DIVIDEND DISTRIBUTION PROPOSALS: THE DIVIDENDS RECEIVED DEDUCTIONS BY CORPORATIONS AND RELATED MATTERS

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The two-tiered tax system raises special problems in determining what amount is to be taxed to corporate distributees, how that amount should be determined, and what opportunities for tax avoidance exist. The Senate Finance Committee Staff Report identified areas of abuse in retaining the concept of "earnings and profits," which is the prime factor in measuring ordinary income on corporate distributions to shareholders. The report identified abuses, including complexity in the concept of earnings and profits (which must be distinguished from both taxable income and income for financial accounting purposes), potential for manipulation in determining what is chargeable to "capital account" on stock redemptions, and use of certain accounting methods (such as the completed contract method), which allow complete elimination of earning and profits where deferred income and accelerated deductions are apparently allowed.

Professor Blum advocates repeal of the "earnings and profits" limitation on dividend income. After tracing some of the early history which was directed at other problems, such as timing, Blum concludes that taxing most corporate distributions of a corporation would eliminate a needless intermediate step of defining earnings *and profits, which serves only to complicate the double-tax regime.*

The dividends received deduction of section 243 (85% of dividends received by one domestic corporation from another) was originally thought to prevent multiple taxation of the same profit. However, here too, abuses have surfaced. For example, a corporation has substantial business income and borrows $100,000 at 12% interest; it then invests the proceeds in preferred stock of another corporation, which pays a 10% dividend. The $10,000 dividend received is subject to an 85% deduction of $8,500; the $12,000 interest paid produces a tax loss of $10,500, even though it has a cash flow shortfall of $2,000, resulting in a tax savings of over $5,000. These types of distortions have been utilized by oil companies using royalty trusts to parlay ordinary income into capital gain and with the aid of the 85% deduction some corporations, as Howard G. Krane describes, have been able to convert some income to short term capital losses.

Lawrence M. Stone opposes repeal of the "earnings and profits" concept to deal with Wall Street (and Chicago) gimmicks, recommending instead that we move toward a fundamental change in corporate taxation, including a system of integration, where the impact of the two-tiered tax on corporate income would give way to some type of single-tax scheme. [See discussion of integration proposals by Professors Andrews, Warren, and Cohen infra.] *Stone asserts that the principal opponents of integration are corporate management groups who oppose large distributions of potential working capital to shareholders, many of whom would prefer accumulation of earnings and ultimate capital gain. Stone feels the more we attempt to curb abuses under the present system, the greater the chance the system, as a whole, will collapse. He feels that Congress should not be so quick to react to a few celebrated abuses by patchquilt measures.*

Repeal of the "Earnings & Profits" Concept: The Limitation of the Extent to Which Dividends will be Taxed as Ordinary Income

WALTER J. BLUM*

My topic is "The Limitation on Income from Dividends" or, better put, "The Limitation on the Extent to which Dividends will be Taxed as Ordinary Income." This statutory limitation has two prongs. If there is a distribution in the nature of a dividend, it will not be treated as ordinary income to the recipient unless the distributing corporation has either current earnings and profits (meaning earnings and profits in the current year) or has accumulated earnings and profits. If the dividend is neither covered by current nor accumulated earnings and profits, then the distribution will be treated first as basis reduction to the recipient and, after basis is recovered in full, the remainder as capital gain.

Over the years, a now widely held view has grown inside the tax world to explain this dividend limitation. In general, the explanation is that there cannot be dividend income to shareholders unless the distributing corporation has been profitable. If the corporation has not been profitable, the shareholder must be receiving something in the nature of a return of his investment or a profit on his investment; such receipts are not taxed as ordinary income.

It is my position that we would advance the cause of rationality, simplicity, and harmony in taxation by repealing outright the dividend limitation. What follows are some thoughts in support of

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repeal.

Begin with the history of the limitation itself. The major developments are contained in two pieces of legislation. The first dates back to 1916. A provision was enacted to the effect that absent corporate earnings and profits registered after March 1, 1913, a distribution to shareholders is not to be treated as ordinary dividend income. One might think that this supports the general understanding I stated at the outset. The record, however, suggests that the center of attention in the legislature was on the time factor. Congress, in brief, did not want to have the experience of corporations prior to the effective date of the individual income tax — March 1, 1913 — count in ascertaining what distributions are taxable as dividends. For this reason the statute as amended referred to the earnings and profits position of corporations after March 1, 1913.

The second major development occurred in 1936. Congress then distinguished between accumulated earnings and profits (or accumulated deficits) and current earnings and profits. One might conclude that this refinement also indicated the legislators shared the tax society's common understanding of the limitation. Once again, the record seems to reveal a different focus. In 1936, a tax on the undistributed income of corporations was enacted. A problem was presented by a deficit corporation that had earnings and profits in the current year. If it distributed an amount covered by the current earnings and profits, but still had a deficit after the distribution, did it distribute its earnings and profits in view of the fact that it ended the year with a deficit? Congress enabled the corporation to escape the new tax by allowing it to take into account any distribution out of current earnings and profits. The aim of Congress in all this was narrow and associated with the tax on undistributed profits. Thus, history shows that little attention was paid to the question why a general limitation on dividend income is sensible for a tax on income — particularly a tax on the income of individuals.

Apart from the historical record, there is support for the position that the general limitation is not in harmony with the basic structure of our tax law. Reflect on distributions by corporations, putting aside the limitation on dividends. The law divides these distributions into two major categories. One consists of payouts usually referred to as a dividend, by which we mean a return on the investment (or basis) that a shareholder has in his shares. The other consists of distributions by the corporation which we think of as cashing out some or all of the stockholder's investment in his shares. The shareholder is regarded as though he had sold part or all of his shares in the corporation. The most common example of this pattern is a substantially disproportionate redemption — that is, a redemption that leaves the shareholder with a percentage of the stock substantially smaller than the percentage he owned before the redemption took place. Another illustration is a partial liquidation of the corporation in the form of a corporate contraction — that is, a transaction in which the corporation reduces its trade and business activities to a significant extent and either (1) thereby generates cash and then makes a distribution of the cash to the shareholders, or (2) makes a distribution in kind of the unwanted assets.

On the basis of this distinction between pay-outs which are in the nature of sales to the corporation and pay-outs in the nature of dividends to those invested in the shares, there is no compelling reason to impose a limitation on the taxable treatment of the dividends. Why so? As I see it, the person who invests in shares is not making an investment in the corporate position. For example, suppose an individual buys shares of General Motors stock on the market, while sometime later the company declares and pays a dividend of a dollar a share. From the individual's point of view, that dividend is a return on investment in the General Motors stock. The average investor would think it odd to inquire whether General Motors has current earnings and profits or past earnings and profits. Looking at the circumstances of this distribution, it is enough that the individual is assured it does not represent a substantially disproportionate reduction in his interest in General Motors and it does not reflect a payment associated with a significant contraction in a trade or business being conducted by General Motors. Whether the corporation has earnings and profits should be irrelevant in determining the individual's taxable income in the supposed situation.

Repeal of the dividend limitation, by and large, would not have jarring effects on shareholders. I could conceive of a few exceptions to this proposition. It should be remembered, however, that almost every change that takes place in the taxation of corporations or shareholders might be jarring to some participants. My general assertion here is that, all things considered, this change would rate very low on a scale of upset to taxpayers.

While my proposed change is simple, the existing limitation results in great complexities and difficult issues. Notably, the two prongs of the present test (either current earnings and profits or accumulated earnings and profits, which both lead to ordinary income treatment of dividends) have never fit together well; and there is no way of making them do so. To illustrate, take a corporation that has a very large accumulated deficit. This year is an absolutely banner one for the company, but the expectation is that next year it will again lose money or, at best, break even. Think of the planning that is invited. If the corporation makes a distribution to shareholders this year (the banner earnings year) the payout will be taxed to the shareholders as ordinary income. If instead it holds up paying a dividend until next year — and aggregates the profits of this banner year with the deficit that had already been accumulated, still leaving the company with a deficit — the distribution to shareholders will be subject to the limitation on dividend income. What position will the shareholders be in? They will be treated as having a return of basis and then capital gain rather than ordinary income. The connection between the two prongs of the limitation invites game-playing, and the strategy is unseemly.

Moreover, the limitation on dividend income necessarily calls for generating a vast host of rules. Let me quickly run through four or five illustrations, keeping in mind that many more puzzles could readily be added to the list.

The starting point is to solve the basic question of how the rules for determining earnings and profits relate to the rules for computing taxable income or deductible loss. To what degree are we to be bound by the same accounting rules in computing taxable income or loss and in computing the positive or negative earnings and profits of a corporation? Every time an accounting rule or convention is used in calculating the profit or loss of the corporation for purposes of the corporate income tax, we might need to know whether the same rule or convention is to be used in computing the earnings and profits of that corporation.

Think of a typical corporate redemption. Let us assume that one shareholder is totally redeemed. Assume also that at the time of the redemption the corporation has paid-in capital, an earned surplus, and a large amount of unrealized appreciation on its assets. Dollars are distributed by the corporation to the redeemed shareholder. To what extent do these dollars come out of paid-in capital, out of the earned surplus, and out of the unrealized and unrecognized appreciation in the assets of the corporation? This question has troubled the tax system for many decades.

Take the case of a corporate separation, where one corporation is divided up pursuant to a procedure that qualifies as a spin-off, split-off or a split-up. The accumulated earnings and profits or accumulated deficit of the intact corporation then must be divided between the various corporations that emerge as a result of the corporate restructuring. But it is unclear whether that division should be along the lines of the net asset values in the various corporations, or the aggregate net basis of the assets that go into the corporations, or the prior profitability of the operations put into the corporations, or some combination of these three different concepts.

Take corporate acquisitions, and focus on a corporation that is very successful, having large earnings and profits. It is acquired by a corporation with an even larger accumulated deficit. Under these circumstances, do the accumulated earnings and profits of the profitable corporation disappear? Or do they go over to and survive in the corporation with the deficit? Now reverse the transaction, so that the deficit corporation is acquired by the profitable entity. Can the profitable corporation offset its accumulated earnings and profits with the deficit of the corporation it has acquired? These are very troublesome issues.

Let me complicate the matter even more. Suppose an acquisition qualifies as a tax-free reorganization. The consideration given in the transaction consists of shares in the acquiring corporation and some boot in the form of cash. Assume that the boot is in the nature of a dividend. Which corporation is to be considered in deciding whether there are current earnings and profits or accumulated earnings and profits to cover the dividend-like boot? Do we look at the earnings and profits of the acquired corporation or of the acquiring corporation or a combination of the two?

Turning to a more common type of case, suppose a corporation has an accumulated deficit going into the current year, which happens to be profitable. Further suppose that dividends are distributed this year, but in the aggregate they are in excess of the earnings and profits for the year. During the year, shares have changed hands many times. At some times it looked as though the corporation would be very profitable for the whole year, while at other times it looked as though the profit would be modest. Which of the numerous shareholders who held shares only for part of the year will qualify for being protected by the limitation on dividend income?

In a nutshell, there are a multitude of difficult problems that have to be resolved in defining earnings and profits for purposes of operating the limitation on dividend income. To make matters worse, this is one area in tax law in which there is no statute of limitations at work. If there is a situation in which shareholders of a corporation are claiming that recent dividends to some extent are protected by the limitation, it might be necessary to dig into the corporate history to trace the accumulation of earnings and profits. This might require running through all the redemption transactions, all the acquisition transactions, and all the corporate division transactions in which the corporation was involved. In doing so, one has to play by the rules that were then in force at the time the division, the acquisition, the redemption or other event took place. What a marvelous job for accountants!

At this point I must reveal that a Lexis print-out I now have in my hand shows that the term "earnings and profits" is used in the Code in well over 200 places other than in section 316 — which prescribes the limitation on dividend income.[1] And so you might rightfully ask this question: if we do away with the limitation on dividend income, will we not somehow torpedo these other provisions? After checking into each reference, I have concluded, with one or two possible exceptions involving foreign income (and I am not sure about these), that it would be possible to abolish the limitation on dividend income without in any way undermining the other provisions that make use of an earnings and profits concept. Indeed, I would like to push this conclusion a step further. By doing away with the limitation, we likely would be in a position to have more appropriate provisions in some of the other sections — provisions that are more responsive in dealing with the problems that gave rise to the particular statutory enactments.

I am aware that the topic for this conference was thought to be timely because Congress is about to consider proposed new legislation bearing on fundamental relationships in the taxation of corporations and shareholders.[2] It is therefore germane to inquire: why talk about the limitation on dividend income at this time? The answer is that the proposed new legislation would make some rather far-reaching changes in how earnings and profits are defined for purposes of the dividend limitation. All of these changes move in the direction of defining earnings and profits not in a way that is grounded on the notion of taxable income, but on a notion of income in some economic sense of the concept.

To illustrate: consider a corporation that is making significant use of the accelerated cost recovery system. As a result it is able to eliminate its current earnings and profits (or at least hold them down to a very low level). Assume further that it has no accumulated earnings and profits. Thus, it is in a position to make distributions of dividends which will not be taxed as ordinary income. You can see why those who are looking for errors or misguided provisions in the Code might well argue that a change is needed in the definition of earnings and profits for purposes of the dividend limitation. Such a change would expand the definition of earnings and profits. For example, the difference in amount between ordinary depreciation deductions and accelerated cost recovery deductions would be added

1. I.R.C. § 316 (1982).

2. Deficit Reduction Act of 1984 (Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (1984).

into earnings and profits. Take another illustration: if the corporation is reporting the sale of an appreciated asset on the installment basis, under the enlarged definition the corporation in the year of sale would be required to pick up in its earnings and profits (but not in its taxable income) the full amount of profit on that sale, thereby lessening the force of the limitation. By shifting the definition from taxable income to a version of economic income, fewer dividends will come under the limitation and hence be exempt from all ordinary income tax.

On initial impression this modification might seem sound. But let us go back to those other provisions in the Code that deal with earnings and profits. Many of them, indeed some central ones, are handling a large problem that is unrelated to the dividend limitation. The problem might best be grasped by focusing on transactions between corporations that are in the same corporate empire. The corporations may be filing consolidated returns or separate returns may be being filed by a parent and a completely owned subsidiary. The subsidiary pays a dividend to the parent, or inside of the consolidated returns groups a dividend is paid by one corporation to another.

In these situations we might want to avoid imposing a double tax at the corporate level on the same income. But we likewise, might not want these dividends to reduce tax at the corporate level. In general, the earnings and profits notion has been utilized to accomplish these goals. It should be apparent that for these purposes the relevant definition or concept of earnings and profits is linked to taxable income. Since the object is to prevent double taxation or prevent something from escaping tax, the yardstick ought to be based on taxable income and not on some measure of economic income.

This point is important in assessing the proposed legislation. If we drastically change the definition of earnings and profits for purposes of the limitation on dividend income, we eventually will end up not with one concept of earnings and profits, but two widely different concepts — one for purposes of the dividend limitation and another for purposes of various inter-corporate transactions, such as those taking place within the same corporate empire.

Earlier, I emphasized that the earnings and profits limitation is already extremely complicated. We seem to be headed in the direction of having a second earnings and profits notion, equally complicated, but applied in different situations. There is, however, an easy way out of this trap. It is to adopt my proposal to repeal the dividend limitation altogether and then address specifically the problems encountered in certain inter-corporate transactions, such as those within the same corporate empire. We would end up with a single earnings and profits notion — a concept that is targeted to the specific problems that strongly call for attention. Perhaps we might find that in trying to prevent double corporate taxation, it is better to abandon the earnings and profits notion and build on some other principle, such as adjusting the basis of assets.

I must acknowledge that my proposal might produce hardships in some situations. It may be prudent to make an exception in limited cases. Let me quickly describe three of them to convey the gist of what I have in mind.

Suppose the four of us on the panel decide to form a corporation, believing the company will need $400,000 of equity capital. We each put in $100,000. Six months later it turns out the corporation doesn't need $400,000; $200,000 will do the trick. So $200,000 is returned to us, divided among the four in proportion to our holding of shares. Where there has been an overcommitment of capital to the corporation and the excess capital is returned within a relatively brief time to the shareholders who contributed it, some kind of relief mechanism might be in order.

Assume that a corporation declares a dividend under some mistaken assumption about the facts. Perhaps we should allow the dividend to be rescinded and returned to the corporation without imposing ordinary income treatment on the shareholders who received it.

Troubling, although important, are some corporations that are primarily mineral operations. In effect, they are in the process of liquidating over a period of time by virtue of not replacing their mineral resources as they become depleted. In that case, the problem might be handled by allowing some kind of set-off against dividends in order to reflect the fact that the depletion reserve, so to speak, is being distributed to the shareholders.

But these are relatively minor matters. They do not, by any means, undercut my major proposition that the dividend limitation should be repealed.

Before ending, I want to present some figures that bolster my case. I asked our law librarian to ascertain how many pages of the Commerce Clearing House Standard Federal Tax Service[3] are devoted to section 312(a),[4] which defines the basic concept of earnings and profits, and how many to section 316,[5] which prescribes the dividend limitation. She counted fifty-seven pages given over to 312(a) and 111 pages on 316. I then asked her to query Lexis on how many

3. 1984 STAND. FED. TAX REP. (CCH), Vol. 1-10.
4. I.R.C. § 312(a) (1982).
5. I.R.C. § 316 (1982).

articles and comments have been published between 1954 and the present time on these two sections. It turns out there were fifty-four articles and comments under section 312 and a total of 128 under section 316(a). From these figures you might get some sense of the magnitude of the complexities that we now face. Finally, I asked her to find out how many cases have involved sections 312 and 316(a). It appears there are 205 cases for 312 and 1395 cases for 316(a) as of the week before this conference began. I am not sure whether these figures represent cases under the two sections or merely citations to them — nor did I have time to check this out.

But I do have one figure ready at my fingertips. The last time I taught my course in taxation of corporations and shareholders, there were twenty-seven sessions, each running an hour and five minutes. One of those sessions was devoted entirely to the limitation on dividend income and its ramifications. I did resent having to give up 1/27th of my allotted time to such an unworthy cause.

DIVIDEND DISTRIBUTIONS — A SPECIAL PROBLEM

HOWARD G. KRANE*

The subject that I have been assigned is "Dividend Distributions," particularly as affected by provisions of the Deficit Reduction Tax Act of 1984.[1] My discussion assumes that there is going to be a continued double tax system, that is, that corporations will be taxed on their income and that shareholders of those corporations will be taxed on distributions out of corporate solution whether there is an earnings and profits limitation or not.

The provisions of the Deficit Reduction Act of 1984[2] which affect dividend distributions deal with: (1) debt financed portfolio stock;[3] (2) certain dividends from regulated investment companies;[4] (3) corporate shareholder basis in stock reduced by reason of extraordinary dividends;[5] (4) distributions of appreciated property by corporations;[6] (5) capital gains distributions from regulated investment companies and real estate investment trusts;[7] (6) denial of deductions for certain expenses incurred in connection with short sales;[8] (7) accumulated earnings tax;[9] and (8) changes in the definition of earnings

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1. Deficit Reduction Act of 1984 (Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (1984).
2. *Id.*
3. Deficit Reduction Act of 1984 (Tax Reform Act of 1984), Pub. L. No. 98-369, § 51, 98 Stat. 494, 562-64 (1984).
4. *Id.* § 52, 98 Stat. 494, 564-65 (1984).
5. *Id.* § 53, 98 Stat. 494, 565-68 (1984).
6. *Id.* § 54, 98 Stat. 494, 568-71 (1984).
7. *Id.* § 55, 98 Stat. 494, 571-72 (1984).
8. *Id.* § 56, 98 Stat. 494, 573-74 (1984).
9. *Id.* § 58, 98 Stat. 494, 574-76 (1984).

and profits.[10]

Those are the provisions in this bill that can be viewed as relating to the dividend distributions issue. I'm not going to talk about all of them, rather I'm going to talk about a few of them. My thesis is that, assuming we have a double tax system, these provisions make sense because they will tend to eliminate discontinuities. They may not be the best solutions, but I think they begin to restore a balance to the Code.

Some of the problems which these changes address can be illustrated with simple examples. Assume that an oil company decides to take its oil interests, which it has held for years, break them up into working interests with a right to receive a royalty with respect to those working interests, and put all or part of the royalty interests in a grantor trust. Assume that the company has a zero basis in the royalty interests and that it distributes interests in the trust to its shareholders as a dividend. Assume further that among the company's shareholders are corporations who are dealers in the company's shares and that, at the time of distribution of the royalty trust, these corporate shareholders have a long position in the shares, holding them as inventory. What are the results for such a corporation on the distribution under current law? Under the law as it is today, and until it is changed by legislation, the dealer corporations pay no tax on the trust interests they receive and are treated as having a tacked-on holding period from the oil company for those interests. When a dealer corporation sells the trust interests, even the next day, it gets long-term capital gain, since, of course, it is not a dealer in the royalty trust units. And when it sells its oil company stock, it gets an ordinary loss measured by the difference between its original cost for the oil company share and the post-distribution value of those shares, which should be reduced by about the value of the royalty trust units. That magic was the law before the 1984 Act changed things.

The new legislation corrects the royalty trust type of discontinuity in several ways. Before I describe the 1984 changes, however, let me give a second example.

In large corporate take-overs today, there is often as much as 40 to 50% of the stock owned, at the time the take-over becomes effective, by arbitrageurs, many of whom are corporations. In those take-overs, which involve a substantial amount of cash and a substantial amount of stock, a corporate shareholder might be well advised to tender enough for cash so that essentially it receives half cash, and half stock. If the shareholder can report the cash as a dividend, it will pay tax on only 15% of the cash because of the dividend re-

10. *Id.* § 61, 98 Stat. 494, 579-83 (1984).

ceived deduction. At the same time, its basis in the stock received in the exchange will be its full basis in the stock surrendered, resulting in a short-term capital loss on sale of the stock. This is often a favorable transaction for an arbitrageur, much of whose income may well be short-term capital gain. Essentially, the transaction eliminates about half the proceeds from income, and creates a short-term capital loss.

It could be argued that the simplest way to deal with both the royalty trust and the dividend/short-term loss situations would be to eliminate the dividend received deduction for portfolio holdings of stock; i.e., unless a corporation owns a threshold amount of stock of another corporation, dividend income is treated like a dividend to an individual — no 85% dividend received deduction, and no tack-on holding period for property distributions. However, that approach may not be politically feasible.

Another method to eliminate these discontinuities, (and the new legislation starts to approach this), is to provide that unless a corporation holds stock for some long period of time (e.g., one year) there is no dividend received deduction. The legislation adopts a modified form of this approach, but only in the case of extraordinary dividends. It provides that if a corporation does not hold stock for more than one year, and if during that period of time it received an extraordinary dividend, any amount that is excluded under the 85% dividend received deduction will reduce its basis accordingly in the stock.[11] In most cases this would prevent the results described above for the royalty trust case and the reorganization case.

I did some arithmetic to see if the change will result in the right amount of tax, and found that it will. For example, in the reorganization case it generates the tax result the arbitrageur would have had but for the dividend received deduction. Thus, assume a corporation buys stock for $50 per share, tenders half for $25 in cash and half for stock, and then sells the stock received in the exchange immediately for $25 per share. If the corporation paid tax on the full $25 dividend, and had a $25 short-term loss which offsets $25 of gain, the net tax effect would be zero. Under the new rule, the corporation will be fully taxed on $3.75 of ordinary income, i.e., 15% of $25. The remaining 85% that was excluded from income, i.e., $21.25, will reduce the corporation's basis in the stock received on the exchange to $28.75 so that when it sells the stock for $25 it will

11. *Id.* § 53, 98 Stat. 494, 565-68 (1984).

recognize a short-term capital loss of $3.75. For a taxpayer with substantial amounts of short-term capital gain, the net tax is zero, which is what it should be.

The result achieved by decreasing the basis in stock subject to an extraordinary dividend could be achieved in other ways. However, one reason for choosing to adjust basis is that if you took the other obvious approach, which would be to say that you have to hold the stock for a year or more before you get the 85% dividend received deduction, people might be filing tax returns before the required holding period had run on stock paying dividends. If you imagine the administrative complications of filing when the dividend received deduction is uncertain, and then amending returns as necessary, I think the basis reduction method seems to be a neater way to get to a similar result.

A second provision, which affects the royalty trust transaction in particular, is one which says that if a corporation receives a dividend in property from another corporation, its holding period for the property received (even if it has a carryover basis under section 301)[12] does not start earlier than the holding period for the stock with respect to which it was received.[13] (If gain is recognized, the recipient corporation has a fair market value basis in the property, and the holding period starts at the time of the distribution.) As far as I'm concerned, I think this provision, even though it is complicated and will add a lot of complexity and new questions to the law, essentially eliminating the royalty trust transaction.

Another provision making sense is the one that says if a corporation borrows money to buy stock, and the stock pays dividends on which the corporation can take an 85% dividend received deduction, there ought to be a limitation on interest deductions, as if the 85% excluded from income were treated like tax-exempt income, to which the rules of section 265 apply.[14] I think the provision doesn't have the teeth it ought to have because it is very weak in terms of identifying amounts borrowed to purchase stock. You almost have to borrow the money on the day you buy the stock to have the disallowance. Therefore, I think the provision is even weaker than section 265 is with respect to municipal bonds. At least this change is a step in the right direction.

The last provision I want to talk about is the short sale provision. Under pre-1984 law, if someone sells stock short and pays the lender of the stock the amount of a dividend that is declared and paid on that stock during the period of the stock loan, the borrower/short-

12. I.R.C. § 301 (1982).
13. Deficit Reduction Act of 1984 (Tax Reform Act of 1984), Pub. L. No. 98-369, § 54, 98 Stat. 494, 568-71 (1984).
14. *Id.* § 51, 98 Stat. 494, 562-64 (1984).

seller gets an ordinary deduction for the amount paid, as a cost of producing income. The proposed provision says if the short-seller closes the sale in less than sixteen days,[15] the amount paid to compensate for the dividend is not deducted, but is capitalized as part of the cost of closing the sale.[16] The other change is if amounts related to the short sale are deductible then they must be treated as an interest expense for purposes of section 163(d) and section 265.[17] I think this provision is going to be greeted with a big round of yawns from the investment community because it does not do anything. The transaction described above, which creates an ordinary loss on borrowed securities, is typically a year-end transaction, involving a sufficient period of time so the sixteen-day requirement should not be difficult to meet.[18] What people are doing, usually at the last minute after searching their soul and harrassing their tax lawyer and tax accountant for shelters, is what is known as the short dividend roll. All they do is short a stock just before its dividend date and pay an amount equal to the dividend, all in December. On January 2nd, they close the short sale (hopefully at a gain by the amount of the dividend). What they have done is convert ordinary income into short-term gain, and recognize the gain in the following year. (They hope, of course, to convert the short-term gain into long-term gain with another transaction.) These taxpayers are still going to be able to do the roll, although they will have to accept a slightly longer period during which they are subject to market risk. Consequently, I don't think there would be a significant impact unless a long holding period, say three or six months, were required. Such a long period might eliminate the year-end dividend roll. However, sixteen (or even forty-six)[19] days will not, in my judgment, eliminate all of the year-end transactions.

15. *Id.* § 56, 98 Stat. 573-74 (1984). *See infra* note 19.
16. *Id.*
17. *Id.*
18. *Id. See infra* note 19.
19. Since this speech was given, the conference committee changed the required holding period to 46 days. This will have some effect on taxpayers, but the conclusions presented will still be true in many cases.

A Few Comments on Earnings and Profits and Dividend Abuses by a Devil's Advocate

LAWRENCE M. STONE*

A discussion of fundamental change in the taxation of corporate income should include the implications of some kind of integrated tax system. Many of the problems that are being looked at here are fundamentally related to that. A lot of the Wall Street gimmicks described by Walter Blum and Howard Krane obviously relate to the classic system of corporate taxation combined with lower tax rate for capital gains. That system has a good deal of support in this country from surprising sources. For example, management of large publicly-held corporations likes it and might even be in favor of Wally's suggested removal of the earnings and profits limitation. Several years ago, there was a great wave of popularity for some form of integrated corporate-individual income tax. Indeed, both presidential candidates, Ford and Carter, ran with those planks and promised that soon after they got elected that some form of intergrated tax would be the first order of business. The opposition to that proposal came from certain sources that you might expect: people who think for various ideological and political reasons that corporations ought to pay lots of taxes. But the really telling opposition came from corporate management. Corporate management likes the system under which dividends are of already taxed corporate income are taxed at high ordinary income rates, so that you get double taxation of income if there are distributions. They also like the other side of that coin, namely, a shareholder can realize on his share of accumulated

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earnings by selling your stock and be taxed on a capital gain. Those two things are fundamental to our present system of corporate taxation. They, of course, mightily discourage the distribution of corporate earnings which is what management likes. If we were to move to an integrated system this pattern of heavy retentions of earnings would change in form of significant distributions.

I certainly do not support the abuses we are talking about and which are under consideration in the Tax Reform Act of 1984. On the other hand, I think if we continue to solve such problems in the context of the present system, we can do some very strange, irrational, and very complicated things. It seems to me even though people have been saying this for many years, the system is indeed in danger of collapsing under its own weight. If we "perfect" this system, we will make it so complicated that maybe we will give it its final push, ending up with a consumption tax or some other substitute for a progressive income tax. Therefore, since a lot of these issues are not earth-shattering, I view with horror this 1984 Tax Act[1] because a lot of its provisions are not well thought through, react too quickly to problems, and add to the Code in such a way that the country's best tax scholars at this conference cannot figure out what the new laws would means. There are certain extremes that have to be covered, but until we come up with really fundamental change, the burden ought to be against any tinkering changes.

There are many changes present in the 1984 Tax Act that Deputy Assistant Secretary Ronald Pearlman frankly stated he is still a little disturbed about because he has not quite worked out all the problems and ramifications. Several provisions were being redrafted day and night by staff. One is the problems is that the staff has not really decided what the problem is let alone how they want to solve it; while Congress does not even understand the problem. That is a very bad way to legislate.

As for earnings and profits, I mentioned there is no rule of natural justice which says that distributions from corporations have to be taxable to the extent of earnings and profits. It seems to me we could have had an entirely different section 301 rule which says that first the shareholders can take back some or all of their initial investments. This would be a great simplification and not entirely unfair or unjustified. Although I do not necessarily push it, if you want to simplify rules consider this rule: if a million dollars of capital were put into a company, allow that company to distribute a million dollars tax free. That would be true whether it was loaned or put in as capital. All other distributions would be taxable as dividends. That is a

1. The Deficit Reduction Act of 1984 (Tax Reform Act of 1984), Pub. L. No. 98-369, 98 Stat. 494 (1984), was signed into law July 18, 1984.

very fundamental simplification that would avoid a lot of problems we have, albeit it would certainly not be supported by the management of many public corporations. Since the retained earnings may be lost tomorrow in the business, this is hardly like letting a creditor of a sound debtor get principal back before being taxed on interest.