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Tax Report # 951



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May 10, 1999

The Honorable Charles O. Rossotti
Commissioner
The Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3000 IR
Washington, D.C. 20224

Dear Commissioner Rossotti:

I enclose a report of the Committee on Financial Instruments of the Tax Section of the New York State Bar Association commenting on Proposed Treasury Regulation Section 1.7701(1)-3. These Proposed Regulations deal with transactions in which a corporation issues two or more classes of stock at least one of which is "fast-pay stock". As the Report indicates, the Tax Section supports the issuance of these Regulations since we believe that these transactions were created to secure tax benefits artificially in a manner which we believe is inconsistent with certain policies and principles underlying the tax law. As we indicate in the Report, however, we believe that, from a strictly tax policy standpoint, the approach taken by the Proposed Regulation is a "second-best" solution.

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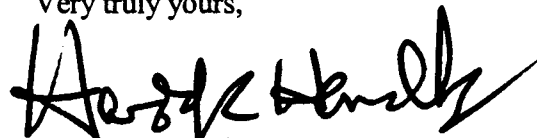
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The approach of this Proposed Regulation, which we describe as the "indirect recharacterization approach", produces a number of anomalies and technical difficulties. These engender substantial complexity which could be avoided if a different approach, one which involves "direct recharacterization", were adopted. This "direct recharacterization" approach would explicitly recharacterize purported dividends as a tax free return of capital. We acknowledge in the Report that this direct recharacterization approach would entail its own complexities and would most likely require supporting legislation either to embody this direct recharacterization approach or authorize regulations to that effect. We would support such legislation.

Nevertheless, we applaud this effort at dealing with these potentially abusive transactions. We are prepared to discuss any of these comments with you and to continue to work with you to construct adequate solutions to this problem.

Very truly yours,



Harold R. Handler
Chair

Enclosure

cc: Philip J. Levine, Esq.
William Alexander, Esq.
Michael S. Novey, Esq.

Introduction

This report of the Committee on Financial Instruments of the Tax Section of the New York State Bar Association (the "Committee") comments on Proposed Treasury Regulation Section 1.7701(1)-3 (the "Proposed Regulations").¹ The Proposed Regulations deal with transactions ("fast-pay arrangements") in which a corporation issues two or more classes of stock at least one of which is "fast-pay stock". Fast-pay stock is stock structured such that dividends paid thereon (within the meaning of Section 316²) represent in substance, in whole or part, a return of the holder's equity investment in the corporation, rather than an economic return on such investment. Pursuant to an exercise of the Government's³ authority under Section 7701(1)⁴, the Proposed Regulations

¹The principal drafter of this report is Lewis R. Steinberg. Helpful comments were received from Kimberly Blanchard, Richard Cassavechia, Harold Handler, Deborah Jacobs, Robert Jacobs, Robert Kantowitz, David Levinson, David Miller, Deborah Paul and Michael Schler.

²Unless otherwise stated, all Section references are to Sections of the Internal Revenue Code of 1986, as amended (the "Code").

³The term "the Government" is used throughout this report to refer collectively to the Treasury Department and the Internal Revenue Service (the "IRS").

⁴Section 7701(1) authorizes the Government to issue regulations recharacterizing a multiple-party financing transaction as a transaction directly among any two or more

provide for recharacterization of certain fast-pay arrangements as arrangements directly between the holders of the relevant class of fast-pay stock (the "Fast-Pay Shareholders") and the holders of the remaining stock (including other classes of fast-pay stock) of the issuing corporation (the "Benefitted Shareholders"). The Proposed Regulations implement and expand upon I.R.S. Notice 97-21, 1997-1 C.B. 407 (the "Notice"), which was issued in the wake of a number of sizeable securities transactions involving fast-pay arrangements. The approach taken by the Proposed Regulations, however, differs in certain respects from that articulated in the Notice.

In general, the Committee supports the issuance of the Proposed Regulations. Regardless of one's view of whether the law in effect prior to the issuance of the Notice would have allowed for dividend treatment of certain amounts paid with respect to fast-pay arrangements, the Committee believes that such treatment is inconsistent with certain policies and principles underlying the tax law, including the principle of "clear reflection of income". Accordingly, the Committee believes that it is appropriate that abusive transactions involving fast-pay arrangements be halted through legislative and/or administrative action.

parties to such transaction where necessary to prevent tax avoidance.

Nevertheless, the Committee believes that, from a strictly tax-policy viewpoint, the approach taken by the Proposed Regulations is not optimal.

Indirect Recharacterization Approach of the Proposed Regulations

The abuse at which the Proposed Regulations are directed is the mischaracterization of amounts with respect to fast-pay stock that economically constitute a return of capital as dividend income.⁵ The Proposed Regulations do not directly recharacterize such amounts as returns of capital. Rather, they attempt to discourage the use of abusive fast-pay arrangements by treating the Benefitted Shareholders as the holders of the fast-pay stock and as

⁵In a typical transaction prior to issuance of the Notice, the fast-pay stock would be held by one or more domestic tax-exempt or other "tax indifferent" parties, while the remaining stock of the issuer would be held by taxable persons. The purported dividend payments on the fast-pay stock were intended to apportion all (or substantially all) of the issuer's earnings and profits to such tax-exempt parties, in excess of the economic income from their investment in the stock. As a result, the remaining (taxable) shareholders' taxable income would be significantly understated (as compared to the economic income attributable to their investment in the issuer's stock). Economically, the overall result would be analogous to a transaction in which the holders of the non-fast-pay stock borrowed funds from the holders of the fast-pay stock, invested such funds in the issuer and deducted for tax purposes both interest and principal payments with respect to such borrowings.

having paid certain amounts to the Fast-Pay Shareholders.⁶ The approach taken by the Proposed Regulations (the "Indirect Recharacterization Approach) thus represents a "second-best" solution to the problem of mischaracterization of amounts as dividend income.

The Indirect Recharacterization Approach of the Proposed Regulations is consistent with the language of Section 7701(1), which allows the Government to recharacterize multiple-party financing transactions as transactions directly between two or more of the participants thereto. However, as discussed in greater detail below, the Indirect Recharacterization Approach engenders substantial complexity and potentially adverse collateral tax consequences to the parties⁷ that could be avoided if a different approach, one that explicitly recharacterized purported dividend amounts as returns of

⁶Because, as noted in note 5 *infra*, the Benefitted Shareholders are typically taxable investors, treating them as holding the fast-pay stock and as having made (deductible) payments of certain amounts to the Fast-Pay Shareholders will generally result in the Benefitted Shareholders' recognizing taxable income approximately equal to their economic income from the transaction, thus denying them the desired tax benefits (*i.e.*, economic income without corresponding taxable income) from their participation in the fast-pay arrangement.

⁷As discussed further below, many of these adverse collateral tax consequences are not necessary to ensure that amounts constituting a return of a shareholder's investment are properly characterized for tax purposes.

capital where necessary to reflect the economic substance of a financing transaction, were adopted.

Direct Recharacterization Approach

An alternative approach (the "Direct Recharacterization Approach") would treat an amount denominated as a dividend for state-law purposes and paid out of the issuer's current or accumulated earnings and profits as a tax-free return of capital to the extent such "dividend" constituted a return of the shareholder's investment as a matter of economic substance.⁸

⁸A precise application of the Direct Recharacterization Approach would recharacterize a dividend payment only to the extent it constituted a return of the holder's equity investment as an economic matter. In some cases, such as those involving contingent dividend payments, strict application of such an approach could lead to great complexity. In such limited cases it might be appropriate, solely because of concerns of administrative convenience, to treat the entire dividend payment as a return of capital. Cf. Section 1059(f) (dividends on "disqualified preferred stock" treated as extraordinary dividends in their entirety).

Strictly speaking, the determination of whether a purported dividend constitutes a return of capital as an economic matter should not turn on whether the dividend is received by a tax-exempt (or other tax-indifferent) person or whether the stock is structured to achieve a tax avoidance purpose. However, an "across-the-board" adoption of a Direct Recharacterization Approach might, under certain circumstances, encourage transactions in which taxable investors attempt to utilize fast-pay stock to avoid being taxed on amounts constituting returns on (rather than of) their investment in the stock. For example, this might be

The Committee recognizes that crafting a Direct Recharacterization Approach might entail its own complexities. More significantly, a majority of the Committee believes that the language of Section 7701(1), which mandates recharacterization of multiple-party transactions as transactions directly between two or more participants, precludes adoption of the Direct Recharacterization Approach pursuant to the authority granted to the Government by such Section. Moreover, a majority of the Committee believes that alternative sources of regulatory authority, such as Section 446,⁹ are not sufficiently robust to allow issuance of Regulations that would embody the Direct Recharacterization Approach.

the case if, as discussed above, distributions on fast-pay stock were treated as tax-free returns of capital in their entirety under certain circumstances. In such cases, the Committee would not object to limiting the application of the Direct Recharacterization Approach to particular types of Fast-Pay Shareholders (e.g., tax-exempt investors) or transactions (e.g., transactions undertaken for a tax avoidance purpose).

⁹While the Committee recognizes that the Government's authority pursuant to Section 446 is expansive, given the long-settled structure of the Code, including Section 316's broad definition of a dividend as "any distribution of property made by a corporation to its shareholders" out of current or accumulated earnings and profits [emphasis supplied] and the absence of any provision analogous to Section 302 that characterizes certain dividends as returns of capital for tax purposes, a majority of the Committee believes that Section 446 does not afford the Government sufficient authority to adopt the Direct Recharacterization Approach.

However, because the Committee believes that the Direct Recharacterization Approach is to be preferred as a matter of tax policy, it would strongly support enactment of legislation that would either embody the Direct Recharacterization Approach or specifically authorize the Government to issue Regulations to that effect.

The remainder of this report discusses a number of issues of a more technical nature.

Technical Issues With Respect to the Proposed Regulations

1

1. Definition of Fast-Pay Stock. Section (b)(2)(i) of the Proposed Regulations defines fast-pay stock as stock "structured so that dividends (as defined in [S]ection 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment)." The scope of this definition is unclear. In particular, a number of provisions of the Code, including Sections 302, 304, 306 and 356(a)(2), treat certain redemption transactions as distributions under Section 301 (and therefore potentially dividends within the meaning of Section 316). For example, because of the application of the Section 318 attribution rules, this is frequently the case in transactions involving related

parties. It is unclear whether the definition of fast-pay stock is intended to apply to such transactions.

Thus, a taxpayer might acquire stock in a related corporation. At the time of the acquisition, the parties might intend that any subsequent disposition of that stock by the taxpayer be structured so as to qualify as a distribution pursuant to Sections 302(d) and 301. For example, a U.S. corporate parent ("Parent") that owns stock in a related controlled foreign corporation ("CAC") may prefer to have that stock redeemed in a transaction qualifying as a dividend under Section 302(d), rather than disposing of that stock to an unrelated third party, in order to enhance its foreign tax credit position.¹⁰

The Committee does not believe that the Proposed Regulations should be applied to overrule existing statutory rules and principles (such as those under Section 302) by characterizing the stock owned by Parent in CFC as fast-pay stock, even if Parent and CAC intend from the outset that the stock be ultimately redeemed in a transaction treated as a dividend pursuant to Sections 302(d) and 301. The purpose of the Proposed Regulations is to avoid mischaracterization

¹⁰Whether a redemption versus a sale to a third party of the CFC stock will be more beneficial to Parent depends on the application of Section 902 with respect to the redemption as compared to the result under Sections 1248 and 902 with respect to the sale.

of amounts received as dividend income. In the typical cases against which the Notice and the Proposed Regulations are directed,¹¹ this mischaracterization results from the general absence in the Code of any mechanism for treating a distribution on stock that, as a matter of corporate form, is structured as a dividend and that is made out of accumulated or current earnings and profits as anything other than a dividend. In essence, the existing approach of the Code is economically unsophisticated, is focused on the formal structure of the relevant transaction and is intended to err on the side of finding dividend treatment.¹²

In the case of redemption transactions, however, the Code already contains a panoply of provisions, as described above, intended to characterize properly a redemption transaction as either a dividend or a sale. These provisions embody, in essence, the type of Direct Recharacterization Approach that the Committee believes is the optimal solution to the problem of mischaracterization of amounts as dividend income. Furthermore, these provisions have been elaborated upon through legislative

¹¹See, for example, the types of stock that are generally presumed to be fast-pay stock under the Proposed Regulations, as described in Sections (b)(2)(i)(A) and (B) thereof.

¹²This reflects, of course, Congress' traditional focus on avoiding earnings "bailouts" by individual taxpayers.

amendment, court decision making and administrative guidance over the course of over seventy years, providing a framework for analysis that can be drawn upon by taxpayers, the Government and courts. Indeed, whenever Congress has thought that these provisions could be used for tax avoidance ends it has seen fit to modify them.¹³

Thus, in the case of redemption transactions, a well-wrought and integrated series of provisions already protects the fisc from the type of mischaracterization of amounts received that animated the issuance of the Notice and the Proposed Regulations. As a result, the Committee believes that it would be unwise and inappropriate to override the rules and principles of Section 302 by applying the Proposed Regulations to redemption transactions. Instead, the Committee recommends that the Proposed Regulations, when finalized, contain an explicit statement to the effect that stock will not be considered to be fast-pay stock merely because the parties intend to redeem such

¹³For example, the extraordinary dividend rules of Section 1059, including the amendments thereto made in 1997, manifest Congress' intent that the provisions dealing with redemption transactions not be abused by corporate taxpayers. See, e.g., Section 1059(e)(1) (treating certain redemptions characterized as dividend distributions under Section 302(d) as extraordinary dividends without regard to the corporate taxpayer's holding period for the redeemed stock).

stock in the future in a transaction qualifying as a distribution pursuant to Sections 302(d) and 301.

The Committee recognizes that the approach advocated here, standing alone, could result in an enhanced potential for tax abuse. For example, a RIC having only a single class of common stock could issue a large block of such stock to a domestic tax-exempt entity ("Tax-Exempt"). In a series of subsequent transactions and pursuant to a plan in effect at the time of the acquisition of the RIC stock by Tax-Exempt, the RIC could serially redeem the stock held by the Tax-Exempt. Each block of stock would be redeemed for cash and an option to acquire an additional number of RIC shares equal to the number of shares being redeemed; the exercise price for the option would far exceed the current fair market value of the RIC shares. Arguably, each such redemption would be characterized as a dividend pursuant to Sections 302(d) and 301 under the "meaningful reduction" test of U.S. v. Davis, 397 U.S. 301, reh'g denied, 397 U.S. 1071 (1970), thereby implicating the same type of concerns that the Proposed Regulations are intended to address.¹⁴

¹⁴Such transaction might also be subject to challenge by the IRS on tax ownership, step transaction or other general principles.

The Committee agrees that the transaction described above is clearly abusive and should be prevented. The question, however, is the most appropriate means of doing so. Assuming arguendo that the posited transaction would qualify as a dividend under current law, the defect appears to lie in an overly narrow interpretation of Section 302(b)(1), which characterizes certain redemptions as "not essentially equivalent to a dividend" (and therefore as an exchange). The Committee therefore believes that the best solution to the problem lies in a reinvigorated approach to Section 302, the Section that, since the earliest days of the Code, has been the principle means of policing the distinction between dividend and exchange treatment in redemption transactions.¹⁵ Accordingly, the Committee would propose that the Government issue a Regulation providing that redemption transactions involving the retention of out-of-the-money options on the issuer's stock are "not essentially equivalent to a dividend" (within the meaning of

¹⁵Unlike the Proposed Regulations, whose application sometimes turns on the parties' purpose in entering into a transaction, see Prop. Reg. Sec. 1.7701(1)-3(c)(1)(ii), determinations under Section 302 turn on the economic effect of a redemption transaction. In the context of an anti-abuse provision such as Section 7701(1) adoption of an approach looking to tax-avoidance purpose is appropriate. Nevertheless, the Committee believes that Section 302's economic effect approach is generally superior because it avoids the need to examine taxpayers' subjective intent and thereby (hopefully) leads to more evenhanded treatment of transactions and taxpayers.

Section 302(b)(1)).¹⁶ Such Regulation should be issued concurrently with finalization of the Proposed Regulations.¹⁷

2. Determination of Existence of Fast-Pay Stock

Section (b)(2)(ii) of the Proposed Regulations requires that a determination of whether stock is fast-pay stock be made at the time such stock is issued, whenever there is a significant modification to the terms of such stock (or related agreements), or whenever there is "a significant change in the relevant facts and circumstances". The scope of the latter clause is unclear. In particular, the Proposed Regulations offer no guidance as to what facts and

¹⁶Given the lack of legal authority dealing directly with a fact pattern like that discussed in the text, the Committee believes that any such Regulation under Section 302(b)(1) would be valid.

A similar approach has already been adopted legislatively in the context of the extraordinary dividend rules. See Section 1059(e)(1)(A)(iii)(I) (special rule for redemptions treated as dividends by virtue of the option attribution rule of Section 318(a)(4)).

¹⁷In order to avoid a gap between the effective date of the two sets of Regulations, the Committee would support retroactive application of any such Section 302(b)(1) Regulation to taxable years ending after February 26, 1997, at least where the party whose stock is redeemed is a tax-exempt or other "tax indifferent" party or the transaction otherwise has a tax-avoidance purpose. In general, however, since any such Section 302(b)(1) Regulation would be characterizing redemption amounts based upon their economic substance, the Committee believes that it should apply evenhandedly regardless of the taxable status of the relevant shareholder or the purpose of the relevant redemption transaction.

circumstances might be relevant, or what types of changes in such facts and circumstances might be viewed as significant, for this purpose. The Committee believes that inclusion of one or more examples describing circumstances where redetermination is required because of a significant change in the relevant facts and circumstances would be helpful.

3. Scope of the Proposed Regulations. Section (c)(1) of the Proposed Regulations sets forth the scope of the Proposed Regulations. Pursuant thereto, a fast-pay arrangement will be subject to recharacterization under the Proposed Regulations if: (i) the issuer of the fast-pay stock is a regulated investment company (a "RIC") or a real estate investment trust (a "REIT") or (ii) in any other case, the IRS determines, in its discretion, that a principal purpose for the fast-pay arrangement is the avoidance of any tax imposed by the Code. The Committee has three comments on this provision.

First, the Committee believes that, in the event that a fast-pay arrangement involving a RIC or REIT does not have a principal purpose of tax avoidance, the parties involved should be able to avoid having the arrangement recharacterized under the Proposed Regulations. The Committee, however, believes that such circumstances will be infrequent, at best. The Committee therefore recommends that fast-pay arrangements involving RICs and REITs be

presumed to have a tax avoidance purpose (and thus be subject to recharacterization) unless, prior to the time the fast-pay stock is issued, the RIC or REIT obtains a favorable private letter ruling exempting the arrangement from recharacterization on the basis that no principal purpose of the arrangement is tax avoidance.¹⁸

Second, in the case of any type of issuer, the Committee suggests that the Proposed Regulations be clarified to provide that recharacterization will be required only if the tax avoidance at issue with the fast-pay arrangement is furthered by, or otherwise related to, the mischaracterization of amounts received as dividend income. This concept is arguably already implicit in the Proposed Regulation's requirement that "a principal purpose for the structure of the fast-pay arrangement is the avoidance of" tax [emphasis supplied], but clarification of the point would forestall taxpayer arguments that the Government has exceeded its authority under Section 7701(1)

¹⁸In the case of fast-pay stock issued by a RIC or a REIT and already outstanding at the time the Proposed Regulations are finalized, the issuer should be granted a limited period of time after the date the final Regulations are issued to seek such a private letter ruling.

If there were a significant modification to the terms of the fast-pay stock or related agreements, or a significant change in any other relevant facts and circumstances, a supplemental favorable private letter ruling would be required to avoid recharacterization on a going forward basis.

by attempting to use the Proposed Regulations as a general anti-abuse rule.

Finally, as noted above, the Proposed Regulations would not recharacterize fast-pay arrangements entered into by non-RIC or -REIT issuers unless there were an adverse determination by the IRS. The Committee encourages the IRS to utilize the private letter ruling process to enable taxpayers who wish to do so to request such a determination.¹⁹ As the IRS's experience with such private letter rulings grows, it might be possible for the IRS to issue one or more Revenue Procedures that set forth the types of transactions where, ordinarily, a favorable or unfavorable determination will be issued, thus streamlining

¹⁹The analogy here, of course, is to the IRS's active ruling process with regard to Section 355 transactions. Unlike RIC and REIT issuers, however, applying for such a private letter ruling would be discretionary on the part of the issuer.

Pursuant to Section (d) of the Proposed Regulations, the IRS can abstain from recharacterizing a fast-pay arrangement otherwise subject to recharacterization if the parties attempt to affirmatively avail themselves of recharacterization in order to avoid any tax imposed by the Code. The Committee believes that taxpayers should also be able to utilize the private letter ruling process to establish (i) whether the IRS will or will not recharacterize the relevant fast-pay arrangement and (ii) if it won't (in whole or part), how it intends to tax the transaction.

Significant changes in the terms of the arrangements or the relevant facts and circumstances would necessitate a supplemental private letter ruling.

the process (for both the IRS and taxpayers) for the future.²⁰

4. Recharacterization Rule. Pursuant to the recharacterization rule of Section (b)(2) of the Proposed Regulations (the "Recharacterization Rule"), the Benefitted Shareholders are treated as having received cash from the Fast-Pay Shareholders in exchange for the issuance by them to the Fast-Pay Shareholders of financial instruments ("Financing Instruments") having payment terms identical to those of the fast-pay stock. The Benefitted Shareholders are then treated as having contributed that cash to the issuing corporation. It is unclear whether this "cash-is-received" rule is to apply in cases where the Fast-Pay Shareholders, in form, receive their stock in exchange for property other than cash. More generally, it is unclear whether the Recharacterization Rule is intended to apply for all purposes of the Code, including for purposes of determining the collateral effects of the relevant transaction.²¹

²⁰Even in such case, however, an actual private letter ruling would be required to ensure that a fast-pay arrangement would not be recharacterized.

²¹Cf. Section (d) of the Proposed Regulations which deals with cases in which a fast-pay arrangement is structured to enable the parties to avail themselves of the Recharacterization Rule for tax avoidance purposes. In such case, the IRS may "recharacterize (for all purposes of the Code) the fast-pay arrangement in accordance with its form

For example, assume that A and B form a new corporation ("Newco"). A contributes a piece of land with a fair market value of \$100 and an adjusted tax basis of \$0 in exchange for \$100 of Newco fast-pay stock. Concurrently, B contributes \$100 of cash to Newco in exchange for \$100 of Newco non-fast-pay stock. A and B intend that the transaction qualify as a tax-free transaction under Section 351.

The intended scope of application of the Recharacterization Rule to this transaction is unclear. In particular, is it intended that the transaction be treated as if (i) A transferred the land to B in exchange for a "Financing Instrument" containing payment terms identical to those of the fast-pay stock, and then (ii) B transferred the land and \$100 cash to Newco in exchange for (non-fast-pay) stock of Newco? In such case, the transfer of the land by A to B would presumably be taxable to A and Newco would presumably have a \$100 adjusted tax basis in the land immediately after its contribution.

The Committee believes that, at least for reasons of consistency and simplicity, this result is appropriate and believes that the Proposed Regulations should explicitly state that the Recharacterization Rule will apply for all,

or its economic substance." [emphasis supplied].

purposes of the Code.²² An example showing the consequences to the parties in a case in which the fast-pay stock is acquired for property, rather than cash, would be a helpful addition to the Proposed Regulations.²³

²²As discussed above, the abuse that the Proposed Regulations are intended to stop is the mischaracterization of amounts received as dividend income. If the Direct Recharacterization Approach were adopted, mischaracterization would be avoided, but the overall transaction would still presumably qualify as a tax-free Section 351 exchange. This result, of course, might be viewed as appropriate since the mischaracterization of amounts as dividend income is not inconsistent with the policy rationale for treatment of the overall transaction as tax-free under Section 351. Thus, a strong argument could be made that the Recharacterization Rule should not apply for purposes of determining whether the transaction is a valid Section 351 exchange.

The Committee, however, believes that attempting to apply the Recharacterization Rule for some purposes but not others will inevitably lead to increased confusion and complexity and, at least in certain cases, over- or under-taxation of the parties. Moreover, since the focus of the Proposed Regulations is on transactions having a tax avoidance purpose, the Recharacterization Rule will likely apply to only an extremely limited universe of transactions. Given the Government's inability to adopt a Direct Recharacterization Approach, as discussed above, the Committee believes that application of the Recharacterization Rule for all purposes of the Code is appropriate.

²³The result proposed in the text might be advantageous to the parties in certain circumstances. For example, if A had expiring net operating losses of at least \$100, application of the Recharacterization Rule in the manner suggested would generally be favorable. Given the ease with which taxpayers can elect whether Section 351 is or is not to apply to a particular transaction, however, the Committee believes that it would not be appropriate to apply the rule of Section (d) of the Proposed Regulations to deny application of the Recharacterization Rule to the transaction.

Whether the Recharacterization Rule was intended to have other collateral effects is also unclear. For example, under certain circumstances the qualification of the issuer as a REIT may turn on whether the Fast-Pay Shareholders are treated as shareholders of the issuer, or whether instead only the Benefitted Shareholders are so treated.²⁴ Similarly, whether a foreign corporation will be treated as a controlled foreign corporation (within the meaning of Section 957) or a foreign personal holding company (within the meaning of Section 552) may depend on whether the Fast-Pay Shareholders are treated as owning stock in the issuing corporation.²⁵ While, once again, arguments could be adduced why the Recharacterization Rule should not apply for determining these (and other) collateral effects of the transactions²⁶, the Committee

²⁴See Section 856(a)(5) and (6), (k) (stock ownership requirements for REIT status).

²⁵See Sections 957(a) (stock ownership requirements for controlled foreign corporation status), 552(b) (stock ownership requirements for foreign personal holding company status). See also Sections 542(a)(2) (stock ownership requirements for personal holding company status); 1504(a) (stock ownership requirements for affiliated group status).

²⁶See note 21 *supra*.

Where the non-fast-pay stock is held by tax exempt investors, the Recharacterization Rule may also result in application of the "unrelated debt-financed income" rules of Section 514 with respect to such investors.

It should be noted, once again, that adoption of a

believes that, given the Government's inability to adopt the Direct Recharacterization Approach, general application of the Recharacterization Rule to determine the tax consequences to the parties is warranted and the Proposed Regulations should so state explicitly.²⁷

5. Character of Financing Instruments. As noted above, pursuant to the Recharacterization Rule Fast-Pay Shareholders are treated as having received Financing Instruments directly from the Benefitted Shareholders with payment terms identical to those of the fast-pay stock. According to Section (c)(3) of the Proposed Regulations, "[t]he character of these Financing Instruments (for example, stock or debt) is determined under general tax principles and depends on all the facts and circumstances".

The Proposed Regulations give no hint as to what "facts and circumstances" are relevant for making this determination. The Committee, however, believes that it would be appropriate if the Proposed Regulations explicitly

Direct Recharacterization Approach would avoid most of these adverse collateral tax consequences.

²⁷Again, examples in the Proposed Regulations to illustrate this point would be helpful.

Application of the Recharacterization Rule to determine the collateral effects on the parties assumes, of course, that the IRS does not apply the "anti-abuse" rule of Section (d) of the Proposed Regulations to prevent application of the Recharacterization Rule in the first place.

mandated that, in all cases, the Financing Instruments be characterized as debt.²⁸ Such a rule would have the virtue of certainty. Moreover, given the original issue discount rules of Sections 1271 through 1275 and the other "time value of money" provisions of the Code, the Committee believes that treating Financing Instruments as debt ensures

²⁸Some may object that this rule would be overly favorable to taxpayers in cases in which, because of thin capitalization or other reasons, debt issued by the Benefitted Shareholder(s) would be recharacterized as equity under general tax principles. The Committee, believes, however, that an approach recharacterizing the Financing Instruments as other than debt would result in unnecessary complexity and, at least in certain cases, inappropriate multiple taxation.

For example, assume that A, a CFC, issues fast-pay stock to B; all the remaining stock of A is owned by C, a U.S. corporation. C's stock, in turn, is owned by D, a U.K. company. C is thinly capitalized. Under the Recharacterization Rule, C is treated as owning all the A stock (including the fast-pay stock) and as having issued a Financing Instrument to B. If taking into account the hypothetical issuance of the Financing Instrument to B and the investment of the proceeds of such issuance as additional equity in A, C would be so thinly capitalized that a debt instrument issued by C and having payment terms identical to those of the fast-pay stock would be treated as equity of C under general tax principles, some might argue that the Financing Instrument should be treated as equity for purposes of applying the Recharacterization Rule. In such case, C would be treated as having issued fast-pay stock and it is unclear whether the Recharacterization Rule would apply again to treat D as the issuer of the Financing Instrument to B (and payments with respect to the fast-pay stock as payments to D with respect to its C stock). The result would potentially be multiple layers of U.S. income and withholding tax. The Committee sees little to be gained by such an approach given that the "real" abuse is the mischaracterization of amounts paid by A with respect to its (fast-pay) stock.

that the taxable income of the parties will be clearly and accurately reflected.²⁹

6. Application of the Proposed Regulations to Publicly Held corporations. Where the stock held by the Benefitted Shareholders (the "Benefitted Stock") is widely held and publicly traded, application of the Recharacterization Rule may result in an administratively burdensome result for the IRS, the issuing corporation and the Benefitted Shareholders. In some cases, unsophisticated Benefitted Shareholders may be unaware of the net amounts includible in their taxable income as a result of the Recharacterization Rule;³⁰ other Benefitted Shareholders may be tempted to ignore the "phantom income" resulting from application of the Recharacterization Rule on the basis that the result is "nonsensical".³¹ Even if the Benefitted

²⁹Where the fast-pay stock is issued for property other than cash, the Committee believes that the issue price of the Financing Instrument should be determined under the relevant provision of Section 1273 or 1274.

³⁰Presumably, the issuing corporation will be required to file the relevant information returns in a manner consistent with Recharacterization Rule. (An explicit statement to this effect in the Proposed Regulations would be helpful.) Unsophisticated Benefitted Shareholders, however, may be unaware of their entitlement to an offset for interest deemed to be paid by them with respect to the Financing Instruments.

³¹Again, consistent information reporting by the issuing corporation may eliminate or reduce any such temptation.

Shareholders accurately report their income, inconsistent treatment by the Fast-Pay Shareholders, perhaps out of ignorance, may result in over- or under-taxation of the parties to the transaction.³² Some may be concerned that the potential for such inappropriate results may, in some cases, encourage publicly-traded corporations to issue fast-pay stock.

The Committee believes, however, that any such concerns should, as a practical matter, be relatively negligible. As noted above, consistent information reporting may alleviate concerns in this area. Furthermore, application of the Recharacterization Rule, with its potential for creating "phantom income" for the Benefitted Shareholders, coupled with SEC disclosure requirements, is likely to discourage adoption of fast-pay arrangements in the future, particularly in the case of public-traded corporations.³³ In any event, the Committee believes that exempting publicly-held corporations from the Proposed

³²As a practical matter, of course, this concern may be unwarranted since fast-pay stock has typically been issued to tax-exempt or otherwise tax-indifferent investors.

³³In some cases, of course, public non-RIC and -REIT issuers of fast-pay stock may claim that they are outside the Recharacterization Rule on the basis that they do not have a tax avoidance purpose for the issuance. Nevertheless, only the bravest of issuers would attempt to issue such stock without even mentioning the consequences to holders if they are wrong in this assertion.

Regulations would necessitate difficult questions of "line drawing" and likely encourage continuation of the types of transactions that the Notice and the Proposed Regulations were intended to stop.³⁴

7. Use of Derivatives in Tax Avoidance

Transactions. It may be possible to avoid unfavorable tax consequences under the Proposed Regulations through the use of derivatives. For example, assume that Corporation X forms a REIT. The REIT has two classes of stock, one of which is fast-pay stock with an effective maturity of ten years. A, a domestic tax-exempt entity, purchases the fast-pay stock; B, another domestic tax-exempt entity, purchases the remaining stock of the REIT (the "benefitted stock"). REIT lends to X the proceeds of the sale of its stock in exchange for a bullet maturity ten-year note secured by a mortgage on X's real property.³⁵

Concurrent with its purchase of the benefitted stock, B enters into a prepaid forward contract with X whereby it obligates itself to sell to X its REIT stock in

³⁴Because it would affect characterization of amounts paid at the issuing corporation level, adoption of the Direct Recharacterization Approach might alleviate some of the difficulties discussed in the text with respect to publicly-held corporations.

³⁵We are ignoring the requirements of Sections 856(a)(5) and (6) here. Satisfaction of such requirements would make the example more complex but not alter its thrust.

ten years for \$1, an amount substantially less than the expected fair market value of the benefitted stock at that time. In ten years, X will acquire the benefitted stock from B for \$1 (in a transaction not resulting in any gain or loss to X) and then liquidate the REIT in a Section 332 liquidation.

Obviously, if X is not treated as the owner of the benefitted stock for tax purposes, the parties will have been able to achieve the same after-tax economics as in a "traditional" fast-pay arrangement without running afoul of the Proposed Regulations.³⁶ The Committee accordingly believes that the posited transaction should be subject to the Recharacterization Rule of the Proposed Regulations. How to do so, however, is not completely clear.

One possibility would be to apply an expanded version of general principles to treat X as the owner of the benefitted stock ab initio.³⁷ Alternatively, the Proposed Regulations could provide for a special rule treating

³⁶Obviously, the IRS may be able to treat X as the owner of the benefitted stock by virtue of tax ownership, step transaction or other general principles. Expansion of the Recharacterization Rule to cover this (and similar) cases would, however, afford the IRS an additional means of attacking abusive transactions.

³⁷Cf. Revenue Ruling 82-150, 1982-2 C.B. 110 (holder of deep-in-the-money option to acquire stock treated as owner of stock for purposes of foreign personal holding company rules).

forward contracts, options and other derivatives as ownership interests in the issuer for purposes of applying the Recharacterization Rule.³⁸ Another possible approach would be to impute income with respect to a derivative, such as a prepaid forward contract, over the life of the derivative.³⁹ Finally, the Proposed Regulations could provide that a physical settlement of a derivative on benefitted stock be treated as a taxable sale of the derivative,⁴⁰ perhaps coupled with an ordinary income taint and an interest charge to account for X's ability to avoid

³⁸Cf. Section 1298(a)(4) (under Regulations, treating owner of option as owner of the underlying stock for purposes of applying the passive foreign investment company rules).

³⁹Cf. Treasury Regulation Section 1.1275-5 (imputing interest at the issuer's "comparable yield" in the case of a contingent payment debt instrument).

In order for X to achieve a favorable after-tax economic result from a fast-pay arrangement, the transaction must be structured such that X (rather than B) benefits from the economic return with respect to the amount invested in the benefitted stock without bearing any associated tax cost. Accordingly, abusive fast-pay arrangements involving derivatives will generally entail (i) X's "fronting" the initial investment in the benefitted stock through a prepayment or loan to B and (ii) physical, rather than cash, settlement of the derivative, such that X can acquire the benefitted stock without being required to pay any tax with respect to the increase in the fair market value of such stock over the life of the derivative.

⁴⁰See note 38 supra.

recognizing dividend income over the life of the derivative.⁴¹

Each of these alternative approaches (and no doubt others) raise delicate policy issues concerning complexity, effectiveness in preventing abusive transactions without impeding non-abusive uses of derivatives, consistency with other areas of the tax law and the Government's authority under Section 7701(1). The Committee has not reached a view as to which, if any, of these approaches would be most appropriate to avoid evasion of the Recharacterization Rule. Nevertheless, the Committee believes that the use of derivatives in fast-pay arrangements is an important issue that deserves additional study and analysis.

8. Reporting Obligations in the Case of Non-Avoidance Transactions. Under Section (f) of the Proposed Regulations, issuers of fast-pay stock are generally required to report certain information to the IRS with respect to such stock. This is the case even if the fast-pay stock is not part of a fast-pay arrangement that is subject to the Recharacterization Rule because it is issued

⁴¹Cf. Section 1256(c)(2) (physical settlement of Section 1256 contract treated as taxable event); Section 1291 (imposing ordinary income taint and interest charge on excess distributions with respect to passive foreign investment company stock).

by a non-RIC or -REIT issuer in a transaction that does not have a tax avoidance purpose.

The Committee recognizes that the reporting requirement is intended to have a prophylactic effect by enabling the IRS to learn of extant fast-pay arrangements, thus allowing it to determine whether application of the Recharacterization Rule is appropriate. Given the complexity of the Proposed Regulations, however, some non-RIC/REIT issuers of fast-pay stock may issue such stock without a tax avoidance purpose and yet, for good cause shown, fail to satisfy the reporting obligations under the Proposed Regulations. The Committee believes that the Proposed Regulations, when finalized, should explicitly grant the IRS authority to excuse such failures to report under such circumstances.

Conclusion

On balance, and given the view of a majority of the Committee that the Government is not authorized under current law to adopt the Direct Recharacterization Approach, the Committee believes that the Proposed Regulations represent an appropriate exercise of the Government's regulatory authority under Section 7701(1). Nevertheless, given the complexities and adverse collateral tax

consequences resulting from the Indirect Recharacterization Approach adopted by the Proposed Regulations, the Committee would support legislation that would adopt the Direct Recharacterization Approach or authorize the Government to issue Regulations to that effect.