

AMENDING SECTION 905 OF THE TAX REFORM
ACT OF 1969

DECEMBER 30 (legislative day, DECEMBER 28), 1970.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 17984]

The Committee on Finance to which was referred the bill (H.R. 17984) to amend section 905 of the Tax Reform Act of 1969 having considered the same, reports favorably thereon with amendments and recommends that the bill (as amended) do pass.

I. SUMMARY

The bill H.R. 17984, is concerned with a provision added to the tax laws by the Tax Reform Act of 1969. Under that act a corporation recognizes gain if it distributes appreciated property to a shareholder in redemption of his stock. Transitional rules, however, provide for the nonrecognition of gain where there was a binding contract, a public offering, or a filing with a public agency with respect to the redemption before the matter was considered in Congress. This bill, as passed by the House, adds transitional rule under this provision where certain conditions are met. The principal conditions limit the rule to cases where a corporation made provision for a redemption before the matter was discussed in Congress, but only if a significant proportion of the stock was redeemed in property other than money before the effective date of the 1969 act. The committee accepted the House-passed provision without change.

In addition, the committee added to the House bill another transitional rule providing for nonrecognition of gain under this same provision of the Tax Reform Act of 1969. The transitional rule added by the committee is concerned with situations where before the adoption of the Tax Reform Act, provision was made for the distribution of stock of an employer corporation in redemption of stock of a holding company held by employees of the employer corporation.

The Treasury Department has indicated it has no objection to the enactment of this bill as amended.

II. REASONS FOR THE BILL

The Tax Reform Act of 1969 (sec. 905) provided that if a corporation distributes appreciated property to a shareholder in redemption of some or all of his stock, gain is recognized to the distributing corporation (sec. 311(d) of the code).

Transitional rules provided in the 1969 act made the provision inapplicable to contracts in existence on November 30, 1969, and offers which were made before December 1, 1969, or were in accordance with a ruling request filed with the Internal Revenue Service or a registration statement filed with the Securities and Exchange Commission before that date. The effect of these rules, in general, was to continue the nonrecognition of gain in those cases in which a definite program was apparent before the time the matter was discussed in Congress as evidenced by a binding contract, a public offer, or a written description of such proposed program filed with a public agency.

A substantially similar type of case has arisen, where corporations have, in fact, begun plans of redemption pursuant to boards of directors resolutions adopted before the congressional consideration of the provision and where a substantial part of the plans had been carried out before the date of enactment of the 1969 act. The type of situation referred to is not within the transitional rules of the 1969 act, however, because it does not involve a binding contract, public offer, or description filed with a public agency. The committee agrees with the House that the existence of an authorization to redeem—taken together with the fact that to a significant extent the program had been carried out—is substantially the equivalent of the situations covered by the existing transitional rules. The committee has, therefore, agreed with the House on an additional transitional rule provided by the House bill covering cases of the type described above.

The committee added another transitional rule to the bill concerned with this same provision of the Tax Reform Act of 1969. The transitional rule added by the committee provides for situations where before the initiation of the 1969 act provision providing for recognition of gain where property is distributed by a corporation in redemption of its stock, corporations had established deferred compensation plans for their employees involving a distribution of stock of the operating company in redemption of holdings of the employees in a holding company. To encourage the interest of employees in the business and also as a means of compensation, employer corporations in some situations have created corporations to hold substantial quantities of their stock. The employees of the employer corporation are then encouraged to purchase an interest (e.g., convertible common shares) in the holding company, the value of which is dependent solely on the operation of the employer company. When the employee owning the stock in the holding company retires or, in some cases, at earlier dates, he may turn in his shares in the holding company in return for stock of the employer corporation held by the holding company.

Under the Tax Reform Act of 1969, the distribution of the employer's stock by the holding company in the type of situation referred

to above would give rise to a taxable gain to the holding company. This is a tax liability which was not foreseen when the compensation plan was first arranged, and the committee believes that to the extent that these arrangements were entered into with existing employees before the adoption of the Tax Reform Act provision it is appropriate to provide for nonrecognition of gain under a transitional rule. Not only would the holding company be faced with a capital gains tax in this case, but if the distribution is a nonqualifying redemption (e.g., one that is pro rata) the employees turning in their stock in the holding company might find the amount received by them being taxed as ordinary dividend income.

III. EXPLANATION OF BILL

The bill (as amended) adds two new transitional rules to the Tax Reform Act of 1969. The first rule (sec. 905(c)(4)) provides that gain is not to be recognized upon the distribution of appreciated property to a shareholder in redemption of part or all of his stock in the corporation (under sec. 311(d) of the code), where the transaction satisfies the following conditions.

First, the redemption must be pursuant to a resolution adopted before November 1, 1969, by the Board of Directors, authorizing the redemption of a specific amount of stock representing more than 10 percent of the outstanding stock of the corporation at the time of the adoption of the resolution.

Second, the exception is restricted to those cases where more than 40 percent of the stock which the Directors authorized to be redeemed was, in fact, redeemed before December 30, 1969.

Third, more than one-half of the stock redeemed before December 30, 1969, must have been redeemed with property other than money. This condition is met, however, even though the authorization by the Board of Directors permitted the redemption to be made either in cash or other property, as long as, in fact, more than half of the stock was redeemed with property other than money.

Fourth, the property used in the redemption must have been owned by the distributing corporation (or its wholly owned subsidiary) on December 1, 1969.

Fifth, the stock redeemed must have been outstanding on November 30, 1969.

Sixth, the stock must be redeemed before July 31, 1971, and must be canceled before that date (that is, it must not be held as Treasury stock).

The second transitional rule (sec. 905(c)(5)) relates to distribution of appreciated property by corporations formed to hold stock of an employer corporation for the benefit of employees of an operating corporation. The holding company, in such cases, was formed as a means of facilitating the acquisition by the employees of the operating company of an equity interest in their employer. The transitional rule provided here specifies that, in such situations, gain is not to be recognized upon the distribution of appreciated stock to a shareholder in redemption of part or all of his stock in the corporation where the transaction satisfies the following conditions.

First, the corporation distributing the stock (referred to as the holding company) must have been organized before December 1, 1969, for the principal purpose of providing an equity participation plan for the employees of the corporation whose stock is being distributed (referred to as the employer corporation.)

Second, the stock being distributed must have been owned by the holding corporation on November 30, 1969 (the time when the Tax Reform Act provision was initially adopted).

Third, the stock being redeemed must be acquired before January 1, 1973, as a result of an equity participation plan by a shareholder presenting the stock for redemption (or by a predecessor of the shareholder).

Fourth, the employment of the shareholder (or the predecessor of the shareholder) presenting the stock for redemption, by the employer corporation must commence before January 1, 1971.

Fifth, at least 90 percent in value of the assets of the holding corporation on November 30, 1969, must have consisted of common stock of the employer corporation.

Sixth, at least 50 percent of the outstanding stock of the employer corporation must be owned by the holding company at some time within the 9-year period ending 1 year before the date of the distribution of the appreciated stock.

IV. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

