
Washington, D.C. 20510

Identical Letter and Report Sent to the Following:
The Honorable Bill Archer
The Honorable Lloyd Bentsen
The Honorable Bob Packwood
The Honorable Ronald A. Pearlman
The Honorable Kenneth W. Gideon

Tax Report #627

TAX SECTION
New York State Bar Association

September 19, 1989

The Honorable Lloyd Bentsen
Chairman, Senate Finance Committee
703 Hart Office Building
Washington, D.C. 20510

Dear Senator Bentsen:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Act of 1989 as introduced in the House of Representatives on August 4, 1989. Portions of the Report were drafted by Wm. L. Burke, John A. Corry, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Mr. Reinhold coordinated its preparation.

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Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
4601r
Enclosure

cc (w/ encl.): H. Patrick Oglesby, Esq.
Chief Tax Counsel, Majority Office
Senate Finance Committee
205 Dirksen
Washington, D.C. 20510

Identical Letter and Report Sent to the Following:
The Honorable Bob Packwood
The Honorable Dan Rostenkowski
The Honorable Bill Archer
The Honorable Ronald A. Pearlman
The Honorable Kenneth W. Gideon

Tax Report #627

TAX SECTION

New York State Bar Association

September 19, 1989

The Honorable Kenneth W. Gideon
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Gideon:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Act of 1989 as introduced in the House of Representatives on August 4, 1989. Portions of the Report were drafted by Wm. L. Burke, John A. Corry, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Mr. Reinhold coordinated its preparation.

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Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
4568r-1
Enclosure

cc (w/ encl.): Dana L. Trier, Esq.
Deputy Assistant Secretary
for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20224

Identical Letter and Report Sent to the Following:

The Honorable Dan Rostenkowski
The Honorable Bill Archer
The Honorable Lloyd Bentsen
The Honorable Bob Packwood
The Honorable Ronald A. Pearlman

TAX SECTION

New York State Bar Association

September 19, 1989

The Honorable Bill Archer
Ranking Minority Member
House Ways & Means Committee
1135 Longworth
Washington, D.C. 20515

Dear Congressman Archer:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Act of 1989 as introduced in the House of Representatives on August 4, 1989. Portions of the Report were drafted by Wm. L. Burke, John A. Corry, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Mr. Reinhold coordinated its preparation.

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Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
4568r-2
Enclosure

cc (w/ encl.): Phillip D. Moseley, Esq.
Minority Chief of Staff
House Ways & Means Committee
1106 Longworth
Washington, D.C. 20515

Identical Letter and Report Sent to the Following:
The Honorable Dan Rostenkowski
The Honorable Lloyd Bentsen
The Honorable Bob Packwood
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Tax Report #627

TAX SECTION

New York State Bar Association

September 19, 1989

The Honorable Ronald A. Pearlman
Chief of Staff
Joint Committee on Taxation
1015 Longworth
Washington, D.C. 20510

Dear Mr. Pearlman:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Act of 1989 as introduced in the House of Representatives on August 4, 1989. Portions of the Report were drafted by Wm. L. Burke, John A. Corry, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Mr. Reinhold coordinated its preparation.

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Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
4568r-3
Enclosure

Identical Letter and Report Sent to the Following:

The Honorable Dan Rostenkowski
The Honorable Bill Archer
The Honorable Lloyd Bentsen
The Honorable Bob Packwood
The Honorable Kenneth W. Gideon

TAX SECTION
New York State Bar Association

September 19, 1989

The Honorable Bob Packwood
Ranking Minority Member
Senate Finance Committee
259 Russell Office Building
Washington, D.C. 20510

Dear Senator Packwood:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Act of 1989 as introduced in the House of Representatives on August 4, 1989. Portions of the Report were drafted by Wm. L. Burke, John A. Corry, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Mr. Reinhold coordinated its preparation.

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Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
4568r-4
Enclosure

cc (w/ encl.): Ed Mihalski, Esq.
Minority Chief of Staff
Senate Finance Committee
203 Hart
Washington, D.C. 20510

Identical Letter and Report Sent to the Following:
The Honorable Lloyd Bentsen
The Honorable Dan Rostenkowski
The Honorable Bill Archer
The Honorable Ronald A. Pearlman
The Honorable Kenneth W. Gideon

Tax Report #627

TAX SECTION

New York State Bar Association

September 19, 1989

Ms. Marianne Evans
Editor
Tax Notes Today
6830 N. Fairfax Drive
Arlington, Virginia 22213

Dear Ms. Evans:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Bill of 1989, as introduced in the House of Representatives on August 4, 1989. Richard L. Reinhold coordinated preparation of this Report.

The principal comments and recommendations are summarized in the transmittal letter and pages 2-9 of the Report.

Very truly yours,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4600r

TAX SECTION

New York State Bar Association

September 19, 1989

Mrs. Sharon W. Potter
American Bar Association
Section of Taxation
1800 M Street, N.W.
Washington, D.C. 20036

Dear Mrs. Potter:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Bill of 1989, as introduced in the House of Representatives on August 4, 1989. Richard L. Reinhold coordinated preparation of this Report.

The principal comments and recommendations are summarized in the transmittal letter and pages 2-9 of the Report.

Very truly yours,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4600r

TAX SECTION

New York State Bar Association

September 19, 1989

Ms. Dorothy Coleman
Daily Tax Report
1231 25th Street, N.W.
Room 517
Washington, D.C. 20037

Dear Ms. Coleman:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Bill of 1989, as introduced in the House of Representatives on August 4, 1989. Richard L. Reinhold coordinated preparation of this Report.

The principal comments and recommendations are summarized in the transmittal letter and pages 2-9 of the Report.

Very truly yours,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4600r

Tax Report #627

TAX SECTION
New York State Bar Association

September 19, 1989

Eric Kracov, Esq.
Silverstein & Mullens
1776 K Street, N.W.
Washington, D.C. 20006

Dear Mr. Kracov:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Bill of 1989, as introduced in the House of Representatives on August 4, 1989. Richard L. Reinhold coordinated preparation of this Report.

The principal comments and recommendations are summarized in the transmittal letter and pages 2-9 of the Report.

Very truly yours,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4600r

TAX SECTION
New York State Bar Association

September 19, 1989

Mr. Scott Schmedel
Wall Street Journal
World Financial Center
200 Liberty Street
New York, New York 10281

Dear Scott:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Bill of 1989, as introduced in the House of Representatives on August 4, 1989. Richard L. Reinhold coordinated preparation of this Report.

The principal comments and recommendations are summarized in the transmittal letter and pages 2-9 of the Report.

Very truly yours,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4600r

TAX SECTION
New York State Bar Association

September 19, 1989

Timothy J. McCormally, Esq.
Tax Executives Institute, Inc.
1001 Pennsylvania Avenue, N.W.
Suite 320
Washington, D.C. 20004-2505

Dear Tim:

Enclosed is a Report on Certain Provisions of the Revenue Reconciliation Bill of 1989, as introduced in the House of Representatives on August 4, 1989. Richard L. Reinhold coordinated preparation of this Report.

The principal comments and recommendations are summarized in the transmittal letter and pages 2-9 of the Report.

Very truly yours,

Wm. L. Burke
Chair

WLB/JAPP
Enclosure
4600r

Tax Report #627

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Certain Provisions

of the

Revenue Reconciliation Act of 1989[1]

September 19, 1989

This Report comments on the following provisions of H. R. 3150, the "Revenue Reconciliation Act of 1989," as introduced by the Chairman of the House Ways and Means Committee on August 4, 1989 (the "Bill"):[2]

(1) Section 11202 - Treatment of certain high yield original discount obligations (see pp. 10-34)

[1] Portions of this Report were drafted by William L. Burke, Michael Hirschfeld, Matthew M. McKenna, Charles M. Morgan III, Richard L. Reinhold, Michael L. Schler and Kenneth R. Silbergleit. Helpful comments were received from Renato Beghe, Richard J. Bronstein, Peter C. Canellos, John A. Corry, Joseph Feit, Arthur A. Feder, Richard O. Loengard, Jr. and James M. Peaslee. Mr. Reinhold coordinated preparation of the report.

[2] The Bill was adopted by the House Committee on Ways and Means on September 14, 1989. It is understood that the provisions considered in this report were not changed substantially from the Bill as introduced.

(2) Section 11203 - Treatment of certain transfers to controlled corporations (see pp. 35-40)

(3) Section 11206 - Distributions on certain preferred stock treated as extraordinary dividends (see pp. 40-49)

(4) Section 11210 - Limitation on deduction for certain interest paid to related person (see pp. 50-57)

(5) Section 11404 - Disposition of stock in domestic corporations by 10-percent foreign shareholders (see pp. 5868)

(6) Section 11642 - Treatment of distributions by partnerships of contributed property (see pp. 68-75)

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

The provisions in Sections 11203, 11206 and 11642 address structural deficiencies that have developed in the tax law. We support these provisions, and suggest some modifications that we think will enhance their effectiveness. However, we believe that the other three provisions considered conflict to a significant extent with fundamental tax and, in some cases, other governmental policies. In our view, those policies should not be disturbed except in the face of actual abuse warranting action and a full and deliberate airing of the implications of the proposed changes. We recommend modification of Section 11202 to reduce unnecessary intrusion on those fundamental policies, assuming that, on balance, the perceived concern warrants action. However, we believe the proposed limitation on deductibility of interest paid to tax-exempt related parties and the proposal to tax gains on sales of stock by 10-percent foreign shareholders are unsound and should be eliminated from the Bill.

Section 11202 of the Bill. We believe that the Bill’s mechanism of recharacterizing specified debt obligations as preferred stock does not represent a sound means of achieving the measure’s intended objective; and that there is a preferable means of achieving that objective. Treating specified debt obligations as preferred stock (in whole or in part) raises a multiplicity of collateral problems and creates opportunities for abuse, in addition to placing undesirable strains on already difficult technical issues in the determination and handling of original issue discount. Moreover, the preferred stock recharacterization mechanism is highly inflexible, and produces dramatically differing consequences where there are even minor differences in the form of the instrument. We believe a more effective approach -- and one with more immediate impact -- would be to defer the obligor's deduction for accrued original issue discount until the year in which it is paid. (The usual original issue discount accrual rules would continue to apply to require current inclusion of the income by the holder of the obligation.) We also believe that further consideration should be given to the triggering conditions under the measure. In particular, we believe that the 5 percentage points above the “applicable federal rate” threshold (i.e., a threshold of 12.88% for 5-9 year obligations today) may be too low.

Section 11203 of the Bill. In general, we support the Bill's proposed limitation on the use of securities in Section 351 transactions. We believe, however, that the Bill's treatment of debt securities as taxable “boot” in Section 351 transactions should be extended to all taxpayers, rather than corporations alone. Under this approach, the Bill's proposed restrictions on the receipt of securities by non-corporate tax-payers (where, for example, the security is supported by a. guarantee) can be eliminated, thereby avoiding significant complexity and uncertainty. We also support the Bill's continuing priority for the more liberal rule for securities in transactions also constituting a reorganization under Section 368 or distribution under Section 355 (at least pending a fuller review of Subchapter C of the Code)[3]. However, we think that the proposed exception from boot treatment of securities in certain transactions between related corporations is not necessary and should be deleted. To the extent that the more restrictive treatment of securities that we suggest could be viewed as overly restrictive in the case of certain small businesses, we believe that issue is better addressed directly through appropriate exceptions in the interest charge and leveraging restrictions applicable to the receipt of installment obligations.

Section 11206 of the Bill. In general, we support the Bill’s provision to eliminate the potential double tax benefit that can arise from issuing preferred stock at a significant premium over its redemption price (and in similar situations). As drafted, however, the measure produces punitive tax consequences: we think the scope of the measure should be restricted to eliminating the double tax benefits that can arise. Specifically, the measure should require basis adjustment only with respect to the portion of the dividend receipts that represent a return of issue premium, and only to the extent such receipts are excluded from income by reason of the

[3] Except as noted, “Section” references herein are to the Internal Revenue Code of 1986, as amended.

corporate dividends received deduction. We also believe the measure should not apply where the issue premium is de minimis; we suggest the measure not apply where the premium does not exceed 10% of the instrument's issue price.

Section 11210 of the Bill. We believe the Bill's proposed disallowance of deductions for interest payments to “tax-exempt” related parties is unsound. Insofar as the measure would apply to interest payments to related foreign entities -- who, in general, may be expected to be fully taxable on the interest income in their country of residence -- it flies in the face of longstanding policy of the United States (actively being advocated at the moment) in favor of free movement and a “level playing field” for goods and capital. Moreover, the measure is contrary to non-discrimination provisions contained in tax treaties, and to the long-established position of the United States in treaty negotiations. The reversal of treaty provisions, some just negotiated, by this provision and Section 11404 of the Bill call into question the credibility of commitments by the United States to its treaty partners. The adverse effect on the United States economy and revenue collections if foreign countries take reciprocal steps is obvious. Insofar as the provision relates to tax-exempt entities within the United States, it effects a de facto revision of the unincorporated business tax rules which have been developed to deal with this kind of issue and represents an intrusion into the fundamental policy of not taxing such entities on their genuine investment income. If any of these basic policy decisions are to be abandoned or modified, the issue should be faced squarely in terms of taxation of the interest in the hands of the recipients, with due regard to accomodating the non-revenue interests involved, and only after a full and considered review of those broader issues.

We also believe the provision as drafted can be easily avoided, does not achieve appropriate consequences where it is effective, and will create myriad administrative difficulties and complexity. In particular, for the well-advised, the ability to avoid the rules through placing loans with unrelated commercial lenders is likely to render the provison ineffectual in reducing either the total interest expense of the U.S. enterprise that is deductible within the United States (after consideration of the offsetting tax relief given commercial lenders with whom the loan could be placed) or the amount of interest passing out of the United States without bearing U.S. tax. And where the provision is effective, by disallowing the deduction to the corporation, it will visit some of the adverse effects upon fully tax-paying U.S. shareholders where they own part of the equity of the corporation paying the interest.

Section 11404 of the Bill. We believe the proposal to tax dispositions of stock of U.S. corporations by 10% or greater foreign shareholders is also unsound. Like the interest limitation provision, this measure would run contrary to the broader policy of free movement of goods and capital that the. United States has long promoted. Similarly, it is contrary to our longstanding tax treaty policy, and the need to limit taxation to the shareholder's country of residence to avoid double taxation under prevailing income source rules that the United States would presumably continue.

We are also concerned that the measure could invite harsh responses that would adversely affect United States multinational enterprises. Moreover, the technical problems in implementing the provision, particularly the problems of applying attribution principles and dealing with ownership through intervening and flow-through entities, make the provision so unmanageable as to threaten to subject the tax system to loss of respect not only abroad, but within the United States as well. In our view, even with diligent effort on the part of the IRS, it will be difficult, and simply impossible in some cases, to obtain satisfactory compliance with this measure. Especially in light of the increasing awareness of the need to maintain taxpayer confidence and acceptance to insure the continued functioning of our self-assessment system, we think the reality that this measure will be routinely disregarded or avoided should raise very serious questions as to the wisdom of enacting the provision. Finally, if the principal purpose of this provision is to reduce takeover activity by foreign corporations in the United States, we seriously question whether it will have any significant effect in achieving that objective.

Section 11642 of the Bill. We support the Bill's proposed modification of Section 704(c) to require recognition of gain or loss where contributed property is distributed to another partner. To be effective, however, we think the measure should be expanded to apply to situations where the contributing partner's interest in the partnership is redeemed by the distribution of property other than the contributed property. However, we believe that the contributing partner should be allowed the benefit of Section 1031 like-kind exchange relief from this special rule, if, on a look-through basis, the requirements of Section 1031 would be met. Finally we believe that practical administration would be enhanced by providing that the new measure would cease to apply once there has been a suitable lapse of time -- say 10 years -- after property is contributed to a partnership.

I. Treatment of Certain High-Yield Original Issue Discount Obligations

Section 11202 of the Bill (adding new Code Section 386) would treat certain original issue discount (“OID”) and “pay-in kind" ("PIK") debt instruments as preferred stock, in whole or in part.

Description of Measure

Initially, the measure would treat as preferred stock any "disqualified discount obligation" issued by a "C" corporation. A debt obligation would be treated as a "disqualified discount obligation" if it meets three conditions:

(i) Term. A maturity date of more than 5 years from the date of issue.

(ii) High yield. A yield to maturity in excess of 5 percentage points over the applicable federal rate (determined under Section 1274(d)) ("AFR") for the month in which the obligation is issued.

(iii) Significant OID. The obligation bears "significant OID." An obligation would be considered to bear significant OID if, in general, at the end of any accrual period ending after 5 years following issuance, the cumulative accruals of interest will exceed the cumulative interest payments by more than a single year's interest accrual (measured by the obligation's issue price multiplied by its yield to maturity).

For purposes of these rules, interest that is "paid" by issuance of a debt obligation of the issuer or a related person would be considered to give rise to discount. Importantly, the provision does not require that the proceeds of the obligation be devoted to an acquisition, leveraged restructuring or any other particular purpose. Instead the measure would apply to every debt obligation meeting the technical requirements of the new statute.

Thus, for example, a six-year zero-coupon debt instrument issued in September 1989 with a yield of 14% would satisfy the term, yield and significant OID requirements of the statute, and accordingly would be treated as preferred stock "for purposes of this title," i.e., for all purposes of the Internal Revenue Code.[4] As a result, (i) OID accruals under the obligation would not be deductible by the issuer during the term of the obligation or at maturity; (ii) the holder of the obligation would not be required to include OID accruals or interest in income at any time; (iii) the holder may be in receipt of constructive distributions under Section 301 (Section 305(c) and Treas. Reg. § 1.305-7(a)); (iv) the issuer would reduce its earnings and profits by the amount of such distributions to the extent treated as dividends; and (v) the payment of the obligation at maturity would give rise to exchange treatment or Section 301 distribution treatment to the holder depending on the application of the tests under Section 302(b). Other consequences also would follow from preferred stock characterization, as discussed in greater detail below.

To the extent that a disqualified debt obligation provides for payments of current interest meeting the requirements of "qualified periodic interest," new Section 386 provides for a bifurcation of the obligation into: (i) a debt instrument that bears the current interest and (ii) a preferred stock instrument to which the "discount" is allocated. For example, a typical "split coupon" obligation might provide for annual interest payments at an

[4] New Section 386(a). The AFR for mid-term obligations providing for semi-annual compounding for September 1989 is 7.88%. Since the obligation described in the text has a yield above 12.88%, it would satisfy the yield requirement of the new measure.

8% rate for the first 5 years of its term, and 14% for the remaining 2 years; with the obligation being sold for 79% of face to produce an overall yield to maturity of 14%. Such an obligation would clearly satisfy the term and yield requirements of the new measure, and thus would constitute a disqualified discount obligation since, as of the close of the first accrual period following the fifth anniversary of issuance (x) total interest accruals under the obligation ($680) would exceed (y) the sum of (a) interest paid in cash up to that time ($470) plus (b) the product of the obligation's issue price and yield to maturity ($790 x .14 = $111), or $581.

The 8% annual interest payments, including 8% of the total 14% interest payable during the last 2 years of the obligation, apparently satisfy the standard of “qualified periodic interest.”[5] As a result, the obligation would be bifurcated. One element would be a debt instrument with (i) an issue price of $571 (i.e., an issue price which, taking into account only the qualified periodic interest of $80 per year, produces a yield equal to the yield on the overall obligation (80/571 = .14)), (ii) a stated redemption price at maturity of $571, and (iii) current interest of $80 annually.[6] The other element would be a preferred stock instrument-with (a) an issue price of $219 (the difference between the issue price of the overall obligation ($790) and the interpolated issue price of the debt instrument deemed under (i) ($571)), (b) a redemption price of $428 ($1,000 - 571), and (c) current “dividend” payments of $60 ($140 - 80) in years 6 and 7. Obviously, the preferred stock instrument is issued at a significant discount -- approximately 51% of face -- producing a

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[5] New Section 386(e)(2) defines qualified periodic interest as “interest based on a fixed rate and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the disqualified discount obligation”

[6] New Section 386(c)(1).

premium on redemption that probably would give rise to constructive distributions under Section 305(c)

Comments

1. General

Our comments on new Section 386 fall into two categories: first, we have a broad concern about the efficacy of the preferred stock characterization mechanism that has been chosen to limit deductions for OID accruals. In our view, the mechanism is extraordinarily cumbersome, and not well-suited to the apparent policy objective of denying interest deductions for non-cash interest on targeted debt obligations. In addition to the failure of the mechanism to effectively perform its intended function (even with the assistance of the bifurcation provision) preferred stock characterization of a debt instrument would have a variety of side-effects that would greatly magnify the measure's arbitrary results. These results will in some cases be adverse to taxpayers and in other cases may pave the way for abuses. In short, we doubt the measure can work in a rational manner if the preferred stock characterization mechanism is retained.

Second, if the preferred stock characterization mechanism is retained, we have a variety of technical concerns about the operation of the measure. These arise chiefly from the restrictiveness of the concept of qualified periodic interest and the uncertainties that derive from the OID computational rules. The importance of these concerns is significantly enlarged where deductibility, rather than timing of deductions, is at issue.

We refrain from comment generally, however, on the tax policy underpinnings of the proposed measure. We take as our starting point the assumption that it is desirable to eliminate the deductibility of interest and original issue discount expense on corporate debt obligations with a maturity exceeding five years if the obligation is issued with a high yield and a substantial portion of the interest payments is deferred.[7] We have some concern, however, that the threshold yield has been set at too low a level, particularly, inasmuch as the measure will reach common corporate financings such as construction loans and the like. We would think a standard of 7 or 8 percentage points above the AFR might better target debt obligations involving a yield that could properly be a cause for concern.

2. Preferred stock characterization mechanism

A. Inadequacies of the mechanism

Our reason for believing that the preferred stock mechanism is ill-suited to its apparent objective is based in the first instance on the inconsistent (even capricious) results accorded various debt instruments. A few examples will illustrate.

Taking as the first case a pure zero-coupon obligation (which satisfies the disqualified discount obligation term and yield requirements), the measure functions rationally to some degree, denying interest (OID) deductions to the issuer, and providing corporate distribution treatment -- dividend if there are sufficient earnings and profits -- to the holder via Section 305(c). The character of the interest accretions is parallel as between issuer and holder.

[7] In adopting this assumption for purposes of these comments, we do not wish to be understood to either endorse or reject the merits of the proposition.

The functioning of the measure begins to break down in even slightly more complex cases. Take the relatively common example of a six-year debt obligation with a 2-year interest holiday issued by a start-up company. Because the issuer’s untested status could easily result in the obligation's yield exceeding 5 percentage points above the AFR, the obligation would constitute a disqualified discount obligation. Most important in the present context, however, is that the obligation would not be eligible for partial debt characterization under the bifurcation rule of new Section 386(c) since it provides for no payments of qualified periodic interest (due to the absence of any interest payments during the first two years).

It is difficult to identify a sound tax policy objective for disallowing all interest deductions in the case of an interest-holiday obligation. Reasoning from the precedent of the split-coupon obligation, where a significant portion of the current cash interest payments would be deductible under new Section 386(c), it seems apparent that the policy of the measure generally is to allow deductions for interest, and to preserve debt status, to the extent the interest is paid currently. We do not think it possible to square the result in the split-coupon case with the outcome in the interest-holiday situation on sound tax policy grounds. Moreover, since preferred stock characterization carries with it numerous other potentially adverse tax effects (<u>see</u> the discussion below at B. and C.), 100% preferred stock characterization of the interest-holiday obligation seems particularly inappropriate.

Given the treatment accorded split-coupon obligations under new Section 386(c), we can only conclude that the drafters would have accommodated interest-holiday obligations at least to some degree if a means to do so could reasonably have been devised.

We do not believe it a satisfactory answer to leave the resolution of this problem to Treasury Regulations.[8] Full interest-holiday obligations and lesser variations, such as increasing interest rate obligations, are both useful and used widely in the financial marketplace in a variety of contexts. In the absence of a sound policy reason to treat these obligations more harshly than split-coupon obligations, we think the preferred stock characterization mechanism that produces these distinctions should be reconsidered.

We do not believe that an exception similar to the qualified periodic interest rule could be fashioned to deal with interest-holiday obligations, and still preserve a semblance of the measure. The most obvious drafting solution would be to treat an interest-holiday obligation as representing preferred stock for the period when interest is not being paid currently, and, when current interest payments commence, treat the stock instrument as exchanged for a debt instrument under which all interest payments (but no OID accruals) would be deductible.[9]

It appears that a “temporal” bifurcation such as that outlined would produce not only results that are inconsistent with the general bifurcation principles of new Section 386(c) but also

[8] Indeed, we have significant doubts as to the authority of the Treasury Department to remedy this problem, assuming it could devise a workable solution. Although the grant of regulatory authority in new Section 386(g) authorizes the Treasury to “[m]odify the provisions of this section,” there is no indication in the listing of subjects that regulations might address that interest-holidays are included. Since, as discussed below in the text, any possible solution in this area cuts across the bifurcation rules of new Section 386(c), there would be a significant question wehther Congress intended to provide relief in this area.

[9] The result would be a deemed exchange subject to Sections 301 and 302. If the holder of the obligation also held (or was related to a holder of) stock interests in the corporation, the exchange might be taxable as a dividend. If the holder were a corporation, the dividends received deduction would effectively be unavailable since the dividend would be deemed “extraordinary” under Section 1059. Section 1059(e)(i)(B). The collateral effects of preferred stock characterization are considered further in B. and C., below.

an unworkable level of complexity. For example, an obligation might provide for a low level of interest payments (say 2%) during an early period rather than a complete interest holiday. Would temporal birfurcation be required in this instance in lieu of general Section 386(c) bifurcation, so that none of the current interest payments would be deductible in years one and two? Or would the minimum interest (the 2%) be deductible under the general bifurcation rule of Section 386(c), with the temporal bifurcation rule then applied to permit deductibility of the balance of the interest payments after the rate steps up? That is to say, would taxpayers be permitted (or required) to combine the general and temporal bifurcation rules? For cases in which the rate of current interest payments increase periodically, the decision would be whether to allow serial temporal bifurcations -- i.e., a series of debt-for-stock exchanges (obviously a recipe for daunting complexity). Aside from the problem of potentially unacceptable levels of complexity, it is difficult to see why the drafters would have rejected the temporal bifurcation rule. The fact that the drafters likely rejected that approach should, however, be a clear sign of the formidable task that will be encountered in getting the statute to work properly.

At bottom, the question is the policy goal sought to be achieved. If the policy objective is to permit interest deductibility (and debt treatment generally) to the extent of current interest payments, that approach may be implemented significantly more easily than partial preferred stock characterization permits, and without the collateral consequences of preferred stock characterization (which appear undesirable). On the other hand, the desired policy may be to allow deductibility (and debt treatment) for something less than all current interest payments, and at the same time to avoid complete non-deductibility in most cases where cash interest is paid currently. Unfortunately, it appears that the desire to reconcile these two irreconcilable objectives can lead only to untoward consequences. In our view, it is obvious that significant discontinuities in the proportion of the disallowance will result, depending wholly on fortuitous aspects of the interest payment/deferral configuration. Stated differently, the failure to ground debt and interest deductibility treatment in either the economics of the transaction or settled tax law principles will certainly lead to arbitrary results, and/or to extraordinary complexity.

B. Collateral issues presented by preferred stock characterization

The apparent intention of the Section 386 drafters was to re-draw the debt-equity line taking into account, primarily, two factors -- yield and deferral of current interest payments. Since these factors are of secondary importance under traditional debt-equity analysis, the result of the measure is to classify as equity many securities whose status as debt would be unquestioned. The result is a dramatic shift in tax effects due to minor and virtually irrelevant variations in the terms of an instrument. Following is a partial listing of the potentially unwarranted consequences of preferred stock recharacterization under the measure:

° If a disqualified discount obligation is issued by a corporate subsidiary, its issuance at a discount will disqualify the instrument from non-stock status under Section 1504(a)(4)(C), potentially jeopardizing affiliated group status. Similarly, if the issuer is a loss corporation, the issuance or retirement of disqualified discount obligations could trigger an ownership change due to their treatment as “stock” under Section 382(k)(6)(A).

- A disqualified discount obligation held by a non- U.S. person would fail to qualify for the exemption from withholding tax for portfolio interest. Sections 871(h), 881(c). Thus, a dividend withholding tax at 30%, or applicable treaty rate, rather than a zero rate, would apply.

- The characterization of a debt instrument as preferred stock could produce dramatically different results in debt-for-debt exchanges. For example, assume a debt instrument was originally issued at $100 (with a redemption price of $100), and is now trading at $55. The old debt instrument is exchanged for a new debt instrument also having a redemption price of $100. Section 1275(a)(4) prevents the market discount on the old obligation from being converted into OID, and no cancellation of indebtedness results from the exchange income. If, however, the new debt instrument provides for deferral of interest payments for a period of 2 years, and therefore constitutes a disqualified discount obligation, the issuer would have $55 of cancellation of indebtedness income under Section 108(e)(10).

- The treatment of disqualified discount obligations as stock would lead to a variety of consequences in the application of stock attribution rules dependent on the value of stock held (e.g., Sections 267, 269, 318, 957, 958 and 1239). As indicated, affiliated group analysis will be affected, as will the existence of a "qualified stock purchase" under Section 338 and qualification of liquidations under Section 332.

- The presence of "control" under Section 368(c) would be determined in part by reference to disqualified discount obligations. (Section 368(c) defines "control" as the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.)

C. Potential "offensive" use of preferred stock <u>characterization by taxpayers</u>

The possibility of an instrument with both creditor protections and assured equity status for tax purposes will almost certainly give rise to abuses:

- A loss corporation with no present ability to utilize interest deductions could issue a disqualified discount obligation, giving corporate holders the right to utilize the dividends received deduction while having the protection of creditor's rights (even to the extent of giving a holder priority over other creditors). If the issuer had no earnings and profits, a holder might obtain significant deferral of tax liability.

- Disqualified discount obligations would be counted as equity in corporate reorganization transactions, and, if endowed with voting rights, apparently as voting stock that could be utilized in reorganzations under Sections 368(a)(1)(B) and (a)(1)(C). Such a possibility is seemingly inconsistent with longstanding requirements for continuity of interest in reorganizations.

- A disqualified discount obligation received in exchange for appreciated property in a Section 351 transaction would permit deferral of the recognition of gain, quite clearly inconsistent with the policy of new Sections 351(g) and (h), added by Section 11203 of the Bill. Moreover, tax deferral would be available without triggering any interest charge under Section 453A, and even if the preferred stock were exchange-traded. (Compare Section 453(f)(4), denying installment sale treatment in such a case.)

- Bearer disqualified discount obligations could be issued by a loss corporation free of the sanctions applicable to bearer debt instruments. See Sections 165(j), 312(m) and 4701.

D. Preferred stock treatment for certain purposes only?

In view of the significant possibility of distortion and abuse if a disqualified discount obligation is treated as preferred stock for all tax purposes, one solution might be to treat such obligations as equity only for purposes of computing the issuer's income and loss from the security (issuance non-taxable under Section 1032; dividends non-deductible; and redemption payments non-deductible, see Section 162(k)) and for purposes of computing the holder's income from the security (distribution treatment governed by Sections 301, 305 and 243, but subject to the limitations of Section 1059), with gain and loss to the holder determined without regard to Subchapter C, and specifically without regard to Section 302.

There are serious difficulties with such an approach. First, it seems clear that inconsistent debt and equity treatment of the same instrument (or portions of the same instrument) is certain to produce enormous complexity, with attendant traps and windfalls. Second, proceeding on this basis would acknowledge the fundamental deficiency of the preferred stock characterization mechanism. We believe that treating debt as preferred stock for some but not all purposes can only make matters worse, especially in light of the unsatisfactory results this mechanism produces on the basic issue of the appropriate level of allowable interest deductions.

3. Alternate solution: retain debt characterization, but allow deduction <u>only at the time of payment</u>

In our view, the underlying policy of the measure could be achieved significantly more simply and effectively -- and with more immediate impact -- by deferring deductions with respect to OID until the time of payment. While this approach may not be a perfect solution, we believe it represents a far better resolution of the competing considerations than reclassification of actual debt as equity for several reasons.

First, an approach that defers deductions for interest to the year of payment fully responds to any concern that OID deductions of highly-leveraged borrowers are improper to the extent the obligation may never be paid. Second, the deferral of interest deductions until the time of payment does represent a penalty on issuers of the targeted obligations -- it being recognized that the issuer's liability for tax is artificially increased if the deduction is postponed from the year of accrual to the later year in which payment occurs.[10] Third, such a rule is consistent with existing precedents that defer OID deductions until the time of payment.[11] The policies underlying these deduction-deferral provisions differ significantly from the objective of the present measure; nonetheless, these precedents provide some guidance as to the proper treatment where OID deductions are considered to confer an improper[12] benefit. Fourth, because this approach avoids far-reaching characterization issues, it avoids significant complexity, thereby benefiting taxpayers and the government. Finally, the approach is evenhanded, and creates no major discontinuities among taxpayers that engage in transactions having similar economic effects.

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[10] see Halperin, "Interest in Disguise: Taxing the 'Time Value of Money,'" 95 Yale L. J. 506, 509-11 (1986).

[11] See Section 163(e)(3) (applicable in case of OID loans from related foreign lenders); Section 1275(b)(2) (applicable to OID on loans to finance personal use property).

[12] Section 163(e)(3) was enacted to prevent OID deductions from being claimed where a related foreign lender was not taxed on the income; the "payment" requirement being designed to assure taxability of the lender. Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 401-02 (Comm. Print 1984). The policy underlying Section 1275(b)(2) is less clear, but may have derived from a desire not to depart from cash accounting for individuals; but see Garlock, A Practical Guide to the Original Issue Discount Regulations 48.1 ("[Section 1275(b)] is largely a revenue-driven provision designed to deny additional or accelerated deductions to buyers of consumer goods purchased on the installment plan").

4. Technical comments regarding <u>"qualified periodic interest"</u>

This part assumes that the general preferred stock characterization mechanism of Section 386 is retained; that relief is provided only for qualified periodic interest (via the bifurcation principle of new Section 386(c)); and that no relief is provided for interest-holiday obligations (through temporal bifurcation or otherwise). Under these circumstances, we believe significant elaboration of the qualified periodic interest concept is required if the statute is to function without causing significant dislocations in ordinary lending transactions.

The definition of "qualified periodic interest" in new Section 386(e)(2) tracks the exclusion from the definition of "stated redemption price at maturity" in existing Section 1273(a)(2), that exclusion in turn being the source of the more comprehensive concept of "qualified periodic interest payments" ("QPIP") in the proposed regulations under Sections 1271-75. <u>See</u> Proposed Regulation $1.1273-1(b)(1)(ii) (hereinafter the "Proposed Regulations").

Initially, it must be recognized that the precise delimiting of the Section 386(c) concept of qualified periodic interest is of critical significance because that definition will determine the deductibility <u>vel</u> <u>non</u> of interest payments on a disqualified discount obligation. By contrast, failure to satisfy the QPIP definition of the Proposed Regulations, generally results, in the context of Sections 1271-75, only in changing the timing of interest deductions and inclusions. With these stakes in mind, the ambiguities of the already articulated QPIP definition are many. A single long accrual period can destroy QPIP status. While some floating rate interest formulas will qualify as QPIPs, the status of a variety of related formulations -- involving caps, collars and multiple indices -- are not certain.[13] Again, where relatively minor timing adjustments are the only issue, this uncertainty may be manageable. Once the consequence is non-deductibility of interest payments, however, business transactions cannot proceed on an orderly basis if there is uncertainty on basic issues -- such as whether an instrument whose current interest payments fluctuate with a major bank's prime rate is considered to bear qualified periodic interest. Nonetheless, this issue is in question due to the proposed measure's unqualified reference to a “fixed rate.”[14]

The following is a partial listing of basic computational issues that, in our view, must be addressed clearly either in the statute or in the legislative history. Deferral of these issues for regulations will create intolerable uncertainty, with materially increased transactional inefficiencies and costs:

- As indicated, floating rate obligations present numerous issues, such as where multiple indices are involved (as is often the case in commercial lending transactions) or where maximum and minimum rates are provided (again, a common commercial practice). The presence of these computation mechanisms should not prevent current interest payments from constituting qualified periodic interest. Similarly, qualified periodic interest should be considered present where the floating rate is combined with a “spread” over the index that increases over time, at least where (as is typically the case) the issuer typically has

13 New York State Bar Association Tax Section, “Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations,” 34 Tax Notes 363, 401 (1987).

14 New Section 386(e)(2).

the right to call the obligation at par at any time, so that no OID would be considered to exist.[15]

° Varying length accrual periods should be permitted within limits. For example, a single "long" accrual period (not in excess of two regular accrual periods) could be permitted in lieu of use of a "short" accrual period.

° The treatment of contingent interest under the Section 386 standard of qualified periodic interest should be clarified. (Contingent interest clearly would not constitute a QPIP under the Proposed Regulations.) From a policy viewpoint, it appears that contingent interest will in many cases represent a charge for the use of money over multiple periods. Typical of such situations would be a shared appreciation loan. In such circumstances, it would appear that the contingent interest should not be treated as qualified periodic interest under the Bill.

° The broad "aggregation rule" of Proposed Regulation $1.1275-2(d) could raise questions as to whether the aggregated instruments will bear qualified periodic interest for purposes of Section 386. If two or more obligations were aggregated -- even though they might

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15 see Proposed Regulation § 1.1272-1(f)(4), treating instruments as due on a call date if exercise of the call produces a lower yield; such would be the case here, since failure to call allows an increase in the spread amount with resulting higher yield.

otherwise be regarded as part of separate issues -- the existence or level of qualified periodic interest could be significantly affected. We think the purpose for applying the aggregation rule in the setting of Sections 1271-75 -- assuring application of a constant yield to instruments -- does not extend to determining whether current interest is paid, and therefore should be treated as deductible. As a result, we recommend that the legislative history specifically state that the aggregation rule of Proposed Regulation $1.1275-2(d) will not apply for purposes of Section 386.

II. Treatment of Certain Transfers to Controlled Corporations

Section 11203 of the Bill would amend Section 351 to add two additional subsections. Both would limit the extent to which "securities" could be received by the transferor without recognition of gain.

Description of Measure

New Section 351(g) would treat a corporate transferor in a Section 351 transaction as receiving taxable "boot" to the extent it receives securities in the exchange. This rule would not apply if (i) the transaction also qualifies as a reorganization under Section 368 or a corporate distribution under Section 355 or (ii) the transferor meets the requirement of Section 1504(a)(2) that it own 80% or more in vote and value of the transferee and the exchange is not part of a plan pursuant to which the transferor will reduce its ownership below the necessary level.

New Section 351(h) would treat all transferors, whether corporations or non-corporate taxpayers, as receiving taxable boot with respect to any securities received if (i) the holder of the security is “substantially protected” against risk of default through a letter of credit, a guarantee, a right to sell the indebtedness, a segregation of assets or any other arrangement, or (ii) less than 25% of the value received by the transferor in the exchange is stock (other than preferred stock) of the transferee. The Treasury Department would be given broad authority to promulgate regulations to prevent circumvention of the purposes of new subsection (h), including authority to deny any increase in tax basis to a transferee that fails to comply with such reporting requirements for subsection (h) as may prescribed.

<u>Comments</u>

The proposed changes apparently arise from the concern that Section 351 may be used to avoid the interest charge and pledge restrictions now imposed with respect to postponed tax on gain deferred under the installment sale rules.[16]

We agree with the objective of the proposed changes, but we believe that the measure would operate both more fairly and significantly more simply if the treatment of securities as boot (the rule of new Section 351(g)) were made generally applicable to

[16] Section 453A. For example, assets can be contributed to a new corporation in exchange for debt securities and a minor amount of stock, with the putative buyer acquiring. the balance of the stock. The securities can then be “monetized” so as to effect a “cash out” without the built-in gain in the securities being taxed. If, on the other hand, the assets had been sold for debt securities, “monetization” of the securities would trigger the inherent gain under Section 453A(a)(2) and (d). We note that the two transactions are not identical, however: a transfer under Section 351 results in no increased tax basis in the assets in the hands of the transferee corporation whereas a sale of the assets produces a cost basis to the transferee.

transactions governed by Section 351 In our view, new Section 351(h) is extremely complex, and creates both pitfalls for the unwary and opportunities for manipulation. As a result, Section 351(h) will be difficult to implement. The question of what constitutes “substantial protection against risk of default” in today's world of increasingly sophisticated and varied financial arrangements almost certainly will become a quagmire for both taxpayers and the Commissioner. Valuation issues similarly are prone to problems of administration, particularly when the transaction may involve multiple properties and multiple transferors. The choice of a 25% value threshold and the exclusion of preferred stock (particularly a participating preferred) appear to us needlessly arbitrary.

We think a far better approach would be to expand the rule of proposed Section 351(g) to all taxpayers, with the installment sale rules generally being applicable to any non-traded securities received.[17] Not only would this approach permit elimination of the more complex (and potentially avoidable) rules of Section 351(h), it also renders the operation of Section 351(g) more certain by foreclosing avoidance strategies such as the use of partnerships to circumvent Section 351(g).[18] We recognize that Section 351(g) may have been limited to transfers by corporations in order to afford relief where securities are received in such transactions involving individuals or small businesses operated through partnerships. We think, however, the need for special relief for the receipt of debt securities in such transactions may be more apparent than real. Moreover, if relief is required in these cases, we believe it would be more conceptually consistent to

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[17] See Proposed Regulation $ 1.453-1(f)(3)(ii).

[18] New Section 351(g)(1) recognizes this possible use of a partnership and attempts to respond to it by picking up transfers of property “indirectly through a partnership or otherwise.” While this approach would surely curb some abuses, there may still be avoidance opportunities where property “comes to rest” in a partnership.

provide the relief directly, through appropriate revisions in the de minimis exceptions to the interest charge and pledge restrictions applicable to installment obligations under Section 453A.

We also recommend the deletion of the related corporate party exception to Section 351(g) that is contained in proposed Section 351(g)(2)(C). The deferred intercompany transaction rules of the consolidated return regulations render this exception unnecessary where a consolidated return is filed. Where a consolidated return is not filed, the issue would appear to be a broader one more appropriately dealt with by postponing any basis increase to the transferee until the earlier of the transferor's talking the gain into income or ceasing to hold the requisite interest in the transferee.

We note that the priority rule for reorganizations and Section 355 distributions in new Section 351(g)(2)(A) and (B) will result in differing consequences depending upon whether securities are received in a reorganization or Section 355 distribution, in a Section 351 transaction or in a distribution subject to Section 301. We think it would be desirable to consider the appropriateness of the differing treatment of the receipt of securities in these contexts. Since the treatment of securities obviously implicates a number of broad, questions, we think such consideration should occur as part of an overall review and revision of Subchapter C, including Section 351.

We are also concerned about both the broad grant of regulatory authority given in proposed Section 351(h)(2), and specifically in proposed Section 351(h)(2)(B) to penalize the transferee corporation with loss of basis if the required reporting does not occur. The recognition of implementation problems implicit in the broad regulatory grant adds weight to the argument for elimination of proposed Section 351(h) (in addition to exacerbating the uncertainties of the proposed subsection). The disallowance of basis penalty reflects a legislative approach that we think is not justified in the absence of widespread noncompliance that would warrant the extraordinary recourse of a penalty provision. In any event, the legislative history should clearly state that any regulations in this area would not be effective prior to their promulgation.

III. Distributions On Certain Preferred Stock Treated as Extraordinary Distributions

Section 11206 of the Bill would add new Section 1059(f), applicable to certain issuances of preferred stock at a premium, and certain similar transactions.

Description of Measure

Under new Section 1059(f), all dividends received with respect to “disqualified preferred stock” would be treated as “extraordinary” for purposes of Section 1059, irrespective of the period that the stock was held. As a result of applying Section 1059, (i) the holder would be required to reduce its tax basis in the dividend-paying shares by an amount equal to the non-taxed portions of dividends received on the stock until such basis is reduced to zero and (ii) any additional non-taxed portions of dividends would give rise to gain recognition in the year of disposition of the dividend-paying stock.

New Section 1059(f) provides three alternative definitions of the term disqualified preferred stock:

(i) Declining dividend rate. When issued, the rate of dividends on the stock declines, or can reasonably be expected to decline.

(ii) Issued at a premium. The issue price of the stock exceeds its liquidation price or its stated redemption price.

(iii) Structured to avoid 1059. The stock is otherwise structured (a) to avoid the provisions of Section 1059 (other than new subsection (f)) and (b) to enable holders to reduce tax through the combination of the dividends received deduction ("DRD") and a loss on the disposition of stock.

To illustrate the operation of the measure, assume that P sells a 5-year preferred stock for §150 with an annual dividend of $22.83 and a redemption price of $100. The instrument has a yield to maturity of 10% (assuming quarterly dividends). Economically, a material portion of the annual dividend would represent a return of the $50 issue premium; nonetheless, it is reasonably clear under present law that the holder would obtain tax treatment significantly more beneficial than return of capital treatment to the extent that dividends qualify for the 70% or 80% DRD, and, at the same time, there is no basis reduction required with respect to the stock. Thus, failure to reduce basis under present law produces what is in effect a second deduction with respect to amounts that have already been received tax-free due to the DRD. Under new Section 1059(f), this tax arbitrage opportunity would be eliminated, since the portion of the dividends received tax-free would reduce the holder's tax basis in the-stock. Thus, since the holder's aggregate non-taxed portions of dividends over five years would be $79.91,[19] under the measure its tax basis in the stock would be reduced from $150 to $70.09, producing $29.91 of gain on retirement of the instrument at maturity.

Comments

In general, we support the enactment of a statutory rule that would eliminate the double tax benefit that can arise where preferred stock is sold at significant premium over its redemption price. As drafted, however, new Section 1059(f) goes considerably beyond the scope of what is needed to prevent such improper benefits. If the measure is appropriately limited, we would support its enactment. A listing of our concerns with the measure as drafted follows:

1. General overbreadth

In general, we do not believe it is appropriate to adopt punitive tax treatment for situations where preferred stock is issued at a premium.[20] There could be any number of non-tax reasons why an issuer might choose to sell preferred stock at a premium, one being to allow the sale of an instrument that has terms identical to an existing issue of preferred stock. Thus, the measure should not do more than tax holders of preferred stock that is issued at a premium in a way that recognizes that the "excess"

[19] $22.83 x .70 x 5 = $79.91

[20] The penalty can be illustrated by reference to the facts, in the example above. The tax imposed is the sum of (i) the tax on the dividend income of $11.64 ($22.83 x .30 x .34 x 5), plus (ii) the tax on the gain at maturity of $10.17 ($29.91 x .34), for total tax of $21.81. The taxpayer's economic income, however is $64.15 (($100-150) + ($22.83 x 5)), resulting in an overall tax rate of 34% ($21.81 - 64.15) instead of the 10.2% rate generally applied to dividend income.

dividend payments constitute a return of the issue premium, and should give rise to basis reduction to the extent excluded from income via the DRD.

To limit the scope of the measure so as only to eliminate the tax-arbitrage benefit, it is necessary to identify the instrument's issue premium, and then to provide a mechanism to characterize dividend receipts as a return of that premium over time. In the circumstance where an instrument's issue price exceeds its redemption price, the issue premium is relatively easily identified (more complex cases are discussed below). Having identified the issue premium, we think it would be appropriate to treat a portion of each dividend payment as a “return of issue premium” and, to the extent that portion of the dividend qualifies for the DRD, require basis reduction under Section 1059. Since the terms of these securities will most likely provide for a redemption date or call price that will assure the holder the desired economic return on investment, it would be appropriate to allocate the premium over the period from the issue date to the redemption date (or earlier call date). Consistent with the treatment of bond amortization, it would be appropriate to amortize the issue premium on a constant interest basis.[21] Thus, in the example used earlier, the $50 of issue premium would be allocated to each year that the taxpayer held the stock, with the taxpayer's stock basis being decreased by an amount equal to the DRD claimed with respect to the year's allocable premium.[22] Thus, at the end of five years, the holder's tax basis would have been reduced from $150 to $115 ($150 - ($50 x .70)).

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[21] See Section 171(b)(3)(A).

[22] To the extent that the dividend payment representing a return of issue premium is taxable to the holder (i.e., 30% in most cases), no double benefit results from allowing the loss on disposition, and, thus, no basis reduction is appropriate.

The treatment of subsequent holders of the stock would follow the same approach. In the case of non-traded stock, it is reasonable to believe that holders could obtain information as to the original issue, price of the security either from the issuer or by means of a legending requirement.[23] While we are not aware of any pattern of public issuances of preferred stock at a significant premium, there appears to be no reason why such issuances could not occur. In that event, we would think that, in addition to the legending requirement, some type of information reporting to corporate holders could be appropriate[24]. In either case, subsequent holders would treat dividend receipts (allocated on a constant-interest basis) as a return of issue premium, and reduce stock basis according to the DRD claimed with respect to the annual issue premium recovery, but in no event would basis reductions be required beyond the redemption price of the stock.

2. De minimis exception

In view of the purpose of the measure to combat a specific tax-arbitrage device, we do not think it appropriate to apply new Section 1059(f) where only a minor premium is involved, and the opportunity for tax avoidance is not significant. Accordingly, we would not apply the measure if the issue premium is less than 10% of the instrument's issue price.[25]

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[23] For an analogy, see Section 1275(c) (applicable to instruments issued with OID).

[24] Compare Treas. Reg. $1.6045-2 (requiring information reporting with respect to payments in lieu of dividends, since such payments do not qualify for the DRD).

[25] See Treas. Reg. $1.305-5(b)(2).

3. Declining dividends

The triggering of disqualified preferred stock status presents some difficulties in cases in which preferred stock has a dividend rate that declines, or may reasonably be expected to decline. First, the definitional standard may be overbroad, and could inadvertently apply to floating rate preferred stock whose dividends “can reasonably be expected to decline” (as well as to increase). Clarification that the measure would not apply to such stock would be appropriate.

Second, in some cases it may be more difficult to apply an economically neutral rule such as that suggested above to declining rate preferred stock because the issue premium may not be easily computed. For example, if perpetual preferred stock is sold for an amount equal to its redemption price, but bears a dividend of 15% for years 1 through 5, and 4% thereafter, it seems apparent that the difference between the two dividend rates should be treated as corresponding to the issue premium. Accordingly, it would be appropriate to treat the difference in the rates (the 11%) as extraordinary dividends.[26] Where the dividend configuration is more complex, it may be more difficult to identify the issue premium. In such cases we think it could be appropriate, as a general rule, to treat 100% of dividends received as return of issue premium (but in no event applying Section 1059 beyond the point at which the taxpayer's basis in the instrument is exhausted). We recognize that this rule is potentially quite harsh, but we do not believe declining rate preferred stock instruments

[26] By selling the stock following the year-5 dividend, the holder would be able to realize the loss resulting from the decline in value of the instrument (which, in turn, results from the reduction in the dividend rate).

have been issued in ordinary commercial settings. We would recommend, however, that taxpayers be permitted to obtain a ruling that a lesser portion of the dividends on a declining rate security represents a return of issue premium in cases where the issue premium can be discerned from the terms of the instrument.[27]

4. "Liquidation rights" and "stated redemption price"

The excess issue price formulation of proposed Section 1059(f)(2)(B) is triggered where the issue price of preferred stock exceeds either its "liquidation rights" or its "stated redemption price." Neither of these terms has current usage in the tax lexicon as applied to preferred stock. This is particularly unfortunate since Section 1059(f)(2)(B) is most likely to apply to mainstream business transactions and certainty of application would be highly desirable.

Section 305 and the regulations thereunder use the term "redemption price" to describe the terminal payment with respect to preferred stock.[28] By contrast, the original issue discount rules use the term "stated redemption price at maturity" to describe all payments under a debt instrument other than certain periodic interest payments.[29] In the OID setting, non-qualifying interest payments are included in an obligation's stated redemption price at maturity to prevent timing distortions through incorrect characterization of payments. In the present context, however, only

[27] Cf. Treas. Reg. $15A.453-l(c)(4) (ruling procedure with respect to rate of basis recovery in certain installment sale transactions where application of general rule would produce inappropriate acceleration of income).

[28] Section 305(c); Treas. Reg. $1.305-7.

[29] Section 1273(a)(2); Proposed Regulation $1.1273-l(b)(1)(ii).

a terminal payment on liquidation or redemption (and not periodic dividend payments) can trigger a loss under Section 165. As a result, we are not aware of any need to enlarge the concept of "redemption price" to include dividend payments. Therefore, we think that new Section 1059(f)(2)(B) should be articulated in terms of the issue price of stock exceeding the lesser of the stock's redemption price or its liquidation rights.[30]

IV. Limitation on Deduction for Certain Interest Paid to Related Person

Section 11210 of the Bill would add new Section 163(i), disallowing a deduction in certain circumstances for interest paid or accrued on an obligation held by a "tax-exempt" related person.

Description of Measure

New Section 163(i) would provide that if for any taxable year a corporation's "net interest expense" exceeds 50 percent of such corporation's "adjusted taxable income," no deduction would be allowed for the "disqualified interest" paid or accrued by the corporation. For this purpose, disqualified interest would be defined as any interest paid or accrued by the corporation to a related person if no U.S. tax would be imposed on such income. In the case of payments to related foreign parties, if a treaty would have the effect of reducing or eliminating the U.S. tax that would otherwise be imposed on the interest income, new Section 163(i)(5)(B) would treat the interest as not subject to U.S. tax based on the degree of relief provided by the treaty. New Section 163(i) would also apply to payments to domestic tax-exempt entities (such as qualified pension and profit-sharing plans, hospitals, etc.).

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[30] Compare Section 1504(a)(4)(C).

Any interest expense that is disallowed under new Section 163(i) would be carried forward and treated as disqualified interest in the succeeding taxable year.

Comments

We believe the proposed measure is unsound and should not be enacted.

We have attached to this report the report submitted by the Tax Section in 1986 with respect to the provision contained in H.R. 3838, which was substantially similar to the current proposal. Because of the close similarities of these proposals, we feel those comments are relevant and should be stressed again.

1. Payments to foreign persons

In the case of payments to foreign persons, the measure would, if enacted, significantly alter longstanding principles of U.S. tax law concerning the treatment of non-U.S. persons. In addition, the measure is contrary to a policy of free movement of capital that is reflected, among other things, in the portfolio interest rules enacted in 1984. Under those rules, U.S. taxpayers are able to claim deductions for interest paid to non-U.S. persons, notwithstanding that the recipient of the interest income is exempt from U.S. and foreign taxes on such income. In this setting, it would seem to be an unjustifiably harsh result to impose what could amount to a double tax on interest paid to related non-U.S. persons, many of whom are subject to full tax on the interest income in their country of residence.

From a treaty policy perspective, the proposed measure would violate the principles of non-discrimination clauses in the

1981 U.S. Model Income Tax Treaty, the 1977 OECD Model Income Tax Treaty and several tax treaties that the United States has entered into with foreign governments. Unilateral modification of statutory law that so clearly violates our bilateral treaty obligations will almost certainly invite retaliation by our foreign treaty partners, most of whom have tax rates as high as or higher than those in the United States. If account is taken of the likely reciprocal action by our foreign treaty partners, this measure would seem unlikely to raise any net revenue. The broad reversal of treaty obligations made by this provision and Section 11404 of the Bill will cause foreign governments to question whether the United States carries on its treaty negotiations in good faith, and the benefit of negotiating tax treaties with the United States.

There is a significant question whether this measure would produce any meaningful reduction in the amount of net U.S. interest deductions taken or generate any meaningful increase in the amount of interest income subject to U.S. tax. Congress should expect that many non-U.S. persons would, rather than subjecting themselves to the punitive effects of the measure, restructure their operations so that financings would be routed through unrelated financial intermediaries, making use of guarantees or other credit support mechanisms. In this regard, a realistic assessment of the achievable objectives of this measure should be made with reference to the significant challenges likely to be encountered by the Internal Revenue Service in its efforts to administer the new rules.

2. Payments to domestic tax-exempt entities

The measure also raises a number of troublesome issues as regards the treatment of payments made to U.S. tax-exempt entities.

In general, a tax-exempt organization can exclude interest income from unrelated business taxable income. However, under Section 512(b)(13) interest income is treated as unrelated business taxable income where the underlying debt obligation is that of a controlled organization (i.e., an organization that satisfies the 80% control test of Section 368(c)).New Section 163(i) generally would apply a 50% standard of control for purposes of disallowing the issuer's interest deduction. Especially since disallowing the interest deduction will unfairly burden non-tax exempt shareholders of the payor (see the discussion below in 3), we think the. policy underlying new Section 163(i) would be more appropriately implemented (as regards tax-exempt entities) through modification of Section 512(b)(13).

We note that any modification of Section 512(b)(13) (or adoption of proposed Section 163(i)) implicates the larger question whether the underlying controlled organization's activities should be aggregated with those of the tax-exempt organization for purposes of determining tax-exempt status. For this reason, we think that Congress should not address part of the controlled entity issue (namely the treatment of interest paid by controlled entities) outside the context of a more complete review of the issues presented by tax-exempt entities involvement with taxable corporations.

3. Effect on shareholders that are U.S. taxpayers

Because new Section 163(i) operates so as to disallow the deduction of interest, the measure would thus adversely affect the payor corporation's cash flow, which in turn would adversely affect both tax-exempt controlling shareholders and other shareholders. We think this indirect effect on non-tax-exempt shareholders is seriously unfair. To the extent it is desired to act in this area, we believe it more appropriate to tax the income to the tax-exempt shareholder -- foreign or domestic -- rather than disallow the payor’s deduction. While we recognize that this solution may be unpalatable for several reasons, we are not aware of any other means by which the unintended harm to non-exempt shareholders can be avoided.

4. Other comments

Although we refer to our 1986 report on this subject for a more complete exposition of these issues, we believe the following points bear particular mention:

° If the perceived abuse is the nontaxability of interest payments made to foreign affiliates, it is our experience that such interest generally is subject to foreign income tax in the payee's country of residence. This is because the United States does not enter into income tax treaties that reduce or eliminate U.S. tax on interest income unless such income is generally taxable by the other treaty party.

° If the measure is based on the concern of aggressive positions taken by foreign parents in the debt-equity area, such abuses would apply equally to U.S. corporations that are closely held by taxable U.S. persons. By not applying payments to such taxable U.S. persons, the proposal clearly discriminates against foreign-owned U.S. corporations.

° The measure would also discriminate against U.S. corporations owned by treaty residents when compared to U.S. corporations owned by other foreign persons. Interest paid to a related person that is a treaty country resident on whom there is no 30% U.S. withholding tax would be nondeductible by the payor and hence indirectly taxable to it at an effective 34% rate. This rate would be 4% greater than the 30% rate at which deductible interest paid to a non-treaty resident related party is taxed. This is an unsound result.

° The measure appears as if it may be intended to limit the attractiveness of incurring debt to finance corporate acquisitions in the U.S. However, the proposal would apply to all U.S. subsidiaries, including historic subsidiaries and those operations that were not established or expanded through acquisitions.

° If the measure is intended as a substitute for a traditional debt-equity analysis under Section 385, it establishes rules which in most cases would be much more restrictive than the accepted application of Section 385 to the capitalization of a subsidiary. Whatever benefits may be perceived in the precision of the proposed standard are certainly outweighed by its arbitrariness.

° As there is no clear rule contained within Section 482 to determine whether two persons are considered “related,” it is an inappropriate reference point in this context. Use of the Section 482 standard will only increase the uncertainty as to whether the interest limitation rules apply.

V. Disposition of Stock in Domestic Corporations by 10-Percent Foreign Shareholders

Section 11404 would add new Section 899, imposing tax on the disposition by a foreign shareholder of all or any part of a 10-percent or greater stock interest in a U.S. corporation.

Description of Measure

New Section 899 would provide that if any nonresident alien individual or foreign corporation is a "10-percent share holder" in any U.S. corporation, any gain or loss from the disposition of any stock in such U.S. corporation would be taken into account as if effectively connected with a trade or business engaged in by the taxpayer in the United States. In addition, the proposal would adopt a withholding tax system whereby U.S. withholding agents would be required to deduct and withhold tax equal to 10 percent of the amount realized on the dispositions of the stock. New Section 899 would be generally effective for dispositions after December 31, 1989, with a delayed effective date of July 10, 1992 for certain beneficiaries of treaty countries.

Comments

We believe the proposed measure is unsound and should not be enacted. As in the case of the interest deduction disallowance rule of proposed Section 163(i), new Section 899 would significantly alter longstanding principles of U.S. tax law concerning the treatment of non-U.S. persons. Exemption from U.S. tax for gains and losses of non-U.S. persons has been part of the U.S. statutory regime for over 70 years. Moreover, the Foreign Investors Tax Act of 1966 actively encouraged foreign investment in U.S. stocks and securities. New Section 899 would, nevertheless, retroactively (in relation to their. investment commitment).impose U.S. tax on foreign investors who relied in good faith on such clearly articulated U.S. policies. Especially in light of the fundamental change this measure would make in the longstanding U.S. tax treatment of foreign persons, we think the proposed measure should not be adopted in the absence of a compelling tax or other policy justification to do so. We are aware of no policy justification that would support this measure.

The proposed measure would contradict, albeit on a deferred basis, policies underlying provisions of the 1981 U.S. Model Income Tax Treaty, the 1977 OECD Model Income Tax Treaty and several tax treaties that the U.S. has entered into with foreign governments. It seems apparent that actions on the part of the United States which have the effect of abrogating our treaty responsibilities should be undertaken only if they are in furtherance of policy objectives that will outweigh the damage to our international relations that can be expected to arise from such unilateral conduct. As far as we have been able to determine, there are no overriding policy objectives that could justify the negative impact that adoption of this proposal would likely have on our relations with foreign treaty partners. Moreover, in pure monetary terms, the likely retaliatory response by our treaty partners, by itself, should eliminate any benefit from the de minimis revenue estimates.

Even where a foreign buyer does wish to dispose of part of its economic interest in a U.S. business, the effectiveness and consequences of the provision will be subject to question. A well-advised foreign parent with the benefit of a tax treaty will frequently find it advisable first to cause the U.S. subsidiary to borrow and distribute to it an amount up to the sum of the maximum dividend payable for U.S. tax purposes (whatever earnings and profits restrictions will allow) plus its unrecovered original investment.[31] In due course, the borrowing can be paid off by a new issuance of stock by the U.S. subsidiary. No foreign parent need subject itself to the capital gains tax, therefore, unless it wishes to withdraw more than the sum of its investment plus the earnings of the business. If it wishes to sell out to a foreign purchaser, it is likely to have more flexibility in structuring such a transfer free of U.S tax than it would in selling to a U.S. purchaser. The heaviest burden thus is likely to fall on a sale to a U.S. purchaser.

If a purpose of the proposal is to discourage foreign acquisitions of U.S. corporations, it should be understood that this change will discourage few if any foreign takeovers of American corporations. Typically, foreign takeovers of U.S. target corporations are accomplished by purchasing the parent company of an operating group. The foreign purchaser is usually an operating company intent on securing ownership of one or more businesses operated by the U.S. target corporation. If the takeover is successful, the foreign buyer then proceeds to cause the U.S. target corporation to sell those lines of business which the foreign corporation cannot integrate with its basic foreign business, and the proceeds of those sales are then used to pay down debt incurred in the acquisition. The gains arising from the sales of these “non-core” businesses have, since General Utilities repeal, been fully subject to U.S. tax. New Section 899 would not impose any additional tax on those gains. When all is done, the foreign buyer owns the target U.S. corporation with its core businesses which it proceeds to operate and integrate with its

31 The net United States tax realization thus would be as little as 5% of the amount taxable as a dividend. The distribution may not attract tax in the foreign parent's home country, for example, because the foreign country gives double taxation relief through exemption of dividends or a Section 902-type indirect foreign tax credit, or because the distribution is not treated as a dividend if nominally effected as a stock redemption (even though pro rata).

foreign business. It is generally not the plan in most of these situations to then dispose of the stock of the U.S. target. Thus it is very unlikely that new Section 899 would produce any change in the pattern of foreign takeovers of U.S. businesses.

The proposed measure is also objectionable from the perspective of the complexity the measure will engender and the extreme difficulty (and expense) the IRS is likely to encounter in attempting to administer it. We believe that it is essential that Congress, prior to enacting an extremely complex proposal such as Section 899, first balance the policy objectives of the legislation against the negative aspects of increased complexity and the burdens of administering the new rules. While we recognize that occasions arise when it is necessary to adopt complex rules, those cases should be limited to situations where overriding policy objectives will be served. It is difficult to imagine how such a balancing, if performed in connection with new Section 899, could justify its enactment.

A listing of our more particular concerns with the measure as drafted follows:

1. The statute should make clear that, as is currently true with the FIRPTA tax, taxable gain under new Section 899 will not be subject to the branch profits tax. Cf. Section 884(d)(2)(C).

2. Proposed Section 899(e)(2) should refer to convertible debt rather than “the conversion feature” of a debt obligation. Otherwise, there will be uncertainty in treatment of a convertible debt obligation sold at a gain, some of which arises from a drop in prevailing interest rates. If, as in subsection (e)(3), any other interest not held solely as a creditor is treated

as stock, there is no reason why a convertible debt obligation as such should not also be so treated.

3. A more important and difficult problem involves the application of the vote and value percentages to options and convertible securities. Presumably, ownership of the option or security should be treated as ownership of the voting power that would be possessed if the option or conversion right were exercised, as is the case under Section 318. Would options and convertibles (if the definition is changed as suggested above) be valued as if they were stock without any consideration being given to their other attributes? The statute probably compels that result and it seems desirable. The most difficult problem is what to do with options and convertible securities held by other persons. The uncertainty in this are under Section 318[32] may be acceptable where the only question is a determination of the liability for tax of the person making the determination (who, in general, may be presumed to have adequate knowledge of the facts), but it becomes intolerable when the issue is faced by a withholding agent who could be penalized if he makes the wrong decision. Although the withholding provisions are not to apply for six months after enactment of the legislation, it is unclear whether the Service will be able to issue guidance on these issues in that period of time and, indeed, withholding agents will be required to put a withholding process in place before that date. Therefore, guidance on these subjects and the statute or legislative history is essential.

4. The phrase “or have reason to know” in proposed Section 1447(b)(2)(A) should be deleted. Where stock is traded on a securities market, particularly on a stock exchange, a broker will

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[32] Cf. Rev. Rul. 68-601, 1968-2 C.B. 126 and Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964).

normally be an unrelated third party who is not willing to run any risk of being subjected to penalty for failure to collect a withholding tax especially since the phrase “or have reason to know” is open to varying interpretations. Thus, we are concerned that such a requirement will have substantial adverse effects on the orderly trading process. In the information reporting area, Treas. Reg. $35a.9999-5 Q&A 2 provides that there is no information reporting unless the issuer or its agent has actual knowledge that a payee is a United States person. A similar standard should apply here.

5. The exception to the regularly traded rule in proposed Section 899(b)(2)(B) for separate dispositions of 1% or more of the stock of a corporation would presumably make the affidavit requirement for non-publicly traded stock applicable, whether the dispositions are by U.S. persons or by foreign persons. The provision raises a question as to whether and to what extent different trades are to be treated as a single “disposition” for purposes of this rule. What if 1% of the stock of X Corporation is represented by 100,000 shares and a shareholder sells 20,000 shares in the morning of day 1, 40,000 shares that afternoon and 50,000 shares the next day? If the seller uses the same-broker for all three trades, how does this provision apply, if at all?

6. We fail to see the reason for the requirement in proposed Section 1447(b)(2)(C) that any time Section 899 applies to a disposition by a foreign person of regularly traded stock, that person will notify the withholding agent that Section 899 applies. The statute should be modified to provide (i) that no such notification is required if the sale represents less than 1% of the

issuer's stock, and (ii) that the withholding agent shall have no liability for failure to withhold if such notification is not provided to it (unless it has actual knowledge that withholding was required).

7. Either the statute or its legislative history should provide a definition of “established securities market.” See proposed Section 897(d)(3). The FIRPTA definition in Treas. Reg. $1.897-l(m) would appear appropriate here.

8. Having established 10% as the ownership threshold for taxing foreign shareholders’ gain, the proposed measure would include a novel attribution rule (new Section 899(c)(3)) inconsistent with this principle, under which a foreign holder of an interest in a partnership would be treated as a person owning 10% or more of the shares of a U.S. corporation, if the partnership owns 10% or more of the shares in that corporation. The result of this approach would be to extend the scope of the proposal to situations well beyond its apparently-intended application. For example, under this partnership attribution rule, a 1% limited partner (who has no control over the identity of the other partners, the investment decisions of the general partner or the actions of the partnership as a shareholder) would be treated as a “10% shareholder” if the partnership owns 10% of the issuing corporation, even though such limited partner's beneficial interest in the issuing corporation would only be l/10th of 1%. This novel attribution rule has the potential to create extraordinary uncertainty and complexity. The proposal would put additional pressure on the difficult question of when an arrangement (such as a co-investment contract or investment management contract) constitutes a partnership. There would also be substantial factual disputes in determining whether a common investment by several individual accounts with common management should be viewed as a

partnership. We recommend that the special partnership attribution rule be eliminated from the proposal, allowing the normal attribution rules of Section 318 to govern.

9. Proposed Section 1447 contains no provision similar to Code Section 1445(c) permitting the amount of the withholding to be reduced to the amount of the transferor's maximum tax liability. Accordingly, withholding would be required even if the transferor is selling the stock at a loss. We suggest that the words “section 1445(c) and” be added to proposed Section 1447(d)(5) immediately before the reference to “section 1445(e).”

VI. Treatment of Distributions by Partnerships of Contributed Property.

Section 11642 of the Bill would amend existing Section 704(c), relating to the distributive share of a partner that contributes appreciated or depreciated property to a partnership, to require the recognition of gain or loss where the contributed property is distributed to another partner.

Description of Measure

New Section 704(c)(2) would provide in effect that if property contributed to a partnership by one partner is distributed to another partner, then upon the distribution the contributing partner must recognize gain or loss, to the extent provided under existing Section 704(c) (i.e., to the extent of the built-in gain or loss at the time of contribution), as if the property were sold at its fair market value at the time of the distribution.

This provision appears to be intended primarily as an extension of the “disguised sale” rule of Section 707(a)(2)(B). As such, its primary effect would be to accelerate gain that would otherwise be deferred under the general partnership rules.

Comments

We support this provision. We believe that if contributed property is distributed to another partner, the change in ownership of the property (viewed from the time just before the contribution to the time just after the distribution) is sufficient to trigger gain (or loss) recognition. Moreover, the provision would close a technical gap in existing Section 704(c), under which built-in gain that is specially allocable to a contributing partner “disappears” when the property is distributed to another partner.

We have a number of additional comments:

1. Redemption of contributing partner

The provision does not explicitly deal with the situation where, prior to the distribution of the contributed property, the contributing partner is redeemed out of the partnership with other property. If this situation is not covered, the new measure would be very easy to avoid.

Consider the following extreme example. A contributes appreciated property ($0 basis, value $100) to partnership P. B contributes $100 in. cash, and C contributes $1 in cash. The $100 in cash is used to buy a long-term Treasury bond. All assets retain the same value. After a waiting period sufficient to avoid the disguised sale rules of Section 707(a)(2)(B), A is redeemed out with the Treasury bond. A has a $0 basis in the Treasury bond and no immediate gain. Now that A is no longer a partner, as a “separate step” P is liquidated with B receiving the appreciated property (with a substituted basis of $100) and C receiving back its $1. While the appreciated property has moved from A to B and B has obtained a stepped-up basis in the property, unless the new provision applies A is not taxed on that appreciation until the Treasury bond matures.

We suggest that the provision be modified so that the contributing partner is taxed on the Section 704(c) gain at the time the contributing partner is redeemed out of the partnership, even if the appreciated property is still held by the partnership. This rule would be analogous to Section 751(b)(1)(B), under which any distribution of property to a partner in exchange for that partner's interest in “tainted” assets of the partnership is treated as a taxable sale or exchange.

It appears that if the rule is adopted that the proposed legislation applies to a redemption of the contributing partner, an exception could be made for redemptions described in Section 736(a). Payments under that Section are treated as a distributive share of partnership income or as a guaranteed payment, and the recipient is considered a partner for tax purposes as long as those payments continue. Thus, if the appreciated property is still held by the partnership when the Sect ion 736(a) payments cease, application of the proposed measure would have no net effect, since any gain triggered to the contributing partner by reason of his cessation of partner status would give him basis in his partnership interest and an immediate offsetting loss. If the property were distributed to another partner while the contributing partner was receiving Section 736(a) payments, presumably the measure would result in taxation of the built-in gain to the contributing partner since he would still be a partner for tax purposes.

2. Applicability of Section 1031

If the measure is applied to a redemption of the contributing partner, as suggested above, there should be an exception where the contributing partner receives back from the partnership, in redemption of the partnership interest that such partner received for the contributed property, property that would have been eligible for a Section 1031 exchange with the contributed property. In other words, if the contributing partner could have achieved the same economic exchange tax-free under Section 1031, that partner should not be taxed solely because the same result was achieved through a partnership. (The same exemption to a deemed sale should already apply under Section 707(a)(2)(B).)

In addition, consideration should be given to a similar exemption in the situation where the new measure now clearly applies, namely where the contributing partner remains a partner and the contributed property is distributed to another partner. In that situation, the new measure should not apply to the contributing partner if, following the distribution of the appreciated asset, the contributing partner's remaining indirect interest is in partnership assets that could have been received tax-free by the contributing partner in exchange for the distributed property under Section 1031. While Section 1031 would not literally apply because the partner has in effect exchanged a direct interest in an asset for an interest in a partnership holding similar assets, the principles of Section 1031 could logically still be applied by statute to limit the breadth of the deemed realization rule.

3. Holding period exception

We suggest that the Bill be modified so that after a period of time following a contribution of appreciated property (perhaps 10 years), the new provision would not be triggered even though the property was distributed to another partner (or the contributing partner was redeemed out of the partnership). This modification would greatly simplify partnership recordkeeping without, we believe, permitting abusive transactions to take place.

4. Constructive liquidation

We do not believe the contributing partner should be taxed solely as a result of a constructive liquidation of the partnership under Section 708(b)(1)(B) (constructive liquidation if 50% or more of the interests are sold or exchanged within a twelve-month period). At the same time, however, we do not believe that a constructive liquidation should be a means for the contributing partner to permanently avoid the potential built-in gain on the appreciated asset. We suggest that Section 704(c) be clarified to provide that built-in gain or loss allocable to a partner shall remain so allocable following a constructive termination of the partnership.

5. Special allocations

We recognize that it would be possible for taxpayers to avoid many of the effects of the proposed measure by neither distributing the appreciated property nor redeeming out the contributing partner, but rather by providing in the partnership agreement for special allocations of income from specific properties held by the partnership. This problem is, however, broader than the new amendments to Section 704(c) and exists presently in the context of the disguised sale rule of Section 707(a)(2)(B). Unfortunately, we think the variety of allocations that are commonly used for non-tax reasons precludes a statutory solution to this problem. If it is believed that the IRS and the courts cannot deal adequately with these issues through application of the substance over form doctrine, we would recommend that regulatory authority be granted to deal with it.

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TEXT:

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON U.S ACTIVITIES OF FOREIGN TAXPAYERS

Report on the Proposed Disallowance of Deductions For Interest Paid to Certain Related Foreign Parties

Section 984 of the Senate Amendments to H.R. 3838 (the “Senate Bill”) would disallow certain Interest paid by United States persons to related foreign persons that are exempt from U.S. Tax on the interest[/1/] Insofar as the exemption results from exemptions from or reductions in United States withholding taxes pursuant to income tax treaties, we believe that the proposal is unsound and should be rejected by the Conference Committee.

I. SUMMARY OF PROPOSAL

Section 984 of the Senate Bill would amend Code Section 163 to disallow deductions for certain interest paid by U.S. persons to “related tax-exempt parties”.

The disallowance would apply to the extent that net interest deductions otherwise available to the borrower exceed 50% of its taxable income, as recomputed by adding back all interest payments and net operating loss deductions.

For this purpose, the Senate Bill would treat as “exempt” not only U.S. entities such as employee benefit trusts and charitable organizations but also any related person that is a foreign corporation if no United States tax is imposed on interest paid by the taxpayer to such person, such as by reason of a tax treaty exemption. If a treaty reduces the rate of U.S. tax on interest paid to a Foreign person, the payment would be deemed exempt in the same proportion that the treaty’s rate reduction from the 30% rate bears to the 30% rate, payments of interest to a foreign person would be subject to these rules even though such person is taxable on such interest in Its country of domicile. /2/

This provision results from the Finance Committee’s Concern that unlimited deductions for all interest paid to related exempt entities permits significant erosions of the tax base in situations where the Finance Committee believes that an economic unit is contracting “with itself at the expense of the government” (Committee Report, 0.4241. The Finance Committee states that the uncertainties of present law (C) 1986, Tax Analysts, Tax Notes Today, July 8, 1986 Regarding debt-equity questions may allow taxpayers to take aggressive positions that inappropriately erode the U.S. tax base and that case law dealing with the debt-equity question may not be adequate to address this concern, The Committee concluded that, rather than adopting debt-equity rules limited to “earning-stripping cases”, it is preferable to tie this limitation to taxable income which, in the Committee’s opinion, “goes to the heart of the earnings-stripping question”.

The Bill permit's carryforwards of disallowed interest deductions. However, the Finance Committee concludes, without explanation, that carrybacks are inappropriate.

The Finance Committee concludes that the proposal would not violate provisions of U.S. income tax treaties that prevent discrimination against foreign-owned U.S. businesses because it also applies to interest paid to tax-exempt related U.S. entities. The Committee adds that, in any event, it does not intend that any contrary treaty provision should "defeat its purpose in enacting this limitation."

II. GENERAL DISCUSSION OF PROPOSAL

To the extent that the proposal treats as "exempt" interest that is not fully subject to U.S. tax by reason of a specific treaty provision, we believe that it is unsound and should not be adopted.

Although the Committee Report states that-such interest income "may or may not be subject to foreign tax" (p. 425), in our experience in most cases such interest is subject to foreign income does not enter into income tax treaties that reduce or eliminate United States tax on U.S. source income unless such income is generally taxable By the other treaty party. One of the two primary purposes for adopting income tax conventions is to avoid double taxation of income earned in one country by a resident of the other country. /3/ Because such interest is generally taxable to treaty country recipients, it is the tax treaty negotiating policy of the United States, as evidenced in the June 18, 1981 U.S. Model Income Tax Convention, that non-effectively connected U.S. source interest payments will be exempt from U.S. tax when paid to another treaty party resident.

Thus, in the normal case, although a treaty party may be exempt from U.S. tax on U.S. source income, its overall tax status is very different from that of a U.S. stockholder that is also exempt. The U.S. stockholder will pay no tax of any kind on such income, whereas the foreign person usually pays taxes on such income, albeit to a foreign government rather than the United States Government. It is therefore a clear misnomer to refer to the foreign taxpayer as “Exempt”, Although it might be appropriate to apply the interest disallowance rules in the Exceptional case of foreign taxpayers that disallowance rules in the exceptional case of foreign taxpayers that are exempt from tax on such income in both the United States and their countries of residence, such disallowance should not apply to the usual situation of a taxable recipient. Moreover, we believe that (C) 1984, Tax Analysts, Tax Notes, July 8, 1986 the appropriate method of addressing the problem posed by such exempt foreign taxpayers is by treaty amendment rather than by an amendment to the Internal revenue Code Which, for the reasons discussed below, would be inconsistent with many tax treaty anti-discrimination provisions.

The Finance Committee’s concern that the uncertainties of present law may allow taxpayers to take aggressive positions in the debt-equity area is probably well Founded, but it applies equally to U.S. corporations that are closely held by taxable U.S. persons. Apart from the nominal dividends received Exclusion (which both H.R. 3838 and the Senate Bill would repeal), individual stockholders of closely held U.S. corporations are taxable at the same rate on dividends and interest that such corporations pay to them, Such corporations thus have the same ability and incentive to “strip earnings” through interest payments in lieu of dividend distributions so as to reduce their U.S. tax liability as do U.S. corporations owned by foreign shareholders. Indeed, the fact that most U.S. corporations are owned by U.S. persons rather than foreign corporations causes the revenue loss in the case of U.S.-owned domestic corporations to be much greater than the revenue loss in the case of Foreign-owned domestic corporations. Hence, there is no policy reason to adopt a rule that discriminates against Foreign-owned U.S. corporations. Particularly if the disallowance is to be determined on the basis of taxable income, it should be applied, if at all, to both taxable and tax-exempt related persons.

The double taxation concerns that have invariably led to treaty reductions of or exemptions from the statutory U.S. 30% tax on interest should not be circumvented in such a heavy-handed manner merely because interest is paid to a related person. The treaties themselves provide exceptions for excessive payments base on transactions that are not at arm’s length. By penalizing all U.S. corporations owned by treaty residents, the proposed interest disallowance would vitiate well-established tax treaty policies of the United States and for that reason alone should be rejected by the conference committees.

The Senate Bill would also discriminats against U.S. Corporations owned by treaty residents when compared to U.S. corporations owned by other foreign persons. Interest paid to a related person that is a treaty country resident on whom there is no 30% U.S. withholding tax would be nondeductible by the payor and hence indirectly taxable to it under the senate Bill at a 33% rate. This rate would be 3% greater than the 30% rate at which deductible interest paid to a non-treaty resident related party is taxed. This is an unsound result.

Apart from its policy defects, this proposal would violate two non-discrimination clauses that appear in the 1981 U.S. Model

Income Tax Treaty, the 1977 OECD Model Income Tax Treaty and Several tax treaties that the United States has entered into with foreign governments. [/4/].

The First of these clauses specifically addresses the effects of Services of Mead Data Central

the finance committee provision:

> Except where (related parties engage in other than arm's-length transactions, resulting in Excessive payments) interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the First-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the First-mentioned Stats.

1981 U.S. Model, Art, 24(4); OECD Model, Art, 24(5). There can be no doubt that the Senate proposal would conflict with this provision in those treaties containing it, especially considering the OECD comment that the provision "is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest ... allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident." Perhaps more noteworthy is that not all treaties negotiated subsequent to 1981 contain this provision. The OECD comment states that "Contracting states (may) modify this provision in bilateral conventions to avoid its use for tax avoidance purposes." With regard to just such a concern, the United States-Canada Income Tax Treaty, Art. XXV (8) allows for the continued operation of the Canadian "thin capitalization" withholding provisions and any subsequent provisions intended to ensure that nonresidents do not enjoy more favorable tax treatment than residents, See U.S. Treasury Dept., Technical Explanation of the U.S. – Canada Income Tax Treaty, Art. XXV, reprinted in 1 Tax Treaties paragraph 13170 (CCH) (1981).

Predating the interest deductibility clause, and therefore present in many more treaties, is a non-discrimination clause that pertains to resident Entities related to non-residents. This clause provides:

> Enterprises of a contracting State, the capital of which is wholly or partly or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxations OR ANY REQUIREMENT CONNECTED THEREWITH which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or say be subjected. (emphasis added).

1981 U.S. Model, Art. 24(5); OECD Model, Art.24(6). The Finance Committee apparently believes that the interest disallowance proposal would not violate this type of non-discrimination provision because U.S. corporations controlled by foreign entities are "similar enterprises" to U.S corporations controlled by tax-Exempt U.S. enterprises. We disagree, The Committee's reasoning is circular in justifying the proposed discriminatory treatment by defining the similarity in this way, The purpose of this non-discrimination provision "is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the Service of Mead Data Central

Partners or shareholders, to identical treatment to that applied to domestic capital." OECD Model Treaty Commentary, Art. 24, para, 8.

Furthermore, defining similarity by reference to whether a related party must pay U.S. Taxes contravenes treasury Department Policy. For Example, the Technical Explanation For this provision in the U.S-U.K. Income Tax treaty compares enterprises “carrying on the same activities.” U.S. Treasury Dept., Technical Explanation of the J.S.-U.K. Income Tax Treaty, reprinted in 3 Tax Treaties paragraph 8103DD (CCH) (1977). The U.S. tax status of interest paid to related persons is obviously irrelevant in comparing the activities of such corporations.

Therefore, the proposed disallowance is inconsistent with and vitiates an important part of the tax treaty negotiating policy of the United States and also violates non-discrimination clauses of the type contained in the 1981 Model Treaty. /5/

The Treasury Department has previously stated, in response to H.R. 3838, that it opposes amendments to the Internal Revenue Code that override U.S. income tax treaty provisions. This is because such amendments could diminish the value of Future treaty commitments from the United States and offer foreign treaty partners an Excuse to unilaterally abrogate the provisions of non-tax treaties. /6/ The Tax Section supports the general tax treaty policy of limiting double taxation through reciprocal withholding tax reductions and exemptions for interest in cases where the other treaty party is taxable on such income in its country of residence.

For the foregoing reasons, the Tax Section strongly opposes this provision insofar as it relates to interest payments to foreign corporations that are exempt or subject to reduced tax only by reason of treaty provisions. /7/

SPECIFIC COMMENTS

1. Disallowing interest deductions in relation to a corporation’s taxable income often will bear little relationship to the perceived abuse. The disallowance will often be the same whether the taxpayer pays interest only to related parties or pays substantial amounts of interest (but not in excess of its recomputed taxable income) to taxable

persons such as banks. Thus, assure that a foreign controlled U.S. corporation has recomputed taxable income of $20 million, that it pays $10 million of interest to unrelated banks and $1 million of interest to its foreign stockholder. The $1 million would be non-deductible. However, the same result would apply if all the interest were paid to its foreign stockholder. Further, the disallowance would apply whether or not the disallowed deduction related to indebtedness that clearly qualified as debt for tax purposes, e.g., nonsubordinated, not bases on earnings or receipts and a very low debt-equity ratio, or whether it was only barely on the “safe side” of the debt-equity line, e.g., subordinated interest based to some Extent on earnings, and a high debt-equity ratio. We therefore suggest that if interest

Paid to related Foreign stockholders is to be olsallwed to all, the disallowance should relate only to indebtedness that is equity-flavored.

2. Under the Senate Bill, a carryforward for disallowed interest would be provided but a carryback would not, The Committee Report States (p. 425) that the carryforward is intended to prevent inequitable results where interest is disallowed because of “a bad year in a business cycle” which “might reduce pre-interest deduction taxable income to the point where the limitation takes effect.” In that event, we believe that a taxpayer that would not have been subject to the limitation in prior years had the interest been paid at that time should be allowed a limited carryback deduction under rules similar to those provided for net operating loss deduction.

3. The Finance Committee Report (p. 427) states that whether a foreign entity is tax-exempt for purposes of this provision should be determined on an item of interest by item of interest basis. The Senate Bill itself is ambiguous on this point. We suggest that the point is sufficiently important that it should be

resoled by the statutory language, rather than in the legislative history of the provision.

4. Under the Senate Bill, if interest 15 subject to a reduced tax treaty withholding rate, it will be treated as partially exempt and partially taxable. The entire amount of the portion that is treated as exempt would be non-deductible to the extent that total interest payments Exceed 30% of the taxpayer’s recomputed taxable income. It therefore appears that the example on page 427 of the Finance Committee Report is incorrect in applying this Exempt characterization rule only to the interest in Excess of 50% of the taxpayer’s recomputed taxable income[8] on the other hand, if the Example represents the drafters actual interpretation of this provision, the proposed statutory language should be modified to reflect that position.

5. The Bill requires the adoption of regulations that would treat back-to-back loans through unrelated parties like direct loans to related parties. The only Example of such a transaction that appears in the Finance Committee Report involves a U.S. corporation that borrows money from a Dutch bank that has borrowed money from a U.S. corporation’s foreign parent. We suggest that, if the interest disallowance provision is included in the bill that is agreed upon by the Conference Committee, the conference Committee Report should include additional examples of what are and what are not back-to-back loans to which this provision applies, Thus, a back-to-back situation might also include a loan to a U.S. subsidiary by a U.S. bank that was made on the basis of deposit with the bank by a related offshore party. On the other hand, interest should not be disallowed in a case where the U.S. branch of a foreign bank lends to a U.S. corporation and the foreign parent puts money on deposit with the foreign branch of the foreign

bank where there is no transfer of funds from the foreign branch of

the bank to its U.S. branch and where the U.S. branch does not deduct for U.S. income tax purposes the deposit interest paid by the foreign branch.

6. If no effort, is to isolate the extent, if any, that interest paid to a "related tax-exempt entity" is included in a net operating loss, it may be possible for at least some taxpayers to achieve the result that the Senate Finance Committee believes is inappropriate by careful timing or interest expense. Thus, a U.S. corporation might incur a substantial net operating loss in year I which result to a large extent from interest paid to related foreign parties, Under the crryforward rules, the loss will by fully available against taxable income in year 2 to the same extent as if the loss had resulted from other deductions. We believe that the generally applicable Limitations on a corporation's ability to accrue interest deduction on a non-economic basis are sufficiently restrictive that such a situation is not likely to occur except on an infrequent basis. Therefore, we believe that curbing this potential abuse would not justify the complex drafting and resulting interpretive problems that probably would be involved in doing so.

FOOTNOTES

/1/ This report was prepared by, John A. Corry, Helpful comments were received from Renato Beghe, William L. Burke, Herbert L. Camp and Richard G. Cohen.

/2/ The Senate Finance Committee Report (p. 426) states that because interest received by a Netherlands Antilles finance subsidiary of a U.S. person will normally be paid by it as interest to unrelated persons except for the “spread” retained by it, which will be currently subject to U.S. tax under the Subpart F rules of the Code, such payments would not be disallowed under this provision, If the Netherlands Antilles finance subsidiary is owned by a foreign corporation, the Senate Bill presumably would apply, although it is possible that the recently agreed upon but yet to be released revision of the United States income tax treaty with the Netherlands Antilles may renove the withholding tax exemption (at least in the case of newly issued obligations) so that the question in that context would at least Eventually become academic.

/3/ Thus, the preamble to the June 16, 1981 U.S. Model Income Tax Convention states that the convention is “for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital.”

/4/ It is also probable that the Senate proposal would violate several treaties of friendship, commerce and navigation (“F CN”), Some F CN non tax treaty, perhaps giving the foreign entity the choice of the more favorable provision. See O’Brien, “The Non-Discrimination Article in Tax lreaties,” 10 Law & Policy in ine Bus, 545, 586-591 (1978).
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/5/ Although the Senate Finance Committee Report (p. 429) merely states that if the tax violates any U.S. treaty obligations, the committee “does not intend that any contrary provision defeat its purpose in enacting this limitation”, we assume that this means that the Finance Committee intends that the deduction disallowance rule should override these treaty provisions, If, contrary to the recommendation contained in this report, the conference committee decides to retain this provision in the Senate Bill, we suggest that the Conference Committee report specifically state that such an override is intended.

/6/ See letter dated April 7, 1986 from treasury Secretary Baker to Senate Finance Committee Chairman Packwood.

/7/ we assume that enactment of such a provision could lead foreign treaty partners to enact similar provisions relating to foreign subsidiaries of U.S. corporations on the basis that the United States stockholders in such companies are also “tax-Exempt entities”.

/8/ In the Example, a U.S. corporation has recomputed taxable income of $100 and pays sac of interest to its Swiss parent, which is subject to a 5% withholding tax. We believe that the proper result under the Senate Bill is that 5/6 of the sac payment, or $64, is treated as Exempt and that therefore the entire $30 by which the total $80 of interest exceeds 50$ of recomputed taxable income would be disallowed as a deduction.
The Committee Report therefore is incorrect in treating as Exempt only 5/6 of the $30 Excess, and thus disallowing only $25 of the taxpayer’s interest deduction.