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Treasury Brings "Fast Pay" Arrangements to a Screeching Halt

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It is commonly said that taxation—at least sometimes—follows the "substance" of a transaction, rather than its "form." However, determining what the "substance" of a transaction *is* and when it will (or will not) be given effect, in disregard of the "form," is not an easy task or one for which the courts have always given us clear guideposts. Moreover, the imagination and enthusiasm of taxpayers, investment bankers, and their respective advisors in creating new, ever-more-complex structures cannot always be constrained.

As a result, it has sometimes been possible to avoid taxation, in ways viewed as inappropriate by the Treasury Department and the Internal Revenue Service, by structuring financial transactions which utilize multiple entities. Certain transaction forms have been subject to attack, sometimes successfully, by the IRS, but the case-by-case and issue-by-issue development of the law has left the IRS "playing catch-up" again and again, as new techniques, arguably different from those disapproved in prior authorities, were developed. In order to level the playing field a bit, Congress has responded in recent years by granting some new weapons to the IRS. This column focused a number of months ago on the Clinton Administration's controversial proposals to impose further restrictions on transactions considered to be "corporate tax shelters." This month we focus on Regulations that were recently proposed to implement authority granted by Congress in 1993 to the IRS to recharacterize "any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary [of the Treasury or his authorized delegate] determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by" the Internal Revenue Code.[1]

Since this provision was added to the Code, the IRS has used it to adopt or propose Regulations in three areas involving "multiple-party financing transactions." A first set of Regulations proposed in 1994 and promulgated in 1995 dealt with abuses of the rules relating to the taxation of foreign corporations and nonresident aliens.[2] Then, the IRS attacked "lease stripping" transactions with proposed Regulations issued on December 27, 1996.[3] The most recent subject to have caught the IRS's eye is "financing arrangements involving fast-pay stock," concerning which the IRS issued Notice 97-21 on February 27, 1997,[4] following up with a comprehensive set of proposed Regulations published on January 6, 1999. We focus in this column on the scope of these proposed "fast-pay stock" rules, both in terms of the sorts of economic arrangements that may be brought within their ambit and in terms of the range of tax consequences that may be affected by a determination that "fast-pay stock" has been issued.

What Is "Fast-Pay Stock?"

Background. "Fast-pay stock" was brought into existence by the fact that certain corporations, particularly regulated investment companies ("RIC's") and real estate investment trusts ("REIT's"), are subject to regimes of Federal income taxation different from the regime applicable to other C corporations.

Ordinarily, a C corporation is taxed on its own income, when that income is earned, regardless of whether some or all of that income is distributed to its shareholders immediately, at a later date, or not at all. The shareholders of the corporation are subject to an additional level of tax when distributions are made to them. Certain shareholders, such as pension funds, tax-exempt charitable organizations, and investors entitled to the benefit of a tax treaty may be relieved of this additional level of tax liability, but the presence of such shareholders does not relieve the corporation of its *own* income tax liability.

By contrast, a RIC or a REIT is entitled to *deduct*, in computing its own taxable income, the amount of "dividends" paid to its shareholders.[5] Moreover, in order to be entitled to this benefit, the RIC or REIT is *required* to distribute as a dividend each year an amount equal to at least 90%, in the case of a RIC, or 95%, in the case of a REIT, of its ordinary taxable income for the year.[6] Accordingly, the income of a RIC or a REIT is generally taxable *only* to its

shareholders. If those shareholders are themselves exempt from tax, the income of the RIC or REIT will be free from Federal income tax.

One situation that is frequently problematic for RIC's and REIT's involves the use of income to make principal amortization payments on borrowed funds. Take the case of a corporation that hopes to qualify as a REIT and that borrows $100.00 to buy a building as its sole asset. Assume that the loan is a 10-year, self-amortizing loan, bearing interest at 10%. The annual mortgage payment will be $16.27, which, in the first year of the financing, will consist of $10.00 of interest and $6.27 of principal. Assume further that the building generates $20.00 per year of net cash flow, before debt service, and that annual depreciation deductions are $2.56 ($100.00 cost, divided by 39-year depreciation period). The corporations's cash flow after debt service will be only $3.73 ($20.00 gross cash flow - $16.27 debt service), although its taxable income will be $7.44 ($20.00 gross cash flow - $10.00 interest expense - $2.56 depreciation). In order to qualify as a REIT, the corporation will be required to distribute dividends equal to 95% of its taxable income, or $7.07. How can it comply, when it has only $3.73 of available cash?

It was to solve this sort of problem that fast-pay stock was created. Suppose that the party providing funds to the REIT were willing to provide those funds in the form of preferred stock, rather than as a loan. The terms of the preferred stock could entitle the holder to annual dividends of, say, $16.00 per year for an initial period of ten years. After the 10-year period had ended, the dividend rate would drop sharply, perhaps to 1% of the prior rate. The holder would have the right to be receive $100.00 upon liquidation of the REIT, but would have no mandatory redemption rights prior to that time.

The economic consequences of this preferred stock investment are very similar to those of a self-liquidating, 10-year loan. The crucial tax difference is that REIT would treat the full annual distributions to the preferred stockholder as *deductible dividends,* so that the REIT would not have a problem in meeting its distribution requirements.[7]

Proposed Regulations. The recently proposed Regulations are premised on the notion that allowing this sort of reporting fails "to clearly reflect" [*sic*] the income of either the holder of the preferred stock or the holders of the remaining shares of the REIT. It is true that the effects on the two parties are in a sense offsetting. The holder of the preferred stock will overstate its dividend income and then have an overstated capital loss at the time of its disposition of the preferred shares. On the other hand, the holders of the remaining shares (or the REIT itself) will understate their taxable income, because the deduction of amounts paid to the holder of the preferred shares really represents principal amortization paid out of earnings that increase, on a year-by-year basis, the value of the investment of the holders of the common shares. Those holders will thus have an increased capital gain to be reported upon disposition of their shares in the REIT. The IRS sees some abuses in this case; for example, if the holder of the preferred stock is a tax-exempt entity, it will suffer no actual disadvantage from being required to overstate its dividend income.

In order to prevent these perceived abuses, the proposed Regulations provide that, *whenever* the issuer of fast-pay stock is a RIC or a REIT, the resulting "fast-pay arrangement" will be recharacterized, apparently for all tax purposes,[8] as an "arrangement directly between the benefitted shareholders [*i.e.*, the holders of all stock in the corporation other than the fast-pay stock[9]] and the fast-pay shareholders."[10] Moreover, if the IRS determines that a "principal purpose for the structure of [any other] fast-pay arrangement is the avoidance of any tax imposed by the [Internal Revenue] Code," the IRS may, in its discretion, recharacterize the fast-pay arrangement.

The proposed Regulations provide a general definition of "fast-pay stock" and then list specific two cases in which stock is presumed to be "fast-pay stock."

Stock is fast-pay stock if it is structured so that *dividends* ... 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). Unless clearly demonstrated otherwise, stock is presumed to be fast-pay stock [if]--

(A) It is structured to have a dividend rate that is reasonably expected to decline (as opposed to a dividend rate that is reasonably expected to fluctuate or remain constant); or

(B) It is issued for an amount that exceeds (by more than a de minimus amount, ...) the amount at which the holder can be compelled to dispose of the stock.[11]

Although issuance of fast-pay stock by foreign corporations with United States shareholders may lead to some of the same sorts of perceived abuses as issuance of fast-pay stock by RIC's and REIT's, the proposed Regulations do not adopt a *per se* recharacterization rule in the case of foreign corporations; rather, the IRS has indicated that it will "closely scrutinize" any such arrangements involving foreign corporations and may utilize its discretionary authority in such cases.

As is evident from the foregoing definitions, stock may be considered to be "fast-pay stock" even if it is not issued by a RIC or a REIT, even if it is not preferred stock, and even if, by its terms, it is far from certain that it will "pay faster" earlier in its term than later.

Consequences of Recharacterization

If the recharacterization rules apply to a fast-pay arrangement, it will be recharacterized as an arrangement directly between the benefitted shareholders and the fast-pay shareholders. In the arrangement, as so recharacterized, the fast-pay shareholders are deemed to have transferred to the benefitted shareholders an amount of cash[12] equal to the fair market value of the fast-pay stock at the time that the fast-pay stock is issued. The benefitted shareholders are deemed

to have issued to the fast-pay shareholders financial instruments having the same payment terms (as to timing and amount) as the fast-pay stock. The character of these deemed financial instruments (for example, as stock or debt) is determined under general tax law principles and depends on all the facts and circumstances. The benefitted shareholders are deemed to contribute the cash received by them (from the fast-pay shareholders, in consideration of the issuance of the deemed financial instruments) to the issuing corporation.[13] Distributions made with respect to the fast-pay stock are deemed to have been made to the benefitted shareholders, with respect to their benefitted stock, and then deemed to have been paid by them to the fast-pay shareholders with respect to the deemed financial instruments. The fast-pay stock, as such, is ignored in determining whether the existence or nature of any relationship between the fast-pay shareholders and the issuing corporation.[14]

Special rules are provided to deal with the treatment of the buyer and seller in the case of a sale of benefitted stock at a time at which fast-pay stock is outstanding. Rules are also provided describing the obligations of the issuing corporation to withhold Federal income tax on certain payments made with respect to fast-pay stock.[15]

The consequences of recharacterization of a fast-pay arrangement can be surprising. Benefitted shareholders may find themselves deemed to be receiving income and making payments in unexpected ways, requiring complicated and counterintuitive reporting. Moreover, many rules in the Internal Revenue Code depend on the relationship or "nonrelationship" of parties to each other. The recharacterization of transactions under the proposed Regulations can stand on its head the analysis of whether such a relationship exists. Accordingly, recharacterization of a fast-pay arrangement could have effects on transactions completely unrelated to the fast-pay investment.[16]

Reporting Requirements

The proposed Regulations would require any corporation that has fast-pay stock outstanding at any time during a year, whether or not the recharacterization rules apply to that stock, to attach a special disclosure statement to its tax return for that year.[17]

Effective Dates

The recharacterization required by the proposed Regulations would apply to all taxable years ending after February 26, 1997, with respect to any fast-pay arrangement, regardless of when created. If, upon issuance of final Regulations, a taxpayer has filed to comply with the recharacterization rules for periods to which they are (retroactively) made effective, the taxpayer will be required to file amended returns. However, for taxable years ending before the date on which final Regulations are published, taxpayers (particularly holders of benefitted shares) would be given an election to compute the amount of additional income required to be reported by them by reference to the somewhat different method of computation set out in Notice 97-21. The special reporting rules for corporations with "unrecharacterized" fast-pay arrangements will be effective for taxable years ending after the date of publication of final Regulations.[18]

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1 Internal Revenue Code section 7701(*l*).

2 Treasury Regulation sections 1.881-3 and 1.881-4.

3 Proposed Treasury Regulation section 1.7701(*l*)-2.

4 1997-1 C.B. 407.

5 Internal Revenue Code sections 11(c)(3), 852(b)(2)(D), 857(b)(2)(B).

6 Internal Revenue Code sections 852(a)(1), 857(a)(1). These are the rules that apply to ordinary income; RIC's and REIT's are not required to distribute their capital gains, but, to the extent that they do so (or elect for their shareholders to be taxable on undistributed entity-level capital gains), the RIC or REIT is not subject to tax on its capital gains.

7 The REIT's taxable income, before deduction for dividends paid, would be $17.44 ($20.00 gross cash flow - $2.56 depreciation deduction). A $16.00 deduction for dividends paid on the preferred stock would reduce this amount to $1.44. Cash flow from the property, after paying the preferred stock dividend, would be $4.00. The REIT would have more than enough money available to distribute sufficient dividends on its common shares to maintain its REIT qualification.

8 By contrast, the 1995 Regulations dealing with "conduit financing arrangements" involving foreign corporations and nonresident aliens recharacterize such arrangements solely for purposes of specified provisions of the Internal Revenue Code.

9 The proposed Regulations contemplate that there may be multiple classes of fast-pay stock in a corporation. In applying the new rules to any one class of fast-pay stock, each other class will be considered benefitted stock "as appropriate to match the economic substance of the fast-pay arrangement."

10 However, a taxpayer will not be able affirmatively to use these rules, "if a principal purpose for using such rules is the avoidance of any tax imposed by the Code." With respect to any taxpayer who tries to do so, the IRS may treat the fast-pay arrangement "in accordance with its form or its economic substance." Proposed Treasury Regulation section 1.7701(*l*)-3(d). This authority may be exercised on a taxpayer-by-taxpayer basis, so a single transaction may be recharacterized as to some parties and not as to others.

11 Proposed Treasury Regulation section 1.7701(*l*)-3(b)(2)(i) (emphasis added). The determination of whether stock is fast-pay stock will be based on all the facts and circumstances and must be made when the stock is issued, whenever there is a significant modification in its terms, and whenever there is a significant change in the relevant facts and circumstances. Proposed Treasury Regulation section 1.7701(*l*)-

3(b)(2)(ii). A literal application of this last rule could lead to treating stock as fast-pay stock based solely on economic developments that were unanticipated at the time that it was issued.

[12] The proposed Regulations do not address what to do when the fast-pay shareholders transferred property other than cash as the consideration for their acquisition of their fast-pay stock.

[13] *Example 3* in proposed Treasury Regulation section 1.7701(*l*)-3(e) makes clear that the fast-pay stock is *not* considered to be outstanding in the hands of the benefitted shareholders; rather, they are deemed to have made an additional capital contribution in their capacity as holders of the benefitted stock.

[14] Proposed Treasury Regulation section 1.7701(*l*)-3(c)(2), (3)(i).

[15] Proposed Treasury Regulation section 1.1441-7(g). These withholding rules are proposed to be effective to payments made *on or after January 6, 1999*. In other words, corporations which make payments on fast-pay stock during 1999 cannot defer consideration of the issues raised by the proposed Regulations to the time at which they will be preparing their 1999 tax returns.

[16] For example, take the case of an individual who acquires 100% of the sole class of fast-pay stock issued by a particular REIT. The individual also happens to own almost 50% of the outstanding stock of a corporation ("X") that owns 5% of the REIT's common stock. Upon recharacterization of the fast-pay arrangement, X is deemed to have issued to the individual a financial instrument with terms requiring it to make payments to the individual equal to 5% of the payments that are (actually) required to be made by the corporation with respect to the fast-pay stock. Assume that, under general principles of tax law, this deemed financial instrument is considered to be an equity investment by the individual in X. This equity investment could cause X to be considered to own *more than* 50% of the stock of X, thereby changing the tax consequences of completely unrelated transactions between the individual and X.

[17] Proposed Treasury Regulation section 1.7701(*l*)-3(f).

[18] Proposed Treasury Regulation section 1.7701(*l*)-3(g).

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