American Bar Association  
Section of Taxation  
Comments on Dividend Exclusion Provisions of  
S. 2, Jobs and Growth Tax Act of 2003

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I. Introduction and Summary

The following comments on the proposed dividend exclusion provisions of S.2 (the “Proposal”) were prepared by a working group comprised of members of the Corporate Tax Committee, the Affiliated & Related Corporations Committee, the S Corporations Committee and other committees of the Section of Taxation of the American Bar Association.¹ The views expressed herein represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Enactment of the Proposal would effectuate a type of integration of the corporate and individual income taxes. Many knowledgeable commentators and other observers have long supported the general concept of integration. The Section likewise believes that eliminating or substantially reducing the “double taxation” of corporate earnings is an attractive tax policy goal. However, in addition to the “dividend exclusion” approach reflected by the Proposal, there are various other technical approaches to implementing an integrated system. Each of these approaches is likely to spawn different economic behavior and results that are beyond the expertise of the Section to evaluate.

Accordingly, although we do have general concerns regarding the potential impact of the dividend exclusion approach upon the “debt v. equity” choice of raising corporate capital, the Section does not feel qualified to express a definitive position as to the overall desirability of the Proposal relative to other possible integration models. We therefore have limited our examination of the Proposal, and these comments, to an analysis of its specific provisions from the perspective of technical soundness and administrability.

Despite all best efforts, any Proposal of this type will necessarily entail some degree of complexity. Achieving significant simplification of the Internal Revenue Code is a legislative priority of the ABA and an area of continuing major importance to the Section. If an integration regime is to be enacted, we urge that wherever possible the Congress make choices in favor of simplifying provisions, even if they do not embody the highest theoretical purity. We have attempted to suggest several modifications of the Proposal in that direction, and there are no doubt others that could be identified and considered.

¹ Principal responsibility for drafting the comments was exercised by Jasper L. Cummings, Jr. Other members of the working group include: James L. Dahlberg, Julie A. Divola, Andrew J. Dubroff, C. Wells Hall, III, Robert P. Hanson, James A. Kalashian, Jeffrey L. Kwall, Thomas J. Nichols, Michael L. Schler, Robert H. Wellen, Benjamin G. Wells and Robert G. Woodward.
Our recommendations as to ways in which the Proposal might be modified include, principally, the following:

- Provide mandatory carryover of EDA. This would (1) reduce the need for the complicated CREBAA/REBA in that it would take the "use it or lose it" pressure off of EDA distributions, (2) address the need of some corporations for sufficient EDA to pay level dividends; and (3) tend to increase the limited ability provided by the Proposal for corporations to receive tax refunds currently.

- Eliminate CREBAA and REBA. We anticipate that the use of an annual basis adjustment mechanism would be an unduly complicating feature of dividend exclusion. We believe that CREBAA/REBA is not the only way to address a felt need to equilibrate distributed and retained earnings, and that this approach may largely fail in its intended purpose of assisting the mass of shareholders in avoiding capital gains reflecting taxed corporate income.

- The proposed rule pro-rating EDA to all dividends should be changed to allow dividends to be first "streamed" to preferred stock; the Congress should consider whether excluding dividends that are non pro rata within a class from the EDA system is advisable.

- The proposed basis reduction for all dividends received within the first year of ownership of stock should be limited to "extraordinary dividends" as now defined in §1059.

- With respect to debt-financed stock paying excludable dividends, the intended roles of §§163(d) and 265 should be clarified. We agree with the limitation of the exclusion as to corporations receiving dividends on debt-financed portfolio stock, although we have reservations about the theoretical purity of this rule.

- With respect to consolidated return groups, legislative reports should give as much guidance as possible, subject to Treasury authority, due to the extremely short time that will be available for derivation of rules as to the 2003 year and the many complex issues involved. For simplicity, we recommend that the consolidated level EDA/CREBAA accounts not be allocated to subsidiaries within the group, or be allocated only where necessary to accommodate minority shareholders. If this results in a subsidiary not being able to pay excludable dividends to minority shareholders, we do not consider that to necessarily be a totally unacceptable result; if the Congress agrees, it should give Treasury the specific authority to deny excludable dividends to minority shareholders of consolidated group members in some or all cases. To the extent it becomes necessary to allocate EDA within the group, the principles now used for allocating E&P should be used where possible.

- With respect to S corporations, the Proposal should be clarified to make clear that EDA generated by an S corporation will be first carried out in distributions, and
that those distributions will reduce E&P and will not come from the AAA. The Congress should consider eliminating the §1374 tax on built-in gain and allowing the pass-through income to the shareholders to suffice for the one level of tax. The Congress also should consider eliminating the recapture of the LIFO reserve upon the S election.

- With respect to the foreign provisions, we generally support the Proposal and suggest consideration of extending the exclusion to foreign shareholders by unilaterally eliminating the withholding tax. We also suggest eliminating the branch tax should be considered.

- Consider eliminating the two-year lag between the EDA origination year and EDA payout year as to non-publicly traded C corporations and S corporations.

- Broaden the authority of the Secretary to provide transition and grandfathering rules as to the 2003 year and as to widely held preferred stock.

II. **Background**

On February 27, 2003 Senator Nickles introduced S. 2, Jobs and Growth Tax Act of 2003. Title II of the Bill is entitled Dividend Exclusion to Eliminate Double Taxation of Corporate Earnings. The introduction followed a series of Treasury announcements beginning on January 7, 2003 when a Treasury release forecast a legislative Proposal concerning "excludable dividends" as part of the President's Growth Package. The releases did not refer to, but they appear to have relied heavily on, the Dividend Exclusion Prototype, which was one of three prototypes described by the Treasury in the document *Integration of Individual and Corporate Tax Systems - Taxing Business Income Once* (U.S. Treasury January 1992), supplemented on December 11, 1992 (the "1992 Report").

III. **General Comments and Reasons for Change**

If enacted, the Proposal would effect what is arguably the most fundamental change to the taxation of corporations and their shareholders since 1913 when the Sixteenth Amendment authorized the extension of the income tax to individuals. (Corporations had been subject to an income tax since 1909.) This extension set in place the potential for double taxation of corporate income, once to the corporation and again to the shareholder upon receipt of a dividend or the recognition of gain on sale of appreciated stock. Over the years various Code rules have ameliorated this potential, but none have eliminated it in all cases.

The Tax Reform Act of 1986 exacerbated the double taxation of corporate income by removing a mechanism based on the General Utilities doctrine for avoiding the corporate level taxation of certain gains. This made the corporate tax on such gain very difficult to avoid, thus perhaps contributing to impetus for some of the corporate tax shelters of the last decade and also setting the stage for the Proposal.
Although the Section believes that eliminating or substantially reducing the "double taxation" of corporate earnings is an attractive tax policy goal, we decline to endorse or reject the Proposal because its stated justifications rely largely on views about macroeconomic efficiencies on which we do not profess expertise. We recognize that many observers, in addition to the 1992 Report, have criticized the "classical system" of taxing corporations and also taxing their shareholders on income related to the corporate stock; they have argued that macroeconomic efficiencies can flow from the elimination or diminution of the two tiers of taxation. The differential treatment of debt and equity at the corporate level that necessarily results from the classical system causes many complications. Consequently, we do applaud the Proposal as a serious effort to address fundamental issues in the income tax. We will comment herein on taxpayer conduct and how it has been affected by the classical system and might be affected by the Proposal.

The Proposal embraces one approach to integration of the corporate and shareholder taxes, being perhaps the most easily implemented of the prototype integration systems that the Treasury identified in the 1992 Report. A contemporaneous Reporter's Study by Prof. Alvin Warren, commissioned by (but not necessarily approved by) the American Law Institute also carefully analyzed corporate tax integration. See, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration (ALI, March 31, 1993). We observe that these studies are examples of the value of in-depth studies of fundamental tax reform, even in advance of political interest in their implementation.

If an integration system is to be adopted, we are not confident that the dividend exclusion Proposal is the best choice from the standpoint of achieving the largest portion of the potential goals of integration as generally discussed in the 1992 Report (including elimination of the preference for corporate level debt, elimination of the penalty for incorporated business forms, and the taxation of business income according to the characteristics of the business entity owners rather than the business entity). The Proposal embodies a hybrid position between a simple dividend deduction (which would tend to equalize the treatment of debt and equity at the corporate level) and a complicated pass-through integration system (which would tend to equalize the treatment of corporations and unincorporated business entities). Its main features of limiting pass-through treatment to the amount of deemed taxed corporate income, and of allowing a stock basis increase similarly based on that taxed income, appear designed to treat a selected, albeit primary, symptom (the double taxation of corporate income) rather than more pervasive aspects of the disease of the two tier "classical" system.

The Proposal does leave in place the stark contrast between a corporation's deductible interest payments and its nondeductible dividend payments, which is thought to exacerbate the tendency of U.S. corporations to use debt to the point of over-leverage. See Federal Income Tax Aspects of Corporate Financial Structures (Joint Committee on Taxation Print (January 18, 1989). The Administration has stated a belief that the dividend exclusion Proposal can have an effect similar to that of a dividends paid deduction in equilibrating the use of debt v. equity, but that effect is accomplished by
creating a competing consideration (increasing the potential for excludable dividends) rather than more fully leveling the playing field between debt and equity financing.

The whipsaw potential of the debt v. equity choice being made by taxpayers in favor of the more favorable of the two regimes, will remain in even starker form if the Proposal is enacted. While there are other ways to raise capital (e.g., leasing), as between debt and equity C corporations currently have the option of raising capital either by issuing debt and paying interest that is deductible as accrued, or issuing equity, which may be debt-like, and paying dividends that are not deductible when paid but that may be received substantially by persons who will not pay tax on some or all of the dividends (i.e., tax-exempts, other corporations, foreigners who enjoy treaty benefits). This differential treatment of different types of corporate financing is the source of both substantial complexity and substantial difficulty for the government in enforcing the corporate income tax. This area of electivity may be exacerbated in that the Proposal greatly expands the group of shareholders who can receive non-taxed dividends. That is, the choice will become a purer one between taxation at the corporate level (stock) and at the investor level (debt, assuming the creditors are taxable). A vast new group of taxpayers will be able to elect to receive the favored stock instruments, and all C corporations can elect whether to seek that group of investors. Thus, although corporate elections to pay excludable dividends may in fact lead to a shift toward less leverage in corporations, it may also lead to an even greater detriment to the fisc than that caused by the current elective regime.

A much more direct attack on both the revenue and definitional problems caused by the debt v. equity dichotomy would be to allow a dividends-paid deduction, which would be less likely to cause massive shifting in ownership of corporate equity from tax-exempt persons to taxable persons. A dividends-paid deduction would, however, tend to have the effect of seriously reducing the corporate tax base, because corporate CFOs would gain a much more direct interest in effectuating integration (which would then affect their bottom line, as contrasted with the dividend exclusion regime, which only benefits shareholders). We understand the Proposal's aim to be exactly the reverse, to enhance the corporate tax base and diminish shareholder level tax. That choice has merit in that many shareholders (and debt holders) are non-taxpayers already and the corporation can be an efficient locus of revenue collection. However, we urge consideration of whether the reduction in leverage anticipated from the Proposal is worth the enhanced electivity we fear.

As to the other reasons for adopting the Proposal cited by the Treasury releases, we agree that the current system tends to encourage use of unincorporated business entities that are not publicly traded. We are not aware, however, that such use fosters dysfunctions in the marketplace, particularly given the rise in acceptance of the limited liability company as a business entity. As to whether adoption of the Proposal would encourage distribution of earnings, we first are not confident that there is good data on the benefits to be obtained from more or less distributions, and we second believe that it is extremely difficult to predict the level of additional distributions that might be encouraged by adoption. As to whether adoption of the Proposal would reduce share repurchases, we believe it well
might, but again we find it difficult to quantify how that might or might not provide a general benefit. As to whether adoption will discourage corporations from engaging in tax savings efforts, we are very doubtful.

Again, in making these observations we do not purport to advance a definitive position regarding the relative merits of the Proposal’s dividend exclusion approach and other possible approaches to achieve integration. It goes without saying, however, that the tax policy considerations that underlie that comparative analysis entail delicate subtleties and nuances, not all of which are readily apparent. Accordingly, even if this particular Proposal is adopted, we suggest that Treasury and the Congress continue to study the advisability of more complete integration Proposals, including those described in the 1992 Report.

IV. Specific Design Suggestions

The following suggestions include expressions of concern over complexity and complicated tax planning pitfalls and opportunities. We acknowledge that the current system is also complex, and that some of our comments may reflect shortcomings of the current system more than they reflect problems in the Proposal itself. Nevertheless, many, many parts of the Code and regulations are predicated on the current system. Therefore, the ability of even the most astute students of tax to forecast all of the untoward results of any form of integration is incomplete and so one should proceed with care. In addition, at every possible point we encourage the choice for simplicity in designing the integration system, a choice that the Treasury admirably has recently pursued in other areas.

A. Elimination of CREBAA and Carryover of EDA

1. CREBAA Concerns

We recommend elimination from the Proposal of the stock basis adjustment mechanisms insofar as they relate to annual corporate decisions not to distribute EDA. We agree, however, that basis reductions may be a necessary component of anti-abuse rules, as discussed later.

Aside from the need for and design of anti-abuse rules, we consider the shareholder stock basis adjustment mechanism, called the REBA ("retained earnings basis adjustment"), and the accompanying corporate level "cumulative retained earnings adjustment amount" (CREBAA), to be the most complicating and problematic features of the Proposal. We recommend that Congress consider deleting these features and replacing them with other mechanisms tending to produce similar consequences, as discussed below.

These features of the Proposal reflect two reasonable goals: (1) to equalize the treatment of retained and taxed corporate earnings (and the presumed accompanying stock value increases) with the treatment of excluded dividends, which reflects an appropriate desire that the Proposal not create a new bias, this time toward distributing earnings; and (2) to
provide a substitute for EDA carryover so as to allow the corporation to "level out" its payment of excludable dividends by paying them out of the corporate level CREBAA account even when there is no available EDA to support an excludable dividend. The CREBAA is not mandatory, but this is no justification for its complexity because the Proposal is structured to encourage many corporations to adopt a CREBAA rather than allow undistributed EDA to be eliminated at year end.

The Proposal would allow the corporation to allocate a stock basis increase "at 1 or more times during the calendar year" to shareholders to the extent of the EDA it does not distribute in a year. Thus, the REBA is a way for shareholders to benefit from corporate taxes paid when earnings are not distributed and the CREBAA is a way for the corporation to "bank" EDA, which the Proposal does not otherwise generally allow to be carried over.

When the corporation draws down the bank account, the exclusion must be matched by a reduction of both the corporate-level CREBAA and the stock basis of the shareholder that gets the excluded dividend- not necessarily the same shareholder who, or the stock which, got the REBA that accompanied the bank account increase, but the shareholder on whose stock is later paid an excludable dividend supported by the corporate level CREBAA. The Proposal justifies this scheme in part to allow certain corporations to pay level dividends from year to year, despite lack of level EDA.

This may be a case of two rights making a wrong.

There are practical difficulties with the CREBAA system. As noted, shareholders who receive dividends from CREBAA and suffer a stock basis decrease will not necessarily be the same shareholders whose stock basis was increased by the REBA that accompanied the CREBAA; thus it should not be viewed at the shareholder level as a clawback of basis earlier provided (although the purchaser of stock may effectively replicate the REBA in her cost basis). Also, under this system shareholders may not know their stock basis until after year end and so may sell their shares in ignorance of the gain or loss realized.

In addition, we believe that the adjusting up and down of shareholder basis accounts is fine in theory but could be unworkable in practice for all but the most sophisticated and large shareholders. We fear that stock basis computations are already too complex, and honored mostly in the breach. We are concerned that small shareholders likely will not typically benefit from the basis increases upon sale of their shares, simply because they may not be able to, or want to, keep up with numerous small increases over many years, no matter how rigorously corporations are compelled to report REBAs annually. Conversely, larger well-advised shareholders likely will take better advantage of them. Thus, the basis increases that are probably intended as a boon to a large number of public shareholders (the same shareholders that the dividend exclusion undoubtedly is intended to benefit) may in fact become a boon for a much smaller subset of shareholders.
Furthermore, we fear that neither type of shareholder can be expected to rigorously observe the downward adjustments. How is a small shareholder to respond to receipt of notifications from the corporation that the excluded dividend she receives in one year carries a basis reduction and in another does not? She probably will simply not come to expect or understand the basis adjustment where the majority of dividends carry none. This situation likely will result in electivity against the fisc on most occasions: basis increases accounted for when most helpful to large shareholders; basis decreases not accounted for, either by inadvertence, misunderstanding, or design relying on the severely diminished audit rate for individuals.

We also do not view as being sufficiently motivating the asserted need to help the corporation that wants to pay level excludable dividends. The straightforward alternative, discussed below, of allowing carryover of EDA, should reach the identical result. Whatever amount could be added to the reserve for future excludable distributions under the CREBAA system would be carried over as EDA increases. The Proposal gives the Secretary authority to allow a carryover of EDA that is not allocated as a deemed dividend. (We interpret this to grant authority to allow carryover of EDA to be exercised generally as to all corporations, but if Congress intends the authority to be exercised only on a case-by-case basis, the statute should make that clearer and provide some standards for guidance.) If the authority is exercised on a general basis, this would create a menu of (1) excludable dividends, (2) stock basis increase, and (3) carry over of residual EDA all in the same year. Facing this three way choice, many corporations might elect EDA carryover and not stock basis increase both (1) generally, because stock basis increase will be enjoyed only by departing shareholders, in whom corporations may be presumed to have less interest, except to the extent the departing shareholders are controlling shareholders (in which case electivity likely will occur against the fisc) and (2) specifically, in cases when refunds are expected and will be allowed only to the extent of EDA, and the corporation wants to maximize its ability to collect a refund.

Therefore, we anticipate that the CREBAA may be a substantially complicating feature with relatively little usage if the Secretary exercises the proposed authority to allow unlimited EDA carryover. For these reasons, we propose eliminating the CREBAA and attempting to address the concerns that prompted it with a statutorily permitted EDA carryover and perhaps a diminution of the tax on stock gains.

2. EDA Carryover

We recommend that the Proposal be amended to allow EDA to carryover from year to year, to the extent not distributed. This recommendation is a necessary follow-on to our recommendation that the CREBAA (and concomitant stock basis reduction) regime be eliminated. We recognize that CREBAA is a partial substitute for carryover of EDA, but because we reject its basis reduction mechanism we cannot support its use.

The effect of lack of the CREBAA on the corporate decision whether to pay out dividends would be softened, and the need for sufficient EDA to pay level excludable dividends could be entirely met, by providing that EDA carries over and can be
accumulated. The most obvious policy reason not to allow EDA to accumulate is concern about EDA “trafficking,” a legitimate concern. Of course a similar, if lesser, sort of trafficking in CREBAA can occur under the Proposal.

We believe that “trafficking” by way of dividend stripping through the acquisition of corporations with large EDA would be better policed with an anti-abuse provision. On the one hand, we do not believe that there is any per se objection to allowing persons who were not shareholders when a corporation pays tax to benefit from EDA later; indeed the two year lag time built into the Proposal almost insures that that will be the case to some extent. A proposal to eliminate or limit EDA on a change in control of a corporation, by analogy to §382, could place a severe damper on normal business transactions. If any such limitation were pursued, it should permit a corporation to make an actual excludable or deemed stock basis distribution immediately prior to a change in control.\textsuperscript{2}

On the other hand, corporations with huge EDA accounts accrued over several years could become too attractive vehicles for transactions designed to bleed out huge non-taxable payments. Although unstated, we assume that the lack of carryover of EDA was intended in part as a rough brake on this sort of transaction. How much of a brake this might be is uncertain. Presumably, corporations could routinely add to their CREBAA accounts 100% of the undistributed EDA. Such corporations could pay future dividends out of their CREBAA, with the only downside to shareholders being the loss of basis. This basis reduction system could have advantages from the viewpoint of abuse control when applied to dividends to new, acquiring or larger shareholders.

We view the Proposal's choice to give up carryover EDA for carryover CREBAA with basis reduction as an insightful one, but also a gamble whose success is dependent on the practical efficacy of the basis reduction mechanism. We are unable both to determine the seriousness of the problem of trafficking in EDA or CREBAA and to determine the effectiveness of a basis reduction rule, but we fear the trafficking problem could be large and we have already stated that we distrust the basis reduction mechanism.

Consequently, we recommend serious consideration of allowing carryover of EDA, in place of the REBA/CREBAA system, accompanied by some other brake on the abusive utilization of EDA.

\textsuperscript{2} There may be other corporate-level systems that could ensure exclusion of dividends in loss or break-even years without affecting the stock basis of stockholders. In theory this could be accomplished by permitting a corporation to “purchase” EDA by paying a deposit of tax to the Treasury. For example, a corporation could make a $53.85 tax deposit in Year 2 and generate $100 EDA ($53.85/0.35 – $53.85) to support an exclusion for its preferred stock dividend in Year 3.

- The deposit would be nonrefundable but would be credited against tax in future years.
- Interest should probably accrue on the deposits at the refund rate. (A case could be made for no interest, however, since the deposit results in a tax exclusion for shareholders, which is presumably the reason that the Proposal generally does not provide for the accrual of interest on refunds.)
- The use of such a procedure might be limited to normal dividends on preferred stock.

Such a procedure would be unusual, but not necessarily more problematic than the CREBAA system.
3. **Equilibrating Distributions and Gains without CREBAA**

We recommend that other means be explored to substitute for the equalizing effect of stock basis increases for undistributed EDA.

Although allowing EDA to carryover would, itself, somewhat lessen the bias toward dividends under the Proposal by avoiding the "use it or lose it" view, it would not lessen, and might even exacerbate the disparate treatment of capital stock gain created by the Proposal. In theory that bias could be offset by a further reduction in the tax rate on capital gains. Alternately, dividends could be taxed at capital gains rates rather than excluded entirely up to EDA.

We recognize that this suggestion would require substantial reworking of the Proposal and would carry collateral consequences of its own, and for those reasons may not be palatable in the short term.

**B. Anti-Abuse Rules**

1. **General**

The devil that we know is often preferable to the devil that we don't know. Current law contains many tensions, which, for examples, foster efforts to convert ordinary income into capital gain, capital gain into dividend (to a corporate recipient), domestic into foreign income, the income of a high bracket taxpayer into the income of a low or no bracket taxpayer, etc. Anti-avoidance rules abound, and have a checkered record of success.

The dividend exclusion Proposal offers a vast new type of excludable income, which can lead to all manner of tax planning, both by investors separately positioning their investment decisions to take maximum advantage of what corporations offer and by corporations (in conjunction with their shareholders where closely held, or having large minority shareholders) selecting the most tax efficient capital raising techniques. Clearly the Proposal intends advantage to be taken of the exclusion. However, if enacted as law this Proposal can be expected to lead to taxpayer conduct that will wind up in court for a determination whether it exceeded the boundaries of Congressional intent.

Ideally the Proposal should be adopted only if Congress can generally identify the major ways in which it can be abused and is satisfied that those abuses can be reasonably dealt with in the statute or administratively. We claim no completeness in identifying the problem areas, but the following list discusses major areas of concern.

2. **Allocation of EDA among Dividends Distributed: Streaming Issues**

We agree that a corporation should not be able to deflect EDA away from certain distributions simply by labeling them as "non-EDA dividends," but we urge that dividends on preferred stock be given primacy on receipt of limited EDA, just as they
first receive E&P. We recommend reconsideration of whether non pro rata dividends within a class should be excludable.

The Proposal would pro rate the EDA among all dividends paid in the year. It is important to observe that this rule appears to have two primary effects, both of which appear to involve the cases where there is less EDA than dividends in the year. First, the pro ration rule would prevent allocating EDA first to the class first entitled to distributions. Second, it would prevent the corporation from somehow identifying certain dividends actually paid as not absorbing scarce EDA, which would then be allocated to other dividends actually paid (or REBAS actually allocated) on other stock that was not preferred relative to the other class. Both of these effects can be said to be aimed at problematic "streaming," meaning here processes by which a corporation with limited EDA might plan its affairs so as to maximize the receipt of excludable dividends by shareholders who can best enjoy them, such as taxable U.S. persons as contrasted with tax-exempts (which typically have been large holders of stocks).

Note that such concerns would tend to arise principally where EDA available annually is limited (as it will tend to be under the Proposal, which does not allow EDA carryover). Where EDA is greatly in excess of all dividends and REBA allocations the corporation will pay or allocate, then the shareholders receiving excludable dividends will not generally benefit (in terms of the availability of more EDA) from the fact that other shareholders received non-excludable dividends on a similar class.

The pro rata rule is different from the current rule as to E&P, which streams E&P first to preferred distributions. Rev. Rul. 69-440, 1969-2 CB 46. We believe that that rule should apply to distributions on preferred classes, but that other streaming should be curtailed.

a. In a Year When Dividends Exceed EDA, Dividends on Preferred Should Use EDA First

We believe that dividends on a class of stock that has a preferred claim to distributions should have a similarly preferred claim on the EDA account. The law now recognizes that such distributions have a preferred claim on the E&P account, and the Proposal generally intends to follow E&P approaches. Currently, buyers of corporate stock that are themselves corporations benefit from the E&P rule in effect to "stream" dividends that qualify for the dividends received deduction to themselves as shareholders. Applying this rule would further alleviate the concern about ability to pay level preferred dividends, discussed above in connection with CREBAA, and likely would result in the least impact by the adoption of the Proposal on the current usage of preferred stock (in that it would assist dividends on preferred stock to consistently be excludable to all shareholders).

Giving preferred classes a prior claim to EDA may exacerbate a potential abuse whereby abnormally large but still pro rata dividends might be paid on a preferred class. IRS has addressed a similar issue recently in the stepped-down preferred regulations. Reg. §1.7701(l)-3. The issue becomes more acute in the EDA area because of the abuse possibility of the excluded dividend/stock loss combination. Consideration might be
given to limiting the allocation of EDA on preferred stock to "normal" dividends as somehow defined. See for examples, §1291(b) and §1059. Also the transitory creation of special classes of stock for the purpose of paying a one time excludable pro rata dividend should be prevented.

b. "Preferred as to EDA Only" Classes Should Not Be Permitted

For clarity we observe that the Proposal does not permit, and rightly so, EDA streaming by the mechanism of the corporation labeling a class as the EDA recipient class while other shareholders who have an equal preference claim on corporate earnings do not received excludable dividends. That is, streaming of EDA that accompanies preference claim to dividends should be permissible, but streaming of EDA without the appropriate linkage to a preferred claim to distribution is properly what the Proposal prevents by requiring a pro rata allocation of EDA.

The requirement of pro rating EDA to all dividends (except as to preferred classes) somewhat approximates the role of §305(b)(2). That subsection of the Code treats a stock distribution as a taxable increase in proportionate interest in the corporation when it is somehow accompanied by receipt of a taxable dividend by another group of shareholders who do not receive the proportionate increase. Section 305 can be viewed as addressing two interrelated issues. In part §305 is aimed at taxing disguised property distributions (i.e. proportionate interest increases). But it is also aimed in part at preventing electivity on the part of shareholders as to whether they will receive taxable or tax free distributions (which would be the case if the stock distributions were excluded).

The electivity aspect of streaming EDA away from an equivalent class seems to be the concern at which the pro ration rule is aimed. But note that where there is abundant EDA and the streaming of EDA away from some dividends toward other dividends does not have the effect of manipulating limited EDA towards those who can best enjoy it, then the streaming only has the effect of giving shareholders a choice of which type of dividend (excludable or not) they would like to receive. We assume this is not perceived as part of the streaming problem, but if it is, then further articulation of that problem is needed.

c. Consider Whether Non Pro Rata Dividends Within Classes Should Be Excludible

The only remaining potential streaming category is the dividend that results from a non pro rata distribution within a class. This could occur upon a non pro rata dividend within a class, a redemption treated as a dividend, an effective redemption that occurs in the context of a merger or other corporate level event. Such dividends frequently are created by the operation of §§302, 304, and 356 (insofar as not a pro rata distribution to an entire class). It is possible that the operation of §305 in conjunction with such a dividend could convert it into a pro rata dividend within the class (as where redemptions is not "isolated," see Reg. §1.305-3(e), Exs. (8), (9)).
The Proposal requires such dividends to receive a pro rata allocation of EDA, and as to
most of them will require a basis reduction under §1059, as discussed below. We are
uncertain whether this is the correct result.

This type of dividend can appear to be a problematic recipient of EDA because it (1) may
tend to be abnormally large in amount by some measure, and (2) will tend to occur
episodically at the election of corporations as a result of tax planning. Arguably, if this
type of dividend provides significant abuse potential then the more direct control
mechanism would be to deny the exclusion. However, that approach would have the
disadvantage of tending to permit the streaming of EDA away from a certain type of
dividend, which we agreed above should not be permitted. Furthermore, that approach
would lead one to question whether a general rethinking of the rules of §§302, 304 and
356 that prefer dividend treatment is in order.

3. Dividend Strip

We agree with the proposed application of §§246 and 1059 but disagree with the
application of the §1059 basis reduction to all dividends received in the first year of stock
ownership.

The following example prompts severe reservations about the Proposal, absent some
remedy:

Example: Corp. X normally has taxable operating income in the neighborhood of $100M
and normally pays a dividend of $5M. Its share value varies slightly around the payment
of a dividend, meaning that an individual could buy the stock, receive the ordinary
income dividend and sell the stock at a capital loss. This is normally not a desirable
practice due to the limitations on deduction of capital losses. After adoption of the
Proposal the same practice can yield an excluded dividend and a capital loss, a more
desirable result.

This result is highly analogous to that which has long been available to corporations that
could buy stock paying a dividend that enjoyed the dividends received deduction, and has
been addressed in that context in two principal ways, on both of which the Proposal
intends to piggyback. One way the Proposal prevents such an abusive result is to extend
to the excluded dividend and to individual shareholders the rules of §246 and impose a
holding period on the ability to exclude the dividend; but the Proposal will allow the
exclusion and instead mandate a basis reduction. Presumably the reason for this change in
the operation of §246 is that the paying corporation cannot be expected to report non
excludable dividends to such short term holders, and so there is little alternative but to
pursue the difficult to enforce basis reduction. Presumably the universe of shareholders
who might pursue this ploy will be knowledgeable and largely dissuaded by the rule from
this course of conduct.

The Proposal also applies §1059 basis reduction to all excludable dividends (as if they
were deductible dividends received by corporations) and expands the definition of
extraordinary dividend to include all dividends within the first year, regardless of whether it would otherwise be "extraordinary". We believe this rule should go far toward controlling trafficking in EDA. We note that it overlaps the basis reduction of §246.

Although we generally oppose the use of basis reduction in this Proposal, we do not find its use here as objectionable because this is an anti-abuse rule and presumably not a generally applicable rule as in the case of the CREBAA. We oppose, however, the application of the rule to all dividends received in the first year without regard to whether they are otherwise extraordinary. This places an undue limitation on normal dividends that do not run afoul of the rule of §246.

4. **Debt Financing of Ownership of Dividend Paying Stock**

We recommend clarification of the role of §265 and if the debt financing rule in the Proposal (as described below) is not to apply to non corporate shareholders, then consideration should be given to making §265 apply, particularly in light of the fact that individual's interest deductions will be shifted to offset other investment income by the operation of §163(d).

Debt financing of ownership of excludable dividend paying stock can occur at either the level of the non corporate shareholder or the level of a corporation whose EDA is increased by receipt of an excluded dividend (or REBA). In each case the taxpayer would deduct interest that presumably was incurred in order to receive untaxed income.

a. **Section 163(d)**

In the case of noncorporate taxpayers, §163(h) severely limits the interest deduction to certain types of interest, one of which is investment interest under §163(d). Investment interest can only be deducted against investment income, as defined. Section 163(d) will treat the interest deduction to the extent allocable to EDA paying stock as investment interest so that it can offset net investment income; however, excludable dividends will not be investment income because they will not be gross income. As a consequence, the Proposal will tend to make the limitation of §163(d) less severe than it currently is in the sense that interest deductions allocable to stock paying excludable dividends can offset investment income from other non debt financed investments.

**Example:** A borrows $100 in 2002 to buy $100 of stock that pays a $5 dividend. A pays $5 of interest annually. Assume the entire $5 of interest is investment interest, and A has no other investment income. For 2002 A will have no net gain or loss with respect to the borrowing and stock holding. For 2003 the $5 dividend is excludable. Again A will have no net gain or loss with respect to the borrowing and stock holding, but A will have $5 of unused investment interest that carries over to 2004. In 2004 A inherits a Treasury bond paying $5 interest. A will pay no tax on the bond interest due to deduction of the interest on the debt incurred to buy the stock paying excludable dividends.
Whether this is appropriate is somewhat related to the broader question discussed below whether §265 should apply to deny a deduction for the cost of carrying EDA paying stock. If the interest deduction is denied, then the issue of §163(d) becomes moot except to any extent the two rules allocate interest differently. If the interest deduction is not denied, that presumably reflects a decision that the interest deduction should be allowed to offset other income, which should include other investment income under §163(d). We question whether this is too favorable a result in light of the much more severe rule proposed for corporate shareholders.

b. Section 265(a)(1)

If §265(a)(1) were to be applied, setting aside the difficulties of allocation, "cost of carry" deductions would be denied to both corporate and non corporate shareholders to the extent they receive excludable dividends. We understand that §265 is not intended to apply to deny deductions for interest and other expenses "allocable" to excludable dividends. Presumably the drafters of the Proposal believe that excluded dividends will not be a class of income wholly exempt from tax (perhaps this should be clarified). We discuss here the implications of applying §265(a)(1), principally as it might affect individuals, because there appears to be no other limitation on their debt financing of stock.

i. Individuals

At the individual level, the Proposal would accord excludable dividends the same treatment as interest received on tax-exempt municipal bonds. Such interest received does not reflect income taxed in the U.S. taxing system to the payor. In contrast, by definition the excludable dividend received by the non corporate shareholder has been taxed once in the U.S. taxing system (counting foreign tax credits applied). Other categories of exempt income to which §265 can apply include gifts and fellowships, life insurance proceeds, ministers' allowances, and recoveries for personal injury. Some of these sources reflect prior tax payment by the payor and some may not. Therefore, the theory of §265 as now applied appears not to derive from whether or not the income was taxed in the system elsewhere but mainly from an intention not to allow the expense to be deducted against other taxable income.

Such shifting of deduction by individuals to other investment income clearly could occur, as discussed above, if §265 did not apply to the excludable dividends. Whether this should be allowed because of the special nature of excludable dividends as reflecting tax paid by another "related" taxpayer is a difficult question. Considerations include the following:

- The goal of avoiding double taxation of corporate income is achieved by excluding the dividend and does not require sheltering other investment income
- To the extent the Proposal is viewed as an integration Proposal (somewhat in contrast with the stated purpose of avoiding double tax), then collapsing the
shareholder and corporate taxing levels would yield no net tax if the shareholder's
deduction is allowed

- Section 265 is not going to perform successfully as a self enforcing means of
denying deductions, and audit enforcement is going to be very spotty and
contentious
- To the extent application of §265 is effective it will disrupt the expectations of the
financial markets as to EDA stock
- The application of §163(d) to limit the use of the deductions to other investment
income only is a sort of a brake on the interest deduction
- Sec. 265 as now written would not apply to REBA increases, which would seem
to provide a discontinuity that either will not be addressed, or if addressed will
require great complexity.

On balance, we agree with the apparent intent that §265 not apply and we recommend
that the Proposal be amended to make clear that §265 does not apply to non-corporate
taxpayers.

ii. Corporations

Section 265 could be applicable to corporate recipients of excluded dividends only after
the application of proposed §286(d), which would deny the exclusion based on §246A
principles. Such taxable dividends would not be subject to the dividends received
deduction, by a specific exclusion contained in proposed §246(f). Any remaining
excluded dividends after the application of the §246A rule, presumably will have run the
gamut of what the Proposal intends to do to excludable debt financed dividends at the
corporate level. Therefore, the Proposal could also make clear that §265 will not apply to
corporate recipients of excluded dividends.

c. Proposed §286(d)

We agree with proposed §286(d), as a practical safeguard against possible substantial
corporate tax reductions.

Section 246A currently reduces the dividends received deduction on debt financed
portfolio stock by an amount reflecting the deemed proportion of the stock value financed
by the debt. Because the DRD will not apply to excludable dividends under the Proposal,
§246A will not apply. However, proposed §286(d) would use the methodology of §246A
to identify the proportion of the otherwise excludable dividend that will not be excludable
and will not be eligible for the DRD. Similarly, the provision would increase gross
income of the corporation for the same proportion of REBA it received from another
corporation. The title of the section states that it applies to corporations borrowing money
and holding stock, but the texts does not appear to be so limited; we assume it applies
only to corporations.

The following is one example of what could occur absent the proposed §246A rule.
Example: Assume unrelated Corp. X and Corp Y each will have $100 of net taxable income for every year from operations and could pay an EDA dividend of $65, permitting total excludable dividends to individual shareholders "in the world" of $130. On 1/1/04 Corp X borrows $650 and uses the funds to buy preferred stock of Corp. Y, which pays a 10% dividend, all of which is EDA (assume this is debt financed portfolio stock for purposes of illustration). Corp. X pays 10% interest, or $65, in 2004 and every year thereafter. As a result, in 2004 and thereafter Corp. X has $35 net taxable income, saving tax of $22.75 (absent the proposed rule). X has EDA of $65 (from Y) + 22.75 = $87.75. Y would not have any EDA left to distribute to any other shareholder but X except for the fact that it now has an additional $650 to invest, and assuming a 10% return has $65 income, which will create $42.25 EDA. Therefore, aggregate individual shareholder level EDA "in the world" remains constant at $130. X saved tax of $22.75, but Y pays more tax of $22.75.

Although there is in theory no global tax leakage as a result of the borrowing, from the viewpoint of the borrowing corporation, X, this is a win-win situation. It reduces the tax it pays out of pocket, and increases its EDA available to pay to its shareholders.

There is a view that no limitation should be placed on the interest deduction because the EDA has already been taxed once (unlike tax-exempt interest – but like dividends subject to DRD under current law, now subject to §246A). In addition, any restrictions on the dividend exclusion based on financing would severely disrupt the markets, which rely on margin debt-financed purchases. Such a restriction would also be hard to administer, under a standard like that of either §246A or §265(a). The situation of each shareholder would have to be reviewed separately.

However, on balance we agree that the proposed exclusion denial, or some similar brake on such financing of excluded dividends, is probably a necessary protection for the fisc. There is no stronger tax related motivation operating on corporations than the motivation to reduce any given corporation's current tax. Relying on a hypothetically balancing increase in tax at some other point in the system has proved to be an uncertain safeguard for the fisc, as illustrated by recent tax shelters where the "balancing" taxpayer was a non-taxpaying foreigner. We realize that that particular taxpayer planning technique would be more difficult here since the corporation paying the excludable dividends, by definition, must be a taxpayer (but see illustration of foreign investment below). Nevertheless, it makes little sense to try to prove that the problem cannot arise when there is so much impetus for it to arise.

Not imposing a rule such as that proposed would freely allow income shifting among corporations. The abuse will likely be exacerbated because the borrowing will likely be from tax exempts. Furthermore, it involves a negative tax rate on the stock investment, which is generally indicates that a tax rule goes too far. The justification that the result will be the same as if Y borrowed and took the deduction is not fully satisfactory because it would allow X to get an interest deduction in many cases where Y could not use one for any number of reasons (debt/equity, foreign tax credit limitation, etc.). Note that when you put the preceding example together with the fact that foreign taxes count for EDA, it
would allow X to borrow from a tax exempt to buy the preferred stock, and Y to use the proceeds to invest offshore and pay foreign taxes that would create EDA to it and then to X. When the smoke clears, all that has happened from a U.S. revenue point of view is that total taxable income has been reduced by the amount of the interest expense, but EDA is not reduced correspondingly because more foreign taxes are being paid by the X subsidiary.

The application of §286(d) will change the example as follows:

Revised Example: Assume unrelated Corp. X and Corp Y each will have $100 of net taxable income for every year from operations and could pay an EDA dividend of $65, permitting total excludable dividends to individual shareholders "in the world" of $130. On 1/1/04 Corp X borrows $650 and uses the funds to buy preferred stock of Corp. Y, which pays a 10% dividend, all of which is EDA (assume this is debt financed portfolio stock for purposes of illustration). Corp. X pays 10% interest, or $65, in 2004 and every year thereafter. Assume §286(d) operates to eliminate $65 of the dividend exclusion. As a result, in 2004 and thereafter Corp. X has $100 net taxable income and $65 of EDA. If Y earns $65 on the capital infusion of $650, it will pay $22.75 more in tax and have $42.25 of EDA (in addition to the $65 it started with). Therefore, the net result of the transaction is to increase corporate level tax paid and reduce EDA available for individual shareholders by $22.75.

C. Consolidated Return Issues.

1. Background

Included in the proposed legislation is the following amendment to the Internal Revenue Code, relating to the filing of consolidated returns:

SEC. 287. REGULATIONS.

The Secretary shall prescribe such regulations as may be appropriate to carry out section 116 and this part, including regulations --

* * * *

(4) modifying the consolidated return regulations to the extent necessary or appropriate to apply the provisions of this part, including regulations that accelerate the inclusion in the excludable dividend amount of a higher-tier member with respect to --

(A) activities of lower-tier members of the group,
(B) dividends excludable under section 116(a) received from such lower-tier members, and
(C) increases in basis allocated under section 282 to stock in such lower-tier members,

* * * *
(6) as are necessary to further the purposes of section 116 and this part and to prevent the circumvention of such purposes.\(^3\)

The Joint Committee on Taxation described these provisions as follows:

The Secretary of the Treasury is provided authority to prescribe appropriate regulations to carry out these provisions.

The Secretary of the Treasury may amend the consolidated return regulations (effective as of the effective date of the Proposal) to properly account for an EDA of a member of the group, for basis adjustments allocated to a member of the group, and for CREBAA distributions received by a member of the group. These regulations may accelerate the inclusion in the excludable dividend amount with respect to activities of lower-tier members of the group, excludable dividends received from lower-tier members, and increases in basis allocated to stock in lower tier members.\(^4\)

The Treasury Department had earlier described the consolidated return regulation provisions of the President’s Proposal as part of its *General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals*:

Corporations may continue to file consolidated returns as under current law. The consolidated return regulations will be amended to reflect the dividend exclusion.

\* \* \* \* \*

H. Consolidated Returns

The Secretary of the Treasury will amend the consolidated return regulations to effect the provisions of the Proposal. For example, regulations might provide that, in a consolidated group, EDA will be calculated on a consolidated group basis based on U.S. income taxes of the group, and then apportioned among the entities that were members of the group during the taxable year based on each member’s separate taxable income. No EDA will be allocated to members that generated a loss during the taxable year. The stock basis adjustment rules of the current consolidated return regulations, rather than the rules described above, will control for members of a consolidated group.\(^5\)

\[ 2. \text{ General Principles} \]

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\(^4\) Staff, Joint Committee on Taxation, *Description of the Revenue Provisions Contained in the President’s Fiscal Year 2004 Budget Proposal* 26-27 (JCS-7-03 Mar. 2003).

\(^5\) U.S Treasury Department, *General Explanations of the Administration’s Fiscal Year 2004 Revenue Proposals* (Feb. 3, 2003). See also U.S. Treasury Department, *Treasury Releases Details of the President’s Dividend Exclusion Proposal* (Jan. 21, 2003) (same description, as part of a Treasury Department description released in advance of the President’s formal budget Proposal).
The Proposal provides no guidance beyond the general statements quoted above. Due to the brevity and flexibility of the statements, the consolidated return regulations that will be required to implement the Proposal must be guided by (i) the generally applicable single entity principles of the consolidated return regulations, (ii) the desire for simplicity, and (iii) the generally applicable goal to reduce double taxation of corporate distributions.  

Although some of our comments relate to possible additional guidance that can be given on consolidated issues in the legislative process, most of the following relates to administrative matters that will follow enactment. We here make recommendations as to those regulations, realizing that these recommendations will not directly affect the legislative process. However, we believe it is appropriate and necessary to forecast those regulations during the legislative process, both to uncover any unexpected difficulties that might be clarified by legislation and to expedite the tremendously difficult task that will face the Treasury and IRS in crafting the needed regulations within a very short period of time.

We do not generally encourage more detailed coverage of consolidated treatment in the statute because of the intense administrative study that will be needed to integrate the needed regulations into the complex structure of existing consolidated return regulations. We do, however, encourage inclusion in appropriate legislative history indications of Congressional intent, except as regulations otherwise provide, on most if not all of the following subjects, because consolidated taxpayers will need guidance immediately if the Proposal is to be enacted and effective this year.

3. Consolidated EDAs

We agree with the Treasury's view that EDA should be a consolidated account and urge that the legislative history so indicate, except as provided in Treasury regulations. A consolidated EDA would be computed for the group as a whole, rather than for each member separately.  

A separate return corporation will calculate its EDA based on the amount of its Federal income tax paid. In the consolidated group context, the computation of Federal income tax reflects single entity principles, with the tax computed for the group as a whole (i.e., based on the aggregate activities of the members) rather than for each member

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6 See also Reg. §1.1502-80(a) (“The Internal Revenue Code, or other law, shall be applicable to the group to the extent the regulations do not exclude its application”).

7 Numerous exceptions to single entity treatment exist under the consolidated return context, and the policies underlying each exception will require separate consideration. For example, in the context of a life-nonlife consolidated return, section 1503(c) and Reg. §1.1502-47 limit life income being offset by nonlife losses. Cf. section 806(b)(3)(C) (adopting similar limitations for a life company that also conducts nonlife activity). Similarly, section 1503(d) and Reg. §1.1503-2 limit the consolidated group absorption of “dual consolidated losses” generated by members that are “dual resident corporations.” See also Reg. §§1.1502-15 and 1.1502-21(c) (separate return limitation year rules).
separately. For example, member losses generally offset member income, and the group’s tax is computed based on their aggregate, net income.

4. Allocating Consolidated Group EDA

a. Is Allocation Necessary?

(i) Subsidiary Minority Dividends Should not Be Excludable

We question whether allocation of EDA is necessary or appropriate. It is neither if group subsidiaries that pay minority dividends are not allowed to pay excludable dividends. However, in that event it also would be appropriate to view the subsidiary minority dividends as analogous to non-excludable dividends paid by the parent. In that light it becomes apparent that the same sort of streaming at which the EDA proration rule in the Proposal is aimed could occur through use of minority stock of subsidiaries, but that proration rule would not apply.

Example: X owns 80% of the common stock of Y and they file a consolidated return. The public owns 20% of the common stock of Y. The X group has EDA of $100, all of which is attributable to the earnings of Y. Y distributes $20 to its minority shareholders as a dividend, which is not excludable. If X's EDA is not reduced to reflect its proportionate ownership of Y, then X can distribute $100 of excludable dividends. This is the same result as if X had a class A and a class B common, one of which paid excludable dividends and one of which did not.

Because of the streaming problem reflected in the foregoing example we believe that group EDA available for distribution by the parent in the year would have to be reduced by the amount of subsidiary minority shareholder dividends for the year, or by some amount reflecting the portion of EDA allocable to the sub, despite the fact that such dividends are not excludable. That portion of the EDA would simply disappear.

To prevent streaming of EDA to the parent shareholders, it would be necessary to reduce the EDA of the group for the year by at least the amount of subsidiary minority dividends paid in the year, despite the fact that they are not excludable. In order to deal with a case where the subsidiary defers payment of its non excludable minority dividends (as in cumulative preferred), it may be necessary instead to reduce the group EDA by some amount representing EDA allocable to the subsidiary minority (but avoiding falling into the complication of a tiering system for EDA as discussed below).

The Treasury analysis assumes that consolidated group EDA will be apportioned based on each member's contribution to the consolidated income. Whether or not it is advisable to allocate group EDA among the members of the group is a critical decision as to which

8 See Reg. §§1.1502-2 and 1.1502-11. Thus, the group’s tax is not simply the sum of each member’s separate tax.
"fairness" to certain groups of shareholders must be weighed against administrative feasibility. Allocation is theoretically relevant to only two events (1) dividends paid by subsidiary members to minority shareholders, and (2) exit of a member from a group, whether or not it joins another group. The latter event will be episodic and presents more manageable problems that can be solved by a one time rule applicable upon exit. The former event will be ongoing as to those members with minority shareholders and will require considerably more regulatory complications.

We generally believe that the need to provide rules for minority shareholders of consolidated subsidiaries is the source of a major complication in the consolidated return regulations. We understand that theoretical purity would require allocating EDA to minority shareholders and that if there were substantial numbers of consolidated groups with minority shareholders and substantial numbers of minority shareholders, then there could be practical reasons to pursue this theoretical purity. However, we believe that the majority of consolidated groups do not currently have any subsidiaries with minority shareholders. Most minority shareholder cases involve §1504(a)(4) "plain vanilla" preferred stock, which generally is held by corporations seeking to benefit from a dividends received deduction. There should not be any concern over disrupting the tax treatment these investments because the entire dividend exclusion Proposal will be disruptive. Moreover, the scope of this problem has likely diminished since the enactment of §1503(f) and the development of other financing mechanisms, and the fact that this type of stock can often be easily replaced with debt.

Other less common minority interests include (1) individuals who frequently are employees of the subsidiary and who desire an interest in the subsidiary but not the parent, (2) equity carve outs in which a 19.9% stake in a subsidiary has been issued to the public, (3) corporations, including foreign entities, that are effectively joint venturers in the subsidiary, but on a very limited basis, and (4) a variety of parties that are utilized as minority shareholders for tax planning purposes. The latter two categories should not be of concern in designing the Proposal. The first category is an extremely small one for which to fashion an allocation system. The equity carve outs frequently were created in connection with a spin-off of the subsidiary, which is no longer then a subsidiary. All other things being equal, we believe it would be desirable to reduce complexity by not parsing EDA to minority subsidiary shareholders.

It might be thought that the existing system of allocating E&P found in Reg. §1.1502-33 could be adapted for EDA. We agree that if allocation is to occur it should be based on the E&P regime and recommend that legislative history so reflect. However, the E&P regime is not perfectly designed for EDA because it does not contain adequate rules to prevent duplicative use of the same E&P. That is, E&P tiers up to the common parent, meaning that the common parent has the sum total of the E&P for a year of all of its subsidiaries, subject only to a rule that prevents a proportion of a subsidiary’s E&P from tiering up to reflect the proportion of its stock held by a minority. So long as distributions to the minority are similarly proportional, in theory there should be no multiple use of the same E&P, but those will not necessarily be the facts, and where the stakes are the ability to pay out excludable dividends there will be much more pressure on the EDA rules to
prevent multiplication than perhaps can be handled by the vague anti-abuse approach of the current E&P regulations.

For these reasons, we recommend that the statute be amended to specifically give Treasury the authority to deny EDA distributions to some or all minority shareholders of consolidated subsidiaries. Treasury should be allowed the flexibility to determine that none of these types of minority shareholders will be entitled to excludable dividends, and thus no EDA allocation will be provided for subsidiaries on a year to year basis (as opposed to exit). In such case, corporations receiving dividends on minority stock could be allowed the dividend received deduction as under current law.

(ii) Alternatives to Allocation

If subsidiary minority shareholders are to receive excludable dividends, then as an alternative to the complicated allocation and tiering system discussed below, for example holders of §1504(a)(4) preferred stock receiving dividends from a group's subsidiaries could be allowed to participate in the consolidated pool of EDA as if such stock were issued by the parent. Thus, if it were thought that it would be particularly unfair to deny excludable dividends to individual minority shareholders, complexity could be reduced by making their dividends excludable by participation in the pool.

Any such pooling approach would lead to mismatching between E&P and EDA and facilitate taxpayer manipulation through techniques such as “streaming” of E&P to minority shareholders that only bore a proportionate amount of the group’s taxes paid.\(^9\) Because a distribution will be out of EDA only to the extent it is also out of E&P of the corporation paying the dividend, if there is not some general correlation between a subsidiary’s E&P and EDA resulting from the consolidated return regulations consistently computing and allocating these amounts,\(^10\) there will have to be an anti-abuse rule, as discussed below.

Under a pooling approach, if any member paid a dividend to a shareholder that was not a member during the calendar year (necessarily meaning that the payor had sufficient E&P to support the dividend), all such payments would participate in the common EDA pool as if all such stock were issued by the parent and payments made by the parent. This approach would eliminate the possibility of multiple use of the same EDA, but is inconsistent with the statement in the Treasury analysis that no EDA should be allocated to a member that had a loss for the year. Apparently Treasury is concerned with some sort of "trafficking" in EDA whereby shareholders of a member that did not contribute to

\(^9\) Consideration has been given in the past to fully consolidating the computation of E&P, with each member having access to the group’s entire E&P, but this approach historically has been rejected. See, e.g., H.R. Rep. No. 247, 101\(^{st}\) Cong., 1\(^{st}\) Sess. 1215-19 (1989) (computation of E&P on a consolidated, rather than member-by-member, basis). Many of the numerous problems of this approach are described in a letter from the AICPA to Ways and Means Committee Chairman Dan Rostenkowski (Sept. 7, 1989).

\(^10\) Because significant timing disparities will separate the generation of E&P from the related EDA, the correlation between the two accounts will never be precise in any particular year. Moreover, if substantial E&P is distributed before the related EDA is generated (e.g., to a tax-exempt shareholder that is indifferent to E&P distributions), it might become impossible for the two to ever correlate.
the EDA nevertheless enjoy its benefits (which also could occur when a corporation joins the group after the year that produced the group EDA). This concern is a subset of the broader concern that corporations and their shareholders will make an infinite number of choices to maximize the use of EDA. So long as a member has sufficient E&P to pay a dividend, it might not be worth the effort to allocate EDA, so long as the minority stock is issued for business purposes, and in the case of §1504(a)(4) preferred stock the dividends are not extraordinary in amount (which would indicate a tax avoidance purpose).

b. If Allocation Is Pursued: Parallel E&P

We further recommend that legislative history indicate that if Treasury chooses to allow the exclusion to minority holders and to allocate EDA, then the EDA regulations should parallel the existing E&P regulations to the maximum extent possible and feasible. We recommend that if other alternatives as discussed above are rejected, the authorized legislative regulations provide for allocating the consolidated group EDA among the members in the same manner as group taxes are allocated.

The current consolidated return regulations include provisions for allocating a group’s Federal income tax among its members, among other reasons for the purpose of reducing a corporation's earnings and profits for the amount of its federal income taxes. That can be relevant in the consolidated context because a subsidiary can be included in a consolidated group despite members owning less than all of the subsidiary’s stock, and outsiders owning the minority interest. Under current law, the subsidiary is only capable of distributing earnings and profits (“E&P”) generated by its own operations (and, as discussed below, the E&P from operations of its lower-tier members that tier up to the subsidiary). Accordingly, the subsidiary’s E&P must be separately computed to determine the extent to which the subsidiary’s distributions to minority shareholders should be treated as “dividends.” This computation must take into account the subsidiary’s share of the group’s tax, and section 1552 provides alternative methods for allocating the tax.

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11 For the stock ownership requirements to be included in a group, see section 1504(a) (rules for measuring whether the members own at least 80% of the voting power and value of the subsidiary’s stock); Reg. §1.1504-4 (rules for deeming options exercised in measuring the required 80% ownership of subsidiary stock value).

12 For the E&P computation rules, see Reg. §1.1502-33. A subsidiary generally needs E&P only for purposes of distributions to minority shareholders, because the balance of the subsidiary’s E&P automatically tiers up (as discussed below) within the group to the common parent, and intercompany distributions among members are already excluded from the shareholder’s gross income without regard to the EDA rules. See Reg. §§1.1502-13(f)(2); 1.1502-32(b)(2)(iv). Even a wholly owned subsidiary must be allocated a share of the group’s tax, in order to compute the adjustments of members to their basis in the subsidiary’s stock. See Reg. §1.1502-32(b)(3)(iv)(D).

13 The details of these methods are set forth in Reg. §1.1552-1, and the methods vary in their degree of precision and administrability. Although Reg. §1.1502-6 imposes several liability on each member for the group’s entire tax, we believe this provision merely facilitates the government’s collection of tax rather than indicating that each member economically bears the group’s entire tax. For example, if one member is required to pay more than its allocable share of the group’s tax, the member generally is entitled to
We note that the consolidated return regulations permit groups to elect to supplement the basic methods of allocation of taxes paid by an additional allocation that reflects the tax benefits derived from tax attributes (e.g., net operating losses, credits, etc.) that reduce the amount of consolidated taxes otherwise paid.\textsuperscript{14} For example, if the income of some members is sheltered by the losses of other members, thereby reducing the group’s taxes paid, the income members reduce their E&P by an additional amount reflecting their deemed tax payment of the avoided tax, and the loss members increase their E&P (because they are not allocated tax payments) by a corresponding amount.\textsuperscript{15} A supplemental method must be elected on the group’s initial return, and if no election is made, no supplemental allocations are taken into account for E&P purposes.\textsuperscript{16}

Because a subsidiary has its own E&P, its distributions to minority shareholders can be treated as “dividends” and result in double taxation. Accordingly, the subsidiary must be able to pay out consolidated group EDA if double taxation is to be avoided. To minimize complexity, we believe that the existing basic section 1552 rules are adequate to allocate group tax and thus EDA.\textsuperscript{17} We believe that each of the section 1552 methodologies should be consistent with the Treasury’s view opposing allocating consolidated EDA to members generating loss, although we discuss below why the supplemental method should be disregarded.\textsuperscript{18} Because E&P will be generated before the related EDA arises, section 1552 will apply to allocate tax for E&P purposes before the taxable year in which section 1552 is applied for EDA purposes.

While E&P computations can take into account supplemental amounts for the use of tax attributes as discussed above, we believe that these amounts are not equivalent to taxes paid by the group and that the supplemental method probably should be disregarded. The reimbursement from other members under applicable state law, and if it is not actually reimbursed, the failure is more analogous to forgiveness of an intercompany indebtedness.

\textsuperscript{14} For the various supplemental methods, see Reg. §1.1502-33(d).

\textsuperscript{15} Note that, if the income member does not actually pay its allocated tax amount or allocated supplemental amount, the regulations treat the amount as having been fully paid and separately returned to the member through dividends or capital contributions (as appropriate). See, e.g., Rev. Rul. 73-605, 1973-2 C.B. 109; Rev. Rul. 76-302, 1976-2 C.B. 257. In effect, the failure is treated as more analogous to a separate forgiveness of intercompany indebtedness between the members, and does not affect the allocation of tax. We believe that similar principles should be appropriate for EDA computations, and will generally tend to conform the location of E&P and EDAs within a group.

\textsuperscript{16} By contrast, a supplemental method is mandated for investment adjustment purposes. See Reg. §1.1502-32(b)(3)(iv)(D).

\textsuperscript{17} Because the consolidated return regulations have continued to evolve since these methodologies were developed, each section 1552 methodology is now defective in several respects, but these problems are beyond the scope of guidance specifically required to reduce double taxation of corporate dividends. Consideration might be given to eliminating the current flexibility under section 1552 to elect from among various allocation methods in a group’s initial return. This requires balancing the administrability benefits of current law with the benefits of precision and consistency. To the extent that different methodologies continued to be permitted, consideration might be given to allowing each group to make a new section 1552 election because the adoption of an EDA system may alter the relevance of prior section 1552 elections.

\textsuperscript{18} To the extent concerns exist as to the potential for anomalies, an explicit prohibition can be included in the EDA rules, and require reallocation of any EDA that would otherwise be allocated to a loss member.
funds remain within the group, and the amounts might reflect tax benefits that are inconsistent with the general goal of permitting EDAs only to the extent that corporate-level income fully bears a corporate-level tax. Ignoring these supplemental adjustments will tend to conform a group’s EDAs to the comparable EDA of an equivalent separate return corporation operating through divisions rather than subsidiaries. Of course, not treating supplemental amounts as tax paid for EDA purposes will tend to cause EDAs to diverge from E&P and this divergence is likely to produce anomalies. The problem appears unavoidable, and is only one of several potential anomalies that can arise in the consolidated return context, as discussed below.

c. If Allocation is Pursued: Tiering Up/Down With Respect to Subsidiary EDAs

A system that (1) computes EDAs on a consolidated basis, and (2) allocates the EDAs among the members based on principles discussed above, must then (3) provide for the allocated EDAs to tier up to the common parent without distribution. This third step will require numerous rules to address the movement of members in and out of a consolidated group, the shifting of subsidiary stock ownership within a group, and the potential for “streaming,” duplication, and trafficking techniques. If Treasury determines that the complexity is outweighed by other factors, then it must address many topics including those discussed below.

While it is possible for a subsidiary to distribute its E&P to minority shareholders, the E&P generated by consolidated group members is most commonly distributed through the group’s common parent.\textsuperscript{19} Because the common parent can effectively distribute a subsidiary’s E&P without the subsidiary first transferring its E&P to the common parent through intercompany distributions (e.g., the common parent might finance its own distributions by borrowing against the economic value of the subsidiary’s stock, and subsequently discharge the debt with an intercompany distribution),\textsuperscript{20} the consolidated return regulations automatically tier each subsidiary’s E&P up to the common parent as it is earned.\textsuperscript{21} This tiering system replicates an allocable portion of subsidiary E&P up the subsidiary’s corporate chain and results in the E&P being reflected simultaneously in the subsidiary and in the higher-tier members, with the result that any higher-tier distributions economically supported by the subsidiary’s E&P are treated as dividends without regard to distributions among consolidated group members.

We do not believe that the goal of reducing double taxation of corporate distributions calls into question the existing rules for determining E&P, and we do not believe that the existing E&P rules need to be revised. Because E&P must be both allocated to members, and tiered up to the common parent, double taxation can be effectively minimized with

\textsuperscript{19} In fact, in our experience only a small percentage of consolidated group subsidiaries have minority shareholders.

\textsuperscript{20} \textit{Cf.} Rev. Rul. 80-239, 1980-2 C.B. 103 (in the separate return context, an individual transferred stock of X to newly formed Y in exchange for all of Y’s stock and cash that was borrowed from a bank, and Y later repaid the loan with funds received from X, and the cash received by the individual was treated as a dividend from X).

\textsuperscript{21} See Reg. §1.1502-33(b).
respect to the replicated E&P only if a similar allocation and tiering approach is adopted for EDAs.

We believe that, once consolidated EDA has been computed and allocated among the members, the amounts allocated to subsidiaries should tier up their corporate chains to the common parent in a manner that reflect the group’s economic interest in the EDAs. For example, in a simple structure where a subsidiary is wholly owned by a single, higher-tier member, and the subsidiary’s capital structure does not change, the subsidiary’s entire EDA should tier up to that shareholder. But, if the subsidiary has a single class of stock and a minority shareholder owns 20% of the outstanding stock, only 80% of the subsidiary’s allocated EDA should tier up the corporate chain.\(^22\) If a subsidiary actually makes distributions to a higher-tier member in an intercompany distribution, the distribution generally should have no impact on the shareholding member’s EDA. Instead, the subsidiary’s allocable EDA has already tiered up to the shareholding member when the EDA arose, and while the intercompany distribution would nominally further increase the shareholding member’s EDA, the increase should be immediately offset by the subsidiary’s corresponding EDA reduction also tiering up as a negative adjustment to the shareholding member’s EDA.\(^23\)

Much like an E&P account, an EDA is a general, corporate-level account that is not associated with any particular share of the corporation’s stock. Thus, as changes occur in the EDA balance, or in the corporation’s capital structure, the relationship between the EDA and each share of stock can shift. This raises issues as to whether rules are required to prevent shifting within a group.

Example: If S1 and S2, two subsidiaries in a consolidated group, form S3, by S1 contributing an appreciated asset and S2 contributing cash, S2 will have an interest in S3’s EDA resulting from the tax paid on gain from S1’s asset unless principles analogous to section 704(c) are adopted to specially allocate the EDA to S1. If S2 has a minority shareholder that has no interest in S1, failure to adopt these rules will permit EDA to be shifted to S2’s minority shareholder. Similar shifting can arise within a consolidated group in connection with the E&P and investment adjustment systems, and the current

\(^{22}\) The tiering process will become more complex as a subsidiary’s capital structure becomes more complex. Cf. Reg. §§1.1502-32(c)(2)(ii) (for investment adjustment purposes, “[i]f S has more than one class of common stock, the extent to which the adjustment . . . is allocated to each class is determined, based on consistently applied assumptions, by taking into account the terms of each class and all other facts and circumstances relating to the overall economic arrangement. The allocation generally must reflect the manner in which the classes participate in the economic benefit or burden (if any) corresponding to the items of income, gain, deduction, or loss allocated.”); 1.1502-33(b)(1) (incorporating the investment adjustment rules for E&P purposes).

\(^{23}\) Cf. Reg. §1.1502-33(b). Of course, if the subsequent distribution is disproportionate to the earlier tier up (e.g., if the higher-tier member and the minority shareholder own different classes of the subsidiary’s stock), the distribution can have a net effect on the shareholding member’s EDA because the amount that originally tiered up will not equal the amount of the distribution. This problem can be addressed by rules requiring the EDA amounts that have tiered up to be cumulatively redetermined to reflect the subsequent events. Cf. Reg. §1.1502-32(c)(4) (cumulative redeterminations for investment adjustment purposes).
regulations limit tax planning through vague anti-avoidance rules.\textsuperscript{24} Because the benefits of shifting EDAs can substantially exceed those of shifting E&P or investment adjustments, the current anti-avoidance approach might be inadequate, or more specific adjustments based on section 704(c) principles might be required.\textsuperscript{25}

More generally, any approach that replicates EDAs raises issues of whether the substantial benefits associated with EDAs can be adequately policed through the vague anti-duplication and anti-avoidance approach currently applicable to E&P.\textsuperscript{26} If additional rules are to be adopted, one system that might be considered would require the EDA/CREBAA events of higher-tier members to immediately “tier down” a corporate chain (i.e., reduce a comparable amount of EDA/CREBAA of each lower-tier member that contributed to the higher-tier EDA/CREBAA event). Note that this would be a fourth step in the EDA process (consolidated EDA is computed, is allocated, the allocated amounts tier up and then higher level payouts tier down to reduce lower tier EDA and prevent duplicative payout of EDA).

For example, if the common parent distributes EDA to its shareholders (or makes an election to increase shareholder basis and its CREBAA), the potential for future EDA duplication through lower-tier EDA distributions to minority shareholders can be minimized by immediately “tiering down” the common parent’s EDA decrease. If the common parent’s EDA event involves less than its entire EDA, the tier-down system will require stacking rules to identify the relevant lower-tier EDAs.\textsuperscript{27} Similarly, if a subsidiary distributes a disproportionate amount of its tiered up EDA to a minority shareholder, a negative adjustment should immediately tier up to the EDAs of higher-tier members to reflect the subsidiary’s reduction.

d. If Allocation is Pursued: Son of Mirror Issues Involving Tiering

To prevent the EDA equivalent of the consolidated return transaction commonly referred to as the “son of mirror” transaction (i.e., an individual purchases a target’s stock for an amount reflecting the fair market value of the target’s assets, the target distributes its EDA to the individual without income inclusion or stock basis reduction, and the individual then sells the stock for an amount equal to the original purchase price reduced by the distribution amount), the Proposal would apply §1059 in the separate return

\textsuperscript{24} See Reg. §1.1502-32(e)(2), Ex. 2. Comparable principles are incorporated into the consolidated return E&P rules. See Reg. §1.1502-33(b)(1), (f)(2), and (g).
\textsuperscript{25} To the extent that more accuracy is required for EDAs, and implemented through specific rules, consideration should be given to whether the new EDA rules should be incorporated into Reg. §§1.1502-32 and 1.1502-33. Cf. Reg. §1.1502-35T (apparently concluding that anti-avoidance rules were inadequate to address similar problems with loss duplication, but raising the question of whether stock basis shifting under Reg. §1.1502-35T(b) requires conforming E&P and EDA shifting associated with the original stock basis allocations).
\textsuperscript{26} Cf. Reg. §1.1502-33(a)(2) and (g).
\textsuperscript{27} Several issues must be considered in devising a stacking system. For example, should it make any difference if the various contributing subsidiaries have different minority shareholders?
context to all excluded distributions within the first year of stock ownership.\textsuperscript{28} Might taxpayers attempt to use the consolidated return EDA tiering system to circumvent this limitation?

**Example.** A consolidated group purchases all of a target’s stock on December 31, the target’s EDA tiers up to the common parent on the next day, the common parent immediately distributes this EDA to its long-term shareholders, and either the group sells the target’s stock (but not at a loss facilitated by the transaction), or the common parent’s shareholders receiving distributions sell their common parent stock (possibly at a loss facilitated by the transaction). It is unclear whether the results of these events require special adjustments. On the one hand, the EDA of the recently purchased target was withdrawn from corporate solution, and taxpayers might attempt to form “shell” consolidated groups to age their stock ownership beyond any applicable separate return section 1059 period.\textsuperscript{29} On the other hand, funds have not been withdrawn from the target (and any such withdrawal would be subject to a consolidated return negative investment adjustment), and the common parent’s shareholders have a long-term holding period.\textsuperscript{30}

This example illustrates how a corporation's acquisition of a large influx of EDA can facilitate the same sort of abusive facts that can derive from relatively short term ownership of stock. A limitation of excludable dividends to "normal" dividends as somehow defined would limit this abuse, as discussed above.

### 5. Subsidiary CREBAAs

We recommend that if CREBAAs are authorized by the legislation, then it will not be necessary to maintain them as to stock of consolidated group subsidiary members except to the extent a subsidiary with minority shareholders must maintain a CREBAA as to those shares.

EDAs generally do not carry over from one calendar year to another under the Proposal. Instead, undistributed EDA of a separate return corporation can increase shareholder basis in the corporation’s stock, and the EDA shifts to a CREBAA, measured as the cumulative excess of (i) basis increases, over (ii) CREBAA distributions. Distributions from the CREBAA are tax free to shareholders as distributions of deferred EDA, but reduce shareholder basis to effectively reverse the original CREBAA basis effect (although the shareholder receiving the dividend and reducing basis need not be the same shareholder that enjoyed the basis increase).

\textsuperscript{28} See S. 2, §202(c)(6), *Rules for Application of Dividend Exclusion and Retained Earnings Basis Adjustments*, 108\textsuperscript{th} Cong., 1\textsuperscript{st} Sess. (2003) (proposing new section 1059(g)).

\textsuperscript{29} Perhaps a minimum active trade or business requirement might be imposed in connection with any new section 1059 requirement. Cf. section 355(b) (imposing a 5-year active trade or business requirement for purposes of that section).

\textsuperscript{30} To the extent these consolidated return structures are problematic, perhaps the recently purchased EDA that tiers up to the common parent can be segregated for purposes of backstopping the applicability of section 1059 at the common parent’s level. This will then necessitate a stacking system to identify when any segregated common parent EDA is distributed relative to other common parent EDA.
Unlike separate return corporations, current law already adjusts the basis of consolidated group subsidiaries through an investment adjustment system. While the focus of CREBAA is limited to preventing double taxation of corporate earnings, the investment adjustment system is focused on more comprehensively achieving single entity treatment. Accordingly, the investment adjustment rules adjust the basis of subsidiary stock to reflect all changes in the subsidiary’s net, inside tax basis, whether attributable to its generation of income or loss, or to contributions and distributions with respect to the subsidiary.

The goal of EDAs and CREBAAs does not call into question the more comprehensive single entity approach of the current investment adjustment rules, and we do not believe that these rules need to be revised. Instead, we believe that the investment adjustment system eliminates any need for subsidiaries to maintain CREBAAs with respect to their stock owned by members for EDA derived from taxes paid in consolidated return years. Thus, a wholly owned subsidiary’s EDA would simply expire at the end of each calendar year. Not requiring subsidiaries to maintain CREBAAs might simplify the operation of the rules, and would eliminate any need to reconcile the investment adjustments for distributions with the timing lag that will exist before a subsidiary’s EDA/CREBAA arises. Of course, for those subsidiaries having minority shareholders, a CREBAA would have to be maintained for purposes of distributions to the minority because they are outside the investment adjustment system. By contrast, intercompany distributions within the group would continue to adjust stock basis under the currently applicable rules.

6. Leaving a Consolidated Group

We recommend that the current regulations on when and how a departing member takes E&P out of the group be adapted to EDA/CREBA.

When a subsidiary leaves a consolidated group, the replication of E&P that results from the consolidated return tiering system creates the potential for E&P to be duplicated outside the consolidated group. Viewing the subsidiary’s departure as essentially a divisive asset transfer outside the group, rather than the departure of a pre-existing separate entity, the current consolidated return E&P rules prevent duplication by generally eliminating the departing member’s E&P to the extent that it has tiered up into other group members. It generally does not matter whether the subsidiary leaves in a

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31 See Reg. §1.1502-32.
32 This is also consistent with the Treasury’s description, which envisions that the current investment adjustment system supercedes CREBAAs.
33 The issues raised by subsidiary stock shifting in and out of a group are addressed below.
34 If a minority position in subsidiary stock develops at some point after the subsidiary has already been in the group, but CREBAAs are not maintained, it will be necessary to reconstruct the subsidiary’s CREBAA. This issue should be uncommon because we believe that few subsidiaries will have minority shareholders.
36 See Reg. §1.1502-33(e)(1). Treating a subsidiary’s departure as an asset disposition is inconsistent with many aspects of the subsidiary’s departure. See, e.g., Reg. §§1.1502-21(b) (allocation of any contribution to a consolidated net operating loss); 1.1502-32 (maintenance of any inside/outside basis disparities).
taxable or tax-free stock disposition, in a tax-free asset reorganization, or the group’s ownership of the subsidiary is simply diluted below the 80% interest required to maintain affiliation. Exceptions are provided for the acquisition of an entire group by another consolidated group (in which case there is no duplication outside the original consolidated group, but instead the entire group has relocated), and for certain divisive reorganization transactions for which the Code requires E&P to be allocated.  

A subsidiary’s departure from a consolidated group raises analogous issues as to the proper allocation of consolidated return year EDA/CREBAA to which the subsidiary has contributed. Adhering to the E&P rules for wholly owned subsidiaries would generally result in the group retaining the subsidiary’s entire contribution to the group’s accounts, with exceptions for certain divisive reorganizations. Allowing the group to retain the subsidiary’s EDA contribution is very compelling with respect to the disposition of subsidiary stock or assets in exchange for cash (or other property), because the effects of the transaction are similar to a simple asset sale by the group as a single entity. Keeping a departing subsidiary’s EDA within the group also addresses some of the problems created by timing disparities. A subsidiary’s activities during the two-year consolidated return period preceding its departure will not generate EDAs until after its departure. By having the original group be responsible for filing the relevant tax returns that include the subsidiary’s activities, and retain the related EDAs, as well as control subsequent audit adjustments, the various tax interests will not be divided between two taxpayers.

37 See Reg. §1.1502-33(e)(2) and (e)(3). The principal divisive transaction is a distribution subject to section 355 (and equivalent section 356 distributions), with respect to which E&P is allocated under Reg. §1.312-10. See also Reg. §1.312-11 (additional E&P allocation rules). Numerous anomalies exist because the separate return E&P rules do not envision the E&P tiering system of the consolidated return regulations. Additional exceptions are provided for certain specialized Code rules that use E&P for computations unrelated to characterization of distributions as dividends. See Reg. §1.1502-33(e)(4).

38 Leaving a consolidated group generally terminates the target’s taxable year. See Reg. §1.1502-76(b). We have assumed that a mid-calendar year termination of the subsidiary’s year on leaving the group should not cause expiration of the subsidiary’s EDA unless a comparable mid-year reorganization transaction described in section 368(a)(1) also causes the subsidiary’s EDA to expire by reason of the year ending under section 381(b)(1). Therefore, a consolidated return rule that eliminates these accounts will diverge from the comparable reorganization rules.

39 The E&P exceptions also appear appropriate for EDA/CREBAA purposes. For example, the group’s CREBAA corresponds to shareholder-level stock basis adjustments, and these stock basis adjustments will be allocated under section 358 between the stock of the common parent and a departing subsidiary following a distribution by the common parent under section 355 (or equivalent section 356 distribution). If a subsidiary is the distributing corporation (e.g., the split-off of a lower-tier subsidiary stock, in redemption of the distributing subsidiary’s minority shareholders), special rules will be required to ensure that the distributing subsidiary’s CREBAA is properly reconstructed and allocated to the lower-tier subsidiary.

40 If, as described earlier, subsidiaries do not maintain CREBAAs for consolidated return year taxes paid, a subsidiary’s departure from the group would only affect its current year EDA that tiers up to the common parent.

41 Of course, economic interests will not be aligned with tax interests if the subsidiary remains responsible for paying prior period deficiencies after it has left a group, but the resulting EDA inures to the selling group’s benefit.
The circumstances might be less compelling if the subsidiary’s stock is exchanged for a nonmember acquirer’s stock (whether a taxable or tax-free disposition), because a new shareholder relationship is created.\(^{42}\) In this latter case, there are multiple possible future distributions with respect to the subsidiary that might produce double taxation—the subsidiary’s distributions to the acquiror, the acquiror’s distributions to the group, and the group’s distribution of the acquiror’s stock. If only one distribution can be tax free, which distribution is most compelling?\(^{43}\) To the extent that the EDA/CREBAA rules diverge from the E&P rules, anomalies will arise and might require reconsideration of the E&P rules. Moreover, consideration should be given to the level of communication that realistically can be required between a selling group and the subsidiary in order to address the ordinary course timing disparities between the subsidiary departure and its consolidated return year activities subsequently generating EDAs.

The existing E&P rules represent a combination of single entity and anti-duplication principles, and respond to certain “dividend stripping” strategies that taxpayers had developed.\(^{44}\) If the EDA/CREBAA rules compel a different balance, it is not clear how the E&P rules can be conformed while continuing to address inappropriate tax planning.

### 7. Entering a Consolidated Group

Some corporations will enter a group with SRY EDA/CREBAA. Rules applicable to these can parallel E&P rules in some ways, but must diverge in others.

Because we believe that members leaving a consolidated group generally should not carry their consolidated return year EDA/CREBAA to subsequent separate return years (as described above), special rules for EDA/CREBAA carried into a group by new members should generally arise only if the new member had previously been an independent corporation or the new member’s entire consolidated group is acquired.

Under the current consolidated return E&P rules, if a target joins a consolidated group with E&P accumulated in a separate return year (“SRY”), and subsequently distributes the E&P within the group, the E&P is effectively eliminated in most cases. Although the post-acquisition distribution increases the shareholding member’s own E&P, the target reduces its E&P and the consolidated return rules tier this reduction up to the shareholder to generally offset the increase. Implicit in these rules is an assumption that consolidated E&P generally should not be affected by intercompany distributions. Instead, the group takes the proper amount of E&P into account as it is earned, and the proper amount has

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\(^{42}\) Similar issues arise if the group retains shares of the subsidiary’s stock.

\(^{43}\) *Cf. Adobe Resources Corp. v. U.S.*, 967 F.2d 152 (5th Cir.), *reh. denied*, 975 F.2d 1119 (5th Cir. 1992) (a “reverse acquisition” under Reg. §1.1502-75(d)(3) resulted from the consolidation of two common parents, Old Adobe and Madison, where Madison owned 29% of Old Adobe’s common stock before the transaction, and in testing for a reverse acquisition, the value of the Old Adobe stock held by Madison was attributed to the Old Adobe shareholders, other than Madison, as if Madison had distributed the Old Adobe shares to its shareholders before the consolidation—in effect the Old Adobe was given the credit for its own operating assets).

\(^{44}\) For prior approaches to preventing inappropriate E&P planning, *see, e.g.*, former Reg. §§1.1502-32(g) and (k) (1995); 1.1502-32T (1995).
already tiered up within the group by the time of any intercompany distributions. Thus, intercompany distributions are mere asset restructurings within the group, rather than a source of new E&P.\textsuperscript{45}

The E&P effects of the target’s post-acquisition distributions are effectively equated with the shareholder’s recovery of the purchase price for a target’s stock. For administrability reasons, no distinctions are drawn between target stock acquired in exchange for cash, and stock acquired in exchange for newly issued acquirer stock. The only exception applies to distributions of target E&P accumulated in a SRY that is not a separate return limitation year (“SRLY”), and permits this target E&P to tier up to the group by blocking the target’s own E&P reduction from tiering up to the extent of the SRY/non-SRLY E&P.\textsuperscript{46} Thus, a target’s distribution of this E&P can increase higher-tier E&P. Implicit in this exception is that the group has really generated this E&P, but because the affiliate’s E&P did not tier up into the group as yet because it arose in a SRY. Accordingly, an actual distribution should increase the group’s E&P because it will be the first opportunity for the group to reflect this E&P.\textsuperscript{47}

A target might also join a group with EDA/CREBAA from a SRY.\textsuperscript{48} Although we do not believe that subsidiaries will need to maintain CREBAA for distributions to higher-tier members with respect to consolidated return year taxes paid, we do believe that they should maintain their SRY EDA/CREBAA for taxes paid elsewhere. If the target makes no distributions while in the group, and later leaves the group, it should carry its SRY EDA/CREBAA to its subsequent SRYs.\textsuperscript{49} To the extent the target makes distributions while in the group, the appropriate treatment might vary with the circumstances. For example, if the target’s stock is acquired in exchange cash, the target’s post-acquisition distributions will reduce its own SRY EDA/CREBAA, but perhaps should not increase the group’s EDA/CREBAA (i.e., the subsidiary’s reduction should tier up and offset the shareholder’s increase).\textsuperscript{50} By contrast, if the target’s stock is acquired in exchange for newly issued stock (whether a taxable or tax-free acquisition), the target’s post-acquisition distributions could increase the group’s EDA/CREBAA (i.e., the subsidiary’s reduction should not tier up) because the target represents a new source of assets for the group and the SRY EDA/CREBAA should not be eliminated. Thus, if the group

\textsuperscript{45} These generally applicable consolidated return principles are enhanced with respect to targets acquired from a prior consolidated group because, as discussed above, these targets generally do carry E&P from the prior group.

\textsuperscript{46} See Reg. §1.1502-33(b)(2).

\textsuperscript{47} By contrast, if the stock of a target is acquired in exchange for existing group assets, the target’s distributions might simply replenish the assets used in the purchase and therefore might already be reflected in the group’s E&P.

\textsuperscript{48} Entering a consolidated group generally terminates the target’s taxable year. See Reg. §1.1502-76(b). We have assumed that a mid-calendar year termination of the target’s year on joining the group should not cause expiration of the target’s EDA unless a comparable mid-year reorganization transaction described in section 368(a)(1) also causes the target’s EDA to expire by reason of the year ending under section 381(b)(1).

\textsuperscript{49} In fact, the target’s original shareholders might retain some amount of target stock, and the EDA/CREBAA should be maintained for purposes of distributions with respect to these retained shares.

\textsuperscript{50} As under the E&P rules, these distributions might be considered simply a recovery of the stock purchase price, and therefore the group’s existing EDA/CREBAA already appropriately reflects these assets.
redistributes the target’s funds with respect to stock issued in the acquisition, to the
target’s original shareholders, these shareholders would achieve the same tax-free
treatment they would have enjoyed from a pre-acquisition distribution by the target.\textsuperscript{51}

Any additional rules to preserve SRY EDA/CREBAA will diverge from the comparable
rules for SRY E&P, and the resulting disparities are likely to produce anomalies. The
existing E&P rules reflect historic balances between accuracy and administrability, but
the additional need for precision created by the EDA rules might alter the historic
balance. Any additional precision for SRY EDA/CREBAA is likely to warrant
conforming the E&P rules.

8. Shifting Ownership Within a Consolidated Group

Maintaining subsidiary level EDA/CREBAA accounts will necessitate special rules
applicable to shifting ownership within a group.

A member can change its location within a group, and the percentage of its ownership by
other members can change (e.g., as the result of a sale, issuance, or redemption of its
stock). Numerous consolidated return rules are designed to prevent these events from
having a significant effect on the E&P of a group.

If the common parent of a group changes, but the group does not terminate, the E&P of
the new common parent must be adjusted to reflect the E&P of the former common
parent.\textsuperscript{52} A similar “group structure change” rule appears necessary to similarly reflect
the former common parent’s EDA/CREBAA in the new common parent.

If the location of a member within a group changes, or its percentage ownership in a
particular chain changes, appropriate adjustments must be made to the E&P of the
members to prevent the E&P from being eliminated.\textsuperscript{53} For example, if a holding
company is interposed between a subsidiary and its shareholding member in an
intercompany section 351 transaction, the holding company’s E&P must be adjusted to
reflect the subsidiary’s E&P from consolidated return years. On the other hand, if
another member purchases the subsidiary’s stock in a cross chain sale in exchange for
cash, the purchaser’s E&P is not adjusted. While similar rules appear necessary to reflect
the subsidiary’s EDA/CREBAA, completely paralleling the E&P rules will enable the
subsidiary’s EDA/CREBAA to tier up into a different higher-tier member that owned no

\textsuperscript{51} The results generally should conform to the results of a reorganization described in section 368(a)(1).
Similar issues arise if the group historically owns some amount of the target’s stock before it joins the
group. The target’s distribution of SRY EDA/CREBAA after it joins the group, with respect to the group’s
historically owned shares, might increase the group’s EDA/CREBAA to prevent elimination of the target’s
SRY EDA/CREBAA. This would equate distributions before joining the group with distributions after
joining the group.

\textsuperscript{52} See Reg. §1.1502-33(f)(1). For continuation of the group, see, e.g., Reg. §1.1502-75(d)(2) and (3). For
the basis of the stock of members following a restructuring, see Reg. §1.1502-31. Appropriate adjustments
must be made if the former common parent’s stock is not wholly owned by members immediately after the
restructuring. Any resulting circular stock ownership might require additional adjustments.

\textsuperscript{53} See Reg. §1.1502-33(f)(2).
interest in the subsidiary when the EDA/CREBAA arose, and might ultimately benefit minority shareholders of the other member. This might facilitate inappropriate EDA/CREBAA streaming to minority shareholders, but diverging from the E&P rules will also produce anomalies, as discussed above.

If a member’s relative interest in a subsidiary’s EDA/CREBAA changes (e.g., because the subsidiary issues, redeems, or recapitalizes shares), how should the change be taken into account for purposes of tiering up EDA? Should the change be given retroactive or prospective effect? Because a subsidiary’s EDA/CREBAA is a general, corporate-level account that is not associated with any particular shares of the corporation’s stock, the ability to shift its tiering up on a retroactive basis might be comparable to equivalent separate return shifting (depending on how separate return rules develop). Accordingly, it might be appropriate to take into account any changes in relative ownership on a retroactive basis. While this might facilitate inappropriate EDA/CREBAA streaming to minority shareholders, diverging from the E&P rules will also produce anomalies, as discussed above.

9. Miscellaneous

Numerous other transactions and circumstances that can arise in the consolidated group context will raise issues regarding the proper single/separate entity balance. Because the comparable E&P rules are not well developed and are generally irrelevant as a practical matter because there is generally a surplus of E&P throughout a group, little guidance exists under the current rules for resolving comparable issues with respect to EDAs/CREBAAs.

For example, if the common parent of a group liquidates, thereby terminating the entire consolidated group, it appears that all of the subsidiaries leave the group and their historic contributions to the former common parent’s E&P disappear rather than being carried to their separate return years. Should this result also apply for EDA/CREBAA purposes, essentially in the same manner as our recommendation for subsidiaries leaving a group that survives their departure, or should the former common parent’s EDA/CREBAA be reallocated to the surviving subsidiaries in some fashion? Presumably, any reallocation would compel a similar reallocation for E&P purposes as well.

54 Compare Reg. §1.1502-32(b)(1)(ii) (prospective application of mid-year changes, through application of the principles of Reg. §1.1502-76(b)) with Reg. §1.1502-32(c)(4) (cumulative redetermination).
55 See Reg. §1.1502-33(e)(1).
56 Note that, if a subsidiary liquidates into a higher-tier member under section 332, or is acquired by another member in an intercompany reorganization described in section 368(a)(1), the subsidiary’s termination generally causes the subsidiary to have a premature year-end. If a subsidiary in a fiscal-year group merges into another member at the close of business on December 31, should the merger cause the subsidiary’s year to end on December 31 for EDA purposes, even though the common parent’s taxable year, and the due date for the group’s return with respect to the common parent’s taxable year, is unaffected? Cf. Reg. §1.1502-21(b)(3)(iii) (disregarding short years created by such events for purposes of computing the carryover period for net operating losses). Because EDA arises on the filing of tax returns, rather than the closing of years, it is not clear that a subsidiary’s premature year-end will have a significant impact.
If more than one member owns a subsidiary’s stock, the consolidated return rules treat each member as owning the subsidiary’s stock owned by other members for specified Code purposes.\(^{57}\) As a result, the shareholders generally qualify for nonrecognition treatment under §332 on the subsidiary’s liquidation even if no member directly owns 80% of the subsidiary’s stock.\(^{58}\) By contrast, §337(c) generally limits the subsidiary’s own nonrecognition treatment to its distributions to a direct 80% shareholder. Despite the liquidating subsidiary’s recognition treatment, its liquidation under §332 is described in §381(a)(1) and raises the issue of how the subsidiary’s EDA/CREBAA should be inherited by the shareholders?\(^{59}\)

Where lower-tier members own the stock of higher-tier members (i.e., circular or cross ownership of stock), numerous issues arise regarding the operation of Code and consolidated return rules.\(^{60}\) Special rules might be required to clarify that EDAs/CREBAAs cannot be inflated or streamed to particular shareholders in these circumstances.

As subsidiaries move between consolidated groups, and previously filed returns are audited by the IRS or otherwise adjusted, consideration must be given to who should control the audit issues, and how the subsidiary’s change in circumstances should be taken into account. For example, which group should control an audit of the subsidiary’s taxes paid, and should generate the EDA if a deficiency is satisfied by the subsidiary while a member of another group? Should the resolution of this issue depend on any extent on which party bears the economic burden of any deficiency or enjoys the benefit of any refund? If a subsidiary becomes entitled to a refund with respect to activities in a consolidated group, but not until after it has joined a subsequent consolidated group, should any EDA limitation on the subsidiary’s refund be computed by reference to the prior or current group? Can anything be adopted as general guidance to limit the extent to which existing tax sharing agreements will be obsolete due to their failure to address these types of issues?

These are only a few of the challenging new consolidated return issues that will arise for administering EDAs and CREBAAAs. Because it is impossible to predict all of the new issues, consideration might be given to developing generic anti-avoidance rules, or

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\(^{57}\) See Reg. §1.1502-34.

\(^{58}\) The stock ownership requirements for the subsidiary’s affiliation under section 1504(a) generally conform to those for liquidations under section 332.

\(^{59}\) The same issue arises with respect to other tax attributes, but is only addressed with respect to amounts deferred under the intercompany transaction rules. See Reg. §1.1502-13(j)(9), Ex. 6 & Ex. 7. Cf. FSA 1998-445 (Dec. 1, 1993) (for purposes of applying section 381(c) in the context of a section 332 liquidation to which Reg. §1.1502-34 applies, “the acquiring corporation” can be more than one shareholding member).

\(^{60}\) For issues under the Code, see, e.g., Notice 94-93, 1994-2 C.B. 563 (addressing consequences of certain inversion transactions); Rev. Proc. 96-22, 1996-1 C.B. 662 and Notice 96-6, 1996-1 C.B. 358 (the government closed its study of General Utilities repeal announced in Rev. Proc. 94-76, 1994-2 C.B. 825, without any changes). For issues under the consolidated return rules, consider how the investment adjustment system under Reg. §1.1502-32 should operate.
Section 205: Treatment of S Corporations

1. General: the Proposal

Section 205 of the Proposal includes technical corrections to selected provisions of Subchapter S of the Code to coordinate the treatment of S corporations and their shareholders with other provisions of the Proposal: (1) flow through REBA treatment is provided by Proposal §205(a); (2) Proposal §205(b) prevents an S corporation from adding to its own EDA and CREBAA for the EDA and CREBAA flowed through to its shareholders; (3) however, an S corporation can pay out excludable dividends based on the applicable income taxes imposed for a taxable year the corporation was a C corporation.

Section 205(c) of the Proposal would amend §1366(f) of the Code to provide that items taken into account in determining the corporate level built-in gains tax under §1374 after conversion from C to S status would not pass through to the shareholders, thereby not resulting in double taxation at the corporate and shareholder level, as under current law, and the tax imposed by §1374 will no longer pass through to shareholders as a loss sustained by the S corporation. However, the net §1374 gain will generate E&P.

Section 205(d)(1) of the Proposal would repeal §1375 of the Code providing for a corporate level tax on excess passive investment income of an S corporation with earnings and profits for prior C years. Section 205(d)(2) of the Proposal would repeal §1362(d)(3) of the Code providing for the termination of S corporation status if a corporation with earnings and profits has excess passive investment income for three consecutive years.

The amendments to Subchapter S would be effective for taxable years beginning after December 31, 2002, consistent with the effective date of other provisions of the Proposal, except that taxes imposed by §1374 for any taxable year beginning before

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61 Cf. Reg. §§1.701-2(a) and (e) (different types of partnership anti-avoidance rules); 1.1502-32(a)(2) (modifications to investment adjustment rules to prevent duplicate adjustments); 1.1502-35T(c)(8) (modifications to loss duplication rules to preserve a single deduction for economic loss).

62 See Description of Revenue Provisions Contained in the President’s Fiscal Year 2004 Budget Proposal, prepared by the Staff of the Joint Committee on Taxation (JCS-7-3) (March 2003) (hereinafter the “Joint Committee Print”), p. 23. The transition from C to S raises a number of issues under the proposed legislation because of the delay in computing the EDA for C years: “For example, the applicable income taxes imposed (sic) shown on a return filed in the final year the corporation was a C corporation or the first year the corporation is an S corporation are taken into account in computing the EDA for years the corporation is an S corporation. Any tax imposed by reason of the LIFO recapture rules of section 1363(d) will be taken into account in computing the corporation’s EDA under the usual rules relating to the filing of returns and the payment of tax.” Id., p. 23, note 28. No amounts are added to EDA by reason of excludable dividends received by or basis adjustments allocated to an S corporation; these dividends and basis adjustments flow through to shareholders. Id., p. 23.

63 Joint Committee Print, p. 23, note 29.

64 Bill section 207(a).
January 1, 2003 would not be taken into account for purposes of the dividend exclusion and retained earnings basis adjustments for S corporation shareholders.\(^6^5\)

### 2. General Comments on the Impact of the Proposal on the Present Equilibrium of Choice of Entity

The enactment of the Proposal will favorably affect S corporations in the elimination of the passive income rules and of the double taxation of post-conversion built in gain. It will, however, profoundly impact the present state of equilibrium of choice of entity decisions. Currently, S corporations offer many of the same advantages as partnerships, including particularly flow through of losses (albeit distinguished by differing basis rules), with the signal drawbacks of (1) numerous owner limitations, (2) subjection to General Utilities repeal upon property distributions to shareholders, and (3) the C corporation taints that follow conversion to S status. Currently, S corporations offer a significant improvement over C corporation status, particularly for service businesses, due to the single level of taxation of income. Currently, S corporations offer a significant improvement over partnership status in their ability to engage in tax deferred reorganizations.

After enactment of the Proposal, the preference for S corporations as compared with C corporations would diminish considerably, as illustrated by the following charts.

**Example:** An individual taxpayer invests in a business entity, which is able to achieve earnings before income taxes of $100,000 per year during its first three years of existence, and then sells all of his or her stock in the corporation for $1 million (i.e., for ten times earnings) during its third year of existence. For simplicity, assume the basis of the stock begins at zero. Assuming that all ordinary income in this example would be taxed at a top corporate and individual marginal income tax rate of 35%, either as proposed in the Proposal or when the current income tax rate reductions are fully phased in, and that capital gains at the individual level would be taxed at 20%.

<table>
<thead>
<tr>
<th>RESULTS UNDER CURRENT LAW</th>
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<tr>
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<tr>
<td></td>
</tr>
<tr>
<td>Earnings before taxes</td>
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<tr>
<td>Less: Taxes (35%)</td>
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<tr>
<td></td>
</tr>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td>Less: Taxes (35%)</td>
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<tr>
<td></td>
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\(^6^5\) Bill section 207(b)(1).
<table>
<thead>
<tr>
<th></th>
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<th></th>
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<tr>
<td></td>
<td>1,000,000</td>
<td>1,195,000</td>
<td>1,000,000</td>
<td>1,195,000</td>
<td></td>
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<tr>
<td>Less: Taxes (20%)</td>
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<td>(200,000)</td>
<td>(200,000)</td>
<td>(239,000)</td>
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<tr>
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<td>800,000</td>
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<td>995,000</td>
<td>926,750</td>
<td>956,000</td>
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**Shareholder Summary**

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<td>126,750</td>
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<td>956,000</td>
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<tr>
<td>Total</td>
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<td>995,000</td>
<td>926,750</td>
<td>956,000</td>
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</tbody>
</table>

*a This is assuming that the purchaser is willing to pay an extra $195,000 for the stock, given that the entity has an additional $195,000 of after-tax retained earnings, and that stock basis increases $195,000 in the case of the S corporation with retained income.*
Under the Proposal, the tax consequences of these transactions would be the same, with certain exceptions, regardless of the choice of entity or the status of the corporation as a C corporation or S corporation.

### Results under the Proposal

<table>
<thead>
<tr>
<th></th>
<th>S Corp/LLC/Ptp.</th>
<th>C Corporation</th>
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<tbody>
<tr>
<td>Dividends Retained</td>
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<td>300,000 300,000</td>
</tr>
<tr>
<td>Less: Taxes</td>
<td>(105,000) (105,000)</td>
<td>(105,000) (105,000)</td>
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<tr>
<td></td>
<td>195,000 195,000</td>
<td>195,000 195,000</td>
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<tr>
<th></th>
<th>S Corp/LLC/Ptp.</th>
<th>C Corporation</th>
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<tr>
<td>Dividends Retained</td>
<td>195,000 195,000</td>
<td>195,000 195,000</td>
</tr>
<tr>
<td>Less: Taxes</td>
<td>0 0</td>
<td></td>
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<tr>
<td></td>
<td>195,000 195,000</td>
<td>195,000 195,000</td>
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<tr>
<th></th>
<th>S Corp/LLC/Ptp.</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Proceeds</td>
<td>1,000,000 1,195,000</td>
<td>1,000,000 1,195,000</td>
</tr>
<tr>
<td>Less: Taxes (20%)</td>
<td>(200,000) (200,000)</td>
<td>(200,000) (200,000)</td>
</tr>
<tr>
<td></td>
<td>800,000 995,000</td>
<td>800,000 995,000</td>
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<tr>
<th></th>
<th>S Corp/LLC/Ptp.</th>
<th>C Corporation</th>
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<tr>
<td>Total After-Tax Return</td>
<td>995,000 995,000</td>
<td>995,000 995,000</td>
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### Shareholder Summary

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<tr>
<th></th>
<th>S Corp/LLC/Ptp.</th>
<th>C Corporation</th>
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</thead>
<tbody>
<tr>
<td>Net Earnings</td>
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<td>195,000 0</td>
</tr>
<tr>
<td>Net Gains</td>
<td>800,000 995,000</td>
<td>800,000 995,000</td>
</tr>
<tr>
<td>Total</td>
<td>995,000 995,000</td>
<td>995,000 995,000</td>
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</tbody>
</table>

The above analysis does not take into account the additional complexities under the Proposal and the impact of the two-year delay between the incurrence of federal tax liability at the C corporation level and the offsetting tax benefit at the shareholder level, discussed in further detail below. However, this example does demonstrate that the Proposal would serve to reduce the disparity between S corporation and C corporation taxation, which would seem to be good tax policy.

The drawbacks of S corporation status as compared with partnership treatment will diminish, and the S corporation would retain its signal ability to engage in tax-deferred

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66 Differences may still arise because of the lower marginal rates available at the corporate and individual levels, and the fact that there is no 20% capital gains rate for C corporations, though the Bill would still serve to reduce arbitrary tax disparities in those situations also.
reorganizations. If the shareholder limitations were eased, then the S corporation, rather than being a narrowly crafted alternative single tax regime for small corporations, would become more of a planning alternative, just as the LLC is a planning alternative, for a larger group of businesses. It would permit selection of which single tax regime is desired: one that imposes the tax at the corporate level and allows no loss flow through, and one that imposes the tax at the shareholder level and allows loss flow through.

This level of electivity seems reasonable. There can be business reasons for wanting to operate in the corporate form, and retaining the ability to flow through losses in that form is appropriate. As discussed below, however, there can be abusive efforts to shift compensation to shareholder/employees into S corporation earnings that are not subject to the employment taxes or C corporation excludable dividends. The IRS already has experience dealing with these efforts in the S corporation arena and presumably will have to employ similar efforts in the EDA arena.

There is a concern that expanding the applicability of the S corporation regime would carry with it an inappropriate expansion of access to the reorganization rules, as contrasted with partnerships. Some have suggested that for that reason and others the S corporation regime should be ended, in favor of partnership taxation. Perhaps those issues can be avoided if the 75 shareholder limit is retained, but it seems an arbitrary way to determine how much electivity is acceptable in the system.


a. Clarify Distinction between EDA Received and EDA Generated by the S Corporation

Proposed §1368(f) apparently is intended to provide two separate rules to the effect that (1) EDA/CREBAA received from a separate C corporation do not create EDA/CREBAA accounts at the S corporation level, but (2) that because self generated EDA/CREBAA do create such accounts through the general application of §281 to all corporations, the normal distribution rules of §1368 should not apply. This subsection (f) is so elliptical, however, that its import can be hard to discern. Either the Proposal should be amended to clarify the intended results or accompanying explanations should do so.

Proposed §1367(a)(1)(D) of the Code appropriately provides that retained earnings basis adjustments passed through to an S corporation owning stock in a C corporation would also serve to increase the basis of the S corporation’s shareholders in their stock of the S corporation. Similarly, the excludable portion of dividends received by an S corporation from a C corporation should increase the adjusted basis of shareholders in their stock as a result of the operation of current §§1366(a)(1)(A) and 1367(a)(1)(A) of the Code, which provide that the basis of S corporation shareholders in their stock is increased by all “items of income (including tax-exempt income).” These events occur without adding to any corporate level EDA/CREBAA accounts according to proposed new Code §1368(f)(1)(A), which provides that the EDA and CREBAA “shall not apply to amounts received or allocated in a taxable year for which the corporation is an S corporation."
The following chart illustrates our best understanding of how an S corporation can generate or receive EDA and CREBAA, and the effects thereof:

<table>
<thead>
<tr>
<th>Source of EDA/CREBAA</th>
<th>S E&amp;P</th>
<th>Shr. St. Basis</th>
<th>S EDA/CREBAA</th>
<th>AAA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre S EDA</td>
<td>+</td>
<td>0</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Pre S CREBAA</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>0</td>
</tr>
<tr>
<td>Sec. 1374 EDA</td>
<td>+67</td>
<td>068</td>
<td>+</td>
<td>069</td>
</tr>
<tr>
<td>Received EDA</td>
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<td>+</td>
<td>0</td>
<td>070</td>
</tr>
<tr>
<td>Allocated CREBAA</td>
<td>0</td>
<td>+</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

b. **Section 205(a) of the Proposal -Retained Earnings Basis Adjustments for S Corporations Owning Stock in C Corporations and Basis Adjustments for EDA Dividends**

We recommend that §1368(e)(1)(A) be amended to provide that EDA received by the S corporation and passed through to shareholders also increase the AAA account. We understand that this was intended.

Current §1368(e)(1)(A) provides that “income (and related expenses) which is exempt from tax under this title” should not serve to increase the accumulated adjustments account at the S corporation level. This means that an S corporation with C corporation E&P and exempt income cannot distribute the exempt income, in effect, from the AAA (as return of basis or capital gain), but rather must distribute it as dividends from the E&P. This has always seemed to be a poor policy choice, blocking the flow through of the exemption and treating the S corporation like the C corporation, which cannot flow through exempt income.

The Joint Committee Report states that both EDA and CREBAA received by the S corporation will increase the AAA account. We are unsure how this will occur and recommend that the Proposal be clarified to reach this result.

c. **Distributions from EDA**

We recommend that the Proposal be amended to make clear that an S corporation's distribution from its EDA (1) be given primacy in the ordering of distributions, and (2) reduce the corporate E&P pro tanto, and if E&P is insufficient that it be treated as a distribution of EDA nevertheless. There does not currently appear to be any ordering rule

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67 Proposed §1371(c)(4).
68 Proposed §1366(f)(2) prevents pass through of the §1374 gain, and so apparently prevents an increase in shareholder stock basis under §1367.
69 Presumably AAA does not increase, because it is dependent on §1367.
70 The Joint Committee Report states that this amount will increase AAA. We do not believe that necessarily is the result under the Proposal.
or reduction of E&P in the Proposal. Absent a reduction of E&P for an EDA distribution, too much E&P will be left in the E&P account, thus tainting as taxable dividends more dividends than should be tainted.

A related problem derives from the fact that the S corporation will have E&P from its last C corporation year before it generates EDA from that year. Therefore it is conceivable that it could pay its E&P before it pays out its EDA. In such case a rule should provide that the distribution from EDA is nevertheless excluded.

According to the Joint Committee Print, the Proposal would adjust the priority ordering system for an S corporation with accumulated earnings and profits as follows: (1) An excludable dividend to the extent of EDA (which would derive from either C corporation years' EDA carried into the S years or to EDA attributable to §1374 tax); (2) Reduction of basis or recognition of gain to the extent of CREBAA (which would derive from the same two sources); (3) Reduction of basis or recognition of gain to the extent of the AAA; (4) Taxable dividend to the extent of accumulated E&P; (5) Reduction of shareholder basis; (6) Recognition of gain by the shareholders.

We believe that such a regime is necessary, as contrasted to putting such amounts into the AAA account, because it is necessary and appropriate to reduce E&P at the same time that the reduction of EDA occurs. Assuming this is the case, then it will be necessary to provide for such reduction specifically.

d. Section 205(c) of the Proposal -- Elimination of Double Taxation of Built-In Gains after Conversion from C to S Status

We suggest consideration of eliminating the §1374 tax at the corporate level.

Proposed new §1366(f)(2) of the Code provides that shareholders will not be required to pay tax on recognized built-in gain amounts that are taxed at the S corporation level under §1374 during the 10 year recognition period upon the conversion of a corporation from C to S status. This is consistent with the objective of the Proposal of eliminating the taxation of shareholders on income that has already been taxed at the corporate level.

This provision seems to be an adequate way in which to accomplish the “single tax” policy objectives of the Proposal. But it also has the consequence of retaining the only way an S corporation can owe income tax (after the repeal of the tax on excessive passive income). There is, however, a discontinuity that will result from proposed new §1371(c)(4) of the Code, which provides that earnings and profits would be increased immediately for recognized built-in gains, whereas the excludable dividend amount would not be increased correspondingly until two years later under the rules described above. This discontinuity could result in income taxed under the built-in gains tax rules inadvertently triggering additional income tax at the shareholder level when E&P is distributed prior to the expiration of the two-year lag. The issue is not unique in its

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71 Supra, note 62, pp. 23, 24.
72 Section 205(c)(2)(A) of the Bill appears to mistakenly refer to the new provision being added by that section as paragraph “(B)”, instead of “(4)”. 
impact on S corporations: under the Proposal E&P increases will accrue to C
corporations before the accompanying EDA becomes distributable.

The issue does, however, seem more easily correctible in the case of S corporations
because they are more amenable to elimination of the two-year lag for tax paid by S
corporations. This is discussed further below.

Another alternative would be to provide that an S corporation’s accumulated adjustments
account should be increased by the built-in gains recognized at the corporate level (and
decreased by the corresponding tax), and by the EDA from pre-S corporation years as
well as EDA and CREBAB received by the S corporation from other corporations, rather
than creating a whole new EDA distribution tier as described above. In the large majority
of circumstances, this approach would achieve results similar, if not identical, to the
results of the more complicated distribution scheme contemplated by the Proposal. Thus,
both taxpayers and the IRS would much more easily administer this approach, without
sacrificing any significant policy considerations.

Undoubtedly, consideration has been given to simply repealing the §1374 built-in gains
tax. We suggest that if the facts are that little revenue is generated by that tax, then repeal
should receive more consideration. The tax does have the advantage of administrative
ease of collection, but given that the expressed policy of the dividend exclusion
provisions of the Proposal is to make sure that corporate earnings are taxed once, and
only once, elimination would achieve that result. The only difference beside
administrability then would be that the tax would be imposed at the individual level,
rather than at the corporate level, with the result being that the passed through income
would frequently be §1231 income, which would qualify at the shareholder level for the
capital gains rate. Although it would be most desirable to eliminate the complexity of
§1374, if this avenue of potential tax reduction were thought to be abusive, the definition
of the tainted C corporation gain of current §1374 could be retained for purposes of
excluding it from capital gain treatment at the shareholder level. If that were done,
however, most of the simplification would be lost.

4. Rationale for Recapture of LIFO Benefits Upon Conversion to S
Status no Longer Applicable.

We recommend repeal of the LIFO recapture upon the S election.

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73 This would be consistent with the special transitional rule for built-in gains tax imposed on S
corporations set forth in new §281(d)(1)(B)(iii) of the Code. In contrast to the general “applicable income
tax” transitional rule for C corporations contained in §281(d)(1)(B)(i), which provides that taxes imposed
for all taxable years ending on or after April 1, 2001 would count under the new regime, §281(d)(1)(B)(iii)
provides that §1374 recognized built-in gains subject to tax at the corporate level would not give rise to
excludable dividend amounts unless imposed with respect to taxable years beginning on or after January 1,
2003. These contrasting transitional rules make it clear that the “rough justice” achieved through the two-
year look-back system, while possibly appropriate for C corporations, can be more directly and currently
achieved in the S corporation context by making all adjustments on a current basis.
Section 1363(d) of the Code presently requires the acceleration and taxation of deferred LIFO income on the final C corporation return of a corporation that elects S status. In certain circumstances, the actual tax due may be paid in four installments.\textsuperscript{74} The rationale for this provision is that the income deferred under the LIFO rules during the C corporation period should be taxed at the corporate level, rather than taxed to the shareholders under the S corporation regime after the election becomes effective (which might mean the LIFO layer would never be taxed until the business was sold).

However, the net effect of the Proposal would be to eliminate the double taxation of income earned at the corporate level. Such income would be taxed once, and only once, regardless of whether the corporation was a C corporation (corporate level tax) or S corporation (shareholder level tax) and regardless of whether the income was retained or distributed. Thus, the conversion from C corporation status to S corporation status would no longer seem to be an appropriate event on which to trigger the recapture of tax benefits or tax deferral otherwise allowable or permitted under the Code. If it were, then application of the Proposal to C corporations would also, arguably, be an appropriate reason to accelerate their LIFO reserves.

E. Foreign Provisions

1. Description of Proposal

a. Outbound Investment – Treatment of Foreign Taxes

The foreign tax credit allowable to a domestic corporation does not reduce the amount of the applicable income tax of the corporation. Thus, to the extent the foreign tax credit is allowable, foreign taxes of a domestic corporation are treated as taxes paid for purposes of computing the EDA.\textsuperscript{75} The EDA for any calendar year is determined without regard to a reduction in the foreign tax credit for a prior calendar year.\textsuperscript{76}

b. Inbound Investment – Treatment of Foreign Investors

Foreign individual and corporate shareholders are not permitted to exclude dividends and do not adjust the basis of stock for retained earnings.\textsuperscript{77} Distributions from a CREBAA are subject to U.S. withholding taxes and presumably do not affect the basis of the foreign shareholder in the stock of the corporation.\textsuperscript{78}

c. Distributions from Foreign Corporations

Foreign corporations can generate EDA, which is only derived from the tax on taxable income effectively connected with the conduct of a U.S. trade or business ("ECI"), which tax is also netted against the deemed income to derive the EDA.\textsuperscript{79} The fully taxed

\textsuperscript{74} Code Section 1363(d)(2).
\textsuperscript{75} Proposed section 281(d)(1)(A); JCT Description at 21.
\textsuperscript{76} Proposed section 285(c)(2).
\textsuperscript{77} Proposed section 285(b)(1) and (2); JCT Description at 22.
\textsuperscript{78} Proposed section 285(b)(3).
\textsuperscript{79} JCT Description at 21.
earnings amount is not derived from, and the foreign corporation does not subtract in computing its EDA, the following taxes: branch profits tax imposed by §884 ("branch tax"),
\(^{80}\) tax under §881 on dividends which, if received by a domestic corporation, would be excludable,\(^ {81}\) and tax under §881 on distributions out of CREBAA.\(^ {82}\) No credit is allowed for foreign taxes paid, or deemed paid under section 902 of the Code, with respect to any excludable dividend or distribution out of CREBAA.\(^ {83}\)

A foreign corporation is not entitled to exclude dividends received, which will therefore remain subject to U.S. withholding tax. However, the foreign corporation's EDA is increased by otherwise excludable dividends, and distributions from a CREBAA, in excess of any U.S. withholding tax.\(^ {84}\)

The E&P of a foreign corporation is increased by excludable dividend distributions that the foreign corporation receives and distributions made out of a CREBAA.\(^ {85}\) The E&P is not increased by allocable amounts of retained earnings that would increase the basis of stock owned by a domestic corporation.\(^ {86}\)

2. Discussion

a. Nomenclature

In the discussion that follows, we will sometimes use examples. In those examples, A is a U.S. citizen, USCo is a U.S. corporation, and Forco is a foreign corporation. The time lag built into the calculation of the EDA is ignored.

b. Outbound Investment – Treatment of Foreign Taxes

We support the proposed treatment of foreign tax credits.

Example: A owns all of the stock of USCo, which, in turn, owns all of the stock of Forco. Forco earns 100, on which it pays foreign tax of 30, and distributes the remaining 70 to USCo. USCo pays residual U.S. tax of 5 and distributes the balance, 65, to A. None of Forco's income is subpart F income. There are no other relevant transactions. USCo's EDA is calculated as follows: USCo received a dividend of 100 from Forco, after the gross-up required by section 78. USCo's applicable income tax is 35, which is the U.S. tax that USCo would have paid on this dividend in the absence of the credit allowable by sections 901 and 902.\(^ {87}\) USCo's fully taxed earnings amount is 100, i.e., 35 divided by

\(^{80}\) Proposed section 285(a)(1)(A).
\(^{81}\) Proposed section 285(a)(1)(B).
\(^{82}\) Id.
\(^{83}\) Proposed section 285(c)(1).
\(^{84}\) Proposed section 285(a)(2)(A); JCT Description at 21. The proposed statutory language does not specifically refer to U.S. withholding tax.
\(^{87}\) Proposed section 281(d)(1)(A). The result would be the same if Forco had paid foreign tax on subpart F income, because the credit allowed by section 960 is treated as a credit under section 902 and section 901.
USCo's EDA is 65, i.e., its fully taxed earnings amount (100) minus its applicable income tax (35). A therefore excludes the entire dividend, the same as if USCo had earned the income in, and paid tax to, the United States.

This is a change from the recommendations originally made by Treasury in the 1992 Report. We understand the concerns of the 1992 Report, but find it hard to justify denial of the use of the credit on conceptual grounds. The principal argument in the 1992 Report against counting foreign taxes in calculating EDA is that the United States should not cede all taxing jurisdiction to the source country. However, the United States has long ceded jurisdiction to the source country to impose primary tax on the underlying earnings, in that the foreign tax credit has long been allowed against U.S. tax. In theory there is no reason why the United States should reclaim a portion of that jurisdiction merely because the United States no longer imposes secondary tax on distributions in a purely domestic setting.

We do not view treaty negotiation on this point as an appropriate alternative, because the provision benefits U.S. shareholders and should be within the sovereign jurisdiction of the United States to decide. Treaty negotiations, on the other hand, usually address who is to be treated as a resident of a country and how one country's residents are taxed by another. However, we recognize that there are practical concerns and competing principles. The addition of the U.S. corporate income tax that has been offset by foreign tax credits as a source of EDA will greatly expand the amount of EDA available for distribution tax free to shareholders, and thus increase the cost of the Proposal, and effectively increase the universe of income as to which the U.S. cedes primary taxing authority.

Other corporate level "benefits," such as interest income exempt because paid on municipal bonds, do not currently pass through to shareholders, i.e., taxable dividends can be paid from municipal bond interest, in effect, because such interest adds to E&P. If that principle were applied here it would support payment of taxable dividends without regard to the corporate level "payment" for a benefit. We believe that in the vast majority of cases the addition of municipal bond interest to E&P is not a "cause" of shareholder dividend taxation, whereas failure to take into account federal income tax that is offset by the foreign tax credit in calculating EDA will be a "cause" of significant shareholder dividend taxation. Because failure to pass through the credit as EDA would retain a bias in favor of unincorporated entities doing business abroad and is logically inconsistent, we approve the choice made, deferring to the Congress to decide if this provision is affordable.

It appears that the Proposal could change the circumstances in which U.S. corporations claim a credit rather than a deduction for foreign taxes, making it desirable to claim a credit in excess credit cases.

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88 Proposed section 281(c)(1).
89 Proposed section 281(b)(1).
91 1992 Report at 77-78.
Example USCo earns 200 of income in country X, on which it pays 100 of tax to country X, and has a loss of 100 in country Y. If these transactions are taken on a stand-alone basis, then, under existing law, USCo may be indifferent to whether it claims a deduction or a credit for the taxes paid to country X. If USCo claims a deduction, it has net income of zero from operations in countries X and Y. If it claims a credit, it has net income of 100 from these operations and creditable foreign tax of 100, but the credit is limited to 35, and there is no residual U.S. tax.\(^{92}\) Whichever choice USCo makes, there is no change in its E&P. The tax paid to country X reduces USCo’s E&P whether it is credited or deducted.\(^{93}\) Results under the Proposal: If USCo claims a deduction for the foreign taxes, there is no change from current law in either its E&P or its EDA (zero). If USCo claims a credit for the taxes paid to country X, there similarly is no change in USCo’s E&P from current law (zero), but USCo would calculate the effect on its EDA as follows: USCo has applicable income tax of 35, i.e., the U.S. tax, before foreign tax credit, on net income of 100 (200 - 100); USCo has a fully taxed earnings amount of 100, i.e., applicable income tax (35) divided by maximum corporate tax rate (35%); USCo increases its EDA by 65, i.e., fully taxed earnings amount (100) minus applicable income tax (35). Thus, under the Proposal, if USCo claims a credit, its EDA is increased by 65, even though there is no increase in its E&P. This is attributable to the fact that, when USCo claims a credit, the excess foreign tax paid of 65 is ignored in calculating the EDA in contrast to the E&P calculation. On these facts, the EDA would have no immediate benefit to USCo’s shareholders, since USCo would have no E&P from which to pay a dividend. However, USCo could carry over the EDA to the next year.\(^{94}\)

On other facts, the EDA might produce an immediate benefit. If USCo had other income on which it did not pay full tax, the excess EDA from the foreign transactions would enable USCo to pay excludable dividends to its shareholders.\(^{95}\)

We note one incongruity in the potential operation of the foreign tax credit rule. A U.S. corporation that pays foreign taxes gets EDA credit for those taxes, but a foreign corporation that pays foreign taxes does not get EDA credit for those taxes. Thus, assume foreign corporation F pays foreign taxes at a 35% rate. It could drop all its foreign businesses into a U.S. subsidiary corporation D. D would pay the same foreign taxes that F had paid, in theory D would not owe any U.S. tax because of the foreign tax credit, and D could pay (foreign source) dividends to F without U.S. withholding tax. F would have EDA because D's foreign taxes count for this purpose. Thus, F could now pay tax-exempt EDA dividends to its U.S. shareholders, while it could not do so before.

\(^{92}\) In actuality, USCo would not evaluate the transactions on a stand-alone basis. Relevant additional circumstances would include whether USCo had an overall foreign loss under section 904(f) and whether it had low-taxed foreign income from other sources which could absorb the excess credit for country X tax. All other considerations being equal, USCo would presumably claim a credit in order to carryover of excess foreign tax credits to future years.

\(^{93}\) Bittker & Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.03[6], footnote 113 (7th ed. 2000).

\(^{94}\) Proposed section 281(b)(2).

\(^{95}\) An example would be income subject to a deduction for depreciation. Accelerated depreciation might be allowable in computing taxable income but would not be allowed in computing E&P. Section 312(k).
A few other comments about the treatment of foreign taxes may be helpful. Section 904 sets up a complex system of baskets into which foreign taxes are placed. At least on a preliminary review, it does not appear that any special provisions are required in the dividend exclusion rules to take account of these baskets. We agree that if creditable foreign taxes are to be treated the same as U.S. tax, the type of income on which such foreign taxes were paid does not seem to matter.

There is no proposed conforming amendment to §§861 and 862, relating to the source of income, and we agree that no such amendment is required. The foreign tax credit limitation is based upon taxable income. Since excluded dividends are excluded from gross income, they will not affect taxable income. Under the Proposal, EDA for any calendar year is determined without regard to a reduction in the foreign tax credit for a prior calendar year. This rule is justified by administrative convenience. Presumably, if the corporation pays additional foreign taxes, these will be included in applicable income taxes in the formula for computing EDA.

c. Inbound Investment – Treatment of Foreign Investors

We suggest reconsideration of the treatment of foreign shareholders.

Under the Proposal, foreign individual and corporate shareholders are not permitted to exclude dividends. Thus, U.S. withholding tax will apply to such dividends unless eliminated by treaty. We question this proposed treatment and recommend that the full benefits of dividend exclusion be extended to all foreign shareholders.

We understand that, in theory, the benefit can be extended by treaty, as the 1992 Report indicated in saying that the benefits of integration should be extended only on a country-by-country basis as treaties are negotiated. However, on at least two occasions in the past, the exemption of trading gains in 1966 and the enactment of the portfolio interest exemption in 1984, Congress unilaterally extended important benefits to inbound investors. Where a broad scale exclusion is being provided to domestic shareholders this would seem an appropriate occasion to make a uniform decision as to foreign shareholders, rather than leaving the matter to the cumbersome treaty process, which provides no assurance that broad-based benefits will be available in any reasonable time frame. Furthermore, an important goal of the Proposal as a whole is to make more uniform the taxation of returns earned on alternative financial instruments, particularly debt and equity. Providing disparate treatment for inbound debt and equity

96 Section 907 has a similar effect for foreign oil and gas income.
97 Section 904(a).
98 Proposed section 116(a).
100 Sections 864(c)(2)(A)(ii) and (B)(ii) of the Code, which were enacted by the Foreign Investors Tax Act of 1966, exempt gains from trading in stocks, securities, and commodities for the taxpayer’s own account. The Taxpayer Relief Act of 1997 further liberalized the relief for trading in stocks or securities for the taxpayer’s own account by repealing the principal office rule applicable to certain foreign corporations. The portfolio interest exemption is embodied in sections 871(h) and 881(c) of the Code, which were enacted by the Deficit Reduction Act of 1984.
investments contravenes this goal.\textsuperscript{102} On the other hand, we do note that Congress has recently reemphasized its expectation that reduction of the withholding tax by treaty will be done only after careful scrutiny. We are uncertain whether that caution extends to this area.

We are not in a position to evaluate the arguments that economists have made as to the relative importance of capital export neutrality and capital import neutrality.\textsuperscript{103} However, any measure to promote the free flow of capital would seem to be in keeping with the overall principles of the Proposal as well as with the lessons of experience, for example, as to the interest equalization tax.\textsuperscript{104}

d. Distributions from Foreign Corporations

Under the Proposal, while foreign corporations will maintain an EDA, special treatment is prescribed for branch tax and tax imposed on dividends by §881. If our recommendation to extend the benefits of dividend exclusion to foreign shareholders is adopted, then the branch tax would be modified or eliminated, since the branch tax is a surrogate for the tax that would be paid under §881 on a distribution by a U.S. subsidiary.\textsuperscript{105}

Example: A owns all of the stock of Forco, a country X corporation. Forco has ECI of 100. Forco has effectively connected earnings and profits (“ECEP”) and a dividend equivalent amount of 65 under section 884.\textsuperscript{106} Forco pays corporate tax of 35 and, under the country X treaty, branch tax of 3.25,\textsuperscript{107} leaving it with a net amount of 61.75 which it distributes to A. Forco’s EDA is calculated as follows: Forco’s applicable income tax is 35. Applicable income tax does not include branch tax, because section 884 of the Code is not one of the sections enumerated in section 281(d)(1)(A). Forco's fully taxed earnings amount is 100, i.e., 35 divided by 35%. Forco's EDA is 61.75 (100 [fully taxed - 50 -

\textsuperscript{102} The 1992 Report says: “[T]o ensure parity between debt and equity, the CBIT [dividend exclusion] prototype generally removes the withholding tax on both dividends and interest of CBIT entities and repeals the branch profits tax. The result is that both debt and equity income would be subject to tax only once.” 1992 Report at 80. However, in light of other statements in the 1992 Report, the import of the quoted language is unclear.

\textsuperscript{103} The 1992 Report at 75 offers a succinct and well-written discussion, but one that can be fully understood only by someone with a background in economics. See also Reuven S. Avi-Yonah, \textit{Back to the 1930s: The Shaky Case for Exempting Dividends}, 97 TAX NOTES 1599, 1603 (Dec. 23, 2002) (the United States can and should abolish U.S. withholding taxes on dividends).

\textsuperscript{104} An article from the \textit{Wall Street Journal} which was placed in the Congressional Record by Senator Daniel Moynihan described the interest equalization tax as an "ill-fated experiment" which was accompanied by "a baroque set of regulations." See \textit{Moynihan Weighs In Against Securities Transfer Tax}, TAX NOTES TODAY (Aug. 2, 1990).

\textsuperscript{105} E.g., Bittker & Eustice, supra, ¶ 15.04[2][a]; Feingold & Berg, "Whither the Branches?" \textit{44 Tax Law Rev.} 205, 207-08 (1989). Conforming changes would also be made to section 881.

\textsuperscript{106} Section 884(b) adjusts ECEP by increases or decreases in U.S. net equity to arrive at the dividend equivalent amount. This is designed to replicate the amount which a U.S. subsidiary would have distributed as a dividend, after any reinvestment which the subsidiary made in its business.

\textsuperscript{107} 5% [assumed rate of branch tax under the country X treaty] X 65 [the ECEP]. In the absence of a treaty, the rate of branch tax is 30%. Section 884(a).
Unlike in Example 2, there is no disparity between EDA and E&P. The branch tax reduces both EDA and E&P.

Although the branch tax is not an applicable income tax and is therefore not taken into account in determining the fully taxed earnings amount, it is nevertheless subtracted from the fully taxed earnings amount in arriving at EDA. The same is true of U.S. withholding taxes on dividends that Forco receives from a U.S. subsidiary. It is true that this result harmonizes EDA and E&P. In the Example, A received a distribution of 61.75, all of which was excludable, thus in effect wiping the slate clean with respect to the original earnings of 100. A has, however, suffered a double tax in the form of branch tax in addition to corporate tax. This contravenes the central goal of the Proposal, that corporate income is taxed only once.

The Proposal rightly gives Forco an EDA for dividends that would be excludable by a U.S. recipient and distributions out of a CREBAA that Forco receives. Otherwise, A would be taxed on earnings that have already been subjected to U.S. corporate tax. As the Example illustrates, however, just this double tax occurs with respect to branch tax paid by Forco.

Turning to a different but related matter, applicable income tax does not include the tax imposed by §881 on U.S. source, noneffectively connected fixed or determinable annual or periodical gains, profits and income described in §881(a)(1) ("FDAP income"). FDAP income includes not only dividends, but interest, royalties, and rents. As a result, the §881 tax does not increase EDA. We question whether this is the proper result. It could be argued that, when a foreign corporation receives FDAP income, it is merely an investor and, to this extent, is not properly compared to a U.S. corporation.

The beneficiaries of the dividend exclusion regime, however, will be the U.S. persons who own the stock of the foreign corporation. It is not clear why they should suffer the detriment of a second tax when they receive a distribution from the foreign corporation, when the latter has already been subject to tax under §881.

We do not push this point too strongly, because it may be that the portfolio interest exemption and treaty exemptions eliminate most U.S. tax on FDAP income other than dividends. However, the point would seem to be valid, especially if the §881 tax is

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109 Id.
113 Proposed section 281(d)(1)(A).
114 Distributions by a foreign corporation to foreign shareholders are seldom subject to U.S. withholding taxes, in view of the source rule of section 861(a)(2)(B) and the exemption provided by section 884(e)(3) and, in some cases, by treaties.
115 Rents from real property, however, are not normally exempt under treaties. See, e.g., Article 6, U.S. Model Income Tax Convention of September 20, 1996.
viewed as merely a substitute for the net income tax that would be imposed if the income
was ECI to the foreign corporation.\textsuperscript{116}

Finally, the E&P of a foreign corporation is not increased by allocable amounts of
retained earnings that would increase the basis of stock owned by a domestic
corporation.\textsuperscript{117} This is consistent with the provision that there is no increase in basis of
stock owned by a foreign corporation for retained earnings of the issuer of the stock that
go into a CREBAA.\textsuperscript{118}

As indicated, we disagree with the conclusion that a foreign shareholder should not
receive excludable dividends. If the Proposal is modified to extend the benefits of
dividend exclusion to foreign shareholders, it appears that a foreign corporation should
increase E&P not only by excludable dividends but also by allocable basis from retained
earnings of the issuing corporation.

F. Impact On Closely Held C Corporations

1. General

We recommend that attention be given to appropriate anti-abuse mechanisms aimed at
closely held C corporations.

We anticipate that enactment of the Proposal will have different impacts on closely held
versus publicly traded corporations. Publicly traded corporations can be expected to tailor
their conduct to facilitate the receipt of excludable dividends, but this is likely to be
motivated by at least a parallel, if not a primary, concern for lowering their cost of capital
through use of the most tax-efficient instruments. Closely held corporations similarly are
likely to tailor their conduct to facilitate the receipt of excludable dividends, but will do
so primarily to promote the interests of their shareholders.

The most foreseeable conduct is efforts to recharacterize compensation or other payments
that otherwise would be made to shareholder/employees/landlords, etc. as dividends.
Such conduct is currently seen in S corporations because compensation paid by an S
corporation to a shareholder/employee is subject to additional employment taxes,
particularly the Medicare tax, which has no wage cap. To any extent that the corporate
tax rate is below the individual tax rate, there may also be efforts to both multiply
corporations owned by the same persons, and to recharacterize other deductible payments
as dividends.

Only the latter conduct would be a new challenge for the IRS. The understatement of
shareholder compensation is an endemic issue for S corporations and efforts to take
multiple runs up the rate brackets are challenged by Reg. §1.269-3(b)(2) and §1561. The

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{116} See generally, e.g., \textit{Bank of America National Trust and Savings Association v. Commissioner}, 61
  T.C. 752, 761 (1974), aff'd in unpublished opinion (9th Cir. Feb. 25, 1976) (U.S. withholding taxes are
  "realistically directed against net gain or profit").
  \item \textsuperscript{117} Proposed section 285(a)(2)(B)(ii).
  \item \textsuperscript{118} Proposed section 285(b)(2)(A)(ii).
\end{itemize}
\end{footnotesize}
latter conduct will be less of a concern to the extent the maximum tax rates for corporations and individuals are the same. We encourage such similarity both for this reason as well as for general simplification.

2. Implications of Two-Year Delay in Calculating EDA and REBA for S Corporations and Closely Held C Corporations

We recommend that Congress consider changing the two-year delay built into the EDA system between the year generating the EDA and the year it can be paid out to shareholders, particularly if not exclusively in the context of the closely held C and S corporation.

Under the Proposal, there would typically be a two-year delay between the payment of tax at the corporate level and the corresponding exclusion from income at the shareholder level. Under proposed new §281(b)(1), the “excludable dividend amount” for a given calendar year would reflect the “fully taxed earnings amount,” dividends received and aggregate basis increases experienced by the C corporation during “the preceding calendar year.” Moreover, the “fully taxed earnings amount” is based on “applicable returns” filed during that preceding year, i.e., based on taxes paid with respect to the second preceding year prior to the year in which the excludable dividend amount can actually be distributed tax free by the C corporation.119

Since excludable dividends and basis increases for the retained earnings basis adjustment are ultimately based on “fully taxed earnings amounts” for preceding years of lower tier C corporations, these amounts would typically also involve delays between taxes paid and the corresponding tax benefits of two years or more.120 Thus, for corporations with a December 31 taxable year, which includes most S corporations and many C corporations, these provisions would result in an automatic delay of two years. For corporations with taxable years ending January 31 through May 31,121 there would be an average delay of slightly less than two years; for corporations with taxable years ending June 30 through November 30, there would be a delay of slightly greater than two years.

119 See section 281(c)(1), (d)(2) of the Code, as added by the Bill. The Bill defines “applicable return” to include any income tax return for which the fifteenth day of the eighth month following the close of the taxable year occurs during the preceding calendar year. Proposed section 281(d)(2)(A). It appears that this provision was intended to correspond with the extended due date for corporation income tax returns, in which case it should have referred to the fifteenth day of the ninth month following the close of the relevant taxable year. Section 6072(b); Treas. Reg. § 1.6081-3(a). Otherwise, it would appear that the April 1, 2001 transitional rule contained in proposed new section 281(d)(1)(B)(i) should be adjusted, because tax paid on April 30, 2001 returns would not qualify as “applicable income tax” for the 2002 calendar year, and should therefore be excluded.

120 This lag time could turn out to be much greater, depending on the chain of corporate ownership. For example, an individual shareholder who owns stock in corporation A, which in turn owns stock in corporation B, which in turn owns stock in corporation C, would typically not be entitled to receive the tax free distribution of the “fully taxed earnings amount” from corporation C distributed up through the corporate chain until the fifth taxable year following the taxable year in which corporation C paid the underlying taxes.

121 This would be April 30 if the operative filing date was the ninth month after tax year end.

122 This would be May 31 if the operative filing date was the ninth month after tax year end.
While these tax consequences are potentially problematic for publicly held corporations, they seem especially inappropriate in the closely held context where the underlying tax calculations would be readily available and the potential for abusive tax arrangements involving change of ownership are much more feasible. All closely held entities must compute and file income tax returns within either 8-1/2 months or 9-1/2 months of the end of their respective taxable years, depending upon whether they are classified as corporations or partnerships for tax purposes, respectively.\textsuperscript{123}

For S corporations and partnerships (including limited liability companies treated as partnerships), the tax amounts at the entity level for each year are required to be calculated promptly in order for the shareholders to properly report income, losses and gains on their own individual returns for the same year, in much the same fashion as the “excludable dividend amount” would be relevant for the individual returns of corporate shareholders under the Proposal. Over the years, this system of inter-related tax calculations for S corporations/partnerships and their owners has proved to be quite workable and able to be accomplished on a timely basis during the succeeding calendar year.

Under the regime proposed in the Proposal, a shareholder would experience the ultimate economic benefit of earnings, and the economic detriment of taxes to be paid on those earnings, during year #1 (and the value of his or her stock would presumably go up and down accordingly), whereas the tax benefit of such economic occurrences (i.e., excludable tax dividends and/or basis increases) would actually pass through to shareholders who own stock during year #3. Such tax consequences could encourage transfers of stock among taxpayers to accomplish tax avoidance objectives. Such tailored tax consequences would be less easily achievable through publicly held entities, whose ownership is not easily manipulated. Eliminating the two-year delay for closely held entities would advance the tax policy objectives of the Proposal and reduce opportunities for tax avoidance and abuse.

Eliminating the two-year deferral would accomplish both of the above objectives. In the case of S corporations, this would be done on a fiscal (usually calendar) year basis, with excludable dividends payable from EDA as of the last day of its taxable year, as currently applies for pass-through items from S corporations\textsuperscript{124} and partnerships. The EDA should be distributable shortly after year end, as currently allowed for S corporations\textsuperscript{125}. There would seem to be no compliance reason to defer these tax consequences, because, as mentioned above, these entities already compute and report their tax consequences during the subsequent calendar year and already engage in the type of interrelated corporate/shareholder tax calculations that are contemplated by the “excludable dividend amount” provisions of the Proposal.

\textsuperscript{123} Code Section 6072(b),(a); Treas. Reg. §1.6081-3; 1.6081-2.
\textsuperscript{124} The Bill itself seems to treat S corporations differently than other corporations for purposes of this deferral rule, because proposed new section 281(d)(1)(B) does not allow S corporations to use earnings prior to January 1, 2003 to determine “excludable dividend amounts,” which is in contrast to regular C corporations which are allowed to go back to all taxable years ending on or after April 1, 2001.
\textsuperscript{125} Code Section 1368(e)(1)(C).
For C corporations with non-calendar years, the rule would provide that excludable dividends for the calendar year would be payable from EDA as it existed on the last day of the fiscal year ending in the calendar year (which would be the last day of the calendar year in cases of calendar year closely held C corporations). Alternately, it may be possible to allow C corporations to report to shareholders on their fiscal year, as do S corporations and partnerships.

We recognize that the suggested change could result in corporations not knowing the character of their distributions made during the year until after year end. However EDA carryover and the ability to pay out the EDA for a year within a short period after year end should ameliorate this concern.

The two-year delay in converting tax into EDA may have an additional impact on redemptions by closely held C corporations. Proposed new §286(a) of the Code under the Proposal would provide that the “excludable dividend amount” for a corporation that redeemed some of its stock during a calendar year, as well as the cumulative retained earnings basis adjustment amount “as of the beginning of the calendar year,” would be reduced on a ratable basis to reflect such redemptions.

The policies behind the Proposal and of simplification could be further implemented by adopting an “end of the year” EDA adjustment mechanism for redemptions, similar to the one already in place for accumulated adjustments accounts of S corporations. These accumulated adjustments accounts for S corporations are quite similar to the EDA and CREBAA contemplated by the Proposal. If S corporation eligibility were expanded to cover all closely held entities, the S corporation basis adjustment approach would address these situations. The relatively simple S corporation methodology for redemptions and other distributions has proven easy to administer, and has not resulted in tax avoidance.

G. Refunds

We oppose the limitation on refunds to taxes owed in the year of refund plus EDA (as currently generally limited to a one year amount). At minimum, carryover of EDA by election in limited cases (if general carryover is not be permitted) should reasonably enhance the ability of corporations to currently benefit from refund rights.

1. The Proposal

Under the Proposal, a credit or refund of corporate income tax is generally limited to (i) the amount of income tax paid by the corporation during the calendar year in which the credit or refund is otherwise allowed (the “Refund Year”); plus (2) to the extent elected

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126 The methodology for redemption adjustments to S corporation accumulated adjustments accounts was worked out in a collaborative effort between the Section of Taxation and the Department of Treasury. See Treas. Reg. § 1.1368-2(a)(5); Comments Concerning Regulations under Sections 1366, 1367 and 1368 of the Internal Revenue Code of 1986, Section of Taxation, American Bar Association, Sept. 11, 1991, at pp. 43-47.

127 For purposes of this discussion, references to income taxes are to taxes taken into account in computing an EDA (e.g., taxes reflected on a return or an assessment, but not estimated tax payments).
by the corporation, the amount of income tax taken into account by the corporation in determining it’s EDA for the Refund Year. As a practical matter, a corporation’s credit or refund generally would be limited to the amount of income tax paid by the corporation in the Refund Year plus, to the extent elected by the corporation, the amount of income tax paid by the corporation in the year preceding the Refund Year. The limitation on credits and refunds applies to a credit or refund attributable to a net operating loss carryback. Credits and refunds that are subject to the limitation are treated as overpayments that may be taken into account in succeeding calendar years, subject to the limitation in such years. However, interest does not accrue on overpayments that are deferred as a result of the limitation.

2. Effects on Taxpayer Conduct

We understand that the limitation on credits and refunds arises from a need to prevent the use of one tax payment to both (1) support excludable dividends or stock basis increases, and (2) support a refund of the same tax. However, we are concerned that the limitation itself may lead certain corporate taxpayers to take aggressive return filing positions that may be contrary to the interests of the corporation and the government, so as to reduce the likelihood of refunds that they may not be able to collect. We are also concerned that a limitation on a corporation’s ability to receive an immediate refund from the carryback of a net operating loss could, in certain situations, impose an undue economic hardship on a corporation that may be desperately in need of capital.

Taxpayers that are concerned that a filing position could be viewed as aggressive may file an initial tax return that does not reflect the potentially aggressive position, along with an amended return containing the more aggressive position. In a post-Enron environment, such an approach may be beneficial to a corporate taxpayer that does not want to be accused of taking aggressive tax-filing positions (since all taxes have been paid by the corporation and a refund is only available to the extent that the Internal Revenue Service agrees to the position reflected in the amended return). Such an approach is also beneficial to the government since it provides the government with notice and an opportunity to audit the potentially aggressive position. The proposed limitation on credits and refunds, however, may cause such a taxpayer to reflect the more aggressive filing position on its initial returns.

Example. Assume that in Year 1 a corporation engaged in a transaction that potentially gives rise to a deduction of $100. Without taking the deduction into account, the corporation’s net income for Year 1 is $120. In Year 2, the corporation files an original tax return for Year 1 reflecting net income of $120 (resulting in a tax payment of $42). In Year 2, the corporation also files an amended return that reflects the $100 deduction.

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128 The credit or refund amount would also be increased by the amount of taxes paid by the corporation in the second year preceding the Refund Year to the extent that such taxes gave rise to an EDA that was carried forward into the Refund Year (because the EDA for the preceding year exceeded the amount of dividends that could be paid by the corporation in such preceding year).

129 For this purpose a taxpayer generally will not file a tentative claim for refund but will instead file a regular amended return that is subject to audit before the refund is approved.
and accordingly results in a potential refund of $35. In Year 3, Year 4 and Year 5, the corporation pays income tax of $3, $4 and $5, respectively. If the corporation’s claim for refund is not allowed until Year 5, then the maximum amount of the refund available to the corporation would be $9 (the sum of the taxes paid in Year 5 and Year 4). \(^\text{130}\) A corporation facing such a limitation would be motivated to reflect the deduction on its original return to avoid such a potential disallowance. Since no interest is paid on the refund amount that is delayed as a result of the limitation, a corporation might also be concerned that the Internal Revenue Service could delay approval of the corporation’s claim for refund as a tactic to reduce the present value of the amount ultimately paid to the corporation.

The limitation can also be expected to interfere with a corporation’s ability to benefit from a net operating loss carryback.

**Example.** Assume a corporation pays tax of $70 in Year 2 (on taxable income of $200 earned in Year 1) and tax of $35 in Year 3 (on taxable income of $100 earned in Year 2). In Year 4 the corporation files its Year 3 return, reflecting a net operating loss of $400 that can be carried back to Years 1 and 2. As a result of the limitation, the refund of $105 that would otherwise be available to the corporation is limited to $35 (the sum of the income taxes paid by the corporation in Year 3 and Year 4). \(^\text{131}\) In certain situations, the refund generated by a net operating loss carryback may be critical to a corporation’s ability to survive a severe, but temporary, economic downturn. Accordingly, we are concerned about the consequences of such a limitation upon a corporation’s ability to utilize the carryback provisions.

The concern regarding the limitation on refunds would be lessened by allowing a taxpayer to carry its unused EDA forward. If general carry forward is not permitted, then perhaps a limited carryforward by election could be allowed, for example based on the amount of a refund claim filed in a year or some other measure.

**H. Personal Holding Company Tax and Accumulated Earnings Tax Repeal**

We support the Proposal's repeal of these taxes.

**I. Effective Date/Transition Issues**

The Proposal's effective date is generally for distributions and basis allocations made after December 31, 2002. Proposal Section 207(a).

1. **Information Reporting**

We recommend that the Secretary be granted authority to provide alternate means/times for information reporting for the 2003 year.

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\(^{130}\) This example assumes that the corporation’s Year 4 EDA is not carried over to Year 5. Even if all of the Year 4 EDA is carried to Year 5, the maximum amount of refund allowed in Year 5 is limited to $12.

\(^{131}\) This example assumes that the corporation’s Year 2 EDA is not carried forward into Year 3.
Current law requires that issuers and nominees (sometimes referred to as middlemen) report dividends aggregating $10 or more on Form 1099-DIV to the IRS and individual investors. The Form 1099-DIV statements must be mailed to individuals by January 31 and the IRS on or before February 28 in the year following the distribution. If a corporation makes a nontaxable dividend (e.g., a return of capital) to its shareholders, it must also file Form 5452 (Corporate Report of Nondividend Distributions) with the IRS (generally with its income tax return for the year in which the nondividend distributions were made). There are penalties for late filing and failure to include correct information on the return or statement.

The Proposal expands Code §6042 to include in the statement to shareholders (Form 1099-DIV) excludable dividends and the amount of basis adjustments and the date to which they are allocated. The Joint Committee Report also states that a corporation will report its EDA and CREBAA to the IRS annually on its income tax return.

The Proposal effective date places a time constraint on corporations and nominees during the current year to the extent the IRS maintains the existing due dates. It is not inconceivable that corporations and nominees will need six months (or more) to build reporting systems that can comply with the new requirements. If the Proposal passes close to year end, it may be impossible to meet deadlines similar to due dates under existing law. Thus, it may be prudent to consider alternative means of disseminating the required information to avoid potential hardship and a general delay in individuals filing income tax returns. For example, an issuer or a nominee may be treated as satisfying the statement requirements if it reports the gross amount of dividends paid on Form 1099-DIV and reports the additional information (i.e., excludable dividends and basis adjustments) on its web site or in supplemental statements.

The IRS also may need to add a requirement that corporations report excludable dividends to other corporations that are shareholders. Currently the Form 1099 dividend report applies only to non corporate shareholders.

2. Current Law Dividends-Received Deduction - Stock Issued Prior to February 3, 2003

We recommend that the Secretary be granted authority to provide practical means for identifying stock issued prior to February 3, 2003.

The Proposal provides a limited transition rule for dividends paid to a U.S. domestic corporate shareholder that are not out of a corporation’s EDA. Generally, a dividend paid in a calendar year out of a corporation’s EDA for that respective year is excludable from income of U.S. corporate recipients. Dividends not paid out of EDA (or out of a

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132 Code §§6042(a) and (b).
133 Code §6042(c) and Regs. §1.6042-2(c).
134 Code §§6721 and 6722.
cumulative EDA carryover) generally are fully taxable to corporate recipients (assuming the corporation paying the dividend has sufficient earning and profits) unless the distributor corporation has a CREBAA. Thus, the Proposal eliminates the current law dividends-received deduction currently applicable to corporate portfolio investors and replaces it with the EDA regime. However, under a limited transition rule, the current law’s 70 and 80 percent dividends-received deduction will continue to apply to corporate investors that received distributions (not otherwise treated as excludable dividends) of earnings and profits accumulated in taxable years ending before April 1, 2001, that are distributed prior to January 1, 2006, with respect to stock issued prior to February 3, 2003.\footnote{Bill §202(c)(2)(B).}

The transition rule may be difficult for holders of publicly traded common stock where the corporation issues new shares of stock after February 3, 2003 and the corporation has the same class of shares outstanding prior to February 3, 2003. The fungibility of the shares may prevent a new holder from taking advantage of the limited transition rule.

Preferred stock may incur similar fungibility concerns; however, our experience is that preferred stock issued at different times is often designated as a different series of stock for local law purposes. The local law designation may be a convenient way for corporate holders to identify stock issued prior to February 3, 2003.

3. Potential Need for a Broader Transition Rule

In previous sections of this report we have recommended the carryover of EDA, the streaming of EDA to preferred classes and the elimination of non-extraordinary first year dividends from §1059. These changes should go far toward ameliorating the adverse effects of enactment of the Proposal on the markets in preferred stocks, including remarked and auction rate preferred stocks. However, to the extent these changes are not adopted, the Congress should consider broader grandfathering or transition rules to minimize adverse market impact on issuers and holders of portfolio preferred stock investments.

IV. Conclusion

The Proposal reflects a major tax policy initiative to eliminate the double taxation of corporate earnings. If enacted, it would change tax planning in ways that surely are only dimly foreseeable; and it likely would lead as well to some measure of both deliberate and inadvertent taxpayer behavior that could have a significant adverse impact upon the fisc. In order to minimize the opportunities for such behavior, it is critical that the operative statutory provisions be crafted at every point possible to provide clear and objective “governing” rules (as opposed to vague anti-abuse rules) that are relatively simple to understand and relatively easy to administer. Our specific recommendations for modifying the Proposal are offered with those objectives in mind. In addition, whatever the content of any ultimately enacted provisions may be, we urge that the
committee reports identify as many specific fact patterns as possible that will or may be regarded as inappropriate attempts to yield tax consequences which contradict the legislative intent.

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We appreciate the opportunity to submit these comments and hope that they will be useful in connection with further congressional consideration of the Proposal. Representatives of the Section would be pleased to meet with taxwriting committee members and staff to discuss our views in further detail. Please contact Bill Wilkins, the Section’s Vice Chair for Government Relations (at 202-663-6204), if that might be helpful.