Notice of Proposed Rulemaking and Notice of Public Hearing

Section¬1059¬Extraordinary Dividends

CO–9–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to certain distributions made by corporations to certain corporate shareholders. The proposed regulations are necessary to clarify that certain distributions in redemption of stock are treated as extraordinary dividends notwithstanding provisions that otherwise might exempt the distributions from extraordinary dividend treatment. Corporations that receive a distribution in redemption of stock may be affected if the redemption is either part of a partial liquidation of the redeeming corporation or is not pro rata as to all shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of topics to be discussed at the public hearing scheduled for Wednesday, October 2, 1996, must be received by September 16, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (CO–9–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (CO–9–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the hearing, Mike Slaughter, Regulations Unit, Assistant Chief Counsel (Corporate), at (202) 622–7190 (not a toll-free number). Concerning the proposed regulations, Richard K. Passales at (202) 622–7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to the extraordinary dividend provisions under section 1059 of the Internal Revenue Code. Section 1059 was added by the Deficit Reduction Act of 1984, Public Law 98–369. One of the purposes of section 1059 is to prevent a corporate shareholder from creating an artificial loss on stock. See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.

Section 1059(a) generally requires a corporation that receives an extraordinary dividend on stock it has not held for at least two years before the dividend announcement date to reduce its basis (but not below zero) immediately before any sale or disposition of the stock by the nontaxed portion of the dividend (generally, the amount of the dividends received deduction). If the nontaxed portion of the dividend exceeds basis, the excess generally is treated as additional gain recognized when the stock is sold. Section 1059(c) generally defines an extraordinary dividend as a dividend that equals or exceeds the threshold percentage of the taxpayer's adjusted basis in such stock.

Sections 1059(d)(6), (e)(1), and (e)(2) were enacted as part of the Tax Reform Act of 1986. Each of those sections affects the definition of extraordinary dividends contained in section 1059(c). Section 1059(d)(6) generally excludes an extraordinary dividend from section 1059(a) treatment if the distributee is an original shareholder of the distributing corporation and the earnings and profits from which the dividend is paid are attributable solely to the original shareholder. Section 1059(e)(2) generally excludes a dividend from extraordinary dividend treatment if it is a ''qualifying dividend.'' A dividend generally is a qualifying dividend if the distributee and distributing corporations are affiliated at the time of the distribution and the distribution is out of affiliated year earnings and profits. Both sections 1059(d)(6) and (e)(2) contemplate that the distribution that otherwise would be an extraordinary dividend subject to section 1059(a) is derived from earnings and profits accumulated while the distributee corporation is a shareholder of the distributing corporation. Generally, a corporate shareholder's ability to create an artificial loss is reduced if all of the distributing corporation's earnings and profits are accumulated while the distributee corporation is a shareholder of the distributing corporation.

Section 1059(e)(1) expands the scope of the extraordinary dividend definition in section 1059(c) by disregarding the holding period and threshold rules for certain distributions. Generally, section 1059(e)(1) provides that a non pro rata redemption or a partial liquidation that is treated as a dividend under section 301 is an extraordinary dividend to which section 1059(a) applies without regard to the threshold percentage or the period the taxpayer held such stock. See General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, 100th Cong., 1st Sess. (May 4, 1987).

These regulations address the question of whether section 1059(d)(6) or (e)(2) applies to a distribution otherwise treated as an extraordinary dividend under section 1059(e)(1). The IRS and Treasury Department believe that applying¬ those¬ provisions¬ to¬ section 1059(e)(1) is inconsistent with the purpose of section 1059 and may create inappropriate consequences, such as basis shifting that eliminates gain or creates an artificial loss.

Accordingly, these regulations clarify that neither section 1059(d)(6) nor section 1059(e)(2) applies to a distribution treated as an extraordinary dividend under section 1059(e)(1). In finalizing these regulations, the IRS and Treasury Department will consider comments that illustrate distributions described in section 1059(e)(1) to which the application of section 1059(d)(6) or (e)(2) is appropriate or to which section 1059(e)(1) otherwise should not apply.

These regulations also address the question of whether an exchange treated as a dividend under section 356(a)(2) is subject to section 1059(e)(1). These regulations clarify that for purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

Explanation of Provisions

Proposed § 1.1059(e)–1(a) provides that neither section 1059(d)(6) nor section 1059(e)(2) will prevent any distribution treated as an extraordinary dividend under section 1059(e)(1) from being treated as an extraordinary dividend. For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

Proposed § 1.1059(e)–1(b) provides that for purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

Proposed Effective Date

These regulations are proposed to apply to distributions announced on or after June 17, 1996.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled at 10 a.m. on Wednesday, October 2, 1996, room 3313, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more that 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by September 16, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 16, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Richard K. Passales, Office of Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1059(e)–1 also issued under 26 U.S.C. 1059(e)(1) and (e)(2). * * *

Par. 2. Section 1.1059(e)–1 is added to read as follows:

§ 1.1059(e)–1 Non pro rata redemptions.

(a) *In general*. Section 1059(d)(6) (exception where stock held during entire existence of corporation) and section 1059(e)(2) (qualifying dividends) do not apply to a distribution treated as an extraordinary dividend under section 1059(e)(1). For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

(b) *Reorganizations*. For purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

(c) *Effective date*. This section applies to distributions announced (within the meaning of section 1059(d)(5)) on or after June 17, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 17, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 18 1996, 61 F.R. 30845)