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Corporate Provisions of the Taxpayer Relief Act of 1997

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Under the caption of "Title X—Revenues," the Taxpayer Relief Act of 1997 (the "1997 Act"), signed by President Clinton on August 5, 1997, contains just five provisions in subtitle B, relating to "Corporate Organizations and Reorganizations." Do not be fooled. The 1997 Act is replete with provisions of relevance to businesses and their advisors, including some which, although not included in subtitle B of title X, are nevertheless relevant specifically to businesses organized in corporate form (as distinguished from partnerships and limited liability companies). In this column, we touch on a few of the provisions that are likely to be of general interest.[1] Some of these, like the new limitations on the ability of corporations to implement tax-free spin-offs (the so-called "anti-*Morris Trust*" legislation) have already received significant notice in the financial press; others have for some reason so far attracted less attention.

Rollover of Gain from Sale of Qualified Stock

Prior to the 1997 Act, the maximum Federal income tax rate applicable to capital gains of noncorporate taxpayers was generally 28%. However, the Revenue Reconciliation Act of 1993 (the "1993 Act") created a preferential maximum tax rate of only 14% for noncorporate taxpayers in the case of certain sales of stock in small, start-up enterprises; the 1993 Act achieved this by allowing the taxpayer to exclude 50% of the gain from income. In order to qualify for this special rate, the stock has to have been acquired by the taxpayer after December 31, 1992, and at its original issuance and has to be held for more than five years. (In other words, no taxpayer has yet become eligible for the special rate, although stock acquired in early 1993 will soon start to pass the five-year benchmark.) There are also a variety of other tests relating, *inter alia*, to the nature and amount of the assets of the corporation that must be satisfied.

As almost everyone knows, the 1997 Act generally reduced the maximum Federal income tax rate on capital gains of noncorporate taxpayers to 20%, effective for sales after May 6, 1997.[2] In order to prevent an inappropriate duplication of benefits, gain from the sale of small business stock held for more than five years that is eligible for the 50% exclusion is *not* eligible for the reduced 20% rate as well (since eligibility for both benefits would have resulted in a net tax rate of only 10%), but continues to be subject to the 28% rate of prior law (resulting in a continuation of the net tax rate of 14%).

However, the 1997 Act does add a new tax planning opportunity in the case of any qualified small business stock that has been held for more than six months. An individual who sells such stock after August 5, 1997, and, within 60 days after the sale, reinvests the proceeds in other qualified small business stock, is allowed to defer taxation of the gain by "rolling over" into the newly-purchased stock, thereby reducing its basis. To the extent that proceeds are not reinvested, the individual will continue to be subject to tax at the preferential 14% rate.

Exemption from Alternative Minimum Tax for Small Corporations and Repeal of Separate Depreciation Lives for Minimum Tax Purposes

The "alternative minimum tax" (or "AMT") may be imposed on both corporate and noncorporate taxpayers who have significant "preferences" and "adjustments." In order to account properly for the AMT, a taxpayer may effectively be required to maintain two sets of tax records, one maintained under regular tax principles and the other maintained under AMT principles. One of the adjustments applicable to corporate taxpayers in computing the AMT is the "adjusted current earnings" (or "ACE") adjustment, which may require the maintenance of a *third* set of books under ACE principles. In the case of all taxpayers, one of the most significant differences between income as computed for regular tax purposes and income as computed for AMT purposes is that depreciation on tangible personal property is generally allowed on a much less accelerated basis under the AMT than under the regular tax.

Effective for taxable years beginning after December 31, 1997, the 1997 Act repeals the AMT entirely for any corporation that had average annual gross receipts of $5,000,000 or less for the three-year period beginning after December 31, 1994.[3] If a corporation meets this $5,000,000 test as applied for the three-year period from 1995 through 1997, it will not lose its exemption from the AMT until its average annual gross receipts for a three-year period exceed $7,500,000 and, even then, the AMT will be applied in a somewhat less onerous manner. The special AMT rules for depreciation are also repealed for all taxpayers (large and small, corporate and noncorporate), with respect to property placed in service after December 31, *1998*.

Election for 1987 Partnerships to Continue Exception from Treatment of Publicly Traded Partnerships as Corporations

The Omnibus Budget Reconciliation Act of 1987 added a provision to the Internal Revenue Code (the "Code") under which "publicly traded partnerships" are required to be treated as corporations. Two broad exceptions to this rule exist. First, partnerships that derive at least 90% of their gross income from "passive-type" sources, including interest, dividends, and real property rents, are not treated as corporations under this provision. Second, partnerships that were already publicly traded on December 17, 1987, were "grandfathered" for a period of ten years, regardless of the nature of their gross income, as long as they did not add a substantial new line of business. This "grandfather" protection has been scheduled to expire for taxable years beginning after December 31, 1997.

The 1997 Act provides grandfathered publicly traded partnerships that do not meet the 90% passive-type gross income test with an election to continue to be treated as partnerships. The price for making the election is that the partnership will be subject to a tax of 3.5% of its *gross* income from the active conduct of a trade or business. A publicly traded partnership that makes this election will nevertheless be treated as a corporation commencing on any day on which it adds a substantial new line of business.

Limitation on Exception for Investment Companies Under Section 351

Section 351 of the Code generally permits a taxpayer to transfer property to a corporation, in exchange for stock in that corporation, without the taxpayer's being required to recognize (and pay tax on) gain on the transfer, so long as the taxpayer is part of a group of transferors who own, in the aggregate immediately following the exchange, at least 80% of the stock of the corporation. Similarly, under section 721 of the Code, no gain is recognized on a transfer of property to a partnership in exchange for an interest in the partnership, regardless of whether the 80% test is met. The Code provides, however, that neither of the foregoing rules applies in the case of a transfer of property to an "investment company." Neither the Code nor the Treasury Regulations (the "Regulations") directly defines the term "investment company"; however, the Regulations provide that a transfer of property to a corporation "will be considered to be a transfer to an investment company" if two tests are met:

> (i) The transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) The transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than *80 percent* of the value of whose assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are *readily marketable stocks or securities,* or interests in regulated investment companies or real estate investment trusts.[4]

Similar rules apply in determining whether a transfer to a partnership is considered to be a transfer to an investment company, except that, since a business entity treated as a partnership for income tax purposes is not eligible to be a regulated investment company or a real estate investment trust, clause (ii)(a) and (ii)(b) are inapplicable. The Regulations contain rules relating to when "diversification" will be found to result from a transfer, the treatment of assets held by a subsidiary of a transferee corporation or partnership, and the time at which determination of "investment company" status is made.

As noted above, it is only the Regulations, and not the Code, that provide even an indirect definition of an "investment company" and that do so by reference to "readily marketable stocks or securities." Without changing this basic structure (*i.e.*, without inserting a definition in the Code of an "investment company"), the 1997 Act does add a provision to the Code providing that a variety of other assets *held for investment*, in addition to readily marketable stocks or securities, are to be taken into account for purposes of the 80% test in the Regulations. These now include money, all stocks and other equity interests in a corporation (whether or not readily marketable),[5] evidences of indebtedness,[6] options, forward or futures contracts, notional principal contracts and derivatives, foreign currency, equity interests in noncorporate entities that are readily convertible into other assets on this list, and precious metals (unless, after the transfer, the metals are used or held by the transferee in the active conduct of a trade or business). Rules are provided to "look through" an entity an interest in which is transferred if the entity owns assets otherwise included on the list. Assets not held for investment will continue not be counted toward the 80% threshold. The new rules are generally applicable for transfers after June 8, 1997.

Certain Preferred Stock Treated as "Boot"

As noted above, the Code may sometimes permit a taxpayer to transfer property to a corporation, in exchange for stock in that corporation, without the recognition of gain by the transferor. Similarly, gain is not recognized in connection with a corporate "reorganization" if stock in a corporation which is a party to the reorganization is exchanged for stock in another party to the reorganization. The Code has not generally distinguished between common and preferred stock for these purposes.

Effective generally for transactions after June 8, 1997, "nonqualified preferred stock" received by a taxpayer in a section 351 exchange or reorganization will not be considered to be "stock" for purposes of these provisions and the taxpayer will be forced to recognize gain to the extent of the value of such stock received. However, the receipt in a reorganization of nonqualified preferred stock in exchange for other nonqualified preferred stock, for debt securities, or, in the case of a recapitalization of a "family-owned corporation," for common stock, may still qualify for nonrecognition. "Nonqualified preferred stock" is defined as any stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, if (1) the holder has the right to have the issuing corporation redeem the stock, (2) the issuing corporation is required to redeem the stock, (3) the issuing corporation has the right to redeem the stock and, as of the date the stock is issued, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies with an index similar to interest rates or commodity prices.[7]

Denial of Interest Deductions on Certain Debt Instruments

One of the fundamental distinctions in our income tax system is that between debt and equity. The issuer of a debt instrument is generally allowed a deduction for interest paid or accrued on that debt instrument and the holder of a debt instrument is required to include the interest in income. If a debt instrument is issued with "original issue discount," or "OID" (which may in some cases include all or a portion of the stated interest on the instrument), the issuer and holder will generally account for the OID on the accrual method, regardless of their respective overall methods of accounting. The issuer of an equity interest, by contrast, cannot generally deduct dividends paid with respect to that interest, but a corporate holder of stock in another corporation may be entitled to a "deduction for dividends received" that lowers the effective rate of tax on dividend income. In order to prevent the manipulation of these rules, the tax law has long contained nonstatutory doctrines under which the Internal Revenue Service may attempt to recharacterize purported debt instruments in some cases, such as "thin capitalization," as equity.

Several recent tax acts have imposed limitations on the ability of issuers to deduct interest on "equity-flavored" debt instruments that would *not* otherwise have been recharacterized as equity. The 1997 Act continues this trend by denying any interest deduction for interest paid on a "disqualified debt instrument." A disqualified debt instrument is any indebtedness of a corporation if (a) the instrument is payable only in stock of the issuer or a related party, (b) the instrument is payable at the option of the issuer in (or convertible at the option of the issuer into) stock of the issuer or a related party, or (c) a substantial amount of the principal and interest is determined (or may at the issuer's option be determined) by reference to the value of stock of the issuer or a related party. The rules will also apply if (d) principal or interest is required, at the option of the *holder*, to be paid in (or determined by reference to) stock of the issuer or a related party, if there is a substantial certainty that the option will be exercised, or (e) the indebtedness is part of an arrangement which is "reasonably expected" to result in one of the transactions described in clauses (a) through (d). These rules are generally applicable to debt instruments issued after June 8, 1997.

Tax Treatment of Certain Extraordinary Dividends

When a corporation receives a "dividend" with respect to shares of stock that the recipient corporation holds in another corporation, the recipient may be entitled to a "deduction for dividends received." For this reason, dividends are a favorite form of income for corporations. The proceeds of certain redemptions of stock held by the recipient corporation may be considered "dividends" for this purpose if the redemption does not effect a "meaningful reduction" in the recipient's stock ownership in the distributing corporation; by contrast, if the redemption does effect a "meaningful reduction," the transaction may give rise to capital gain to the corporate shareholder, taxed at the same rates as ordinary income *without* the benefit of the deduction for dividends received. In general, stock obtainable under options held by a stockholder before or after a redemption are taken into account in determining whether there has or has not been a "meaningful reduction" in that shareholder's interest.

In order to prevent abuse of these rules, the Code provides that a corporate recipient of an "extraordinary dividend" (which would generally include any stock redemption transaction) is required to reduce its basis in the stock with respect to which the extraordinary dividend is paid. Before the 1997 Act, if the amount of the required reduction exceeds the basis of the stock, the excess was taken into account as additional gain only at the time that the stock was sold.

In 1995, a much-publicized transaction involving Seagram's investment in DuPont—in which Seagram received a large redemption distribution, which it treated as a "dividend" on the theory that it held sufficient options with respect to DuPont stock after the transaction that its interest in DuPont had not been reduced, even though its actual shareholdings went down substantially—led Congress to take another look at these provisions. They have now been tightened materially, on a retroactive basis, with respect to distributions (including redemptions) occurring after May 3, 1995. First, in any case in which the basis reduction required in the case of an extraordinary dividend exceeds the basis of the stock, gain will be recognized *immediately,* rather than being deferred until the recipient corporation disposes of the stock. Second, if the reason that a redemption distribution that is received by a corporation is treated as a "dividend," rather than as a capital gain transaction, is that options that continue to be held by the recipient prevent there from being a "meaningful reduction" in the recipient's interest in the distributing corporation, the amount of the basis reduction is required to be recognized in income immediately, without regard to the recipient's remaining basis in its stock. In each of these cases, the benefit of the deduction for dividends received is effectively eliminated.

Modification of Holding Period Applicable to Dividends Received Deduction

In order to qualify for the deduction for dividends received, a corporation must hold the stock with respect to which the dividend is received for a minimum period—91 days in the case of certain preferred stock and 45 days in the case of all other stock. In determining whether the holding period requirement is satisfied, the taxpayer may not take into account any time during which it is protected from the risk of loss otherwise inherent in the ownership of an equity interest. Prior to the 1997 Act, however, the holding period requirement had to be satisfied only once; if a corporation once held the stock in question on an "unhedged" basis for the requisite number of days, all subsequent dividends were considered to satisfy the requirement, even if received when the taxpayer had hedged its position.

Effective for dividends paid or accrued after September 4, 1997,[8] the holding period will be determined on a dividend-by-dividend basis. The taxpayer will have to be "unhedged" for at least 46 days of the 90-day period beginning 45 days before each ex-dividend date (91 days of the 180-day period beginning 90 days before the ex-dividend date in the case of preferred stock subject to the 91-day rule). A "grandfather" rule is provided for certain stock which was held and hedged on June 8, 1997, and continuously thereafter.

Application of Section 355 to Distributions in Connection with Acquisitions and to Intragroup Transactions

Of all the relatively technical changes made by the 1997 Act, this one—restricting so-called "*Morris Trust*" transactions—seems to have drawn the most interest in the press. One of the requirements for a tax-free spin-off of a subsidiary is that there be a "continuity of interest" in the distributing and controlled corporations by the shareholders of the distributing corporation. In the now famous case of *Commissioner* *v. Morris Trust,* 367 F.2d 794 (4th Cir. 1966), a spin-off was followed by a merger involving the distributing corporation and the court held that the post-spin-off merger of the distributing corporation did not break the required "continuity" and, thus, did not make the preceding spin-off taxable to either the distributing corporation or the distributee shareholders. This concept has been accepted by the IRS since 1968 and a number of high-profile corporate transactions have been structured to take advantage of this decision. The 1997 Act changes the result in *Morris Trust*—and requires recognition of gain by the distributing corporation, although not by its shareholders—when a post-spin-off merger is part of a plan (or series of related transactions) pursuant to which one or more persons acquire directly or indirectly stock representing a 50%-or-greater interest in either the distributing or the controlled corporation.

The new rules presume such a plan exists where one or more persons acquire directly or indirectly stock representing a 50% or greater interest in either the distributing or controlled corporation during the four-year period beginning on the date two years before the date of the distribution; this presumption is, however, rebuttable. Broad regulatory authority is also granted to the Treasury Department to alter the normal tax rules in the case of spin-offs within an affiliated group. The legislative history reflects particular concern with basis-shifting and gain-elimination possibilities within such groups. The new rules are applicable generally with respect to distributions occurring after April 16, 1997, but only in the case of a plan (or series of related transactions) which involves an acquisition of stock of the distributing or controlled corporation that occurred after April 16, 1997.

Registration and Other Provisions Relating to Confidential Corporate Tax Shelters

An "organizer" of a tax shelter must "register" the shelter with the Internal Revenue Service on or before the first day on which interests in the shelter are offered for sale. The penalties for failure to register are quite onerous. However, many transactions have been exempt from this registration requirement because certain confidential arrangements did not fall under the strict definition of "tax shelter."

The 1997 Act extends the registration requirement to certain "confidential corporate tax shelters." A confidential corporate tax shelter is a transaction (a) which has as a significant purpose the avoidance or evasion of tax by a corporation, (b) which is offered to potential participants under conditions of confidentiality, and (c) in which the promoters of the shelter may receive fees which exceed $100,000 in the aggregate. The information required to be registered includes a description of the shelter, the tax benefits it expects to generate, and a list of the people who have signed confidentiality agreements or who have been subjected to nondisclosure requirements. Failure to comply with these requirements may result in penalties equal to the greater of $10,000 or 50% of the total fees paid to the promoter prior to the date of registration. (If the failure to register was deemed to be caused by an intentional act, the penalty rises to the greater of $10,000 or 75% of all fees paid prior to the registration date.) This provision will become effective for tax shelters offered to potential participants after the date that the Treasury Department issues guidance on these filing requirements.

Modification of Taxable Years to Which Net Operating Losses May Be Carried

A net operating loss ("NOL") for a taxable year has generally been carried back three years and forward for fifteen years to offset income earned in the years to which the NOL is carried. The 1997 Act changes these carryover rules for NOL's arising in tax years beginning after August 5, 1997. NOL's arising in such years may be carried back only two years, but can be carried forward for twenty years.

Modification of Taxable Years to Which Unused Credits May Be Carried

The "general business credit," which includes the investment tax credit and the low-income housing credit,[9] is subject to various limitations on its use each year. The excess of the credit over the limitation amount may be carried back for three years and forward for fifteen years. For credits arising in tax years beginning after December 31, 1997, however, the 1997 Act changes these rules, so that the unused credit can be carried back for only *one* year, but can be carried forward for twenty years.

Expansion of Denial of Deduction for Certain Amounts Paid in Connection with Insurance

The 1996 Health Insurance Portability and Accountability Act prohibited a deduction for interest paid or accrued after October 13, 1995, on any indebtedness incurred with respect to life insurance policies or annuity or endowment contracts owned by a taxpayer, if the insurance covers an individual who is an officer or employee of, or financially interested in, any trade or business conducted by the taxpayer. The 1997 Act extends this disallowance to indebtedness incurred with respect to life insurance policies or annuity or endowment contracts covering *any* individual.

Prior to the 1997 Act, no deduction was permitted for premiums paid on life insurance policies covering the life of any employee or officer, or any person financially interested in a trade or business of the taxpayer, if the taxpayer was a direct or indirect beneficiary of the policy. The 1997 Act extends this rule to prohibit deductions for premiums paid on certain annuity and endowment contracts as well.

The 1997 Act also adds a provision disallowing deductions for a corporate taxpayer's interest expense allocable to *unborrowed* policy cash values, *i.e.,* the excess of the cash surrender value of any insurance policies or contracts over the amount of any loan in respect of such policies or contracts. This allocation of interest expense on other, unrelated loans to unborrowed cash policy values is calculated by multiplying the aggregate amount allowable to the taxpayer as a deduction for interest by the ratio of the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to the sum of these average unborrowed policy cash values plus the adjusted bases of the remainder of the taxpayer's assets.

Certain Notices Disregarded Under Provision Increasing Interest Rate on Large Corporate Underpayments

In order to induce corporations to avoid controversial tax filing positions, the interest rate on "large corporate underpayments" of tax is set at 2 percentage points above the rate ordinarily applicable to tax underpayments. A corporate underpayment is considered "large" if it exceeds $100,000. This punitive rate of interest generally applies for periods beginning thirty days after the first letter or notice of deficiency is sent. The 1997 Act, for periods beginning after December 31, 1997, amends this provision to provide that notices or letters which set forth assessments not greater than $100,000 (not including any other interest or penalties) will not be considered in calculating the thirty-day period from which the large corporate underpayment penalty begins to run. Thus, a notice issued relating to a relatively insignificant deficiency would not subject the taxpayer to the large corporate underpayment rate if a significant tax deficiency is later identified.

[1] Among the more specialized areas in which the 1997 Act made significant changes that are beyond the scope of this article are taxation of certain financial products (including most noticeably elimination of "short against the box" transactions), the foreign-related provisions of the Internal Revenue Code, the rules governing real estate investment trusts, the rules governing pensions and employee benefits, and estate and gift taxes (including a special provision relating to "qualified family-owned business interests").

[2] The tax rates applicable to capital gains realized by corporate taxpayers were generally *no* reduced by the 1997 Act.

[3] In order to prevent easy evasion of the $5,000,000 requirement through the use of multiple corporations, the gross receipts of certain related entities are aggregated in order to determine if any of them satisfies that requirement.
Although it seems clear that the repeal of the AMT is intended to apply to "small corporations" that were not yet in existence during 1995 (or 1997), it is less clear how the mechanics of the $5,000,000 test would be applied to such corporations.

[4] Treasury Regulation section 1.351-1(c)(1) (emphasis added).

[5] The rule in the Regulations permitting a "look-through" in the case of a 50%-or-more-owned subsidiary ought to prevent this rule from creating investment company status in the case of a transferee corporation or partnership that does business through subsidiaries. However, venture capital funds that acquire minority interests in nonmarketable securities may now be treated as investment companies.

[6] Presumably this means that the complete exclusion from consideration, for purposes of the 80% computation, of nonconvertible debt instruments, will no longer apply.

[7] Clauses (1), (2), and (3) apply only if the right or obligation can be exercised within 20 years of the date of issuance and is not subject to a contingency at the issue date which makes the likelihood of redemption remote. Redemption of preferred stock by a person related to the issuer is generally treated like redemption by the issuer for purposes of this provision.

[8] The 30th day after the date of enactment of the 1997 Act.

[9] As well as the alcohol fuel credit, contributions to community development corporations credit, disabled access credit, employer social security credit, empowerment zone employment credit, enhanced oil recovery credit, incremental research credit, Indian employment credit, orphan drug credit, and work opportunity credit.