REPORT #850

TAX SECTION

New York State Bar Association

Taxation of Certain Extraordinary Dividends —-
Proposed Amendment to Code Section 1059

October 05, 1995

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The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20515-6348

Re: Taxation of Certain Extraordinary Dividends —- Proposed Amendment to Code Section 1059

Dear Mr. Chairman:

I am writing on behalf of the Tax Section ofthe New York State Bar Association to express our support for the proposed changes to the tax treatment of certain extraordinary dividends, as set forth in Section 13601 of the Budget Reconciliation Recommendations reported by the Committee on Ways and Means on September 19, 1995 (the "Proposal").

The Proposal would amend Section 1059 of the Internal Revenue Code of 1986, as amended (the "Code").In its current form, Code Section 1059 cuts back on the benefits of the dividends received deduction by requiring a corporation that receives an "extraordinary dividend" with respect to a share of stock held for two years or less to reduce basis (but not below zero) in such share by the nontaxed portion of such dividend, and to include in income as gain upon any sale or Benefits disposition of such share an amount equal to any nontaxed portion of the dividend that did not reduce stock basis by reason of the limitation on reducing

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* This letter was prepared with substantialassistance from Deborah L. Paul, Co-Chair of ourCommittee on Corporations.

basis below zero. Under Code Section 1059(e)(1), an “extraordinary dividend" includes, and the basis reduction and gain inclusion rule applies to, a dividend that arises in connection with a redemption of stock that is part of a partial liquidation or is not pro rata as to all shareholders, in each case, without regard to the holding period of the recipient corporation. An extraordinary dividend that arises in a redemption is considered as paid with respect to the shares retained by the recipient corporation. H.R. Conf. Rep. No. 861, 98th Cong., 2nd Sess. 817 (1984).

The Proposal would provide that the nontaxed portion of an extraordinary dividend in excess of basis is treated as gain in the year that the extraordinary dividend is received ("New Section 1059(a)(2)").Further, under the Proposal, a redemption that would not have been treated as a dividend under Section 302 but for the option attribution rules of Section 318 (a)(4) would constitute an extraordinary dividend(again without regard to the holding period of the recipient corporation) ("New Section 1059(e)(1)(A)(iii)"). In the case of a redemption described in New Section 1059(e)(1)(A)(iii), only the basis in the redeemed shares would be taken into account for purposes of the basis reduction and gain recognition rule of Section 1059(a)("New Section 1059(e)(1)(A) Flush Language"). Finally, if boot in a reorganization exchange described in Section 356(a)(1) is treated as a dividend under Section 356(a)(2), then such exchange shall be treated as a redemption for purposes of the extraordinary dividend rules ("New Section 1059(e)(1)(B)").

The Proposal aims to counter the ability of corporate taxpayers to structure as dividends stock redemptions that are in substance sales or exchanges, and thereby receive the benefit of the dividends received deduction of Sections 243, 244 and 245. Given the structure of existing law, we generally support that aim. We also believe that the Proposal implements an effective and practical solution to this problem. The Proposal is a significant improvement over its predecessor, H.R. 1551, which would have treated all non pro rata redemptions of shares held by corporations as sales or exchanges.

Because the Proposal retains the current lawcharacterization rules of Section 302, however, and thus will continue to result in the treatment of certain redemptions that economically resemble sales as dividends, the Section 1059 approach reflected in the

Proposal is not as satisfying theoretically, and may not represent as complete a response, as alternative approaches. For example, if the option attribution rules of Section 318(a)(4) were not applied automatically in determining whether a redemption is a sale or a dividend, but instead reflected a qualitativeanalysis of the resemblance of the option to ownership,the type of transaction that has prompted the currentconcerns would be addressed in a manner that not onlyforeclosed the dividends received deduction, but alsodealt with ancillary consequences of such a distribution in a consistent and comprehensive manner.

The theoretical shortcomings of the Proposalperpetuate technical problems that could be addressedunder alternative approaches. For example, in the caseof a redemption that is characterized as a dividend buteconomically resembles a sale, earnings and profits("e&p") of the distributor and distributee, and the deemed paid credit under Section 902, will continue tobe calculated under the rules applicable to dividends, not the rules applicable to redemptions characterizedas sales. While many members of the Executive Committee favor, over the purely mechanical approach ofthe Proposal, an approach that would address the underlying issue of whether a redemption properly should be characterized as a dividend or as a sale orexchange, we nevertheless recognize the difficulty ofdevising a satisfactory means for qualitatively evaluating such things as option attribution. We therefore support the Section 1059 alternative reflected in the Proposal.

Our specific comments on the Proposal are as follows:

1. Scope of New Section 1059(e)(1)(A)(iii).Section 1059(e)(1)(A)(ii), as amended by the Proposal, would treat (and Section 1059(e)(1)(B) in its current form treats) non pro rata redemptions as extraordinary dividends without regard to the shareholder's holding period. New Section 1059(e)(1)(A)(iii) purports to identify an additional category of redemptions that give rise to extraordinary dividends without regard to holding period. It is not clear, however, that there are any redemptions to which New Section 1059(e)(1)(A)(iii) would apply that would not also be covered by Section 1059(e)(1)(A)(ii), as amended by the Proposal. A pro rata redemption would generally be a dividend without regard to option attribution. The articulation of the type of redemption described in New Section 1059(e)(1)(A)(iii) clearly is necessary to the

basis recovery rule set forth in New Section 1059(e)(1)(A) Flush Language (and elimination of New Section 1059(e)(1)(A)(iii) would therefore require an amendment to New Section 1059(e)(1)(A) Flush Language), but we did not understand why that category of redemptions would not otherwise be an extraordinary dividend without regard to holding period under Section 1059(e)(1)(A)(ii), as amended by the Proposal.

2. Scope of New Section 1059(e)(1)(A) FlushLanguage. The basis recovery rule in New Section 1059(e)(1)(A) Flush Language would apply to certain redemptions involving options, but would not apply to other non pro rata redemptions. For example, the rule would not apply in the case of a redemption of shares that reduced a shareholder's interest in a subsidiary from 90% to 85%, or to a non pro rata redemption that is treated as a dividend because of the related party attribution rules of Section 318(a)(2) or (3). We assume that the difference in treatment reflects a judgment that option attribution cases are more likely economically to resemble sales than non pro rata redemptions involving other attribution rules, a general conclusion with respect to which we express no view. We do not, however, see any other rationale for treating option transactions differently from other non pro rata redemptions, and note that that is the effect of the proposal.

3. Reorganizations--New Section lQ59(e)(1)(B). As a practical matter, and because ofthe already existing limitations under Section 356 onthe amount of dividend income that can arise in areorganization, it seems unlikely that reorganizationscould be widely used to circumvent new section 1059. Under Section 356(a), dividend income is limited to the lesser of the amount of gain realized and boot received, and the e&p available to support dividendtreatment is limited to the distributee shareholder's "ratable share" of the distributing corporation's e&p;the latter limitation, in particular, may provide effective protection against abuse of the DRD through a withdrawal of e&p by one corporate shareholder in areorganization.

Nonetheless, we do recognize that in some cases reorganizations (in particular recapitalizations) may be used to achieve results similar to redemptions, and we do not disagree with including in the scope of Section 1059 recapitalizations and other reorganizations that resemble non pro rata redemption and result in dividend treatment under Section

356(a)(2), because that would eliminate any remainingpotential for abuse. As with redemptions, new Section 1059(e)(1)(B) would be overbroad to the extent that it applied to a reorganization that did not effect, in substance, a sale or exchange, but eliminating that over breadth would require the difficult exercise of distinguishing between reorganizations that do and reorganizations that do not economically resemble sales.

4. Earnings and Profits of Distributee. Asa technical matter, the Proposal, and Section 1059 in general, appear to result in a doubling up of e&p to the distributee corporation (although that does not seem to be the intended result). Suppose that a corporation owns shares with a basis of $20 and receives a $100 extraordinary dividend with respect to which the corporation is entitled to a 70% dividends received deduction. Under Section 312, it appears that for purposes of calculating the e&p of such corporation, the entire $100 is included and, for purposes of that calculation, there is no dividends received deduction. Treas. Reg. Sec. 1.56(g)-l(d)(3)(iii). See also Section 56(g)(4)(C); H. Rep.No99-841, 99th Cong., 2d Sess. 11-275 (1986). Under Section 1059(b), the nontaxed portion of the dividendis $70. The corporation therefore reduces basis by $20 to zero under Section 1059(a)(1), and, under New Section 1059(a)(2), the corporation would realize $50 of capital gain. (Under existing Section 1059, that gain would be realized on a later disposition of the shares.) That $50 of capital gain apparently would also be included in e&p of the corporation. Thus, the $100 dividend would result in a total $150 e&pinclusion to the distributee. Furthermore, the application of Section 1059 has eliminated $20 of basis, which would result in more gain (or less loss) on a later sale of the stock. If the stock were later sold for $20, for example, that would result in $20 of capital gain, causing a further e&p inclusion of $20, and bringing the total e&p inclusions to $170.

The 1986 legislative history states thatSection 1059 gain was not intended to result in double inclusion in the e&p of the distributee. See. Jt. Comm.on Taxation, General Explanation of the Tax Reform Actof 1986 (JCS-10-87), May 4, 1987, at 286. The bill should clarify that the basis reductions and incomeinclusions required under Section 1059 will not resultin a double inclusion of the nontaxed portion of a dividend in the distributee's e&p. Thus, at the end ofthe day, the amount of the distributee's e&p inclusion

should equal the excess of (i) amounts received as distributions and sales proceeds over (ii) the distributee's investment in the stock.

Furthermore, where Section 1059 applies, the timing of the e&p inclusion(s) should be clarified. We believe there are two possible approaches. First, following the treatment of dividends to which Section 1059 does not apply, the full amount of the dividend could be included in e&p in the year the dividend is received ($100 in the above example). In later yearse&p would be computed without regard to the Section 1059 basis reductions (so that the sale of shares for $20 in the above example produces no e&p). Alternatively, e&p for the year of the dividend could be increased only by the sum of the taxed portion of the dividend and any gain recognized under Section 1059, with further inclusions in e&p occurring upon a subsequent disposition of the shares with respect to which basis was reduced. (In the case of a redemption any unrecovered basis in the redeemed shares should be transferred over to the remaining shares (see Treas. Reg. §1.302-2(c)), and it is the sale of those remaining shares that would trigger the later e&pinclusion.) This latter approach would conform the e&pinclusions to the computations of taxable income, effectively reducing the e&p inclusion for the dividend year by the basis in the shares; in the above example, this approach would produce e&p inclusions of $80 in the year of the dividend plus $20 in the year of sale. We generally believe that the first alternative is more appropriate, although the special basis rule applied to transactions described in New Section 1059(e)(1)(A)(iii) suggests that, in cases subject to that rule, the e&p inclusion in the year of the redemption could equal the excess of the dividend over the basis of the redeemed shares.

In conclusion, although we identify certaintechnical and theoretical shortcomings of the proposal, we support its practical and relatively narrow approach to a meaningful policy problem. Please do not hesitate to call me if I can be of any further assistance.

Very truly yours,

cc: The Honorable Sam M. Gibbons
House of Representatives
Committee on Ways & Means
2204 Rayburn House Office Building
Washington, D.C. 20515

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Daniel P. Moynihan
United States Senate
Committee on Finance
464 Russell Senate Office Building
Washington, D.C. 20510

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Mr. Kenneth J. Kies

Chief of staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20220