[JOINT COMMITTEE PRINT]

DESCRIPTION OF REVENUE PROVISIONS OF H.R. 1930 AND BACKGROUND RELATING TO PROPOSED TRANSFER OF CONRAIL TO NORFOLK SOUTHERN CORPORATION

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON May 1, 1985

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Committee on Ways and Means has scheduled a hearing on May 1, 1985, on H.R. 1930 (introduced by Chairman Rostenkowski and Mr. Duncan), relating to Federal income tax aspects of the sale of the Federal Government's interest in 85 percent of the common stock of the Consolidated Rail Corporation ("Conrail") to Norfolk Southern Corporation and related transactions. Title I (tax provisions) of the bill ("Sale of Conrail Tax Provisions Act of 1985") was referred to the Committee on Ways and Means; title II (nontax provisions) of the bill ("Sale of Conrail Act of 1985") was referred to the Committee on Energy and Commerce. This pamphlet,[1] prepared in connection with the hearing, provides information relative to the proposed sale and a description of the tax provisions of H.R. 1930.

The first part of the pamphlet sets forth the factual background. The second part generally discusses present law rules. Part three contains a detailed description of title I of the bill.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Revenue Provisions of H.R. 1930 and Background Relating to Proposed Transfer of Conrail to Norfolk Southern Corporation* (JCS-12-85), April 30, 1985.

I. BACKGROUND

A. Overview

Between 1967 and 1973, eight railroads operating in the Northeast and Midwest entered into bankruptcy proceedings. In response to this situation, Congress enacted the Regional Rail Reorganization Act of 1973 ("1973 3R Act").[1] The 1973 3R Act established the United States Railway Association ("USRA"), a nonprofit government corporation organized under the laws of the District of Columbia which is statutorily exempt from income taxes. USRA was charged with formulating a plan (referred to as the "final system plan") to restructure the bankrupt railroads into a financially self-sustaining rail service system. USRA recommended a final system plan that provided for the transfer of rail properties owned by seven bankrupt railroads to the Consolidated Rail Corporation ("Conrail"). The Rail Revitalization and Regulatory Reform Act of 1976 ("1976 4R Act") amended the 1973 3R Act to provide for the implementation of the final system plan.[2] The Northeast Rail Service Act of 1981 (referred to as "NERSA") amended the 1973 3R Act to provide for the transfer of Conrail common stock to the Federal Government, as well as a plan for the sale of the Federal Government's interest in Conrail.[3] Under NERSA, the Secretary of the Department of Transportation ("DOT") is charged with disposing of the Federal Government's common stock interest in Conrail.

1. Details of final system plan

The 1976 4R Act provided for the organization of Conrail as a for-profit corporation under the laws of a State. The Act also authorized the appropriation of $2.1 billion for use by USRA to invest in Conrail debentures and preferred stock. In addition, a special court was created to determine the value of the rail properties transferred to Conrail and the adequacy of the compensation paid therefor.

Conrail was organized under the laws of the State of Pennsylvania and began operations on April 1, 1976. The enabling legislation expressly provides that Conrail is not an agency or instrumentality of the Federal Government. Conrail was authorized to issue debentures, series A preferred stock, series B preferred stock, common stock, and certain contingent interest notes (described more fully below).

As of April 1, 1976, six of the seven bankrupt railroads conveyed rail properties selected by USRA to Conrail. These railroads were the Penn Central Transportation Company (which was the major

[1] 45 U.S.C.A. secs. 701-797m (West Supp. 1973-1983) (as amended by subsequent legislation).
[2] Pub. L. No. 94-210, 90 Stat. 31 (amending 45 U.S.C.A. sec. 701 *et seq.*).
[3] Pub. L. No. 97-35, 95 Stat. 357 (amending 45 U.S.C.A. sec. 701 *et seq.*).

railroad in the Northeast and Midwest), Central Railroad Company of New Jersey, Lehigh Valley Railroad Company, Reading Company, Erie Lackawanna Railroad Company, and Lehigh and Hudson River Railway Company (referred to as the "transferor railroad(s)").[4] In consideration for the transfer, three categories of instruments were deposited in the special court for later allocation among and distribution to the transferor railroads: (1) all of the outstanding Conrail common stock, (2) all of the outstanding Conrail series B preferred stock, and (3) certificates of value ("CVs") issued by USRA. The CVs represented the Federal Government's guarantee that the transferor railroads would receive adequate compensation for the transferred rail properties. The CVs were redeemable at "base value" less the value of the Conrail common stock and series B preferred stock and certain other sums. The term base value was defined as the net liquidation value of the transferred rail properties as of April 1, 1976 (as determined by the special court), less the value of other benefits provided to the transferor railroads, plus compensation for the preconveyance erosion in a transferor's estate, with 8-percent interest compounded annually.[5]

a. Agency agreements

Conrail also entered into agency agreements with each of the transferor railroads. These agency agreements provided for the processing of accounts receivable and accounts payable attributable to each railroad's operations prior to the April 1, 1976 conveyance of properties to Conrail. In this connection, USRA was authorized to make loans to Conrail for the payment of obligations of the bankrupt railroads.[6] USRA was generally permitted to forgive any such loan (plus accrued interest) if Conrail was not reimbursed for the payment of an obligation, and was generally required to forgive such a loan (including accrued interest) on the third anniversary date of the loan. The amount of unreimbursed payments offset the compensation that was ultimately paid for the transferred rail properties.

b. USRA's initial investment in Conrail

USRA was authorized to invest in Conrail debentures and, thereafter, series A preferred stock.[7] The proceeds of these investments were required to be used for the following purposes: (1) the modernization, rehabilitation, and maintenance of Conrail's rail properties, (2) the acquisition of equipment and other capital needs, (3) the refinancing of loans made by USRA to Conrail under USRA's general loan authority, and (4) the provision of working capital. In certain circumstances, Conrail was authorized to issue contingent interest notes to USRA, in lieu of unpaid interest on the debentures. These notes are payable only if Conrail enters into bankruptcy, reorganization, or receivership prior to the redemption of debentures and series A preferred stock held by USRA.

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[4] It is understood that the Ann Arbor Railroad Company, which was among the seven railroads included in the final system plan, declined to participate.

[5] 45 U.S.C.A. sec. 746.

[6] 45 U.S.C.A. sec. 721(h).

[7] 45 U.S.C.A. sec. 726.

c. Valuation settlements

Penn Central transferred approximately 80 percent of the rail properties received by Conrail on April 1, 1976.[8] On November 17, 1980, Penn Central agreed to surrender its interests in Conrail stock and CVs, as part of a cash settlement of $2.113 billion ($.653 billion of which represented accrued interest).[9] Subsequently, NERSA amended the 1973 3R Act to eliminate Conrail stock as a payment medium in the valuation proceedings before the special court. Thus, the Federal Government was also required to satisfy its obligations to the other transferor railroads by paying cash. As a result of valuation settlements, the Federal Government paid an amount that approximated $2.777 billion in cash (including accrued interest) in redemption of the CVs held by the transferor railroads. In a related amendment, NERSA provided for the transfer of all the Conrail common stock and series B preferred stock held by the special court to DOT. The legislative history of the latter amendment indicates that the Conrail stock was "without value" as the result of Conrail's poor financial performance and, thus, the rights of the transferor railroads were adequately secured by the CVs.[10]

2. Tax aspects of final system plan

Tax legislation was an integral part of the final system plan but was not included in the 1976 4R Act because it was viewed as an Internal Revenue Code matter that deserved special attention.[11] Technical issues were raised regarding (1) whether gain or loss would be recognized on the transfer of rail properties in exchange for Conrail stock and CVs issued by USRA, (2) the basis of the transferred properties in Conrail's hands, (3) whether Conrail would succeed to net operating loss ("NOL") carryovers of the transferor railroads, and (4) whether the transferor railroads could offset income arising from valuation settlements by NOL carryovers that were available on April 1, 1976, but expired unused before the awards were made. Section 374 of the Code was amended to address these issues, as discussed below.[12]

a. Gain or loss on exchange

No gain or loss was recognized by transferor railroads that conveyed properties to Conrail solely in exchange for Conrail stock and CVs (sec. 374(c)(1)). The rationale for this provision was that the existing tax treatment of railroad reorganizations should apply because Congress had specifically provided for the conveyances to Conrail.[13]

Gain was recognizable on the receipt of unqualified consideration unless the recipient distributed the unqualified consideration to its shareholders or security holders. No loss was recognized if qualified

[8] Hearing before the House Committee on Ways and Means, 94th Cong. (1976) (Statement of William Goldstein, Deputy Assistant Secretary for Tax Policy, Department of the Treasury).
[9] The Penn Central Corporation, Annual Report (1980).
[10] Pub. L. 97-35, 1981 U.S. Code Cong. and Adm. News., p. 631.
[11] Hearing before the House Committee on Ways and Means, 94th Cong. (1976) (Statement of John J. Terry, Vice President for Financial Planning, USRA).
[12] Pub. L. No. 94-253, 90, Stat. 295 (amending 26 U.S.C. sec. 374). All references to the "Code" are to the Internal Revenue Code of 1954, as amended.
[13] H.R. Rep. No. 940, 94th Cong., 1st Sess. 6 (1976). No Senate Report was submitted with this legislation.

consideration was received, regardless of whether unqualified consideration was also received. Amendments were also made to section 358 of the Code, under which the basis of Conrail stock and CVs in the hands of the transferor railroads was equal to that of the rail properties transferred to Conrail.

In a related development, one of the transferor railroads obtained a private letter ruling from the Internal Revenue Service ("IRS") regarding the gain or loss recognized on redemption of the CVs. This railroad transferred properties with an aggregate basis that exceeded the value of the properties (as determined by the special court). Because the CVs took a basis equal to that of the properties transferred, the railroad realized a loss on redemption of the CVs. The IRS ruled that the excess of the taxpayer's basis for the CVs over the original principal amount constituted an ordinary loss. *LTR 8329101* (April 25, 1983).[14]

b. Basis of transferred property

The aggregate basis of the rail properties transferred to Conrail was substantially higher than the then value of the assets (as estimated by USRA).[15] For example, the railroad discussed in *LTR 8106030* (November 12, 1980), transferred assets with an aggregate tax basis of approximately $3.4 billion, the value of which was determined to be a minimum of $1.460 billion (it is unclear whether this railroad's valuation award was reduced by liabilities paid or assumed by the Federal Government). Similarly, another railroad estimated that it would transfer assets with a tax basis of $230 million for which it would be paid only $34 million.[16] In preparing financial projections for Conrail's operations, USRA assumed that Conrail's basis in the transferred properties would be the same as the basis in the hands of the transferors. Congress was informed that the carryover basis would have the effect of reducing Conrail's income tax expense and, as such, was viewed by USRA as a device that would help Conrail to be economically self sufficient. Thus, notwithstanding the fact that the transferor railroads were ultimately allowed to deduct losses attributable to the excess of the aggregate basis of the transferred properties over their value (see the discussion in the preceding paragraph), the transferred properties took a carryover basis in Conrail's hands, increased by the amount of any gain recognized by the transferors on the transfer (sec. 374(c)(3)). Information provided by Conrail indicates that the total carryover basis to Conrail was approximately $3.511 billion, of which approximately $2.870 billion was depreciable.[17]

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[14] *See also* The Penn Central Corporation, Annual Report (1983). In an earlier private ruling issued to the same taxpayer, the IRS ruled that the loss would constitute a capital loss. *See LTR 8106030* (November 12, 1980); The Penn Central Corporation Annual Report (1982). In the second ruling, the IRS took the position that the difference between the basis of the CVs and the redemption proceeds constituted amortizable bond premium that was deductible under section 171 of the Code.

[15] Hearing before the House Committee on Ways and Means, 94th Cong. (1976) (Statement of John J. Terry, Vice President for Financial Planning, USRA).

[16] Hearing before the House Committee on Ways and Means, 94th Cong. (1976) (Statement of A.W. Hesse, Jr., Chief Executive Officer, Reading Company).

[17] Footnote eliminated.

c. Elimination of NOL carryovers

In preparing financial projections for Conrail, USRA had not anticipated that the NOL carryovers of the railroads would be transferred to Conrail. Because Conrail neither needed nor wanted the NOL carryovers,[18] section 374 was amended to expressly provide that the NOL carryovers of the transferors would not be transferred to Conrail (sec. 374(c)(4)).[19]

d. Extended carryover period

At the time of the conveyances to Conrail, the transferor railroads had current NOL carryovers (assuming they survived bankruptcy) that could have been used to offset income arising from the valuation proceedings before the special court. Because the valuation proceedings were expected to continue for many years, there was a concern that the NOL carryovers would expire prior to the receipt of valuation awards.[20] Section 374 was amended to provide that NOL carryovers that expired unused would be revived for the limited purpose of offsetting amounts arising from an award in (or settlement of) a railroad bankruptcy proceeding, or a proceeding in the special court, or the redemption of a CV.[21]

B. Profile of Conrail

1. Capitalization

USRA holds $850.9 million of Conrail 7-1/2-percent debentures, $351.3 million of contingent interest notes,[22] and 25.5 million shares of series A preferred stock. DOT holds 31.7 million shares of series B preferred stock and 25 million shares of Conrail common stock. As discussed more fully below, a Conrail subsidiary holds approximately 4.4 million shares of Conrail common stock (which stock is beneficially owned by an employee stock ownership plan).

Under present law, upon any sale of DOT's common stock interest, the Federal Government's interest in Conrail debentures and preferred stock (including instruments held by USRA) is to be limited to a contingent interest, which interest would be triggered only in the event of Conrail's bankruptcy, liquidation, or similar proceeding.[23]

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[18] H.R. Rep. No. 940, 94th Cong., 1st Sess. 6 (1976). No Senate Report was submitted with this legislation.

[19] Under the law then in effect, it was unclear whether the NOL carryovers of the bankrupt railroads would be retained by such railroads or transferred to Conrail. The 1976 tax legislation did not resolve the issue of whether the carryovers would be retained by the bankrupt railroads. It is understood that the transferor railroads took the position that the NOL carryovers survived the transaction. For example, as of the beginning of 1976, Penn Central had an estimated $2 billion NOL carryover that could be used to offset future income. *See* Hearings before the House Committee on Ways and Means, 94th Cong. (1976) (Statement of Robert W. Blanchette, Chairman of the Board of Trustees, Penn Central Transportation Company).

[20] At that time, regulated transportation companies, including railroads, were allowed to carry forward NOLs for seven years; the carryover period for NOLs was extended to 15 years in 1981.

[21] The IRS has taken the position that the interest component of the valuation settlements may not be offset by expired NOL carryovers. LTR 8106030 (November 12, 1980). Penn Central has taken the position that the IRS's ruling is incorrect in its Federal income tax returns. The Penn Central Corporation Annual Report (1984).

[22] These contingent interest notes are payable only on commencement of bankruptcy or similar proceedings and, for that reason, are not reflected in Conrail's financial statements.

[23] 45 U.S.C.A. sec. 762.

Conrail has entered into noncancellable long-term leases (principally of equipment). As of December 31, 1984, Conrail's commitments under these capital leases amounted to $946.9 million.[24] For financial reporting purposes, Conrail treats the $946.9 million of obligations as long-term liabilities. For tax purposes, the obligations are reported as long-term leases. Also, as of December 31, 1984, Conrail had current book liabilities of $929.1 million (compared to $1.516 billion of current book assets).[25]

It is understood that Conrail's pension plan is overfunded on a termination basis by approximately $250 million.

2. Employee stock ownership plan

In 1978, Congress appropriated $1.2 billion for use by USRA to make additional investments in Conrail. Of the $1.2 billion amount, the investment of $345 million was conditioned on the establishment of a Conrail employee stock ownership plan ("ESOP").

To implement the ESOP, Conrail issued about 4.4 million shares of its common stock (15 percent of the total outstanding) to Conrail Equity Corporation ("CEC") in exchange for an equivalent number of shares of CEC preferred stock and one share of CEC common stock (which is the only CEC common stock outstanding). Beginning in 1980, Conrail has contributed 10 percent of the CEC preferred stock to the ESOP each year. These contributions are scheduled to continue through 1989.

The CEC preferred stock contributed to the ESOP is allocated on a pro rata basis to each plan participant. The participants' rights to acquire direct interests in Conrail common stock was made contingent on Conrail's satisfying certain financial and operational standards. When Conrail met those standards in 1983, the ESOP became entitled to the conversion of CEC preferred stock to an equivalent number of shares of Conrail common stock in 1991.

On June 23, 1980, Conrail received a favorable determination as to the ESOP's qualified status under section 401(a) of the Code. In accordance with a private letter ruling issued by the IRS, Conrail has claimed deductions for the value of the CEC preferred stock contributed to the ESOP each year.

3. Certain advantages granted to Conrail under NERSA

To facilitate the reduction of Conrail's operating costs, *inter alia*, NERSA provided authority for Conrail to reduce wages and change certain fringe benefits. Similarly, Conrail was exempted from liability for State taxes.

Pursuant to NERSA, during the period beginning on May 5, 1981 and ending on June 30, 1984, Conrail union employees accepted wages that were 12 percent below the national railroad wage levels. Wages were similarly reduced for non-union employees. The amount of foregone wages estimated by Conrail approximate $375 million. It is understood that Conrail employees have taken the position that this amount represents deferred wages, but that Conrail views the amount as a wage concession that does not have to be repaid.

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[24] Consolidated Rail Corporation, Annual Report (1984).

[25] *Id.*

4. Basis of depreciable assets

As of January 1, 1985, Conrail estimated that the aggregate tax basis of its roadway properties was $937 million, the aggregate tax basis of its equipment was $1,217 million, and the aggregate tax basis of its "frozen asset base" was $849 million. Thus, Conrail's aggregate depreciable basis approximates $3 billion. Conrail estimates that the aggregate tax basis of depreciable and nondepreciable assets (including cash and accounts receivable) is about $5 billion.

a. Frozen asset base

Prior to enactment of the Economic Recovery Tax Act of 1981 ("ERTA"), the railroad industry generally used the retirement-replacement-betterment ("RRB") method of depreciation for rail, ties, ballast, labor costs, and other items in track accounts.[26] ERTA repealed section 167(r) of the Code, which permitted the use of the RRB method, as of January 1, 1981. In general, the cost of property that would have qualified for treatment under the RRB method of prior law is recovered over a five-year period under the Accelerated Cost Recovery System ("ACRS"). With respect to RRB property that existed as of December 31, 1980, railroads were given an election to recover the basis (costs that were capitalized and not recovered by virtue of retirements) over a period of at least five years but not more than 50 years. The so-called "frozen asset base" could be recovered using a prior-law depreciation method, including the 200-percent declining balance ("DDB") method, switching to the "sum of the years digits" method at a time to maximize the deductions.

As of December 31, 1980, Conrail's frozen asset base was approximately $1.2 billion. For 1981, Conrail elected to recover its frozen asset base using the DDB method over a ten-year period, resulting in a deduction of about $318 million for that year. In 1982, Conrail switched to the straight-line method of depreciation over the same ten-year period, reducing the annual deduction for its frozen asset base to approximately $141 million.

b. Tax benefit transfers

For 1981 through 1983, Conrail obtained the use of new equipment by entering into "safe harbor leases." The safe harbor lease rules, which were generally repealed in 1982, permitted a taxpayer who acquired and used property to, in effect, sell the tax deductions and investment tax credits ("ITC(s)") associated with the property while retaining all other economic benefits and burdens of ownership. Pursuant to these rules, Conrail sold new equipment to a lessor for a cash downpayment and the lessor's purchase money note. Because the lessor was treated as the tax owner of the prop-

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[26] Under the RRB method, when a new railroad line was laid, the cost (both materials and labor) of the line was capitalized. No depreciation was claimed for the original installation, but a deduction for the costs could be claimed if the line was retired or abandoned. If the original installation was replaced with components (rail, ties, etc.) of a like kind or quality, the cost of the replacements (both materials and labor) was deducted as a current expense. When the replacement was of an improved quality, the improved portion of the replacement was a "betterment" that was capitalized, and the remainder of the replacement cost was deducted as a current expense.

erty, the lessor was entitled to claim ACRS deductions and ITCs. The cash downpayment represented the value of the tax attributes transferred to the lessor. Because the sale price was equal to Conrail's cost for the equipment, no gain was recognized on the sale. Simultaneously, the lessor leased the property back to Conrail under a safe harbor lease.

The timing and amount of Conrail's obligation to pay rent under a safe harbor lease is the same as that of the lessor's obligation to make payments of principal and interest on the purchase money note. Thus, no cash changes hands after the downpayment. The lessor's deemed interest payments constitute income to Conrail; however, this income is more than offset by deductions for Conrail's deemed rent payments. As the amount of the lessor's interest payments declines over the term of the purchase money note (the lessor's deemed payments of principal are not income to Conrail), Conrail's net rental deduction increases. Conrail estimates future net rental deductions of approximately $575 million over the next 17 years.

5. NOLs and other carryovers

As of January 1, 1985, Conrail estimated having NOL carryovers of $1.804 billion. In addition, there are ITC carryovers of approximately $305 million. Conrail's carryovers will not begin to expire until 1991.

Given the amount of Conrail's NOL carryover and its financial history, it is likely that Conrail has a substantial deficit in earnings and profits ("E&P"). The magnitude of any deficit in E&P has not been established.

C. The Sale Process

NERSA authorized DOT to transfer the Federal Government's interest in Conrail's common stock, contingent on USRA's determining, as of June 1, 1983, that Conrail would be a profitable carrier, and that Conrail was a profitable carrier during the period beginning on June 1, 1983 and ending on October 1, 1983.[27] The profitability determinations were made, and DOT, with the assistance of Goldman, Sachs & Co. (an investment banking firm), began the process of soliciting bids.

In evaluating bids, DOT was guided by statutory criteria that require a plan for the sale of the Federal Government's stock interest to (1) ensure continued rail service, (2) promote competitive bidding for the stock, and (3) maximize the return to the United States on its investment.[28] In addition, DOT imposed several financial conditions: the surrender of Conrail's pre-acquisition NOL and ITC carryovers and the cancellation of the Federal Government's interest in debt and preferred stock issued by Conrail. The rationale for eliminating Conrail's NOL and ITC carryovers is that these tax attributes arose during the Federal Government's ownership and are generally attributable to monies invested in Conrail by the Federal

[27] 45 U.S.C.A sec. 763. If USRA had been unable to make the profitability determinations, then DOT would have been authorized to sell Conrail's rail properties and service responsibilities piecemeal.

[28] 45 U.S.C.A. sec. 761(a)(2).

government.[29] DOT proposes to cancel the debt and preferred stock to make the Conrail common stock marketable.[30]

After approaching 100 potential buyers, DOT received 15 bids. DOT also received a proposal for a public offering, submitted by the management of Conrail. Before making a final decision, DOT narrowed the field to three bidders: Alleghany Corporation; an investment syndicate headed by J. Willard Marriott, Jr.; and Norfolk Southern Corporation ("Norfolk Southern"). On February 8, 1985, DOT announced the selection of Norfolk Southern as the buyer of the Federal Government's common stock in Conrail.

Together with a letter dated March 5, 1985, DOT transmitted to Congress a proposal for legislation required to implement a purchase by Norfolk Southern. (Substantially all of DOT's proposals are included in title II of H.R. 1930.) The legislation proposed by DOT would, *inter alia*, amend the 1973 3R Act to permit cancellation of debt and preferred stock issued by Conrail. The proposed recapitalization would be effective as of the consummation of the sale of the Federal Government's ownership interest.

1. Summary of losing bids

Each of the bids submitted by the three finalists included a cash payment of at least $1.2 billion. In addition, both Alleghany Corporation and the Marriott Group proposed to increase the ownership interest of the Conrail ESOP. Neither Alleghany Corporation nor the Marriott Group is currently involved in the railroad industry.

By letter dated January 4, 1985, the management of Conrail submitted a proposal that was structured to provide sale proceeds to DOT of $1.4 billion. The $1.4 billion amount would be raised by a $500 million public offering of common stock, a $600 million private placement or public sale of preferred stock (with a 12-percent dividend), and by utilizing $300 million of Conrail's excess cash. In addition, the Conrail ESOP would increase its ownership interest from 15 percent to 30 percent.

2. Norfolk Southern memorandum of intent

Norfolk Southern is a holding company that was formed in connection with the 1982 combination of Norfolk & Western Railway Company and Southern Railway Company. Norfolk Southern's railroad system extends over 20 states in the Southeast and Midwest. At present, Norfolk Southern does not do extensive business in the Northeast. The corporations included in Norfolk Southern's affiliated group file a consolidated Federal income tax return. On February 8, 1985, Norfolk Southern and DOT entered into a memorandum of intent ("MOI").

The MOI sets forth the principal terms of the agreement between Norfolk Southern and DOT. The consideration to be paid by Norfolk Southern consists of $1.2 billion in cash, the surrender of approximately $1.8 billion of NOL carryovers and $300 million of ITC carryovers, and the amount of any "excess cash" (described

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[29] Letter from Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury, to Representative Dan Rostenkowski (March 29, 1985).

[30] Hearing before the Senate Committee on the Judiciary, 99th Cong. (1985) (Statement of Christopher Rooney, Deputy Administrator, DOT).

below). Norfolk Southern also proposes to provide up to $375 million (in cash or Norfolk Southern stock) for use in settling various claims of Conrail employees. A portion of this amount is to be used to acquire the ESOP's 15-percent common stock interest in Conrail. In addition, Norfolk Southern agreed to certain covenants and to divest itself (or Conrail) of certain rail assets pursuant to requirements of the Antitrust division of the U.S. Department of Justice. Finally, DOT has agreed to warrant certain tax results and to indemnify Norfolk Southern in the event of a breach of such a warranty.

The MOI generally provides that Norfolk Southern cannot use Conrail's cash on hand to finance the $1.2 billion purchase price. Thus, Norfolk Southern proposes to borrow $1.2 billion. An exception is provided under which Norfolk Southern would be permitted to use Conrail's cash to pay the costs of certain arrangements made for Conrail employees (see the discussion below). This exception, together with another provision that generally requires the maintenance of a $500 minimum cash balance, apparently may enable Norfolk Southern to use up to $300 million of Conrail's cash to implement the arrangements made for Conrail employees (assuming no decrease in Conrail's cash balance as of December 31, 1984).

a. Turn back of "excess cash"

As of December 31, 1984, $846 million in cash was reflected on Conrail's consolidated balance sheet. The MOI provides that, in general, the excess cash payable by Norfolk Southern as additional purchase price at the closing is the amount by which Conrail's cash and temporary investments "as at the end of the month immediately prior to the date of closing" exceeds the sum of (1) $800 million, (2) the net increase in long-term liabilities (during the period beginning on December 31, 1984 and ending on the last day of the month prior to closing), (3) proceeds from the sale of non-current assets (such as equipment), (4) cash attributable to certain transactions not in the ordinary course of business, and (5) certain other items.

b. Norfolk Southern's arrangements for Conrail employees

Norfolk Southern has agreed to provide up to $375 million, plus future payments over time, as part of a labor settlement. The total labor package is to include (1) the acquisition of the ESOP's beneficial interest in 15 percent of Conrail's common stock, (2) the satisfaction of employee claims arising from prior wage concessions, and (3) the payment of "New York Dock" labor protection benefits[31] to employees who are adversely affected by the transaction.

The allocation of the $375 million is the subject of negotiations between the Railway Labor Executives' Association and Norfolk Southern. If the 15-percent interest is purchased for the same $48 per share that Norfolk Southern proposes to pay for DOT's 85-percent interest, the purchase price would be $212 million. On the other hand, as noted above, the amount of past wage concessions estimated by Conrail approximates $375 million. Thus, it is unclear

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[31] *See* New York Dock Railway-Control-Brooklyn Eastern Terminal, 360 ICC 60 (1979).

what portion of the $375 million will be allocated to the purchase of the ESOP's 15-percent common stock interest.

c. Five-year covenants

Norfolk Southern has agreed to comply with certain covenants for five years following the closing, including: (1) the continuation of Conrail's business substantially as it is now conducted, (2) the making of capital investments (e.g., replacement of trackage or equipment) of at least $350 million each year, (3) the retention of a beneficial interest in at least 51 percent of Conrail's outstanding stock, and (4) restrictions on the payment of cash dividends unless, *inter alia*, Conrail has on hand a minimum cash balance of $500 million (determined without regard to the amount of offsetting current liabilities). Norfolk Southern has also agreed to other five-year covenants, such as (1) not to dispose of a substantial part of Conrail's assets, (2) not to obtain a reversion of any excess assets held in Conrail's pension plan, and (3) not to liquidate Conrail.

d. Divestitures

Norfolk Southern's bid was the only purchase offer that presented a possible violation of the antitrust laws.[32] Accordingly, the Justice Department recommended that a sale of Conrail to Norfolk Southern should be conditioned on the prior or concurrent divestiture of certain rail properties by both Norfolk Southern and Conrail.

e. Routing concessions

Norfolk Southern has agreed to maintain or re-establish cost-competitive routes with certain small rail carriers that have annual operating revenues of less than $300 million.

f. Tax matters

DOT's obligation to sell the Conrail stock to Norfolk Southern is conditioned on a closing agreement between Conrail and the IRS. The required closing agreement is to provide generally that (1) Conrail's taxable year will close as of the date of Closing, (2) Conrail's pre-acquisition NOL and ITC carryovers will be surrendered, except to the extent of NOL carryovers that are attributable to reductions required by the IRS in the basis of Conrail's depreciable or amortizable assets, and (3) Conrail's asset basis will not be increased by any adjustment to a pre-acquisition taxable year.

Further, DOT warrants that (1) the cancellation of the Federal Government's interest in Conrail debt (including debentures, contingent interest notes, and accrued interest) and preferred stock will not result in the recognition of income or in adjustments to the basis of any assets, (2) the basis of Conrail's assets after the acquisition will be as shown on Conrail's last pre-acquisition return (determined without extraordinary departures form the methods of prior years), (3) no gain or loss will be recognized by Norfolk Southern or Conrail upon the sale of shares to Norfolk Southern, unless Norfolk Southern makes an election (or is deemed to have made an

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[32] Hearing before the Senate Committee on the Judiciary, 99th Cong. (1985) (Statement of J. Paul McGrath, Assistant Attorney General, Antitrust Division, Department of Justice).

election) to have the stock purchase treated as a purchase of Conrail's assets under section 338 of the Code, and (4) Norfolk Southern will not be deemed to have made a section 338 election as a result of certain direct asset purchases so long as Norfolk Southern either complies with applicable Treasury regulations or elects to take a basis for the purchased assets that does not exceed the basis in the hands of the seller.

In general, Norfolk Southern is indemnified against any tax liability that arises from the IRS's taking a different view of a matter than is as warranted by DOT. Norfolk Southern would not receive any cash payments but would be permitted to offset any tax liability. The tax indemnity is perpetual and is not limited to a dollar amount (although, as indicated above, the ability to offset is limited to the amount of tax liability resulting from a breach of warranty). Under the MOI, Norfolk Southern becomes entitled to bring suit in any U.S. District Court or the Claims Court if the IRS issues a statutory notice of deficiency[33] of a tax liability that is inconsistent with a representation made by DOT.

Finally, Norfolk Southern's obligation to purchase is conditioned, *inter alia*, on the receipt of a ruling from the IRS or a warranty by DOT to the effect that amounts (otherwise constituting ordinary and necessary business expenses) paid to Conrail employees to increase their post-acquisition wages to industry standards and the costs paid or incurred for certain routing concessions (described above) will not be treated as "built-in losses" within the meaning of the Treasury regulations applicable to corporations that file consolidated income tax returns. (If these expenses were treated as built-in losses, they could not be used to offset the post-acquisition income of any corporation—other than Conrail—included in the Norfolk Southern affiliated group.)

[33] The MOI actually refers to a "30-day" letter; however, it is understood that the definitive agreement between Norfolk Southern and DOT will refer to a "90-day" letter (or notice of deficiency).

II. DISCUSSION OF PRESENT LAW RULES

A. Utilization of Conrail's Tax Attributes

In directing DOT to undertake a sale of the Federal Government's interest in Conrail common stock, Congress's primary concern appeared to be the transfer of Conrail as an on-going entity (rather than the liquidation of Conrail's assets). Under the general rules of present law, the purchase of all or part of a corporation's stock does not affect the corporation's tax history (e.g., carryovers, E&P, and asset basis). The Treasury Department has taken the position that the application of general tax rules would be inappropriate to the extent a buyer obtained the use of NOL and ITC carryovers that were funded with Federal monies.[34]

Although DOT would require the elimination of Conrail's carryovers, other aspects of Conrail's tax history would be unchanged.[35] For example, any deficit in Conrail's E&P would be available after the transfer of the Federal Government's ownership interest.

1. Surrender of Conrail's carryovers

The value to the Federal Government of eliminating Conrail's NOL, ITC, and other carryovers depends on the extent to which the carryovers would be utilized if they were available. This determination would require projections of Conrail's future income, as well as future deductions that would offset taxable income (and thereby defer the use of carryovers).

An acquiring corporation would not directly succeed to Conrail's NOL, ITC, and other carryovers; however, an acquiring corporation could benefit from such tax attributes if Conrail joins it in the filing of a consolidated return (and if no election under section 338 of the Code is made or deemed made).[36] Further, under section 381 of the Code, if Conrail were liquidated into an acquiring corporation, the NOL and ITC carryovers would be transferred to the acquiring corporation (unless the principal purpose of the transaction was tax avoidance).

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[34] Letter from Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury, to Representative Dan Rostenkowski (March 29, 1985). As discussed above, in addition to the $3.3 billion that USRA was authorized to invest in Conrail securities, the Federal Government paid $2.777 billion to the railroads that conveyed property to Conrail in 1976.

[35] The MOI would not prevent Norfolk Southern from making an election under section 338 of the Code, in which case Conrail's tax history would disappear. Under the circumstances, as discussed below, it is unlikely that Norfolk Southern would make this election.

[36] Sections 382 and 383 of the Code, which impose special limitations on the use of NOL and ITC carryovers after an acquisition, would be inapplicable so long as the buyer continues Conrail's business. Section 269 of the Code authorizes the disallowance of certain tax attributes but would apply only if it is determined that tax avoidance was the primary purpose of the acquisition of Conrail stock. The MOI does not explicitly warrant that section 269 of the Code will not apply.

In addition to the special limitations on the use of carryovers in sections 382 and 383 of the Code, Treasury regulations governing corporations that file consolidated returns provide "separate return limitation year" (SRLY) rules (Treas. reg. sec. 1.1502-21(c)). Under the SRLY rules, Conrail's carryovers could not be used to reduce the tax liability of other members of an acquiring corporation's affiliated group; however, Conrail would be permitted to use the carryovers to offset "its own" income. As the Treasury Department has pointed out, the SRLY rules could be avoided if the acquiring corporation successfully diverted income-producing activities from other corporations in the group (or contributed income-producing assets) to Conrail.[37] In the case of an acquisition by Norfolk Southern, the surrender of Conrail's carryovers could represent value to the Federal Government to the extent Norfolk Southern has the ability to increase Conrail's income.

Although the value of Conrail's carryovers is speculative, it is possible to identify certain factors that would bear on the question of whether Conrail (as an independent company or as part of an acquiring corporation's affiliated group) would generate sufficient taxable income before the carryovers expire. For purposes of discussion, it is assumed that Conrail will not be liquidated for some period of time after the transfer of the Federal Government's ownership interest (as would be the case under the MOI).

a. Possibility of augmenting Conrail's income

In the first instance, the income that Conrail can be expected to earn from its existing assets should be considered. It would also be relevant to consider the possibility that Conrail's income would be augmented after an acquisition.

There are various means by which an acquiring corporation could augment Conrail's income. By way of example, prior to the combination of Norfolk & Western and Southern Railway, there was little interchange between the two railroads. After the formation of Norfolk Southern, each railroad's length of haul was extended and productivity was increased as a result of interchange.[38] Similarly, Norfolk Southern proposes to not only hold Conrail's business level but increase it.[39] The acquisition of Conrail would permit Norfolk Southern to extend its markets in the Northeast, while permitting Conrail to extend its markets in the Southeast and Midwest.[40] Conrail's income would also increase if its operating costs are reduced as the result of efficiencies introduced by Norfolk Southern. After the formation of Norfolk Southern, various departments of the predecessor railroads (e.g., sales force, marketing, finance, and computer activities) were combined.[41] Given

[37] Letter from Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury, to Representative Dan Rostenkowski (March 29, 1985).

[38] Roberts, *Norfolk Southern Builds for Multi-Modal Future*, MOD. RAILROADS 22, 24 (February 1985) (Interview with Harold H. Hall, President and Chief Operating Officer of Norfolk Southern).

[39] *Id.* at 23 (Interview with Robert Claytor, Chairman and Chief Executive Officer of Norfolk Southern).

[40] Hearing before the Senate Committee on Commerce, Science, and Transportation, 99th Cong. (1985) (statement of Robert Claytor, Chairman and Chief Executive Officer, Norfolk Southern).

[41] Roberts, *supra* at 22.

that Conrail's operations would compliment Norfolk Southern's existing business, Norfolk Southern could be expected to cause Conrail to generate additional income against which the carryovers could be used. Further, at some future date Conrail could be liquidated into Norfolk Southern, with the result that the carryovers may be available to directly offset income of the Norfolk Southern affiliated group of corporations. Finally, Norfolk Southern could simply transfer income-producing assets to Conrail as a capital contribution.

It should be noted that Norfolk Southern's ability to utilize the carryovers by increasing Conrail's income would be restricted by the terms of the MOI, business considerations, and, possibly, sections 269 and 482 of the Code. For example, because the MOI limits Norfolk Southern's ability to withdraw Conrail's earnings for five years, Norfolk Southern might refrain from diverting substantial income-producing activities to Conrail.

b. Termination of cost advantages granted under NERSA

After the Federal Government transfers its ownership interest, Conrail will become liable for State taxes.[42] Further, as of July 1, 1984, Conrail increased its employees' wages to industry standards. The requirement that Conrail pay these additional expenses will reduce future taxable income.

c. Pattern of future depreciation deductions

Conrail's projected taxable income would be reduced by depreciation deductions (and sales) attributable to its asset basis. Further, Conrail is likely to make continuing investments in depreciable property, the deductions from which would also defer the use of NOL carryovers.

d. Deductions generated by tax benefit transfers

Conrail's safe harbor leases will generate a stream of net rental deductions in future years and are akin to built-in deductions (to the extent that the rentals are in lieu of depreciation deductions).

2. Deficit in earnings and profits

a. Significance of earnings and profits

In general, the amount of a distribution by a corporation to a shareholder is includible in the shareholder's gross income as a dividend (taxable at ordinary income rates) only to the extent the distribution is made out of current or accumulated E&P.[43] If a distribution exceeds E&P, the balance is treated as a tax-free return of capital (and reduces the basis of the dividend-paying stock). To the

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[42] 45 U.S.C.A. sec 727(c).

[43] Subject to a $100 exclusion ($200 on a joint return), dividends are taxed to individual shareholders at a maximum rate of 50 percent. In contrast, corporate shareholders are generally permitted to deduct 85 percent of dividends received from domestic corporations. Thus, because the maximum rate of tax on corporate income is 46 percent, the maximum rate of tax on dividends received by a corporation is only 6.9 percent. Dividends distributed between members of an affiliated group of corporations that files a consolidated tax return are excluded from the affiliated group's taxable income (Treas. Reg. sec. 1502-14(a)(1)), although the parent corporation's basis for its stock in the distributing corporation would generally be reduced on account of such distributions (Treas. Reg. sec. 1.1502-32).

extent the distribution exceeds the basis of the stock, the excess is generally taxed at capital gain rates.[44]

b. Utility of Conrail's deficit in earnings and profits

The utility of the deficit in Conrail's E&P will depend on the identity of Conrail's shareholder(s) after the acquisition.

Conrail's deficit in E&P would not affect the current taxation of dividends distributed to an acquiring corporation that includes Conrail in its affiliated group (as Norfolk Southern would do). If Conrail is liquidated into an acquiring corporation some time after the acquisition, the deficit in E&P could reduce the acquiring corporation's post-acquisition E&P (although the deficit could not be applied against that corporation's accumulated E&P). Thus, even if the acquiring corporation has accumulated E&P at the time of the acquisition, after such earnings are paid out, Conrail's deficit could result in the future payment of tax-free dividends to the acquiring corporation's shareholders. The MOI appears to prohibit Norfolk Southern from liquidating Conrail during the five-year period after the closing date. Further, because Norfolk Southern has been profitable in past years, Norfolk Southern's accumulated E&P appear to be significant enough that there is little likelihood of reducing them to zero.

In contrast, any deficit in Conrail's E&P would present a more significant issue if individuals were to purchase stock in Conrail as the result of a public offering. The individual shareholders would benefit because the deficit in E&P would enable Conrail to pay tax-free dividends (after the distribution of any post-acquisition current E&P). On the other hand, non-controlling corporate shareholders who are eligible for the 85-percent dividend received deduction would view the possibility of capital-gain dividends (after recovery of basis) as a disadvantage.

c. Elimination of deficit in earnings and profits

The Treasury Department has suggested that the definitive sale agreement between Norfolk Southern and DOT provide that Conrail's E&P account will not carry over in the sale transaction.[45]

3. Carryover asset basis

In general, the MOI warrants that the basis of Conrail's assets after the acquisition will be as claimed by Conrail on its last pre-acquisition return.[46] If Conrail joins an acquiring corporation in filing a consolidated return, its future depreciation deductions could reduce the post-acquisition income generated by other mem-

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[44] Long-term capital gain of individuals is taxable at a maximum rate of 20 percent. Corporations are taxed on net capital gain (the excess of net long-term capital gain over net short-term capital loss) at an alternative rate of 28 percent if the tax computed using that rate is lower than the corporation's regular tax.

[45] Letter from Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury, to Representative Dan Rostenkowski (March 29, 1985).

[46] One of the reasons the amount of Conrail's aggregate basis for its assets could be called into question, for example, is the ground that the Federal Government did not make investments in Conrail as a shareholder qua shareholder. *See Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943).

bers of the affiliated group, except to the extent the limitations on "built-in" losses (described below) apply.

a. Possible application of separate return limitation year rules

Under applicable Treasury regulations, built-in deductions are subject to the SRLY rules (Treas. Reg. sec. 1.1502-15). The term "built-in deduction" is generally defined as a deduction or loss that is recognized by a corporation in a consolidated return year but which economically accrued before the corporation was included in the consolidated group. Built-in deductions include operating expenses (e.g., pension fund and salary expenses),[47] as well as depreciation deductions attributable to a built-in loss. Under a *de minimis* exception, the SRLY rules do not limit the use of built-in deductions unless, *inter alia*, the aggregate basis of an acquired corporation's assets (other than cash, marketable securities, and goodwill) exceeds the fair market value of such assets by more than 15 percent. If the basis of an acquired corporation's assets exceeds the value by more than 15 percent, then depreciation deductions attributable to the difference between the value and the basis of each asset are limited to use against the acquired corporation's income (and cannot offset income of other members of the affiliated group).

Although Conrail's depreciable asset basis approximates $3 billion (and its total basis—including cash and accounts receivable—approximates $5 billion), DOT proposes to transfer the Federal Government's ownership interest for a minimum of $1.2 billion in cash (plus the purchase price of the ESOP's stock). Treasury has taken the position that the difference between Conrail's aggregate asset basis and the proposed purchase price suggests that Conrail would not satisfy the *de minimis* exception, but could not conclude with certainty that the exception would not apply.[48] On the other hand, it is understood that Norfolk Southern has taken the position that the price of Conrail's stock does not reflect the value of Conrail's assets because of long-term lease commitments, other economic obligations, and the five-year covenants imposed by DOT, but that the value of Conrail's assets substantially exceeds the proposed nominal purchase price.[49] The determination of whether, and by how much, Conrail's asset basis exceeds the value of the assets by more than 15 percent is inherently factual. Even if it were determined that there is a built-in loss, the SRLY rules would not prevent Conrail from utilizing deductions against its own income. Thus, NS could possibly benefit—to some extent—from Conrail's asset basis by augmenting Conrail's income (see the discussion in part II.A.1.a., above).

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[47] Rev. Rul. 79-279, 1979-2 C.B. 316.

[48] Letter from Ronald A. Pearlman, Assistant Secretary for Tax Policy, Department of the Treasury, to Representative Dan Rostenkowski (March 29, 1985).

[49] Note that the economic obligations imposed on NS represent expenditures that NS (or Conrail) will presumably deduct currently when paid (e.g., future rentals under the long-term leases).

b. Possible application of section 338

In general, section 338 of the Code conforms the tax treatment of stock purchases to that of asset purchases if an election is made or deemed made. If a section 338 election were made or deemed made by an acquiring corporation, the basis of Conrail's assets would be adjusted to reflect the buyer's cost (measured by the stock purchase price, liabilities, and other relevant items). To prevent an acquiring corporation from selectively obtaining both assets at a cost basis and the carryover of tax attributes from corporations in the same affiliated group, a consistency requirement is imposed under which an acquiring corporation is deemed to have made a section 338 election if there is a purchase of assets from the corporation whose stock was acquired (or an affiliate) during a prescribed period (sec. 338(e)). The statute contemplates that an exception to the deemed election treatment will be provided if the purchasing corporation elects to take as its basis in the property the adjusted basis of the property in the hands of the seller (except where the purchasing corporation would be treated as having a basis in excess of its cost).[50] Consistent with the legislative history, temporary treasury regulations provide for a protective carryover basis election, pursuant to which a deemed election under section 338(e) of the Code may be avoided.[51]

The applicable temporary regulations do not generally address the specific issue of how an acquiring corporation's stock purchase price is to be allocated among an acquired corporation's assets. Presumably, the allocation will be similar to that under prior-law section 334(b)(2) of the Code (the predecessor to section 338). Under prior law, in general, the stock purchase price to be allocated among assets was adjusted upwards for liabilities of the acquired corporation and other items, but was also reduced by the amount of the acquired corporation's cash or cash equivalents. The adjusted stock purchase price, generally, was then allocated among assets (including depreciable and nondepreciable assets) in proportion to their relative values. For example, if a section 338 election were made with respect to Conrail, the acquiring corporation's adjusted stock purchase price (as reduced by the amount of Conrail's cash and cash equivalents on hand) would be allocated partly to Conrail's depreciable assets and partly to nondepreciable assets such as land. In light of the differential between Conrail's asset basis and Norfolk Southern's proposed nominal purchase price, Norfolk Southern would not benefit from a section 338 election.

B. Cancellation of Debt and Preferred Stock

The MOI seeks to provide certainty regarding the Federal income tax consequences of the cancellation of Conrail's debt and preferred stock.

Section 61 of the Code provides generally that the discharge of indebtedness results in the realization of income by the debtor.

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[50] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 1221 (1984). Apparently, the MOI included a similar provision because Treasury regulations had not been issued when the MOI was executed.

[51] Temp. Treas. reg. sec. 1.338-4T(f).

Under section 108(a) of the Code, income from the discharge of indebtedness incurred by a corporation is excluded from gross income if the debtor/corporation elects to reduce the basis of its depreciable property by the excluded amount (under section 1017 of the Code). Section 108(e)(6) of the Code provides an additional exception where a corporation acquires its debt from a shareholder as a contribution to capital. Ordinarily, the cancellation of preferred stock would be a nontaxable event; however, preferred stock could be recharacterized as debt the cancellation of which could give rise to income. In the proposed acquisition by Norfolk Southern, the MOI provides a warranty that the Federal Government's cancellation of debt and preferred stock issued by Conrail will not result in the recognition of income or in adjustments to the basis of any assets.

It is unclear why the MOI warrants against the recognition of income on cancellation of the Conrail debt and preferred stock. Because the cancellation of Conrail's debt and preferred stock is contingent on Norfolk Southern's obtaining control of Conrail, it could be argued that Norfolk Southern, and not the Federal Government, should be viewed as cancelling the obligations. In such a case, under section 108(e)(6), Conrail would be viewed as having satisfied the indebtedness with an amount of money equal to Norfolk Southern's purchase price for its interest in Conrail. Thus, Conrail would realize income from discharge of indebtedness to the extent the face amount of the debt (including, possibly, the preferred stock) exceeds Norfolk Southern's adjusted basis for its ownership interest. Another possibility is that the Federal Government would be viewed as having cancelled the debt after the change in control. In the latter case, the exception for shareholders may be inapplicable. In either case, Conrail's NOL carryovers would be unavailable to offset the resulting income.

If Conrail were viewed as realizing income on discharge of the debt, Norfolk Southern could cause Conrail to make the election to reduce the basis of depreciable assets; however, given the magnitude of the debt, this would not be an attractive alternative. If the debt cancellation is treated as a tax-free nonshareholder contribution to capital, Conrail's asset basis would also be reduced (sec. 362(c)).

C. Tax Procedure

1. Closing agreements

As discussed above, DOT's obligation to sell the Conrail stock to Norfolk Southern is conditioned on a closing agreement between Conrail and the IRS relating to the closing of Conrail's taxable year, the surrender of Conrail's carryovers, and the basis of Conrail's assets. Section 7121 of the Code authorizes the IRS to enter into written agreements with taxpayers relating to liability in respect of any internal revenue tax for any taxable year. In the absence of fraud, a closing agreement is generally viewed as a conclusive determination of a taxpayer's liability for the period covered by the agreement.

The IRS interprets the term "liability" as used in section 7121 of the Code to require that a closing agreement be, at least arguably, consistent with Federal taxing statutes.[52] Although a closing agreement is intended to dispose of debatable matters, an agreement that is based on adjustments clearly contrary to the taxing statutes could be challenged as not being "in respect of any internal revenue law," and therefore invalid.[53]

2. Warranties

In the MOI, DOT warrants the Federal income tax consequences of various aspects of the purchase of Conrail stock by Norfolk Southern. A breach of a tax warranty would entitle Norfolk Southern to bring suit in a special court proceeding. The effect of the indemnity procedure provided in the MOI is to guarantee the tax results (in that Norfolk Southern would not have increased tax liability). Unlike a private transaction where a breach of warranty generally results in a purchase price adjustment (as described below), Norfolk Southern would not have a claim against DOT (which claim might have to be settled out of direct appropriations).

In the private sector, tax representations and warranties given by sellers may be very limited or very broad. The exact resolution will depend on a variety of factors, including the relative bargaining positions of the parties and the outcome of other issues. If a buyer does obtain tax representations and warranties that survive the closing, it will need to be concerned about how to enforce its rights if there is a breach. Contractual provisions regarding the remedy comes in almost as many forms as the tax representations and warranties themselves. A buyer may content itself with a right to sue the selling shareholders for a breach. Such a remedy would be unwieldy if the buyer is widely held. In such a case, the buyer may put a part of the purchase price into "escrow" or the buyer may protect itself with installment obligations (from which payments can be withheld).

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[52] *See* "Closing Agreements Handbook," I.R. Manual MT 8(13)10-6.
[53] *Id.*

III. EXPLANATION OF TITLE I OF H.R. 1930

Title I of H.R. 1930 would provide expressly for the tax consequences of certain aspects of the transfer of ownership of Conrail to Norfolk Southern. The bill addresses the following issues: (1) whether Conrail's carryovers will be available after the consummation of the sale of the Federal Government's interest in the common stock of Conrail (the "Closing"), (2) whether income will be recognized, or adjustments to Conrail's assets required, as the result of the cancellation of debt obligations and preferred stock issued by Conrail, (3) whether Conrail's asset basis will be adjusted after the Closing, (4) whether a section 338 election will be deemed under certain circumstances, (5) whether, as the result of certain transactions, the ESOP will meet the qualifications of sections 401 and 501 of the Code, (6) whether certain expenses will be treated as built-in deductions, and (7) whether Conrail's taxable year will close as of the Closing. The bill would render unnecessary the tax indemnity procedure provided in the MOI.

A. Treatment of Carryovers

Under the bill, Conrail's NOL, ITC, and capital loss carryovers attributable to any period before the Closing would not be carried forward to any period after the Closing. Conrail's carryovers would be available to offset income or tax liability determined with respect to a taxable year ending prior to the Closing.

B. Cancellation of Debt and Preferred Stock

The bill provides that no amount would be included in the gross income of any person (and no basis adjustments in Conrail's assets would be made) by reason of the cancellation of any obligation or preferred stock of Conrail.

C. Asset Basis

Under a general rule, the adjusted basis of Conrail's assets immediately after the closing would be as shown "in good faith" on Conrail's tax return for its taxable year ending as of the Closing. Consistent with the effect of the MOI (which provides a tax indemnity), under the bill, Norfolk Southern generally would incur no economic detriment if it were later determined that the aggregate basis of Conrail's assets as shown in good faith on the last pre-closing tax return was incorrect.

D. Coordination with Section 338

Except as otherwise provided, the general rule regarding the post-closing basis of Conrail's assets would be inapplicable if NS makes an election (or is deemed to make an election) under section

338 of the Code. The bill also provides that NS would not be deemed to have made an election by reason of an acquisition of an asset of Conrail if the person acquiring such asset agrees, subject to conditions prescribed by Treasury regulations, to treat the basis of such asset as not exceeding its adjusted basis immediately before such acquisition.

E. Waiver of Certain ESOP Provisions

Under the bill, two provisions would be added to clarify the status of the Conrail ESOP as a qualified plan under section 401 of the Code. First, the bill would provide that the limits on contributions and benefits generally applicable to qualified pension plans (sec. 415 of the Code) does not apply with respect to interests in stock transferred to the Conrail ESOP pursuant to a previously enacted law.

Second, the bill would provide an exception to the general rule that precludes a participant in a profit-sharing or stock bonus plan from withdrawing contributions made on the participant's behalf prior to the expiration of two years after the year in which the contributions were made. Thus, the participants in the ESOP could, in 1991, begin to withdraw their interests in the ESOP without regard to when the contributions to the ESOP were made.

F. Built-in Deductions

For purposes of the consolidated return regulations, certain amounts that are otherwise ordinary and necessary business expenses would not be treated as built-in deductions. The expenses covered by this provision are expenses paid to Conrail employees for services rendered after the Closing in order to increase post-closing wages to industry standards, and expenses paid or incurred for the routing concessions required by the MOI.

G. Taxable Year of Conrail

Consistent with the MOI, the bill includes a provision for the termination of Conrail's taxable year as of the closing.[54]

H. Definitions

The bill defines a number of terms for purposes of the tax provisions of H.R. 1930.

1. Conrail

The term "Conrail" means the Consolidated Rail Corporation, as well as any corporation that was a subsidiary of Conrail immediately before the closing (as defined below).

2. Definitive Agreement

The term "Definitive Agreement" means any and all agreements between the United States and Norfolk Southern, including all rep-

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[54] The reason this provision was included in the MOI is unclear since Conrail's taxable year would terminate in any event as the result of Conrail's inclusion in NS's affiliated group. *See* Treas. reg. sec. 1.1502-76.

resentations and warranties made therein, entered into to implement the memorandum of intent (defined below).

3. Memorandum of Intent

The term "Memorandum of Intent" means the Memorandum of Intent between the United States and the Norfolk Southern Corporation signed February 8, 1985, along with attachments and exhibits pertaining thereto on such date.

4. Closing

The term "Closing" means the consummation of the sale of the interest of the United States in the common stock of Conrail.

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