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June 2, 1999

Re: Year 2000 Budget, Tracking Stock Proposal

The Honorable Bill Archer  
Chair  
House Ways & Means Committee  
1236 Longworth House Office Building  
Washington, D.C. 20515

Dear Chairman Archer:

This letter comments on one of the proposals in the Fiscal Year 2000 Budget submitted on February 1, 1999. This proposal would require gain recognition upon the issuance of tracking stock in an amount equal to the excess of the fair market value of the assets tracked by the stock over the adjusted basis of the tracked assets (the "Proposal"). The Proposal would tax issuances of, or recapitalizations into, tracking stock, and would provide the Secretary with authority to treat tracking stock as nonstock or stock of a different entity, as well as authority to provide for a step-up in the basis for the tracked assets as a result of corporate gain recognition. For these purposes, the Proposal defines tracking stock as stock that tracks the performance of less than all the assets of the

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corporation that issues it and possesses either dividend or liquidation rights that are directly or indirectly determined by reference to the tracked assets.

As we explain below, we believe a coherent tax policy with respect to tracking stock is a matter of some complexity and the tax law would be ill served by legislation creating a host of problems and which deals, we believe inappropriately, with only one aspect of this issue. Moreover, we are generally of the view that this financial strategy is not presently being utilized in public situations primarily for tax avoidance purposes. As a consequence, we do not support the adoption of this Proposal. However, we believe a comprehensive review of issues raised by tracking stock would be appropriate and we would support an undertaking to rationalize and develop a coherent response to the issues raised by this sophisticated corporate financial instrument.

In 1987, the Corporations Committee and the Reorganizations Committee of New York State Bar Association Tax Section prepared a report in response to a request from the Internal Revenue Service and the Treasury Department for views regarding the proper Federal income tax treatment of tracking stock (hereinafter referred to as the "Prior NYSBA Report").<sup>1</sup> This Prior NYSBA Report concluded that "where a sufficient high degree of correlation in performance exists between the tracking stock and the tracked property, a tax policy concern is present." NYSBA Report, 43 Tax Law Review 70. We reaffirm this

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<sup>1</sup> New York State Bar Association Tax Section Corporations Committee and Reorganizations Committee Report Regarding "Tracking Stock" Arrangements, 43 Tax L. Rev. 51 (1987).

position today. However, in the twelve years since the issuance of our Prior Report, a considerable amount of tracking stock has been issued. We generally are satisfied that publicly issued tracking stock without a "high degree of correlation in performance" does not raise significant tax policy concerns and appear to serve legitimate non-tax business objectives, including maintenance of consolidated management, credit and methods of financing the company's business units, motivating employee performance, preservation of synergies and economies of scale, allowing for improved research analyst coverage of distinct lines of business, enhancing capital formation through the offering of focused investment vehicles, providing accounting benefits and increasing the financial viability of start-up companies.

Nevertheless, there remain questions in identifying the appropriate degree of correlation that would give rise to a tax policy concern requiring either a legislative or regulatory response. For one thing, a careful analysis of tracking stocks that have already been issued would help identify the relevant factors. Among the factors that should be considered are

- (i) corporate liabilities and the degree to which the interests of the tracking stock shareholders are subordinated to creditors of the entire company as opposed to being protected, for example, by a corporate holding company structure;
- (ii) the rights of the tracking stockholder with respect to annual or special distributions, as well as distributions in liquidation or in bankruptcy;
- (iii) the rights of tracked Shareholders if the issuer disposes of the tracked assets;
- (iv) the terms on which the issuer can redeem the tracking stock or force a conversion of the tracking stock into regular common stock of the issuer;

- (v) the protection of the tracked shareholders' interests, either through contractual requirements, or punitive "default" mechanisms upon failure to satisfy required or assumed levels of earnings distributions;
- (vi) issues relating to control, either with respect to the issuer's management prerogative with respect to the tracked assets, or conversely with respect to the rights of tracked shareholders relating to these tracked assets;
- (vii) the use of proceeds from the issuance of tracked stock, and the question of whether those funds are committed to servicing the tracked assets or the general needs of the entire business;
- (viii) whether there are differing considerations involving public, as opposed to private companies; and
- (ix) the ability of corporate management with respect to allocations and other financial decisions that might affect the financial results of the tracked assets, as well as the residual stock interests in the issuing company.

At least three discrete tax policy concerns must be considered in any review of the issues raised by tracking stock:

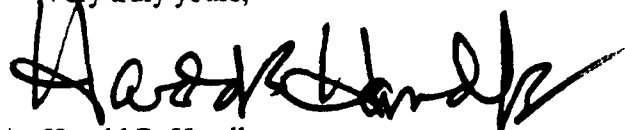
- (i) Section 311/Section 1032: The Proposal appears to address the question of whether issuance of tracking stock facilitates the avoidance of gain recognition that was intended by the repeal of the so-called General Utilities doctrine in 1986 (removal of corporate assets without corporate-level gain recognition, coupled with a stepped-up basis to distributees, as was possible pre-1986 under Code Sections 336 and 337). We believe tracking stock does not generally raise this concern since the appreciated assets continue to be owned and controlled by the issuing company. However, we are clearly aware that a high level of "correlation in performance" of economic results, as well as elements of control in the holders of the tracking stock, could raise this General Utilities concern.
- (ii) Consolidation Issues: A different concern is the fact that tracking stock permits corporations to create interests in identified pools of assets allocated to different groups of shareholders while retaining tax ownership and therefore the benefits of consolidation. On the other hand, financial accounting permits a corporation to account separately for each tracked business. Thus, tracking stock allows profitable companies (which are generally valued on an earnings

or EBITDA multiple) that run businesses that are currently generating losses to grow these businesses without suffering earnings dilution. But this very accounting advantage demonstrates the tax advantage as well. Separating the financial accounting results of a loss company from the core business so that from an accounting standpoint the financial results of the loss operation do not diminish the core operating business income highlights the fact that the tax treatment is quite different, and that the issuing corporation retains the tax benefit of offsetting the income of the profitable operations with the losses of the tracked business.

- (iii) Section 305: Still another area for review involves the relationship for tax purposes among groups of shareholders. Clearly, tracking stock separates shareholders interests vertically and divides the interests of groups of shareholders in the overall assets of the issuing company in a manner which may involve concerns similar to those raised by Section 305 (which assumes that shareholders receiving a distribution of parent company stock have not altered their interest in the parent company) or other similar provisions.

Many of these issues, as well as others, were raised in our Prior NYSBA Report. While our members generally believe that the issues of public tracking stock seen to date have not involved a sufficiently high degree of concern to require legislative response at this time, we continue to be of the view that a comprehensive review of the many issues involved could lead to the issuance of regulations that would establish the degree of correlation that would give rise to tax policy concerns. After completing the recommended review, it may be determined that legislation is necessary to authorize certain of these regulations. We would support that review, and are prepared to work with the Government in developing the regulatory, and potentially legislative, approach.

Very truly yours,



Harold R. Handler  
Chair

cc: James D. Clark, Esq.