These comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association.

These comments were prepared by individual members of the Committee on Corporate Taxation of the Section of Taxation. Principal responsibility was exercised by Jasper L. Cummings, Jr. Substantive contributions were made by Jerred G. Blanchard, Jr. and William M. Richardson. The Comments were reviewed by Robert H. Wellen of the Section’s Committee on Government Submissions and by Terrill A. Hyde, Council Director for the Committee on Corporate Taxation.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Executive Summary

The “fast-pay stock regulations” authorize treating corporate stock with respect to which a dividend is paid that effectively returns capital as if the stock were a loan between the holder of that “fast-pay” stock and the other “benefited” shareholders. The impetus for these regulations was fast-pay stock issued by conduit entities (RICS and REITS), which can deduct dividends paid on the fast-pay stock, thus decreasing the taxable income allocable to the other, “benefited” shareholders.

But the regulations extend the possible recharacterization to stock of C corporations, which frequently pay dividends that effectively return capital in the ordinary course of business; such C corporations normally cannot reduce the taxable income of one shareholder by paying another shareholder such a dividend. To address the possibly unintended application of the regulations in such cases, we recommend that the IRS issue guidance on the following points:

1. Guidance should make clearer that the regulations cannot be applied to isolated C corporation redemptions that are treated as distributions by §302, where the C corporation did not issue the redeemed stock for the purpose of serving as a debt-like financing.

2. Application of the regulations should be limited to cases in which the “principal purpose of tax avoidance” relates to the taxation of the issuing corporation or the benefited shareholders rather than the fast-pay stock shareholder. In any event, there should be no such tax avoidance when a C corporation pays a dividend of any size and retains substantial earnings and profits or when the same person holds both the benefited stock and the fast-pay stock (or the two types of stock are held substantially pro rata).

3. The regulations should apply in the case of C corporations to stock the terms of which contain a fast pay feature only if such stock is issued or the terms added after the date of the proposed regulations.
Background

On February 27, 1997 the IRS published Notice 97-21. The Notice was concerned with transactions in which the income of a “conduit [corporate] entity” (principally RICs and REITs) was allocated preferentially to one class of stockholder for a limited period of time. After that period the conduit’s income was allocated preferentially to the other class of stockholder. The Notice asserted that the value of the stock receiving the initial preference allocations fell below par after the preference period and the value of the remaining stock rose in offsetting fashion. The Notice expressed concern that this increase in value would not be taxed as it occurred because it derived not from dividends (that would have had to be reinvested in order to increase the stock value) but rather from the reduction in value of the stock receiving the preference allocation. The Notice did not assert that the preferred stock received more than the total current income of the conduit, but only that it received a disproportionate share of the entity’s current income for a specific period.

The Notice viewed the recipient of the “fast-pay” dividends as the lender of a self-amortizing loan. The Notice emphasized the fact that, during the period the holder of the “fast-pay stock” received distributions in excess of a market return, the excess of those distributions over the income portion constituted a return of, not a return on, the holder’s investment in the “fast-pay stock.” It should be noted that such a holder would not be transferring value it owned to the other shareholders, because the parties were unrelated, dealing at arms length, and were all presumably protecting their own investments in the corporation. However, the fast-pay stock holder would be absorbing corporate earnings disproportionately in the early years, by virtue of the characterization of its payments as dividends, which are deductible by RICs and REITs.

Given the similarity of the preference stock to debt, it is unclear why the common interest should increase in value during the “pay down” of the preferred, except insofar as it enjoys the benefits of leverage when the borrower can earn more money than its cost of borrowing. It might be argued that the fast-pay stock enhanced the common stock value because it permitted the repayment of principal out of the conduit entity’s pre-tax income, as contrasted with payment out of after-tax income. That argument would be valid, if at all, only where the use of the conduit entity permits a deduction for dividends (as for RICs and REITs).

The Notice stated: “These expectations [of economic benefit to the common equity owner, without current tax] result from the parties’ treatment of the full amount of the payments to the exempt participants as dividends.” That statement seems to acknowledge that the characterization of the preferential flow as §316(a) dividends is the mischief maker, not preferential receipt of an entity’s cash flow per se (indeed, it commonly occurs in many partnerships).

In addition, the Notice clearly conveyed the message that the characterization of the preferential cash flow as dividends is problematic only to the extent that cash flow
constitutes a return of, not a return on, the holder’s investment. Then the Notice states that the forthcoming regulations would be limited to a recovery of investment that is treated by the entity as a distribution “of earnings and profits or otherwise as reducing the conduit entity’s or any other taxpayer’s taxable income.” This language forecasts that the regulations would relate to “conduit entities” for which a distribution of earnings and profits to shareholders does reduce the entity’s taxable income. In other words, the concern was not with the tax treatment of the dividend recipient (which was described as generally exempt from U.S. tax), but with the effect on the common shareholder, and to a lesser extent on the entity.

The Notice asserted that §7701(l) could be applied to this transaction. That subsection gives the Secretary power to recharacterize by regulations any multiple party financing transaction into a transaction directly between any two parties.

Subsequently, the IRS issued proposed regulations. REG-104072-97, 64 F.R. 805-813. The Notice implied, and the regulations proposed on January 6, 1999 confirmed, that the “conduit entities” described in the Notice were RICs and REITs, the shareholders of which are taxed on their incomes. However, the proposed regulation was not limited to conduits. It also applied to any “fast-pay arrangement” (as defined) as to which the Commissioner determines that a principal purpose for the structure is the avoidance of any tax imposed by the Code. Thus, the proposed regulation applied to a C corporation, which is not generally viewed as a “conduit entity.”

The final regulations are very similar to the proposed regulations, as to the definition of fast-pay stock and the circumstances under which it can be recharacterized. T.D. 8853 (January 10, 2000). Reg. §1.7701(l)-3(b) defines “fast-pay arrangement” as any arrangement in which a corporation has “fast-pay stock” outstanding, and defines “fast-pay stock” as stock structured so that dividends (as defined in § 316) paid with respect to the stock are economically, in whole or in part, a return of the holder’s investment. The regulations require a recharacterization of the transaction as a loan or equity investment between the fast-pay shareholder (as holder of the note or equity) and the “benefited shareholders” (as the issuer of the note or equity), with multiple radiating tax effects.

In addition, the final regulations apply not only to de jure conduits such as RICs and REITs, but they also can apply to other arrangements, including those involving C corporations, “[i]f the Commissioner determines a principal purpose for the structure of the fast-pay arrangement is the avoidance of any tax imposed by the Internal Revenue Code.” Furthermore, the scope of the definition of a “fast-pay arrangement” is materially broadened by the final regulations, in that (a) they no longer require the “fast-pay stock” to be a separate class of stock from the “benefited stock”; and (b) Reg. §1.7701(l)-3(b)(2)(ii) makes it clear that stock that is redeemed in a transaction treated as a §301(c) distribution pursuant to §302(d) can constitute a “fast-pay arrangement” if the redemption is structured for “a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.”
Areas of Concern

Application to C Corporations: General

This comment does not address the application of the regulations to true conduit entities, RICs and REITs. Furthermore, this comment does not address the methodology of the recharacterization that can be applied to stock found to be fast-pay stock, although we find that recharacterization to be uncertain and unwieldy.

Rather, our primary concern is with the impact of the regulations on C corporations that have not been organized or have not issued stock for the purpose of exploiting fast-pay “stock” as a loan substitute. Such C corporations can very easily issue fast-pay stock as defined under the extremely broad definition in the final regulations, or make payments with respect to stock causing it to be treated as fast pay stock, thus empowering the Commissioner to require a recharacterization on a finding of a “principal” tax avoidance purpose (apparently of any kind, and favoring any shareholder or the corporation itself). The regulations contain little guidance as to how the Commissioner will exercise his discretion. Moreover, the regulations require a corporation issuing fast-pay stock (whether or not there is a bad purpose) to report that fact on its tax return.

These rules can have a tremendously negative commercial impact on C corporations. A publicly held C corporation that issues stock falling into the fast-pay definition (or makes distributions on stock outside the ordinary course) may feel compelled either to attempt to obtain a legal opinion that the Commissioner could not prevail in an attempt to apply the regulation to the stock, or to disclose to the public the possibility that the IRS could recharacterize the transaction and affect the taxation of persons who have no knowledge of or involvement with the fast-pay stock. Moreover, the corporation will be hard pressed to explain exactly how any such recharacterization might affect the shareholder. Likewise, privately held C corporations may be inhibited from carrying out normal stock issuances or redemptions, or alternately will be ignorant of their failure to give notice to the IRS of issuance of fast-pay stock.

Application to C Corporations: Fast-Pay Stock with No Tax Abuse Favoring the Corporation or the Benefited Shareholders.

In the C corporation area there is no reason for the IRS to be concerned that the “benefited” interests “increase” in value without tax. If this happens, it happens only because the “borrowed” capital produces more income than the payments needed to amortize it, not because the repayment of principal creates a deduction against the entity’s taxable income. The owners of leveraged C corporations are not taxed as their stock values increase due to such effective borrowing, or due to the use of preferred equity. If the IRS views the fast-pay stock as truly debt, then it should attack it on that basis and not in this new convoluted fashion. (Alternately, consideration might have been given to the application of §305(b) and (c)).
Furthermore, any “tax avoidance” enjoyed by the holders of the “fast-pay stock” should not be taken into account in determining whether the recast rule applies, in cases in which those tax benefits would have been available regardless of whether stock in the issuer is held by other persons. After all, §7701(l) empowers the government to issue regulations recharacterizing any “multiple party financing transaction as a transaction directly among any 2 or more of such parties”; it does not authorize the government to issue regulations reversing intended federal income tax deductions (such as the dividends received deduction) or other allowances that are available with respect to dividends or other distributions made with respect to, or in exchange for, stock.

The only “fast-pay” concern that Treasury and the IRS could have in the C corporation area might be the bleeding of earnings and profits out of a C corporation to the preferred stockholders in the form of dividends in a manner that provides a tax benefit to the “benefited” shareholders or the corporation issuing the “fast-pay” and the “benefited” stock. In other words, a benefit that properly is a concern of the fast-pay regulations does not occur simply because fast-pay stock increases the value of the “benefited” stock, as the same benefit results from a self-amortizing loan to the corporation (which is not the characterization chosen by the regulation). In the context of a domestic C corporation or foreign subsidiary located in a high-tax jurisdiction, because dividends on the preferred stock do not reduce the taxable income of either the issuing corporation (in contrast with the case of the true conduits) or the holders of the benefited stock, there is absolutely no basis for applying a recast rule authorized by §7701(l), except possibly where the C corporation is “engineered” to have minimal E&P that is bled into the preferred stock, thus permitting tax free returns of capital to the benefited shareholders. Such engineering requires that the fast-pay stock be issued at the outset (and probably that the C corporation be organized) with the aim to minimize or eliminate the earnings and profits of the C corporation, to the tax benefit of the remaining shareholders. Concern may be warranted, however, in the context of a controlled foreign corporation organized in a “no-tax” or “low-tax” jurisdiction.

The following example illustrates stock that will be defined as fast-pay, but that does not involve any tax benefit to the “benefited shareholder.”

Example 1: Each of two corporate shareholders, Y and Z, owns (and has owned during the entire existence of X) 50% of the common stock of X, a C corporation, which also has outstanding a class of preference stock that is held by other persons. Each has a basis in its X common stock of $5 million, and the fair market value of the X common stock held by each of Y and Z is $25 million. X borrows $20 million (which it can and expects to repay from future earnings) and distributes the cash pro rata as a distribution that is a tax dividend to Y and Z. Because Y and Z have owned their X stock for over 2 years and during the entire existence of X (and no other exception applies), the 80% dividend received deduction allowed to each distributee with respect to its $10 million dividend does not cause a reduction in its basis in its X common stock under §1059(a). This puts each of Y and Z in a position to sell its X common stock to a
third party purchaser for $15 million, recognizing $10 million gain on the sale. A principal purpose for the payment of the $10 million dividend by X to each of Y and Z is to reduce the federal income tax burden on each shareholder produced by a sale of the X common stock from $7 million (35% times the excess of the $25 million amount realized over $5 million basis) to $4.2 million (35% times 20% times the $10 dividend plus 35% times the $10 million stock sale gain). Under the regulations it is possible that the X preference stockholders and X common stockholders must be concerned that the final fast-pay regulations will be applied by the IRS to recast the dividend paid on the X common stock as a distribution paid to the X preference stockholders followed by a payment by the X preference stockholders to the X common stockholders.

From a policy perspective, the transaction described in Example 1 should not invoke the fast-pay recast. First, unlike the case outlined in the Notice, treatment of the distributions to Y and Z with respect to their X common stock as dividends within the meaning of § 316 provides no federal income tax or economic benefit to X or the X preference stockholders (who presumably would be the holders of the “benefited stock”); rather, the only persons to benefit from dividend treatment with respect to those distributions are the holders of the “fast-pay stock.” (Note that the common stock could be fast-pay stock, even if all the stock of Y were owned by a single shareholder. IRS should at least make clear that there can be no fast-pay stock in this situation.) Second, the IRS should have no issue with taxpayers that take advantage of the dividend received deduction allowed by §243 in a manner that complies in full with the basis reduction policy of §1059. Unfortunately, the immense scope of the final fast-pay regulations creates significant ambiguity in this case.

Application to C Corporations: Treating Stock as Fast-Pay On the Basis of Post-Issuance Events

Reg. §1.7701(l)-3(b) defines stock as fast-pay only if it is “structured” so that dividends are a return of investment, clearly implying that the stock must be issued with that plan. However, subdivision (2)(ii) states that a determination can be made at the time of a change of circumstances, including a redemption treated as a distribution; it then somewhat carves back on that by stating:

Stock is not fast-pay stock solely because a redemption is treated as a dividend as a result of §302(d) unless there is a principal purpose of achieving the same economic and tax effect as a fast-pay arrangement.

The problem with this “saving” clause is that the regulation does not satisfactorily explain what is the tainting bad “tax effect.” Reg. §1.7701(l)-3(c)(1)(ii) identifies such purpose as the avoidance of any tax imposed by the Code, apparently by any taxpayer. Reg. §1.7701(l)-3(e) Example (3) identifies a §302 redemption treated as a distribution that may lead to a recharacterization by the Commissioner where the issuing corporation apparently was organized with a plan to redeem the fast-pay stock and provide a tax
benefit (stripped earnings and profits) to the benefited shareholder. Outside of that case, the isolated redemption treated as a distribution should not subject the stock to redetermination as fast-pay stock because the “benefited” shareholders are not tax-benefited.

Example 2: US Parent owns all the stock of CFC1, a foreign corporation that has accumulated earnings and profits totaling $6.5 million and is subject to taxation in its foreign domicile at a 35% rate. The CFC1 stock is worth $10 million and has a basis of $1 million in the hands of US Parent. Normally, US Parent would repatriate CFC1’s earnings and profits via a dividend of $6.5 million, which would produce a grossed-up dividend of $10 million under § 78, a deemed paid foreign tax credit of $3.5 million under § 902, and no residual federal income tax. However, under the laws of CFC1’s domicile, CFC1 is prohibited from making such a distribution to US Parent as a dividend, but would be allowed to make a distribution to US Parent in redemption of CFC1 shares, provided another corporation continues to own CFC1 stock that is not redeemed. Thus, to facilitate the repatriation of CFC1’s earnings and profits, US Parent plans to transfer 35% of its CFC1 stock to CFC2, a newly created foreign corporation organized in the same jurisdiction, in exchange for all the common stock of CFC2, worth $3.5 million, shortly after which CFC1 will distribute $6.5 million in cash to US Parent in redemption of 65% of the CFC1 stock. This redemption will be taxed to US Parent as a dividend under §302(d) to the extent of CFC1’s earnings and profits. As such, the federal income tax consequences of this transaction normally would be the same as a $6.5 million dividend paid by CFC1 to US Parent. This result is clearly contemplated by the Code and does not involve tax avoidance by the issuing corporation or its other shareholder. Again, note that the holder of the benefited stock and the fast-pay stock are the same person.

Effective Date

The regulations apply to amounts accrued or paid during taxable years ending after February 26, 1997. Presumably this means that stock issued many years before 1997 that fits the definition of fast-pay stock can result in the receipt of a payment that is recharacterized under the regulations. See Reg. §1.7701(l)-3(e) Example (6). Such retroactive effect seems unwarranted as to C corporation stock issued before the expansion of the fast-pay concern to C corporations in the proposed regulations.

Recommendations

To avoid the problems discussed above, we recommend that the IRS issue guidance on the following points:

1. Guidance should make clearer that the regulations cannot be applied to isolated C corporation redemptions that are treated as distributions by §302,
where the C corporation did not issue the redeemed stock for the purpose of serving as a debt-like financing.

2. Application of the regulations should be limited to cases in which the “principal purpose of tax avoidance” relates to the taxation of the issuing corporation or the benefited shareholders rather than the fast-pay stock shareholder. In any event, there should be no such tax avoidance when a C corporation pays a dividend of any size and retains substantial earnings and profits or when the same person holds both the benefited stock and the fast-pay stock (or the two types of stock are held substantially pro rata).

3. The regulations should apply in the case of C corporations to stock the terms of which contain a fast pay feature only if such stock is issued or the terms added after the date of the proposed regulations.

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