



Bush Administration Proposes Eliminating Double Tax on Corporate Earnings

David Early-Hubelbank

Broad Implications and Technical Complexity

Current federal income tax law generally subjects corporate earnings to two levels of taxation – first at the corporate level and then again at the shareholder level.

On January 7, 2003, President Bush announced a proposal to eliminate the double tax by excluding from shareholder income dividends paid out of previously taxed corporate earnings. Two weeks of speculation and confusion followed, quelled somewhat by the January 21 release of a detailed explanation that significantly altered earlier pronouncements.

Further details will likely be fleshed out through additional public statements, more comprehensive written guidance and wrangling in the tax legislative and lobbying community. The timing of actual draft legislation may depend on the speed of the budget process.

Deceptive in its apparent simplicity, the proposal has broad implications for investors and corporations, and raises complex technical issues.

Principal Terms

The proposal would integrate corporate and shareholder income taxation by excluding certain dividends from shareholder income.

- The exclusion would apply only to dividends paid out of earnings that had been fully taxed at the corporate level, with a two year lag. For example, a dividend paid in 2006 would be excludable only if the corporation showed a 2004 tax liability on its return filed during 2005.
- Corporations would maintain an “excludable dividend account,” or EDA, to determine fully taxed income from which excludable dividends could be paid.

- Corporations would continue to maintain earnings and profits, or E&P, accounts as under current law.
- A corporation that did not distribute its entire EDA as an excludable dividend could allocate retained EDA (up to its E&P) to its shareholders, permitting them to increase their stock bases. This “retained earnings basis adjustment,” or REBA, would reduce the amount of any gain (or increase any loss) on a later sale of the stock.
- Corporations would be required to maintain records of the total REBAs made with respect to prior tax years. This calculation would be known as the cumulative REBA, or CREBA.
- Dividends in excess of the EDA would be treated (i) first as a return of basis and then as capital gain to the extent of CREBA, (ii) then as a taxable dividend to the extent of E&P, (iii) then as a return of capital to the extent of the shareholder’s remaining basis and (iv) thereafter as capital gain.
- The proposal generally would be effective for dividends paid on or after January 1, 2003, with respect to corporate earnings after 2001.

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for 2002 Inversion Reporting
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General Implications

The proposal has broad implications for investors and corporations.

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Corporate Finance. Although the proposal would not make dividends deductible, it may lower the cost of equity financing sufficiently to bring preferred stock back into favor. Corporations may choose to refinance debt with equity. Would the terms of preferred stock include provisions to “gross up” dividends paid to shareholders to make them whole if dividends were to become taxable again in the future? Would it mean the demise of “hybrid” preferred securities that pay interest for tax purposes?

While the proposal would generally repeal the 70 percent and 80 percent dividends received deductions, or DRD, available to corporate shareholders, it would remain available for distributions of pre-2001 E&P made before 2006, but only with respect to stock issued before February 3, 2003. For stock issued on or after that date, dividends paid to corporate shareholders would be taxable to the extent the proposed exclusion did not apply.

Choice of Investment Vehicle. Distributions from 401(k) accounts and IRAs would still be taxable, even if dividends paid into the accounts would have been excludable by a taxpaying shareholder. Would individuals shift dividend-paying investments out of 401(k) accounts and IRAs and into their taxable investment accounts? Could we expect significant changes in the marketing of mutual funds to different investor bases?

Effective Tax Rate Management

Corporate tax shelters, offshore reincorporations and other tax-reduction techniques could be turned on their heads. Since corporations that do not pay taxes would have no benefit to pass on to their shareholders, could the proposal create new incentives for a corporate tax manager to pay income taxes? That might depend on the composition of his shareholder base.

Corporate managers, as well as investors, generally prefer corporate earnings not to fluctuate from year to year. Taxable income, generally only an internal concern, tends to fluctuate more than earnings. Would the proposal put pressure on a tax manager to make taxable income follow earnings more closely?

Dividend Policy. The proposal is intended to bring tax-neutrality to dividend policy. Would cash-rich corporations come under pressure from investors to pay or increase their dividends? What about cash-strapped but otherwise tax-paying corporations?

Traditionally, dividends have been a way to demonstrate that claimed earnings are real. Would corporate managers lose some of the discretionary control they have over the use of cash reserves? The proposal may generally foster increased corporate transparency and accountability as shareholders focused on what corporations were doing with those reserves.

State and Local Finance. Would states and cities that base their own income taxes on federal taxable income suffer significant reductions in tax revenues? Would their financing costs increase as a result of the competition posed by tax-free dividends?

Margin Accounts. Under the proposal, otherwise excludable dividends on debt-financed stock would be includable in shareholders' income. Investors might move away from holding dividend-paying stocks in margin accounts.

Stock Loan Transactions. Would the proposal make short selling more complicated and costly? Would shareholders insist that their shares not be lent around the time of a dividend if it would result in their receiving a taxable fee in lieu of an excludable dividend? Would only tax-exempt investors, such as pension funds and charitable organizations, be willing to lend stock? Would stock lenders demand higher fees?

Dividend Reinvestment Programs. The proposal would presumably eliminate any current bias against dividend reinvestment programs.

Compensation Planning. In the closely-held context, with individual rates higher than corporate rates (and employment taxes as an additional cost of compensation), would there be a new preference for dividends over salary payments to employee-shareholders?

Choice of Business Entity. To what extent would the proposal slow the ascension of the limited liability company as the small business entity of choice? To what extent would it push the S corporation further into disfavor?

Technical Complexity

Tax complexity abounds in this seemingly simple proposal.

Corporate Income Tax. Corporations would continue to calculate and pay income tax under current rules and rate schedules. The corporate alternative minimum tax, or AMT, would continue to apply.

Earnings and Profits. Corporations would continue to maintain calculations of E&P as under current law.

Calculating EDA. Corporations generally would pay excludable dividends in a particular year to the extent of EDA for that year. The formula for calculating EDA would divide the U.S. income taxes (other than estimated taxes) shown on the corporation's returns filed in the immediately preceding year (*i.e.*, in respect of earnings from two years before the year of the dividend payment) by the maximum corporate tax rate (currently 35 percent), then subtract the taxes shown on the return. (This is mathematically the same as multiplying taxes paid by approximately 1.86.) For this purpose, U.S. income taxes would include taxes on foreign source income that had been offset by foreign tax credits. (This would presumably add pressure to the perennial problem of excess foreign tax credits.) They would also include AMT. For purposes of calculating EDA, U.S. income taxes paid at lower graduated rates, or at the AMT rate, would be treated as having been paid at the maximum 35 percent rate, effectively understating the pool of taxed earnings in most cases.

Income taxes paid for a particular year would also include deficiency assessments paid in that year, and would be reduced (but not below zero) by any income tax refunds received during that year.

An EDA would include excludable dividends received from other corporations in the prior year and any REBAs for the prior year with respect to stock owned by the corporation.

It is not clear whether other permanently excludable items (*e.g.*, tax-exempt interest) would also be included in a corporation's EDA.

Distributions and CREBA. A corporation that did not distribute its entire EDA for a particular year could, to the extent of its E&P, allocate all or a portion of its undistributed EDA to its shareholders, thereby increasing their stock bases. Any such retained earnings basis adjustments, or REBA, would not be taxable, but would reduce the corporation's EDA and E&P.

Basis increases would be allocated in the same manner as distributions, except that they could not be allocated to

preferred stock. (It is not entirely clear how a corporation's EDA would be distributed among multiple classes of stock.)

A corporation would be required to maintain records of its cumulative REBA, or CREBA.

A corporation that distributed dividends in excess of its EDA would still be able to pay those amounts tax-free to its shareholders to the extent of its CREBA. Such amounts would be a tax-free return of capital to the shareholders, resulting in a stock basis reduction, and thereafter would be taxable as capital gain. Any further distributions in excess of the CREBA would be a taxable dividend to the extent of E&P, then a tax-free return of capital to the extent of the shareholder's remaining basis and thereafter capital gain.

Redemptions. Under current law, a stock redemption may be treated either as a sale or exchange or, under certain circumstances, as a dividend. The proposal would retain current rules, but could modify certain attribution rules, particularly as they relate to options.

A redemption treated as a sale or exchange would reduce *pro rata* the corporation's current year EDA and CREBA.

Other Anti-"Bailout" Provisions. In addition to the rules treating certain redemptions as dividends, a number of other provisions that convert capital gains into dividends would be retained. Feared for decades, these provisions could suddenly become popular, turning decades of tax planning around 180 degrees.

Tax Refunds. In general, if a refund was due in a particular calendar year, the refund would be paid to the extent the corporation had paid taxes shown on a final return previously filed in that calendar year. If any refund remained unpaid, the corporation could recompute its EDA for the current year as if the refund had reduced the tax previously used to compute that year's EDA. This would permit the corporation to receive an additional refund amount. Any unpaid refund would be credited against future tax liability (and therefore presumably against future EDAs).

Net Operating Loss Carrybacks. Under current law, net operating losses, or NOLs, may be carried back two years. Under the proposal, a corporation would be able to carry back an NOL only one year. If an NOL were carried back, the EDA for the loss year would have to be recomputed.

Carryover of Tax Attributes. Current rules providing for the carryover of certain tax attributes in a tax-free reorganization or liquidation would be amended to provide for the carryover of a target's EDA and CREBA. Rules would also provide for the allocation of CREBA in a tax-free spin-off.

Current section 269, intended to discourage tax-motivated transactions, would apply to acquisitions undertaken to obtain an EDA or CREBA. Since EDAs generally would expire at the end of each year, however, the proposal does not contemplate a rule, similar to section 382, to limit attribute use after a change of control.

Consolidated Returns. Consolidated return regulations would be amended, for example to provide that EDA be calculated on a consolidated group basis, based on income taxes of the group, and then allocated among members based on their separate taxable income. No EDA would be allocated to a member that generated a loss, however. Current investment adjustment rules, rather than the basis adjustment rules contained in the proposal, would continue to apply to members of a consolidated group.

Corporate Penalty Taxes. The proposal contemplates repeal of the accumulated earnings tax and personal holding company tax.

Foreign Corporations. U.S. income taxes on effectively connected income would be treated as U.S. income taxes in calculating a foreign corporation's EDA. Branch profits taxes would not be so treated, however, and they would reduce the foreign corporation's EDA. The corporation's EDA would also be increased by any excludable dividends it received as a shareholder, as well as allocations of CREBA, and reduced by any U.S. withholding taxes, which would not be treated as U.S. income taxes for purposes of the EDA computation.

U.S. shareholders would not be entitled to foreign tax credits for taxes paid or accrued with respect to EDA and CREBA distributions.

It is unclear to what extent the proposal would necessitate changes to the various complex anti-deferral measures relating to non-repatriated foreign earnings, such as the CFC (controlled foreign corporation) and PFIC (passive foreign investment company) rules.

Real Estate Investment Trusts and Mutual Funds. REITs and mutual funds would be permitted to pass on

to shareholders their excludable dividend income and REBA basis adjustments. However, they would not be entitled to a deduction for distributions designated as excludable or from CREBA. For purposes of their distribution requirements, excludable dividends would be treated in the same manner as tax-exempt interest.

S Corporations. The S corporation rules would be retained, with certain modifications. An S corporation liable for corporate income tax (e.g., because of built-in gain) would have an EDA. Distributions in excess of EDA and CREBA would generally be treated as they are under current law.

Shareholder Limits. Many of the rules limiting the shareholder benefits of tax-exempt interest or dividends otherwise eligible for the DRD would apply to otherwise excludable dividends. These would include the holding-period rules under current section 246(c) limiting eligibility for the DRD, the extraordinary dividend stock basis reduction rules under section 1059, the section 246A DRD prohibition for debt-financed portfolio stock and the section 852(b)(4) loss disallowance rule for mutual fund shareholders that receive exempt-interest dividends on shares held for six months or less.

Shareholder AMT. The proposal would not affect the AMT. Excludable dividends would not be an AMT adjustment or preference. In addition, they would not be a preference for adjusted current earnings for corporate AMT.

Foreign Shareholders. U.S. withholding tax would continue to apply to dividends paid to foreign shareholders out of E&P, and would apply to distributions from CREBA. Withholding would not apply to REBA allocations, which would not increase a foreign shareholder's basis (and a distribution from CREBA would not decrease basis).

In the case of a foreign corporate shareholder, distributions of excludable dividends (reduced by U.S. withholding taxes), but not REBAs, would increase the foreign corporation's EDA. Distributions from a corporation's CREBA would be treated the same as an excludable dividend.

Employee Stock Ownership Plans. Under the proposal, an otherwise excludable dividend would be taxable, and would not reduce EDA, if it was deductible by the paying corporation. REBA basis adjustments would not be permitted to be made to stock held by an ESOP. A corporation would be permitted a deduction for

distributions from CREBA in respect of shares held by an ESOP, and such distributions would not reduce stock basis and would be taxable to the ESOP.

Private Foundations. Excludable dividends and CREBA distributions would not be taxable to a private foundation as net investment income.

Enactment Uncertain

The proposal has encountered widely differing amounts of enthusiasm and opposition from various lawmakers, economists, business leaders, editorialists and

others in a position to influence policy. It remains to be seen whether the proposal will be enacted in its current form.

Material Available On-Line

We have posted a copy of the January 21, 2003 explanation of the President's proposal from the U.S. Department of the Treasury, "Eliminate the Double Taxation of Corporate Earnings," which is also available via ftp at:

<ftp://pmstax.com/corp/exp030121.pdf> [687K].

IRS Grants 15-Day Grace Period for 2002 Inversion Reporting

Brian Wainwright

On November 18, 2002, the Internal Revenue Service ("IRS"), in Treasury Decision 9022, adopted temporary regulations requiring information reporting by corporations and brokers with respect to domestic corporations undergoing an "acquisition of control" or "substantial change in capital structure" after 2001. These reporting rules, which contain many exceptions and apply generally only to transactions involving \$100 million or more, are aimed at large "inversion" transactions and require statements with respect to 2002 transactions (on IRS Form 1099-CAP) to be sent to affected shareholders by a reporting corporation by January 31, 2003. In addition, brokers are required to send Forms 1099-CAP for 2002 transactions to actual owners by February 28, 2003.

In Announcement 2003-7, the IRS stated that it will not impose penalties for failures to file Forms 1099-CAP by the due dates if a letter in the following form is provided to shareholders by February 15, 2003 (March 15, 2003 for brokers reporting to actual owners):

On [date], you exchanged shares in [name of corporation] for new shares [and cash and other property] in a transaction that may be subject to United States federal income tax due to the application of section 367(a) of the Internal Revenue Code. Depending on your individual circumstances, you may be required to report any gain from the exchange on your federal income tax return. You had gain from the exchange if [the cash and] the fair market value on [the date of the exchange] of the new shares [and any other

property] you received exceeded your basis in the shares of [name of corporation] that you gave up in the exchange. You are not permitted to claim a loss on your tax return with respect to the exchange.

In addition, the legend "Important Tax Document Enclosed" must appear in a bold and conspicuous manner on the outside of the envelope containing the letter.

A reporting corporation must also file an interim statement with the IRS reporting the transaction in accordance with the temporary regulations and must, upon inquiry by a shareholder of record on the date of the transaction (including any clearing organization or broker), identify itself as a corporation described in section 3.01 of Announcement 2003-7.

Material Available On-Line

The following materials have been posted and are also available via ftp in the directory <ftp://pmstax.com/corp> with the indicated file name:

- [T.D. 9022](#), [td9022.pdf](#) [58K] and
- [Announcement 2003-7](#), [an20037.pdf](#) [48K].

Brian Wainwright is a tax partner in the Palo Alto office of Pillsbury Winthrop LLP. This article, which is only a general review of the subjects covered and does not constitute an opinion or legal advice, also appears on the world wide web as part of the firm's Tax Page. © 2003 Pillsbury Winthrop LLP.