

# Proposed Regulations Treat Redemptions as Extraordinary Dividends

by Robert W. Wood • San Francisco

The Service has proposed regulations under Section 1059 to clarify that corporate shareholders must treat some redemption distributions as extraordinary dividends. The proposed regulations (CO-9-96) are intended to apply to distributions announced on or after June 18, 1996. A public hearing on the regulations has been scheduled for October 2, 1996 in Washington. Written comments are due by September 16.

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

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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).

### Regulatory Clarification

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

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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). They 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. ■