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INTEREST ON CORPORATE DEBT TO ACQUIRE ANOTHER CORPORATION

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

REPORT

[To accompany H.R. 7929]

The Committee on Finance, to which was referred the bill (H.R. 7929) relating to the deduction of interest on certain corporate indebtedness to acquire stock or assets of another corporation, having considered the same, reports favorably thereon with amendments and an amendment to the title and recommends that the bill as amended do pass.

I. SUMMARY

Present law disallows any deduction for interest paid or incurred by a corporation, under certain circumstances, where the debt is incurred in order to acquire the stock (or assets) of another corporation. The Tax Reform Act of 1969, which enacted this provision, included a transition rule under which, if one corporation held at least 50 percent of the voting stock in another corporation on October 9, 1969, then the first corporation is permitted to acquire 80-percent control (but not more) of the second corporation without being subject to the nondeductibility provision.

This bill (H.R. 7929) eliminates the 80-percent limit. Thus, a corporation which held at least 50 percent of the voting stock in another corporation on October 9, 1969, is to be allowed to acquire all the remaining stock of the second corporation without being subject to the nondeductibility provision.

The committee amendments deal with the application of the unrelated business income tax to income which an exempt organization receives from lending securities to brokers in order to enable the brokers to make timely deliveries of securities to purchasers. Div-

idends, interest, annuities, royalties, rents, and capital gains are passive types of income that generally are excluded from the unrelated business income tax of most exempt organizations. It is not clear under existing law, however, whether payments made with respect to loans of securities are subject to the unrelated business income tax. The committee amendments provide that payments on securities loans are to be exempt from the unrelated business income tax; they also provide that those payments are to be treated in the same manner as dividends and interest for purposes of the excise tax on private foundations, for the 90-percent income test for regulated investment companies, and for the support test limitations on investment income in determining whether a charitable organization is a publicly supported organization rather than a private foundation. The amendments provide this treatment only for payments of security loans which are fully collateralized and which may be terminated on five business days' notice by the lending organization.

II. General Statement

A. Interest on Acquisition Indebtedness of Corporation (sec. 1 of the bill and sec. 279 of the Code).

PRESENT LAW

Under present law, a corporation generally is allowed to deduct interest paid or incurred on its indebtedness but is not allowed a deduction for dividends paid on its stock or equity. However, under certain circumstances, a corporation is not allowed an interest deduction (either for stated interest or unstated interest such as original issue discount) for indebtedness which it issues as consideration for the acquisition of stock in another corporation, or for the acquisition of assets of another corporation (sec. 279).

A number of exceptions or modifications are provided under existing law to this interest disallowance rule. Generally the disallowance of the deduction for interest in the case of acquisition indebtedness applies to interest paid or incurred with respect to indebtedness incurred after October 9, 1969. However, this provision is inapplicable in certain cases where the issuing corporation had at least a 50-percent voting interest in another corporation on October 9, 1969, even though the obligation is issued after that date; this exception does not apply to indebtedness issued to acquire stock in excess of the amount necessary for control for tax purposes (ie., 80 percent).

REASONS FOR CHANGE

The interest disallowance provision was added to the Code in 1969 because of a Congressional concern over the increasing number of corporate mergers in which debt, rather than equity, was being exchanged for control of acquired corporations. This trend was thought to have adverse implications for the economic well-being of the companies involved (by increasing corporate debt to dangerous levels) as well as for the economy as a whole. The purpose of the exception for acquiring corporations having 50-percent or greater control of another corporation on October 9, 1969, was to permit such acquiring corporations

to obtain the 80-percent control of the acquired corporation necessary for certain tax purposes.

The committee has concluded that the 80-percent limitation imposed in connection with pre-October 10, 1969, control situations does not appear to serve the purpose of the interest disallowance provision (which is to discourage the future use of debt acquisitions under certain prescribed circumstances). This is so since the acquisition, in such cases, has already occurred. In addition, minority shareholders of a corporation which is 80-percent controlled may find themselves without a ready market for their stock, unless the controlling corporation is able and willing to purchase their shares.

EXPLANATION OF THE PROVISION

Under the provision, the provision denying a deduction for interest on corporate acquisition indebtedness is not to apply where a corporation which had acquired at least 50 percent of the total combined voting power of all classes of stock of another corporation by October 9, 1969, incurs acquisition indebtedness in increasing its control over the acquired corporation. Thus, the 80-percent limitation (contained in sec. 279(i) of the Code) which applies under present law in such situations, is to be removed.

EFFECTIVE DATE

The provision bill applies to taxable years ending after October 9, 1969.

Under this provision, any refund or credit resulting from the removal of the 80-percent limitation is not to be barred (by the statute of limitations, by *res judicata* in a litigated case, by a closing agreement, or otherwise) if the claim is filed within 1 year of the date of enactment.

REVENUE EFFECT

This provision is estimated to result in a one-time revenue loss of less than $1,000,000.

B. Treatment of Amounts Received on Loan of Securities (sec. 2 of the bill and secs. 512, 509, 851, and 4940 of the Code).

PRESENT LAW

Exempt organizations—unrelated business income

The investment income of exempt organizations [1] generally is not subject to tax on unrelated business income.[2] The types of investment income sources listed as being generally free of this tax are dividends, interest, annuities, royalties, rents, and capital gains from the sale of investment assets (sec. 512(b) (1), (2), (3), and (5)).

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[1] In this report references to "exempt organizations" do not include social clubs (sec. 501(c)(7)) and employees' beneficiary associations (sec. 501(c)(9)), which may be taxable on investment income of all types. The term "exempt organizations," as used in this report, also does not include political organizations (as described in sec. 527) and homeowners' associations (as described in sec. 528).

[2] In the case of "debt-financed property", different rules apply, and the investment income may be taxable in part. Those rules are dealt with under section 514 of the Code (see sec. 512(b)(4)) and are not amended by this bill.

Exempt organizations—public charities

Certain organizations may be treated as public charities (i.e., not private foundations) if they normally receive more than one-third of their support from a combination of gifts, grants, contributions, or membership fees and gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities which are not unrelated trades or businesses. This rule applies only if the organization normally receives not more than one-third of its support from gross investment income plus the excess of the organization's unrelated business taxable income over the amount of the tax imposed on such income (sec. 509(a)(2)). Under this provision, the term "gross investment income" means the gross amount of income from interest, dividends, rents, and royalties, but not including any such income to the extent included in computing the unrelated business income tax.

Exempt organizations—private foundations

The Code imposes on each private foundation a tax equal to 4 percent of its net investment income for the taxable year (sec. 4940). For this purpose, net investment income is the amount by which the sum of gross investment income and net capital gain exceeds the deductions which are attributable to the earning of this income. For this purpose, gross investment income also means the gross amount of income from interest, dividends, rents, and royalties (but not including any such income to the extent it is included in computing the unrelated business income tax).

Regulated investment companies

For a corporation to qualify as a regulated investment company, at least 90 percent of its gross income must be derived from dividends, interest, and gains from the sale or other disposition of stock or securities (sec. 851(b)(2)). The Internal Revenue Service has ruled privately that payments on securities loans are not dividends or interest even if they are paid by the broker (borrower) as the equivalent of a dividend or interest payment on the underlying security.

REASONS FOR CHANGE

Because of time delays which a broker may face in obtaining securities to deliver to a purchaser (from the seller), brokers are frequently required to borrow securities from organizations with investment portfolios. In general, it is felt desirable that organizations (and individuals) with securities holdings should be encouraged to make them available for loan sine the greater the volume of such securities available for loan the less frequently will a broker be in a position where he must fail to deliver a security to a purchaser within the time required by the relevant market requirements.

The Securities and Exchange Commission provides rules governing the lending of securities by regulated investment companies. These rules, in general, require that the loan of security be fully collateralized (with adjustments made on a daily basis) by cash or marketable securities with a fair market value equal to the fair market value of the securities loaned and that the lender be able to terminate the loan with 5 business days' notice.

In general, the lender of securities is compensated for the loan in two ways. First, if a dividend or interest is paid with respect to the security during the term of the loan, the borrower pays the lender and amount equal to that dividend or interest payment. Second, a fee is paid for the use of the security. This fee may be computed by reference to the period for which the loan is outstanding and the fair market value of the security during that period, or it may be the income from the collateral security for that loan, or it may be income from the investment of the collateral secuirty.

As indicated above, the Internal Revenue Service has ruled privately that neither portion of this compensation constitutes dividend or interest income to regulate investment companies. Existing law is unclear as to whether such income is subject to the unrelated business income tax, but there is some concern that the Service might take that position. It does not appear that under existing law these payments would be treated as gross investment income for the purposes of whether the lending organization is a public charity or whether the income is subject to the private foundation excise tav on investment income. The Service also is unwilling to rule as to whether an organization is engaged in a trade or business when it holds its investment portfolio securities available for such loans. If so, the income therefrom would be subject to the unrelated business income tax. Also, gains from the sale of such securities might be treated as gains from the sale of property held for sale to customers in the ordinary course of business.

The committee believes that is is not desirable to discourage [3] exempt organizations and regulated investment companies from making their securities available for loans to brokers, because making such loans of securities can have a favorable impact on the liquidity of securities markets. The committee also belieevs that it is an appropriate use of markets. The committee also believes that it is an appropriate use of activity.

The committee has concluded that, where the loan is fully collateralized in accordance with the Securities and Exchange Commission requirements, the income from the lending of a security should be regarded as investment income which is similar to dividends and interest in the case of exempt organizations and regulated investment companies.

EXPLANATION OF THE PROVISION

The provision provides, in general, that payments in respect to securities loans which satisfy certain requirements are to be treated in the same manner as dividents and interest in the case of a lender who is an exempt organization or a regulated investment company. Thus, if an exempt organization lends a security [4] to another party, in order for the payments to qualify for the passive income treatment the agreement between the parties must provide for reasonable procedures to implement the obligation of the borrower to furnish collateral to the

[3] If a dividend or interest equivalent payment would be subject to tax, while the dividend or interest if paid directly would be not taxable, then in many cases the exempt organization would find itself with less income after tax if it lent the securities than would be the case if it kept the securities.

[4] For this purpose, the definition of a security is that provided by section 1236(c) of the Code, as "any share of stock in any corporation, certificate of stock or interest in any corporation, note bond, debenture, or evidence of indebtedness, or any evidence or an interest in or right to subscribe to or purchase any of the foregoing."

lender with a fair market value on each business day the loan is out-for the payments to qualify for this passive income treatment the agreement between the parties must provide for reasonable procedures to implement the obligation of the borrower to furnish collateral to the notice of no more than five business days.

Also, it is contemplated that the activity of an exempt organization in merely making available its securities for a loan is not to affect its status an an investor with respect to those activities nor is it to result in the organization's being treated as being in the trade or business of selling or lending securities so as to result in the gains from such securities being treated as subject to the unrelated business income tax. Similarly, payments on securities loans of this sort are to be treated as gross investment income for purposes of determining whether an organization has met the limitations on investment income as a percentage of support required under section 509(a)(2). These payments also are to be treated as gross investment income for the purpose of the excise tax on the investment income of private foundations (sec. 4940), and the expenses of earning such income are to be deductible in computing that tax.

Similarly, in the case of regulated investment companies, payments on securities loans are to be treated in the same manner as dividends and interest. However, where these payments are passed through to the shareholders of these companies, they would not be treated as dividends for the purpose of divided exclusions.

In making these provisions for payments on securities loans which meet the prescribed standards, the committee intends that no inference is to be drawn with respect to the active or passive classification of income from securities loans that lack the safeguards required in the bill, either for purposes of the unrelated business income tax, treatment as gross investment income, or for other income tax purposes, such as determining whether such income is personal holding company income.

It is not intended that this treatment be available if the securities which are loaned constitute inventory or are being held for sale to customers in the ordinary course of the organization's trade or business. These activities go beyond the concept of production of investment income that is intended to be exempted, or treated as passive income. Also, it is not intended that this bill detract from the court's decision in *Randall Foundation* v. *Riddell*, 244 F. 2d 803 (C.A. 9, 1957), that securities trading can be so large a part of the activities of an organization that the organization fails to meet the statutory test of being "organized and operated exclusively for religious, charitable, scientific," etc. purposes, and thus does not qualify for exemption from tax.

EFFECTIVE DATE

This amendmnt applies to amounts received after December 31, 1975, regardless of whether the organization involved is a calendar year taxpayer or a fiscal year taxpayer.

REVENUE EFFECT

This amendment is estimated to have, at most, a small effect (under $5 million per year loss) on the revenues.

III. Cost of Carrying Out the Bill and Committee Vote

In compliance with section 252(a) of the Legislative Reorganization Act of 1970, the following statement is made relative to the effect on the revenues of this bill. The enactment of H.R. 7929, as amended, will result in a small annual revenue loss (under $5 million) and a one-time revenue loss of less than $1 million. The Treasury Department agrees with this statement.

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote of the Committee on reporting this bill. This bill was ordered favorably reported by the Committee by voice vote.

IV. Changes in Existing Law Made by the Bill

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 committee amendment, as reported).