

News from Senator

BOB DOLE



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FOR IMMEDIATE RELEASE:
MONDAY, OCTOBER 24, 1983

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STATEMENT OF SENATOR BOB DOLE REFORM AND SIMPLIFICATION OF CORPORATE TAXATION

FOR THE FIRST TIME IN FIFTY YEARS, THIS AFTERNOON'S HEARING WILL GIVE THE CONGRESS A CAREFUL, COMPREHENSIVE LOOK AT THE FUNDAMENTAL RULES FOR CORPORATE TAXATION. THE STAFF HAS IDENTIFIED A NUMBER OF SERIOUS PROBLEMS, AND HAS PROPOSED A NUMBER OF POSSIBLE SIMPLIFYING SOLUTIONS. THESE PROPOSALS ARE A RESULT OF THE SAME EFFORT TO SIMPLIFY AND REFORM THE FEDERAL INCOME TAX THAT YIELDED THE SUBCHAPTER S AND INSTALLMENT SALES BILLS IN THE 96TH AND 97TH CONGRESSES. BEFORE TURNING TO THE SUBSTANCE OF THIS AFTERNOON'S HEARING, I WANT TO COMMENT BRIEFLY ON THE PROCESS THAT HAS LED TO THIS HEARING, AND THE STEPS THAT REMAIN BEFORE US.

THE OCTOBER 28TH PRESS RELEASE

ALMOST ONE YEAR AGO I ISSUED A PRESS RELEASE CALLING FIRST FOR PUBLIC COMMENTS ON THE CORPORATE TAX REFORM AND THEN A STAFF STUDY. ALTHOUGH WE OBVIOUSLY MADE A GREAT DEAL OF PROGRESS IN 1982 ELIMINATING CORPORATE TAX LOOPHOLES, PRELIMINARY STUDY SUGGESTED THAT MORE COULD AND SHOULD BE DONE. THAT PRESS RELEASE SINGLED OUT RECENT PROPOSALS BY THE AMERICAN LAW INSTITUTE AND THE AMERICAN BAR ASSOCIATION TAX SECTION AS MERITING STUDY.

WE RECEIVED A NUMBER OF PUBLIC COMMENTS AS WELL AS MORE INFORMAL COMMENTS. WE HAVE STUDIED THOSE COMMENTS AND THE ABA AND ALI PROPOSALS VERY CAREFULLY. INDEED THESE QUESTIONS HAVE PROBABLY ALREADY HAD THE MOST CAREFUL CONSIDERATION OVER THE PAST YEAR OF ANY ISSUES NOW PENDING BEFORE THE CONGRESS.

THE WORKING GROUP

THE STAFF CONCLUDED THAT IT COULD DO A BETTER JOB OF EVALUATING THE PRIOR LEGISLATIVE PROPOSALS AND MAKING RECOMMENDATIONS TO THE CONGRESS IF IT SOLICITED THE ASSISTANCE OF A NUMBER OF DISTINGUISHED TAX PRACTITIONERS. THE WORKING GROUP THAT RESULTED HAS, THUS FAR, MET TEN TIMES OVER THE PAST SIX MONTHS AND THERE WILL BE FURTHER MEETINGS NEXT MONTH. I WANT TO TAKE THIS OCCASION TO THANK THE MEMBERS OF THE WORKING GROUP PUBLICLY FOR THEIR DEDICATED VOLUNTEER SERVICE:

M. BERNARD AIDINOFF, FORMER CHAIRMAN OF THE ABA TAX SECTION AND A DISTINGUISHED PRIVATE PRACTITIONER IN NEW YORK CITY.

DONALD ALEXANDER, FORMER COMMISSIONER OF THE INTERNAL REVENUE SERVICE, AND A DISTINGUISHED PRIVATE PRACTITIONER IN WASHINGTON, D.C. DON ALEXANDER WILL APPEAR THIS AFTERNOON IN HIS INDIVIDUAL CAPACITY.

WILLIAM D. ANDREWS, PROFESSOR OF LAW, HARVARD UNIVERSITY AND REPORTER FOR THE AMERICAN LAW INSTITUTE ON ITS CORPORATE TAXATION PROPOSALS. BILL ANDREWS WILL APPEAR THIS AFTERNOON IN HIS INDIVIDUAL CAPACITY.

FRANK BATTLE, JR., A DISTINGUISHED PRIVATE PRACTITIONER IN CHICAGO, ILLINOIS. FRANK BATTLE WILL APPEAR ON BEHALF OF THE CHICAGO BAR.

HERBERT CAMP, CHAIRMAN OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION COMMITTEE ON CORPORATIONS.

PETER FABER, FORMER CHAIRMAN OF THE ABA TAX SECTION'S COMMITTEE ON CORPORATE STOCKHOLDER RELATIONS AND A PRIVATE PRACTITIONER IN NEW YORK.

MARTIN D. GINSBURG, PROFESSOR OF LAW AT GEORGETOWN UNIVERSITY AND FORMER CHAIRMAN OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION.

FRED. T. GOLDBERG, FORMER ASSISTANT TO THE COMMISSIONER OF INTERNAL REVENUE, NOW A PRIVATE PRACTITIONER IN WASHINGTON, D.C.

HAROLD HANDLER, CHAIRMAN OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK'S TAX SECTION.

JAMES HOLDEN, A DISTINGUISHED PRACTITIONER IN WASHINGTON, D.C.

ROBERT JACOBS, CHAIRMAN OF THE ABA TAX SECTION'S COMMITTEE ON CORPORATE STOCKHOLDER RELATIONS AND A PRACTITIONER IN NEW YORK CITY.

HOWARD KRANE, A DISTINGUISHED PRACTITIONER IN CHICAGO, ILLINOIS.

WILLARD TAYLOR, CHAIRMAN OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION, AND A PRIVATE PRACTITIONER IN NEW YORK.

THIS COMMITTEE MAY NEVER BEFORE HAVE HAD THE BENEFIT OF SO MUCH HARD WORK BY SUCH A DISTINGUISHED GROUP. INDEED IT IS HARD TO IMAGINE A MORE DISTINGUISHED GROUP OF CORPORATE TAX LAWYERS. THE HARD WORK OF THIS GROUP IS REFLECTED IN THE STAFF REPORT. THAT IS NOT TO SAY THAT ANY OR ALL OF THESE INDIVIDUALS SUPPORT ANY PARTICULAR PROPOSAL MADE BY THE STAFF. IN THIS PROJECT WE HAVE ALSO BENEFITED FROM THE TECHNICAL ASSISTANCE OF THE EXPERTS AT THE INTERNAL REVENUE SERVICE AND THE TREASURY DEPARTMENT.

WORKING ASSUMPTIONS

IN UNDERTAKING THIS PROJECT THE STAFF MADE FIVE VERY SENSIBLE ASSUMPTIONS. FIRST, IT WAS ASSUMED THAT WE WOULD CONTINUE, IN GENERAL, TO HAVE A CORPORATE LEVEL TAX. THAT IS, WE WOULD NEITHER ABOLISH THE CORPORATE LEVEL TAX NOR TAX SHAREHOLDERS ON ALL CORPORATE INCOME WITHOUT REGARD TO ITS DISTRIBUTION. MANY OF US--INCLUDING THE PRESIDENT, APPARENTLY--HAVE SUBSTANTIAL DOUBTS ABOUT THE ULTIMATE DESIRABILITY OF IMPOSING A CORPORATE LEVEL TAX. BUT IT IS PRETTY CLEAR TO THIS SENATOR THAT POLITICS AND ECONOMICS WILL PREVENT ANY RADICAL CHANGE IN THE NEAR FUTURE.

SECOND, THE REPORT ASSUMES THAT THE TAX LAW WILL CONTINUE GENERALLY TO DISTINGUISH BETWEEN ORDINARY INCOME AND CAPITAL GAINS, AND THAT DIVIDENDS WILL BE TAXED AS ORDINARY INCOME. IN GENERAL, THAT PREMISE IS UNCONTROVERSIAL, ALTHOUGH ONE WITNESS WILL ARGUE THAT DIVIDENDS SHOULD GENERALLY BE TREATED AS RETURNS OF CAPITAL.

THIRD, IT WAS ASSUMED THAT WE SHOULD PERMIT CORPORATIONS TO MERGE TAX-FREE IN A VARIETY OF CIRCUMSTANCES. THAT WILL PERMIT INVESTMENTS TO BE SHIFTED INTO THE MOST PRODUCTIVE ENTERPRISES.

FOURTH, IT WAS ASSUMED THAT INDIVIDUALS WOULD BE PERMITTED A STEP-UP IN BASIS FOR ASSETS HELD AT DEATH.

FIFTH, THE STAFF ADDRESSED THIS PROJECT AS A MEANS OF PREVENTING ABUSES, CLOSING LOOPHOLES, SIMPLIFYING THE RULES AND ELIMINATING UNINTENDED HARDSHIPS. THE STAFF HAS NOT BEEN INSTRUCTED TO COME UP WITH A REVENUE-RAISING PROPOSAL.

IT IS CLEAR THAT SOME OF THE WITNESSES MISUNDERSTOOD WHAT THE STAFF WAS INSTRUCTED TO DO. ONE WITNESS CHARACTERIZES THE "PREOCCUPATION" OF THE REPORT WITH ABUSE AND MANIPULATION AS "DISTURBING." THIS SENATOR IS MORE DISTURBED BY THE MANIFOLD TYPES OF ABUSE AND MANIPULATION--A FEW OF WHICH I WILL HIGHLIGHT BELOW--THAN BY THE REPORT. LET'S NOT SHOOT THE MESSENGER.

I WANT TO THANK ALL OF THE MEMBERS OF THE WORKING GROUP, AND PARTICULARLY THOSE APPEARING TODAY, FOR THEIR EFFORTS.

PROBLEMS IDENTIFIED BY THE REPORT

o LEVERAGED BUY-OUTS. LAST WEEK THE WALL STREET JOURNAL RAN A STORY THAT DESCRIBED A PROBLEM IDENTIFIED BY THE STAFF REPORT. BECAUSE LIQUIDATION OF A CORPORATION OR A DEEMED LIQUIDATION FOLLOWING AN ACQUISITION OF A CONTROLLING STOCK INTEREST IN A CORPORATION PERMITS THE STEP-UP IN BASIS FOR ACQUIRED ASSETS WITHOUT PAYMENT OF A CORPORATE LEVEL TAX, THE FEDERAL INCOME TAX PROVIDES AN UNINTENDED BIAS IN FAVOR OF THE SALE OF BUSINESSES.

o CORPORATE ACQUISITIONS. THE STAFF REPORT NOTED THAT THE CURRENT LAW PROVIDES AN UNINTENDED BENEFIT FOR CORPORATIONS WHO BUY SUBSTANTIAL AMOUNTS OF A TARGET CORPORATION'S STOCK AND PAY FOR THEM WITH BORROWED MONEY. THIS POSSIBILITY HAS BEEN VIVIDLY DEMONSTRATED BY THE RECENT INVESTMENT BY MESA PETROLEUM IN GULF OIL.

IN ROUGH TERMS, ACCORDING TO MESA'S FILING WITH THE SEC, ITS INVESTMENT GROUP HAS ACQUIRED \$530 MILLION WORTH OF GULF OIL CORPORATION STOCK, WHICH PAYS A \$3 DIVIDEND PER SHARE. APPROXIMATELY \$500 MILLION OR MORE OF THE STOCK WAS PAID FOR WITH BORROWED MONEY THAT ACCRUES INTEREST AT ABOUT 11 PERCENT. AS A RESULT, MESA PETROLEUM, IN THE FIRST QUARTER, WILL HAVE A CASH FLOW, ECONOMIC LOSS OF ABOUT \$2.875 MILLION ON ITS INVESTMENT. THE TAX LAW WILL CONVERT THIS PRE-TAX LOSS INTO AN AFTER-TAX GAIN OF \$2.575 MILLION.

WHATEVER WE THINK OF THE MESA PETROLEUM INVESTMENT IN GULF, MANY OF US PROBABLY THINK THAT THE TAX LAW SHOULD BE NEUTRAL--AND SHOULD NOT PROVIDE A TAX SUBSIDY FOR SUCH INVESTMENTS--PARTICULARLY WHEN WE HAVE AN ESTIMATED NEARLY \$200 BILLION FEDERAL DEFICIT.

o PUBLICLY TRADED COMPANIES. THERE IS CURRENTLY LISTED ON THE NEW YORK STOCK EXCHANGE, A COMPANY WITH ABOUT \$1 BILLION IN ASSETS AND 5 TO 10 THOUSAND EQUITY OWNERS. IT PAID NO TAX LAST YEAR AND WILL PAY NO TAX NEXT YEAR. UNDER CURRENT LAW, IT IS EXEMPT FROM FEDERAL INCOME TAX. FOR STATE LAW PURPOSES, THIS ENTITY IS A LIMITED PARTNERSHIP. SHOULD SUCH ENTITIES BE EXEMPT FROM TAX IF THEY ARE FORMED IN THE FUTURE?

o DIVIDEND ROLLS. ANOTHER PROBLEM IDENTIFIED BY THE STAFF REPORT THAT HAS RECEIVED SUBSTANTIAL ATTENTION IS THE DIVIDEND ROLL. CURRENTLY, CORPORATIONS MAY OBTAIN SUBSTANTIAL TAX BENEFITS BY BUYING PREFERRED STOCK SHORTLY BEFORE A DIVIDEND DECLARATION, THEN SELLING SUCH STOCK IMMEDIATELY AFTER THE DECLARATION OF THE DIVIDEND. THE CORPORATION IS ENTITLED TO THE DIVIDENDS RECEIVED DEDUCTION--REDUCING THE TAX RATE ON THE DIVIDEND TO A MAXIMUM OF 6.9 PERCENT. THE CORRESPONDING SHORT-TERM CAPITAL LOSS, HOWEVER, OFFSETS TAX AT UP TO A 46 PERCENT RATE. THE RESULTING 39.1 PERCENT TAX RATE ARBITRAGE PRESENTS AN ENORMOUS LOOPHOLE.

FOR EXAMPLE, WHEN THE CHRYSLER CORPORATION PAYS A \$110 MILLION CUMULATIVE DIVIDEND NEXT WEEK, THE LOSS TO THE TREASURY WILL PROBABLY BE AT LEAST \$43 MILLION--AND MAY BE EVEN MORE IF CERTAIN OTHER TAX AVOIDANCE TECHNIQUES ARE EMPLOYED.

THE REPORT'S RECOMMENDATIONS

THE STAFF REPORT MAKES COMPREHENSIVE RECOMMENDATIONS IN SIX AREAS: (1) MERGERS, ACQUISITIONS AND LIQUIDATIONS;

(2) SPECIAL LIMITATIONS ON NET OPERATING LOSSES;

(3) CORPORATE DISTRIBUTIONS;

(4) BASIS IN CONTROLLED SUBSIDIARIES;

(5) CLASSIFICATION OF ENTITIES AS CORPORATIONS; AND

(6) USE OF FOREIGN CORPORATIONS TO AVOID TAX.

I DO NOT WANT TO RECAPITULATE HERE EACH OF THE PROPOSALS DESCRIBED IN THE REPORT. THE ANNOUNCEMENT OF THIS HEARING ASKED FIVE PRINCIPAL QUESTIONS RELATING TO THOSE PROPOSALS. I AM PLEASED BY THE CAREFUL ATTENTION THAT THE WITNESSES HAVE GIVEN TO THESE PROBLEMS AND QUESTIONS.

THERE ARE, HOWEVER, TWO SUBSTANTIVE PROBLEMS ON WHICH I WANT TO COMMENT FURTHER.

PUBLICLY-TRADED PARTNERSHIPS

FIRST, MORE THAN ANY OTHER STAFF PROPOSAL, THE SUGGESTION THAT PUBLICLY-TRADED LIMITED PARTNERSHIPS FORMED IN THE FUTURE SHOULD BE TAXED AS CORPORATIONS HAS EXCITED A GREAT DEAL OF INTEREST. THREE COMMENTS ARE IN ORDER.

FIRST, IF THE COMMITTEE WERE TO ADOPT THIS PROPOSAL, THIS SENATOR WOULD SEEK TO APPLY THE RULE ONLY PROSPECTIVELY. AT THIS TIME, I SEE NO REASON TO APPLY THE NEW RULES TO EXISTING ENTITIES. MOREOVER, I AGREE WITH THOSE WITNESSES WHO SUGGEST THAT WE OUGHT TO LOOK AT THIS PROBLEM VERY CAREFULLY BEFORE ACTING. FINALLY, THERE IS NO HIDDEN AGENDA. THERE IS NO PLAN TO EXTEND THESE RULES TO OTHER PUBLICLY MARKETING LIMITED PARTNERSHIPS OR PARTNERSHIPS WITH MORE THAN A CERTAIN NUMBER OF PARTNERS.

SECOND, A NUMBER OF WITNESSES SPEND A LOT OF THEIR TIME EXPLAINING THAT PUBLICLY-TRADED LIMITED PARTNERSHIPS ARE GENERALLY TREATED AS PARTNERSHIPS UNDER CURRENT LAW. THAT QUESTION IS NOT AT ISSUE. WHAT WE ARE HERE THIS AFTERNOON TO WRESTLE WITH IS NOT WHETHER SUCH ENTITIES ARE TREATED AS PARTNERSHIPS, BUT WHETHER SUCH ENTITIES SHOULD BE TREATED AS PARTNERSHIPS.

THIRD, I HOPE THAT THE WITNESSES WILL FOCUS ON THE PROBLEM STATED AT THE OUTSET: SHOULD A BILLION DOLLAR NEW YORK STOCK EXCHANGE COMPANY WITH TEN THOUSAND SHAREHOLDERS BE EXEMPT FROM TAX? SHOULD, GENERAL MOTORS BE GIVEN AN ELECTION TO PAY TAX AS A CORPORATION OR TO DISTRIBUTE ALL OF ITS ASSETS TO GM LIMITED PARTNERSHIP AND THEREAFTER PAY NO TAX?

THE DIVIDENDS RECEIVED DEDUCTION

THE SECOND AREA THAT MERITS SPECIAL COMMENT IS THE PROPOSAL TO LIMIT THE DIVIDENDS RECEIVED DEDUCTION. THERE SEEMS TO BE LITTLE DOUBT THAT THE DIVIDEND ROLL AND SHORT-SALE PROBLEMS DESCRIBED BY THE REPORT POSE SERIOUS PROBLEMS. MORE SERIOUS PROBLEMS ARE POSED, HOWEVER, BY THE USE OF THE DIVIDENDS RECEIVED DEDUCTION TO FINANCE CORPORATE ACQUISITIONS AND THE ISSUANCE OF PREFERRED STOCK BY NON-TAXPAYING CORPORATIONS AS A MEANS TO TRANSFER TAX DEDUCTIONS THAT CANNOT BE USED. ISSUANCE OF PREFERRED STOCK BY SUCH NON-TAXPAYERS POSES TO SOME THE SAME PROBLEMS AS SAFE HARBOR LEASING OR TRAFFICKING IN NET OPERATING LOSSES.

NEVERTHELESS, MANY OF THE WITNESSES SUGGEST THAT THE REPORT'S PROPOSALS WOULD ADVERSELY AFFECT CAPITAL MARKETS AND HAVE UNINTENDING RESULTS. ONCE WE AGREE ON WHAT THE PROBLEMS ARE, PERHAPS WE CAN COME UP WITH NARROWER SOLUTIONS.

THE NEXT STEPS

AT LEAST ONE COMMENTATOR HAS CHARACTERIZED THIS PROJECT AS EMBRYONIC. AFTER 12 MONTHS OF STAFF STUDY AND PUBLIC DISCUSSION, PRECEDED BY A DECADE OF PROFESSIONAL DISCUSSION, IF THIS PROJECT WERE EMBRYONIC, IT WOULD IMPLY A LONGER GESTATION PERIOD FOR TAX LEGISLATION THAN I HAVE RECENTLY SEEN.

THIS SENATOR DOES NOT REGARD THIS PROJECT AS AN ACADEMIC EXERCISE. THE WASHINGTON POST PUT IT VERY WELL IN ENDORSING THESE PROPOSALS NEARLY A MONTH AGO: "THERE WILL BE MANY VOICES URGING MORE YEARS OF STUDY, BUT THE TIME FOR ACTION IS NOW."

BASED UPON THE TESTIMONY WE WILL RECEIVE AT THIS HEARING-- MOST OF WHICH WAS SUBMITTED IN ADVANCE AND HAS BEEN STUDIED BY ME AND BY THE STAFF--IT IS MY HOPE TO MOVE FORWARD WITH THIS PROJECT ON A BIPARTISAN BASIS. AT THE LEAST, I HOPE THAT SENATOR LONG AND I WILL GET A BILL INTRODUCED BY DECEMBER. IT MAY EVEN BE POSSIBLE TO BRING THIS MATTER BEFORE THE FINANCE COMMITTEE, IF THE SENATE DOES NOT RECESS ON SCHEDULE. WITH RESPECT TO THE PROPOSED CHANGES TO THE DIVIDENDS RECEIVED DEDUCTION OF COURSE, THOSE CHANGES ARE ALREADY PENDING BEFORE THE COMMITTEE.