TAX MANAGEMENT PORTFOLIOS™

U.S. INCOME

Stock Rights and Stock Dividends — Sections 305 and 306

by

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Stock Rights and Stock Dividends — Sections 305 and 306

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Stock Rights and Stock Dividends — Sections 305 and 306,* No. 765-4th, analyzes the tax problems that arise in connection with dividend distributions of common or preferred stock and stock rights. The Portfolio provides a framework for analysis of the tax treatment of such distributions by summarizing the early judicial determinations in this area and the statutory responses to such decisions. In addition, the cases, regulations and rulings applicable to stock dividends are discussed in detail. The Portfolio analyzes the issues as to when a distribution will be taxable; what factors must be considered in determining whether stock is common or preferred; when a distribution of preferred stock will be subject to taint under §306; and the basis and holding period issues surrounding stock distributions.

The Worksheets contain a checklist of key factors relating to stock dividends and stock rights; resolutions authorizing a stock dividend and the distribution of stock rights; an extract from a prospectus in which tracking stock was distributed; resolutions adopting a recapitalization plan; an extract from a prospectus issued by a publicly held corporation in which subscription rights were offered; and example computations.

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I. Introduction

A. *Overview of Portfolio*

At first blush, a corporation's distribution of stock or stock rights to its shareholders would seem to constitute a relatively simple event that should not raise intricate questions of tax policy and treatment. Nevertheless, virtually since the inception of the income tax, Congress, the courts and the IRS have struggled with the concepts of whether, when, and how to tax such distributions. When a corporation distributes a pro rata dividend of common stock on common stock, the respective positions of the shareholders have not changed and there has been no economic increase in any shareholder's wealth. Nor has there been a change in the nature of any shareholder's investment. Consequently, the distributees should not have to pay a tax to the government because their wealth has not changed in any manner as a result of the common stock distribution. However, if the corporation allows some shareholders the option to take cash or to take a distribution that alters the equity interest of all shareholders, there has been a distribution, or deemed distribution, which should be taxed to the recipients of the economic benefit.

When a corporation makes a pro rata distribution of preferred stock with respect to its outstanding shares of common stock, there has also not been a change in either the economic positions or the nature of the investment of the shareholders. Such a distribution, however, creates the possibility for the shareholders to effectively convert ordinary income into capital gain. For instance, if shortly after the distribution, a shareholder sells the preferred stock received in the distribution and the sale is considered to be a capital transaction, the selling shareholder will have effectively received a "cash dividend" (since the shareholder's percentage interest in the residual assets of the corporation has not effectively changed) while receiving capital gain treatment. Moreover, if the preferred stock would have been nonvoting, or if the corporation redeemed it from the purchaser, the common shareholder's control of the corporation would not have been altered.

The distinction between capital gains and dividends has historically been significant primarily due to preferential tax rates for capital gains. Of course, the greater the rate differential, the more important capital gain treatment is to an individual taxpayer. For tax years beginning after 2002, however, §1(h)(3)(B) and (h)(11)[1] provides that the tax rate for individuals on dividends from domestic corporations and qualified foreign corporations is equal to the capital gains tax rate. Thus, given the equality of tax rates under current law the importance of the characterization of an income item as a dividend or a capital gain is diminished, but not eliminated. Capital gain treatment remains important to taxpayers with a large capital loss carryover, and also to taxpayers having a tax basis in an asset that far exceeds the asset's value (thus creating a large capital loss upon disposition of the asset). Additionally, a corporate shareholder would ordinarily prefer dividend treatment as a result of the dividends-received deduction.[2] Because of the withholding rules applicable to dividends, non-U.S. investors may have a strong preference for avoiding dividend treatment.

This portfolio traces the evolution of §305 (regarding the tax treatment of stock distributions), §306 (regarding "tainted" distributions of preferred stock and the consequences of disposing of such preferred stock), and §307 (regarding basis and holding period issues). In addition, the portfolio analyzes the current tax treatment of stock distributions. Finally, it examines methods to avoid current taxation under §305, and eliminate or minimize the taint of §306.

B. *Definition of a Stock Dividend*

A stock dividend is a distribution by a corporation to its shareholders of shares of the corporation's own stock, including the distribution of a right to subscribe to the corporation's stock.[3] From an income tax perspective, there is no difference between a stock dividend and a stock split. Similarly, there is no economic difference. Literally, a stock dividend is a distribution of an additional share of stock for each X number of shares of stock held by a shareholder (e.g., a dividend of one share for each two shares held). On the other hand, a stock split is a conversion of X number of shares to Y number of shares (e.g., two shares are converted into three shares).

A distribution by a corporation to its shareholders of stock of another corporation does not constitute a stock dividend. Rather, such an event is a property distribution.[4] Thus, the distribution by a parent corporation of the stock of its subsidiary is not a stock dividend.[5]

The distribution of stock of a company which "tracks" the performance of a specific division or subsidiary (so-called "tracking stock") does not fit neatly into either the stock dividend or property dividend categories. Tracking stock is discussed in detail in III.I.1. and VI.D., below.

[1] Added by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, P.L. 108-27. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 TRA), P.L. 111-312, §102, extended the JGTRRA sunset to the end of 2012. The American Taxpayer Relief Act of 2012 (2012 ATRA), P.L. 112-240, §102, made the preferential tax rates for net capital gains and qualified dividends permanent.

All section references are to the Internal Revenue Code of 1986 (the Code), as amended, and the regulations issued thereunder, unless otherwise indicated.

[2] See 561 T.M., *Capital Assets*, for a discussion of the treatment of capital gains and losses.

[3] §305(d)(1).

[4] *U.S. v. Phellis*, 257 U.S. 156 (1921), rev'g 56 Ct.Cl. 157 (1921); *Rockefeller v. U.S.*, 257 U.S. 176 (1921), aff'g 274 F. 952 (S.D.N.Y. 1921); *Peabody v. Eisner*, 247 U.S. 347 (1918); *Lonsdale v. Comr.*, 32 F.2d 537 (8th Cir. 1929), aff'g 11 B.T.A. 659 (1928), cert. denied, 280 U.S. 575 (1929). *See also* §317(a).

[5] A distribution of appreciated property by a corporation to its shareholders results in gain recognition by the distributor, pursuant to §311. For a detailed discussion of such distributions, see 764 T.M., *Current Distributions — Cash and Property*.

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C. Reasons for Issuing Stock Dividends

There are many reasons why a corporation may declare a stock dividend. The corporation may decide that it needs to retain cash for expansion, modernization, or working capital; yet still feel the need to distribute something to its shareholders. A corporation may also perceive that its stock is trading at a value which is so high that it is discouraging small investors from purchasing its stock. A stock dividend which initially results in a reduced trading price often sparks increased market interest in the stock, ultimately resulting in greater market capitalization of the company.

As noted above, issuing nonvoting stock (whether preferred or common) may allow the shareholders to realize cash on a part of their investment by selling the nonvoting stock, while retaining their voting stock and, thus, control of the corporation. In that case, §306 may cause the income to be taxed as ordinary income, as opposed to capital gain; the significance of this distinction is discussed in I.A., above. A corporation may also wish to issue a special class of stock which is tied to the earnings of a particular division or subsidiary. So-called "tracking stock" may be attractive since it allows existing and new shareholders to separately invest in different aspects of the company. Such a split of the bundle of ownership rights normally contained in a share of corporate stock may be attractive to management in that it allows them to maintain control over the entire corporation while, at the same time, creating a new pool of investors. At the same time, the issuance of tracking stock may spark market interest in the company, ultimately increasing its market capitalization. Finally, a corporation may also decide to issue stock rights to its shareholders, enabling the corporation to obtain additional capital without incurring the expenses of a public offering (i.e., primarily underwriters' fees and commissions).

There is a somewhat subtle accounting difference between a distribution which is characterized as a "stock dividend," as opposed to a "stock split." When a corporation pays a "stock dividend," the retained earnings account is reduced and the capital stock account is increased by an amount equal to the value of the stock distributed. In a stock split, no such book transfer takes place that would reduce retained earnings. While the tax law does not differentiate between a stock split and a stock dividend, corporate law may differentiate between the two types of stock transactions. Nevertheless, most modern state business corporation statutes treat stock splits and stock dividends similarly in that each may be declared by the board of directors even if the corporation has no earnings. State statutes oftentimes exclude a corporation's dealings in, or transfers of, its own stock from the definition of a "distribution."[6]

It should also be noted that a stock dividend which is not taxable to the corporation's shareholders does not result in a reduction in the corporation's earnings and profits.[7]

[6] *See, e.g.*, §§1103 and 1551 of the Pennsylvania Business Corporation Law and §§2-301, 2-309 and 2-311 of the Corporations and Associations Article of the Annotated Code of Maryland. Delaware law provides that stock splits can be made at any time while stock dividends may be made even though the corporation has no surplus, so long as the corporation has net profits in the current or preceding fiscal year. 8 Del. C. §173.

D. Types of Stock Dividends

The types of stock dividends which a corporation may declare can be summarized as follows:

1. Common stock on common stock of the same class as the outstanding stock on which it is paid (i.e., one share of Class A common for each five shares of Class A common held).

2. Common stock on common stock of a different class (i.e., one share of Class B nonvoting common for each five shares of Class A voting common held).

3. Common stock on preferred stock (i.e., one share of Class A common for each five shares of Class B preferred held).

4. Preferred stock on common stock (i.e., one share of Class A preferred for each share of Class B common held).

5. Preferred stock on preferred stock in the same class as the outstanding stock on which it is paid (i.e., one share of Class A preferred for each five shares of Class A preferred held).

6. Preferred stock of a different class on an outstanding class of preferred stock (i.e., one share of Class A preferred stock for each five shares of Class B preferred stock held).

E. Stock Bailouts

1. In General

As noted above, a stock dividend can have the potential for reducing taxes by converting a dividend into a capital gain, either because capital gains are subject to a lower tax rate in years in which there is a rate differential, or because a taxpayer can offset the capital gain by capital losses. The former reason has historically been the principal motivation for such transactions, and the absence of a rate differential for long-term capital gains and dividends for taxable years beginning after 2002 significantly reduces the incentive to avoid dividend treatment for income tax purposes.

The first step in the prototypical bailout transaction was the issuance of a tax-free stock dividend to the shareholders of the corporation. Next, the shareholder would sell the shares so distributed to a third party purchaser. Finally, the corporation would redeem the shares from the third party. The economic effect of this series of steps was essentially a cash dividend to the shareholders of the corporation. However, the difference between the ordinary cash dividend and the stock bailout was the character of the income recognized by the shareholder. While a dividend of cash was taxed as ordinary income, the sale of the distributed stock was intended to result in capital gain treatment.

[7] §312(d)(1)(B); Reg. §1.312-11(b)(4). *See Sheehan v. Dana*, 163 F.2d 316 (8th Cir. 1947), rev'g 66 F. Supp. 47 (E.D. Mo. 1946); *Long v. Comr.*, 155 F.2d 847 (6th Cir. 1946), aff'g 5 T.C. 327 (1945); *Beretta v. Comr.*, 141 F.2d 452 (5th Cir. 1944), aff'g 1 T.C. 86 (1942); *American Gypsum Company v. Comr.*, 3 T.C.M. 286 (1944).

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Such a series of steps has often been referred to as a capital gain "bailout" of corporate earnings. The typical bailout was structured so as to achieve the desired capital gain while simultaneously preserving the equity and voting power of the shareholders. Such protection was imperative since the third party purchaser would hold the distributed shares until the corporation was in a position to redeem them. The shares distributed were almost always preferred stock with a fixed redemption price to prevent the third party from sharing in any subsequent growth of the corporation. The shares were also usually nonvoting to prevent the third party from exercising control over the affairs of the corporation. The same result could not be achieved by distributing corporate debentures, since the distribution of such securities would have been treated as a taxable dividend.[8]

A redemption of the distributed shares from the original distributees would not have resulted in capital gain treatment since such a redemption would have been pro rata and "essentially equivalent to a dividend" under §302 and its predecessors.[9] Thus, the redemption from the original distributees would have resulted in an ordinary income dividend. Because the shareholders continued to own all of their pre-existing shares of the corporation's stock, those shareholders could not have had the redemption qualify as a complete termination of their interest under §302(b)(3).

2. Stripped Preferred Stock

Section 305(e) contains a provision governing the treatment of "stripped preferred stock," which includes certain stock where there has been a separation in ownership between such stock and any dividend on such stock which has not become payable.[10] Stripped preferred stock is defined, under §305(e)(5)(B), as stock which (a) is limited and preferred as to dividends, and does not participate in corporate growth to any significant extent, and (b) has a fixed redemption price. Taxpayers who purchase stripped preferred stock after April 30, 1993, the effective date of §305(e), must include in gross income amounts equal to the amounts which would have been includible in income if such stripped preferred stock were a bond issued on the purchase date having original issue discount equal to the excess, if any, of: (a) the redemption price for such stock; over (b) the price at which the taxpayer purchased the stock. Under §305(e)(1), this rule also applies to any taxpayer whose basis in such stock is determined by reference to the basis in the hands of such purchaser.[11]

The term "purchase" is defined in §305(e)(6) as any acquisition of stock where the basis of such stock is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired. Under §305(e)(3), any person who strips the rights to one or more dividends from any stripped preferred stock and, after April 30, 1993, disposes of such dividend rights is treated as having purchased the stripped preferred stock on the date of such disposition for a purchase price equal to such person's adjusted basis in the stripped preferred stock.

Amounts included in gross income under §305(e) are treated as ordinary income.[12] It is significant that the income is treated as ordinary income, and not as a dividend. If the income were treated as a dividend, §1(h)(3)(B) and (h)(11) would, subject it to the capital gains tax rate. As ordinary income, however, the income does not fall under §1(h)(11) and, therefore, does not benefit from the capital gains rate.

F. Statutory Framework

1. Overview of §305

Section 305(a) provides the general rule that gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders. This general rule is subject to significant exceptions under §305(b) and (c). Section 305(b) specifies five different situations in which a stock dividend will constitute a taxable distribution:

(a) A distribution is taxable if any shareholder may elect to receive the stock dividend in lieu of money or other property.

(b) A distribution is taxable if one or a series of distributions results in some shareholders receiving cash or property and other shareholders increasing their proportionate interest in the corporation's earnings or assets.

(c) A distribution is taxable if it results in some (but not all) common shareholders receiving common stock.

(d) A stock dividend on preferred stock is taxable, unless it is an increase in the conversion rate of a convertible preferred issue to take into account a stock dividend or stock split of the stock into which the convertible preferred stock is convertible.

(e) Any distribution by a corporation of its convertible preferred stock is taxable, unless the corporation establishes that the distribution will not result in a disproportionate distribution.

Section 305(c) grants the IRS broad authority to issue regulations treating as taxable situations or transactions whereby a shareholder's proportionate interest in a corporation's assets and earnings and profits may change as a result of, inter alia, a change in the conversion ratio, redemption price, or a difference between a redemption price and the issue price.

The Revenue Reconciliation Act of 1990 (1990 RRA), P.L. 101-508, added certain requirements to the regulatory au-

[8] *See* §317 and Reg. §1.301-1.

[9] *See* §115(g) of the Internal Revenue Code of 1939.

[10] The 1993 RRA, §13206(c), redesignated former §305(e) as §305(f), and added §305(e).

[11] Section 1286(e), as redesignated by the 2018 Consolidated Appropriations Act (CAA), Pub. L. No. 115-141, Div. U, §401(c)(2)(A), effective for bonds purchased on or after July 2, 1982, authorizes the Secretary of the Treasury to promulgate regulations that, in appropriate cases, apply rules that are similar to the present-law rules for stripped bonds and stripped preferred stock to direct or indirect interests in an account or entity substantially all of the assets of which consist of bonds (as defined in §1286(d)(1), as redesignated by the 2018 CAA, Div. U, §401(c)(2)(A), effective for bonds purchased on or after July 2, 1982), preferred stock (as defined in §305(e)(5)(B)), or any combination thereof. This provision applies only to cases in which the present-law rules for stripped bonds and stripped preferred stock do not already apply to such interests and is effective for purchases and dispositions after October 22, 2004.

[12] §305(e)(4).

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thority of §305(c).[13] Specifically, the regulations promulgated must provide that:

(a) Where the issuer of stock is required to redeem stock at a specified time, or the holder of stock can require its redemption, the redemption premium will be treated as reasonable only if it does not exceed the amount determined under the principles of §1273(a)(3);

(b) A redemption premium will not fail to be treated as a distribution merely because the stock is callable; and

(c) Where a redemption premium is treated as a distribution, it will be taken into account under principles similar to those in §1272(a).

Reg. §1.305-3 was amended by T.D. 8643, 1996-1 C.B. 29, to reflect the 1990 RRA changes to §305(c) and to address the issue of stock redeemable at a premium by the issuer. Under the regulations, a call premium generally gives rise to a constructive dividend only if redemption under the call provision is more likely than not to occur. Section 305(c) and the regulations promulgated thereunder are discussed in detail in III.H., below.

2. Overview of §306

Section 306 is designed to prevent the bailout of corporate earnings at capital gains tax rates through the device of using preferred stock. Although a distribution of preferred stock may be received by a shareholder tax free under §305 or pursuant to a reorganization, the subsequent sale of that stock may be caught in the web of §306 and taxed as a dividend. The enactment of §306 was spurred by the concern that, because preferred stock possesses many debt-like characteristics and the disposition of such stock did not effectively diminish the shareholder's underlying interest in the corporation, the receipt of the preferred stock should be treated like the receipt of a dividend when the instrument was converted to cash.

Section 306 does not provide for immediate taxation of a shareholder who receives a distribution of "section 306 stock." Rather, §306(a)(1)(A) provides that when a shareholder sells or otherwise disposes of §306 stock, the amount realized will be treated as ordinary income. The amount of income is limited to the amount which would have been treated as a dividend at the time the §306 stock was distributed, assuming the corporation had distributed cash in an amount equal to the fair market value of such stock distribution. Any excess over such amount is treated as capital gain. Pursuant to §306(a)(1)(C), however, a sale of §306 stock cannot result in the recognition of a loss.

For taxable years beginning after 2002 , §1(h)(11) applies the capital gains tax rate to dividends from domestic corporations and qualified foreign corporations. Under §306(a)(1)(D), the amount treated as ordinary income on a sale of §306 stock is treated as a dividend for purposes of §1(h)(11). Thus, under current law sales of §306 stock should be taxable at capital gains rates, assuming it is stock in a domestic corporation or a qualified foreign corporation.

Where a corporation redeems §306 stock, the amount realized is treated as a distribution of property to which §301 applies.[14] Therefore, to the extent of the corporation's earnings and profits, the shareholder will have dividend income, taxable at capital gains rates under §1(h)(11).

While §306(a) provides the general rule of ordinary income treatment on the disposition of §306 stock, §306(b) provides four exceptions to the general rule. Section 306(b)(1) provides an exception in the case of a termination of a shareholder's interest. Similarly, §306(b)(2) provides an exception in the context of a complete liquidation, while §306(b)(3) provides an exception to the extent that the §306 stock is disposed of in a transaction in which no gain or loss is recognized to the shareholder (i.e., a reorganization). Finally, §306(b)(4) exempts transactions which are not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

"Section 306 stock" is defined by §306(c) as stock (other than common stock issued with respect to common stock) which was distributed to a shareholder selling or otherwise disposing of such stock if, by reason of §305(a), any part of such distribution was not includible in the gross income of the shareholder. It also includes stock (a) which is not common stock; (b) which was received by the shareholder selling or otherwise disposing of such stock in a tax-free reorganization or spin-off; and (c) with respect to the receipt of which gain or loss was to any extent not recognized by the shareholder, but only to the extent that either the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for §306 stock. The analysis of whether a particular class of stock may be considered as common stock is critical to the issues arising under both §§305 and 306 and is undertaken at IV.B.3., below. Section 306 stock also includes stock which has a substituted basis from §306 stock.

Stock cannot be characterized as §306 stock if the corporation making such distribution had no earnings and profits at the time of the distribution.[15] Stock, which is not common stock acquired in a §351 transaction, constitutes §306 stock if the receipt of money in lieu of such stock would have been treated as a dividend to any extent.[16] In determining whether stock falls within the definition of §306 stock, certain attribution rules apply.[17] These rules are discussed in detail at IV., below.

For purposes of §306, stock rights are treated as stock, and stock acquired through the exercise of a stock right is treated as stock distributed at the time of the distribution of the stock right to the extent of the fair market value of such right at the time of the distribution.[18]

In determining whether stock is §306 stock, conversion privileges are taken into account. For example, where §306 stock was issued with respect to common stock, and subsequently such §306 stock is exchanged for common stock in the

[13] The changes to §305(c) are generally effective with respect to stock issued after October 9, 1990. However, there is an exception for stock issued after that date pursuant to (1) a binding written agreement in effect on that date (and at all times thereafter before issuance), (2) a registration or offering statement filed on or before that date with a federal or state agency regulating the offering or sale of securities and the stock is issued within ninety (90) days of the date of the filing, or (3) a plan filed on or before such date in a Title 11 or similar case. *See* §11322(b) of the 1990 RRA.

[14] §306(a)(2).

[15] §306(c)(2).

[16] §306(c)(3).

[17] §306(c)(4).

[18] §306(d).

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same corporation, the common stock received is not treated as §306 stock. Common stock which can be converted into stock other than common stock, however, is not treated as common stock.[19]

Section 306(f) provides that proceeds from the disposition of §306 stock, to the extent they are treated as ordinary income, are treated as coming from the same source as would a direct dividend from the corporation for the purposes of Part I of Subchapter N (the rules for determining whether income is from U.S. or foreign sources).

Whenever a substantial change is made to the terms and conditions of any stock, then the fair market value of such stock is the fair market value at the time of its distribution, or at the time the change is made, whichever is higher. Additionally, such stock's ratable share of the amount which would have been a dividend if cash had been distributed in lieu of the stock is determined at the time of the distribution, or at the time of the change, whichever share is higher.[20]

[19] §306(e).
[20] §306(g).

3. Overview of §307

Section 307 provides the rules for determining a shareholder's basis in stock and stock rights distributed in a transaction to which §305(a) applies. The adjusted basis in the old stock is apportioned between the old stock and the new stock in accordance with regulations promulgated by the IRS.[21] The regulations provide that basis is apportioned in accordance with the fair market values of the old stock and the new stock on the date of the distribution.[22]

Section 307(b) creates an exception with respect to the distribution of certain stock rights. If stock rights are distributed and the fair market value of such stock rights at the time of the distribution is less than 15% of the fair market value of the old stock at such time, then, §307(a) does not apply, and the basis in the stock rights is zero, unless the taxpayer elects to use the allocation method provided in §307(a) and the regulations promulgated thereunder. Once such an election is made, it is irrevocable.[23]

[21] §307(a).
[22] Reg. §1.307-1.
[23] §307(b)(2).

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II. Development of the Tax Treatment of Stock Distributions

A. Statutory Treatment Before Eisner v. Macomber

The 1913 Act taxed corporate dividends in general without making specific reference to stock dividends.[24],[25] The Supreme Court interpreted such Act to mean that a stock dividend paid in common stock of the same class as that on which it was paid did not constitute income under the 16th Amendment, and was not taxable to the shareholder.[26] The 1916 Act amended the definition of the term "dividend" to include "any distribution made or ordered to be made by a corporation, … out of its earnings and profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, … which stock dividend shall be considered income, to the amount of its cash value."[27] Congress again amended the definition of a dividend in the 1918 Act.[28] In that Act, corporate distributions were taxable as dividends if paid out of earnings and profits accumulated after February 28, 1913. Moreover, the 1918 Act specifically provided that "a dividend paid in stock of the corporation shall be considered income in the amount of the earnings or profits distributed."

B. Eisner v. Macomber

The Supreme Court decided *Eisner v. Macomber* under the 1916 Act. In that case, the Court held that a dividend of common stock paid on the stock of the same class was not income under the 16th Amendment and, therefore, could not constitute taxable income to the shareholders. It is important to note that the Supreme Court's decision in *Eisner v. Macomber* did not address the consequences of a stock dividend of one class of stock with respect to a different class of stock. Indeed, subsequent decisions at least suggested that the court would have considered such a distribution to be taxable.[29]

Nevertheless, the IRS interpreted the Supreme Court's decision to mean that every stock dividend was constitutionally exempt from taxation under the 16th Amendment. Accordingly, it revoked its regulations which held that stock dividends constituted taxable income and issued new regulations which broadly exempted all income in the form of stock dividends. The regulations treating stock dividends as tax free drew no distinctions between dividends of the same class of stock and dividends of a different class of stock.[30]

[24] 252 U.S. 189 (1920).

[25] Act of October 3, 1913 (38 Stat. 166), §11-B (income defined).

[26] *See Towne v. Eisner*, 245 U.S. 418 (1918), rev'g 242 F. 702 (S.D.N.Y. 1917).

[27] Revenue Act of 1916 (originally enacted September 8, 1916, amended by Act of October 3, 1917), Part I, §2 (Income defined).

[28] Revenue Act of 1918, Part I, §201(b) and (c).

[29] *See Marr v. U.S.*, 268 U.S. 536 (1925), aff'g 58 Ct. Cl. 658 (1923); *Cullinan v. Walker*, 262 U.S. 134 (1923); *U.S. v. Phellis*, 257 U.S. 156 (1921), rev'g 56 Ct.Cl. 157 (1921); and *Rockefeller v. U.S.*, 257 U.S. 176 (1921), aff'g 274 F. 952 (S.D.N.Y. 1921).

[30] T.D. 3052, 3 C.B. 38; O.D. 732 and O.D. 735, 3 C.B. 39 and 40; O.D. 625, 3 C.B. 308.

C. Legislation in Response to Eisner v. Macomber

In the Revenue Act of 1921 (1921 Act), Congress exempted stock dividends from tax. The Committee Reports accompanying the legislation explained that the 1921 Act modified the definition of dividends in existing law by exempting stock dividends from income tax, as required by the decision of the Supreme Court in *Eisner v. Macomber*. The Revenue Acts of 1924, 1926, 1928, 1932, and 1934 all continued the tax exemption for stock dividends.

In *Koshland v. Helvering*,[31] the Supreme Court pointed out that both the IRS and Congress had misinterpreted *Eisner v. Macomber*. In *Koshland*, the taxpayer had purchased nonvoting preferred stock in a corporation which had both common and preferred stock outstanding. The corporation subsequently distributed a common stock dividend with respect to the preferred stock, but not with respect to the common stock. The regulations governing the transaction required the preferred stockholder to allocate her cost basis between the preferred and common, a requirement which she challenged when she later disposed of her preferred stock. The Court stated:

> Under our decisions the payment of a dividend of new common shares, conferring no different rights or interest than did the old, — the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, — does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented, he receives income. The latter type of dividend is taxable as income under the 16th Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes.

The Court concluded that although Congress had the power to tax the receipt of the common stock dividend, it chose not to do so. Therefore, the regulations could not require an allocation of basis between the preferred and common stock, so that the taxpayer retained her full cost basis in the preferred stock in computing her gain on its disposition.

Congress changed the law with respect to stock dividends under the 1936 Act, in response to the *Koshland* decision. Section 115(f) of the 1936 Act provided:

> Stock Dividends —
>
> (1) General Rule — A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.
>
> (2) Election of Shareholders as to Medium of Payment — Whenever a distribution by a corporation is, at the election of any of the shareholder (whether exercised either (A) in its stock or in rights to acquire its stock, of a class which if distributed without elec-

[31] 298 U.S. 441 (1936), rev'g 81 F.2d 641 (9th Cir. 1936).

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tion would be exempt from tax under paragraph (1), or (B) in money or any other property, including its stock or in rights to acquire its stock), of a class which if distributed without election would not be exempt from tax under paragraph (1), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

A corollary of the *Koshland* decision was that any stock dividend paid prior to the effective date of the 1936 Act, which could have been taxed as income under the 16th Amendment, would result in a reduction of post-February 28, 1913 earnings and profits. However, Congress prevented that result by including §115(h) in the 1936 Act. That section provided that a corporation's earnings and profits would not be reduced if the distributee of a stock dividend recognized no gain, or the distribution was not subject to tax. Because all Acts before 1921 provided that income from stock dividends was to be recognized, post-February 28, 1913 earnings and profits were reduced by such dividends regardless of whether they were taxed, as long as the stock dividend represented income under the 16th Amendment. The reduction was determined by the fair market value of the stock dividend when it was paid. However, a distribution in excess of earnings and profits did not reduce earnings and profits below zero, and could not create a "deficit" for dividend purposes.[32] A distribution which exceeded aggregate earnings and profits reduced the shareholder's basis in his stock.

Conversely, all Revenue Acts, beginning with the Revenue Act of 1921, through the Revenue Act of 1924, provided that income from stock dividends was not recognized. Accordingly, §115(h) of the 1936 Act did not permit a reduction of earnings and profits as a result of the payment of stock dividends under those Acts, even though there may have been a realization of income within the meaning of the 16th Amendment.

Both the 1938 Act and the 1939 Code continued the treatment of stock dividends provided for in the 1936 Act.

Subsequent to the Supreme Court's decision in *Koshland* and the 1936 Act, the courts considered a number of stock dividend cases. The following situations were determined to be nontaxable:[33]

(a) Common stock distributed to holders of common stock.

(b) Preferred stock issued as a dividend to holders of common stock where only common stock had been outstanding.

(c) Dividends of Class A stock to holders of Class A stock and dividends of Class B stock to holders of Class B stock.

(d) Dividends of Class A stock to holders of both Class A and Class B stock.

A few cases found that dividends were taxable:[34]

(a) Common stock distributed to holders of preferred stock.

(b) Dividends of one class of preferred stock paid to holders of another class of preferred stock without any distributions to the common stock holders.

(c) Dividends of preferred stock distributed to the holders of common stock when both the common and preferred stock had been outstanding and no distributions were made to the holders of the outstanding preferred stock.

D. Treatment of Stock Dividends Under the 1954 Code

As originally enacted under the 1954 Code, §305 provided that stock dividends and stock rights were not includible in gross income except where (a) the shareholders had the option to elect the medium of payment, or (b) the stock was distributed in discharge of preference dividends. At the same time, §306 was enacted to prevent stock bailouts, and §307 provided rules for the allocation of basis. In general, the new rules applied to distributions of stock and stock rights on or after June 22, 1954.[35]

1. Exception for Distributions in Discharge of Preference Dividends

Section 305(b)(1) of the 1954 Code provided that a distribution by a corporation to its shareholders of its stock or of rights to acquire its stock was to be treated as a distribution of property to which §301 applied, to the extent that the distribution was made in discharge of preference dividends for the taxable year of the corporation in which the distribution was made, or for the preceding taxable year. Distributions in discharge of preference dividends from other prior years were not taxable.

Regulations promulgated under §305 (as then in effect) provided that, to the extent that stock or stock rights were received in discharge of preference dividends and were not taxable under §305, such stock (whether or not preferred stock) or rights could constitute §306 stock.[36] Reg. §1.305-3(c), as then in effect, drove home the point with the following example: Assume 100 shares of common stock were distributed in payment of all dividends due on preferred stock. One-tenth of such stock applied to the current and the immediately preceding year's dividends and nine-tenths to the earlier arrearages. Nine-tenths of each share (as opposed to nine-tenths of the total stock distributed) would constitute §306 stock. Under §305(b)(1), one-tenth of each share would have been treated as a distribution to

[32] O.D. 163, 1 C.B. 28, declared obsolete by Rev. Rul. 68-674, 1968-2 C.B. 609; *Henninger v. Comr.*, 21 B.T.A. 1235 (1931).

[33] *See, e.g.*, *Helvering v. Sprouse*, 318 U.S. 604 (1943), aff'g 122 F.2d 973, rev'g *Keister v. Comr.*, 42 B.T.A. 484 (1940); *Strassburger v. Comr.*, 318 U.S. 604 (1943), rev'g 124 F.2d 315 (2d Cir. 1941); *Helvering v. Griffiths*, 318 U.S. 371 (1943); *Chamberlin v. Comr.*, 207 F.2d 462 (6th Cir. 1953), rev'g and rem'g 18 T.C. 164 (1952), cert. denied, 347 U.S. 918 (1954); *Sprouse v. Comr.*, 122 F.2d 973 (9th Cir. 1941), rev'g *Keister v. Comr.*, 42 B.T.A. 484 (1940), aff'd 318 U.S. 604 (1943); *Stern v. Comr.*, 43-1 USTC ¶9474 (7th Cir. 1943), rev'g and rem'g 46 B.T.A. 416 (1942); *Daggitt v. Comr.*, 23 T.C. 31 (1954), acq., 1955-2 C.B. 5 (withdrawn), *nonacq.*, 1967-2 C.B. 4; *Jacksonville Paper Co. v. Comr.*, 13 T.C.M. 728 (1954); *Blount v. Comr.*, 1 T.C.M. 986 (1943); *Woodward v. Comr.*, 1 T.C.M. 957 (1943); and *Sorg Est. v. Comr.*, 1 T.C.M. 879 (1943).

[34] *See Pizitz v. Patterson*, 183 F. Supp. 901 (N.D. Ala. 1960); *Messer v. Comr.*, 20 T.C. 264 (1953); *Helms Bakeries v. Comr.*, 46 B.T.A. 308 (1942), acq., 1942-1 C.B. 8.

[35] Section 305, as enacted, did not apply where stock was received as a dividend before June 22, 1954, or where the stock was received on or after such date in transactions subject to the provisions of the 1939 Code.

[36] *See* Reg. §1.305-1, as then in effect.

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which §301 applied, and would have been taxed as a dividend to the extent of the corporation's earnings and profits.

A number of odd results followed from that example. First, one-tenth of each share of common stock distributed was not §306 stock. Since it was taxable under §301, the basis of one-tenth of each share would have been its fair market value at the time of the distribution. Nine-tenths of each share of common stock would have constituted §306 stock. Because it was not taxable when received, its basis under §307(a) was an allocated basis determined by reference to the basis of the preferred shares with respect to which the distribution was made. Upon a disposition of the stock, the difference between the basis of one-tenth of each share and one-tenth of the purchase price would have constituted a capital gain or loss. To the extent §306 was applicable to the disposition, nine-tenths of the purchase price for each share would have resulted in dividend treatment, and under the rate structure in effect at the time would have been taxed at a higher rate than a capital gain. The unrecovered basis would have been reallocated to the remaining shares of preferred stock.[37]

In the context of the distribution of stock rights and a distribution in discharge of preference dividends, §305(b)(1), as in effect prior to the Tax Reform Act of 1969 (the "1969 Act") provided that the receipt of stock rights was, in itself, a taxable event regardless of whether such rights were subsequently sold or exercised. Prior to the 1954 Code, stock rights were taxed only when sold or exercised, since the "deemed" distribution of earnings and profits occurred at that point.[38] Where a taxpayer merely received rights which have neither been sold nor exercised, it is difficult to conclude that there has been a distribution of earnings and profits. In the context of a distribution of rights to acquire stock, at less than fair market value, in a corporation other than the one making the distribution, the Supreme Court has held that the receipt of the stock rights does not represent a distribution of earnings and profits until the rights are actually exercised.[39] Nevertheless, in a more recent case, the Court of Appeals held that, in the context of a tax-free spinoff, such a distribution was taxable at the time it was made.[40]

2. *Exception for Election of Shareholders of Medium of Payment*

Section 305(b)(2) of the 1954 Code continued the rule that a distribution of stock by a corporation is taxable if any shareholder had the option to receive money or other property in lieu of such stock. It was the presence of such an option — rather than the actual exercise of the option — that resulted in the distribution being taxed. The transaction was taxable even if:

(a) the distribution was actually made completely in stock, partly in stock and partly in stock rights, or completely in stock rights;

(b) the option was exercised or exercisable before or after the declaration of the distribution;

(c) the declaration of the distribution provided that the distribution would be made in one medium (i.e., stock), unless the shareholder specifically requested payment in the other medium (i.e., cash);

(d) the election governing the nature of the distribution was provided in the declaration of the distribution, in the corporation's charter, or arose from the circumstances of the distribution; or

(e) all or part of the shareholders could exercise an election that would determine the nature of the distribution.[41]

This bright line test prevented nontaxable treatment of a distribution of stock or stock rights even though no shareholder elected to take cash or other property in lieu thereof. It also resulted in the taxation of a shareholder who did not have such an option, if any other shareholder had such an option. Similarly, the point in time when a choice was made was irrelevant. That is, whether the choice was made before or after the declaration of the dividend, as long as at some point in time any shareholder directly or indirectly, through action or inaction, had made a choice which permitted the corporation to distribute stock or stock rights to some shareholders and money or property to other shareholders, the transaction was taxable. Where some shareholders agreed, expressly or impliedly, to accept the distribution of stock or stock rights with respect to their common stock, notwithstanding the distribution of money or other property with respect to other shares of common stock, any distribution of stock or stock rights became taxable.[42] It was also irrelevant whether the right to demand cash was waived before or after the declaration date, by private agreement, under the terms of the corporation's charter, or otherwise.[43] However, where the option applied only with respect to a portion of the stock dividend or stock rights, then the portion as to which there was no option was nontaxable.[44]

If a corporation declared a cash dividend but gave the shareholders the option to take stock in lieu of the cash, the distribution was treated under §305(b)(2) as a cash dividend to all shareholders. This was simply the flip side of the option to take cash in lieu of a stock dividend.[45] In that ruling, dividends payable in cash were declared in 1914. At the same time, the board authorized an increase in the capital stock, and all of the shareholders agreed to purchase the new stock with the cash dividend. Such fact was known by the directors when the dividend was declared. The directors adopted this procedure deliberately, in preference to showing a stock dividend, because of certain state laws. Since there was no corporate action making the cash dividend conditional upon subscription to the new issue of stock, the IRS refused to accept the argument that in essence, the transaction was a nontaxable stock dividend. At least one court reached a contrary result (at the behest of the

[37] *See* Reg. §1.306-1(b)(2), as then in effect.

[38] *See, e.g., Palmer v. Comr.*, 302 U.S. 63 (1937), rev'g 88 F.2d 559 (1st Cir. 1937), vacating 32 B.T.A. 550 (1935), acq., XIV-2 C.B. 17 (1935). *See also* GCM 25063, 1947-1 C.B. 45.

[39] *See Baan v. Comr.*, 391 U.S. 83 (1968), aff'g 382 F.2d 485 (9th Cir. 1967), rev'g 45 T.C. 71 (1965).

[40] *Redding v. Comr.*, 630 F.2d 1169 (7th Cir. 1980), rev'g and rem'g 71 T.C. 597 (1979), cert. denied, 450 U.S. 913 (1981).

[41] *See* Reg. §1.305-2(a)(2), as then in effect.

[42] Reg. §1.305-2(b)(1), as then in effect.

[43] *Id.*

[44] *See* Reg. §1.305-2(c)(2), *Ex. (1)*, as then in effect.

[45] Such treatment dated back to the 1913 Act. *See* T.B.R. 63, 1 C.B. 24, declared obsolete by Rev. Rul. 67-112, 1967-1 C.B. 381.

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IRS) in a similar fact situation.[46] In that case, a corporation proposing to declare a stock dividend sent a notice to its shareholders purporting to give each an election to choose either stock or cash, but also saying that since it had insufficient cash, the dividend would be passed if cash were chosen. None of the shareholders elected to receive cash and the dividend was declared in stock without reference to the directors' resolution to any election to take either stock or cash. The corporation contended that the stock dividend was taxable to the shareholders because of the election and that it was entitled to a dividends paid credit. The Board of Tax Appeals held that no election was given, and that, under §115(f)(2) of the 1936 Act, the stock dividend was not taxable to the shareholders.

Section 305 as enacted by the 1954 Code left substantial room for creative tax planning by taxpayers. One device which attracted considerable attention was the so-called "Citizens' Utility Plan" adopted by the Citizens Utility Company of Stamford, Connecticut. The company recapitalized by reclassifying its outstanding common stock into Class A and Class B. Both classes were equal in all respects except that holders of Class A stock could receive only stock dividends and holders of Class B stock could receive only cash dividends. Under the recapitalization plan, the holders of the old common stock could elect which class of stock they would exchange their old stock for. The Class A stock was convertible into Class B stock at any time, but Class B stock could not be converted into Class A stock. Under the plan, the stock dividend payable on the Class A stock would have a fair market value on the dividend date equal to the cash dividend payable on the Class A stock. While the IRS originally ruled that stock dividends received on the Class A stock were nontaxable, a proposed regulation published in 1956 took the opposite view.[47] The proposed regulation dealing with the Citizens Utility Plan was not included in the final regulations promulgated in 1960, but was finalized in 1969 and subsequently superseded by T.D. 7281 in 1973.[48]

Some corporations sought to get around the IRS's objections to the Citizens Utility Plan in a number of creative ways. In one variation, one class of stockholders received property, while another class of stockholders received an increase in their proportionate interest in the assets and/or earnings of the corporation. One method of accomplishing that involved issuing convertible preferred stock that carried an increasing conversion ratio, i.e., the amount of common stock into which the preferred was convertible would increase each year. A shareholder could sell a portion of his preferred stock each year equal to the increase in the conversion rate, effectively realizing a cash dividend at capital gains rates without reducing the number of common shares into which the preferred stock was originally convertible.

> *Example:* On January 1, 1968, X received 100 shares of preferred stock initially convertible into 100 shares of common stock. The conversion rate would increase by 2% each year. Thus, on January 1, 1969 X could get 102 shares of common stock, on January 1, 1970 he could get 104 shares, etc. X had the option of doing nothing, thereby effectively receiving a 2% stock dividend each year. Alternatively, he could sell 1.96% of his preferred stock each year thereby realizing a 2% "cash dividend" and the balance would still be convertible into 100 shares of common stock.

Another method which received substantially the same result involved having two classes of common stock, with neither class of stock receiving stock dividends or stock rights. Instead, Class A (paying no dividends) could be converted into Class B (paying cash dividends) at an increasing conversion ratio. A third method involved the periodic redemption of the stock of one group of shareholders.

In order to put an end to such plans for avoiding taxation under the two exemptions in pre-1969 Act §305(b), the IRS withdrew the 1956 proposed regulations and issued new proposed regulations in 1968, which were finalized in 1969.[49] Those regulations continued the attack on the Citizens Utility type of plan and included the following statement:

> Where a corporation having two types of common stock outstanding, with respect to which dividends may be paid in stock on one type, and in money (or other property) on the other type, makes a distribution (or series of related distributions) in money (or other property) as to one type, and in stock (or rights to acquire stock) as to the other, the distribution of the stock is not under §305(a) since, in substance, there is a choice as to the medium of payment of any distribution by virtue of the existence of the two types of common stock, shares of either of which may be exchanged for shares of the other under §1036 without recognition of gain or loss.[50]

The regulations illustrated the application of this rule in the context of a recapitalization under §368(a)(1)(E) whereby all the outstanding shares of the common stock of a corporation were exchanged for Class A common stock and Class B common stock. Some shareholders chose to receive only Class A, others only Class B, and still others some of each. Dividends would be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend was declared on the Class A stock payable in additional Class A stock, and a cash dividend was declared on the Class B stock. Section 305(a) did not apply to the stock dividend. The result was the same even if the shareholders did not have a choice initially as to which class of stock they received, and received some stock of each class, if the two classes of stock could be exchanged.[51]

The regulations also dealt with a situation where two classes of common stock resulted from a reorganization under

[46] *See Capital Estates, Inc. v. Comr.*, 46 B.T.A. 986 (1942), aff'd, 138 F.2d 156 (3d Cir. 1943).

[47] 1956 Prop. Reg. §1.305-2(b) were essentially adopted by T.D. 6990 on Jan. 10, 1969; however, these regulations were replaced with new regulations pursuant to T.D. 7281 on July 11, 1973. *See also* "Two Classes of Stock: One Gets Cash, One Stock Dividends; A Useful Tax Planning Tool," 4 *J. Tax'n* 312 (1956); Note, "Treasury may change position," 5 *J. Tax'n* 71 (1956); "IRS Attempts to Stop Two-Classes-of-Common Tax-Saving Plan Legality Questioned," 5 *J. Tax'n* 178 (1956).

[48] *See* T.D. 6476, 1960-2 C.B. III; T.D. 6990, 1969-1 C.B. 95; and T.D. 7281, 1973-2 C.B. 92.

[49] *See* T.D. 6990, 1969-1 C.B. 95.

[50] Reg. §1.305-2(b)(1), as then in effect.

[51] Reg. §1.305-2(b)(2), *Exs. (1)* and *(2)*, as then in effect.

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§368(a)(1)(B). For example, assume Corporation X (X), which had only one class of stock outstanding, acquired all the stock of Corporation Y (Y) in exchange for its newly issued Class B common stock. Each share of Class B was convertible into one share of Class A. This conversion ratio increased each year by 0.04 shares of Class A for each share of Class B. However, if the cash dividend on the Class A stock that is paid in any year was less than $1.00 per share, the conversion ratio for that year was decreased proportionately. During the year following issuance, the cash dividend paid on the Class A stock was $.50 per share and the conversion ratio of Class B into Class A stock was thus 1.02 shares.

In this situation, the regulations provided that X was considered to have made a distribution of a right to acquire 0.02 shares of Class A stock, and §305(a) did not apply to the distribution.[52] A similar result would be achieved if the conversion ratio of Class B into Class A would be decreased if cash dividends were paid on the Class B stock.[53]

In recognition of the confusion that existed under the prior regulations, the provisions in the regulations described above did not apply where a corporation having two classes of common stock outstanding made a distribution in money or other property with respect to one class of stock, provided the distribution was made either (a) on or before December 31, 1968, or (b) on or before December 31, 1990, if the distribution related to stock outstanding on September 7, 1968, or to stock issued pursuant to a contract binding on the distributing corporation on such date (including stock distributed, directly or indirectly, with respect to stock outstanding on such date, or with respect to stock so issued, if §305(b) would have applied to the distribution, but for the application of Reg. §1.305-2(b)(3)).[54]

Where a corporation had two or more classes of stock outstanding, and the terms of one class required, in all events, periodic distributions of stock or stock rights, then such class of stock was considered to be preferred stock, and a distribution with respect to such stock was a distribution made in discharge of preference dividends.[55] Thus, if a corporation had two classes of stock, and Class A could be converted, at the option of the stockholder, into a share of Class B at a conversion ratio that increased by 0.05 shares each year, then (a) the Class A stock was considered to be preferred stock, (b) the distribution of 0.05 shares of Class B stock was considered to have been made with respect to each share of Class A stock, and (c) such distribution was deemed made in discharge of preference dividends for that year.[56]

An increase in the conversion ratio of convertible stock was not considered to be a distribution made in discharge of preference dividends, if the increase was made solely to adjust for a stock dividend or a stock split of the class of stock into which the convertible stock could be converted, or if all of the following conditions were met:

(a) the increase occurred within three years after the issuance of the convertible stock;

(b) all such increases were required, under the terms of its issuance, to occur within three years after its issuance; and

(c) the stock was not acquired in exchange for stock which also qualified for this exemption from tax.[57]

Similarly, distributions were not treated as made in discharge of preference dividends if (a) such distributions represented adjustments in the amount of consideration in situations where assets or stock were acquired in exchange for the stock with respect to which distributions were made, and (b) all distributions reflecting such adjustments were required, under the terms of the exchange, to be made within five years.[58] This latter provision was inserted to take into account contingent stock provisions in reorganizations, pursuant to §368(a).

Once again, in recognition of the confusion before the issuance of the regulations, the rules regarding distributions in discharge of preference dividends, and the rules described above, did not apply to a distribution made on or before December 31, 1968, or December 31, 1990, if made with respect to stock outstanding on September 7, 1968, or with respect to stock issued pursuant to a contract binding on such date upon the distributing corporation (including stock distributed, directly or indirectly, with respect to stock outstanding on such date, or with respect to stock so issued, if §305(b) would have applied to the distribution but for the application of Reg. §1.305-3(b)(5)(ii)).[59]

E. Chamberlin and the Stock Bailout Sin

In *Chamberlin v. Comr.*,[60] the Sixth Circuit considered the tax implications of a stock bailout transaction. In that case, the corporation issued a preferred stock dividend pro rata on its outstanding common stock. Before the issuance of such shares, a sale of the dividend shares by the shareholder to an insurance company had been negotiated, but not formally consummated. The corporation was to redeem the preferred shares over a seven-year period commencing approximately 17 months after the dividend. The IRS contended that the preferred stock dividend itself was not tax free. The IRS maintained that in light of the prearranged sale and eventual redemption, the effect of the transaction was the same as a cash dividend to the shareholders. The Appeals Court refused to step the transaction together. Thus, the court concluded that the dividend of the preferred stock was tax free. Moreover, the subsequent sale of the preferred stock resulted in capital gain as opposed to ordinary income.

[52] Reg. §1.305-2(b)(2), *Ex. (3)*, as then in effect.
[53] Reg. §1.305-2(b)(2), *Ex. (4)*, as then in effect.
[54] Reg. §1.305-2(b)(3), amended by T.D. 7004, 1969-1 C.B. 97.
[55] Reg. §1.305-3(b)(1), as then in effect.
[56] Reg. §1.305-3(b)(2), *Ex. (2)*, as then in effect.
[57] Reg. §1.305-3(b)(3), as then in effect.
[58] Reg. §1.305-3(b)(4), as then in effect.
[59] Reg. §1.305-3(b)(5), as amended by T.D. 7004, 1969-1 C.B. 97.
[60] 207 F.2d 462 (6th Cir. 1953), rev'g and rem'g 18 T.C. 164 (1952), cert. denied, 347 U.S. 918 (1954).

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F. Statutory Response to Chamberlin

In enacting §306 as part of the 1954 Code, Congress considered and rejected the holding in *Chamberlin*. Section 306 prevents the conversion of dividend income into capital gain through the preferred stock bailout device. As noted above, the recipient of §306 stock is not taxed upon its receipt. Instead, upon the disposition of §306 stock, the shareholder generally recognizes ordinary income equal to the hypothetical dividend which he would have received had cash been distributed in lieu of the §306 stock.

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III. Current Treatment of Stock Dividends

A. Section 305

The Tax Reform Act of 1969 (1969 Act) made major revisions in §305 to cover situations which Congress viewed as abusive, and were not covered by the regulations issued by the IRS.[61] The Revenue Reconciliation Act of 1990 (1990 RRA) made more modest changes to §305, which generally require that redemption premiums on certain preferred stock be treated as being distributed to the holders of the preferred stock on an economic accrual basis.

Nevertheless, the general rule of §305(a) remains the same as that originally included in the 1954 Code. That is, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock. Section 305(d)(1) defines the term stock as including rights to acquire such stock. The general rule is subject to significant exceptions under §305(b) and §305(c), which were greatly expanded by the 1969 Act and the 1990 RRA. The Omnibus Budget Reconciliation Act of 1993 (1993 RRA) added §305(e), which requires the purchaser of stripped preferred stock to include certain amounts in his gross income. The amount which must be included in income is that which would be includible if the stock were a bond issued at a discount equal to the excess of the redemption price over the purchase price.[62]

It should be noted that §305(a) does not apply to distributions of stock of another company. Thus, a distribution of stock rights by a subsidiary directly to the shareholders of its parent is treated as a nontaxable distribution of stock rights under §305(a) from the subsidiary to the parent, followed by a taxable distribution from the parent to its shareholders.[63]

B. Elections by Shareholders as to Medium of Payment

Section 305(b)(1) provides that if, at the election of any of the shareholders (whether exercised before or after the declaration thereof), a distribution is payable either: (a) in the corporation's stock; or (b) in property, then it is treated as a distribution to which §301 applies. That is, it is treated as a taxable distribution. For purposes of §305, the term "property" includes money.[64] Current §305(b)(1) is virtually identical to pre-1969 Act §305(b)(1).

Where any stockholder has the option or election to choose between stock (including stock rights) or other property (including cash), the distribution of stock or stock rights is a taxable dividend to all shareholders. Reg. §1.305-2(a) provides that such a distribution is taxable regardless as to whether:

(a) the distribution is actually made in whole or in part in stock or stock rights;

(b) the option is exercised or exercisable before or after the declaration of the distribution;

(c) the declaration of the distribution provides that the distribution will be made in one medium (i.e., stock), unless the shareholders specifically request payment in another medium (i.e., cash);

(d) the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

(e) whether all or part of the shareholders have the option.

> *Example:* Corporation X (X) declares a dividend pursuant to which its stockholders are entitled to receive, at their election, either: (a) two additional shares of X stock, with a fair market value of $10 each; or (b) one additional share of X stock, valued at $10 plus an amount of Corporation Y securities (owned by X) having a face amount of $12, a fair market value of $11, and an adjusted basis in X's hands of $9. The distribution of the first share of X stock is not a taxable distribution under §305, since there is no election with respect to such share. The stockholders who elect to receive a second share of X stock are treated as receiving a $10 taxable distribution. The shareholders choosing to receive the Y securities are treated as receiving an $11 taxable distribution.[65]

In Rev. Rul. 76-258,[66] preferred stock was distributed to a corporation's common shareholders. The shareholders had the immediate option to cause the corporation to redeem the preferred stock. The IRS ruled that because the shareholders had the immediate ability to have the stock redeemed for cash, §305(b)(1) applied to the transaction.

The shareholders of a corporation must have a true election to receive cash or stock in order to be taxed on a distribution. In Rev. Rul. 80-154,[67] the IRS considered the following situation. Two domestic corporations were the sole shareholders of a foreign "limited liability" corporation. Under the foreign country's law, the shareholders declare dividends or otherwise direct the disposition of profits. If profits are neither distributed to shareholders nor capitalized, the corporation pays a higher tax on the profits. Pursuant to the foreign law, the shareholders directed the foreign corporation to increase its capital in the amount of the profits. While the form of the resolution appeared to direct a cash dividend, no cash was distributed to

[61] *See* H.R. Rep. No. 413, 91st Cong., 1st Sess. 111-16 (1969).

[62] *See* the discussion at I.E.2., above.

[63] *See* Rev. Rul. 80-292, 1980-2 C.B. 104. *See also Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980), rev'g and rem'g 71 T.C. 597 (1979), cert. denied, 450 U.S. 913 (1981). *But see Centel Communications Co., Inc. v. Commissioner*, 92 T.C. 612 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990) (stock rights issued to shareholders to reflect additional risks associated with shareholders' guarantee and subordination agreement fell within §305).

[64] *See* §317(a).

[65] *See* Reg. §1.305-2(b) *Ex.* (1). The amount of the distribution of X stock or Y securities is determined under §301(b)(1), which states that the amount of a distribution is the amount of money received plus the fair market value of any other property received. *See also* Reg. §1.301-1(b), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(b)(1) in 1988.

[66] 1976-2 C.B. 95, *distinguished by* Rev. Rul. 87-132, 1987-2 C.B. 82.

[67] 1980-1 C.B. 68. *See* PLR 9409034 (citing Rev. Rul. 80-154, IRS ruled that the dividend paid by a foreign subsidiary (FS), which is immediately reinvested in FS stock pursuant to an irrevocable shareholder subscription agreement, is treated as a deemed distribution of FS stock that is tax-free under §305(a)). *See also* PLR 9835011. *But see* PLR 200406031 (distribution by corporation anticipating REIT status election of its stock and cash to eliminate all earnings and profits where shareholders may opt to receive cash in lieu of stock is distribution of property to which §301 applies). *Accord* PLR 200618009.

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the shareholders; rather, accounting entries were made to show an increase in capital and a decrease in undistributed earnings. The IRS concluded that the transaction was the equivalent of a stock dividend. The ruling goes on to state that the fact that the shareholders could have initially directed the corporation to distribute cash did not mean that the shareholders had an election under §305(b)(1). The IRS ruled that the choice was not made by corporate action, but rather by virtue of the foreign country's law. Once the choice was made by the corporation to increase its capital and decrease undistributed earnings (by shareholder action), the shareholders had no election to receive cash or stock.

The language of §305(b)(1) is broad enough to cover dividend reinvestment plans. In a typical plan, shareholders choose to have cash dividends automatically reinvested to purchase additional shares of stock. Shareholders who elect to participate in such a plan acquire that number of shares of the company which have a fair market value equivalent to the cash dividend. Often, the corporation allows the shareholders who participate in a dividend reinvestment plan to acquire stock at a discount, i.e., 95% of the fair market value of the stock on the dividend payment date. In such a case, the IRS has ruled that the shareholders who elect to reinvest their dividends have a dividend equal to the fair market value of the stock.[68]

In Rev. Rul. 77-149,[69] a corporation established a dividend reinvestment plan administered by a local bank, which acted as agent for the shareholders. The shareholders could elect to have cash dividends paid to the bank, which would purchase the corporation's stock on the open market with the dividends. The IRS ruled that §301 applied directly to the dividends without reference to §305(b)(1) because the distribution was payable only in cash and the shareholders did not have the option of receiving stock directly from the company. However, where the agent purchased the stock directly from the corporation, the IRS ruled that §305(b)(1) applied, and the stock distribution was treated as a §301 distribution.[70]

The IRS has also considered the situation of a corporation that established an automatic dividend reinvestment plan which allowed shareholders to elect to have all cash dividends otherwise payable on common stock automatically reinvested in additional shares of common stock. Shareholders who elected to participate in the plan acquired additional stock at a price equal to 95% of the fair market value of the stock. The option to receive a dividend in additional stock rather than in cash was not transferable separately from the transfer of the common stock itself. Relying upon Rev. Rul. 76-53 and 77-149, the IRS ruled that shareholders who elected to reinvest their dividends received distributions subject to §301 by reason of §305(b)(1). More importantly, the IRS concluded that, pursuant to Reg. §1.305-1(b), the amount of the distribution includible in the shareholders' income was the fair market value of the stock received, increased by any service fee subtracted from the shareholders' distribution.[71]

Section 305(b)(1) has also been applied to the Federal Home Loan Bank (FHLB) Act. Under the FHLB Act, member banks are required to maintain certain minimum stock interests in a Federal Home Loan Bank. The minimum interests change based upon the member bank's outstanding mortgages and borrowings from the FHLB. The FHLB Act provides that an FHLB has the discretion to redeem stock held by a member bank in excess of its required amount. In Rev. Rul. 83-68,[72] the IRS ruled that a stock dividend by an FHLB was taxable to its shareholder banks, pursuant to §305(b)(1), since the member banks effectively had the option of receiving either stock or cash. Under the facts of the ruling, an FHLB declared a 6% stock dividend. At least one member bank already held excess shares. Accordingly, it could request redemption of all of the shares distributed. The IRS based its conclusion upon the FHLB's policy of honoring any redemption request barring very unusual circumstances. The FHLB had not refused to redeem any stock for 10 years before the ruling, and there was no reason to believe that it would do so under the circumstances described in the ruling.

In *Frontier Sav. Ass'n v. Commissioner*,[73] however, the Tax Court rejected the IRS's position in Rev. Rul. 83-68. The Tax Court concluded that a member bank was not taxable on its stock dividends received from an FHLB despite the fact that some member banks could request redemption of their stock dividends for cash. As noted above, the FHLB was authorized to redeem stock, in its discretion, provided various regulatory requirements had been satisfied. Moreover, the FHLB's longstanding practice was to honor all redemption requests. The IRS contended that the taxpayer effectively had an election to receive cash in lieu of stock. Its conclusion was largely based on Reg. §1.305-2(a)(4). The Tax Court rejected the IRS's argument primarily because, in the court's view, the stock divi-

[68] Rev. Rul. 76-53, 1976-1 C.B. 87, *distinguished by* Rev. Rul. 77-149, 1977-1 C.B. 82. In PLR 200414022, the IRS ruled that the participation in a corporate discount stock purchase plan followed by a short sale of the stock and then a subsequent stock purchase is not a distribution of the stock under §305(b).

[69] 1977-1 C.B. 82, *distinguished by* Rev. Rul. 79-42, 1979-1 C.B. 130, and by Rev. Rul. 78-375, 1978-2 C.B. 130.

[70] *See* Rev. Rul. 79-42, 1979-1 C.B. 130.

[71] Rev. Rul. 78-375, 1978-2 C.B. 130. *See also* PLR 201306012–PLR 201306014 (any and all cash and common stock distributed in RIC's proposed distribution of one or more future "spillback" dividends will be treated as distribution of cash and property with respect to its stock to which §301 applies; amount of any distribution of common stock received by any shareholder that receives common stock in proposed distribution will be considered equal to amount of cash which could have been received instead by such shareholder), PLR 200832009 (cash and stock distributed in special dividend by REIT would be distribution subject to §301; pursuant to Reg. §1.305-1(b)(2), amount received by any shareholder electing to receive stock would equal amount of money that could have been received), PLR 200122001 (addressing REIT, which gave its shareholders election to receive dividend either as cash or stock, IRS ruled that, when few days elapse between valuation date for distributed stock and actual distribution date, amount of distribution paid in stock will equal value of stock on valuation date), PLR 9750033 (shareholders who participate in both DRIP and stock purchase plan will be treated as having received at time of purchase distribution of discount amount of stock to which §301 applies by reason of application of §305(b)(2)).

[72] 1983-1 C.B. 75, *distinguished by* Rev. Rul. 87-132, 1987-2 C.B. 82 and *modified by* Rev. Rul. 90-98, 1990-2 C.B. 56 so as not to apply in the case of a bank in the FHLB program.

[73] 854 F.2d 1001 (7th Cir. 1988), aff'g, 87 T.C. 665 (1986), *acq.*, 1990-1 C.B. 1, *cert. denied*, 489 U.S. 1090 (1989). *See Western Fed. Sav. and Loan Ass'n v. Commissioner*, T.C. Memo 1988-107, aff'd, 880 F.2d 1005 (8th Cir. 1989). *See also Colonial Sav. Ass'n v. Commissioner*, 854 F.2d 1001 (7th Cir. 1988), aff'g 85 T.C. 855 (1985), cert. denied, 489 U.S. 1090 (1989); *First Fed. Sav. Bank of Elizabethtown v. United States*, 90-1 USTC ¶50,218 (W.D. Ky. 1990); *Leader Fed. Sav. & Loan Ass'n of Memphis v. Commissioner*, T.C. Memo 1989-321.

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dend plan was primarily intended to facilitate the acquisition of stock by member banks, which are required by FHLB regulations to increase their capital. As such, the stock dividends were not a disguised cash dividend. Nevertheless, a concurring opinion suggested that even a discretionary act of redeeming stock dividends on a routine basis could be construed as an option or plan to receive cash in lieu of stock, and fall within the parameters of §305(b)(1). The IRS has since abandoned the position it espoused in Rev. Rul. 83-68, *Frontier Savings* and *Western Federal*.[74] The IRS stated that its change in position was because the congressional intent in establishing the FHLB system was to give the FHLB broad discretion to deny redemption requests, and that the FHLB had a statutory duty to protect the public interest by denying requests where appropriate. Accordingly, the IRS could not infer that the FHLB had waived its authority and obligation to deny requests in appropriate cases.

In at least one private letter ruling, the IRS has applied §305(b)(1) to an open end mutual fund which provided its stockholders with the option to receive dividends in the form of stock or property.[75] That ruling is somewhat odd in that, by definition, an open end mutual fund is obligated to redeem shares of any stockholder. Accordingly, the option to receive cash in lieu of a stock dividend would seem to always be present in the context of an open end mutual fund.

Fisher v. Commissioner[76] involved a §368(a)(1)(B) reorganization in which dividends were to accrue after a certain date regardless of the actual date on which the reorganization was consummated. The parties were concerned that a cash dividend could disqualify the reorganization. Accordingly, the reorganization agreement was amended to provide that if the consummation of the transaction occurred subsequent to the dividend accrual date, the shareholders would receive additional shares of the acquiring corporation's stock rather than cash. Additional shares were eventually issued because the closing occurred after the dividend accrual date. The Tax Court concluded that the additional shares were not issued pursuant to the reorganization; consequently, the shares constituted a taxable stock dividend under the predecessor of current §305(b)(1).

A district court, construing pre-1969 TRA §305(b)(2) (the predecessor of §305(b)(1)), concluded that even though the board of directors authorized a stock dividend and determined that such shares might be cashed in by the corporation at any shareholder's request, the transaction was not a taxable dividend. The court was persuaded that the statement in the board's resolution merely continued an established policy of the company to redeem employees' stock when they needed money. Under the established policies, such redemptions were discretionary and did not constitute a right to convert dividend shares to cash.[77]

An intriguing question to be raised regarding taxpayer elections is the extent to which an election to take any portion of a dividend in cash will taint the entire distribution. An election available to shareholders to take a corporate distribution in an amount up to 20% in cash could possibly result in the entire value of the distribution becoming taxable, rather than the distribution being tax free to the extent that the shareholder effectively had no election (i.e., the 80% stock portion of the distribution).[78] However, Reg. §1.305-2(b) *Ex.* 1 would indicate that if an election is limited to declining a fixed number of shares in order to take property instead, then only the elective portion of the distribution will be taxable.

C. Disproportionate Distributions

Section 305(b)(2) is the codification of the judicial "proportionate interest" test. It provides that a distribution of stock (or stock rights) is taxable if the distribution (or a series of distributions of which such a distribution is part) results in (a) the receipt of property by some shareholders; and (b) an increase in the proportionate interests of other shareholders in the assets or earnings of the corporation. Section 305(b)(2) was designed to prevent corporations from manipulating the classes of their stock to allow shareholders the choice of receiving stock dividends or cash, as was the case in the Citizens Utility Plan.[79] Under the typical plan, shareholders had the choice of holding Class A common stock, which would receive only stock dividends, or Class B common stock, which would receive only cash dividends. Usually, the Class A shares were convertible into Class B shares. As a result, shareholders could achieve capital growth by holding Class A stock, or realize a return on their investment by converting to Class B stock. The conversion right allowed shareholders to change their strategy whenever it suited them. Thus, §305(b)(2) provides that where a corporation has two classes of common stock, one paying cash dividends and the other paying dividends in stock, the stock dividends are taxable. This result occurs because the proportionate interests in the corporation of the shareholders who receive stock increase every time they receive a dividend.[80] Conversely, where a corporation has a single class of common stock, and also has nonconvertible preferred stock paying cash dividends, a stock dividend with respect to the common stock is not taxable. Such a distribution does not result in any increase in the proportionate interest of any shareholder.[81] The preferred shareholders of a company, as a group, are entitled

[74] Rev. Rul. 90-98, 1990-2 C.B. 56.

[75] PLR 8329054. *See also* PLR 9335044 (dividend from a mutual fund was taxable under §305(b)(1) since each shareholder had an unrestricted right to receive distribution in cash); PLR 9114032, and PLR 9709044 (no gain or loss realized upon a stock split by a mutual fund). *See also* PLR 200348020 (distribution by REIT of pre-REIT years earnings and profits where shareholders elected medium of payment is distribution to which §301 applies), PLR 200618009.

[76] 62 T.C. 73 (1974). *See also* TAM 200335032 (cash distribution that shareholder elected to receive instead of stock was separate from recapitalization and thus treated as a dividend under §305(b)(1), not as boot received in the recapitalization).

[77] *Rinker v. United States*, 297 F. Supp. 370 (S.D. Fla. 1968).

[78] In PLR 200832009, a REIT planned three distributions providing the shareholders the right to elect to receive cash or additional shares. The REIT would make cash available for distribution up to 20% of the value of the distribution. If elections were made that would cause the REIT to pay out more than 20% of any of the distributions in cash, then all shareholders who elected cash would have their distributions scaled back so that the REIT would not pay out more than 20% of the total distribution in cash. If elections were made resulting in less than 20% cash being paid out, then all shareholders electing to receive cash would indeed receive cash in the full amount of their elections. The IRS ruled that the elections tainted the entire distribution. *But see* Reg. §1.305-2(b) *Ex.* 1.

[79] *See* discussion at II.D.2., above.

[80] *See* Reg. §1.305-3(a).

[81] *See* Reg. §1.305-3(e) *Ex.* (2).

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to a fixed amount upon the liquidation of the company. The common shareholders are entitled to all of the residual equity. Thus, an increase in the number of common shares outstanding by virtue of a common stock dividend has no economic impact; it merely divides the interests of the common shareholders as a group without altering their interests relative to the preferred. There has been no impact on the rights to the preferred shareholders in the earnings of the corporation, or with respect to their preferential residual equity interest.

Note: Section 305(b)(2) covers both actual stock dividends and "deemed" distributions.[82] Thus, deemed distributions under §305(c) are generally picked up as taxable stock dividends under §305(b)(2). Deemed distributions include: (a) changes in conversion ratios; (b) redemption premiums; (c) recapitalizations; (d) redemptions treated as dividends; and (e) changes in redemption prices. Deemed distributions are discussed at III.D., below and must be considered in conjunction with §305(b)(2).

It should also be noted that the regulations treat the payment of interest to holders of convertible debentures as a distribution of property to a shareholder for purposes of §305(b)(2).[83] Nevertheless, §305 does not apply to a distribution unless it is made to a shareholder in his capacity as a shareholder.[84] The IRS ruled that §305 does not apply to a debt-stock swap, because it was not a distribution with respect to stock.[85] In the ruling, a parent corporation, in connection with the issuance of a stock dividend, offered the employees of its subsidiaries the right to exchange stock owned in the subsidiaries for shares in the parent. The parent also allowed certain employees of its foreign subsidiaries who had borrowed money from the parent the option to purchase stock in the foreign subsidiaries to reduce their debt, which had increased as a result of fluctuating currency exchange rates. As part of the exchange offer, the parent permitted the debtor employees to reduce their debt rather than take the stock dividend which they would have received under the exchange offer.

The disproportionate interest test of §305(b)(2) applies to classes of stock as a whole rather than individual stockholders. For example, a stock distribution with respect to Class A stock and a cash distribution with respect to Class B stock may not change a particular stockholder's interest in the corporation if he owns both Class A and Class B stock. Nevertheless, Reg. §1.305-3(b)(6) treats the stock dividend as taxable because the owners of the Class A stock, as a group, have an increased interest in the corporation.[86] There is no requirement in §305(b)(2) that there be a connection between a distribution of stock and a distribution of cash or property. Rather, the only requirement is that the distribution result in the receipt of property by some shareholders and an increase in the proportionate interests in the corporation of other shareholders.

Reg. §1.305-3(b)(1) provides that "a series of distributions" includes all stock distributions resulting in the receipt of cash or property by some shareholders, and an increase in the proportionate interests of the other shareholders. Both actual and deemed distributions can be part of a series of distributions even though there is no plan to distribute cash or property to some shareholders, and to increase the interests of others. It is the result which is taxed, not the intent.[87] Reg. §1.305-3(b)(4) creates the presumption that, where more than 36 months have elapsed between a distribution of cash or property and a distribution of stock, the later of such distributions will be presumed not to result in the receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders unless both distributions are made pursuant to a plan. The determination as to whether there has been a disproportionate distribution is made separately with respect to each class of stock.[88] Stock options and convertible securities are treated as outstanding stock for this purpose even if the options are not immediately exercisable, or the securities are not immediately convertible.[89]

Provided certain requirements are satisfied, a distribution of cash in lieu of fractional shares will not result in a stock dividend being treated as disproportionate. A disproportionate distribution will not result if, solely for reasons of convenience and economy, a corporation either (a) declares a stock dividend and distributes cash in lieu of fractional shares to which the shareholders would otherwise be entitled; or (b) distributes cash in lieu of fractional shares upon the conversion of convertible stock or securities.[90] A distribution of cash in lieu of fractional shares with respect to a stock dividend will be considered made for valid reasons if the total amount of the cash distributed in lieu of fractional shares is 5% or less of the total fair market value of stock distributed.[91]

The character of the income recognized by the shareholders receiving cash under this rule is determined under the stock redemption rules of §302.[92]

1. Antidilution Rules

Where a corporation has both common stock and convertible preferred stock outstanding, or securities which are convertible into common stock, and the corporation distributes a stock dividend with respect to the common stock, the recipients of the distribution will acquire a larger proportionate interest in the corporation's assets or earnings than they had immediately before the dividend occurred (unless, of course, a "full adjustment in the conversion ratio or conversion price" is made to reflect such stock dividend).

Not all antidilution protection formulas provide for a "full adjustment." Where a full adjustment is not present in an antidilution formula, a stock dividend creates the potential for the application of §305(b)(2) because an increase in the proportionate interests of the common shareholders has occurred. If a cash dividend is paid (or is deemed to have been paid) to the holders of the convertible security, Reg. §1.305-3(d)(1) provides that the shareholders receiving the stock dividend will be treated as receiving a taxable stock distribution, unless a full adjustment in the conversion ratio or the conversion price of the convertible stock or securities is made to take into account

[82] *See* Reg. §1.305-3(b)(1) and Rev. Rul. 75-513, 1975-2 C.B. 114.
[83] Reg. §1.305-3(b)(3).
[84] *Id.*
[85] PLR 8916072.
[86] *See* Reg. §1.305-3(e) *Ex.* (1).
[87] *See* Reg. §1.305-3(b)(2).
[88] Reg. §1.305-3(b)(6).
[89] Reg. §1.305-3(b)(5).
[90] Reg. §1.305-3(c)(1).
[91] *Id.*
[92] Reg. §1.305-3(c)(2).

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the stock dividend to the common stockholders. The adjustment must preserve the prior proportionate interests of the holders of the convertible instrument. This type of adjustment is referred to as antidilution protection.

> *Example:* X Corporation (X) has one class of stock outstanding (Class A common) and interest-paying securities which are convertible into Class A common stock, and which have a fixed conversion ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the Class A shareholders. X distributes to the Class A shareholders rights to acquire additional shares of Class A stock. During the year, interest is paid on the convertible securities. (The payment of interest supplies the important first prong of §305(b)(2).)
>
> The stock rights and convertible securities are treated as outstanding stock of X, and the distribution of the stock rights increases the proportionate interests of the Class A shareholders in the assets and earnings and profits of X to the detriment of the convertible security holders. Accordingly, the distribution is treated as a distribution to which §301 applies. The same result occurs if, instead of convertible securities, X had outstanding convertible stock. If, however, the conversion ratio of the securities or stock were fully adjusted to reflect the distribution of rights to the Class A shareholders, the distribution of rights would not increase the proportionate interests of the Class A shareholders in the assets or earnings and profits of X and, therefore, would not be treated as a distribution to which §301 applies.[93]

Convertible stock or securities typically contain antidilution provisions which require an automatic adjustment in the conversion ratio or conversion price whenever changes are made with respect to the stock into which such stock or securities are convertible (the "underlying stock"). For example, where preferred stock is convertible into common at a 1-to-1 ratio, and the corporation pays a 100% stock dividend to the common shareholders, the preferred shareholders have been disadvantaged unless their conversion ratio is changed so that they can acquire two shares of common stock for each share of preferred stock. Such a change in the conversion ratio increases the proportionate interest of the preferred shareholders over what it was after the event which triggered the exercise of the antidilution provision.

The lack of antidilution protection in the example above does not create the taxable event. Instead, it is a combination of events that causes income tax consequences under §305. In the above example, the payment of interest to convertible security holders combined with the distribution of stock rights to the common stockholder created the taxable event under §305(b)(2) because the overall result was a loss by the convertible security holders of their proportionate position in the residual assets and earnings and profits of the corporation. The operation of §305(b)(2) causes the distribution of the stock rights to be taxable to the common stockholders. When antidilution protection provisions provide a "full adjustment" in the conversion ratio to reflect the distribution of the stock rights, then the distribution of the stock rights does not dilute the proportionate interest of the convertible security holders in the residual assets or earnings and profits of the corporation. As stated above, there must be two distributions under §305(b)(2) for a taxable event to arise — one, the receipt of cash or property by some shareholders and two, an increase in the proportionate residual equity interests of other shareholders. In this fashion, §305(b)(2) backstops §305(b)(1) in cases where shareholders are not overtly given the choice to take cash and/or property versus stock. The antidilution provisions of convertible instruments must be closely examined to determine whether the proportionate interests of the holders of convertible instruments are preserved. This discussion will focus on stock dividend distributions and stock sales, and III.D.1., below will address other events giving rise to changes in antidilution conversion ratios.

Adjustments in conversion ratios and conversion prices of antidilution formulas essentially represent a distribution of stock or rights to stock. Adjustments can be triggered by a corporation's distribution of a stock dividend, as indicated above, or by a corporation's sale of stock. The adjustments to the conversion formula triggered by a stock dividend or stock sale are not subject to taxation if there has been no increase in the proportionate interest of the holders of the convertible stock or securities taking into account both the underlying transaction which brings the antidilution formula into play and the specific change in conversion rights resulting from application of the formula. A taxable event will not have arisen if the change resulting from the conversion formula simply caused the holders of the convertible securities and the owners of the underlying stock to have maintained their respective proportionate interests in the corporation.

The §305(b) regulations initially provide that conversion formulas must make a "full adjustment" in the conversion price or conversion ratio to prevent a class of stock from experiencing a disproportionate increase in the corporation's assets or earnings.[94] However, Reg. §1.305-7(b)(1), which seemingly concurrently applies to events triggering application of antidilution provisions, does not appear to supply as burdensome a standard. It provides that a change in the conversion ratio or conversion price which is made pursuant to a bona fide, reasonable adjustment formula (including, but not limited to, either the so-called "market price" or "conversion price" type of formulas) which has the effect of preventing dilution of the interests of the holders of the convertible stock or securities does not result in a deemed distribution of stock. Here, the regulation specifically identifies two types of adjustment formulas that seem to be acceptable in all cases, the "market price" and "conversion price" formulas. Nevertheless, the regulation provides that the range of possible formulas is not limited to those two formulas. Under the market price formula, there is a downward adjustment in the conversion price when stock is issued to the holders of the underlying stock as the result of a rights offering below the market price. The conversion price formula provides for a downward adjustment when shares of the underlying stock are issued to anyone other than the holders of

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[93] Reg. §1.305-3(e) *Ex.* (4).

[94] Reg. §1.305-3(d)(1)(i).

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the convertible stock or securities at less than the conversion price.[95]

Example: Corporation U (U) has two classes of stock outstanding, Class A and Class B. Each Class B share is convertible into Class A stock. In accordance with a bona fide, reasonable antidilution provision, the conversion price is adjusted if the corporation issues Class A stock to anyone for less than the conversion price. U sells stock to the public at the market price, which is below the conversion price, so that, pursuant to the antidilution provision, the conversion is adjusted downward. Such a change in the conversion price is not deemed to be a distribution under §305(c), for the purposes of §305(b).[96]

The extent of the downward adjustment is not specifically identified in this example of the regulations. Consequently, since this example is vague, it is unclear whether the "full adjustment" required by Reg. §1.305-3(d)(1) is achieved. It is difficult to reconcile the two apparent tests (the "full adjustment" requirement versus the "bona fide, reasonable adjustment formula") which cannot be readily said to be complementary.[97] The safer course of action would be to follow the more specific guidance for a full adjustment at Reg. §1.305-3(d). Examples of a few formulas which specifically satisfy the full adjustment requirement are provided in the regulations.[98]

Adjustments to conversion formulas arising by virtue of stock dividends or stock splits do not pose the same complexities as stock sales. A full adjustment would typically be provided for in the case of stock dividends issued by a corporation because convertible instruments would, as a general rule, entitle the convertible instrument holder to the same stock dividend as if the instrument had already converted. The potential trap for the unwary lies in the adjustments made by the conversion formula where a corporation has one or more sales of stock subsequent to the issuance of the convertible instrument.

Convertible instruments of privately held companies, particularly start-up companies with venture capital financing, will typically possess antidilution protection not only with respect to stock dividends but also with respect to stock sales. However, as indicated above, antidilution protection formulas may take many forms. An antidilution protection provision which takes into account the lowest priced sale of stock should automatically satisfy the requirement of the regulations that a "full adjustment" be made in order to preserve the proportionate interests of the classes of outstanding stock.[99] This type of protection is referred to as "full ratchet" antidilution protection. It allows an investor to gain the benefit of the corporation's lowest priced stock issuance because the conversion formula in this type of instrument takes into account any shares of common stock sold (or distributed) by the corporation after the investor's purchase and applies the lowest issue price as the conversion price. It is unclear whether full ratchet antidilution protection is required to be in place to achieve a "full adjustment" thereby satisfying Reg. §1.305-3(d)(1), or whether full ratchet antidilution protection is more antidilution protection than is necessary to achieve a "bona fide, reasonable adjustment formula" in accordance with Reg. §1.305-7(b).[100]

If the conversion calculation of any convertible instrument takes into account the issuance by the corporation of stock at *all* price levels, rather than merely those issuances at prices below the conversion price, then the "full adjustment" required by the regulations may not be provided for by the antidilution instrument.[101] Notwithstanding the terms of any antidilution formula, however, the actual facts surrounding the corporation's stock issuances must be examined to determine whether a taxable stock dividend is present (of course, necessarily combined with some other distribution of property or cash as required by §305(b)(2)). For instance, an antidilution formula that takes into account issuances at prices higher than the conversion price of the convertible instrument, as well as stock issuances at lower prices, is irrelevant if no higher priced issuances have actually occurred.[102]

Most convertible instruments do not possess full ratchet antidilution protection because such protection acts as a severe restraint on future financing of the corporation. More commonly, antidilution protection is provided for under a weighted-average formula that takes into account how many shares are sold in the later issuance, along with the price of the shares in such issuance. Consequently, these types of instruments must be closely examined in order to determine whether stock dividends result in taxable events. Founders of a corporation are not as disadvantaged under this type of antidilution formula as they are under a full ratchet provision. As a general rule, if the lowest priced stock issuance is not considered or fully taken into account, seemingly a full adjustment could not take place, notwithstanding that such adjustments had been bona fide, reasonable adjustments negotiated by the investors and corporation. Instead of using a conversion price formula which operates on a cumulative basis, other conversion formulas are approved by the regulations based on shares outstanding.[103] Publicly traded convertible instruments normally only possess antidilution protection for stock dividends and stock splits. If such instruments possess antidilution protection for stock sales, however, the conversion formulas should be closely scrutinized to determine whether the application of such provisions results in disproportionate increases in the rights of some class of shareholders.

Reg. §1.305-3(d)(2) provides that a distributing corporation must make the adjustment with respect to the convertible stock or securities as of the date of the distribution of the stock

[95] *See* Reg. §1.305-7(b)(1), §1.305-7(b)(2). *See also* Prop. Reg. §1.305-7(c)(3), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, a taxpayer may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-7(g).

[96] Reg. §1.305-7(b)(2) *Ex. See also* Prop. Reg. §1.305-7(c)(6) *Ex.* 1.

[97] In a Technical Memorandum issued on November 30, 1971 to accompany a Notice of Proposed Rule Making, Reg. §1.305-7(b) was described as containing a more "liberal" rule. 1971 WL 32867.

[98] *See* Reg. §1.305-3(d)(1)(ii).

[99] Reg. §1.305-3(d)(l)(i).

[100] Proposed regulations, issued in 2016, regarding deemed distributions of stock and rights to acquire stock would not clarify the requirements of a "bona fide, reasonable adjustment formula" for purposes of current Reg. §1.305-7(b), but request comments on all aspects of the proposed regulations. *See* Prop. Reg. §1.305-7(c)(3); preamble to REG-133673-15.

[101] Reg. §1.305-3(d)(1)(i).

[102] Reg. §1.305-3(d)(1)(ii) *Ex.* (c).

[103] Reg. §1.305-3(d)(1)(ii) *Ex.* (e).

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dividend or elect to make it by the earlier of (a) three years after the date of the stock dividend; or (b) the date on which the aggregate stock dividends for which no adjustment has been made total at least 3% of the outstanding stock on which the stock dividends have been paid. Where a corporation makes such an election, it must file a statement that an adjustment will be made in accordance with such regulations, and a description of the antidilution provisions under which the adjustment will be made with its tax return for the year in which the stock dividend is distributed.[104]

2. *Isolated vs. Periodic Redemptions*

Theoretically, §305(b)(2) is broad enough to cover the redemption of the stock of a principal shareholder upon his death, retirement, or withdrawal pursuant to a buy-sell agreement. However, the regulations specifically exclude such a redemption from the scope of §305(b)(2).[105] In Rev. Rul. 75-93,[106] the IRS went even further and ruled that the following situation was not subject to §305(b)(2) because the recapitalization was an isolated transaction. In the recapitalization considered therein, the corporation had 700X shares of $2.00 par value Class A common stock, 2,100X shares of $0.20 par value Class B common stock and 62X shares of no par convertible preferred stock outstanding. All of the Class B stock was owned by the officers and directors of the company who owned no Class A stock. The Class A stock was publicly traded. The Class A and Class B stock each carried one vote per share. Thus, as a group, the officers and directors controlled 75% of the corporation's voting power. The common stock was subordinated to the preferred stock. The Class B common stock shared in dividends and liquidation proceeds with the Class A common stock in relation to their respective par values (i.e., 10-1). In a recapitalization which took into account both the voting power and the interests in the earnings and profits and assets of the company, the 2,100X Class B shares were exchanged for 300X shares of newly issued Class A stock. The effect of the exchange was that, as a group, the Class B shareholders went from having 75% of the voting power and approximately a 23% interest in the earnings and profits and assets to having 30% of each of those attributes. Thus, the former Class B shareholders saw their proportionate interests in the assets and earnings and profits increase.[107]

It should be noted that, from a point of statutory construction, the foregoing recapitalization could fit squarely within §305(b)(2). The issuance of Class A common stock to the Class B shareholders in the reorganization was found to be an exchange in Rev. Rul. 75-93, rather than a distribution by the corporation. However, §305(c) contemplates that a recapitalization could be treated as a distribution if the transaction has the effect of increasing the proportionate interest of any shareholder in the earnings and profits or assets of the corporation. In such a case, a distribution may be considered to have been received by those shareholders who have experienced a proportionate increase in the earnings and profits or assets of the corporation. Although various regulations would have supported finding a distribution to have occurred in Rev. Rul. 75-93, the ultimate holding was that no distribution could be said to have occurred in reliance on Reg. §1.305-7(c)(1), which provides that a recapitalization will be deemed to result in a distribution if it is pursuant to a plan to periodically increase a shareholder's proportionate interest. Because there was no plan in Rev. Rul. 75-93, there was found to be no actual distribution.[108]

Periodic redemptions occur most often in freeze out and leveraged buyout transactions. In Rev. Rul. 77-19,[109] the IRS considered three isolated redemptions by a corporation, over a three-year period, from retired employees/shareholders and from the estates of deceased shareholders. While the corporation had no plan or resolution authorizing such redemptions, it determined that it would be beneficial to eliminate all shareholders with small interests in the corporation. Accordingly, the corporation merged with a newly formed corporation, and issued one share of the new corporation's stock for each 200 shares of its own stock. Shareholders who held less than 200 shares in the old corporation received cash. The merger resulted in the new corporation having approximately 20% of the number of shareholders as that of the old corporation. The IRS concluded that §305(b)(2) was not applicable because the shareholders had their interests completely terminated, and there was no relationship among the three redemptions. The conclusion in Rev. Rul. 77-19 is substantially more liberal than Reg. §1.305-3(b)(4), which provides for the presumption that §305(b)(2) does not apply only if more than 36 months have elapsed between the receipt of cash or property and the distribution or a series of distributions. The IRS privately ruled in PLR 201002022 that periodic redemptions of a closely held corporation's nonvoting stock from an employees' retirement plan, which were designed to provide liquidity to the retirement plan, would be treated as sales or exchanges under §302(b)(1) (and did not give rise to taxable stock dividends pursuant to §305(b)(2)). In the same ruling, an isolated stock redemption from the controlling family group represented a single, isolated transaction which would not give rise to a deemed distribution under §305.

In Rev. Rul. 78-60,[110] a corporation with 24 shareholders instituted a periodic redemption plan in which 40 out of 6,000 shares were redeemed. The IRS ruled that none of the participants received a deemed distribution to which §305(b)(2) applied. Nevertheless, the IRS concluded that the shareholders who did not tender their shares increased their proportionate interests in the corporation's assets and earnings. Since the redemption was not isolated, but was pursuant to a plan, the shareholders who did not have their stock redeemed were deemed to receive a taxable distribution.

It is possible for a security agreement to prevent the application of §305(b)(2) to a leveraged buyout.

[104] Reg. §1.305-3(d)(2)(iii).

[105] Reg. §1.305-3(e) *Ex.* (12).

[106] 1975-1 C.B. 101.

[107] *See also* S. Rep. No. 552, 91st Cong., 1st Sess. 153–54 (1969). In PLR 9623029 and PLR 9623030, the IRS ruled that a regulated investment company's (RIC's) redemption of its stock for the purpose of increasing the market price of its shares was an isolated transaction that did not result in a §305 deemed distribution to the RIC's shareholders, without regard to whether they redeemed their shares.

[108] For further discussion of recapitalizations, see III.D.5., below.

[109] 1977-1 C.B. 83.

[110] 1978-1 C.B. 81.

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Example: Corporation M (M) is a manufacturer whose products are sold through independent dealers. In order to assist individuals who lack capital to become dealers, M established an investment plan pursuant to which it provides 75% of the capital required to form a new dealership corporation in exchange for Class A stock and a note. The individual dealer who has invested the remaining 25% receives Class B stock which is nonvoting until the Class A stock is completely redeemed. The Class A stock has a fixed redemption price, and at least 70% of the dealership's earnings and profits each year must be used to pay off the note and redeem the Class A stock. Accordingly, M's investment is systematically eliminated. Since the plan is essentially a security arrangement, the redemptions are not taxable under §305(b)(2) as deemed distributions.[111]

The IRS, in Rev. Rul. 78-115,[112] extended the concept to a leveraged buyout using preferred stock. In that ruling, one corporation sought to acquire a second corporation, but could only pay 75% of the purchase price. The balance of the purchase price was paid with nonparticipating and nonconvertible preferred stock. The preferred stock, however, carried special voting powers if dividend arrearages exceeded a threshold amount. The acquiring corporation was required to redeem the preferred stock at a rate of 5% per year at a specific price, together with all accrued dividends. The IRS concluded that the transaction had the effect of a security or financing arrangement so that §305(b)(2) did not apply.

D. Deemed Distributions Under §305(c)

As noted above, a direct stock dividend to some shareholders and not others is only one method of increasing a shareholder's proportionate interest in a corporation. A shareholder's interest could similarly be increased where a corporation (a) increased the ratio at which such shareholder's stock, convertible securities, or stock rights may be converted into other stock, (b) decreased the ratio at which other stock, convertible securities, or stock rights can be converted into stock, or (c) periodically redeemed stock owned by other shareholders. Before the 1969 Act, it was unclear whether, and to what extent, such changes could be treated as a distribution of stock or stock rights. Accordingly, Congress enacted §305(c) authorizing Treasury to issue regulations governing the extent to which such transactions should be treated as taxable distributions.

A deemed distribution under §305(c) is merely a constructive stock distribution. A taxable stock distribution will arise to the constructive distribution recipient by virtue of §305(c) only if it creates one of the results listed in §305(b). Hence, §305(c) always works in conjunction with §305(b) with the result that the stock distribution (constructive or actual) is taxable to the class of stockholders as a group that has experienced the prohibited event described in §305(b).[113]

The IRS and Treasury have issued proposed regulations under §305(c) that would resolve ambiguities regarding the amount and timing of deemed distributions that are or result from adjustments to rights to acquire stock.[114] The proposed regulations would also provide additional guidance to withholding agents regarding their current withholding and information reporting obligations with respect to the deemed distributions.[115] For further discussion of the proposed regulations, see III.D.6., and III.D.7., below.

1. Changes in Conversion Ratios and Antidilution Provisions

Reg. §1.305-7(a) provides that a change in the conversion ratio, a change in the redemption price, a difference between the redemption price and issue price, a redemption taxable under §301, or any transaction (including a recapitalization) which has a similar effect on the interest of any shareholder, may be treated as a taxable stock dividend if both of the following conditions exist: (a) the transaction produces an increase in the proportionate interest of any shareholder in the earnings and profits or assets of the corporation deemed to have made the distribution; and (b) the deemed distribution produces a result described in §305(b)(2), §305(b)(3), §305(b)(4), or §305(b)(5).[116]

Such a distribution is deemed to be made only with respect to a shareholder whose interest in the earnings and profits or assets of the "distributing" corporation is increased as a result of such deemed distribution. Even though no stock is actually received, the deemed distribution is considered to be in common or preferred stock, depending upon the facts. For example, where there is a redemption premium for preferred stock under any of the circumstances described in Reg. §1.305-5(b), and the other requirements of Reg. §1.305-7 are met, the distribution will be deemed to have been made with respect to such preferred stock. The distribution will also be deemed to be made in preferred stock.[117]

An adjustment in the conversion ratio or conversion price of a convertible instrument which compensates for cash divi-

[111] Reg. §1.305-3(e) *Ex.* (14).

[112] 1978-1 C.B. 85.

[113] Reg. §1.305-7(a). See also Prop. Reg. §1.305-7(b)(1), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, a taxpayer may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-7(g).

[114] Preamble to REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, a taxpayer may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-7(g).

[115] Preamble to REG-133673-15, proposed to apply to payments made on or after the date the regulations are finalized; however, a withholding agent may rely on the proposed regulations for all deemed distributions or deemed payments occurring on or after January 1, 2016, until the date the regulations are finalized. Prop. Reg. §1.1441-2(f).

[116] See also Prop. Reg. §1.305-7, §1.305-7(c)(4) (would provide the amount of the deemed distribution), §1.305-7(c)(5) (would provide the date and time of the deemed distribution), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, taxpayers may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-7(g). For a discussion of the amount and timing of a deemed distribution under the proposed regulations, see III.D.6., below.

[117] Reg. §1.305-7(a). *See also* Reg. §1.305-3(e) *Ex.* (15), Prop. Reg. §1.305-7(e). In PLR 200615024, the operation of the conversion ratio of convertible debt and terms of outstanding warrants gave rise to taxable deemed dividends pursuant to §305(b)(2) and §305(c) when a corporation issued a taxable dividend.

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dends, or property distributions taxable under other code sections, is not considered as made pursuant to a bona fide adjustment formula.[118] For a discussion of the application of antidilution provisions to compensate for a stock dividend or stock sale, see the discussion at III.C.1., above. On the other hand, the IRS has ruled that an increase in the conversion ratio of convertible preferred stock to protect against dilution of the preferred shareholders' interests resulting from a spinoff, under §355, is not treated as a deemed distribution to which §301 applies.[119] Under the facts of that ruling, X Corporation (X) had both common and convertible preferred stock outstanding. Pursuant to a consent decree, X distributed all of the stock of its subsidiary, Y Corporation (Y), to X's common shareholders in a nontaxable spinoff. The distribution of the Y stock diluted the conversion value of the preferred stock by decreasing the value of the X common stock. To protect the preferred shareholders against such dilution, the tax-free increase in the conversion ratio was permitted.

Reg. §1.305-3(e) provides two examples illustrating how a change in a conversion ratio could result in a taxable distribution.

> *Example:* X corporation has two classes of stock outstanding, Class A and B. The Class B shares are convertible into Class A shares at a 1-to-1 ratio the first year. Thereafter, the conversion ratio gives the Class B shareholders an additional .05 shares of Class A stock each year. Accordingly, during the second year, the conversion ratio would be 1.05 shares of Class A stock for each share of Class B stock; during the third year, the ratio will be 1.10 shares of Class A stock for each share of Class B stock, and so on. Cash dividends are paid by the corporation annually on the Class A stock. At the beginning of the second year, when the conversion ratio is increased to 1.05 shares of Class A stock for each share of Class B stock, a distribution of .05 shares of Class A stock is deemed made with respect to each share of Class B stock, since the proportionate interests of the Class B shareholders in the assets or earnings and profits of the corporation have increased disproportionately to those of the Class A shareholders.[120]

> *Example:* X corporation has two classes of stock outstanding, A and B. The Class B stock is convertible into Class A stock. In accordance with a specified formula, the conversion ratio is decreased each time a cash dividend is paid on the Class B stock, to reflect the amount of such dividend. Consequently, whenever the ratio is decreased, a distribution of stock is deemed made to the Class A shareholders, since their proportionate interests in the assets or earnings and profits of the corporation have increased, relative to that of the Class B stockholders. The formula also provides that the conversion ratio is increased each time a cash dividend is paid on the Class A stock, to compensate the Class B shareholders for such dividend. Such increases in the conversion rights of the Class B shareholders are deemed to be taxable distributions, since they result in an increase in the Class B shareholders' proportionate interests in the corporation's assets or earnings and profits.[121]

Notably, in both of the above examples, it did not matter whether either class of stock was characterized as common or preferred. The IRS seems to take the position that §305(c) will apply in the context of a change in conversion ratios involving two classes of common stock, as well as conversions of preferred stock into common stock.

The IRS ruled that it was possible to structure a transaction so that the conversion ratio could be determined later, without resulting in a taxable stock dividend, under §305(c).[122] In that ruling, X corporation (X) was a publicly traded corporation which proposed a public offering of debentures. The bonds could be redeemed if (a) the taxpayer's net worth fell below a certain level, or (b) the average market price for X's common stock fell below a specified level for eight consecutive days. If X did not redeem the debenture upon the occurrence of either event, the debentures were convertible into X stock, at a fixed rate, based on the average market price of the X common stock for the eight consecutive days before the occurrence of the triggering event. Once the exchange rate was established, it could only be altered in accordance with a specified antidilution formula.

The IRS concluded that the debentures were stock, for the purposes of §305, at the time of issuance, since they included rights to acquire X common stock. It reached that conclusion notwithstanding the fact that the rights could not be exercised except upon the occurrence of a subsequent event which was outside the control of the holders of the debenture. The IRS also ruled there was no change in the conversion ratio when a triggering event gave rise to the fixing of an exchange price. In making that determination, the IRS relied on the following four factors:

(a) The method for fixing the exchange price was specified in the debenture.

(b) Upon a triggering event, the exchange price would be readily determined.

(c) Once the exchange price was determined, it was fixed, other than changes in accordance with an antidilution formula satisfying Reg. §1.305-3(d).

(d) The debentures were comparable to securities which are convertible into a fixed number of shares of stock.

[118] Reg. §1.305-7(b)(1), Prop. Reg. §1.305-7(c)(3); Rev. Rul. 75-513, 1975-2 C.B. 114.

[119] Rev. Rul. 77-37, 1977-1 C.B. 85.

[120] Reg. §1.305-3(e) *Ex.* (6). See also Prop. Reg. §1.305-3(e) *Ex.* 6 (would clarify that an applicable adjustment has occurred as defined in Prop. Reg. §1.305-7(a) and the amount and timing of the deemed distribution), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, taxpayers may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-3(f) .

[121] Reg. §1.305-3(e) *Ex.* (7). *See also* Prop. Reg. §1.305-3(e) *Ex.* 7 (would clarify that an applicable adjustment has occurred as defined in Prop. Reg. §1.305-7(a) and the amount and timing of the deemed distribution).

[122] PLR 8811018.

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2. Redemptions

The IRS has addressed the issue of whether a redemption is a periodic redemption which will be considered a taxable distribution under §305(c) on numerous occasions. For example, assume X corporation (X) has 10 shareholders, each of whom own 100 shares of X stock. Each year, each shareholder has the option of causing the corporation to redeem up to 5% of his stock. Assume nine out of the 10 shareholders elect to have five of their shares redeemed for cash, but that shareholder A does not. A's proportionate interest in the earnings and profits and assets of X is increased, and he is deemed to receive a taxable distribution of 5.25 shares.[123] The value of the deemed distribution is computed by disregarding the redemption of the shares. Thus, 1,005.25 shares are considered to be outstanding after the redemption. The value of each of the 5.25 shares deemed distributed to A is then determined by dividing the aggregate fair market value of the 955 actual shares outstanding after the redemption by the deemed number of shares outstanding (1,005.25).[124]

The calculation as to the deemed distribution becomes more complicated if more than one shareholder elects not to have his shares redeemed. In making the determination as to the number of shares deemed distributed to the shareholders who elect not to have part of their stock redeemed, all nonredeeming shareholders are first treated as a single shareholder for the purposes of determining their aggregate percentage of ownership after the redemption. The nonredeeming shareholders' stock interests are also added together to compute the total number of shares deemed received by them as a taxable distribution. The nonredeeming shareholders are then treated as receiving the deemed stock distribution in the same ratio as that of each nonredeeming stockholder's actual stock interest divided by the actual stock owned by all nonredeeming shareholders.[125]

The IRS has also considered the situation where a stockholder has some of his stock redeemed, but does not have the maximum amount redeemed that is permitted by the corporation.[126] In one situation, 24 shareholders held all of the 6,000 outstanding shares of a corporation. A plan of annual redemption permitted each shareholder to have two-thirds of 1% of his shares redeemed; provided, however, the total annual redemption was limited to 40 shares. If one or more shareholders chose not to redeem, the others could redeem more than two-thirds of 1%, subject to the 40-share cap. In a given year, eight out of the 24 shareholders redeemed a total of 40 shares. The IRS concluded that the 16 nonredeeming shareholders had increases in their proportionate interests in the corporation. Moreover, two shareholders who did not have the maximum amount of their shares redeemed also enjoyed an increase in their proportionate interests in the corporation. Accordingly, the IRS concluded that both the nonredeeming and the two partially redeeming shareholders were deemed to have received stock distributions to which §305(b)(2) and §301 applied.[127]

While every redemption, other than a proportionate redemption, has the effect of increasing the proportionate interest in the corporation of some shareholders, not every redemption results in deemed distributions to the nonredeeming shareholders. A single isolated redemption, which is not part of a plan of periodic redemptions, does not result in a deemed distribution to the nonredeeming shareholders even if the distribution is taxable as a dividend to the redeeming shareholders as essentially equivalent to a dividend. While the statutory language of §305(c) is broad enough to cover any redemption, the regulations exclude isolated redemptions.[128] Similarly, the redemption of part of the stock of a number of shareholders, which is not part of a plan of periodic redemptions, would not trigger a deemed distribution to the remaining shareholders if the redemptions had a legitimate business purpose such as planning for the retirement of certain officers. The fact that the redemptions are treated as essentially equivalent to a dividend under §301(b) is irrelevant.[129]

In Rev. Rul. 77-19,[130] the IRS concluded that a series of stock redemptions, followed by a merger, did not result in any deemed distributions. In that ruling, a corporation redeemed some 20,000 shares of its common stock in 20 separate transactions over a period of three years. At the end of the three-year period, the corporation was merged into another corporation, with the shareholders of the target corporation, who owned less than 200 shares of the target, receiving solely cash for their target stock. Both the series of redemptions and the reorganization resulted in some shareholders receiving cash, while others increased their proportionate interests in the corporation. Nevertheless, neither the merger nor the redemptions resulted in deemed distributions to any shareholder, since both transactions were isolated and not part of a periodic redemption plan.

For a discussion of the treatment of redemption premiums under §305(c), see III.H., below.

3. Security Arrangements and Reorganizations

Stock redemptions which are required as part of a security arrangement also do not result in deemed distributions to the remaining shareholders.

> *Example:* In order to assist individuals lacking capital to become its dealers, a manufacturing company provides

[123] The calculation of the number of shares which are deemed distributed is as follows: A's percentage of interest in the corporation, after the redemption, is 10.47% (i.e., 100 shares divided by 955 shares). If the redemption were ignored, A would have been deemed to have received a distribution of x shares which, when divided by 1,000 plus x shares, would equal 10.47%. That is, 100 plus x, divided by 1,000 plus x, equals 10.47%. In that formula, x equals 5.25.

[124] Reg. §1.305-3(e) *Ex.* (8).

[125] *See* Reg. §1.305-3(e) *Ex.* (9).

[126] Rev. Rul. 78-60, 1978-1 C.B. 81.

[127] Rev. Rul. 78-60, 1978-1 C.B. 81.

[128] Reg. §1.305-3(e) *Ex.* (10). *See* PLR 9344036 (a redemption did not cause a §305(c) deemed distribution because it was an isolated transaction, despite a similar redemption one year earlier). *See also* PLR 200428023, PLR 200428024, PLR 200329023, PLR 200215018, PLR 200215016, PLR 9519046 (redemption of stock by corporation planning to operate as a diversified, closed-end RIC, in order to encourage the market to value its stock at a price reflecting the underlying assets' value, is a single and isolated transaction and does not result in a §305 deemed distribution).

[129] Reg. §1.305-3(e) *Ex.* (11). *See* PLR 9344036 (a redemption did not cause a §305(c) deemed distribution because it was an isolated transaction, despite a similar redemption one year earlier).

[130] 1977-1 C.B. 83. *See* PLR 9344036 (a redemption did not cause a §305(c) deemed distribution because it was an isolated transaction, despite a similar redemption one year earlier).

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75% of the capital for a dealership corporation in exchange for Class A stock and a note. The dealer provides the other 25% of the capital in exchange for Class B stock. The Class B stock is nonvoting, until such time as all of the Class A stock has been redeemed. Under the terms of the agreement, each year at least 70% of the earnings of the dealership company must be used to retire the note and redeem the Class A stock at a fixed price. Consequently, the manufacturer's investment is systematically eliminated, and the individual dealer becomes the sole owner of the business over time. Notwithstanding the periodic increases in the dealer's proportionate ownership of the assets and earnings and profits of the corporation, the redemptions of the Class A stock do not result in deemed distributions to the holder of the Class B stock, since the purpose of the whole arrangement was essentially a security arrangement and not a substitute for redemptions or dividends.[131] The IRS extended the concept to a leveraged buyout in Rev. Rul. 78-115.[132] In that ruling, a corporation acquired a target corporation for cash and nonparticipating nonconvertible preferred stock. The acquiring corporation was required to redeem the preferred stock, at the rate of 5% per year, at a set price plus accrued dividends. The IRS concluded that the transaction was essentially a security arrangement and that §305(b)(2) was inapplicable.

4. *Purchases for Corporate Purposes*

Corporations often find it necessary to purchase stock in order to reissue it to employee stock purchase plans, to holders of convertible stock or debt, to employees who hold stock options, or for future acquisitions. Provided the purchases are not made as part of a plan to systematically increase the proportionate interest of some shareholders and distribute property to other shareholders, the nonselling shareholders are not treated as having received a taxable dividend, notwithstanding the fact that their proportionate interests in the corporation have increased.[133] The IRS has privately ruled that a deemed distribution did not occur where a closed end regulated investment company repurchased shares through its own tender offer.[134]

5. *Recapitalizations*

The regulations provide that a recapitalization (whether or not it is an isolated transaction) will be deemed to result in a distribution to which §305(c) applies if —

(a) it is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation, or

(b) a shareholder owning preferred stock, with dividends in arrears, exchanges his stock for other stock and, as a result, increases his proportionate interest in the assets or earnings and profits of the corporation. An increase in a preferred shareholder's proportionate interest occurs in any case where the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization), exceeds the issue price of the stock surrendered.[135]

In the latter situation, the amount of the deemed distribution is the lesser of:

(i) the amount by which the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or

(ii) the amount of the dividends in arrears.[136]

Note: For the purposes of applying these rules, with respect to stock issued before July 12, 1973, the term "issue price of the preferred stock surrendered" means the greater of the issue price or the liquidation preference (not including dividends in arrears) of the stock surrendered.[137]

The regulations do not expressly provide that a bona fide recapitalization for a legitimate business purpose will not be treated as giving rise to a deemed distribution. Nevertheless, many of the examples under Reg. §1.305-5(d) conclude that recapitalizations are generally outside the scope of §305.

Example: A corporation has both common and preferred stock outstanding, the latter having an issue price of $100 per share. The corporation is four years in arrears on dividends to the preferred shareholders. In a recapitalization, under §368(a)(1)(E), the preferred shareholders exchange each share of their existing preferred stock (including the right to dividend arrearages) for 1.20 shares of new Class A preferred stock, which has a liquidation preference of and is traded in the market at $100 per share immediately following the recapitalization. Since the fair market value of 1.20 shares of new Class A stock is $120, which exceeds the issue price of the old preferred stock, the preferred shareholders have increased their proportionate interests in the assets and earnings and profits of the corporation. Thus, the preferred shareholders are deemed to have received a taxable distribution of $20 on each share of the old preferred stock.[138] The same result would occur if the old preferred stock were exchanged for one share of new preferred stock plus one share of common stock, which had a fair market value of $20 per share immediately following the recapitalization.[139]

These examples must be contrasted with a recapitalization which is not done pursuant to a plan to periodically increase the shareholders' proportionate interests in the corporation's assets or earnings and profits and which does not involve dividend arrearages.

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[131] Reg. §1.305-3(e) *Ex.* (14).
[132] 1978-1 C.B. 85.
[133] *See* Reg. §1.305-3(e) *Ex.* (13).
[134] PLR 199928021.

[135] Reg. §1.305-7(c)(1). *See also* Prop. Reg. §1.305-7(d)(1), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016).
[136] Reg. §1.305-7(c)(2). *See also* Prop. Reg. §1.305-7(d)(2).
[137] Reg. §1.305-7(c)(3). *See also* Prop. Reg. §1.305-7(d)(3).
[138] Reg. §1.305-5(d) *Ex.* (1)(i).
[139] Reg. §1.305-5(d) *Ex.* (1)(ii).

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Example: A corporation whose stock is publicly traded has both cumulative preferred and common stock outstanding. Each share of the preferred stock is convertible into three-quarters of a share of common stock. There are no dividend arrearages. When the preferred stock was issued (at $100 per share), there was no plan or arrangement by which it was to be exchanged for common. In a §368(a)(1)(E) recapitalization, each share of preferred stock is exchanged for one share of common, which has a fair market value of $110 per share immediately following the recapitalization. Even though the fair market value of the common stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, the recapitalization is not deemed under §305(c) to result in a distribution to which §305(b)(4) and §301 apply.[140]

Comment: A critical fact in the foregoing example may be that the company was publicly traded, rather than the fact that no plan existed to periodically increase any shareholder's proportionate interest. It may be unlikely that a closely held corporation could persuade the IRS that the same result should apply.

Example: Corporation C (C) has widely held common stock and non-widely held preferred stock outstanding. The preferred stock is convertible into common stock on a one-for-one exchange ratio, is redeemable at C's option after Date 1, and must be redeemed by Date 2. To enhance its balance sheet, C reduces the conversion ratio to 9/10 of a share of common stock for each share of preferred stock (and increases the preferred shareholders' call protection by the amount of the decrease in conversion ratio), which results in an increase in the common shareholders' interests in the equity of C on a fully diluted basis of less than 1%. The reduction in the conversion ratio will not be treated as a §305(c) deemed distribution to the common shareholders, if it is a one-time increase in the common shareholders' interests in C rather than part of a plan to periodically increase their proportionate interests in C.[141]

Where preferred stock is not convertible into common, and there are no dividend arrearages, the regulations indicate that §305(c) will not be invoked to find a taxable dividend where such preferred stock is exchanged for common stock in a recapitalization involving a publicly held corporation whose stock is traded on an exchange or over-the-counter market. Of course, there must have been no plan or arrangement when the preferred stock was issued to effect such an exchange. Similarly, if preferred stock is exchanged in a reorganization for new preferred stock having substantially the same market value and no greater call price or liquidation preference than the old preferred stock, §305(c) should not apply. Moreover, the fact that the new preferred stock has voting rights or is convertible into common at a fixed ratio, subject to adjustment to take into account stock dividends, splits, or other transactions affecting the common stock, should not result in the invocation of §305(c).[142]

[140] Reg. §1.305-5(d) *Ex.* (2).
[141] *See* PLR 9344035.
[142] *See* Reg. §1.305-5(d) *Ex.* (6).

A recapitalization under §368(a)(1)(E), which results in a change in the conversion rights of preferred stock, does not necessarily result in a deemed distribution.

Example: A corporation is organized with 1,000 shares of Class A common and 1,000 shares of Class B convertible preferred. Each share of Class B preferred stock is convertible into two shares of Class A common. In a recapitalization, all of the 1,000 shares of Class A stock outstanding were surrendered for 500 shares of new Class A common, plus 500 shares of new Class C common. The conversion right of the Class B preferred stock was changed to one share of Class A plus one share of Class C stock for each share of Class B stock. The change in the conversion right was not deemed to be a taxable distribution.[143]

Historically, one of the most common uses for an "E" reorganization (i.e., a recapitalization) was an "estate freeze." In the typical estate freeze, the common stockholders exchange some or all of their common stock for preferred stock, or for both preferred and a new class of common stock. The goal was to "freeze" the current equity in the hands of the existing shareholders. Common stock is then sold or given to the next generation. In such a recapitalization, the future growth of the company was transferred to the younger generation. While Congress has limited the value of estate freezes with the enactment of §2701, *et seq.*, there are still significant planning devices which can be impacted by §305.[144]

Generally, a recapitalization to transfer control of a company to the younger members of a family will not result in the application of §305(c) to treat the transaction as taxable under §305(b)(2) and §301.

Example: Corporation X (X) has 2,000 shares of Class A common stock outstanding. Five shareholders each own 300 shares and five shareholders each own 100 shares. In preparation for the retirement of the five largest shareholders, and in a single isolated transaction, X adopts a recapitalization plan in which each share of Class A stock could be exchanged for (a) five shares of new Class B nonconvertible preferred stock plus 0.4 shares of new Class C common stock, or (b) two shares of new Class C common stock. The five largest shareholders elect to take 1,500 shares of Class B nonconvertible preferred stock and 120 shares of Class C common stock. The remaining shareholders each elect to exchange their stock for 200 shares of Class C common stock. None of the exchanges were within the scope of §305.[145]

[143] Reg. §1.305-5(d) *Ex.* (3). *See also* PLR 200252073 (deemed stock exchange due to removal of certificate provision triggering conversion when outstanding shares reaches certain threshold does not result in a taxable distribution).
[144] For a complete discussion of estate freezes, see 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations*, and 835 T.M., *Transfers of Interests in Family Entities under Chapter 14: Sections 2701, 2703, and 2704* (Estate, Gifts, and Trusts Series).
[145] Reg. §1.305-3(e) *Ex.* (12). *See also* PLR 9728005 (exchange of voting stock for non-voting stock to give employee owners greater voting power was not a taxable distribution).

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Similarly, in Rev. Rul. 86-25,[146] the IRS ruled that a recapitalization undertaken for valid business reasons was an isolated transaction and not part of a plan to periodically increase the proportionate interests of any shareholder. Thus both §305(b)(3) and §305(c) were inapplicable. In that ruling, one group of shareholders exchanged 2,500 shares of old common stock for 2,500 shares of new Class A common stock and 15,000 shares of Class C preferred stock. Another group of shareholders exchanged 500 shares of old common stock for 500 shares of new Class A common and 49,500 shares of Class B common stock.

The receipt of preferred stock in a recapitalization can result in a deemed distribution of additional preferred stock over a period of time, even though the recapitalization itself does not result in a deemed distribution. For example, the majority shareholder of a closely held corporation owned 80% of the outstanding common stock. He surrendered all of his common stock for all the outstanding shares of a single class of nonvoting preferred stock that was redeemable upon the shareholder's death at its stated value. The fair market value of the surrendered stock equaled the stated par value of the stock received, but the actual value of the preferred stock was significantly less than its redemption price. Since the exchange was not part of a plan to periodically increase the shareholder's proportionate interest in the corporation, the recapitalization itself did not result in a deemed distribution. However, the disparity between the value of the preferred stock on the date of issuance and the redemption price of the preferred stock resulted in the IRS concluding that there would be a deemed distribution of additional stock, with respect to the preferred stock, pursuant to §305(b)(4) and §305(c), in an amount equal to the redemption price less the fair value of the preferred stock on the date of issuance less a reasonable redemption premium. This amount was deemed constructively received over the life expectancy of the shareholder.[147]

6. *2016 Proposed Rules on Amount and Timing of Deemed Distributions*

Proposed regulations would provide guidance regarding the amount and timing of deemed distributions that are or result from adjustments to rights to acquire stock.[148]

Under Reg. §1.305-7(a), a shareholder is treated as receiving a deemed distribution from a corporation with respect to rights to acquire stock in the corporation if the shareholder's proportionate interest in the earnings and profits or assets of the corporation is increased by a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption that is treated as a distribution to which §301 applies, or any transaction having a similar effect on the interest of the shareholder.

The proposed regulations would provide that a shareholder also be treated as receiving a deemed distribution with respect to certain other adjustments to a right to acquire stock that are similar to a change in conversion ratio. These would include a change in conversion price, a change in exercise price, and a change in the number of shares the holder would receive upon exercise. Under the proposed regulations, these types of adjustments to a right to acquire stock would be referred to as an "applicable adjustment." More specifically, the proposed regulations would provide that an "applicable adjustment" is an adjustment to a right to acquire stock that includes any of the following:

(1) with respect to a convertible instrument and a holder thereof, an increase in the conversion ratio or a reduction in the conversion price of such instrument;

(2) with respect to a warrant, subscription right, stock right, option, or other similar right and a holder thereof, an increase in the number of shares to be received by the holder upon exercise or a reduction in exercise price;

(3) with respect to a convertible instrument and a holder of actual stock into which such instrument may be converted, an increase in the conversion price or a reduction in the conversion ratio of such instrument;

(4) with respect to a warrant, subscription right, stock right, option, or similar right and a holder of actual stock into which such instrument is exercisable, an increase in the exercise price or a reduction in the number of shares to be received by the holder upon exercise; and

(5) an adjustment in the terms of a right to acquire stock having an effect similar to the effects of the adjustments described in (1) through (4), above.

For a deemed distribution under §305(b) and §305(c) that is made to a deemed shareholder and is an applicable adjustment, the amount of the deemed distribution, under the proposed regulations, would be the excess of (1) the fair market value (FMV) of the right to acquire stock held by the deemed shareholder immediately after the applicable adjustment, over (2) the FMV, determined immediately after the applicable adjustment, of such right to acquire stock as if no applicable adjustment had occurred.[149]

For a deemed distribution under §305(b) and §305(c) that is made to an actual shareholder and results from an applicable adjustment, the amount of the deemed distribution would be the FMV of the stock deemed distributed, determined in accordance with the methodology used in Reg. §1.305-3(e) *Exs.* 8 and 9.[150]

[146] 1986-1 C.B. 202.

[147] Rev. Rul. 83-119, 1983-2 C.B. 57, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388. This revenue ruling was obsoleted because its positions on characterizing the taxpayer's life expectancy as a "specified period of time" and deeming the premium "reasonable" are no longer relevant since, effective for stock issued on or after December 20, 1995, Reg. §1.305-5(b), T.D. 8643, 60 Fed. Reg. 66,134 (Dec. 20, 1995), does not contain an exception for immediately redeemable preferred stock and only excludes de minimis premiums, rather than reasonable premiums, from constructive distribution treatment. See also Rev. Rul. 83-120, 1983-2 C.B. 170, *amplifying* Rev. Rul. 59-60, 1959-1 C.B. 237 and Rev. Rul. 80-213, 1980-2 C.B. 101, with respect to the factors taken into account in determining the fair market value of preferred and common stock. See also Reg. §1.305-5(b) and discussion in III.H., below.

[148] REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, taxpayers may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-7(g).

[149] Prop. Reg. §1.305-7(c)(4)(i). See Prop. Reg. §1.305-7(c)(4)(iii) for the FMV standard.

[150] Prop. Reg. §1.305-7(c)(4)(ii).

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When an applicable adjustment is or results in a deemed distribution,[151] the deemed distribution would generally occur at the time the applicable adjustment occurs, in accordance with the instrument setting forth the terms of the right to acquire stock, but in no event later than the date of the distribution of cash or property that results in the deemed distribution (taking into account Reg. §1.305-3(b)).[152]

7. *2016 Proposed Rules for Withholding Agents and Issuers of Specified Securities*

Proposed regulations would provide guidance to withholding agents regarding their obligations to withhold on deemed distributions under §305(c).[153] The proposed regulations would clarify who is considered a withholding agent with respect to a distribution[154] and would explain when and how to withhold on a deemed distribution.[155] A withholding agent would also benefit from a new exception to withholding, under the proposed regulations, for deemed distributions of stock or a right to acquire stock on a specified security (as defined in Reg. §1.6045-1(a)(14)).[156]

To address concerns of brokers and withholding agents regarding the difficulty of complying with reporting and withholding obligations in the absence of information about deemed distributions under §305(c), including a deemed distribution resulting from an applicable adjustment, and their amounts, the IRS issued Prop. Reg. §1.6045B-1(i).[157] Prop. Reg. §1.6045B-1(i)(2) would require an issuer to provide an issuer return to the IRS and a written statement to each holder of record of a specified security (or to the holder's nominee) relating to a deemed distribution under §305(c) on the security, without regard to any of the general exceptions in the current §6045B regulations or in the instructions to Form 8937.

E. *Distributions of Common and Preferred Stock*

Section 305(b)(3) provides that if a distribution (or a series of distributions of which such distribution is one) results in the receipt of preferred stock by some common shareholders, and the receipt of common stock by other common shareholders, the distribution is taxable under §301. The distribution is taxable to both the recipients of the common and the preferred stock.[158] Similarly, the distribution is taxable irrespective of whether or not the preferred stock is convertible into common stock.[159]

The regulations provide that §305(b)(3) will apply and dividend treatment will be imposed upon distributions which, as a factual matter, "can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders."[160]

For example, assume a corporation, which has a single class of stock outstanding, declares a dividend on its common stock. The dividend is payable in newly authorized Class B preferred stock, which is convertible into Class A stock, no later than six months from the date of the distribution, at a price which is only slightly higher than the market price of the common stock on the date of the distribution. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period of time, some shareholders will exercise their conversion rights and some will not exercise. Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders, and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which §301 applies.[161]

Literally, §305(b)(3) applies to a recapitalization designed to shift control of a corporation from older family members to younger family members.

> *Example:* Assume X corporation (X) has 3,000 shares of voting common stock outstanding. The older shareholders own 2,500 shares, and the younger shareholders own the remaining 500 shares. Pursuant to a plan to shift the future growth of the corporation to the younger shareholders, X authorized new Class A voting common stock, new Class B nonvoting common stock, and new Class C nonvoting and nonconvertible preferred stock paying a fixed dividend rate. The voting rights are the only difference between Class A and the Class B stock. Each outstanding share of voting common stock can be exchanged either for (a) one share of Class A stock plus 99 shares of Class B stock; or (b) one share of Class A stock plus six shares of Class C stock. The fair market value of the stock surrendered equals that of the stock received. As a result of the exchanges, the older shareholders receive 2,500 shares of

[151] *See* Prop. Reg. §1.305-7(c)(1), §1.305-7(c)(2).

[152] Prop. Reg. §1.305-7(c)(5).

[153] Prop. Reg. §1.1441-2(d)(1), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to payments made on or after the date the regulations are finalized; however, a withholding agent may rely on the proposed regulations for all deemed distributions or deemed payments occurring on or after January 1, 2016, until the date the regulations are finalized. Prop. Reg. §1.1441-2(f). *See also* preamble to REG-133673-15. Generally, a withholding agent would have an obligation to withhold on a deemed distribution (as defined in Prop. Reg. §1.305-1(d)(7)) that is made on a security. Prop. Reg. §1.1441-2(d)(4)(i).

[154] An issuer of a security upon which a deemed distribution is made and any person that holds directly or indirectly (e.g., through an account maintained for an intermediary) a security on behalf of the beneficial owner of the security, or a flow-through entity that owns directly or indirectly (through another flow-through entity) a security, would be considered to have custody of or control over the deemed distribution made on the security and, therefore, would be a withholding agent with respect to the distribution. Prop. Reg. §1.1441-7(a)(4).

[155] *See* Prop. Reg. §1.1441-2(d)(1), §1.1441-2(d)(4)(ii).

[156] Under the exception, a withholding agent (other than the issuer of the specified security) would have an obligation to withhold on a deemed distribution only if, before the due date (not including extensions) for filing Form 1042 for the calendar year in which the deemed distribution occurred, either (i) the issuer meets its reporting requirements under Reg. §1.6045B-1 (by furnishing an issuer statement or publicly reporting the required information) or (ii) the withholding agent has actual knowledge that a deemed distribution has occurred. Prop. Reg. §1.1441-2(d)(4)(i).

[157] REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), proposed to apply to a deemed distribution under §305(c) occurring on or after the date the regulations are finalized. Prop. Reg. §1.6045B-1(i)(4). If the issuer satisfies the public reporting requirements in Reg. §1.6045B-1(a)(3), the issuer would not have to provide an issuer return to the IRS or a written statement to the holders regarding the deemed distribution. Prop. Reg. §1.6045B-1(i)(2).

[158] Reg. §1.305-4(b) *Ex.* (1).

[159] Reg. §1.305-4(a).

[160] Reg. §1.305-4(b) *Ex.* (2).

[161] Reg. §1.305-4(b) *Ex.* (2).

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> Class A voting common stock and 15,000 shares of Class C preferred stock. The minority shareholders receive 500 shares of Class A voting common stock, and 49,500 shares of Class B nonvoting common stock.[162]

In that situation, it is clear that some shareholders have received common stock while other shareholders have received preferred stock. Nevertheless, it does not appear that Congress intended §305(b)(3) to apply to such a recapitalization. Senators Aiken and Long engaged in the following colloquy during the Senate debate of the 1969 Act:

> *Mr. Aiken*: At this point, Mr. President, I would like to ask the Chairman of the Committee on Finance a question for the purpose of clarifying one section of the bill. I noticed that the bill — page 297, section 421 — taxes dividends in stock in all cases where there are two classes of stock outstanding and there are different distributions with regard to these two classes such as stock on one class and cash on the other class or preferred stock on one class and common stock on the other class.
>
> However, I note the bill also provides that under certain conditions a recapitalization may be treated as a distribution of stock or property. It is my understanding that there is no intention to alter the status of a recapitalization in which, for example, the older stockholders exchange some or all of their common stock for preferred stock and retire from the business while the younger stockholders exchange some or all of their preferred stock for additional common stock and continue to be active in the business. This has been a classic type of recapitalization which has always been considered tax free in the past. Am I correct that there is no intention to change the status of a recapitalization of this type with a bona fide business purpose?
>
> *Mr. Long*: The Senator is correct. There is no intention to impose a tax on a bona fide recapitalization of this type, except to the extent stock is given in payment for dividend arrearages on the preferred stock.[163]

While there are no regulations which expressly state that recapitalizations will not be treated as a taxable dividend, Reg. §1.305-3(e) provides numerous examples that isolated redemptions and recapitalizations that are not part of a plan to periodically increase a common stock interest of a shareholder are not within the scope of §305(b)(2) and §305(b)(3).[164]

In a private letter ruling, the IRS ruled that a distribution of a new class of participating stock to the company's common stockholders and the holders of an old series of participating stock did not constitute a taxable dividend under §305(b).[165]

[162] The special valuation rules of §2701 should be carefully examined to determine the extent to which any gifts would arise as a result of this type of recapitalization. *See e.g.*, Reg. §25.2701-3(d) *Ex.* (4).

[163] 115 Cong. Rec. 37,902 (daily ed. Dec. 9, 1969).

[164] *See* Reg. §1.305-3(e) *Ex.* (12). *See also* discussion at III.C.2., and III.D.5., above.

[165] PLR 199901024. *See also* PLR 9804039.

F. Distributions on Preferred Stock

Section 305(b)(4) provides that a distribution by a corporation with respect to its preferred stock is taxable under §301, unless the distribution is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend or stock split with respect to the stock into which such convertible stock is convertible. A change in the preferred stock's conversion ratio to take into account a similar event, such as the sale of stock at less than its fair market value pursuant to a rights offering, which would otherwise dilute the conversion right, is also not taxable.[166] The exception is limited exclusively to adjustments to the conversion ratio. It does not permit the distribution of common stock to holders of convertible preferred stock in order to offset the dilution of preferred shareholders' conversion rights following a stock dividend to the common shareholders.[167]

The holder of cumulative preferred stock is deemed to have received a distribution of common stock, with respect to the preferred stock, if the terms of the preferred stock allow the holder the right to elect to receive common stock with a value equal to cash dividends in arrears. The deemed stock distribution will be taxable under §301 through the application of §305(b)(4).[168]

As originally proposed, Reg. §1.305-5(a) specifically provided that the sale of stock to employees at less than fair market value was an event similar to a stock dividend or stock split. Thus, a change in the conversion ratio to take into account such a sale would not have been a taxable event to the preferred shareholders. However, the final version of the Reg. §1.305-5(a) eliminated such reference; however, this regulation provides that §301 is inapplicable to a distribution with respect to convertible preferred stock to take into account a "… stock dividend, stock split, or any similar event (such as the sale of stock at less than the fair market value pursuant to a rights offering) … ." Presumably, that phrase is broad enough to cover bargain sales to employees.

Reg. §1.305-5(a) also states that permissible antidilution adjustments do not include an adjustment in the conversion ratio made solely to take into account the distribution by a closed-end mutual fund of a capital gain dividend, with respect to the class of stock into which the stock is convertible.

For the purposes of §305(b)(4), preferred stock is stock which has limited preferences (generally associated with specified dividend and liquidation priorities), and which does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Consequently, stock which enjoys a priority as to dividends and on liquidation, but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits, and in assets upon liquidation, may nevertheless be treated as preferred stock for purposes of §305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is

[166] *See* Reg. §1.305-5(a).

[167] Rev. Rul. 83-42, 1983-1 C.B. 76.

[168] Rev. Rul. 84-141, 1984-2 C.B. 80.

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deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and in assets upon liquidation beyond its preferred interest. In making the determination as to whether such a right to participate lacks substance, the IRS will consider all of the facts and circumstances including prior and anticipated earnings per share, cash dividends per share, book value per share, the extent of preference and of participation of each class, both absolutely and relative to one another, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. However, any right to convert stock into another class of stock of the corporation is ignored for the purposes of determining whether the stock is "preferred." Moreover, convertible debentures are expressly excluded from the definition of preferred stock.[169]

In describing excluded antidilution adjustments, the regulations originally proposed under §305(b) referred to "convertible preferred stock (or securities)." The regulations actually promulgated eliminated the reference to securities consistent with a further statement in the regulations that convertible debentures are not treated as preferred stock.[170] Nevertheless, §305(d)(1) specifically provides that the term "stock" includes rights to acquire stock. Moreover, Reg. §1.305-3(e) *Ex.* (4), treats convertible securities as stock. Similarly, Reg. §1.305-7(b), which sets forth the antidilution provision exception in some detail, refers to "convertible preferred stock (or securities)."[171] Accordingly, there is some authority for contending that debentures which are convertible into preferred stock may be treated as preferred stock. Such an argument might be buttressed by application of debt versus equity principles.

In a 1999 private letter ruling, the IRS ruled that the distribution of a new series of participating stock by a company to its common stockholders and the holders of an old series of participating stock was not a taxable dividend.[172] The IRS also ruled that a distribution of participating preferred stock to the common stockholders and the holders of participating preferred stock, so as to increase the float of the preferred stock, was not a taxable distribution.[173]

For a discussion of redemption premiums treated as distributions on preferred stock, see III.H., below.

G. *Distributions of Convertible Preferred Stock*

Section 305(b)(5) provides that a distribution of convertible preferred stock is taxable under §301, unless it is established that such distribution will not have the result of a disproportionate distribution described in §305(b)(2). The Senate Committee Report contained the following explanation of the operation of this provision:

> If a corporation makes a pro rata distribution on its common stock of preferred stock convertible into common stock at a price slightly higher than the market price of the common stock on the date of the distribution, and the period during which the stock must be converted is 4 months, it is likely that a distribution would have the result of a disproportionate distribution. Those stockholders who wish to increase their interests in the corporation would convert their stock into common stock before the end of the 4-month period, and those stockholders who wish to receive cash would sell their stock or have it redeemed. On the other hand, if the stock were convertible for a period of 20 years from the date of issuance, there would be a likelihood that substantially all of the stock would be converted into common stock, and there would be no change in the proportionate interest of the common shareholders.[174]

While the regulations provide some guidance into the operation of §305(b)(5), with respect to distributions of convertible preferred stock, the guidelines are far from precise. A distribution of convertible preferred stock is likely to have a disproportionate effect if the following two factors are present:

(a) the conversion right expires "within a relatively short period of time" after the distribution, and

(b) taking into account such factors as dividend rights, redemption provisions, marketability, and conversion price, it may be anticipated that some shareholders will exercise their conversion rights and others will not.[175]

The regulations further provide that "where the conversion right may be exercised over a period of many years and the dividend rate is consistent with market conditions at the time of distribution of the stock, there is no basis for predicting at what time and the extent to which the stock will be converted and it is unlikely that a disproportionate distribution will result."[176] The examples provided in the regulations are identical to those contained in the Committee Report. Since the IRS has offered no guidance for situations in between those two extremes, there is substantial uncertainty for anything in the middle. The regulations underscore the fact that §305(b)(3) and §305(b)(5) are complementary. For example, assume X corporation had only common stock outstanding and declared a dividend payable in convertible preferred. The conversion privilege expired six months after issuance and for a price only slightly higher than the market price of the common stock at the time of distribution. In view of the factors set forth above, it is reasonable to expect that within a relatively short time, some shareholders would have exercised their conversion rights while others would not have done so. On such facts, the regulations conclude that §305(b)(3) renders the stock distribution taxable.[177] Similarly, it is likely that such a distribution would be consid-

[169] Reg. §1.305-5(a). *See also* Reg. §1.305-5(d) *Exs.* (9) and (10).

[170] Reg. §1.305-5(a).

[171] Proposed regulations would not directly refer to "convertible preferred stock (or securities)" but would continue to include rights to acquire stock in its antidilution provision exception. See Prop. Reg. §1.305-1(d)(3)(i), §1.305-7(a), §1.305-7(c)(3), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to deemed distributions occurring on or after the date the regulations are finalized; however, taxpayers may rely on the proposed regulations for deemed distributions under §305(c) that occur prior to such date. Prop. Reg. §1.305-1(e), §1.305-7(g).

[172] PLR 199901024. *See also* PLR 9804039.

[173] PLR 9814015.

[174] S. Rep. No. 552, 91st Cong., 1st Sess. 152–53 (1969). *See also* Reg. §1.305-6(b) *Exs.* (1) and (2).

[175] Reg. §1.305-6(a)(2).

[176] *Id.*

[177] Reg. §1.305-4(b) *Ex.* (2).

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ered taxable under §305(b)(5). The overlap between the two provisions presumably reflects the fact that distributions of convertible preferred with an early expiration date actually present the recipients with an election to hold the preferred, or to select common stock instead. Accordingly, such a distribution can be viewed either as a distribution of common and preferred stock, or as a distribution of convertible preferred, which will result in a disproportionate distribution.

In any case where a corporation makes a distribution of convertible preferred, there would seem to be the risk of a disproportionate distribution, under §305(b)(2), if some shareholders are likely to sell their stock, while others are likely to elect to convert and, thus, increase their proportionate interest in the corporation. The IRS has offered no guidance as to whether or when §305(b)(2) will apply in such a case. The IRS adopted a standard in Rev. Proc. 77-37,[178] where the characterization, as §306 stock, of convertible preferred stock received in a reorganization depends upon the existence of a "concerted plan" for some shareholders to convert and for others to retain their preferred stock. There is no similar "concerted plan" rule under §305 with respect to the taxability of distributions of convertible preferred stock. Nevertheless, while the presence of a plan is not a prerequisite to a taxable disproportionate distribution under §305(b)(2), the 36-month rule of Reg. §1.305-3(b)(4) will serve to preclude disproportionate distribution treatment unless a plan is present.

H. Treatment of Redemption Premiums

1. Before the 1990 RRA

Before the 1969 Act, holders of a debt instrument or preferred stock which was issued at a discount did not pay income tax on the amount of the discount, until the instrument matured or was redeemed. The House Ways and Means Committee was concerned about the consequences of this treatment. In the context of a debt instrument, the debtor would accrue a discount. However, the holder of the instrument did not take any income into account until the bond matured. The result was a mismatch in the timing of income and deductions. Similarly, the holder of preferred stock issued at a discount would not pick up income until the stock was sold or redeemed. Section 1232 *et seq.*, as then in effect, (subsequently incorporated into §1272 *et seq.*) provided that the bond holder and the corporation issuing the bond were to be treated in a consistent manner, with respect to the original issue discount on the bond. Similarly, under §305(c), if there was a discount between the issue price of the preferred stock and its redemption price, that discount was to be accounted for by the holder as dividend income over the life of the preferred stock.

There was a significant inconsistency between the way debt instruments and preferred stock were treated in the 1969 Act. Interest on debt is accrued as a deduction by the corporate debtor and included as income by the bond holder in equal annual amounts. Conversely, a corporation which issues preferred stock does not get a deduction equivalent to the ratable inclusion in income by the shareholder. Obviously, the disparity arises from the different treatment of debt and equity in the Code. In enacting §305(c), Congress sought to prevent corporate use of preferred stock to achieve the results that §1272 had eliminated for bonds. In effect, Congress grafted interest rules onto equity instruments. A shareholder owning preferred stock purchased at a discount has equity in a corporation subject to the varying fortunes of its business. Nevertheless, this equity participant is deemed to have received a distribution each year without regard to the fluctuations in the company's net worth.

Section 305(c) authorizes the IRS to promulgate regulations under which a redemption premium will be deemed a distribution on preferred stock. Before their revision in December 1995, the regulations issued pursuant to §305(c) provided that, if a corporation issued preferred stock which could be redeemed after a specified period of time at a price higher than the issue price, the difference would be considered a distribution of additional stock on preferred stock, which is constructively received by the shareholder over the period of time during which the preferred stock could not be called for redemption.[179]

The general rule, however, did not apply to the extent that the redemption price represented a reasonable call premium, as opposed to a substitute for dividends. A redemption premium was considered reasonable (a) if it was in the nature of a penalty for a premature redemption of the preferred stock and (b) if such premium did not exceed the amount the corporation would be required to pay for the right to make such a premature redemption under market conditions existing at the time of the issuance. Such amounts could be established by comparing call premium rights on comparable stock and comparable dividends. The regulations recognized that such a test was subjective, and provided a safe harbor rule. Under the former regulations, a redemption premium not in excess of 10% of the issue price on stock, which was not redeemable for five years from the date of issue, was considered reasonable.[180]

The determination as to whether a redemption premium which did not fall within the safe harbor rule was reasonable depended upon all the facts and circumstances surrounding the instrument. In one case, convertible preferred stock was issued in a reorganization with an issue price of $6 and a redemption price initially set at $11 five years later (an 83% redemption premium). However, the terms of the convertible preferred stock provided that the shares could not be redeemed, unless the fair market value of the common stock into which the preferred was convertible was at least 25% higher than the redemption price. The IRS concluded that most shareholders would convert their shares, rather than permit them to be redeemed, and that the higher redemption premium was in fact a penalty. Accordingly, it ruled that §305(c), and consequently §305(b)(4), did not apply to the transaction.[181]

[178] 1977-1 C.B. 85.

[179] *See* former Reg. §1.305-5(b)(1).

[180] *See* former Reg. §1.305-5(b)(2). *See also* PLR 8753005 (redemption premium considered reasonable under safe harbor rules in former Reg. §1.305-5(b)(2) was considered reasonable redemption premium for purposes of §1504(a)(4)(C)). In CCA 201152016, the Chief Counsel's Office advised that because the safe harbor rules under former Reg. §1.305-5(b)(2) no longer exist, the safe harbor standard no longer applies for purposes of §1504(a)(4)(C).

[181] Rev. Rul. 75-179, 1975-1 C.B. 103, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388. In PLR 8338001, a 60% redemption premium was ruled to be reasonable under the circumstances of the ruling.

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In another ruling, the IRS concluded that a redemption premium in excess of 10%, which was not bargained for, and which was not intended to exceed the amount of a typical call premium, was reasonable. Under those circumstances, the fair market value of the stock of the target corporation was $20 per share. Pursuant to the agreement of merger, each share of the target company was exchanged for one share of preferred stock of the acquiring company which could be redeemed at $21 per share beginning five years after the reorganization. Between the shareholders' meetings and the consummation of the reorganization, the share price of the target company fell to $18 per share. Thus, the redemption premium at the time the preferred shares were issued was approximately 16%. Nevertheless, the IRS concluded that the redemption premium was reasonable, and §305(b)(4) and §305(c) did not apply.[182]

The IRS reached a similar conclusion in Rev. Rul. 81-190.[183] In that ruling, two widely held corporations were engaged in similar lines of business. The acquiring corporation (X) decided to acquire the outstanding stock of the target (T), so that T would become a subsidiary of X. T's management refused to endorse an exchange in which T shareholders would receive X common stock. Accordingly, X issued a new class of $100 par value nonvoting 18% noncumulative, nonconvertible, nonputtable preferred stock, callable by X at a price of $110 per share at any time after five years from the date of issuance. At the time the agreement was entered into, the fair market value of the preferred stock was $100 per share, and it was reasonably estimated that the stock would have a fair market value of at least $100 per share at the time of its issuance. However, an unforeseen event occurred which reduced the market value of X's preferred stock. The actual fair market value of such stock on its issue date was $91 per share. Thus, the difference between the redemption price and the issue price was approximately 21%. Notwithstanding that the parties could have taken into account that unforeseen circumstances between entering into the agreement and consummating the transaction would have changed the redemption premium, because the redemption premium was initially set at the maximum safe harbor rate, the IRS concluded that the redemption premium was reasonable.

While the former regulations did not expressly define the term "issue price," examples in the regulations implied that the term meant either the price paid for newly issued preferred stock, or the fair market value of preferred stock after its issuance.[184]

In Rev. Rul. 75-179 and 75-468, discussed above, the issue price of preferred stock, issued in connection with the reorganization, was found to be the value of the common stock surrendered in the reorganization exchange. The rulings also demonstrate some flexibility in determining the date on which the value of the consideration received is to be measured. In Rev. Rul. 75-179, the closing date of the exchange was used, while in Rev. Rul. 75-468, the date of the approval of the merger by the shareholders of the target corporation was used.

[182] Rev. Rul. 75-468, 1975-2 C.B. 115, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388.

[183] 1981-2 C.B. 84, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388.

[184] Former Reg. §1.305-5(d) *Exs.* (4), (5) and (7).

Former Reg. §1.305-5(d) provided an example in which a corporation distributed newly authorized preferred stock to its common shareholders. The preferred stock had a face value of $100 value per share, and was redeemable at the end of five years for $105. The example states that, at the time of distribution, the fair market value of the preferred stock was $50 per share. Since there were no facts to indicate that a call premium in excess of $5 per share was reasonable, the difference between the redemption price and the fair market value exceeded a reasonable call premium by $50. Accordingly, each stockholder was deemed to have received a distribution of $10 per share on his preferred stock each year for five years.[185]

Before the 1990 RRA, the entire redemption premium was not the measure of a deemed distribution. Rather, the difference between the redemption premium and a reasonable call premium was considered a distribution of additional stock. For example, if preferred stock issued at $100 per share is redeemable in five years for $185, and a reasonable call premium is $10, only $75 is deemed to be a distribution of additional stock, constructively received over a five-year period.[186]

Before the effective date of the 1990 RRA changes, such a distribution was deemed to be constructively received on the last day of each taxable year during the period.[187] Such timing was important in determining whether or not a shareholder had underpaid estimated income tax for the year he was deemed to have received the distribution.

When preferred stock was immediately redeemable, the IRS ruled that an unreasonable redemption premium analysis was inappropriate. The IRS found that in a situation where a corporation has a right to redeem the preferred stock at any time, the premium exists to compensate the investor for the loss of the income the investor would have earned from the stock had it not been redeemed (and is, therefore, in the nature of a penalty). According to the IRS, it is in those cases where the issuing corporation has no right to redeem for a specified period of time, that the premium may represent disguised dividends not paid that are being accumulated and distributed to the shareholder on redemption to be taxed at capital gains rates.[188]

2. After the 1990 RRA

The 1990 RRA modified §305(c) to provide that, generally, the entire amount of a redemption premium on certain preferred stock is treated as being distributed to the holders of such preferred stock on an economic accrual basis over the period that the stock is outstanding (the "Economic Accrual Rule"). A deemed distribution arising by virtue of §305(c) may then be considered an actual distribution on preferred stock triggering application of §305(b)(4). Stock will generally be considered to have a redemption premium for this purpose, if its redemption price at maturity exceeds the issue price by an amount that equals or exceeds the product of: (a) one-quarter of 1% of the redemption price and (b) the number of complete years to maturity (the "OID De Minimis Rule").[189]

[185] Former Reg. §1.305-5(d) *Ex.* (7).

[186] Former Reg. §1.305-5(d) *Ex.* (5).

[187] *Id.*

[188] TAM 8430002.

[189] §305(c)(1) and Reg. §1.305-5(b)(1).

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Example: As an illustration of the OID De Minimis Rule, assume X corporation (X) issues preferred stock at a price of $1,000 per share. X is required to redeem the preferred stock on the sixth anniversary of its issuance for $1,500 per share. The $500 premium is unreasonable since it exceeds $22.50 ($1,500 × .0025 × 6). A premium of $15 would be reasonable since such amount is less than $15.23 ($1,015 × .0025 × 6). The result would apparently be the same if the redemption date were after the sixth anniversary but before the seventh anniversary of issuance. Similarly, the result would be the same if the holder of the stock had a put option beginning on the sixth anniversary of the date of issuance.

Example: As an illustration of the Economic Accrual Rule, assume Y corporation (Y) issues preferred stock for $1,250 per share. Y is required to redeem the preferred stock on the sixth anniversary of its issuance for $1,600 per share. The premium is not reasonable under the OID De Minimis Rule. The instrument has a yield to maturity of 4.16% compounded semiannually. The holder of the stock is required to include in gross income the daily portions of the premium during the first six-month accrual period after he acquires the stock. Such amount is calculated as follows:

($1,250 × .0416) ÷ 2 = $26

$26 ÷ 180 = $0.14

Similarly, during the second accrual period the daily portion would be calculated as follows:

($1,276 × .0416) ÷ 2 = $26.54

$26.54 ÷ 180 = $0.15

Note: The foregoing example uses six-month accrual periods, which is the standard accrual period set forth in §1272(a)(5) for the accrual of OID and, accordingly, the period that may be used for §305(c) purposes. However, since §1272(a)(5) also authorizes the issuance of regulations providing for other accrual periods, and Reg. §1.1272-1(b)(1)(ii) allows for use of accrual periods of any length not exceeding 12 months, a corporation is not required to use six-month periods for §305(c) purposes but may use other, more convenient periods if it so chooses.[190]

The Economic Accrual Rule and the OID De Minimis Rule apply to preferred stock that is subject to a mandatory redemption, or that is puttable by the holder of such stock. The redemption premium on preferred stock that is subject to a mandatory redemption or that is puttable will not fail to be subject to the Economic Accrual Rule and the OID De Minimis Rule merely because the stock is also callable at the issuer's option.[191] Moreover, Congress directed Treasury to provide regulations consistent with the original issue discount rules in order to determine the maturity date and price of puttable preferred stock. For example, the holder of a debt instrument with a put option that was issued for cash or publicly traded property will be presumed to exercise such option if the total yield on the instrument determined, assuming that the holder exercises the put option, exceeds the total yield on the instrument determined, assuming that the holder does not exercise the option.[192]

Note: Despite the congressional directive to issue regulations concerning maturity date and price of puttable preferred stock, the final regulations implementing the 1990 RRA changes, Reg. §1.305-5(b)(1), simply takes the general approach that application of the Economic Accrual Rule — whether to puttable preferred stock, or to mandatorily redeemable preferred stock — should be consistent with the OID principles of §1272(a).

The OID De Minimis Rule does not apply to preferred stock that is callable solely at the option of the issuer (unless the stock is subject to a mandatory redemption, or is puttable).[193] The original House Report accompanying the 1999 RRA provided that the Economic Accrual Rule was intended to apply to the entire call premium on such stock, if such premium was considered to be unreasonable under regulations in effect without regard to the changes made by the 1990 RRA.[194] In such cases, except as provided in regulations, the entire call premium was directed to be accrued over the period of time during which the preferred stock could not have been called for redemption.[195] Subsequently, regulations were issued providing that the Economic Accrual Rule applies to the call premium if, as of the issue date, redemption pursuant to the call right is more likely than not to occur.[196] Further, the regulations currently provide that, even if redemption is more likely than not to occur, the Economic Accrual Rule will not apply if the premium is solely in the nature of a penalty for premature redemption.[197]

Note: Reg. §1.305-5(e), which sets forth effective dates for the 1990 RRA changes implemented by the regulations, limits application of the statutory changes effectuated by the 1990 RRA (and, hence, any directives in the legislative history) to callable stock issued on or after October 10, 1990, and before December 20, 1995. The treatment of callable stock issued after December 19, 1995, is governed by the regulations finalized by T.D. 8643 and found at Reg. §1.305-5(b), which are analyzed below.

Stock that is subject to mandatory redemption (or is puttable) and is also callable should be tested under both rules. If one or more of the premiums is less than the amount considered de minimis under such tests, accrual would not be required for such premium or premiums. If more than one premium exceeds the applicable rule, the House Report directed that regulations are to provide for appropriate accrual methods.[198] The 1995 regulations provide guidance regarding multiple redemption possibilities. The put premium of a mandatory redemption is tested

[190] See Reg. §1.305-5(b)(1), providing for application of "principles similar to the principles of §1272(a)." For a detailed discussion, see 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments.*

[191] §305(c)(2).

[192] H.R. Rep. No. 881, 101st Cong., 2d Sess. 348 (1990). *Cf.* Reg. §1.1272-1(c)(5), §1.1272-1(j) *Exs.* (5)–(8).

[193] *Cf.* §305(c)(1), §305(c)(2). Nevertheless, Reg. §1.305-5(b)(1) may invoke the de minimis rules of §1273(a)(3).

[194] H.R. Rep. No. 881, 101st Cong., 2d Sess. 348 (1990); Reg. §1.305-5(e).

[195] §305(c)(2); H.R. Rep. No. 881, 101st Cong., 2d Sess. 348 (1990); Reg. §1.305-5(e).

[196] Reg. §1.305-5(b)(3)(i).

[197] *Id.*

[198] H.R. Rep. No. 881, 101st Cong., 2d Sess. 348 (1990).

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under the OID De Minimis Rule, while the call premium would be tested under Reg. §1.305-3(b)(2).[199]

Congress did not intend to limit the authority of the IRS regarding the proper treatment of redemption premiums on preferred stock. Accordingly, the IRS can determine exactly what constitutes a redemption premium, or a disguised redemption premium. Congress suggested that, if, at the time of the issuance of cumulative preferred stock, there is no intention for dividends to be paid currently, the IRS may treat such dividends as a disguised redemption premium. Similarly, the IRS may treat stock that, in form, is merely callable as being subject to mandatory redemption, or as a put based on the existence of other arrangements effectively requiring the issuer to redeem the stock.[200]

The Economic Accrual and OID De Minimis Rules apply to stock issued after October 9, 1990. Congress did not intend to limit the authority of the IRS to promulgate regulations relating to the accrual of redemption premiums on callable preferred stock. Nevertheless, Congress indicated that it expected such regulations to be prospective.[201]

The IRS issued final regulations in December 1995 implementing the 1990 RRA amendments.[202] The regulations are generally effective for preferred stock issued on or after December 20, 1995. However, the De Minimis and Economic Accrual Rules for puttable and mandatorily redeemable preferred stock, as statutorily prescribed in §305(c)(1), §305(c)(2) and §305(c)(3), apply in accordance with the 1990 RRA effective dates described above (i.e., most preferred stock issued after October 10, 1990). Also, as described above, the Economic Accrual Rules apply to "unreasonable" premiums on callable preferred stock issued between October 10, 1990, and December 20, 1995, which is not puttable or mandatorily redeemable.[203]

One major addition in the final regulations[204] is an anti-abuse rule that expands the definition of "issuer" to include certain third parties who may acquire the preferred stock if (1) the acquisition of the preferred stock by the third person would be treated as a redemption for federal income tax purposes (under §304 "or otherwise"), or (2) the issuer and the third person are members of the same affiliated group as defined in §1504(a) (except that §1504(b) does not apply) and a principal purpose for the third person's acquisition is to avoid the application of §305 and the regulations.[205] The anti-abuse rule does not cover acquisitions of preferred stock by unrelated parties that may occur in anticipation of the unrelated party becoming related to the issuer.[206] The preamble to the regulations provides, however, that an agreement or other arrangement for a person other than the issuer to acquire the preferred stock may constitute a conversion transaction under §1258.[207]

[199] Reg. §1.305-5(b)(4), §1.305-5(d) *Ex.* (7).

[200] *Id.*

[201] H.R. Rep. No. 881, 101st Cong., 2d Sess. 349. 1990 RRA §11322(a).

[202] T.D. 8643, 1996-1 C.B. 29, 60 Fed. Reg. 66,134 (Dec. 21, 1995).

[203] Reg. §1.305-5(e).

[204] T.D. 8643, 1996-1 C.B. 29, 60 Fed. Reg. 66,134 (Dec. 21, 1995).

[205] Reg. §1.305-5(b)(1).

[206] *See* Willens, *Final §305 Reg. Abate Constructive Dividend Dangers*, 10 Tax Notes 597 (Jan. 29, 1996).

[207] T.D. 8643, 1996-1 C.B. 29, 30.

With respect to preferred stock that is subject to mandatory redemption or is puttable, the final regulations follow the statutory language of §305(c)(1), §305(c)(2) and §305(c)(3) and 1990 RRA legislative history, providing for application of the Economic Accrual Rule to a more than de minimis redemption premium on such preferred stock.[208] However, the regulations provide an exception where the issuer's obligation to redeem, or the holder's put option is subject to a contingency that (1) is beyond the legal or practical control of either the holder or the holders treated as a group (or through a related party), and (2) renders remote the likelihood of redemption based on the facts and circumstances as of the issue date.[209] The preamble to the regulations gives as an example preferred stock that is mandatorily redeemable by the issuer in the event of an initial public offering ("IPO"), and provides that the regulations shall require evaluation of the likelihood of the occurrence of the IPO.[210] A contingency will not include the possibility of default, insolvency or similar circumstances, or that the redemption may be precluded by state law requirements regarding corporate capital.[211]

Reg. §1.305-5(b)(3) sets forth rules for callable preferred stock issued after December 19, 1995. The regulation provides for application of the Economic Accrual and De Minimis rules to such stock (even where the call is immediately exercisable), but only if, based on all the facts and circumstances at the issue date, redemption pursuant to the issuer's call right is more likely than not to occur. This is a change from prior law in which the test was more objective (no constructive distribution treatment if premium did not exceed 10% of issue price, and preferred stock not redeemable for five years). Similar to prior law, constructive distribution treatment will not apply, even if redemption is more likely than not, if the redemption premium is solely in the nature of a penalty for premature redemption. To qualify as a penalty, the payment of the premium must result from changes in economic or market conditions over which neither the issuer nor the holder has legal or practical control.[212]

The final regulations provide for a safe harbor from constructive distribution treatment that should apply to most publicly offered preferred stock that is callable by the issuer.[213] The safe harbor applies if (1) the issuer and holder are not related within the meaning of either §267(b) or §707(b), applying a more than 20% ownership threshold instead of a 50% threshold, (2) there are no plans, arrangements, or agreements that effectively require, or are intended to compel, the issuer to redeem the preferred stock, and (3) exercise of the redemption right would not reduce the yield of the preferred stock, as determined under OID principles. Failure to satisfy the safe harbor

[208] Reg. §1.305-5(b)(1), §1.305-5(b)(2). For §305(c) purposes, the Economic Accrual Rule is based on the principles of §1272(a), and the De Minimis Rule is to follow the principles of §1273(a)(3). For full analysis of the OID rules of §1272, §1273, §1274 and §1275, see 181 T.M., *Time Value of Money — Holders of Debt Instruments*, 535 T.M., *Time Value of Money: OID and Imputed Interest.*

[209] Reg. §1.305-5(b)(2).

[210] Preamble to T.D. 8643, 1996-1 C.B. 29, 30.

[211] *Id.*; Reg. §1.305-5(b)(2); a contingency also does not include an issuer's option to require earlier redemption of the stock.

[212] Reg. §1.305-5(b)(3)(i).

[213] Reg. §1.305-5(b)(3)(ii).

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does not affect the determination as to whether a redemption pursuant to a call right is more likely than not to occur.[214]

Example:[215] Corporation X (X), a domestic corporation with only common stock outstanding, issues 100 shares of 4% preferred stock to unrelated shareholders of Corporation T (T), pursuant to T's acquisition. The issue price of the X preferred stock is $40 per share and each share of X preferred stock is convertible at the election of the shareholder into three shares of X common stock. At the time the preferred stock is issued, the X common stock has a value of $10 per share. The X preferred stock has no mandatory redemption rights, or redemptions rights at the option of the holder, but it is callable, at X's option at any time beginning three years following its issuance, at $100 per share. There are no other plans, arrangements, or agreements that effectively require or are intended to compel X to redeem the preferred stock. The safe harbor applies here because (1) X and the former T stockholders are unrelated, (2) there are no plans, arrangements, and agreements that effectively require, or are intended to compel, X to redeem the stock, and (3) calling the stock for $100 would not reduce the yield on the X preferred. Therefore, the call premium of $60 on the X preferred stock is not subject to §305(c).

Reg. §1.305-5(b)(4) contains rules for coordinating multiple redemption provisions. The regulation states that if stock may be redeemed at more than one time, the time and price at which the redemption is most likely to occur must be determined, based on all the facts and circumstances as of the issue date, and the Economic Accrual Rule will be applied with respect to such time and price. The regulation then provides that if the redemption does not occur at the identified date, any additional premium payable on any later redemption date (to the extent not previously treated as distributed) is taken into account as a constructive distribution over the period from the missed call or put date to the later date, to the extent required by the OID De Minimis and Economic Accrual Rules.[216]

Example: Corporation Y has only one class of common stock outstanding. On January 1 of year 1 it issues 100 shares of 10% preferred stock to a holder who is unrelated to Y. The issue price of the preferred stock is $100 per share. It is callable at the option of Y on or before January 1 of year 5 at a price of $105 per share, plus any accrued but unpaid dividends. It must be redeemed on January 1, year 6, at $100 plus all accrued and unpaid dividend. The terms of the preferred stock provide that if Y fails to redeem the stock by January 1, year 5, the holder may appoint a majority of Y's directors. Based on all of the facts and circumstances as of the issue date, Y is likely to have the legal and financial capacity to redeem the stock. No other facts and circumstances would affect whether Y would redeem the preferred stock on or before January 1 of year 5. The change of control provision will likely result in a deemed distribution under Reg. §1.305-5(b)(1), because it is more likely than not that Y will exercise its call before January 1 of year 5. The safe harbor rule does not apply, because the change of control provision appears designed to require or compel Y to redeem the stock. The constructive distribution occurs over the period ending on January 1 of year 5. The redemption is most likely to occur on that date because it is the date which minimizes the return to the holder while preventing the change in control. The de minimis exception does not apply, because the $5 premium exceeds the amount determined under §1273(a)(3) principles (5 years × 0.25% × $105 = $1.31). Thus the entire $5 is treated as a constructive dividend received by the holder on an economic accrual basis over the five-year period.[217]

Example: Assume Y has only common stock outstanding until it issues 100 shares of 10% preferred stock to an unrelated holder, at an issue price of $100, on January 1 of year 1. The preferred stock is not callable for five years from the issue date. On January 1 of year 5, Y can call the stock at a price of $110 per share plus any accrued and unpaid dividend. The stock is also callable by Y on January 1 of year 6 at a price of $120 per share plus all accrued and unpaid dividends. Y must redeem the stock, on January 1 of year 8, at a price of $150 per share plus all accrued and unpaid dividends. No other plans or arrangements between Y and the holder affect the redemption of the stock, and no facts or circumstances, as of the issue date, affect whether Y would call the stock on January 1 of either year 5 or year 6.

The mandatory redemption of the stock on January 1 of year 8 subjects the stock to the rules of Reg. §1.305-5(b)(1) by virtue of Reg. §1.305-5(b)(2). Moreover, because Y may call the stock, on January 1 of year 5 or year 6, it is also covered under Reg. §1.305-5(b)(3). The safe harbor rule would not apply to the first call option because an exercise of that option would reduce the stock's yield when compared to the yield produced at the mandatory redemption date. The fact that the redemption on January 1 of year 5 produces the lowest yield on the stock indicates that such date is the most likely redemption date. The de minimis exception does not apply since the redemption premium on that date is in excess of the amount calculated under §1273(a)(3) principles (5 × 0.25% × $110 = $1.38). Thus, the entire $10 premium is included in the holder's income as a constructive distribution over the five-year period on an economic accrual basis. If Y does not call the stock on January 1 of year 5, the additional $10 of redemption premium would be included in the holder's income over the next year on an economic accrual basis. If Y does not call the stock on January 1 of year 6, then the additional premium of $30 must be included in the holder's income, over

[214] Reg. §1.305-5(b)(3)(iii).

[215] Reg. §1.305-5(d) *Ex.* (4).

[216] Reg. §1.305-5(b)(4), §1.305-5(d) *Ex.* (7).

[217] *See* Reg. §1.305-5(d) *Ex.* (5).

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the remaining three years, until the mandatory call on an economic accrual basis.[218]

The regulations also provide a consistency similar to the issuer-holder consistency rule under the contingent payment debt instrument regulations.[219] The issuer's determination as to whether a constructive distribution has occurred is binding on all holders of the preferred stock, except for a holder who discloses a different determination on a federal income tax return for the year in which the preferred stock is acquired. Such a disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the year in which the holder acquired the stock.[220]

Accruing Dividends: If preferred stock provides for a dividend that accrues periodically but does not become payable until declared by the corporation's board of directors, the dividend should not be includible in the shareholder's income until at least declared by the board.[221] Preferred stock issued by publicly traded companies is ordinarily issued when the corporation fully expects to pay the accruing dividend. However, in early-stage companies requiring private capital, it is common for a preferred instrument to provide for an accruing dividend that does not become payable until declared by the corporation's board. To the extent dividends are not paid, they are typically added to the stock's liquidation preference. In this manner, investors can attempt to realize the value of the accruing dividend as a capital gain on exit from the investment, either by a conversion to common stock (and subsequent sale) or upon a redemption of the preferred stock. Preferred stock issued by public companies is frequently not convertible to common (consequently, there is not the same opportunity for an accruing, undeclared dividend to be converted to capital gain), whereas, in a start-up setting, the preferred stock typically is convertible, thereby providing an opportunity for the undeclared dividends to be recovered by factoring them into the conversion ratio.

The redemption premium rules of §305(c) and Reg. §1.305-5(b) could be read to encompass accruing dividends. Indeed, it could be said that Congress had in mind accruing dividends when it passed §305(c) in the 1990 RRA. The House Conference Report states:

> There is no intention to limit the present-law authority of the Secretary and the IRS regarding the proper treatment of redemption premiums on preferred stock. Thus, the Secretary may determine what constitutes a redemption premium (or a disguised redemption premium). For example, if at the time of issuance of cumulative preferred stock there is no intention for dividends to be paid currently, the IRS may treat such dividends as a disguised redemption premium.[222]

Nevertheless, the 1995 regulations failed to address accruing dividends. The preamble to the 1995 regulations explicitly provided that "[t]he preamble to the proposed regulations requested comments on the appropriate treatment of unpaid cumulative dividends. Because of the complexity of this issue, the final regulations do not provide rules for those dividends. The IRS and Treasury will continue to consider the issue … ."[223]

In addition to using the redemption premium rules to attack accruing dividends, the IRS could attempt to find a constructive distribution by way of a change in redemption price or a change in conversion ratio. Indeed, this was the position taken for a preferred stock instrument issued even before the effective date of the 1990 RRA. In a 1992 Field Service Advisory, the IRS treated the daily, ratable increases in the redemption price of preferred stock as deemed dividends under §305(c).[224] The IRS's position was, in essence, that the change in redemption price resulted in an increase in the shareholder's proportionate interest of the issuing corporation.[225] In a recapitalization setting, Reg. §1.305-7(c)(1)(ii)[226] finds a deemed stock distribution results by virtue of §305(c) if a holder of preferred stock with dividends in arrears exchanges his stock for other stock and, as a result, the holder increases his proportionate interest in the assets or earnings and profits of the corporation.[227] In CCA 201152016, the Chief Counsel's Office advised that the payment of accumulated dividends on the redemption of preferred stock, where the holders had a legal right to the accumulated dividends on redemption under the corporation's governing documents, did not represent a redemption premium under §1504(a)(4)(C). Instead, the Chief Counsel's Office found that the accruing dividends were required to be reported currently as distributions pursuant to §305(b)(4) and §305(c). Although the term "redemption premium" is used in both §305(c) and §1504(a)(4)(C), the Chief Counsel's Office concluded that the provisions are not interrelated and that there is no legislative history indicating that the usage of the term in each of these sections was intended to represent the same meaning.

[218] *See* Reg. §1.305-5(d) *Ex.* (7). For a discussion of redemption premiums before the effective date of the 1990 RRA's changes to §305 and the changes to Reg. §1.305-5 and §1.305-7 by T.D. 8643, 1996-1 C.B. 29, as well as an analysis of the economic accrual rules, see III.H., below.

[219] Reg. §1.305-5(b)(5). *Cf.* Reg. §1.1275-4(b)(4)(iv).

[220] Reg. §1.305-5(b)(5).

[221] Reg. §1.301-1(c); Rev. Rul. 69-131, (*distinguished by* FSA 1992 WL 1355090 (Feb. 19, 1992)).

[222] H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. 1095.

[223] T.D. 8643, 1996-1 C.B. 29.

[224] 1992 WL 1355090 (Feb. 19, 1992).

[225] For further analysis of this Field Service Advisory, see Furci and Schnabel, *Convertible Preferred Stock Investments By Private Funds*, 588 PLI/Tax 429 (October-November 2003).

[226] *See also* Prop. Reg. §1.305-7(d)(1)(ii), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016).

[227] *See* Reg. §1.305-5(d) *Ex.* (1).

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I. Miscellaneous Issues

1. Tracking Stock

In the 1980s and 1990s, a number of corporations issued what has become known as tracking stock. Such stock bears dividends and is entitled to liquidation proceeds, in whole or in part, in relation to the performance of a specific division or subsidiary of a company.[228]

In its simplest form, tracking stock is essentially a type of common stock. It "tracks" the performance of a specific division or subsidiary so that the holders of the tracking stock receive all or a designated portion of the earnings of a specific division. The holders of the tracking stock may or may not share in the earnings of the other division (or divisions) of the company. Tracking stock may also include specific provisions regarding the right to elect directors, the right to approve certain transactions, or the right to veto other transactions. For example, the holders of tracking stock might have the specific right to elect all of the directors of a specific subsidiary of a corporation. Similarly, the sale of substantially all of the assets of a specific division or subsidiary might require the affirmative vote of a majority or supermajority of the tracking stock shareholders. Such shareholders might also have the ability to block a reorganization of the entire company. Taken to its extreme, the tracking stock shareholders could have the right to prevent the corporation from incurring debt or liabilities in the other division which would adversely affect the tracking stock division or subsidiary.

As discussed below, the greater the rights of the tracking stock shareholders vis-à-vis the shareholders of the other class or classes of stock, the more likely it is that the IRS could successfully treat a transaction involving the issuance of tracking stock as a taxable event.[229]

Two of the more well-known instances of the use of tracking stock involved General Motors Corporation and U.S. Steel Corporation. General Motors issued in 1984 its Class E stock in connection with its acquisition of Electronic Data Systems ("EDS"). In that case, the GM Class "E" stock was designed to track the performance of EDS as a subsidiary of General Motors. Similarly, General Motors issued Class H stock to track the performance of Hughes Aircraft. In both of those cases, it appeared that tracking stock was used, among other things, to resolve disputes over the value of the targets. Moreover, and perhaps more importantly, the separate classes of alphabet-type stock allowed the markets to independently value separate lines of business of the company. Thus, if the market perceived that the fortunes of the automobile business were not as bright as the aircraft business or the data service business, the stock prices of the E and/or H class stock could rise (or rise more quickly) than the common stock. If tracking stock had not been used, even stellar results of the aircraft or data services businesses could presumably have been buried among the larger lines of business of the company and not been fairly reflected in its stock price. From the shareholders' point of view, this presented the best of both worlds. They received stock which could more directly reflect the fortunes of specific lines of business, but which also carried the right to be converted into common stock of GM.

Several years later, U.S. Steel undertook a similar transaction. In that case, U.S. Steel was operating two separate and distinct lines of business, one as a steel manufacturer and another as an oil company (Marathon Oil Company). Again, there was a perception, if not the reality, that the steel business was growing at a much slower rate than the oil business. Accordingly, some shareholders believed that they could maximize their value by splitting the stock into two separate classes of tracking stock. One class would track the performance of the steel operations exclusively while the second class would track the performance of the oil operations exclusively. Thus, the stock of the two divisions could trade independently and largely rise or fall on their own fortunes rather than being dragged down by a slower growing or depressed sister business. Moreover, each shareholder could decide whether to retain his interest in both businesses, or dispose of his interest in one line without also disposing of his interest in the other line.

Still later, AT&T focused on using tracking stock to unlock the value of its wireless division. The AT&T wireless stock tracked the wireless group which had $7.6 billion in revenue in 1999. In 2002, Loews Corporation issued its Carolina Group tracking stock (which included Loew's interest in Lorillard, Inc.). An excerpt from various prospectuses which Loews Corporation filed with the Securities and Exchange Commission describing its view on the U.S. federal tax considerations of the tracking stock is included in the Worksheets. Loews later spun off Lorillard to its shareholders and ended the existence of the tracking stock. Liberty Media Corp. was very active in the creation of tracking stock (for Liberty Interactive, Liberty Capital, Liberty Starz, and Liberty Entertainment); however, none remained outstanding at the time of the publication of this portfolio.

The issuance of tracking stock requires separate audited financial statements for the tracked business even though the issuer maintains that the tracking stock is stock of the issuing corporation. By virtue of separate accounting for the tracked business, there is no chance for creating distortions brought about by income from one business artificially offsetting losses from another business. The calculation of the earnings per share of the respective companies can become particularly troublesome when tracking stock is outstanding.[230]

a. Distribution of Tracking Stock as a Substitute for a Spinoff

In 1997, Congress repealed the Morris Trust Doctrine.[231] That doctrine, dating back to the case of *Morris Trust v. Commissioner*,[232] stood for the proposition that, a corporation could

[228] *See, e.g.*, General Motors Class E stock and Class H stock, and USX U.S. Steel stock and USX Marathon Oil stock. *See also* Diana, *Recent Transactions Involving Tracking Stock*, 37 Tax Mgmt. Memo. Spec. Ed.: Corp. Tax and Bus. Plan. Rev. S-44 (Mar. 18, 1996).

[229] The Clinton Administration's 1999 Budget Proposal to Congress proposed amending the Code to treat the distribution of tracking stock as a taxable event. *See RIA Federal Taxes Weekly Alert*, Vol. 45, No. 16 (Apr. 15, 1999).

[230] *See* Maddox, *Accounting For the Legal Fiction Called Tracking Stock*, Management Accounting Quarterly (Summer 2003).

[231] §355(e) as enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

[232] 367 F.2d 794 (4th Cir. 1966), aff'g 42 T.C. 779 (1964).

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spin off, on a tax-free basis, one division (the "Unwanted Assets") and, thereafter, the remaining assets (the "Wanted Assets") could be acquired by another corporation in a tax-free reorganization. Congress perceived that in light of the repeal of the General Utilities Doctrine, such a transaction amounted to an end run around the general rule requiring a corporation to pay tax on a distribution of appreciated assets.

Long before Congress set its sights on the Morris Trust Doctrine, sophisticated practitioners used tracking stock to engage in a "virtual spinoff," when an actual spinoff was impossible for tax reasons or impractical for business reasons. Section 355(d) curtailed these transactions by requiring a distributing corporation to recognize gain on the distribution of appreciated stock or securities of a controlled corporation in a disqualified distribution. A disqualified distribution is one in which, immediately after the transaction, any person holds a 50% or greater interest (by vote or value) in either the distributing or controlled corporation consisting of stock purchased within a five-year period ending on the date of the distribution. The running of the five-year period is suspended by §355(d)(6) for any period in which the holder's risk of loss with respect to the stock or securities is substantially diminished by, among other things, a "special class of stock."[233] The regulations define the term "special class of stock" to include a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to earnings, assets, or attributes of less than all of the assets or activities of a corporation or any of its subsidiaries. Tracking stock is specifically identified as an example of such a special class of stock.

b. Economic Distinction Between a Spinoff and a Distribution of a New Class or Tracking Stock

There is a fundamental economic difference between the distribution by a corporation of the actual stock of a controlled subsidiary (i.e., a classic spinoff) and the distribution of tracking stock, which completely and exclusively reflects the results of that same line of business. In a true spinoff, the two businesses wind up completely separate. Day-to-day management will generally have little or no overlap and it is likely that there will be little overlap on the boards of directors. More importantly, as separate legal entities without a common bond, the fortunes of one company will not have any impact on the fortunes of the other company. For example, if U.S. Steel had spun-off Marathon Oil, a depressed steel market or a high debt ratio in the steel business could not have had any adverse impact on the stock price of Marathon Oil.

Unlike a complete separation of two corporate entities in a true spinoff, the distribution of tracking stock in a "virtual spinoff" results, of necessity, in continuing economic ties. While it is possible to completely separate management and even to have separate boards running the different lines of business, it is very difficult to divorce the economic fortunes of the two businesses. Tracking stock is, under state law, stock of the issuing, parent corporation. The tax opinions filed with the SEC in connection with the registration of tracking stock similarly take the position that tracking stock is stock of the parent for federal income tax purposes.

[233] Reg. §1.355-6(e)(5)(iv).

Secured creditors can be limited to specific assets but general creditors cannot be limited in their pursuit of corporate assets. For example, one bank could provide a line of credit to one line of business, wherein the terms would only allow the bank to recover proceeds from sales of assets held by the specific division to which it lent funds, and a second bank could have the same arrangement with the other line of business. This limitation on the lender's recourse is effectuated by contract. General unsecured creditors would not be so limited because they would not have contractually agreed to limited recourse. Using U.S. Steel as an example, if the steel business fell on particularly hard times, its general creditors could reach the assets of the oil division. Of course, creative structuring could limit those opportunities. If the parent became a pure holding company that had no liabilities of its own but simply owned two separate and distinct subsidiaries, one engaged in one line of business and the other engaged in a different line of business, the corporate veil would keep the creditors separated. Thus, unless the parent was somehow responsible for the debts of one of the subsidiaries as a result of guarantees, or a piercing of the corporate veil, the line between the true spinoff and the virtual spinoff would become much less clear.

c. Tax Consequences of Distributions of Tracking Stock/IRS Stance

A pro rata distribution of tracking stock raises two fundamental questions. The first threshold issue is whether there has been a distribution of stock of the issuing corporation at all. Where the stock only partially tracks the operations of a division or subsidiary, it is difficult to see how such stock could be classified as anything other than stock of the issuing corporation. In essence, it is simply a form of participating preferred stock. Where the stock directly and exclusively tracks the operations of a division of the company, the profits and assets of such division are clearly subject to the risks of the other divisions of the company. Again, it is unlikely that such stock could be treated as something other than stock of the issuing corporation. Where the stock wholly tracks the operations of a subsidiary, and neither the stock nor the assets of that subsidiary are subject to the risks of any other line of business of the parent, it is conceivable that the IRS could successfully argue that, in effect, the parent corporation has distributed stock of the subsidiary. Moreover, the greater the rights of the tracking shareholders to exclusively control that line of business, the easier the IRS's argument becomes.

It would appear, however, that the IRS would find that tracking stock represents stock of the parent corporation.[234] In spite of the IRS's no-ruling policy with respect to tracking stock discussed below, several taxpayers have received rulings relating to tracking stock where the taxpayers made representations that the tracking stock qualified as stock of the issuer.[235] Although there is very little case law or other authority addressing the proper tax treatment of tracking stock, the analogies that exist would tend to support the characterization of tracking

[234] In PLR 8817007, a merger was approved which provided for the issuance of tracking stock. The IRS later withdrew this ruling in PLR 8844038.

[235] *See* PLR 200229015, PLR 200212012, PLR 200131003, PLR 9826030, PLR 9802048, PLR 9637043, PLR 9625038, PLR 9624049.

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stock as being stock of the issuing corporation.[236] However, if the IRS were to determine that the stock was in reality stock of a subsidiary, §305(a) would not apply. In Rev. Rul. 80-292,[237] the IRS ruled that the distribution, by a subsidiary, of rights to acquire stock in the subsidiary to the shareholders of the parent corporation was in reality a §305(a) tax-free distribution to the parent followed by a taxable distribution of such rights in the subsidiary, by the parent to its shareholders. Consider further whether regulations issued under §337(d), which directs the Treasury to promulgate regulations to prevent the circumvention of the repeal of the General Utilities Doctrine, apply to such a distribution.[238]

The second threshold question, which also arises under §305, is whether tracking stock is preferred stock. Reg. §1.305-5(a) states:

> The term "preferred stock" generally refers to stock which, in relation to other classes of stock outstanding enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of "preferred stock" for the purposes of §305(b)(4) is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in corporate growth to any significant extent.[239]

Furthermore, stock which has a priority as to dividends and on liquidation, but is still entitled to participate above such priority, may nevertheless be treated as preferred stock under §305 if, based on all the facts and circumstances, it is reasonable to anticipate at the time the distribution is made that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest.[240] It is possible to view a class of tracking stock as preferred in relation to another class of stock. To the extent that the tracking stock participates in growth of one segment of the corporation, it looks like common stock. To the extent it does not participate in another segment, however, because the tracking stock does not suffer the adverse effects of that other segment's poor performance, the tracking stock looks like preferred stock. The IRS has declined to characterize tracking stock.[241] The characterization of tracking stock as common or preferred will obviously affect both (i) distributions with respect to such stock, and (ii) the issue as to whether, in the context of a stock distribution, some shareholders have received common stock while others have received preferred stock. For a more detailed discussion of whether a given class of stock is common stock, or other than common stock, see IV.B.3., below.

Section 305(a) provides the general rule that a distribution of a corporation's stock to its shareholders with respect to its stock is generally not a taxable event. Section 305(b) recites several exceptions to that general rule, including §305(b)(3), which states that if a distribution results in the receipt of preferred stock by some common shareholders, and the receipt of common stock by other common shareholders, the distribution is taxable under §301. Assuming that tracking stock is common stock of the issuing corporation, a pro rata distribution of such stock to all common shareholders should not run afoul of §305(b)(3).

A second exception to the general nontaxability rule of §305 is contained in §305(b)(4). That section provides that a distribution with respect to preferred stock, other than an increase in the conversion ratio of convertible preferred stock made solely to take account of a stock dividend or stock split with respect to the stock, and to which such convertible stock is convertible, is taxable under §301. Thus, the distribution of tracking stock to preferred shareholders would be taxable under §301. Similarly, if the tracking stock is preferred stock, a stock distribution, with respect to the tracking stock, could be taxable as a result of §305(b)(4).

d. Recapitalizations Using Tracking Stock

While a pro rata spinoff under §355 is analogous to a pro rata distribution of tracking stock, a non-pro rata spinoff is analogous to a recapitalization. For example, assume a corporation is engaged in two lines of business, such as commercial aviation and the ownership and operation of hotels. It adopts a recapitalization plan whereby some of its shareholders elect to exchange their common stock for new Class A stock, which tracks the aviation division, while other shareholders elect to exchange their stock for new Class H stock, which tracks the hotel division. Under §1036, no gain or loss is recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation. Thus, under that section, the question becomes: is the tracking stock preferred stock? If the tracking stock is treated as preferred stock, §1036 will not protect the shareholder who exchanges common for tracking stock. On the other hand, if the tracking stock is viewed as common stock, §1036 will result in a nontaxable transaction.

Nevertheless, it is not necessary to make that determination. The recapitalization could just as easily be undertaken under §368(a)(1)(E). In the reorganization context, shareholders can exchange common stock for preferred stock. Thus, the

[236] *See Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), rev'g 41 T.C. 386; *Union Trusteed Funds, Inc. v. Commissioner*, 8 T.C. 1133 (1947). Additionally, see the discussion in the prospectuses included in the Worksheets. To the contrary, see Rev. Rul. 54-65, 1954-1 C.B. 101.

[237] 1980-2 C.B. 104.

[238] *See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). *See also* H.R. Rep. No. 841, 99th Cong., 2d Sess. II-204 (1986). In 2018, the IRS issued final regulations under §337(d) affecting partnerships and their corporate partners. Reg. §1.337(d)-3; T.D. 9833, 83 Fed. Reg. 26,580 (June 8, 2018). *See also* REG-135671-17, 84 Fed. Reg. 11005 (Mar. 25, 2019), (proposing amendments to attribution rules to be used in applying regulatory limitations). These regulations require gain to be recognized upon a corporate partner's contribution of appreciated assets to a partnership that owns or acquires stock of the corporate partner, and in certain circumstances, again upon the distribution of such stock to the corporate partner. *See* 784 T.M., *Corporate Liquidations*.

[239] Note the only statutory definition of preferred stock was enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, which added a new §351(g)(3)(A). That section provides: "The term 'preferred stock' means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent."

[240] Reg. §1.305-5(a).

[241] See PLR 200314018, referencing the "no rule" revenue procedure Rev. Proc. 2002-3, §4.02(1) and §3.01(57). For the current statement of the no-rule position, see Rev. Proc. 2025-3, §3.01(143), §4.02(1).

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receipt of the tracking stock in exchange for common stock should be tax free. As noted above, however, it is possible that the IRS could attempt to attack such a transaction under its regulatory authority, pursuant to §337(d). Additionally, the stock would need to avoid being categorized as nonqualified preferred stock.[242]

e. Basis Considerations

A pro rata distribution of stock to which §305(a) applies is subject to the rules of §307. Under that section the shareholder's basis is allocated between the old stock and the new stock, under regulations which allocate the basis in accordance with the relative fair market values of the two classes of stock. Similarly, the recipient of the tracking stock in such a scenario would have a holding period which includes the holding period of the stock which was the subject of the distribution.

In the context of a recapitalization, §358 would provide for a carryover basis so that the recipient's basis in the tracking stock would be equal to his basis in the surrendered stock, decreased by the fair market value of any other property received, the amount of any money received, and the amount of any loss the taxpayer recognized on the exchange, and increased by any amount which was treated as a dividend, and the amount of any gain which the taxpayer recognized in connection with the exchange.[243] Thus, in the normal recapitalization, where no other property is transferred and no money is distributed, the taxpayer will have a pure carryover basis. Again, the taxpayer would have a tacked holding period.[244]

f. Potential §306 Taint

Where tracking stock is distributed tax-free under §305(a), it could constitute "Section 306 stock" if the tracking stock is treated as preferred stock. Thus, if the corporation had accumulated earnings and profits when the tracking stock was distributed, it could be tainted. In the context of a recapitalization, where the taxpayer completely surrenders common stock for the tracking stock, even if the tracking stock is preferred stock, it will not be treated as §306 stock.[245]

The principal effect of treatment as §306 stock is that some or all of the gain from disposition of the stock can be recharacterized as ordinary income.[246] As discussed in I.A., above, this will not be significant to most individual taxpayers during taxable years beginning after 2002, due to the absence of a rate differential between capital gains and dividends from domestic corporations and qualified foreign corporations. However, the recharacterization remains important to some taxpayers, such as corporations and individuals with capital losses or meaningful tax basis.

2. Fractional Shares

Fractional shares or script issued in conjunction with a stock distribution under §305 are treated in the same manner as distributions of full shares. However, where shareholders authorized fractional shares to be united and sold on their behalf, they recognized gain or loss on the sale of the fractional shares measured by reference to the basis allocated to such fractional shares.[247]

3. Recognition of Income by the Distributing Corporation

Section 311(a) provides that no gain or loss is recognized to a corporation on a nonliquidating distribution, with respect to its stock, of its stock or stock rights, or property. However, under §311(b), a corporation distributing appreciated property (other than an obligation of the corporation) will generally recognize gain on the property. Note that, pursuant to §317(a), the term "property" does not include stock, or rights to acquire the stock, of the distributing corporation. Thus, if the corporation distributes only its stock or rights to acquire its stock, it will not recognize income on the distribution. If it distributes appreciated property, however, it will generally recognize gain.[248]

The general rule of nontaxability is limited to distributions made by reason of the corporation-stockholder relationship. It does not apply to transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee, or vendee, if being a shareholder is merely incidental to the transaction. In such cases, one must look to other provisions of the Code to determine the taxable effects of the transaction.

The general nonrecognition rule of §311(a) applies to a distribution by a corporation, with respect to its stock, of its stock or of rights to acquire its stock, regardless of whether the distribution may be taxable to the shareholders under §305(b). However, the nonrecognition rule will not apply to a distribution by a corporation of rights to acquire stock in another corporation. For example, in Rev. Rul. 80-292,[249] a corporation distributed rights to acquire stock in such corporation to the shareholders of its parent corporation. The transaction was treated as a tax-free distribution by the subsidiary to its parent, under §305(a), followed by a distribution taxable under §301 by the parent to its shareholders. While pre-1986 TRA §311 would not have caused the parent to recognize gain, post-1986 TRA §311(b) would cause such gain to be recognized.[250]

4. Effect on Issuing Corporation's Earnings and Profits

Section 312(d)(1) provides, in general, that the distribution by a corporation of its stock or securities is not considered a distribution of earnings and profits if no gain is recognized to the shareholders, or if the distribution is not subject to tax by reason of §305(a). Thus, if such a distribution is taxable to the shareholders, it is to be treated as a distribution of the corporation's earnings and profits. Section 312(d)(2) provides that the term "stock or securities" includes rights to acquire stock or securities.

[242] *See* §354(a)(2)(C), §355(a)(3)(D).

[243] §358(a)(1).

[244] §1223(1).

[245] *See* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 59-84, 1959-1 C.B. 71.

[246] The tax treatment of dispositions of §306 stock is discussed in V., below.

[247] *See* Rev. Rul. 69-15, 1969-1 C.B. 95. *See also* Rev. Rul. 69-202, 1969-1 C.B. 95.

[248] §311(b)(1).

[249] 1980-2 C.B. 104.

[250] *See also* Rev. Rul. 70-521, 1970-2 C.B. 72, *distinguished by* GCM 36138; *Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980), rev'g and rem'g 71 T.C. 597 (1979), cert. denied, 450 U.S. 913 (1981).

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Where a shareholder receives a taxable stock dividend or taxable stock right, the amount of the distribution with respect to stock or rights is an amount equal to the fair market value of the stock or rights, and the fair market value is to be determined as of the date of distribution, without regard to whether such date is the same as that on which the distribution is includible in the income of the shareholders.[251]

Under Reg. §1.312-1(d), if a portion of a distribution of stock or stock rights is taxable under §305(b), the earnings and profits are to be reduced by the fair market value of the taxable portion of the distribution. Note, however, that this regulation does not specify the date on which such distribution is to be valued.

Comment: A corporation has generally two accounts that reflect its net worth, namely, capital (including capital in excess of par value) and earned surplus/retained earnings. These two accounts should reflect only what has actually been paid in as capital and the undistributed earnings and profits accumulated after organization of the corporation. A corporation does not sell its stock when the corporation issues a stock dividend or rights to acquire its stock, since it receives no consideration from the shareholders. Accordingly, there is no increase or decrease in the corporation's net worth upon the issuance of stock dividends or rights to acquire its stock, even though the distribution may result in taxable income to the shareholders, under §305(b). With respect to a distribution of stock as a dividend that is taxable to shareholders because of §305(b), it seems appropriate that there should be offsetting entries to the capital account and the earned surplus/retained earnings account, on the theory that some of the earnings and profits have been distributed to the shareholders and immediately reinvested in the corporation's capital stock.[252] Use of the fair market value of the stock on the distribution date is not unreasonable in making this adjustment.

The situation is not so easily resolved with respect to the issuance of stock rights that are taxable because of the provisions of §305(b), since the distribution date may not be the date when a shareholder has taxable income as the result of receiving stock rights. He may realize income only upon exercise or sale of the rights, in which case he realizes no income if he allows the rights to lapse. Thus, there is a question as to when to make the adjustments to the capital and surplus accounts of the corporation as the result of issuance of the rights. Should it be on the distribution date (which is the date that determines the fair market value to be used), or on the date a recipient shareholder exercises or sells the rights, or on the date rights are exercised by a buyer from the recipient shareholder? Furthermore, assuming that the adjustments are made on the distribution date, what adjustments must be made if some shareholders allow their rights to lapse?

While the regulations under §301 and §305 specify the date for valuing the rights for the purpose of determining the amount of the distribution,[253] they do not specify the time for making the adjustments necessary to reflect the distribution on the corporate books. Regulations under §306 seem to indicate the adjustment should be made on the distribution date.[254] These regulations point out that no stock may be §306 stock unless the distributing corporation has earnings and profits "at the time of distribution," and that rights to acquire stock are to be treated as "stock." Accordingly, the inference seems to be that if any adjustments are to be made to the capital and surplus accounts of the corporation, they are to be made at the time of issuance of rights, and that if some rights are not exercised, the adjusting entries made with respect to those rights should be reversed at the end of the period permitted for exercising the rights. As in the case of the distribution of stock, use of the fair market value of the rights on the date of distribution in adjusting the two accounts is a rational result. This procedure can be justified on the theory that earnings and profits have been distributed, and then reinvested in capital stock.

As stated above, a distribution of stock or stock rights does not reduce earnings and profits of a corporation if the distribution is not taxable to the shareholders. In two cases decided prior to the repeal of the bad debt reserve method for thrift institutions,[255] *United States v. Zions Savings and Loan Ass'n*[256] and *Buckeye Savings and Loan Co. v. United States*,[257] the courts held that a book transfer from the surplus and undivided profits account to the capital account, as the result of a stock dividend, reduced surplus, undivided profits, and reserves for the purpose of computing the allowable addition to the bad debt reserve under §593. In *Buckeye Savings and Loan Co.*, the Court of Claims said:

> Section 593 was enacted to permit savings institutions to accumulate liberal bad debt reserves without having to pay income taxes on reasonable amounts annually dedicated to that purpose. Whether a stock dividend reduces the "surplus, undivided profits, and reserves" of an incorporated savings and loan association under §593 is an entirely separate question from whether the same stock dividend reduces its "earnings and profits" under §312(d). A stock dividend can be recognized as reducing surplus for purposes of §593 without in any way impinging upon the statutory requirement that it shall not be recognized as a reduction of "earnings and profits" for purposes of §312(d). In the absence of specific congressional direction to the contrary, whether previous bona fide reductions of surplus by means of tax-free dividends were or were not taxed to their recipients

[251] Reg. §1.301-1(b), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(b)(1) in 1988. Before the IRS amended the regulations to reflect the statutory changes, former Reg. §1.301-1(d) specifically provided that the amount of distribution to be taken into account by a corporate shareholder included an amount equal to the fair market value of any property distributed that consisted stock or rights. The amendments to the regulations eliminated the distinction between distributions to corporate and noncorporate shareholders and, therefore, deleted former Reg. §1.301-1(d) as obsolete. However, the regulations do continue to generally provide that the amount of a distribution with respect to property is an amount equal to the fair market value of the property and that the fair market value of the property is to be determined as of the date of distribution.

[252] *See* the discussion at I.C., above.

[253] *See* Reg. §1.301-1(b), §1.305-1(b).

[254] *See* Reg. §1.306-3(a), §1.306-3(b).

[255] See the Small Business Job Protection Act of 1996 (1996 Small Business Act), Pub. L. No. 104-188, §1616, effective for tax years beginning after 1995. *See also* §593(f).

[256] 62-1 USTC ¶9316 (D. Utah 1962), aff'd, 313 F.2d 331 (10th Cir. 1963).

[257] 312 F.2d 912 (Ct. Cl. 1963).

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can have no effect on the fact of its actual reduction so far as §593 is concerned. Defendant's taxability test, *i.e.*, that distributions of surplus will be recognized only if taxed in the hands of the recipients thereof, therefore has no application to the determination of 'surplus, undivided profits, and reserves' in the case at bar.[258]

5. Deductibility of Costs Incurred by the Corporation

The IRS ruled, in Rev. Rul. 60-254,[259] that costs incurred by a corporation, in connection with the issuance of its capital stock or in payment of a stock dividend, are not deductible as ordinary and necessary business expenses under §162, since such costs are capital expenditures.

In *General Bancshares Corp. v. Commissioner*,[260] the taxpayer argued that the fact that this ruling was first published in 1960 showed that before 1960 the IRS had not challenged the deduction of such costs as ordinary and necessary business expenses. The IRS did not specifically deny this, but contended that this fact had no bearing upon the correctness of its position before the court that such expenses are not deductible. The Tax Court found that the case was one of first impression, upheld the IRS, and noted that it was immaterial that under federal law a nontaxable stock dividend did not reduce corporate earnings and profits. The opinion found that under applicable state law, earnings and profits were transferred to the capital account as the result of the stock dividend and became a part of the corporate stated capital. The Tax Court reached a similar conclusion in *United Industrial Corp. v. Commissioner*[261] The IRS continues to maintain that stock issuance costs are not deductible.[262]

6. Substance vs. Form Issues

Under the various Revenue Acts prior to the 1954 Code, the question of substance versus form was given consideration by the courts in cases where a decision had to be made as to whether a distribution by a corporation was a cash or a stock dividend. An example is where a cash distribution, or the declaration of a cash dividend, was tied in with an agreement among the shareholders to use the cash to buy additional stock in the corporation. The Tax Court usually took the position that an appropriate resolution by the board of directors was necessary in order to find a nontaxable stock dividend in lieu of a cash dividend. It reasoned that an agreement among the shareholders to use the cash to buy additional stock was a private arrangement which was not to be imputed to the corporation, or to be considered binding upon it, and that, therefore, the resolution to pay a cash dividend, with the understanding that it would be used to pay for new stock, did not amount to the declaration of a stock dividend.

A corporate resolution declaring a cash dividend gives rise to a presumption that a cash dividend was intended, but this might be refuted by a proper showing of all facts relating to a transaction. In some cases, the absence of a resolution expressly declaring a stock dividend was sometimes considered proof that the distribution was, in substance as well as in fact, a cash dividend. It is, of course, a question of fact to be decided upon the pertinent facts relating to each transaction, even though the form a transaction takes frequently determines its substance.[263]

In Rev. Rul. 67-402,[264] the IRS ruled that payment of a stock dividend to shareholder/employees in lieu of accrued salaries was taxable as compensation income in the amount of the fair market value of the stock.

7. Distributions Pursuant to Orders of the Securities and Exchange Commission

Former §1081, §1082, and §1083, and the applicable regulations, provided specific rules with respect to distributions of stock or stock rights, including rights to acquire stock in a corporation other than the one issuing the rights, where the distributions were made pursuant to orders of the Securities and Exchange Commission.[265] Unless both the purpose and the specific requirements of these sections were clearly met, the recognition of income upon such distributions were not postponed un-

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[258] *Id.*

[259] 1960-2 C.B. 42. *See also* Reg. §1.263(a)-5(a), T.D. 9107, 69 Fed. Reg. 435 (Jan. 5, 2004) (requiring capitalization of transaction costs that facilitate the restructuring or reorganization of a business entity or that facilitate a transaction involving the acquisition of capital).

[260] 39 T.C. 423 (1962), aff'd, 326 F.2d 712 (8th Cir. 1964), cert. denied, 379 U.S. 832 (1964).

[261] T.C. Memo 1962-280, aff'd, 331 F.2d 605 (6th Cir. 1964).

[262] TAM 200503026.

[263] Of interest in this area are the following cases: *United States v. Mellon*, 279 F. 910 (D. Pa. 1919), *aff'd*, 281 F. 645 (3d Cir. 1922); *United States v. Davison*, 1 F.2d 465 (W.D. Pa. 1924), aff'd, 9 F.2d 1022 (3d Cir. 1926), cert. denied, 271 U.S. 670 (1926); *Zellerbach v. Commissioner*, 2 B.T.A. 1076 (1925), nonacq., IV-2 C.B. 6; *Paul v. Commissioner*, 2 B.T.A. 150 (1925); *Hunt v. Commissioner*, 5 B.T.A. 356 (1926); *Michaels v. McLaughlin*, 20 F.2d 959 (N.D. Cal. 1927); *Luthe Hardware Co. v. Commissioner*, 6 B.T.A. 53 (1927); *Norvell v. Commissioner*, 6 B.T.A. 56 (1927), acq., VI-1 C.B. 4; *Wiess v. Commissioner*, 7 B.T.A. 467 (1927), acq., VII-1 C.B. 34; *Wright v. Commissioner*, 10 B.T.A. 806 (1928), acq., VII-2 C.B. 43; *Hull v. Commissioner*, 13 B.T.A. 299 (1928); *Teehan v. United States*, 25 F.2d 884 (D. Mass. 1928); *J.E. Brading v. Commissioner*, 17 B.T.A. 436 (1929); *Payne v. Commissioner*, 19 B.T.A. 1305 (1930); *Henry Vogt Mach. Co. v. United States*, 39 F.2d 986 (Ct. Cl. 1930), cert. denied, 282 U.S. 861 (1930); *Irving v. United States*, 44 F.2d 246 (Ct. Cl. 1930); *Smith v. Commissioner*, 21 B.T.A. 782 (1930); *Carlston v. Commissioner*, 22 B.T.A. 217 (1931), acq., X-2 C.B. 12 (1931); *Jackson v. Commissioner*, 51 F.2d 650 (3d Cir. 1931), *rev'g Crellin v. Commissioner*, 12 B.T.A. 234 (1928); *Alger-Sullivan Lumber Co. v. United States*, 57 F.2d 3 (5th Cir. 1932), rev'g and rem'g 20 B.T.A. 1109 (1930); *Deitz v. United States*, 6 F. Supp. 944 (D. W.Va. 1933); *Tillotson Mfg. Co. v. Commissioner*, 27 B.T.A. 913 (1933), *nonacq.*, XII-1 C.B. 23 (1933), *aff'd*, 76 F.2d 189 (6th Cir. 1935); *Gardner Governor Co. v. Commissioner*, 27 B.T.A. 1171 (1933), aff'd, 75 F.2d 38 (7th Cir. 1935), cert. denied, 295 U.S. 763 (1935); *Makransky v. Commissioner*, 35 B.T.A. 395 (1937); *Miller v. Commissioner*, B.T.A. Memo ¶38,348 (1938); *Indianapolis Glove Co. v. United States*, 96 F.2d 816 (7th Cir. 1938); *Robinette v. Commissioner*, 3 T.C.M. 398 (1944), aff'd, 148 F.2d 513 (9th Cir. 1945); *F. Brody & Sons Co. v. Commissioner*, 11 T.C. 298 (1948), acq., 1949-2 C.B. 1; *Maverick-Clarke Litho Co. v. Commissioner*, 11 T.C. 1087 (1948), acq., 1949-1 C.B. 3, aff'd, 180 F.2d 587 (5th Cir. 1950); *Lester Lumber Co., Inc. v. Commissioner*, 14 T.C. 255 (1950), rem'd pursuant to unpub. op. (4th Cir. May 19, 1950); *Schmitt v. Commissioner*, 20 T.C. 352 (1953), rev'd, 208 F.2d 819 (3d Cir. 1954); *Dietzsch v. United States*, 498 F.2d 1344 (Ct. Cl. 1974) (auto dealer was taxable on cash dividends despite being bound by agreement with corporation to buy stock of the corporation). *See also* Rev. Rul. 80-154, 1980-1 C.B. 68.

[264] 1967-2 C.B. 135.

[265] Former §1081, §1082, §1083, repealed by the 2005 Gulf Opportunity Zone Act (GOZA), Pub. L. No. 109-135, §402(a)(1), effective February 8, 2006. Former §1081, §1082, and §1083 continue to apply with respect to any transaction ordered in compliance with the 1935 Public Utility Holding Company Act (PUHCA), 49 Stat. 810, before its repeal by the 2005 Energy Policy Act, Pub. L. No. 109-58, effective February 8, 2006. 2005 GOZA, §402(m). *See* §3 of the 1935 PUHCA, 15 U.S.C. §79c.

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der these sections, in which event the rules pertaining to §305, §306, and §307 applied.

Where the distributions qualified as nontaxable under former §1081, §1082, and §1083, the cost basis of the stock with respect to which a distribution was made was required to be apportioned between the original stock held and the new stock or rights in proportion to their respective fair market values at the time of distribution of stock or as of the time of issuance of stock rights.[266]

8. Amount Included in Shareholder's Income

When a distribution of stock or stock rights is taxable under §305, the amount includible in the stockholder's income is determined under §301. That amount is the fair market value of the stock or rights on the date of distribution, irrespective as to whether the distributee is a corporate or noncorporate shareholder.[267] For this purpose, the date on which the distributee must include the amount in his taxable income is irrelevant.[268]

9. Mitigation of Effect of Statute of Limitations

Sections 1311 through 1314 are intended to prevent either the taxpayer or the government from taking advantage of an error made in a year against which the statute of limitations has run. Under §1312(7), an error in basis made in a prior barred year with respect to distributions of stock or stock rights may be corrected, provided the qualifications and provisions of these mitigation sections are met. The Senate Report on the 1954 Code[269] cites as an example the case of a taxable stock dividend which the taxpayer erroneously treated as nontaxable, and, accordingly, had made a reduction in the basis of the stock with respect to which the distribution had been made. In a later year, the taxpayer successfully asserted that he was entitled to the full basis for the old stock because the earlier treatment of the stock dividend was incorrect. Under these circumstances, the report says that §1311 is applicable, since the receipt of the stock dividend was erroneously treated as affecting the basis of the old stock and, further, that §1311 would also be applicable if the taxpayer had failed to include the stock dividend in gross income, whether or not he, in fact, made an adjustment to the basis of the old stock.[270]

10. Rights to Subscribe to Convertible Bonds

Neither §305 nor the regulations promulgated thereunder refer to rights to subscribe to corporate debt instruments. Moreover, such rights are not excluded from the term "property" in §317. Nevertheless, since it is difficult to draw a distinction between a right to subscribe to bonds, which are convertible into stock, and a right to subscribe to stock, the former should be considered in connection with §305.

The history of rights to subscribe to convertible bonds can be traced back to a case decided by the Board of Tax Appeals in 1932.[271] In that case, American Telephone and Telegraph Company and the Missouri Pacific Railroad Company issued rights to subscribe to bonds convertible into stock to their shareholders in 1929. Section 115(f) of the Revenue Act of 1928 stated that "a stock dividend shall not be subject to tax." The IRS treated the value of the subscription rights as a taxable dividend on the theory that they were issued for the purchase of bonds, not stock, at less than their fair market value, so that the taxpayer had received property which should be taxed as a dividend to the extent of its fair market value. The Board of Tax Appeals found that the rights were analogous to a stock dividend. Accordingly, they did not constitute gain, profit, or income taxable, without apportionment under the 16th Amendment, and that since there was no sale of the rights during the taxable year, there was no realization of income on which to levy the tax. The uncontroverted testimony in the case showed that the option given in the rights to convert the bonds into stock at less than prevailing market price was what made the rights valuable.

GCM 13275[272] states that "there is neither sound legal basis nor justification for maintaining a rule which results in different income tax treatment of rights to subscribe to new stock directly and rights to subscribe to bonds which are convertible into stock of the company at stipulated terms and within stated periods." In the GCM, the Chief Counsel's Office concludes that rights issued to shareholders to subscribe to bonds, which are convertible into stock, should be considered substantially the same as stock rights, and treated the same as stock rights are treated. Nevertheless, the Chief Counsel's Office goes on to state:

> In some exceptional cases conditions surrounding the issuance of bond rights, including terms of purchase and conversion, may so clearly indicate the use of this device as a means of effecting a distribution of earnings and profits as to justify treatment of a distribution of so-called "bond rights" in whole or in part as a dividend.[273]

Thus, the IRS's view seems to be that if all, or a portion, of the subscription rights are attributable to the bonds, such rights would not be analogous to a stock dividend, and, to that extent, would not come within the provisions of §305. Unfortunately, the IRS's "position" begs the question as to how to determine the value of the subscription rights with respect to the bonds exclusive of the conversion privilege.

11. Use of Treasury Stock

Treasury stock is stock of a corporation which has been reacquired after its original issuance, and has not been cancelled. With respect to a distribution of Treasury stock to shareholders, the issue originally was whether it was to be treated as distribution of a corporate asset (i.e., a property dividend) or treated as a distribution of unissued stock. Prior to the *Koshland* decision,[274] the IRS took the position that a distribu-

[266] Reg. §1.1082-5.

[267] Reg. §1.301-1(b), §1.305-1(b). *See also* Reg. §1.305-2(b) *Ex.* (1)(iii).

[268] Reg. §1.301-1(c).

[269] S. Rep. No. 1622, 83d Cong., 2d Sess. 448 (1954).

[270] *See also* Reg. §1.1312-7(c) *Exs.* (2), (4), and (5).

[271] *Powel v. Commissioner*, 27 B.T.A. 55 (1932), acq., XIII-2 C.B. 15 (1934).

[272] XIII-2 C.B. 121 (1934). Noted to be of some continuing validity in GCM 37260 (Sept. 19, 1977) and in GCM 38906 (Oct. 13, 1982).

[273] *Id.* at 123.

[274] The *Koshland* decision is discussed at II.C., above.

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tion of Treasury stock had the same status, for income tax purposes, as a dividend paid in unissued stock.[275]

After the decision in the *Koshland* case, the IRS changed its view, holding that where a corporation purchased its own stock out of surplus, it was an asset held for investment just as if it had purchased stock of another corporation from its surplus, and that a distribution of Treasury stock must be treated as a distribution of a property dividend, rather than as a stock dividend.[276] The Board of Tax Appeals did not subscribe to this view and, in *Bruckheimer v. Commissioner*,[277] held that a distribution of Treasury stock to the holders of outstanding common stock did not constitute income to the recipients. The IRS has accepted the *Bruckheimer* decision.[278]

Under §305, it is irrelevant whether a stock distribution is made with Treasury stock or previously unissued stock, or rights to acquire either such stock.[279]

12. Definitions of "Stock" and "Shareholder"

Section 305(d)(1) defines the term "stock" for purposes of §305 to include rights to acquire stock. Moreover, §305(d)(2) defines the term "shareholder" to include a holder of stock rights or of convertible securities. Thus, the holder of a convertible debenture presumably is treated as if he were a shareholder for the purposes of §305.

[275] I.T. 2449, VIII-1 C.B. 101 (1929); *Kay v. Commissioner*, 28 B.T.A. 331 (1933), appeal dism'd, 70 F.2d 1017 (4th Cir. 1934).

[276] Reg. 103, §19.27(d)-1; Reg. 101, Article 27(d)(1); Reg. 94, Article 27(c)-1 (1936 Act).

[277] 46 B.T.A. 234 (1942), *acq.*, 1943 C.B. 4, *nonacq.*, 1942-1 C.B. 20.

[278] *See* T.D. 5290, 1943 C.B. 366.

[279] *See* Reg. §1.305-1. *See also* Rev. Rul. 55-746, 1955-2 C.B. 224.

13. Foreign Shareholders

Section 305 does not distinguish between U.S. and foreign shareholders. Nevertheless, a corporation should be cognizant of its responsibilities with respect to foreign shareholders. Where a corporation makes a taxable stock distribution to foreign shareholders out of income from sources within the United States, it may be obligated to withhold U.S. tax on such dividend. Section 871 imposes a 30% tax on dividends paid to foreign shareholders. That tax is often reduced pursuant to a tax treaty.[280] Section 1441 imposes a withholding obligation on the payor corporation.

14. Effective Dates

The 1969 Act amendments to §305 generally apply to actual or constructive distributions made after January 10, 1969, in taxable years ending after that date.[281] The changes to §305, made pursuant to the 1990 RRA, generally apply to stock issued after October 9, 1990. Stock issued after such date is not subject to the rules if issued pursuant to (i) a written binding contract in effect on October 9, 1990, and at all times thereafter before issuance; (ii) registration or offering statements filed on or before October 9, 1990, with a federal or state agency regulating the offering or sale of securities and issued before the date which is 90 days after the filing date; or (iii) a plan filed on or before October 9, 1990, in a Title 11 or similar case as defined in §368(a)(3)(A).[282]

[280] *See* §894.

[281] §421(b)(1) of the 1969 Act.

[282] §11322(b)(2) of the 1990 RRA.

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IV. Section 306 Stock

A. *History of §306*

Section 306 was enacted as part of the 1954 Code to combat the result in *Chamberlin v. Commissioner*[283] In that case, the corporation distributed preferred stock pro rata on its outstanding common stock. Before such distribution, the company had negotiated, but had not entered into a formal agreement, for the shareholders to sell the preferred stock to an insurance company. After such sale, the corporation was to redeem the preferred stock over a seven-year period that was to begin approximately 17 months after the dividend. The IRS contended that the preferred stock dividend was not tax-free since the prearranged sale and eventual redemption were tantamount to a cash dividend to the shareholders. The Court of Appeals refused to apply the step transaction doctrine. Accordingly, the dividend of the preferred stock was tax-free. Moreover, the sale of the preferred stock resulted in capital gain to the shareholders, allowing them to benefit from the lower tax rate for capital gains that was in effect at the time.

In enacting §306 as part of the 1954 Code, Congress specifically sought to eliminate the preferred stock bailout permitted in *Chamberlin*.[284] In short, §306 provides that, where a corporation distributes preferred stock to its shareholders in a tax-free distribution, the shareholders will recognize ordinary income at such time as such preferred stock is "disposed of." Thus, §306 does not tax the receipt of the preferred stock.

The abuse that §306 is aimed at, taking the equivalent of dividends from a corporation while paying tax at capital gains rates, has historically been important because capital gains have usually been taxed at lower rates than ordinary income. For taxable years beginning after 2002, however, individuals are taxed at the capital gains rate on dividends from domestic corporations and qualified foreign corporations.[285] Thus the impact of §306 is significantly reduced under current law. The impact is not, however, eliminated. Capital gain treatment can be important, for example, to an individual with large capital losses. A sale or exchange giving rise to capital gain treatment has the additional benefit in that it allows the taxpayer to reduce the amount realized by the taxpayer's basis in the stock. Also, corporate shareholders will normally prefer dividend treatment in order to claim the dividends-received deduction.

The entire conceptual framework of §306 is based on preventing the conversion of ordinary income into capital gains. Thus, the discussion of the definition of §306 stock that follows is replete with such references as the "capital gains rate" and "bailouts" of corporate earnings. Those references are essential to the analysis of §306 because the sale or exchange treatment of a transaction remains important under current law (due to the availability of capital gains being offset by capital losses and the ability to utilize tax basis in a capital gain transaction). References to the "capital gains rate" and "bailouts" are retained throughout the §306 discussion without reference to §1(h)(11).[286]

B. *Definition of §306 Stock*

1. *General Rule*

"Section 306 Stock" is defined in §306(c). The definition generally includes stock (other than common stock) that was received tax free. It includes stock received in a tax-free stock dividend, under §305, stock received tax-free in a corporate reorganization, under §368, or a corporate division, under §355, and stock that has an adjusted basis determined by reference to §306 stock.[287]

2. *Earnings and Profits Requirement*

It is important to note that §306(c)(2) provides that stock does not constitute §306 stock if the corporation had distributed cash in lieu of the stock, and no part of the cash distribution would have been a dividend. Where a corporation had no earnings and profits in the year the stock was distributed, then a cash distribution would not have been a dividend. Consequently, §306(c)(2) provides that the stock actually received under such circumstances is not §306 stock. The rationale behind §306(c)(2) is that a capital gain bailout cannot occur if the corporation does not have either current or accumulated earnings and profits in the year of the stock dividend. Under those circumstances, a distribution by the corporation would have been treated as a return of basis first and then as capital gain. Accordingly, there can be no conversion of ordinary income into capital gain.

This exception applies only if no part of the hypothetical cash distribution would have been a dividend. The presence of a single dollar of earnings and profits taints all the stock received.[288] Thus, in order to rely on §306(c)(2), the corporation must make an accurate determination of its earnings and profits.

Theoretically, the IRS could be persuaded that a distribution of preferred stock by a corporation which had nominal earnings and profits for sound business reasons would not constitute §306 stock, under the §306(b)(4) exception for transactions not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.[289]

There is also a timing issue raised in invoking the earnings and profits exception. Section 306(c)(2) provides that the stock

[283] 207 F.2d 462 (6th Cir. 1953), rev'g and rem'g 18 T.C. 164 (1952), cert. denied, 347 U.S. 918 (1954).

[284] *See* Conference Report, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 36 (1954).

[285] §1(h)(11), as added by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, Pub. L. No. 108-27, §302(a). The applicability of §1(h)(11) was made permanent by the American Taxpayer Relief Act of 2012 (2012 ATRA), Pub. L. No. 112-240, §102.

[286] Amounts treated as ordinary income under §306 are treated as dividends and, thus, qualify for the reduced capital gain tax rates. §306(a)(1)(D) and §1(h)(11).

[287] §306(c)(1). *See also* PLR 9547011 (preferred ordinary shares distributed by foreign corporation do not constitute §306 stock).

[288] Thus, §306(c)(2) will prevent §306 stock characterization as to preferred stock issued by a newly created holding company if there are no earnings and profits in the first taxable year of the new corporation. *See* Rev. Rul. 79-274, 1979-2 C.B. 131.

[289] Historically, the IRS would not ordinarily rule on whether or not a distribution or redemption of preferred stock was in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. *See* Rev. Proc. 95-3, §4.01(23); Rev. Proc. 2025-3, §4.01(25). However, the IRS would typically issue rulings to this effect in a reorganization context. *See, e.g.*, PLR 200311002, PLR 9146021, PLR 8823113.

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is not §306 stock if, "at the time of the distribution," a cash distribution would not have been a dividend. This language must be contrasted with the language of §316, which provides that an actual distribution is a dividend if there are earnings and profits "computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year."[290] Thus, §316 determines earnings and profits at the end of the year, whereas §306 refers to earnings and profits at the time of the distribution.

> *Example:* Assume X corporation (X) is a calendar year taxpayer and has no earnings and profits on March 1 of year 1. On that date, X distributes a stock dividend. Before the end of the year, X realized earnings and profits. Thus the question is whether the §306(c)(2) exception applies. Reg. §1.306-3 answers the question by providing that the exception applies if a distribution of money in lieu of the stock would not have been a dividend. Since the dividend consequences of a distribution of cash are determined as of the end of the taxable year, the end of the taxable year rule applies for purposes of §306(c)(2).

There is one other interpretive problem with §306(c)(2). The exception applies if a distribution of money would not have been a dividend. The heading to §306(c)(2) reads "Exception Where No Earnings And Profits." There are instances (besides the absence of earnings and profits) where a distribution of money would not be treated as a dividend even though the corporation has earnings and profits. For example, §306(c)(2) could apply where preferred stock is received in a corporate reorganization, if the shareholder had realized no gain, or realized a loss since cash distributed in such a transaction would not have generated a dividend. Similarly, preferred stock received in a recapitalization in exchange for the surrender of all the shareholder's common stock would not be §306 stock because a distribution of money would not have been taxed as a dividend. Based on the unambiguous language in the statute, and the fact that paragraph headings are not part of the statute,[291] §306(c)(2) should apply to such situations.

3. *Tax-Free Distributions Under §305 — What Is Common Stock*

The first category of §306 stock is described in §306(c)(1)(A), and includes stock any part of which was received tax free under §305(a).[292] It should be noted, however, that §306(c)(1)(A) does not apply to a tax-free distribution of common stock received on outstanding common stock. This common stock exemption is premised on the fact that common stock is not a suitable device for a bailout for two reasons: (1) a sale of common stock to an outsider would dilute the original shareholder's equity interest and voting control; and (2) such a sale would effect a change in the ownership interests. Moreover, a corporate redemption of the distributed shares would not receive exchange treatment under §302, so no bailout could occur. In sum, a common stock dividend, followed by a sale, is not suitable for a bailout, and a common stock dividend, followed by a redemption, does not accomplish a bailout. Consequently, §306(c)(1)(A) excepts common stock dividend shares from §306.

The difficulty in applying the common stock exception of §306(c)(1)(A) is in determining what constitutes common stock. Neither §306 nor the regulations promulgated thereunder define common stock.[293] Instead, Reg. §1.306-1(a) merely provides that §306 stock is usually preferred stock.

The meaning of the term "common stock" has been developed primarily through a series of revenue rulings, which indicate that the IRS interprets "common stock" to mean stock that is not suitable for use in a bailout.[294] For example, selling voting common stock to an outsider would cause a proportionate reduction in voting power and residual equity. Consequently, such stock is not appropriate for a bailout transaction, and is "common stock," thus not within the §306(c)(1) definition of §306 stock.[295] Conversely, the IRS will not treat stock that does have bailout potential as common stock for the purposes of §306(c)(1)(A).

In various revenue rulings (discussed below), the IRS set forth several factors which indicate whether stock is within the common stock exception of §306. These factors include (i) whether the stock is redeemable and, if so, whether there is a set price for such redemption, (ii) whether the stock is entitled to a preference on earnings or liquidation proceeds, (iii) whether the stock shares in the growth of the corporation, and (iv) whether the stock has the right to vote. An analysis of the meaning of the term "preferred stock" is also set forth below. Taxpayers may see fit to argue that if their stock is not within a class of preferred stock, then the stock must be common stock.

Stock that is redeemable at the option of the issuing corporation does not have an unlimited right to participate in future earnings and growth. Accordingly, such stock does not enjoy the residual equity that common stock represents. In Rev. Rul. 57-132,[296] a corporation distributed stock which was identical to an outstanding class of common stock in all respects except that the distributed stock was nonvoting and was redeemable at the option of the corporation at 110% of book value. The IRS held that the stock was not common stock, for purposes of §306, due to the corporation's call option. The right to call the shares must be contrasted with the situation where the issuing corporation has a right of first refusal if the shareholder wants to sell the shares. In Rev. Rul. 76-386,[297] the IRS ruled that the stock was common stock for purposes of §306, notwithstanding the fact that the corporation had a right of first refusal at a price equal to the per share net book value. The rationale underlying this

[290] §316(a)(2).

[291] *See* §7806(b). The only reference in the legislative history, however, is to the absence of earnings and profits. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 245 (1954). *See also* Note, *Exclusion from Section 306 Treatment in Unifying Reorganization*, 76 Harv. L. Rev. 1627 (1963).

[292] Section 306(c) defines §306 stock to include three categories of stock. The other two categories are discussed at IV.C., and IV.D., below.

[293] Reg. §1.305-5(a) discusses what is "preferred stock" for purposes of §305. There is a risk in making reference to the §305 regulations for purposes of construing §306 because §305 may be deemed to have a different purpose than §306. Nevertheless, Rev. Rul. 75-236, 1975-1 C.B. 106, did cite to Reg. §1.305-5(a) in determining whether stock was common stock for purposes of §306.

[294] *See* Rev. Rul. 76-386, 1976-2 C.B. 95; and 76-387, 1976-2 C.B. 96.

[295] *Id.* In addition, it should be noted that common stock received as a stock dividend on preferred will not be received tax free due to §305(b)(4). It is taxed as a dividend when it is received, so no bailout occurs.

[296] 1957-1 C.B. 115, *distinguished by* Rev. Rul. 76-386, 1976-2 C.B. 95.

[297] 1976-2 C.B. 95. *See also* PLR 7749051.

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ruling is that a right of first refusal (unlike a call right) does not force the shareholder to give up his interest in the corporation's growth. Thus, the scope of Rev. Rul. 57-132 is limited to the situation in which the corporation has a unilateral call right. If the corporation has only a right of first refusal, the stock will not be deemed to be other than common stock.[298]

The unrestricted right to participate in current earnings and future equity growth is a fundamental characteristic of common stock for purposes of §306(c)(1). The revenue rulings issued by the IRS maintain that, in order to be treated as common stock, there can be no limitation or ceiling on current earnings on the instrument.[299] A number of published rulings address the importance of an unlimited right to current earnings. Rev. Rul. 75-222[300] involved a corporation that issued Class A and Class B stock in exchange for its old common stock in a recapitalization. The Class A and Class B shares had the same voting rights, and the same rights on liquidation. No change in either class of stock could be made without a compensating change to the other class of stock, and stock dividends were required to be equivalent between the two classes. The Class A stock differed from the Class B stock in that (1) the Class A stock was convertible into Class B stock, but not vice versa; and (2) the Class B stock could receive cash dividends without the Class A stock receiving any dividends. If, however, dividends were paid on the Class A stock, then equal or greater dividends had to be paid on the Class B stock. The ruling concluded that, for the purposes of §306(c), both classes of stock were common stock.

In Rev. Rul. 79-163,[301] the IRS considered two similar situations. In that ruling a corporation recapitalized and issued Class A voting stock and Class B nonvoting stock which had par values of $20 and $100 per share, respectively. Upon liquidation in Situation (1) of Rev. Rul. 79-163, Class A and Class B shares were entitled to their respective par values. Any additional assets would be distributed to the Class B shareholders. The IRS also considered in Situation (2) of Rev. Rul. 79-163 the alternative of the Class A and Class B stock sharing liquidation proceeds pro rata in accordance with their respective par values, but having different rights to dividends. Specifically, in Situation (2), the two classes shared dividends up to 6% per year of par value, and, thereafter, all dividends would be paid only on the Class B stock. In both Situation (1) and (2), the IRS concluded that the Class A stock was not common stock. In each case addressed by Rev. Rul. 79-163, the Class A stock did not have an unlimited right to share in corporate earnings and growth.

At first blush, Rev. Rul. 75-222 and Situation (2) of Rev. Rul. 79-163 appear inconsistent. In Rev. Rul. 79-163, stock which had a limited right to cash dividends was deemed to be other than common stock, while in Rev. Rul. 75-222, stock possessing a limited right to cash dividends was deemed to be common stock. Nevertheless, the two rulings are factually distinguishable. Rev. Rul. 79-163 involved stock which had an absolute cap of 6% of par value on cash dividends; whereas, the stock in Rev. Rul. 75-222 did not have a cap, and could share equally in cash dividends. While the facts of Rev. Rul. 75-222 permitted cash dividends to be paid on the Class B shares without the payment of cash dividends on Class A shares, the Class A shareholders could avoid that result by exercising their right to convert to Class B shares. Thus, the Class A stock in Rev. Rul. 75-222 was less restricted than was the stock in Situation (2) of Rev. Rul. 79-163.

As noted above, the purpose of the common stock exception in §306(c)(1)(A) is to exclude from §306 treatment stock that is unsuitable for a bailout. Thus, stock which bears elements of both common stock and preferred stock should be viewed as common stock if it is not suitable for a bailout.[302] Applying this standard to the stock in Situation (2) of Rev. Rul. 79-163 leads to the conclusion that the ruling is likely incorrect. The Class A stock was the only voting stock, and it shared in assets upon liquidation in accordance with its par value. The only limitation on full participation was the 6% of par value cap on annual cash dividends. The Class A stock was particularly ill suited to use in a bailout since disposition of such stock would result in both a loss of voting control and a loss of residual equity. While full participation in dividends is a hallmark of common stock for corporate law purposes, for purposes of §306, the cap on dividends seems inconsequential in light of the other characteristics of the Class A stock. Moreover, the fact that full participation in corporate growth was present makes the ruling inconsistent with Reg. §1.305-5(a) which notes the distinguishing feature of preferred stock is that it does not participate in corporate growth to any significant extent.

In view of the above, the IRS generally maintains that, for stock to be common stock within §306(c), there can be no limitation on the amount that may be received currently as dividends or upon liquidation.[303] Thus, stock that is redeemable at a fixed amount is not common stock for purposes of §306(c)(1) because unlimited participation in equity growth is absent.[304] However, it should be noted that limited participation in corporate growth, albeit risky, may be sufficient to avoid characterization as "preferred stock."

In TAM 200116002, under a set of complicated and unique facts, a corporation issued a class of preferred stock that was not entitled to dividends. Nevertheless, the stock was found to participate in corporate growth, in spite of the fact that the stock was entitled to a fixed amount on liquidation. At the time the stock was issued, the liquidation preference was in excess of the value of the issuing corporation's assets. Under another set of facts, the IRS has privately ruled that "preferred" stock having a stated dividend rate and 20% participation with

[298] *See* PLR 7728001. That ruling involved a corporation owned by a single individual which had issued, as a stock dividend, new stock that was identical to the outstanding common stock of the corporation, except that the new stock was nonvoting and possessed different stock dividend rights. The ruling was concerned with the issue of whether the owner's absolute voting control over the corporation made the nonvoting stock redeemable within the meaning of Rev. Rul. 57-132 and, thus, not common stock, for purposes of §306. The ruling concluded that voting control over the corporation did not make the stock redeemable. Accordingly, the stock was held to be common stock not subject to §306.

[299] *See* Rev. Rul. 79-163, 1979-1 C.B. 131; and 75-236, 1975-1 C.B. 106.

[300] 1975-1 C.B. 105.

[301] 1979-1 C.B. 131.

[302] *See* Rev. Rul. 76-387, 1976-2 C.B. 96.

[303] *See* Rev. Rul. 79-163, 1979-1 C.B. 131 (Situation 1); Rev. Rul. 75-236, 1975-1 C.B. 106; and Rev. Rul. 82-191, 1982-2 C.B. 78.

[304] Rev. Rul. 57-132, 1957-1 C.B. 115, *distinguished by* Rev. Rul. 76-386, 1976-2 C.B. 95.

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another class of stock above a certain dividend threshold was not nonqualified preferred stock pursuant to §351(g)(3)(A).[305] The IRS necessarily concluded that the stock participated in corporate growth to a significant extent, although the IRS affirmatively refused to state whether the stock was §306 stock.[306] An important feature of the stock may have been that the corporation did not have the right to require a redemption of the stock.

Two other factors that may be relevant in determining whether stock is common stock are preferences as to earnings and to assets upon liquidation. Rev. Rul. 66-332[307] involved a recapitalization in which the corporation's existing common stock was converted into Class A voting stock. The Class A stock enjoyed a preference both as to dividends and as to assets upon liquidation. Thereafter, the Class A stock fully participated with Class B common stock as to dividends and as to assets upon liquidation. Notwithstanding the fact that the Class A stock represented a fully participating residual equity interest, the IRS determined that the Class A stock was not common stock for purposes of §306(c)(1) because of its priority. In Rev. Rul. 81-91,[308] the IRS changed its position[309] and ruled that the Class A stock in Rev. Rul. 66-332 was common stock "since it has an interest in the unrestricted growth of the corporation." The IRS also ruled in Rev. Rul. 81-91 that a class of stock is common stock even though it carries a specific annual dividend priority and a preferential right to repayment up to par value on liquidation, as long as the stock shares equally with the other class after satisfaction of such preferences. The preferred stock essentially participated with the common on an as-converted basis. Importantly, the IRS looked to the definition of preferred stock in Reg. §1.305-5(a) to find the meaning of "stock other than common stock" for purposes of §306. This was also done in Rev. Rul. 75-236, discussed below.

Voting rights is another factor which has been considered by the IRS in characterizing stock for purposes of §306(c)(1) with mixed results. In Rev. Rul. 75-236,[310] the IRS addressed a type of stock that was preferred and limited as to both earnings and assets. Notwithstanding the fact that the stock was the only class of voting stock of the corporation, it was not treated as common stock. Conversely, in Rev. Rul. 76-387,[311] the IRS ruled that the lack of voting rights did not preclude stock from being characterized as common stock, for purposes of §306(c)(1), where the stock fully participated in equity. The ruling concluded that although the stock could be disposed of without loss of voting control, since it could not be disposed of without a reduction in the residual equity interest, the stock was not suitable for a bailout. Thus, it was common stock for purposes of §306. Hence, the presence, or absence, of voting rights does not appear to be a key factor for the IRS in analyzing whether stock represents §306 stock.[312]

Section 306(e) provides a special rule for common stock which is convertible into preferred stock or other property. Such convertible common would have obvious bailout potential because, periodically, some of the common stock could be converted into preferred stock with the latter being sold to a third party, generating a capital gain. Section 306(e)(2) prevents that possibility by providing that common stock that is convertible into preferred stock or other property shall be deemed not to be common stock.[313] Thus, such convertible common stock will not fall within the common stock exception of §306(c) and the stock will be subject to §306 treatment.

Another avenue for a taxpayer to explore in arguing that the taxpayer possesses common stock under §306 is to assert that the stock is not preferred stock, thereby resulting in the conclusion that the stock must be common. Likewise, under §305, it is often critical to avoid issuing, or obtaining, preferred stock. Given the IRS's precedent in cross-referencing §305 and §306 in analyzing various instruments, research under each section should be relevant to reaching a conclusion as to whether a given security is common or preferred stock.[314]

Arguably, a definition of preferred stock for purposes of §305 is contained in §305(e) which addresses "stripped preferred stock." Section 305(e) defines stripped preferred stock as stock described in §305(e)(5)(B) if there has been a separation in ownership between such stock and any dividend on such stock which has not become payable. The relevant type of stock is stock which "(i) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, and (ii) has a fixed redemption price."[315] Reg. §1.305-5(a) states:

> The term "preferred stock" generally refers to stock which, in relation to other classes of stock outstanding enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of "preferred stock" … is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in

[305] PLR 200311002.

[306] Based on the IRS's statement in PLR 200311002 that the likelihood that the taxpayer would liquidate was "remote," it appears that the IRS disregarded the stock's fixed liquidation price.

[307] 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123.

[308] 1981-1 C.B. 123, *distinguished by* TAM 8231003. *See also* PLR 9609030. *See* PLR 200411025 (common stock that participates in growth of corporation with a preference regarding dividends that cannot be less than a formula-based amount and that participates on liquidation with the common (but with a preference) is not preferred stock within the meaning of §351(g)(3)(A) nor was it §306 stock.

[309] The associated General Counsel Memorandum to this ruling was GCM 37995.

[310] 1975-1 C.B. 106.

[311] 1976-2 C.B. 96.

[312] *See* Rev. Rul. 79-163, 1979-1 C.B. 131.

[313] Reg. §1.306-3(f) provides that the conversion feature can be "contained in the stock or in some type of collateral agreement."

[314] In CCA 201236025, the Chief Counsel's Office addressed whether certain convertible preferred stock represented common stock for purposes of §302(b)(2). A holder was entitled to receive a dividend in an amount equal to the per-share dividend (if any) declared on the common stock. Upon liquidation, the holder was entitled to receive a premium equal to the holder's purchase price of the convertible preferred stock and to share in the liquidation proceeds to the same extent as the common shareholders. The Chief Counsel's Office noted that several statutory and regulatory provisions provided a definition of preferred stock and concluded that "common stock" should be considered to include any type of stock that does not fall within the definition of preferred stock. The convertible preferred stock was found to represent common stock because the stock participated in dividends to the same extent as common stock and in the corporation's liquidation proceeds, the Chief Counsel's Office advised.

[315] §305(e)(5)(B).

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> corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time the distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest … .[316]

The regulations contain two examples illustrating the IRS's viewpoint under this definition of preferred stock.[317] The important factors in characterizing the stock in these examples can be identified as: (i) the issuer's current and accumulated earnings and profits, (ii) the reasonably anticipated growth rate of the issuer's earnings, (iii) the level of distributions to be made to the Class A shareholders before the Class B shareholders would participate, and (iv) the book value of the issuer's assets. Interestingly, Reg. §1.305-5(a) provides that a conversion right is not to be considered in determining whether or not stock is preferred stock. However, when the conversion price of preferred into common is set equal to the value of the common at the time the preferred is issued, it seems incredible that the conversion feature should be disregarded because the preferred will be participating in corporate growth.[318]

A statutory definition of preferred stock was enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, which added §351(g)(3)(A). That section provides: "the term 'preferred stock' means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent." This language may have its genesis in Reg. §1.305-5(a) which provides, in part, that preferred stock does not participate in growth to any significant extent.[319] The 1997 House Committee Report mentioned a conversion right as being important to assessing whether stock participated in corporate growth.[320] The 2004 American Jobs Creation Act, Pub. L. No. 108-357, §899, further amended §351(g)(3)(A) to refine the definition of "preferred stock" to provide that stock does not participate in corporate growth to any significant extent "unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation."[321] The Conference Report for the 2004 Act provides two examples of stock that is preferred stock under the amended definition but the status of which may have been unclear before the amendment: (1) instruments preferred on liquidation that are entitled to the same dividends as common stock, if the corporation does not, in fact, pay dividends to common or preferred shareholders; and (2) stock entitling the shareholder to a dividend equal to 7% or the dividends that common shareholders receive, whichever is greater, if the common shareholders are not expected to receive dividends greater than 7%.[322] The amendment by the 2004 Act to §351(g) applies to transactions after May 14, 2003. Taxpayers should exercise caution in using §351(g) analogies. Nevertheless, the similarities in language are striking and there is no legislative dictate in either §305 or §306 that prohibits the use of such analogies.

Another place for taxpayers to look for help in determining what type of stock should be viewed by the IRS as preferred stock is in the consolidated return provisions. Section 1504(a)(4) excludes from the definition of stock that stock which is (i) nonvoting, (ii) nonconvertible, (iii) limited and preferred as to dividends and does not participate in corporate growth to any significant extent, and (iv) subject to redemption and liquidation rights which do not exceed the issue price (except for a reasonable premium). The legislative history to a 1984 change to this statute indicates that preferred stock carrying a dividend materially in excess of a market rate may demonstrate significant participation in corporate growth.[323] A case interpreting a predecessor statute found that preferred stock which participated in dividends declared on the common was not "limited as to dividends" as provided in the statutory language.[324] Similarly, Rev. Rul. 79-21[325] found that participating preferred stock is not limited and preferred as to dividends under the pre-1984 version of §1504(a) because the stock was entitled to participate with the common stock in distributions of earnings. Taxpayers should recognize, however, that a possible distinction in application of §1504 authorities to §305 and §306 is that the latter statutes appear to require a detailed consideration of the facts and circumstances to determine the likelihood of participation in corporate growth and whether the extent of participation is substantial; whereas, the former statute, solely in relation to the dividend provision, rests merely upon whether a participation right is granted in the instrument.

The IRS has never addressed the question of whether tracking stock is common stock for the purposes of §306(c). Under the holding in Rev. Rul. 79-163, tracking stock which was only entitled to its share of the liquidation proceeds of a specific division or subsidiary could be considered stock other than common stock. For a discussion of tracking stock in general, see III.I.1., above.

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[316] Note the only statutory definition of preferred stock was enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, which added §351(g)(3)(A). That section provides: "The term 'preferred stock' means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent."

[317] Reg. §1.305-5(d) *Exs.* 9 and 10.

[318] See the discussion related to Rev. Rul. 81-91 above.

[319] First described in 1973 when the §305 regulations were published in T.D. 7281, 1973-2 C.B. 92.

[320] H.R. Rep. No. 148, 105th Cong., 1st Sess. 472 (1997). The Conference Committee Report contains the statement that a conversion privilege will not be considered the equivalent to participating in corporate growth to any significant extent. H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 545 (1997).

[321] For additional discussion of nonqualified preferred stock, see IV.C.5.c.(2), below. The 2004 Act provision is effective for transactions after May 14, 2003.

[322] *See* H.R. Conf. Rep. No. 108-755, at 757–58 (2004).

[323] H.R. Conf. Rep. No. 369, 98th Cong., 2d Sess. (1984).

[324] *Pioneer Parachute Co. v. Commissioner*, 162 F.2d 249 (2d Cir. 1947), aff'g 6 T.C. 1246 (1946).

[325] 1979-1 C.B. 290.

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C. *Interplay Between §306 and the Reorganization Provisions*

Section 306(c)(1)(B) treats stock, other than common stock[326] received in certain corporate reorganizations and corporate divisions, as §306 stock.

1. *Purpose of §306(c)(1)(B)*

Although a detailed discussion of the reorganization provisions exceeds the scope of this portfolio, an overview of the general tax consequences of a tax-free reorganization is necessary to understand the operation of §306. In general, a qualifying reorganization transaction is granted nonrecognition treatment.[327] Accordingly, gain or loss realized by the corporation or its shareholders is not recognized, except to the extent of any cash or boot received in the exchange. Thus, a tax-free distribution of stock in a reorganization could be used as the first step in a bailout plan, just as a tax-free stock dividend could be used to accomplish a bailout. As a matter of consistency, a reorganization transaction which effects a bailout should not be treated any differently than a dividend distribution which has the same effect. However, not all reorganizations have the effect of a stock dividend in that the transactions may involve major changes in the corporate capital structure or a significant change in shareholder interests. Moreover, in order to qualify as a tax-free reorganization, a transaction must have a significant business purpose.[328] Obviously, such a transaction should not result in a §306 taint.

In addressing reorganizations under §306, Congress sought to achieve a reasonable balance so as to cover stock dividend-like reorganizations, but exclude other reorganizations. Thus, §306(c)(1)(B) provides that stock, other than common stock, is §306 stock if it is received in a corporate reorganization qualifying within §368 (or qualifying as a §355 distribution or exchange)[329] and in which gain or loss was to any extent not recognized, but only to the extent that either (i) the effect of the transaction was substantially the same as the receipt of a stock dividend, or (ii) the stock was received in exchange for §306 stock.

2. *Overview of Reorganizations*

Section 368 contemplates three basic types of corporate reorganizations: "acquisitive," "divisive," and "reshuffling."

In an acquisitive reorganization one corporation (acquiring) acquires the stock or assets of a second corporation (target) in exchange for qualifying consideration. There are three basic types of acquisitive reorganizations. The first and simplest acquisitive reorganization is a statutory merger or consolidation, known as an "A" reorganization.[330] In an "A" reorganization, two or more corporations are merged or consolidated pursuant to state law. The consideration for such a transaction is stock of acquiring or, in some cases, its parent corporation. A "B" reorganization, the second type of acquisitive reorganization, is the acquisition by acquiring of the target corporation stock in exchange solely for voting stock of the acquiring corporation (or its parent), if the acquiring corporation obtains at least 80% control of target in the transaction.[331] A "C" reorganization, the third type, is the acquisition of substantially all the assets of the target corporation in exchange for voting stock of the acquiring corporation (or its parent).[332]

A divisive reorganization is a transaction whereby one corporation (distributing) distributes the stock of one or more controlled corporations (controlled) in a transaction which satisfies the requirements of §354, §355, or §356. In essence, those provisions treat as tax-free reorganizations certain transactions in which corporate properties are spun-off to one or more shareholders.

Finally, there are two types of "reshuffling" reorganizations. A recapitalization, or "E" reorganization, is a restructuring of the stock or capital structure of a single corporation pursuant to §368(a)(1)(E).[333] An "F" reorganization is a mere change in identity, form, or place of organization of one corporation.[334]

All reorganizations are subject to various judicial and administrative requirements, including the (i) business purpose, (ii) continuity of shareholder interest, (iii) continuity of business enterprise, and (iv) step-transaction doctrines (however, regulations have been issued which eliminated the continuity of shareholder interest and continuity of business enterprise requirements for "E" and "F" reorganizations because they are single-entity transactions).[335] The preceding discussion of the reorganization provisions is a cursory review of a very complicated area of the tax law. Various other portfolios, cited above, discuss in greater detail the requirements of qualifying a transaction as a reorganization and they should be referred to for a detailed analysis.

3. *Nonrecognition of Gain or Loss on Exchange*

In order for stock to be treated as §306 stock under §306(c)(1)(B), at least some of the shareholder's gain or loss must have gone unrecognized in the reorganization. Under §356(c), loss is never recognized on a qualifying reorganization. To the extent that qualifying consideration is received, realized gains are not recognized. Where nonqualifying consideration, such as money or other property (boot), is received gain is recognized to the extent of the lesser of (i) the gain realized, or (ii) the amount of

[326] As was the case in §306(c)(1)(A), common stock is excepted from the definition of §306 stock because it is not suitable for use as a bailout device. The statute manifests no reason to define common stock differently for purposes of §306(c)(1)(B) than for purposes of §306(c)(1)(A). *See* Rev. Rul. 79-163, 1979-1 C.B. 131. Thus, the common stock exception is not discussed in this division. *See* IV.B.3., above.

[327] *See* §354, §355, §356, §361, §368.

[328] *See* Reg. §1.368-1(b).

[329] More specifically, §306(c)(1)(B)(i) applies to a "distribution or exchange to which §355 (or so much of §356 as relates to §355) applied." *See generally* 776 T.M., *Corporate Separations.*

[330] *See* §368(a)(1)(A), §368(a)(2)(D), §368(a)(2)(E). *See also* 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations.*

[331] *See* §368(a)(1)(B). *See also* 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations.*

[332] *See* §368(a)(1)(C). *See also* 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations.*

[333] *See* 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations. See also* §1036.

[334] §368(a)(1)(F). *See* 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations.*

[335] T.D. 9182, 70 Fed. Reg. 9219 (Feb. 25, 2005).

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nonqualifying consideration.[336] Where no money or boot is received no gain will be recognized. Where the amount of money or boot received is less than the gain realized, only a portion of the gain is recognized. Nevertheless, §306(c)(1)(B) applies by virtue of the "to any extent" language in §306(c)(1)(B)(ii). Where the money or boot received equals or exceeds the gain realized, however, the entire realized gain is recognized, and §306(c)(1)(B) is inapplicable.[337] If a reorganization transaction fails to qualify under either §368 or §355 (for lack of a business purpose, for example), it appears that any preferred stock issued would not be §306 stock because gain or loss would be recognized on the transaction.[338]

4. *Receipt of Preferred Stock in Exchange for §306 Stock*

Section 306(c)(1)(B)(ii) provides that stock will be treated as §306 stock only to the extent that (a) the preferred stock (more technically, stock "which is not common stock") was received in exchange for §306 stock, or (b) the effect of the reorganization transaction was substantially the same as the receipt of a preferred stock dividend. Receipt of preferred stock in exchange for stock that already carries the §306 taint clearly should be subject to §306 stock status. The new preferred stock has the same bailout potential as the §306 stock surrendered. The more difficult §306 analysis relates to reorganizations involving the issuance of preferred stock and determining whether the effect of the transaction was substantially the same as the receipt of a stock dividend.

5. *Reorganizations Having the Effect of a Preferred Stock Dividend*

a. *General Rule*

The difficulty with §306(c)(1)(B) is the "effect of a stock dividend" standard which must be applied to reorganizations that do not involve the surrender of §306 stock. Although no §306 stock is surrendered in such reorganizations, preferred stock may be received by the target company shareholders as part of the reorganization. Unfortunately, the "effect of a stock dividend" standard is vague, and has generated considerable confusion. Rather than formulate a specific, mechanistic kind of test, Congress adopted a general rule that necessitated administrative and judicial interpretation. The regulations and rulings issued by the IRS have afforded minimal guidance. Moreover, there has been very little judicial interpretation of §306(c)(1)(B).

The rationale underlying the "effect of a stock dividend" language was to provide a flexible standard that would apply to preferred stock issued in a reorganization if the transaction could be used to effect a bailout. Perhaps the best example of a transaction that has the same effect as a stock dividend is a §368(a)(1)(E) recapitalization reorganization in which the sole shareholder surrenders common stock, and receives new common and new preferred. Clearly, the effect of the recapitalization is the same as a preferred stock dividend on the old common. Accordingly, the preferred stock would be §306 stock under the "effect of a stock dividend" standard. Another example of a transaction which has the "effect of a stock dividend" is a recapitalization of a corporation owned by more than one shareholder where new preferred stock is received pro rata on the common stock.[339] Likewise, a combination of brother-sister corporations (corporations owned by the same shareholders) through a merger[340] or an acquisition of assets[341] should not be allowed to avoid §306 if preferred stock is issued on a pro rata basis. The transaction would have the same effect as a preferred stock dividend on common.

b. *Cash Substitution Test*

The IRS turned the "effect of a stock dividend" test into a "cash substitution" test.[342] Reg. §1.306-3(d) hypothesizes a cash distribution in lieu of the preferred stock distribution. If cash had been distributed in lieu of the preferred stock, and the cash would have been treated as a dividend (under §356(a)(2),[343] §356(b),[344] or §302(d)),[345] then the preferred stock is §306 stock under the regulation. Unfortunately, the "cash substitution" test may not be much more precise than is the statutory test (i.e., whether the effect of the transaction was substantially the same as the receipt of a stock dividend).[346]

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[336] *See* 356(a). *See also* 782 T.M., *Boot Distributions and Assumption of Liabilities.*

[337] Note, also, that, under §306(c)(2), stock is not §306 stock if money distributed in lieu of the stock would not have been treated as a dividend. If the entire gain realized has been consumed by the boot or money, then distribution of additional money would not generate a dividend, and the stock would not be subject to §306.

[338] If the transaction is taxed at capital gains rates, preferred stock could be used to avoid dividend taxation of corporate earnings. Theoretically, the IRS could argue that §306 should still apply if it could be established that the purpose of the transaction was to avoid §306. In order for that argument to be convincing, however, tax rates applicable to dividends would presumably need to be higher than tax rates applicable to capital gains.

[339] *See* Rev. Rul. 59-84, 1959-1 C.B. 71.

[340] §368(a)(1)(A).

[341] §368(a)(1)(C).

[342] There is no express statutory basis for the cash substitution test. However, §306(c)(2) provides that stock is not §306 stock if cash distributed in lieu of the stock would not have been taxed as a dividend. Under Reg. §1.306-3(d), the cash substitution test is used affirmatively to categorize stock as §306 stock.

[343] Section 356(a)(1) provides that gain is recognized in a qualifying reorganization exchange to the extent of the lesser of: (i) the gain realized, or (ii) the amount of money and boot received. Section 356(a)(2) characterizes the gain by providing that to the extent the transaction has the effect of the distribution of a dividend, the gain recognized is to be a dividend. The gain recognized in excess of such amount is treated as a capital gain from the exchange of property, assuming the stock disposed of was a capital asset.

[344] Section 356(b) provides that a distribution, within §355, is to be treated as a §301 distribution to the extent that nonqualifying property is received. Thus, §356(b) has an automatic dividend rule, whereas §356(a)(2) results in a dividend only if the effect of the transaction is the distribution of a dividend. Note, also, that §356(a)(2) is limited to gain realized, while §356(b) is not. Section 356(b) is limited, however, to the amount of available earnings and profits.

[345] Section 302 is concerned with redemptions of corporate stock. If a redemption qualifies within §302(b), sale or exchange treatment is provided and capital gain results, assuming that the stock is a capital asset. If the redemption does not qualify within §302(b), then §302(d) provides that the redemption is treated as a distribution of property to which §301 applies. Under §301, the distribution is treated as a dividend to the extent of earnings and profits.

[346] The IRS's application of the cash substitution test has not been particularly helpful in contributing to a general understanding of the rule, because the IRS's position has been neither principled nor consistent. *See* Trimble, *The Treatment of Preferred Stock Distributions in Reorganizations Under Section 306 of the Internal Revenue Code of 1954*, 19 Tax. L. Rev. 345, 383 (1964). Moreover, in Rev. Rul. 60-1, 1960-1 C.B. 143, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46, the IRS further confused matters by combining, in effect, §306(c) definitional issues with §306(b)(4) disposition issues.

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In simple situations, the cash substitution rules makes sense. Assume, for example, that A is the sole owner of a corporation with only common stock outstanding. The corporation recapitalizes and issues new common and new preferred. Under the cash substitution test of Reg. §1.306-3(d), the preferred stock is ignored and a fictional cash distribution is assumed. Because the shareholder still owns all the outstanding common stock, the transaction would not be treated as a redemption but would be treated as a dividend, under §302. Accordingly, under Reg. §1.306-3(d), the preferred stock received in the recapitalization will be §306 stock.[347]

Another example demonstrates the opposite extreme of the cash substitution test. Assume that the taxpayer owns 50% of the common stock of a corporation. The corporation recapitalizes; and the taxpayer surrenders all the common stock, and receives back only nonvoting preferred stock. Under the cash substitution test of the regulations, the preferred stock is ignored. As a consequence, the taxpayer is left with no common stock and no preferred stock. Thus, the cash would be treated as if distributed in redemption of the common stock. Because the hypothetical redemption terminates the common stock interest, §302(b)(3) would apply, §302(d) would not apply, and §301 would not result in a dividend. Thus, the preferred stock is not §306 stock.[348] That result is correct in that no bailout can occur. The bailout potential exists where preferred stock is received and can be disposed of without any dilution of the shareholder's voting control and residual equity ownership. In this example, the taxpayer has surrendered completely his voting interest and his residual equity interest.[349]

A significant problem with the cash substitution test is the determination of whether the hypothetical cash distribution would receive dividend treatment under §356(a)(2), or would have been treated as a distribution to which §301 applied by virtue of either §356(b) or §302(d).[350] Of these two scenarios, the less complicated analysis involves a taxpayer treated as receiving boot under §356(b). When a taxpayer receives other property under §356(b), then §301 treatment is mandatory and there is no dividend equivalent analysis to undertake.

However, in situations where a taxpayer must analyze a transaction under §302 (by reason of §356(a)(2)), the various redemption safe harbors within §302 will control whether the taxpayer will potentially have dividend treatment under §301.[351] Thus, the most difficult situation to deal with under the cash substitution test of the regulations is the determination of whether a §356(a)(2) transaction will receive dividend treatment. Section 356(a)(2) provides for dividend treatment to the extent that the exchange "has the effect of the distribution of a dividend."[352] Otherwise, the gain is taxed as a capital gain. The meaning of §356(a)(2) has been far from clear. Indeed, the language of §306(c)(1)(B)(ii) relating to the transaction as having the effect "substantially the same as the receipt of a stock dividend" is not clarified by the reference in §356(a)(2) to the exchange having the "effect of the distribution of a dividend."

Commissioner v. Estate of Bedford,[353] suggested that any §356(a)(2) gain was to be treated as a dividend. The IRS originally adopted an automatic dividend rule with respect to §356(a)(2) gain. After losing the issue in several cases,[354] the IRS relented and conceded that dividend treatment was not automatic. Accordingly, the IRS applies §302 standards to determine if boot received in a reorganization has the effect of dividend.[355] Thus, a substantially disproportionate distribution of the money or boot would not necessarily be a dividend.[356] Because of the limitations on the use of cash, or boot, in a reorganization, it would be unusual to have a boot distribution qualify as a substantially disproportionate distribution under §302(b)(2). The more common method for avoiding dividend treatment in a reorganization transaction implicating §356(a)(2) would be by reason of the application of §302(b)(1).

A second problem area in applying the cash substitution test of Reg. §1.306-3(d) relates to determining the amount of the dividend. Under §356(a)(2) the amount of dividend is limited to the lesser of (i) the gain recognized under §356(a)(1), or (ii) the shareholder's ratable share of accumulated earnings and profits. The gain recognized under §356(a)(1) is equal to the lesser of (i) the gain realized or (ii) the sum of money and boot received. Application of the cash substitution test to §356(a) means that the dividend amount would be limited by the shareholder's gain realized, and by the shareholder's ratable share of accumulated earnings and profits. It appears, however, that the IRS ignores those two limitations in applying the cash substitution rule. The examples in the regulations make no reference to the shareholder's gain or loss realized in the reorganization.[357] Likewise, various revenue rulings have ignored gain or loss realized.[358] In addition, the examples in the regulations make no reference to the shareholder's ratable share of accu-

[347] *See* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 56-223, 1956-1 C.B. 162.

[348] *See* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 59-84, 1959-1 C.B. 71.

[349] *Note:* The preferred stock could be voting and even possess voting control over the corporation. The transaction still would be a recapitalization, within §368(a)(1)(E), and the retained voting control would not make the preferred stock §306 stock. For a discussion of the planning opportunities associated with recapitalizations, see VI., below.

[350] Reg. §1.306-3(d).

[351] Section 302(b)(2) and §302(b)(3) contains objective, numerical tests to be applied in determining whether exchange treatment (rather than §301 treatment) is to be provided. Section 302(b)(1), however, contains a very subjective test: "not essentially equivalent to a dividend." *See generally* 767 T.M., *Redemptions*.

[352] *Note:* The amount of §356(a)(1) gain recognized is equal to the lesser of the gain realized or boot and money received. Note, also, that §356(a)(2) refers only to accumulated and current earnings and profits. Finally, the taxpayer's dividend income is limited to his ratable share of earnings and profits, whereas the ratable share restriction normally does not apply to §301 distributions. *See* 762 T.M., *Earnings and Profits*.

[353] 325 U.S. 283 (1945).

[354] *See Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956), aff'g 23 T.C. 933 (1955); *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958), cert. denied, 358 U.S. 832 (1958).

[355] Rev. Rul. 93-62, 1993-2 C.B. 118; Rev. Rul. 74-515, 1974-2 C.B. 118, *distinguished by* GCM 39261.

[356] *See Commissioner v. Clark*, 489 U.S. 726 (1989), aff'g 828 F.2d 221 (4th Cir. 1987), aff'g 86 T.C. 138 (1986); *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), rev'g 415 F. Supp. 832 (D. Fla. 1976), *cert. denied*, 439 U.S. 1115 (1979); *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), aff'g 72-2 USTC ¶9495 (D. Ark. 1972). Before the Supreme Court's decision in *Clark*, there was a conflict among the circuits as to the correct method of applying §302 standards to §356(a)(2).

[357] *See* Reg. §1.306-3(d). Additional discussion of Reg. §1.306-3(d) and the cash substitution test can be found at IV.C.5.c.(1), below.

[358] If the shareholder has a loss realized on the transaction, no dividend could result under §356(a)(2). *See also* §306(c)(2). Even so, the examples in the regulations and the revenue rulings ignore the gain or loss realized.

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mulated earnings and profits. Indeed, no mention of earnings and profits is made in the regulations,[359] and the revenue rulings do not apply the ratable share of earnings and profits standard. Thus, it appears that the IRS has chosen to ignore the earnings and profits provision of §356(a)(2), as well as the gain realized limitation of §356(a). The examples in Reg. §1.306-3(d) as a whole provide very little assistance in determining whether stock represents §306 stock in a reorganization.

A third difficulty with the cash substitution rule is whether the rule applies on an all-or-nothing basis, or whether the rule can apply to only part of the preferred stock issued. Section 306(c)(1)(B)(ii) provides that the stock is §306 stock "only to the extent that … the effect of the transaction was substantially the same as the receipt of a stock dividend." The House-Senate Conference Committee on the Internal Revenue Code of 1954 intentionally inserted the "to the extent that" language to make clear that preferred stock received in a reorganization may be §306 stock in part, and not §306 stock in part.[360] It is not clear what the conferees intended because no examples were given in the report.[361]

Prior to the enactment of §306(c)(4) by the 1982 Tax Equity and Fiscal Responsibility Act ("TEFRA"),[362] it was uncertain to what extent the attribution rules of §318 applied to testing the hypothetical cash distribution under §356(a)(2), §356(b), and §302. Section 306(c)(4) provides that the attribution rules of §318(a) apply to §306 stock received in a reorganization or separation.[363]

c. *Acquisitive Reorganizations*

(1) *"A" Reorganizations*

The cash substitution test is difficult to apply to an "A" reorganization. As noted above, an "A" reorganization involves at least two corporations, as opposed to the single corporation involved in a recapitalization. In example (1) of Reg. §1.306-3(d) the target had only common stock outstanding. Pursuant to the plan of reorganization, the target common stock was surrendered for both common and preferred stock of acquiring. Without providing any additional facts, Reg. §1.306-3(d) concludes that the preferred stock is §306 stock. The conclusion is troubling in several respects. Application of the cash substitution test would cause the cash distribution to be tested under §356(a)(2) to determine whether the hypothetical cash distribution has the effect of a distribution of a dividend. As noted above, under §356(a)(1), the maximum dividend income which could be recognized, under §356(a)(2), is the taxpayers' realized gain. The regulation does not provide any information as to whether the shareholders realized any gains or losses on the transaction. Thus, the gain realized limitation of §356(a) appears to have been ignored for purposes of the §306 cash substitution test.

Moreover, that example concludes, without any factual predicate or analysis, that the preferred stock is §306 stock. In the absence of any information about the ownership of the shares of both corporations, that conclusion is suspect. Indeed, the conclusion is probably incorrect except in situations involving closely held corporations. Under the cash substitution test, the preferred stock would be ignored and the hypothetical cash from the reorganization would be tested under §356(a)(2). In *Clark*, discussed at IV.C.5.b., above, the Supreme Court determined that §302 standards can be applied in testing for dividend equivalency, under §356(a)(2).[364] Under the *Clark* decision, it would seem that the preferred stock that is received from the acquiring corporation is deemed issued by the acquiring corporation in exchange for common stock of acquiring. At that point, the issue is whether any of the §302 tests would result in dividend treatment or not. The exchange of preferred for common is analyzed under §302(b) to determine if the preferred is §306 stock under the cash substitution test.[365]

Prior to the *Clark* case, the IRS took the position that, in determining dividend equivalency under §356(a)(2), in the context of an "A" reorganization, §302 standards applied as if the target had distributed the boot in exchange for some of its common stock.[366] Presumably, the same rationale would have applied to preferred stock under the cash substitution rule of Reg. §1.306-3(d).

Example (1) of Reg. §1.306-3(d) does not expressly state whether either corporation has any earnings and profits. Nevertheless, §306(c)(2) clearly requires that earnings and profits must be present in order for the preferred stock to be §306 stock.[367] Thus, the example must be premised on the assumption of earnings and profits. The question then becomes which corporation must have the earnings and profits. In Rev. Rul. 75-83,[368] the IRS seemed to take the position that the earnings and profits of the acquired corporation controlled under §356. However, following the decision in *Clark*, Rev. Rul. 75-83 was revoked by Rev. Rul. 93-61.[369] While *Clark* does not directly address the issue, since it applies the dividend equivalence test to the survivor corporation, and such entity would inherit the earnings and profits of the target pursuant to §381, it would seem that the presence of earnings and profits in either corpora-

[359] In order for the stock to be §306 stock, the corporation must have some earnings and profits for the year during which the preferred stock is issued. *See* §306(c)(2).

[360] H.R. Rep. No. 2543, 83d Cong., 2d Sess. 35–36 (1954).

[361] For an example of where the IRS treated part of the preferred stock as §306 stock and part as non-§306 stock, see TAM 6005036680A.

[362] Pub. L. No. 97-248. Section 227(a) of TEFRA added §306(c)(4), effective for stock received after August 31, 1982.

[363] Prior to the enactment of §306(c)(4), the IRS regularly granted favorable private rulings that preferred stock was not §306 stock where all the common stock was given up, even though §318 related parties owned common stock. *See, e.g.*, PLR 7731039, PLR 7730008, PLR 7720006. *See also* Rev. Rul. 77-455, 1977-2 C.B. 93.

[364] Section 302 is concerned with redemptions of corporate stock. If a redemption qualifies within §302(b), sale or exchange treatment is provided, and capital gains results, assuming that the stock is a capital asset. If the redemption does not qualify within §302(b), then §302(d) provides that the redemption is treated as a distribution of property to which §301 applies. Under §301, the distribution is treated as a dividend to the extent of earnings and profits. *See also* IV.C.5.b., above.

[365] For an extended discussion of this problem, and numerical examples of how §302(b) would operate, see Levin, Adess & McGaffey, *Boot Distributions in Corporate Reorganizations — Determination of Dividend Equivalency*, 30 Tax Law. 287 (1977).

[366] Rev. Rul. 75-83, 1975-1 C.B. 112, *revoked by* Rev. Rul. 93-61, 1993-2 C.B. 118. *See also* PLR 7744043 (shareholders of target corporation could receive common and preferred stock of acquiring corporation; preferred stock was §306 stock for taxpayers who received both common and preferred, but §306(b)(4) exception applied).

[367] *See* IV.B.2., above.

[368] 1975-1 C.B. 112, *revoked by* Rev. Rul. 93-61, 1993-2 C.B. 118.

[369] 1993-2 C.B. 118.

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tion would be sufficient to remove the stock from the exception of §306(c)(2).

(2) "B" Reorganizations

Applying the cash substitution test to a "B" reorganization is also problematical. As a threshold matter, the cash substitution test is wholly incompatible with a "B" reorganization. To qualify as a "B" reorganization, the acquiring corporation may exchange only its voting stock; no other consideration is permissible. Where voting preferred stock is issued in a transaction qualifying as "B" reorganization, the question is whether such preferred stock is §306 stock. The cash substitution test provides that cash is deemed distributed in lieu of the preferred stock. If the regulation is read literally, the hypothetical cash distribution would deny reorganization treatment because cash is never permissible consideration in a "B" reorganization. Consequently, the hypothetical cash would cause the transaction to be a taxable reorganization. Therefore, §306(c)(1)(B) would be inapplicable and the preferred stock would not be §306 stock.

However, such a result is inconsistent with the statutory language and intent. If preferred stock, issued in a "B" reorganization, has an effect substantially the same as a stock dividend, §306(c)(1)(B) should be construed so that the preferred stock is classified as §306 stock.[370] Similarly, preferred stock that has no bailout potential should not be classified as §306 stock. Thus, it would appear that a §302-type analysis should be applied to "B" reorganizations, just as in the case of "A" reorganizations.[371]

Before the enactment of §306(c)(3),[372] another problem with applying §306(c)(1)(B) to a "B" reorganization was a potential overlap between §368(a)(1)(B) and §351. The problem arose when a holding company (created to own the stock of a subsidiary corporation) issued preferred and common stock.[373] For example, assume that Corporation X (X) had outstanding 3,000 shares of common stock that were owned equally by B and C. B and C organized Corporation Z (Z) and transferred all of X's common stock to Z. B and C received back 500 shares of Z voting preferred and 1,000 shares of Z voting common stock. As a consequence of the transaction, X became a wholly owned subsidiary of Z. The transaction was a §351 transaction from the perspective of the shareholders because B and C transferred property to Z, shareholders B and C received stock of Z, and B and C were in control of Z after the transaction. Prior to 1997, preferred stock issued in a §351 transaction would not normally constitute §306 stock, since there was typically little chance for bailout when a corporation was newly formed.[374] In addition to satisfying the §351 tests, the transaction satisfied the requirements of §368(a)(1)(B), and could be viewed as a "B" reorganization. Preferred stock issued in a reorganization can be §306 stock under §306(c)(1)(B).

[370] There is nothing in the legislative history indicating that a B reorganization should not be subject to §306(c)(1)(B). *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 241–46 (1954).

[371] *See* discussion at IV.C.5.c.(1), above.

[372] Section 306(c)(3) was added by §226(b) of TEFRA, effective for transfers occurring after August 31, 1982.

[373] For a planning-oriented discussion of the use of a holding company, see VI., below.

[374] S. Rep. No. 1622, 83d Cong., 2d Sess. 245 (1954).

In Rev. Rul. 79-274,[375] the IRS considered the foregoing situation, and held that, if the acquiring corporation had either current or accumulated earnings and profits, §368(a)(1)(B) prevailed over §351 so that the preferred stock was §306 stock under §306(c)(1)(B). As noted above, §306(c)(3) would result in the preferred stock being treated as §306 stock.[376]

The 1997 Taxpayer Relief Act (TRA 1997)[377] added another wrinkle to the analysis. TRA 1997 §1014(a) added §351(g), which treats "nonqualified preferred stock" as boot in a §351 incorporation. Occasionally, a §351 exchange with boot may overlap with §304. Section 304(a) will override §351 if transfers of property are described in both provisions.[378] If property transferred to a controlled corporation consists of stock in another corporation of which the transferor has at least 50% control and the transferee corporation transfers cash or other property, in addition to stock, to the transferor, §304 may cause the transfer of the cash or other property to be treated as a distribution or redemption taxable under §301, §302, or §303 (whichever is applicable) rather than as an exchange of boot taxable under §351(b). The tax consequences of a §304 distribution are markedly different from those of a §351(b) exchange. If consideration other than stock is received in an exchange to which §304 is applicable, the property received is treated as a dividend to the extent that either the corporation whose stock is transferred or the transferee corporation has earnings and profits.[379]

Nonqualified preferred stock, for the purposes of §351, means preferred stock if:

(i) the holder has the right to require the issuer or a related person to redeem or purchase the stock;

(ii) the issuer or a related person is required to redeem or purchase the stock;

(iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised; or

(iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

Clauses (i), (ii), and (iii) above only apply if the right or obligation may be exercised within the 20-year period beginning on the date of issue of such stock and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. Moreover, a right or obligation will not be treated as described in clauses (i), (ii), or (iii) if:

A. It may be exercised only upon the death, disability, or mental incompetency of the holder, or

B. In the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represents reasonable compensation), it may be exercised

[375] 1979-2 C.B. 131. *See also* PLR 8023082, PLR 7821097.

[376] *See* discussion at IV.D., below.

[377] Pub. L. No. 105-34.

[378] §304(b)(3)(A).

[379] §304(b)(2).

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only upon the holder's separation from service from the issuer or a related person. However, clause A does not apply if stock relinquished in the exchange, or stock acquired in the exchange is in:

(1) A corporation, if any class of stock in such corporation or a related party, is readily tradable on an established securities market or otherwise, or

(2) Any other corporation, if such exchange is part of a transaction or a series of transactions in which such corporation is to become a corporation described in subclause (1) above.

For the purposes of §351(g), persons are related if they bear a relationship described in §267(b) or §707(b). As mentioned in IV.B.3., above, "preferred stock" for purposes of §351 generally means stock which is limited and preferred as to dividends and does not participate in growth to any significant extent.[380]

Nonqualified preferred stock will take a fair market value basis in the hands of the recipient. While the gain may be taxable as a dividend under §304 or otherwise, the preferred stock should not constitute §306 stock where no bailout potential exists.[381]

(3) "C" Reorganizations

Section 368(a)(1)(C) provides reorganization treatment to transactions in which substantially all the properties of the target corporation are acquired in exchange for voting stock of the acquiring corporation. At least 80% of the consideration provided by the acquiring corporation must be its own voting stock. The remainder of the consideration may be money or other property. As was the case with "B" reorganizations, the issue raised is whether application of the cash substitution test would cause the "C" reorganization to fail the 80% test, resulting in the recognition of gain or loss. Thus, §306(c)(1)(B) would be inapplicable from a technical standpoint. As discussed above, there is no indication that Congress intended such a result, and the cash substitution test presumably would not be applied to prevent §306 from operating.[382]

The only public ruling involving a "C" reorganization and §306 stock is Rev. Rul. 57-103,[383] which involved the acquisition by a publicly held corporation of all the assets of a closely held corporation. The target shareholders surrendered their common stock in exchange for voting preferred and common stock constituting 5% of the acquiring corporation's stock. Without providing any additional facts, the ruling concluded that the preferred stock was §306 stock, but that §306(b)(4) exempted the preferred stock from the penalty of §306.[384] The conclusion that the preferred stock was §306 stock is difficult to evaluate because important facts were not disclosed. The IRS appeared to be adopting an automatic rule: preferred stock is §306 stock where both common and preferred are received in a "C" reorganization. Due to the differences in size of the corporations, a §302-type of analysis should have been made to determine if the preferred should be §306 stock, but such an analysis was omitted. Perhaps the IRS felt that an analytical discussion of the definitional rule of §306(c)(1)(B) was unnecessary because the §306(b)(4) exemption was provided. Notwithstanding this conjecture, the ruling provides an unsatisfactory justification for its conclusion that the preferred stock was §306 stock. The ruling was subsequently revoked by Rev. Rul. 89-63[385] on the theory that the fact that shares are widely held should not provide justification for application of the §304(b)(4) exemption. The revocation, however, does not mention the failure of the IRS to scrutinize the finding that the preferred stock was §306 stock.

d. Divisive Reorganizations

Section 306(c)(1)(B) applies to "D" reorganizations and §355 corporate divisions, such that preferred stock issued in either kind of transaction can be §306 stock. A "D" reorganization is a transfer by a corporation of all or part of its assets to a corporation controlled (after the transfer) by the transferor corporation, or its shareholders. Further, a transaction qualifies as a "D" reorganization only if stock or securities of the transferee corporation are distributed by the transferor corporation in a transaction that qualifies under §354, §355, or §356. Typically, two transactions qualify as "D" reorganizations: (1) the transfer of substantially all the assets of a corporation to a controlled corporation in exchange for stock or securities of the controlled corporation, after which the transferor corporation liquidates by distribution of the stock or securities of the controlled corporation, and (2) the transfer of part of the assets of a corporation to a controlled corporation in exchange for stock or securities of the controlled corporation, after which the transferor corporation makes a §355 distribution of the stock or securities of the controlled corporation.

Section 355 applies to the distribution of stock and securities of a corporation controlled by the distributing corporation if: (1) immediately before the distribution, the distributing corporation controls[386] the issuing corporation; (2) after the distribution, both corporations are engaged in the active conduct of a trade or business;[387] (3) both corporations have been engaged in the active conduct of trade or business for the preceding five years;[388] (4) the distributing corporation either (i) distributes sufficient stock to provide control[389] of the controlled corporation, and also establishes that any retention of stock or securities is not part of a plan having, as one of its principal purposes, the avoidance of federal income tax, or (ii) distributes all stock and securities of the controlled corporation which distributing owns; and (5) the transaction is not used principally as a device for the distribution of earnings and profits.[390]

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[380] §351(g)(3)(A).

[381] For a complete discussion of §351(g), see 758 T.M., *Transfers to Controlled Corporations: In General.*

[382] See the discussion of the cash substitution test and B reorganizations at IV.C.5.c.(2), above.

[383] 1957-1 C.B. 113, revoked by Rev. Rul. 89-63, 1989-1 C.B. 90.

[384] For a discussion of §306(b)(4), see V.D.4., below.

[385] 1989-1 C.B. 90.

[386] For this purpose, control means ownership of at least 80% of the total combined voting power and at least 80% of the total number of shares of all other classes of stock. *See* §368(c).

[387] *See* 776 T.M., *Corporate Separations.*

[388] *Id.*

[389] *See* §368(c).

[390] *See* 776 T.M., *Corporate Separations.*

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If the transaction qualifies within either §368(a)(1)(D) or §355, then any preferred stock that is distributed may be §306 stock, under §306(c)(1)(B), if the effect of the transaction is substantially the same as a stock dividend. For example, assume a §355 transaction, in which a corporation transfers the assets of a trade or business to another corporation in exchange for all its common and preferred stock, which is then distributed pro rata to the shareholders of the transferor corporation.[391] The effect of the transaction is to provide the original shareholders of the transferor corporation with some preferred stock suitable for a bailout, with no change in control or residual common stock equity. Such preferred stock should be §306 stock because the effect of the transaction is the same as if (1) the assets had been transferred to the controlled corporation in exchange for only common stock of the controlled corporation, (2) the common stock had been distributed pro rata to the shareholders of the transferor corporation, and (3) the controlled corporation had declared a preferred stock dividend on its outstanding common stock. Since preferred stock actually received as a stock dividend would be §306 stock, preferred stock received in a §355 transaction, that has the same effect as a stock dividend, is treated as §306 stock under §306(c)(1)(B).

On the other hand, transactions in which the preferred stock is not distributed pro rata often will not have the effect of a stock dividend. The shareholders of a corporation that is to be divided might agree that some shareholders would receive only preferred stock. In effect, the persons who receive only preferred stock are selling their common stock, and the transaction is not like a stock dividend. For example assume X corporation (X) is owned by three shareholders. If X is to be divided into two corporate entities, one shareholder could receive all the common of one corporation, the second shareholder could receive all of the common of the second corporation, and the third shareholder could receive preferred stock of either or both of the controlled corporations.

Some transactions that involve the non-pro rata distribution of preferred stock still could have the effect of a stock dividend. For example, where a two-shareholder corporation divides into two corporations and the shareholders surrender their stock,[392] one shareholder might receive only common stock in one corporation and the second shareholder might receive common and preferred of the second corporation. Although the preferred is not distributed pro rata, as to the second shareholder the transaction is the same as if only common stock had been received and the second corporation declared a stock dividend. Thus, the effect of the transaction is the same as a stock dividend, and the preferred stock would be §306 stock.

In applying the "effect of a stock dividend" test, it seems clear that pro rata distributions of preferred stock in §355 transactions will cause any distributed preferred stock to be subject to §306. The more difficult situations are the ones in which preferred stock is distributed in a substantially disproportionate manner. These disproportionate distributions of preferred stock may or may not have the effect of a stock dividend. To test such transactions, the IRS applies the cash substitution test of Reg. §1.306-3(d),[393] but not until Rev. Rul. 77-335[394] did the IRS provide any substantial guidance on how to apply §306 in the "D" reorganization-§355 distribution situation. In that ruling, X Corporation (X) had owned for more than five years all the common and preferred stock (not §306 stock) of Y Corporation (Y). Each corporation had engaged in separate trade or business activities for more than five years. For "valid business reasons" X distributed pro rata to its shareholders all of Y's common and preferred stock, in a §355 distribution. At the time of distribution, X had earnings and profits in excess of the fair market value of Y preferred stock. Y had no earnings and profits. By application of the cash substitution test, the ruling concluded that the preferred stock was §306 stock. If X had distributed cash in lieu of the preferred stock, §356(b) and the automatic dividend rule would have applied to the §355 distribution. The ruling's most significant points were (1) that it concluded that the presence of earnings and profits in the distributing corporation made §306(c)(2) inapplicable, and (2) that it made the preferred stock §306 stock, even though the issuing corporation did not have any earnings and profits.

While not addressed in Rev. Rul. 77-335, Reg. §1.312-10 could have been applied, theoretically, to reach the same result. That section requires that in a "D" reorganization earnings and profits be apportioned between the distributing and controlled corporations in accordance with their respective fair market values. In such event, some of X's earnings and profits would have been attributed to Y.

e. Recapitalizations and "F" Reorganizations

(1) Preferred Stock Retained

A recapitalization is the type of reorganization which is most likely to fall within §306. In a typical estate planning recapitalization the older generation shareholders exchange some or all of their common stock for preferred stock. Where the common shareholder gives up all the common and receives back only preferred, the IRS has ruled that the preferred is not §306 stock under the cash substitution test.[395] On the other hand, if a common shareholder receives preferred stock and retains all the common stock, the IRS has ruled that the preferred is §306 stock under the cash substitution test.[396] Where a shareholder exchanges some (but less than all) of his common stock for preferred stock, the result under the cash substitution test is not always clear. Often the issue can be resolved by reference to §302(b). For example, assume that a corporation is owned equally by unrelated individuals B and C (each of whom owns 50 shares of common stock). Assume further that C demands a greater share of future equity growth of the business and also more voting control. B agrees and, as part of a recapitalization, B surrenders 30 of his 50 common shares in exchange for non-voting preferred stock. This would leave B with 20 of the 70

[391] This distribution is called a "spin-off" in tax parlance. *See* 776 T.M., *Corporate Separations*.

[392] This transaction would be a "split-up." *See* 776 T.M., *Corporate Separations*.

[393] *See* Rev. Rul. 59-197, 1959-1 C.B. 77.

[394] 1977-2 C.B. 95.

[395] *See* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 59-84, 1959-1 C.B. 71.

[396] *See* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 59-84, 1959-1 C.B. 71. *See also* Rev. Rul. 56-223, 1956-1 C.B. 162 (where there was no real bailout potential, the IRS ruled that §306(b)(4) would apply to any disposition of the stock). Section 306(b)(4) is discussed at V.D.4., below.

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common shares outstanding. Application of §302 standards to the cash substitution rule would lead to the conclusion that the preferred stock is not §306 stock because cash distributed in lieu of the preferred would have qualified within §302(b)(2) as a substantially disproportionate redemption of the 30 shares of common stock.[397]

The issue is whether the IRS will apply §302(b) standards in determining if preferred stock received in a recapitalization is §306 stock, if a shareholder exchanges less than all of his common stock. The IRS has not publicly ruled that the §302 standards are applicable to such a case.[398] In Rev. Rul. 59-84,[399] the IRS considered a recapitalization in which the common shareholders surrendered their old common. One group of shareholders received back only common (which was not §306 stock under the common stock exception), another group took back only preferred (which was not §306 stock under the cash substitution test since no common was retained), while a third group received some common and some preferred stock in the exchange. The ruling concluded that the preferred stock was §306 stock to the shareholders who also received common stock. While the ruling did not expressly apply the §302(b) standards, it did indicate that there was no substantial change in the shareholders' percentage ownership in the common stock.

Some practitioners have argued that Rev. Rul. 59-84 establishes that a §302(b) analysis is to be used in determining whether preferred stock received in a recapitalization is §306 stock. These practitioners maintain that the reference in the ruling to common stock ownership percentages before and after the recapitalization indicates that a §302(b) analysis is to be undertaken.

Unfortunately, the IRS's position on the applicability of the §302(b) standards is confusing. Some public and private rulings have been issued that indicate that, if any common stock is retained, then the preferred will automatically be §306 stock.[400] Conversely, some private rulings seem to indicate that §302(b) standards do indeed apply.[401]

Comment: It appears that the IRS has refused to apply §302(b) standards in the most recent rulings, and Tax Management understands that the IRS's current position is that §302(b) standards are irrelevant. In the IRS's view, if any common stock is retained the preferred is automatically §306 stock.

Although it appears that the IRS will not apply §302(b) standards in testing recapitalizations under §306(c)(1)(B), a strong argument can be made that the §302(b) standards should be applied. Where the shareholder has surrendered a substantial portion of the common stock, the preferred stock represents payment for the surrendered shares and such preferred stock should not be §306 stock. In such a situation, the preferred is not issued as a substitute for a stock dividend; the preferred is received in payment for the common. Since the shareholder is undergoing a significant reduction in his residual equity interest in the corporation, such a transaction does not have the earmarks of a bailout. Conversely, where the shareholder has surrendered an insubstantial portion of the common stock, the transaction is equivalent to a dividend. The problem of drawing the line in recapitalizations, between preferred issued as a stock dividend and preferred issued in payment for common stock could be determined conveniently by reference to §302(b), which provides quantifiable standards. If the shareholder has sufficiently changed position within §302(b) as to the common stock, it would seem that the preferred should not be §306 stock.

(2) Preferred Stock Surrendered

Reg. §1.306-3(d) contains an example in which preferred stock is exchanged for new preferred stock. Two shareholders each own one-half of the outstanding common stock and preferred stock of a corporation. In a recapitalization, the shareholders surrender their preferred stock in exchange for preferred stock, which is not substantially different from the old stock. The example concludes that the new preferred stock is not §306 stock, assuming the old preferred stock was not itself §306 stock.[402] That result seems reasonable in that there is no bailout being effected by the recapitalization because the shareholder is simply exchanging previously owned preferred for identical new preferred.[403] Bailout potential exists due to the presence of the preferred stock, but that bailout potential arose prior to the recapitalization when the preferred stock originally was issued. Thus, in terms of the "effect of a stock dividend" test of §306(c)(1)(B)(ii), the recapitalization should not result in §306 stock classification of the new preferred stock notwithstanding that application of the cash substitution test would likely have led to the conclusion that a dividend was present.[404]

Rev. Rul. 88-100[405] clarifies Rev. Rul. 60-1,[406] Rev. Rul. 79-287,[407] and Rev. Rul. 82-118.[408] In Rev. Rul. 88-100, corporations X and Y each had a single class of common stock outstanding. Y also had preferred stock outstanding which was not

[397] The §302(b)(2) requirements have been met by the hypothetical redemption because B ends up with less than 50% of voting control and, after the transaction, B has 28% of the voting common (20 of 70 shares), which is less than 80% of the 50% B had before the transaction.

[398] In Rev. Rul. 75-83, 1975-1 C.B. 112, *revoked by* Rev. Rul. 93-61, 1993-2 C.B. 118, the IRS applied §302(b) standards to §356(a)(2), but the IRS has not applied §302(b) for purposes of the cash distribution rule under §306.

[399] 1959-1 C.B. 71.

[400] *See* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by* Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 59-84, 1959-1 C.B. 71.

[401] *See, e.g.*, PLR 7815041, PLR 7803049, PLR 7802050, PLR 7748016, PLR 7737024.

[402] *See also* Rev. Rul. 60-1, 1960-1 C.B. 143, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46. *But see* Rev. Rul. 70-199, 1970-1 C.B. 68 (voting preferred exchanged for common was §306 stock where shareholder owned over 50% of outstanding common stock and all outstanding nonvoting preferred that was entitled to elect a majority of the corporation's directors due to dividend arrearages).

[403] Rev. Rul. 79-287, 1979-2 C.B. 130, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46, extended the holding of Ex. (2) in Reg. §1.306-3(d) to an "F" reorganization in which the corporation changed its state of incorporation.

[404] If the preferred stock is ignored and cash substituted for it, literal application of the cash substitution test of Reg. §1.306-3(d) might seem to result in dividend treatment because of the unchanged common stock ownership under the IRS's position relative to a shareholder retaining any common stock. Alternatively, the cash distribution might be deemed to be in exchange for the old preferred. Due to the common stock ownership, the redemption might receive dividend treatment under §301. The example in the regulations seems to reach the right conclusion, but reaching that conclusion is difficult under the cash substitution test. *See also* Rev. Rul. 60-1, 1960-1 C.B. 143, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46.

[405] 1988-2 C.B. 46.

[406] 1960-1 C.B. 143, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46.

[407] 1979-2 C.B. 130, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46.

[408] 1982-1 C.B. 56, *clarified by* Rev. Rul. 88-100, 1988-2 C.B. 46.

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§306 stock. Y merged into X in an "A" reorganization in which each share of Y common stock was exchanged for one share of X common stock, and the Y preferred stock was exchanged for newly issued X preferred stock of an equal value. The terms of the X preferred stock were not substantially different from those of the Y preferred stock. An individual shareholder of Y realized a gain on the exchange. Since Y had sufficient earnings and profits, if it had distributed an amount of cash equal to the value of the X preferred stock actually exchanged, the cash distribution would have been taxed as a dividend under §356(a).

The IRS concluded that the preferred stock was not §306 stock since the exchange did not have the effect of a distribution of the earnings and profits of either corporation. Thus, the ruling extended the conclusion of Ex. (2) of Reg. §1.306-3(d) to acquisitive reorganizations. This ruling should be of less significance following the Supreme Court's decision in *Commissioner v. Clark*,[409] because, in an acquisition setting, a distribution of cash in lieu of preferred stock would be expected to be treated as "not essentially equivalent to a dividend" under §302(b)(1).

Rev. Rul. 70-199[410] involved the recapitalization of a corporation in which a taxpayer owned more than 50% of the outstanding common and all the preferred. The preferred normally was nonvoting. Over a number of years the corporation incurred substantial arrearages on the preferred stock even though the corporation had earnings and profits. The preferred shareholders were entitled to elect a majority of the corporation's board of directors, due to the dividend arrearages. Pursuant to a plan of recapitalization, the taxpayer exchanged all of his common stock for new, voting, noncumulative second preferred stock. The old preferred stock (which had the power to elect a majority of the board of directors) was retained. The ruling concluded that the new second preferred was §306 stock. Application of the cash substitution test to the "redemption" of the common stock normally would lead to the conclusion that §302(b) would apply and, consequently, the conclusion that the second preferred would not be deemed §306 stock. The ruling, however, reached the opposite conclusion because the transaction was deemed to have resulted in no meaningful change in the taxpayer's position. The taxpayer continued to control the board of directors by the vote given to the first preferred stock. In addition, the taxpayer's right to current earnings was unchanged because no dividends could be paid on the common until the dividend arrearages on the preferred had been discharged. Thus, the IRS concluded that the taxpayer gave up no rights to current income in the exchange because the common, in effect, had no right to current dividends. Finally, it was claimed that the taxpayer did not give up the right to participate in the future equity growth of the corporation. The ruling stated that, in effect, there was no equity growth potential because the annual dividend amount on the first preferred was approximately equal to the annual increase in net worth of the corporation.

The facts in Rev. Rul. 70-199 are unusual, and it must be admitted that the recapitalization involved therein does have a resemblance to a bailout. The transaction could be used to bail out the value of the corporation to the extent of the date-of-recapitalization value of the taxpayer's common stock without surrendering control of the corporation. While such a potential bailout may be precisely what §306 was intended to prevent, the holding of the ruling seems questionable because the taxpayer in fact did relinquish substantial rights. Certainly, it would be possible for the corporation to become profitable enough so that payment of dividends on common stock would become a reality. Moreover, the taxpayer could not participate in any growth in the corporation's equity because he had surrendered the common stock. Thus, while the facts of Rev. Rul. 70-199 suggest a bailout potential, they do not justify the conclusion that nothing of substance occurred when the taxpayer surrendered the common. On the facts, the ruling may seem to reach the right result because the transaction seemed to have an aura of tax-avoidance. In a broader context, however, the holding of the ruling seems incorrect.[411]

D. Substituted Basis Stock

1. General Rule

Section 306(c)(1)(C) provides that stock is treated as §306 stock if the adjusted basis of such stock is determined by reference to the adjusted basis of stock that is §306 stock. Thus, §306(c)(1)(C) applies where a taxpayer disposes of §306 stock in a transaction which causes a "carryover" or "substituted" basis provision to operate. For example, a taxpayer who receives an inter vivos gift of stock obtains a basis in such stock determined by reference to the donor's basis.[412] If the stock was §306 stock in the hands of the donor, it will be §306 stock in the hands of the donee, pursuant to §306(c)(1)(C). Conversely, a donee who inherits stock, which was §306 stock in the hands of the decedent, obtains a fair market value basis pursuant to §1014. Accordingly, §306(c)(1)(C) is inapplicable, and the stock is not §306 stock in the beneficiary's hands.

A taxpayer who exchanges §306 stock for other stock cannot avoid the §306 taint if the adjusted basis of the new stock is determined by reference to the adjusted basis of the §306 stock surrendered.[413] Such a substituted basis rule applies to various nonrecognition transactions such as §351 incorporation transfers of the §306 stock, and §1036 exchanges of identical class stock.[414] Section 306(c)(3) was added to the Code by TEFRA,[415] and provides a special rule for preferred stock issued in certain §351 transactions. If the receipt of money in lieu of the preferred stock would have resulted in dividend treat-

[409] *See* IV.C.5.b., and IV.C.5.c.(1), above.

[410] 1970-1 C.B. 68.

[411] *See also* Rev. Rul. 56-586, 1956-2 C.B. 214, *obsoleted by* Rev. Rul. 2003-99, 2003-34 I.R.B. 388, which also discussed the applicability of §306 to preferred stock received in a recapitalization where the shareholders surrendered previously outstanding preferred stock. The analysis in the ruling is incomplete and otherwise inadequate. The ruling is criticized in Trimble, *The Treatment of Preferred Stock Distributions in Reorganizations Under Section 306 of the Internal Revenue Code of 1954*, 19 Tax L. Rev. 345, 362–64 (1964).

[412] Section 1015 provides that the donee has a dual basis. The basis for determining gain is the donor's adjusted basis. The basis for determining loss is the lesser of the donor's adjusted basis or the fair market value of the property at the time of the gift.

[413] Under §306(c)(1)(C) it makes no difference whether the issuing corporation has any earnings and profits at the time of the exchange. *See* Rev. Rul. 77-108, 1977-1 C.B. 86.

[414] Corporate reorganizations that receive nonrecognition treatment are subject to §306(c)(1)(B), rather than §306(c)(1)(C), by virtue of the first clause of §306(c)(1)(C). Section 306(c)(1)(B) is discussed at IV.C.5., above.

[415] Section 306(c)(3) was added by §226(b) of TEFRA, effective for transfers occurring after August 31, 1982.

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ment to any extent, the preferred stock will be §306 stock. Essentially, §306(c)(3) is a statutory "cash substitution test." The statute provides that in applying the test, rules similar to those in §304(b)(2) apply. Thus, in determining whether the transaction would have resulted in a dividend to any extent, the earnings and profits of both the new corporation and the old corporation are considered. For example, assume B owns 75% of the common stock of X corporation (X). B exchanges his X stock for all of the voting common stock and all of the preferred stock of Newco, in a §351 transaction. Newco has no earnings and profits during its first taxable year but X does. The presence of earnings and profits in X will cause the preferred stock to be §306 stock.[416] Moreover, for purposes of §306(c)(3), the attribution rules of §318(a), as modified by §304(c)(3)(B) apply.[417] Note that §306(c)(3) only applies to preferred stock issued in a §351 transaction. It is inapplicable to common stock issuances.

If the preferred stock issued in a §351 transaction is nonqualified preferred stock, within the meaning of §351(g), the general rule of §351(a) does not apply to the receipt of the preferred stock, and it takes a fair market value basis. While that gain could be taxable as ordinary income under §304, the nonqualified preferred stock should not constitute §306 stock.[418]

A purchaser of stock that is §306 stock to the seller will receive a §1012 cost basis in the stock. Accordingly, the stock in the hands of the purchaser will not be §306 stock.

In contrast to §306(c)(1)(A) and §306(c)(1)(B) and §306(c)(3), there is no exclusion of common stock from §306(c)(1)(C). Thus, common stock can be §306 stock within §306(c)(1)(C). This result is correct because the common could be used to effect a bailout. For example, assume that the taxpayer owned all the common stock and all the §306 preferred stock of a corporation. If the taxpayer were to transfer all the preferred stock to a newly organized corporation in exchange for only common stock of the new corporation, the transaction would be tax-free, under §351, and the taxpayer's adjusted basis in the new common would be equal to the taxpayer's adjusted basis in the §306 preferred.[419] The taxpayer would be willing to sell the common stock of the new corporation because the new corporation merely holds the preferred stock of the original operating corporation. Clearly, the transaction has bailout potential, and the common stock of the new corporation should be §306 stock due to the substituted basis which the common stock succeeds to in the hands of the taxpayer under this type of transaction.

2. Convertible Stock

There is one important exception to the foregoing analysis of common stock under §306(c)(1)(C). Section 306(e)(1) provides that §306 stock may be converted into common stock of the same corporation without tainting the common stock as §306 stock. Under the general rule of §306(c)(1)(C), common stock received in such a conversion would be §306 stock. Section 306(e)(1) properly prevents that result, however, because there is no bailout potential when the preferred is converted into common of the same corporation. No bailout can occur because the disposition of any of the common will dilute the taxpayer's control and residual ownership. Thus, when the §306 preferred is downgraded into common stock of the same corporation, the common is not §306 stock.[420] The exception contained in §306(e)(1) is inapplicable if the holder of the common stock has the right to convert such stock into stock, other than common stock, or other property. For this purpose, it is irrelevant whether the conversion privilege is or is not contained in the stock itself.[421]

E. Definitions and Special Rules

1. Stock Rights

Section 306(d) is concerned with stock rights that authorize the holder of the right to acquire stock of the corporation. Receipt of such stock rights generally would be tax-free under §305.[422] Thus, there would be a major gap in §306 if preferred stock received upon exercise of the rights were not subject to §306. To prevent that gap, §306(d)(1) provides that stock rights are to be treated as stock. Thus, if a corporation distributes rights to acquire preferred stock, the stock rights are deemed to be preferred stock subject to §306(c)(1)(A). Accordingly, if the stock right itself is disposed of, the §306(a) disposition rules will apply.[423] Moreover, §306(d)(2) provides that stock acquired through the exercise of a stock right is deemed to be stock distributed at the time of distribution of the stock rights. Thus, preferred stock acquired by exercise of a stock right can be §306 stock under §306(c)(1)(A).[424]

Section 306(d) addresses traditional stock rights. A more complicated variation of the stock right transaction involves the distribution of rights to acquire corporate bonds.[425] In the context of §306, the problem arises with respect to the distribution of rights to acquire bonds that are convertible into stock of the corporation.[426] The IRS's position seems to be that the distribution of rights to acquire bonds that are convertible into stock of the issuing corporation is nontaxable, under §305, if (i) a dividend distributed in the form of stock into which the bonds are convertible would be nontaxable and (ii) the value of the subscription rights is attributable to the conversion privilege and not to the bond acquisition right.[427] Presumably, the stock right rules of §306(d) would apply to the right to acquire the convertible bond, and to the stock eventually received upon conversion of the bond. Consequently, §306(c)(1)(A) could apply if the stock subject to acquisition is not common stock.

2. Changes in Terms of Stock

Section 306(g) is concerned with attempts to avoid §306 through changes in the terms of previously issued stock. For

[416] *See* Rev. Rul. 79-274, 1979-2 C.B. 131 and discussion at IV.C.5.c.(2), above.

[417] §306(c)(4).

[418] *See* discussion at IV.C.5.c.(2), above.

[419] §358(a)(1).

[420] *See* Reg. §1.306-3(f).

[421] §306(e)(2).

[422] *See* Reg. §1.305-1(a). *See also* discussion at III., above.

[423] The disposition rules, with respect to §306 stock, are discussed in detail at V., below.

[424] *See* Reg. §1.306-3(b).

[425] *See* discussion at III.I.3., above.

[426] If the bonds are not convertible into stock, the distribution of such rights to acquire the bonds would be a distribution of property under §317(a) and would be taxable under §301. *See* GCM 13414, XIII-2 C.B. 124 (1934).

[427] *See* PLR 6-27-56, (1956) Fed. Taxes (P.H.) ¶76,680.

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example, a corporation could issue a preferred stock dividend at a time when the corporation had no earnings and profits. Due to the absence of earnings and profits, the preferred stock would not be §306 stock, under §306(c)(2). After a number of profitable years, however, the corporation might choose to increase the call price of the preferred stock.[428] The inducement for such action would be to increase the capital gain bailout potential of the preferred stock that, at the outset, was not §306 stock. Section 306(g) prevents the bailout by providing that stock, the terms of which are changed substantially, is not §306 stock only if the corporation has no earnings and profits at both (i) the time of distribution of the stock and (ii) the time of change in terms of the stock.[429] Thus, if earnings and profits are present for the year during which the change is made, then the stock will be §306 stock.[430]

3. *Stock Received Before 1954*

Before its repeal by the 1990 Omnibus Budget Reconciliation Act,[431] §306(h) provided that §306 would not apply to stock received in a transaction subject to the Internal Revenue Code of 1939 (or corresponding provisions of prior law), even though the stock is disposed of in a year to which the Internal Revenue Code of 1954 applies.[432] Taxation of the disposition of such stock was to be determined by reference to the Internal Revenue Code of 1939. Nevertheless, the savings clause of §11821(b) of that Act apparently continues such treatment.

[428] S. Rep. No. 1622, 83d Cong., 2d Sess. 245 (1954). Moreover, the change in terms would effect a §368(a)(1)(E) recapitalization. *See* Rev. Rul. 56-654, 1956-2 C.B. 216.

[429] *See* Reg. §1.306-3(g).

[430] *Id.*

[431] Pub. L. No. 101-508.

[432] The effective date of §306 of the Internal Revenue Code of 1954 was January 1, 1954.

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V. Dispositions of Section 306 Stock

A. *General Tax Consequences of a Disposition*

The purpose of §306 is to prevent the bailout of earnings from a corporation at capital gains rates. While the bailout problem could have been attacked upon receipt of the §306 stock, Congress elected to impose the §306 penalty upon disposition of the §306 stock. More specifically, §306 applies in two different fashions: Section 306(a)(2) applies to redemption dispositions of §306 stock and §306(a)(1) applies to any nonredemption disposition of §306 stock. Section 306(b) provides various exceptions from the general rules of §306(a) for transactions that in substance do not accomplish a bailout.

Note that, where the rate differential between ordinary income and capital gains is small or nonexistent, the significance of §306 taint is lessened. Nevertheless, it can be very important to a taxpayer who has a large capital loss carryover or a significant tax basis in his stock. On the other hand, it should also be remembered that corporate shareholders will normally prefer dividend treatment in order to claim the dividends received deduction.

B. *Redemption Dispositions*

1. *Transactions Constituting a Redemption*

Section 306(a)(2) applies to dispositions that are redemptions by the issuing corporation. Under §317(b), a redemption occurs if a corporation acquires its stock from a shareholder in exchange for property. For these purposes it is irrelevant whether the redeeming corporation holds the stock as treasury stock, or cancels or retires it.

2. *Tax Consequences*

Section 306(a)(2) provides that a redemption of §306 stock is to be treated as a distribution of property subject to §301. In other words, the redemption is treated as a distribution of property under §301, rather than as a redemption under §302. Application of §301 to the redemption means that the amount distributed will be a dividend, under §301(c)(1), to the extent of the corporation's earnings and profits, followed by a return of adjusted basis under §301(c)(2), and finally gain from the sale or exchange of property, under §301(c)(3). Thus, where disposition is by means of a redemption, the §306 penalty appears in the form of a dividend.

For taxable years beginning after 2002, treatment as a dividend does not normally constitute a penalty to individual taxpayers, assuming that the corporation redeeming the §306 stock is a domestic corporation or a qualified foreign corporation. Under current law, §1(h)(11)[433] provides that individuals are subject to the same rates for such dividends as for capital gains. However, the recharacterization could have a great impact on an individual who has capital losses and could use those losses to offset capital gains, or an individual who has a significant tax basis in his shares of stock.

[433] Added by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, Pub. L. No. 108-27, §302(a). The American Taxpayer Relief Act of 2012 (2012 ATRA), Pub. L. No. 112-240, §102, made the preferential tax rates for net capital gains and qualified dividends permanent.

Since a §306(a)(2) disposition generates a dividend, it is subject to the §243 intercorporate dividend deduction. In addition, a §306(a)(2) disposition generates a reduction in corporate earnings and profits under §312.

The amount realized from a §306(a)(2) disposition will be treated as a dividend to the extent of the earnings and profits of the corporation for the year of the redemption, as opposed to the year the §306 stock was distributed.[434]

If the amount realized from a §306(a)(2) disposition exceeds the §301(c)(1) dividend amount, then §301(c)(2) allows the recovery of adjusted basis.[435] Since §301 makes no provision for the allowance of loss, if the amount realized is not sufficient to recover all the basis, no loss is allowed. It seems clear that the basis should not disappear; rather, it should be reallocated either to the common stock or to any remaining shares of §306 stock.[436]

If the amount realized from the §306(a)(2) disposition exceeds the sum of (i) the §301(c)(1) dividend amount, and (ii) the §301(c)(2) recovery of adjusted basis, then §301(c)(3) provides that the excess is to be treated as gain from the sale or exchange of the property. Normally the §306 stock will be a capital asset, and any resulting §301(c)(3) gain will be capital gain.

The following example demonstrates the application of §306(a)(2).

> *Example:* In Year 1, B and C form X corporation (X), a calendar year corporation, by each contributing $10,000 to X in exchange for 100 shares of common stock. X declares a preferred stock dividend in Year 4 of 1 share of preferred for each share of common held. At the time of the dividend the common stock is worth $800 per share and the preferred is worth $200 per share. X's total current and accumulated earnings and profits are $44,000 at the end of Year 4 but only $18,000 at the end of Year 6. In Year 6, X redeems B's preferred stock for $25,000.

[434] Where §306 stock of the issuing corporation is received from a parent corporation in a §355 distribution, and then disposed of in a §306(a)(2) redemption by the issuing corporation, the earnings and profits of the issuing corporation are controlling, not the earnings and profits of the distributing corporation. *See* Rev. Rul. 77-335, 1977-2 C.B. 95. Section 312(h) and Reg. §1.312-10 generally provide that, in a spin-off, earnings and profits of the distributing and controlled corporations are allocated among them in accordance with their respective fair market values. Note that under §316, current earnings and profits must be determined, as of the end of the taxable year, without reduction for mid-year distributions.

[435] Neither the Code nor the regulations are specific as to whether the adjusted basis which may be recovered is the basis attributable to the §306 stock redeemed or the basis attributable to the §306 stock and the underlying common stock. It would appear that only the basis of the redeemed §306 stock should be recovered because only the §306 stock is redeemed. *But cf.* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, at 8-135-136 (7th ed. 2000) (reassign the §306 stock basis to the shareholder's original stock and allow §301(c)(2) basis recovery).

[436] Examples in the §306 regulations prevent the loss of any adjusted basis upon a §306(a)(1) disposition of §306 stock. *See* Reg. §1.306-1(b)(2). There is no similar example for §306(a)(2) dispositions, but it would appear that there should be a similar result. Reg. §1.302-2(c) provides for an attribution of unrecovered basis where a non-§306 stock redemption is subject to §301, rather than §302. See also *Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967), aff'g 47 T.C. 258 (1966); Rev. Rul. 66-37.

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Section 306(a)(2) provides that the redemption is to be treated as a §301 distribution in Year 6. Accordingly, under §301(c)(1), the amount distributed will be treated as a dividend to the extent of the Year 6 earnings and profits of $18,000.[437] Next, the adjusted basis of the §306 stock is to be recovered tax free under §301(c)(2). The adjusted basis of the §306 stock in this example is $2,000. Under §301(c)(3), the remaining $5,000 of the amount realized will be treated as a long-term capital gain, assuming that the §306 stock is a capital asset.

C. Nonredemption Dispositions

1. Transactions Which Do Not Constitute Redemptions

Section 306(a)(1) applies to any disposition of §306 stock that is "not a redemption (within the meaning of §317(b))." Thus, §306(a)(1) applies to a sale or other taxable exchange of §306 stock.

While the regulations do not define the term "disposition," they do address pledges of §306 stock. A pledge would not ordinarily constitute a disposition since the benefits and burdens of ownership of the stock are not affected by a security interest. However, Reg. §1.306-1(b)(1) provides that certain pledges of §306 stock may be treated as dispositions. Where the pledgee makes a nonrecourse loan with respect to the stock, only the lender has a risk of loss. The regulations strongly indicate that such a transaction would be a disposition.[438]

An inter vivos gift of §306 stock is not deemed a disposition since the transferee takes the stock with a carryover basis under §1015, and the stock retains the §306 taint under §306(c)(1)(C).[439] Similarly, a donation of §306 stock to a charitable organization is not a disposition within the parameters of §306(a)(1).[440]

2. Tax Consequences

Section 306(a)(1) attributes the amount realized from a disposition other than a redemption between three categories: (i) ordinary income, (ii) return of adjusted basis, and (iii) capital gains.[441] It is the ordinary income component that distinguishes §306 stock from non-§306 stock. In terms of priority, the amount realized is attributed first to the ordinary income element, then to the recovery of adjusted basis, and finally to capital gain. The 2003 JGTRRA[442] amended §306(a)(1) to specify that, for purposes of §1(h)(11), amounts treated as ordinary income under §306(a)(1) are to be treated as a dividend received from the corporation.[443]

The amount realized, which is treated as ordinary income, is limited to the "ratable share of the amount which would have been a dividend at the time of distribution if (in lieu of §306 stock) the corporation had distributed money in an amount equal to the fair market value of the stock at the time of distribution."[444] Thus, the amount of ordinary income a taxpayer must recognize upon disposition is equal to the dividend amount that such shareholder (or his predecessor) would have been required to recognize from a distribution of cash, rather than the §306 stock. There are two factors which come into play in making such a determination. First, the fair market value of the §306 stock, at the time it is received, must be determined. That is inherently a difficult factual question for both taxpayers and the IRS. Second, the earnings and profits of the corporation, for the year in which the §306 stock was distributed, must be determined.[445]

It should be noted that §306(a)(1)(A)(ii) refers to the amount that would have been a dividend "at the time of distribution" of the §306 stock. This language must be contrasted with the normal rule of §316 which defines dividend by reference to the current earnings and profits as of "the close of the taxable year without diminution by reason of any distributions made during the taxable year."[446] Thus, §316 refers to the end of the year while §306 seems to refer to the time of distribution. The §306(a)(1)(A)(ii) reference to the time of distribution is troublesome in that Congress used language different from that used in §316. Nevertheless, there is no manifest intent to adopt a different timing rule.[447] Reg. §1.306-1(b) does not face the issue directly. The IRS has construed identical language, under §306(c)(2), to be subject to the normal §316 end-of-the-year rule.[448]

There is a special rule with respect to stock rights under §306(a)(1). Under §306(d)(1), the issuance of stock rights to preferred stock is deemed to be distribution of stock.[449] Under §306(d)(2) preferred stock acquired through the exercise of such rights is considered to be §306 stock distributed at the time the stock rights were distributed, but only to the extent of the fair market value of the rights at the time of the distribution. Thus, stock acquired pursuant to the exercise of a stock right will be §306 stock if the corporation had earnings and profits at the time of distribution of the rights. However, special rules apply to a nonredemption disposition of such §306 stock. The ordinary income portion is limited to the fair market value of the stock rights (as opposed to the stock itself) at the time dis-

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437 Where only B's preferred is redeemed, the entire amount of corporate earnings and profits is available. Under §316(a), B is not restricted to a ratable share of earnings and profits.

438 *See* Reg. §1.306-1(b)(1). The legislative history of §306 includes a statement that a pledge can be a disposition, within §306(a)(1). *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 242 (1954).

439 *See* discussion at IV.D., above.

440 Rev. Rul. 57-328, 1957-2 C.B. 229, *distinguished by* PLR 5911136570A.

441 Technically, §306(a)(1)(B) simply provides "sale" treatment, without addressing the capital gain characterization issue. In most instances, the §306 stock will be a capital asset. Thus, gain from a sale will be a capital gain under §1223.

442 Pub. L. No. 108-27, §302(e)(3).

443 §306(a)(1)(D). Section 306(a)(1)(D) was originally scheduled to sunset after 2010, but its application was made permanent by the 2012 ATRA, Pub. L. No. 112-240, §102.

444 §306(a)(1)(A)(ii).

445 For an extended discussion of corporate earnings and profits, see 762 T.M., *Earnings and Profits.* Where §306 stock of the issuing corporation is received from the distributing corporation in a §355 distribution, and disposed of in a §306(a)(1) transaction, the earnings and profits of the distributing corporation are controlling, not the earnings and profits of the issuing corporation. *See* Rev. Rul. 77-335, 1977-2 C.B. 95.

446 §316(a)(2).

447 But see S. Rep. No. 1622, 83d Cong., 2d Sess. 242 (1954), where it is stated that the §306(a)(1) ordinary income amount is determined by reference to the earnings and profits of the issuing corporation at the time of its distribution.

448 *See* Reg. §1.306-3(a). *See* discussion at IV.B.2., above.

449 For a discussion of §306(d), see IV.E.1., above.

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tributed, to the extent that a cash distribution of such an amount would have been treated as a dividend.[450] Thus, the fair market value of the stock when it is issued is irrelevant.

Stock described in §306(g) is subject to special treatment upon disposition, within §306(a)(1).[451] Section 306(g) applies to stock that has been substantially changed since the time of original issuance. The statute provides that for purposes of §306(a)(1) the fair market value of the stock is to be the greater of (i) the fair market value when issued or (ii) the fair market value at the time of the change of the terms of the stock. The statute also provides that the stock's share of the amount which would have been a dividend (if money had been distributed) is to be the greater of (i) such share at the time of issuance or (ii) such share at the time of the change of the terms.

It is also important to note that §306(a)(1) provides that the first element of the amount realized is treated as ordinary income; however, for purposes of §1(h)(11), amounts treated as ordinary income under §306(a)(1) are to be treated as a dividend received from the corporation.[452] While §306(a)(1) makes reference to a hypothetical dividend amount, such reference is solely for purposes of quantifying the portion of the amount realized that is to be treated as ordinary income. The characterization as ordinary income, rather than dividend, is significant in several respects. The §243 deduction for intercorporate dividends received is inapplicable. Moreover, the nondividend characterization under §306(a)(1) precludes the corporation from reducing its earnings and profits account under §312, even though the shareholder has been required by §306 to report ordinary income.

Under §306(a)(1)(B)(ii), the amount realized in excess of the ordinary income amount is attributable to the tax-free recovery of adjusted basis of the §306 stock. As long as the amount realized equals or exceeds the sum of (a) the ordinary income amount under §306(a)(1)(A)(ii) plus (b) the adjusted basis of the §306 stock, there will not be an unrecovered basis problem. However, if the amount realized is a lesser amount, the entire basis of the §306 stock will not be recovered. The taxpayer may not claim a loss due to the express provisions of §306(a)(1)(C). Reg. §1.306-1(b)(2) provides that in such a situation, the unrecovered basis does not disappear. For example, where all §306 stock is disposed of, but the underlying common stock is retained, the unrecovered basis in the §306 stock is reallocated to the common stock from which the adjusted basis originally was derived, under §307.[453] Where a taxpayer disposes of only some of his or her §306 stock, unrecovered basis could be attributed either to the remaining §306 stock, or the common stock. Example (3) of Reg. §1.306-1 provides that unrecovered basis must be reallocated to the basis of the common stock in such a situation.[454] Another unrecovered basis situation may occur where a taxpayer makes a gift of §306 stock to someone who owns no common stock in the company. If the donee sells his §306 stock, and does not recover the entire adjusted basis, the donee has no common stock to which the unrecovered basis could be attributed.

Comment: While the regulations do not address this issue, presumably the unrecovered basis would have to be attributed to the donee's remaining §306 stock, if any, or carried over to the donor and added to the donor's adjusted basis in his common stock.[455]

The amount realized that is in excess of the sum of (a) the ordinary income amount under §306(a)(1)(A)(ii), plus (b) the adjusted basis of the §306 stock, is to be treated as gain from sale of the §306 stock. Normally, such stock will be a capital asset resulting in capital gain.

The following example demonstrates the application of §306(a)(1).

> *Example:* Assume a calendar year corporation (X) is formed in Year 1 by shareholders B and C, each of whom contributes $10,000 of cash in exchange for 100 shares of common stock. In Year 4, X declares a stock dividend payable in preferred shares of the corporation pursuant to which each shareholder receives 100 shares of preferred stock. On the date of the stock dividend in Year 4, the preferred shares have a value of $200 per share, and the common shares have a value of $800 per share. X's total current and accumulated earnings and profits at the end of Year 4 is $44,000. B sells the preferred shares for $25,000 in Year 6. X's total current and accumulated earnings and profits at the end of Year 6 is $18,000.
>
> The preferred stock dividend will be received tax free under §305 and the preferred stock will be §306 stock by virtue of §306(c)(1)(A). Under §307, B's $10,000 basis in the common will be allocated between the common and the preferred according to their respective fair market values. At the date of the preferred stock dividend, in Year 4, B's common stock had a total fair market value of $80,000 ($800 per share × 100 shares) and B's preferred stock had a total fair market value of $20,000 ($200 per share × 100 shares). Thus, B's $10,000 original basis is allocated 80% ($8,000) to the common and 20% ($2,000) to the preferred.
>
> When B sells the preferred stock, the amount realized of $25,000 will be treated, under §306(a)(1), as ordinary income to the extent that a cash distribution to B in Year 4, in an amount equal to the fair market value of the preferred stock on the date of distribution, would have been taxed as a dividend. Section 306(b)(1)(A)(ii) refers to B's

[450] *See* Reg. §1.306-3(b).

[451] *See* IV.E.2., above.

[452] §306(a)(1)(D), as added by the 2003 Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, §302(e)(3). Although the Secretary may specify other purposes for which the ordinary income component may be treated as a dividend, as of the date of publication, none were announced. Section 306(a)(1)(D) was originally scheduled to sunset after 2010, but its application was extended through 2012 by the 2010 TRA, Pub. L. No. 111-312, §102. The statute was made permanent by the 2012 ATRA, Pub. L. No. 112-240, §102.

[453] *See* Reg. §1.306-1(b)(2) *Ex.* (2). *See* discussion at VII.B., below.

[454] Where the taxpayer disposes of all her §306 stock and has previously disposed of, or contemporaneously disposes of, all her common stock, §306(a) will not apply due to the exception contained in §306(b)(1) for complete termination of shareholder interest. Thus, the unrecovered basis problem does not arise. For a discussion of §306(b)(1), see V.D.1., below. Where the taxpayer has disposed of all the common but disposes of only part of the §306 stock, the §306(b)(1) exception will not apply. Nevertheless, the §306(b)(4) exception may apply. *See* V.D.4., below. If the §306(b)(4) exception does not apply, it would seem that the unrecovered basis should be allocated to the remaining §306 stock.

[455] However, a complete termination of a donee's interest in the corporation may remove the §306 taint. *See* discussion at V.D.1., below.

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ratable share (50%) of the amount that would have been a dividend in Year 4 as the lesser of (1) the Year 4 earnings and profits of $44,000, or (2) the amount of the distribution (the fair market value of the preferred stock) of $40,000. Thus, the §306(a)(1) ordinary income amount is 50% of the lesser of (1) 44,000, or (2) $40,000. Accordingly, of the Year 6 amount realized of $25,000, the ordinary income amount is $20,000.

The ordinary income amount consumes $20,000 of the amount realized. Section 306(a)(1) provides that the remaining amount realized is first treated as the tax-free return of adjusted basis of the §306 stock, in this case, $2,000. Under §306(a)(1)(B), the remaining $3,000 is gain realized from sale of the §306 stock. Assuming that the §306 stock is a capital asset, the $3,000 gain will be treated as a capital gain.

D. Exceptions Under §306(b)

1. Termination of Shareholder Interest

The concept of a preferred stock bailout seeks to remove periodic earnings without altering the shareholder's underlying control and equity positions in the corporation. No bailout is accomplished where the shareholder disposes of §306 stock and either simultaneously or previously disposes of all of the other stock which he owned in the corporation. Consequently, §306(b)(1) provides that a disposition of §306 stock is not subject to the penalty of §306(a) if the transaction terminates the shareholder's interest in the corporation.

Section 306(b)(1)(B) applies to a disposition of §306 stock by means of a redemption to which §302(b)(3) applies. Section 302(b)(3) encompasses transactions that are redemptions of all stock owned by the shareholder.[456] A redemption from a shareholder of all §306 stock and all other stock would qualify within §302(b)(3) and, thus, §306(b)(1)(B). Similarly, if the shareholder previously had sold all of the non-§306 stock, and the corporation subsequently redeemed all the §306 stock, the §306(b)(1)(B) exception also would apply to the redemption.[457]

The §302(b)(3) analysis becomes more complicated when related parties are involved, and the §318 attribution rules operate. Section 318 attributes ownership of stock between related parties.[458] For purposes of §318, related parties include (i) spouses, children, grandchildren and parents; (ii) estates, trusts, and their beneficiaries; (iii) partners and partnerships; and (iv) corporations and certain shareholders. Section 318 is applicable to §302, by virtue of §302(c)(1). Thus, a shareholder could not achieve a complete termination of interest redemption where any stock is owned by another family member, because the stock of the family member would be attributed back to the shareholder.

However, §302(c)(2) permits a waiver of the family attribution rules. Specifically, §318(a)(1) does not apply to a redemption effecting a complete termination of interest, under §302(b)(3), if (i) after the redemption the former shareholder has no interest in the corporation (including an interest as an officer, director, or employee) other than as a creditor; (ii) the former shareholder does not reacquire any interest in the corporation within 10 years of the redemption; and (iii) the shareholder files an agreement to notify the IRS of any prohibited reacquisition of an interest in the corporation.[459] Thus, §302(b)(3) can apply in limited circumstances, even though other family members own stock of the corporation.

The availability of the §302(c)(2) waiver of family attribution is restricted, however, by §302(c)(2)(B). This waiver is not available if (i) any of the stock redeemed was acquired during the 10 preceding years from a §318(a) related party or (ii) any §318(a) related party owns stock that was acquired from the redeemed shareholder during the 10-year period preceding the redemption (unless such stock is also redeemed). Note, §302(c)(2)(B) refers to acquisitions from or transfers to any related party, not just family members. Finally, §302(c)(2) provides that this denial of the §318(a) attribution waiver is inapplicable, and the waiver is available, if the acquisition within the preceding 10 years, or the disposition within the preceding 10 years, did not have as one of its principal purposes the avoidance of federal income tax.[460] The significance of these rules is that a redemption intended to be a complete termination of interest, under §302(b)(3) is endangered by events occurring up to 10 years either before or after the redemption. Thus, careful supervision over corporate activities is necessary to preserve entitlement to the tax benefits of §302(b)(3) and §302(c)(2).

A redemption of §306 stock, that qualifies within §302(b)(3), is excepted from the penalty of §306 by §306(b)(1)(B). The family attribution waiver rule is made available to §306 stock by Reg. §1.306-2(a).[461] Thus, a redemption of §306 stock can avoid the §318(a)(1) attribution problem if the redemption accomplishes a complete termination of the shareholder's actual stock ownership.

If the termination of interest is accomplished by a transaction other than a redemption, (i.e., a sale or exchange), the §306(b)(1)(A) exception applies. In such a nonredemption disposition, §306(a) will not apply if (i) the disposition is not, directly or indirectly, to a §318(a) related party, and (ii) the disposition terminates the entire stock interest of the shareholder. In determining whether the shareholder's entire stock interest is terminated, the attribution rules of §318 apply. For §306(b)(1)(A) to apply, only the stock interest need be terminated; the former shareholder may continue to be a director, officer, employee, or creditor of the corporation.[462] The §306(b)(1)(A) exception is considerably more narrow than §306(b)(1)(B) since there appears to be no waiver of the family attribution rules in

[456] *See generally* 767 T.M., *Redemptions.*

[457] A contemporaneous sale of part of the stock, and a redemption of the remaining part of the stock can be combined to qualify as a complete termination redemption. *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), rev'g and rem'g 106 F. Supp. 57 (N.D. Ohio 1952); Rev. Rul. 77-455, 1977-2 C.B. 93; Rev. Rul. 75-447, 1975-2 C.B. 113; Rev. Rul. 55-745, 1955-2 C.B. 223.

[458] *See generally* 554 T.M., *The Attribution Rules.*

[459] *See* §302(c)(2)(A) and Reg. §1.302-4(a)(1). The creditor exception is useful where the corporation does not have sufficient cash to pay for all the redeemed stock. Section 302(c)(2)(A) allows the stock to be redeemed in consideration of cash and a deferred payment obligation. Care should be exercised so that the purported debt will be treated as debt for this purpose. *See generally* 767 T.M., *Redemptions.*

[460] *See* 554 T.M., *The Attribution Rules.*

[461] *See also* Rev. Rul. 77-455, 1977-2 C.B. 93.

[462] H.R. Rep. No. 2543, 83d Cong., 2d Sess. 35 (1954).

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determining whether the shareholder has effected a termination of "the entire stock interest." Neither the statute nor the regulations speaks to the family attribution waiver in the context of §306(b)(1)(A). Moreover, the legislative history suggests that the waiver is not available under §306(b)(1)(A).[463] Thus, only a termination of interest by redemption is eligible for the waiver of the family attribution rules; a termination of interest by sale or exchange seems to be subject to the family attribution rules. Accordingly, the §306(b)(1)(A) exception may be difficult to satisfy in the commonly encountered, family-owned corporation situation.

A technical problem exists under §306(b)(1)(A) in the case of a §355 distribution of preferred stock of a controlled corporation which represents §306 stock under §306(c)(1)(B).[464] If the §306 stock is disposed of, other than by redemption, §306(b)(1)(A) applies only if the transaction terminates the entire stock interest of the shareholder in "the corporation." Unfortunately, the statute does not specify whether, in this context, "the corporation" means the issuing corporation, the distributing corporation, or both corporations. In Rev. Rul. 77-335,[465] the IRS decided that the distributing corporation is "the corporation," for purposes of §306 in the case of a disposition of §306 stock other than by redemption.

2. Liquidations

Section 306(b) also excludes stock in a transaction that qualifies as a complete, or partial liquidation, of the issuing corporation from the taint of §306.[466] Thus, a shareholder who surrenders §306 stock in exchange for a liquidating distribution is not subject to §306(a). The rationale supporting this exception is that such a transaction is not accomplishing a bailout. The transaction is not removing periodic earnings at capital gains rates. A complete liquidation does not achieve a bailout because the corporation ceases to exist. Thus, the complete liquidation exception of §306(b)(2), and the termination of interest exception of §306(b)(1) are alike in that they cannot be used to extract periodic profits while leaving the shareholder-corporation relationship unchanged.

Similarly, a partial liquidation is not in principle a bailout transaction because the corporation is altering itself significantly, rather than merely distributing periodic income. The legislative history of §306 states that a bona fide contraction of a corporate business does not accomplish a bailout.[467] At one end of the spectrum, a complete liquidation terminates the existence of the corporation;[468] at the other end of the spectrum, the periodic distribution of earnings leaves the corporation essentially unchanged. The partial liquidation falls in between these two extremes, and the notion is that a partial liquidation represents a substantial change in the scope of activities of the corporation. Specifically, §302(e) provides that a distribution will qualify as a partial liquidation, if all of the criteria are satisfied. First, the distribution must not be equivalent to a dividend (determined at the corporate level).[469] Second, the distribution must be pursuant to a plan, and must occur within the taxable year in which such plan is adopted or within the next year.[470]

The statute provides a safe harbor for satisfying the "not equivalent to a dividend" test if the distribution is attributable to the cessation of a qualified trade or business and the corporation is actively engaged in a qualified trade or business after the distribution.[471] For this purpose, a qualified trade or business is one which was actively conducted throughout the five-year period ending on the date of the distribution, and was not acquired by the distributing corporation in a transaction in which gain or loss was recognized in whole or in part within such five-year period.[472] Section 302(b)(4) treats a distribution to a noncorporate shareholder which is a partial liquidation as a redemption. Section 306(b)(1)(B) provides that §306(a) will not apply to a redemption, under §302(b)(4).

3. Nonrecognition Transactions

Transactions which are dispositions of §306 stock, in which no gain or loss is recognized, are excepted from §306(a) by §306(b)(3). Section 306(b)(3) is premised on the principle that the nonrecognition provisions always involve a carryover or substituted basis. Consequently, §306(c)(1)(C) and §306(c)(3) will operate to preserve the §306 taint. In other words, §306(b)(3) and §306(c) operate to defer the §306 consequences until a subsequent taxable disposition, but do not permanently avoid the operation of §306.

Section 306(b)(3) does not specify the types of transactions that come within its scope. Reg. §1.306-2(b)(2) is some help in identifying (i) §351 transfers;[473] (ii) qualifying reorganizations;[474] (iii) §355 corporate divisions;[475] and (iv) §1036 exchanges of stock of the same class of the same corporation.[476] Where only qualifying consideration is received, no gain is recognized, and §306(b)(3) prevents §306(a) from applying. Analytical difficulties arise when, in addition to qualifying consideration, nonqualifying money or other property ("boot")[477] is also received in exchange for §306 stock. The various nonrecognition provisions identified in Reg. §1.306-2(b)(2) provide that gain will be recognized to the extent of the money or boot received.[478] To the extent of the recognized gain, the §306(b)(3)

[463] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 243 (1954).

[464] *See* discussion at IV.C.5., above.

[465] 1977-2 C.B. 95.

[466] For a general discussion of partial and complete liquidations, see Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, chs. 9 and 10 (7th ed. 2000).

[467] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 243 (1954).

[468] The regulations do not require actual dissolution under local law. *See* Reg. §1.333-1(b)(1) (T.D. 8474, 58 Fed. Reg. 25587 (Apr. 27, 1993), removed former Reg. §1.333-1 through §1.333-6).

[469] §302(e)(1)(A).

[470] §302(e)(1)(B).

[471] §302(e)(2).

[472] §302(e)(3).

[473] *See generally* 758 T.M., *Transfers to Controlled Corporations: In General.*

[474] *See* 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations*; 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations.*

[475] *See generally* 776 T.M., *Corporate Separations.*

[476] Note that §721 is not included. A transfer to a partnership would be a nonrecognition transaction under §721, but the partnership interest would not be subject to §306 because §306(c) applies only to stock. For a discussion of §306 stock owned by a partnership, see 720 T.M., *Partnership Transactions — Section 751 Property.*

[477] *See generally* 782 T.M., *Boot Distributions and Assumption of Liabilities.* Note that "boot" has a different meaning for purposes of §351, §354, §355, §1036. *Id.*

[478] *See* §356, §1036(b).

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exception will not be available, and §306(a) will apply. In such an event, the entire amount of boot received, not limited to the gain recognized, is subject to §306(a).[479]

There is a specific statutory provision, concerned with corporate reorganizations and corporate divisions, in which §306 stock is surrendered. Section 356(f) provides that if §306 stock is surrendered in a transaction subject to either §354 or §355, and any money or boot is received for the §306 stock, then the amount of the money and boot is to be treated as a §301 distribution[480] that will generate a §301(c)(1) dividend, to the extent of corporate earnings and profits. Thus, §356(f) disregards the gain realized on the transaction.

In a reorganization in which the shareholder surrenders both §306 stock and non-§306 stock, and receives back both qualifying and nonqualifying property, there is a factual issue in determining whether the nonqualifying boot or money is attributable to the §306 stock, or to the non-§306 stock. The legislative history of §306 provides a presumption that the money or boot is attributable to the §306 stock, but the presumption may be overcome by the taxpayer.[481] However, the IRS has strictly construed this presumption, as illustrated by Rev. Rul. 76-14.[482] In that ruling, one shareholder owned in excess of 80% of the common stock and all of the §306 preferred stock of a corporation which had adopted a plan of recapitalization. Under the plan, the shareholder was to receive cash for surrendering all the common shares, and receive nonvoting common (which would not be §306 stock) for surrendering all the §306 stock. Because no §306 stock survived the transaction, and because the corporation was subject to the shareholder's control before the recapitalization, the ruling attributed the cash to the §306 stock, notwithstanding a recitation to the contrary in the exchange agreement.

A more relaxed attitude was manifest in Rev. Rul. 76-15[483] which involved the recapitalization of a publicly traded corporation that had both common stock and §306 preferred stock outstanding. The preferred stock was not held pro rata by the common shareholders. After negotiations, the stockholders and the corporation agreed to a recapitalization. Each share of §306 stock was to be exchanged for new preferred stock, which was §306 stock by virtue of §306(c)(1)(B). The ruling concludes that the cash was not to be attributed to the §306 stock because (i) the recapitalization agreement was reached by arm's-length negotiations with shareholders exercising no control over the corporation, and (ii) because §306 stock survived the transaction.

Reading Rev. Rul. 76-14 and 76-15 together suggests that the two key factors which influence the IRS are whether new §306 stock is issued, and whether the corporation is subject to the control of the shareholder(s) owning the §306 stock. If new §306 stock is issued, eventually §306 can operate. If control is present, attribution of the cash or boot to the common stock is a matter of choice and can be done solely to avoid §356(f). If only one of the two factors is present, the IRS's position is unclear.

4. Transactions that Do Not Avoid Tax

Section 306(b)(4) provides that certain dispositions of §306 stock will not be subject to §306(a) if it is established to the satisfaction of the Secretary of the Treasury that the transaction did not have, as one of its principal purposes, the avoidance of federal income tax. The IRS will not ordinarily issue rulings regarding whether the distribution, disposition, or redemption of §306 stock in a closely held corporation is in pursuance of a plan that has as one of its principal purposes the avoidance of federal income tax.[484]

The standard of §306(b)(4) is obviously subjective. Subparagraph (A) of §306(b)(4) applies to dispositions of §306 stock where both the acquisition and the disposition of the §306 stock did not have the prohibited tax avoidance purpose. By contrast, subparagraph (B) seems to be a more generous exception because it requires only that the disposition not have the prohibited purposes; the purpose for the acquisition is not relevant. Subparagraph (B) actually is a more narrow exception, however, because it is limited to dispositions of §306 stock where there have been prior or simultaneous dispositions of all the stock upon which the §306 stock was issued.

Section 306(b)(4)(A) requires that both the distribution and the disposition of the §306 stock be free of the prohibited tax avoidance purpose. The legislative history states that subparagraph (A) should apply to "dividends and isolated dispositions of §306 stock by minority shareholders who do not in the aggregate have control of the distributing corporation."[485] The suggestion seems to be that, with respect to minority shareholders, there is less of a bailout problem because the minority shareholders cannot force the transaction upon the corporation. The transaction seems more arm's length, and less tax avoidance motivated, where minority shareholders are involved in isolated, as opposed to regularly recurring, dispositions. While the isolated disposition rule seems reasonable enough in principle, use of the exception for planning purposes is restricted due to the uncertainty of the scope of the exception. Before May 1, 1989, the IRS had issued three rulings which afforded some comfort that, at least in the context of a publicly traded company and perhaps in the context of minority shareholders, §306(b)(4) would ordinarily apply.[486] Unfortunately, Rev. Rul. 89-63[487] revoked those three rulings, holding that the fact that the issuing company is publicly traded is insufficient, in and of itself, to support relief under §306(b)(4).

One of the three earlier rulings, Rev. Rul. 56-116,[488] involved a §368(a)(1)(A) merger of two corporations, both of which were publicly traded. The shareholders of the target exchanged their stock for both common and preferred stock of

[479] *See* Reg. §1.306-3(d). *See also* H.R. Rep. No. 2543, 83d Cong., 2d Sess. 35 (1954). Note also that the unrecovered basis problem can arise. *See* Reg. §1.306-1(b), and discussion at V.C.2., above.

[480] *See* Reg. §1.356-4.

[481] S. Rep. No. 1622, 83d Cong., 2d Sess. 269 (1954). *See also* Reg. §1.356-4.

[482] 1976-1 C.B. 97. *See also* PLR 7725057.

[483] 1976-1 C.B. 98. *See also* PLR 7741031.

[484] Rev. Proc. 2025-3, §4.01(25).

[485] S. Rep. No. 1622, 83d Cong., 2d Sess. 243 (1954). Similar language is contained in Reg. §1.306-2(b)(3).

[486] *See* Rev. Rul. 56-116, 1956-1 C.B. 164, *revoked by* Rev. Rul. 89-63, 1989-1 C.B. 90; Rev. Rul. 57-103, 1957-1 C.B. 113, *revoked by* Rev. Rul. 89-63, 1981-1 C.B. 90; and Rev. Rul. 57-212, 1957-1 C.B. 114, *revoked by* Rev. Rul. 89-63, 1989-1 C.B. 90.

[487] 1989-1 C.B. 90.

[488] 1956-1 C.B. 164, *revoked by* Rev. Rul. 89-63, 1989-1 C.B. 90.

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the acquiring corporation. The ruling expressly stated that there was no plan to redeem the preferred stock.[489] After the merger, less than 20% of the common stock of the acquiring corporation was held by the former shareholders of the target. Because the growth of the target had not been as great as the growth of the acquiring corporation, the voting rights and future equity participation of the former shareholders of the target was restricted. Accordingly, a limited amount of common stock was issued, and preferred stock was issued to make up the difference. The ruling held that the preferred stock was §306 stock, under §306(c)(1)(B). Nevertheless, based on §306(b)(4)(A), the ruling held that §306(a)(1) would not apply to the proceeds of disposition of the preferred stock, unless the disposition was "in anticipation of a redemption after the issuance of the stock." The "unless" clause apparently was a warning to plans which called for a disposition of §306 preferred shortly after a reorganization. A redemption pursuant to a plan would be outside the protection of §306(b)(4)(A), and a sale in anticipation of such a redemption, likewise, should be outside §306(b)(4)(A).

The next ruling, under §306(b)(4)(A), was Rev. Rul. 57-103,[490] which considered whether the issuance of certain preferred stock was in accordance with a plan having, as one of its principal purposes, the avoidance of federal income tax. The transaction involved a §368(a)(1)(C) acquisition of all the assets of the target. The acquiring corporation issued, to the target corporation shareholders, common stock constituting 5% of the outstanding common stock of the acquiring corporation, and voting preferred. The IRS ruled that the preferred stock was §306 stock, but the ruling is odd in that it held that the issuance of the preferred stock was not tax avoidance motivated, without any discussion of the reasons for which the preferred was issued. Apparently, the controlling fact was that only a small, 5% minority interest had received preferred stock. Thus, the transaction was not like a pro rata bailout.

The third ruling, Rev. Rul. 57-212,[491] involved two large, publicly traded corporations that merged under §368(a)(1)(A). The target had only common stock outstanding. For each share of common stock given up, the shareholders of the target received: (i) one share of first preferred stock; (ii) one-half share of second preferred stock; and (iii) three shares of common. In addition, the merger agreement required the creation of a sinking fund, to be used to redeem or purchase on the open market the first preferred shares. The issue addressed in Rev. Rul. 57-212 is whether the sinking fund provisions deny the §306(b)(4)(A) exception. Just a year earlier, in Rev. Rul. 56-116,[492] the IRS indicated that if a redemption was anticipated, the §306(b)(4)(A) exception would not apply. Rev. Rul. 57-212 holds that the distribution and disposition do qualify within §306(b)(4)(A), notwithstanding the sinking fund.[493] The ruling is noteworthy in that it does not explain the reasons for the sinking fund. The conclusion of the ruling seems to be premised on the fact that the corporations were publicly owned, and not subject to the control of any individual or group.[494]

Again, the revocation of the foregoing three rulings has led to needless uncertainty in this area.

Fireoved v. United States[495] involved a taxpayer who at the time of original incorporation, received both common (100 shares) and preferred stock (65 shares). In 1954, the taxpayer and two others agreed to join together to do business. To accomplish the combination, the corporation changed its name and altered its capital structure. The two new participants contributed property worth approximately $29,800. Fireoved's contribution was approximately $60,000. Control was to be divided equally among the three shareholders. Accordingly, common stock was issued for a nominal consideration and divided equally among the three participants. To compensate for the difference in values contributed, the new corporation issued preferred stock. The two new participants received 298 preferred shares in exchange for their contribution of approximately $29,800. Fireoved contributed approximately $60,000, but since he had previously received 65 shares of preferred in exchange for his 65 shares of preferred stock in the old corporation, only 535 shares of preferred were issued to him as a dividend. These 535 shares were §306 stock. Several years later, one of the shareholders demanded more control of the business, so Fireoved and the third owner each sold to the shareholder 24 shares of common. Finally, in 1959, the corporation redeemed 451 of Fireoved's 600 shares of preferred stock.

Fireoved argued that §306(b)(4)(A) applied to the disposition because acquisition of the §306 stock had not been tax avoidance motivated. The taxpayer insisted that the preferred stock dividend of 535 shares had a substantial business purpose because (i) the newly constituted corporation needed the contributions from Fireoved and the newcomers; (ii) common stock was to be divided equally for purposes of exercising control over the corporation; and (iii) the preferred stock had to be used to compensate for the unequal capital contributions. The Third Circuit was unpersuaded, and stated that the preferred stock dividend was not necessary because the transaction just as easily could have been a cash dividend to Fireoved, followed by a loan back to the corporation. The Third Circuit maintained that such a sequence would have had the same effect on the corporation.

It seems incongruous to view the transaction as a dividend followed by a loan back to the corporation. The loan back seems to belie the substance of the dividend. A dividend should be a distribution of excess corporate funds. If the funds are needed in the business (as evidenced by the loan back) then the dividend characterization seems incorrect. In addition, the preferred stock dividend and the dividend-loan back alternatives have different impacts on the corporation's balance sheet. The cash dividend-loan back scenario results in a substantial liability on the balance sheet, a nominal amount of common stock, and no preferred stock. The stock dividend scenario results in no liability, a nominal amount of common stock, and a substantial amount of preferred stock. In terms of the corporation's

[489] Apparently, redemptions were required under a "purchase fund and the sinking fund agreements," but the terms of the agreements were not disclosed as not relevant for purposes of the ruling. *See also* Rev. Rul. 57-212, 1957-1 C.B. 114, *revoked by* Rev. Rul. 89-63, 1989-1 C.B. 90, discussed below.

[490] 1957-1 C.B. 113, *revoked by* Rev. Rul. 89-63, 1981-1 C.B. 90.

[491] 1957-1 C.B. 114, *revoked by* Rev. Rul. 89-63, 1989-1 C.B. 90.

[492] 1956-1 C.B. 164, *revoked by* Rev. Rul. 89-63, 1989-1 C.B. 90.

[493] For a similar holding, see PLR 7944043.

[494] The legislative history supports the premise of the ruling. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 243 (1954).

[495] 462 F.2d 1281 (3d Cir. 1972), aff'g and rev'g in part 318 F. Supp. 133 (D. Pa. 1970).

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ability both to borrow and to attract other equity investors, the cash dividend-loan back scenario results in a much less attractive balance sheet. Although the Third Circuit's analysis of the effect of the transaction on the corporation may have been too simplistic, it is clear that cash dividend characterization of the transaction would have generated a taxable dividend to Fireoved. Because of the markedly different consequences to Fireoved of the cash dividend-loan back transaction, the court seemed to conclude that the use of the stock dividend indicated that one of the principal purposes was tax avoidance.

The holding of the case seems harsh with respect to the issuance of the preferred stock. The unequal contributions could not be accounted for by use of common stock, so nonvoting preferred stock was used. Since the cash dividend-loan back version of the transaction is less advantageous to the corporation in terms of its balance sheet, the use of the preferred stock dividend had a substantial business purpose. Nonetheless, the legislative history of §306(b)(4)(A) refers only to isolated transactions involving minority shareholders. This does not seem to include Fireoved at the time the preferred stock was issued, as he was in control of the corporation at that time.

Facts somewhat similar to *Fireoved* are present in Rev. Rul. 80-33[496] in which the taxpayer made a charitable transfer of §306 stock. The technical issue in the ruling is whether §170(e)(1)(A) causes a reduction in the charitable deduction. This issue turns on whether the §306(b)(4)(A) exception applies to the disposition. The ruling involves X Corporation (X), which was controlled by the taxpayer and one other individual. The taxpayer (T) owned all the §306 preferred stock and 30.3% of the common. The other individual owned 35.7% of the common. The remainder of the common was publicly held and traded over the counter. T had acquired the preferred in a tax-free reorganization when X acquired from T all the stock of another corporation. T was in control of X at the time the preferred was issued. T had been willing to receive X's common stock, but he was advised not to do so because it would dilute the earnings per share of the common stock. Shortly before the stock-for-stock acquisition with T, X had made a public offering of its stock. The underwriters of the public offering advised that the new public shareholders should not suffer the dilution in earnings per share that would have resulted if T had received only common stock. In addition, X was contemplating another public offering, and the financial advisers feared that the offering would be made more difficult by the dilution that would have occurred if only common had been issued to T.

The ruling cites *Fireoved* and holds that §306(b)(4)(A) does not apply to the facts of the ruling. The ruling states that T was in control of X when the preferred stock was issued. While the ruling acknowledged the presence of a business purpose for not issuing more common, it held that §306(b)(4)(A) did not apply because T did not establish that preferred stock had to be used. The ruling suggests that long-term bonds could have been used to achieve the business purpose. T had failed to establish that bonds would not have been satisfactory to accomplish the business purpose.

Several criticisms of the holding can be made. First, use of bonds in the acquisition from the taxpayer would have destroyed the transaction as a qualifying reorganization within §368(a)(1)(B), which allows use only of the voting stock of the acquiring corporation. As a result, that acquisition would have been taxable and perhaps would not have been consummated. Secondly, use of bonds in lieu of preferred stock would have substantially altered the capital structure of the corporation, causing an unfavorable change of the asset to liability ratios and the debt to equity ratios. Accordingly, the use of bonds would have been inconsistent with the business purpose of preserving the capital structure of the corporation so that another public offering of stock could be made. Unfortunately, the ruling does not analyze the reasons why bonds might have been unsuitable. It simply concludes that use of the preferred stock was not proved to be motivated other than by tax avoidance.

In *Bialo v. Commissioner*,[497] the Tax Court reached a conclusion similar to that in Rev. Rul. 80-33. In *Bialo*, the taxpayer (T) owned in excess of 86% of the stock of a corporation which issued a pro rata dividend of preferred stock on common stock. T contributed the preferred stock to a charitable trust, and sought to fall within §306(b)(4) because the application of §170(e)(1)(A) and §306(a) resulted in a reduction in the charitable contribution deduction by the amount of ordinary income which the taxpayer had to recognize. While the court stated that it is the taxpayer's subjective purpose which determines whether the transaction does not have, as one of its principal purposes, the avoidance of federal income tax under §306(b)(4), the court concluded that the taxpayer had failed to meet the burden of proof. Accordingly, the charitable contribution deduction was limited to the stock's fair market value reduced by the amount of gain which would have been ordinary income had the stock been sold.

In *Pescosolido v. Commissioner*,[498] the Tax Court considered whether the disposition of §306 stock permitted an inference of a tax avoidance purpose. In that case, the taxpayer (T) was the owner of a closely held corporation that engaged in a recapitalization for estate planning purposes. T received nonvoting preferred stock which the IRS determined was §306 stock pursuant to the plan of recapitalization. The preferred stock was donated to a charity and T claimed a charitable contribution deduction equal to the stock's fair market value. Again, the Tax Court concluded that the taxpayer failed to meet his burden of proof that the donation of the preferred stock was not pursuant to a plan having a tax avoidance purpose under §306(b)(4)(A). The court also held that the substantial savings resulting from the contribution of the appreciated stock permitted an inference of a tax avoidance purpose. Accordingly, the court limited the taxpayer's charitable contribution deduction to his cost basis, under §170(e)(1)(A).

In a technical advice memorandum,[499] the National Office took the results in *Bialo* and *Pescosolido* one step further. The National Office advised that a taxpayer who contributed §306 stock to a charitable organization was not allowed to claim a deduction for his cost basis in the stock. The National Office maintained that the deduction allowable for contributions of §306 stock is the fair market value of such stock at the time of contribution, reduced by the amount that would have been

[496] 1980-1 C.B. 69.

[497] 88 T.C. 1132 (1987).

[498] 91 T.C. 52 (1988), aff'd, 883 F.2d 187 (1st Cir. 1989).

[499] TAM 8930001.

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treated as ordinary income had the stock been sold. In the case at hand, the issuing corporation had earnings and profits in excess of the fair market value of the §306 stock at the time of the distribution to the taxpayer. Thus, ordinary income would have been recognized in the full amount of the stock's fair market value if cash had been distributed in lieu of stock. Consequently, the ordinary income component of the stock would reduce the taxpayer's charitable contribution deduction to zero.

Note: While the National Office acknowledged that a number of commentators had taken the position that a taxpayer contributing §306 stock is entitled to deduct his adjusted basis in the stock, as stipulated in *Pescosolido*, it nevertheless argued that the commentators had failed to properly analyze the interaction between §306 and §170(e)(1)(A). Notwithstanding, it is reasonable to read the language of §170(e)(1)(A) to require that the charitable contribution be reduced only by the amount of the gain that would have been ordinary income. Accordingly, the taxpayer should be entitled to deduct his adjusted basis in the stock.[500] Such an interpretation is consistent with the purpose of §170(e)(1)(A) to prevent abuses associated with charitable contributions of appreciated property. Prior to the enactment of that section, the combination of avoiding tax on the appreciated property and deducting the fair market value against ordinary income made it possible for high bracket taxpayers to realize a greater after-tax profit by contributing rather than selling the property. For purposes of §170(e)(1)(A), the sole function of §306 is to determine the character of the gain inherent in the property. The fact that the entire amount realized will be treated as ordinary income upon the sale of stock, under §306, does not alter the operation of §170(e)(1)(A).

For §306(b)(4)(B) to apply, tax avoidance as a principal purpose need be disproved only with respect to the disposition, not the acquisition, of the §306 stock. Section 306(b)(4)(B) is of restricted scope, however, in that it applies only if there has been "a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued." In other words, §306(b)(4)(B) will apply only if the underlying common stock, with respect to which the §306 stock was issued, also is disposed of.[501]

In the simplest situation, where the shareholder simultaneously disposes of both the common stock and the §306 stock, the §306(b)(1) termination of interest exception could apply. However, in many instances §318 attribution might preclude a termination of interest within §306(b)(1). Theoretically, the IRS could be persuaded to rule favorably on such a disposition, under §306(b)(4)(B).[502] Similarly, where the shareholder owns three classes of stock (for example (1) §306 stock, (2) the common, with respect to which the §306 stock was issued, and (3) other stock (perhaps non-§306 preferred)), §306(b)(4)(B) might be applicable. Section 306(b)(1) would not apply to a disposition of the §306 stock and the common stock, if the other stock was retained, because the transaction would not terminate all of the shareholder's interest. The legislative history states that, normally, a disposition of both the common and the §306 stock will be within §306(b)(4)(B).[503] Nevertheless, the Senate Report warns that transactions that would avoid the intended scope of §306 would not come within §306(b)(4)(B). An example in the Senate Report involves a corporation that issues §306 stock as a stock dividend with respect to common stock. The corporation then issues a different class of common. Finally, the shareholder simultaneously disposes of the original common and the §306 stock. Because of the retained common stock, the shareholder's control and equity were preserved. Thus, a bailout is effected, and §306(b)(4)(B) would not apply.

There is relatively little authority that interprets §306(b)(4)(B). Rev. Rul. 56-223[504] did apply §306(b)(4)(B) to a corporation in which older employees who were soon to be retired owned slightly less than 50% of the outstanding stock. The older employees had been approached by a prospective outside purchaser, but to prevent sale of the shares to the outsider, the corporation's employee trust entered into an agreement with the retiring employees. The agreement provided that upon retirement all stock of an employee was to be placed in escrow and the trust was to purchase one-sixth of the total in each of the succeeding six years. The agreement further provided that its terms would apply to any new shares issued by the corporation. The corporation then recapitalized by issuing one share of preferred and three shares of common for each share of previously outstanding common. The recapitalization had been undertaken to reduce the value of the voting stock so that employees would be able to purchase it. The ruling concludes that the preferred stock was §306 stock, under §306(c)(1)(B).

The more difficult question is whether §306(b)(4)(B) applies to the dispositions of the §306 stock to the employee trust upon retirement. Rev. Rul. 56-223 holds that §306(b)(4)(B) applies because both the common and the §306 stock are disposed of simultaneously, and because the issuance of the preferred was not in pursuance of a plan having, as one of its principal purposes, the avoidance of tax. The lack of tax avoidance motivation is established by the fact that the preferred shares are obligated under the agreement with the employee trust even before the preferred shares are issued. The pre-existing contractual obligation negates any tax avoidance motivation.

Fireoved[505] also raised a §306(b)(4)(B) issue. Fireoved had sold 24% of his common stock to one of the other principals who had demanded additional control over the corporation. The corporation then redeemed 451 of Fireoved's 600 preferred shares. On the basis of the prior sale of part of the common, Fireoved argued that 24% of the §306 stock should be protected by §306(b)(4)(B). Essentially, the taxpayer argued that §306(b)(4)(B) could apply to a partial disposition of common and §306 stock. The regulations[506] and the legislative history[507] seem to limit the exception to complete dispositions. The court held that §306(b)(4)(B) does not apply to partial dispositions where there is no substantial change in the taxpayer's control

[500] *See* 2 Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶35.2.2.
[501] *See* Reg. §1.306-2(b)(3).
[502] *See* Rev. Rul. 77-455, 1977-2 C.B. 93.
[503] S. Rep. No. 1622, 83d Cong., 2d Sess. 244 (1954).
[504] 1956-1 C.B. 162.
[505] *Fireoved v. United States*, 462 F.2d 1281 (3d Cir. 1972), aff'g and rev'g in part 318 F. Supp. 133 (D. Pa. 1970).
[506] *See* Reg. §1.306-2(b)(3).
[507] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 244 (1954).

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position.[508] The court noted that Fireoved's disposition of part of his common stock still gave him veto power over corporate action because of the unanimity rule in effect in the corporate bylaws. Due to the manner in which the corporation's governing documents were drafted, the court found that the taxpayer retained as much control in the corporation following the sale of his stock as he had prior to the sale. The court did not address whether §306(b)(4)(B) could apply where a partial disposition did, in fact, change substantially the shareholder's control position.

Subsequent to the court's decision in *Fireoved*, the IRS issued Rev. Rul. 75-247[509] in which it adopted the *Fireoved* holding with respect to §306(b)(4)(B). Fortunately, Rev. Rul. 77-455[510] was subsequently promulgated, providing new vitality to the §306(b)(4)(B) exception. Rev. Rul. 77-455 involves a two-part transaction in which the taxpayer disposes of all his common stock, and all of his §306 stock. The taxpayer, who owned common and §306 voting preferred stock, desired to terminate his interest, and transfer control of the corporation to his son. To effectuate the termination, the taxpayer sold sufficient common and §306 stock to his son to give the son control of the corporation. The taxpayer's remaining common and §306 stock were then redeemed by the corporation. The IRS ruled that the §306(b)(1)(A) termination of interest exception does not apply because part of the stock was sold to a §318 related party.[511] Further, the exception in §306(b)(1)(B) does not provide relief from §306(a) treatment because this exception applies only if the disposition is entirely by redemption.[512] However, the transaction escaped ordinary income treatment, under the §306(b)(4) exception, because it was motivated by business reasons, not the avoidance of taxes.

E. Special Problems

1. Priority Issues

In applying §306(a), several troubling priority questions can arise. One priority issue arises if a taxpayer owns preferred stock, some of which is §306 stock, and some of which is not §306 stock. If the corporation redeems some of the preferred shares, the question becomes whether the redeemed shares were the §306 shares or the non-§306 shares. Earnings and profits will be reduced by the stock deemed to have been redeemed first. If earnings and profits are less than the total amounts distributed, §306 may or may not operate as to the redemption of the §306 stock, depending on which shares are deemed disposed of first.

In *Fireoved v. United States*,[513] the shareholder had received, at incorporation, both common stock (100 shares) and non-§306 preferred stock (65 shares). The corporation subsequently recapitalized in a transaction in which the shareholder received 535 shares of preferred stock as a stock dividend. The shareholder exchanged the stock certificate for the original 65 shares of preferred stock for a stock certificate for 600 shares, of which 535 shares were §306 stock. Thereafter, the corporation redeemed 451 of the preferred shares.

The issue before the court was whether 65 of the 451 shares redeemed were the non-§306 shares. Because of the single, 600-share certificate, the 65 originally owned shares could not be identified specifically. The taxpayer argued, however, that in the absence of specific identification of the shares, Reg. §1.1012-1(c) applied to provide a "first-in, first-out" (FIFO) rule. Under this "FIFO" theory, the first 65 of the 451 shares would have been the originally owned non-§306 shares. The government prevailed on this issue, however, by successfully arguing that the combined operation of §307 and §1223(5) (as then designated)[514] caused the taxpayer's FIFO argument to fail. Section 307 causes an allocation of basis from the common to the §306 preferred. Section 1223(4) (designated as §1223(5) at the time of the *Fireoved* decision) provides that the holding period of the §306 preferred stock relates back to the acquisition date of the common, due to the "tack" of the holding period of the common on to the actual holding period of the preferred. Since the taxpayer in *Fireoved* acquired the common and the non-§306 preferred on the same date, the §306 preferred was deemed to have been acquired on the same date as the non-§306 preferred, through the rules of §307 and §1223(4) (designated as §1223(5) at the time). Accordingly, the taxpayer's FIFO argument failed. The court applied a proportional rule to the 451 redeemed shares: 65/600 × 451 = 48.86 shares were non-§306 stock, and 535/600 × 451 = 402.14 shares were §306 stock.[515] The IRS disagrees with this proportionate methodology.[516]

Another priority question arises where a corporation redeems both §306 stock and non-§306 stock in a single transaction. In such a situation, the availability of earnings and profits, for purposes of §306 characterization of the amount realized as a dividend under §301(c)(1), can become important. If the redemption of the non-§306 stock qualifies within §302(b), then under §312(n)(7) the earnings and profits of the corporation are reduced by an amount which is not in excess of the ratable share of the earnings and profits of such corporation attributable to the redeemed stock.[517] Accordingly, if the qualify-

[508] The case also held that the taxpayer had failed to meet its burden of proving that the redemption of the §306 stock was not in pursuance of a plan having as one of its principal purposes the avoidance of tax.

[509] 1975-1 C.B. 104.

[510] 1977-2 C.B. 93.

[511] *See* §302(c)(2)(B)(ii).

[512] This ruling seems inconsistent with the rationale of *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), rev'g and rem'g 106 F. Supp. 57 (N.D. Ohio 1952), and Rev. Rul. 55-745, 1955-2 C.B. 223, which hold that a combination sale/redemption can qualify within §302(b)(3). Section 306(b)(1)(B) expressly refers to §302(b)(3), and that reference should incorporate *Zenz* and Rev. Rul. 55-745.

[513] 462 F.2d 1281 (3d Cir. 1972), aff'g and rev'g in part 318 F. Supp. 133 (D. Pa. 1970).

[514] The Gulf Opportunity Zone Act (GOZA) of 2005, Pub. L. No. 109-135, §402(a), redesignated the subsection as §1223(4).

[515] The taxpayer's loss in *Fireoved* may have been due to inattention. If the 65 non-§306 shares had been segregated from the §306 shares by a separate stock certificate, the taxpayer would have been able to use the specific identification rules of Reg. §1.1012-1(c). Presumably, the specific identification rules would have caused the first 65 of the 451 shares to have been non-§306 shares. Note that the IRS issued final regulations modifying the first-in, first-out rule for shares of stock in Reg. §1.1012-1(c) to clarify, among other things, that the FIFO rule also applies to multiple lots represented by a single stock certificate, i.e., the stock sold or transferred is charged against the earliest lot included in the certificate. See Reg. §1.1012-1(c), T.D. 9504, 75 Fed. Reg. 64072 (Oct. 18, 2010), applicable for taxable years beginning after October 18, 2010. *See also* Notice 2011-56, 2011-29 I.R.B. 54 (interim guidance on issues raised by regulations under T.D. 9504 pending issuance of proposed regulations).

[516] *See* AOD 1973 WL 35002.

[517] For a discussion of §312(n)(7), see 762 T.M., *Earnings and Profits.*

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ing redemption of non-§306 stock is deemed to be the first redemption, the earnings and profits will be reduced for purposes of the subsequent redemption of the §306 stock. In some cases, the reduction in earnings and profits from the first redemption may leave little or no earnings and profits to be characterized as a dividend under §301(c)(1) with respect to the second redemption. Conversely, if the §306 stock is considered redeemed first, the entire amount of earnings and profits would be available for characterization as a dividend under §301(c)(1).

Unfortunately, this priority question has not been resolved. In light of the punitive effect of §306, a court might conclude that the congressional intent was to treat the §306 stock as if redeemed first so that §306 would be allowed the maximum impact.[518]

2. Source of Income: §306(f)

Section 306(f) applies when §306 stock is disposed of by a nonresident alien or a foreign corporation. Taxation of nonresident aliens and foreign corporations by the United States requires a determination of whether their incomes come from sources within the United States, or from sources outside the United States.[519] These source rules are contained in Part I of Subchapter N of the Code.

When §306 stock is disposed of, other than by redemption, §306(f) provides that the ordinary income amount under §306(a)(1) is to be treated, for purposes of the source of income rules, as if derived from the same sources as if money had been distributed as a dividend at the time of distribution of the §306 stock.[520] Therefore, if the amount is deemed to be from sources within the United States, §306(f) provides that the amount is to be treated as "fixed or determinable annual or periodical" income.[521]

With respect to other dispositions of §306 stock, §306(a)(1)(A) provides that the amount realized is treated as ordinary income to the extent of the stock's ratable share of the corporation's earnings and profits at the time the stock was originally distributed. The excess amount realized is first applied against the adjusted basis of the stock and then treated as capital gain.

Note: When stock is redeemed, the availability of earnings and profits at the time of redemption determines whether the proceeds will be treated as ordinary income, whereas in the event of a sale, earnings and profits at the time of the original distribution of the stock determine the treatment of the proceeds.

3. Viability of Chamberlin

Before concluding the discussion of the disposition of §306 stock, attention must be given to the nonstatutory rules that might apply to the disposition of stock. In circumstances where §306 is inapplicable, the nonstatutory rules still may apply to recharacterize the transaction. The *Chamberlin*[522] case is the genesis of §306. *Chamberlin* involved preferred stock that had been issued as a stock dividend, sold to a third party, and then redeemed by the corporation. In deciding *Chamberlin*, the Sixth Circuit refused to collapse the various steps together by application of a "step transaction" doctrine. In addition, the Sixth Circuit honored the insurance company's ownership of the preferred stock, even though the stock was subject to mandatory redemption. In other words, the insurance company was not deemed a mere "conduit," to be ignored for tax purposes.

The government's conduit theory was resurrected by the Tax Court's decision in *Humacid Co. v. Commissioner*[523] Although *Humacid* did not involve a stock dividend bailout device, it did involve the tax-motivated use of an intermediary. In *Humacid*, the controlling shareholder had purchased Humacid promissory notes from various original holders. The controlling shareholder sold the notes to an intermediary as part of an agreement under which the corporation agreed to redeem the notes within six months at a premium of $2,500 over the amount paid for the notes by the intermediary. Under the agreement, Humacid agreed to pledge to the intermediary, as security, government bonds with a principal amount in excess of the redemption price of the Humacid notes. The Tax Court ignored the involvement of the intermediary. The notes were deemed to have been redeemed from the controlling shareholder, rather than from the intermediary, who was referred to as a mere "conduit." Critical factual elements of *Humacid* no doubt included (i) the short duration of ownership by the intermediary (six months at most) and (ii) the lack of economic risk to the intermediary due to the pledged government bonds. In *Chamberlin*, the intermediary was involved for more than eight years and the intermediary was not secured as was the intermediary in *Humacid*. Thus, *Humacid* would seem to be a restriction on the *Chamberlin* holding, rather than a direct assault.

On the other hand, *Estate of Rosenberg v. Commissioner*,[524] is a direct attack on the *Chamberlin* bailout scheme. That case involved a closely held corporation which sought to place liquid funds in the hands of its shareholders. The corporation issued a preferred stock dividend and, approximately 10 months later, some of the shareholders sold their preferred stock to several intermediaries. The preferred stock was convertible into a different class of preferred which was subject to mandatory redemption. All of the shares acquired by the intermediaries were converted on the date of acquisition. On the date of sale, the corporation's charter was amended to provide additional security to the preferred shares held by the intermediaries. Specifically, the amendment required consent of two-thirds of the preferred shareholders for the corporation to incur

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[518] Note that a redemption of both §306 stock and non-§306 stock might activate the §306(b) exception as to the redemption of the §306 stock. *See* V.D., above, and Rev. Rul. 75-247, 1975-1 C.B. 104.

[519] *See generally* 6400 T.M., *U.S. Income Taxation of Nonresident Alien Individuals* (Foreign Income Series); 6460 T.M., *U.S. Income Taxation of Foreign Corporations* (Foreign Income Series).

[520] *See* Reg. §1.306-3(h). The 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), Pub. L. No. 108-27, §302(e)(3), amended §306(a)(1) to specify that, for purposes of §1(h)(11), amounts treated as ordinary income under §306(a)(1) are to be treated as a dividend received from the corporation. The 2012 ATRA, Pub. L. No. 112-240, §102, made permanent the application of §1(h)(11).

[521] *See* 6460 T.M., *U.S. Income Taxation of Foreign Corporations* (Foreign Income Series); *see also* 6400 T.M., *U.S. Income Taxation of Nonresident Alien Individuals* (Foreign Income Series).

[522] The *Chamberlin* case is discussed at II.E., above.

[523] 42 T.C. 894 (1964), nonacq., 1966-2 C.B. 7.

[524] 36 T.C. 716 (1961).

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certain additional indebtedness, or to sell certain corporate assets.

Within approximately six years from the acquisition by the intermediaries, the preferred stock owned by the intermediaries was redeemed. *Rosenberg* is similar to *Chamberlin* in that the intermediaries bore a substantial economic risk of loss for a lengthy period of time. While *Chamberlin* involved a commitment of the intermediary before the preferred stock dividends had been issued, in *Rosenberg*, only one of the intermediaries had been contacted before the stock dividend, and no commitment was requested or given. Accordingly, the taxpayers in *Rosenberg* had at least as strong a case as the taxpayers in *Chamberlin*.

The Tax Court concluded that the transaction was a taxable dividend to the shareholders because the net effect of the transaction was a cash dividend. Thus, it characterized the transaction as a sale of the preferred stock by the corporation directly to the intermediaries, and a cash dividend from the corporation to the shareholders. It appeared that the key fact in leading the Tax Court to reach its conclusion was the closely held nature of the corporation. Thus, the Tax Court's decision in *Rosenberg* casts a pall on any preferred stock bailout even if §306 is inapplicable.[525]

[525] For an extended discussion of *Chamberlin*, *Humacid*, and *Rosenberg*, see Lowe, *Bailouts: Their Role in Corporate Planning*, 30 Tax L. Rev. 357 (1975).

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VI. Avoiding the §306 Taint

A. Characteristics of Preferred Stock

As noted above, neither §306 nor the regulations promulgated thereunder expressly define the term "stock other than common stock." Reg. §1.305-5(a) defines preferred stock as stock which enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities), but does not participate in corporate growth to any significant extent. For the purposes of §306, the IRS has focused on participation in corporate growth. The facts and circumstances which the IRS generally considers include: prior and anticipated earnings per share, dividends, book value, and the extent of any preference of any class of stock absolutely and in relation to other classes of stock.[526]

In this context, there is an interesting issue as to whether variable rate preferred stock is stock or debt. In Rev. Rul. 90-27,[527] the IRS considered whether dutch auction rate preferred stock was stock or debt for the purposes of the §243 dividends received deduction. In that ruling, X corporation (X) issued 1,000 shares of dutch auction rate preferred stock for $100 million. Each share of stock carried a liquidation preference of $100,000 per share. As a condition of sale, each purchaser was required to execute a letter agreeing to sell the preferred stock only through a dutch auction procedure to an authorized broker-dealer, or to another purchaser who executed a similar letter. X set the initial dividend rate on the shares, but thereafter (approximately every 49 days) the rate was set through a dutch process. The stock was designed to trade at a liquidation preference of $100,000. Therefore, at each auction the holders of the preferred stock bid an interest rate at which the holder was willing to purchase additional stock at the liquidation preference. A holder of the preferred stock could also choose to continue to hold its preferred stock at whatever rate was set for the next period, or agree to hold all of its shares as long as the dividend rate was not below a specified amount.

The IRS concluded that the preferred stock constituted equity not debt, for the purposes of §243.

If the stock distributed by the corporation is "stock other than common stock," the distribution will fall within the parameters of §306. However, if the "stock" distributed was treated as debt, it would not fall within the provisions of §305(a). Accordingly, such a distribution would be a taxable dividend to the shareholders. On the other hand, if it is characterized as debt, the corporation would be entitled to an interest paid deduction.

B. Use of Preferred Stock

Preferred stock has been used to achieve various tax planning goals. The early use of preferred stock was to accomplish a capital gain bailout of corporate earnings. The stock dividend sale and redemption scenario was successful in the *Chamberlin* case. The taxpayer's success in *Chamberlin* was short-lived, however, because Congress almost immediately enacted §306, which largely overruled the case. Tax planners will have limited incentive to attempt bailouts of corporate earnings at times when the income tax rates applicable to dividends are substantially the same as income tax rates applicable to capital gains.

Congress' attempt to overturn the *Chamberlin* case through the enactment of §306 did not prevent all preferred stock bailouts. Preferred stock issued at the time of original incorporation, or issued when the corporation has no earnings and profits is not §306 stock. However, redemption of such untainted stock will not necessarily receive capital gain treatment since the redemption may be classified as essentially equivalent to a dividend under §302.[528]

It should be noted that sale of §306 stock to a third party, coupled with a prearranged redemption (or one occurring shortly after the sale) from the buyer, may be subject to a substantial threat that the redemption will be attributed back to the original shareholder by ignoring the sale to the third party. The question, then, is whether the favorable holding of *Chamberlin* or the unfavorable holding of *Rosenberg* will apply.[529] A technical advice memorandum provides a possibly viable technique for effecting a bailout of corporate earnings.[530] The facts involve a corporation having two common shareholders who were unrelated, one of whom recently acquired his shares. The planning possibility arises if you assume that the newer shareholder purchased, in a capital gain transaction from the old shareholder, the shares now held by the newer shareholder. A dispute arose and the newer shareholder exchanged the common shares for preferred in a recapitalization.[531] Later, the preferred stock was redeemed, presumably in a transaction with little or no gain (given the newer shareholder's recent purchase). The old shareholder remained the sole shareholder going forward and, in the end, obtained funds at capital gains rates — the prototypical bailout. In this scenario, the old shareholder never possessed or transferred preferred stock, which is somewhat different than the historic bailout transaction. The technical advice memorandum did not discuss whether the preferred stock represented nonqualified preferred stock.

However, nonqualified preferred stock may provide its own bailout possibility. If a taxpayer exchanges appreciated common stock for preferred stock (which falls within the definition of nonqualified preferred stock) in a recapitalization, the exchange generates income recognition and a capital gain.[532] Consequently, the nonqualified preferred stock would normally successfully navigate §306(c) and avoid characterization as §306 stock. The shareholder could then dispose of such stock for fair market value, report no further gain (due to the fact that the nonqualified preferred stock had just been received in a taxable transaction), and cause the corporation to ultimately redeem the nonqualified preferred stock from the purchasing

[526] For a detailed discussion of how to determine whether stock is "other than common stock" or is common stock, see IV.B.3., above.

[527] 1990-1 C.B. 50, *distinguished by* Rev. Rul. 94-28, 1994-1 C.B. 86. Note that Notice 2008-55, 2008-27 I.R.B. 11, provides guidance regarding the effect of adding certain liquidity facilities to support certain auction rate preferred stock on the equity character of the stock.

[528] *See generally* 767 T.M., *Redemptions.*

[529] *See* discussion at V.E.3., above.

[530] TAM 200335032.

[531] The newer shareholder's preferred stock should not be §306 stock by reason of §306(c)(1)(B)(ii) and the fact that the entire common stock ownership interest is terminated.

[532] §354(a)(2)(C).

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shareholder.[533] The end result, again, being a sole shareholder possessing cash having been received at capital gains rates. The step transaction doctrine would, obviously, need to be avoided to achieve a client's objectives.

Before TEFRA, a preferred stock bailout of corporate earnings could be effected by the transfer of stock of a controlled corporation having earnings and profits to a newly formed holding company in exchange for the latter's common or preferred stock. Since the newly formed entity had no earnings and profits, the preferred stock did not carry the §306 taint. However, §306(c)(3), added by TEFRA,[534] and amended by the 1984 Act, includes in the definition of §306 stock, any stock other than common stock received in a §351 exchange, if the receipt of money instead of such other stock would have been treated as a dividend to any extent. Furthermore, rules similar to the rules of §304(b)(2) apply to transactions described in §306(c)(3). The practical effect of the §304 application is that, in determining whether the other stock received in a §351 exchange is subject to the §306 taint, the combined earnings and profits of the transferee and the transferor corporation are taken into account. For purposes of determining the source and subsequent effect on corporate earnings and profits, §304(b)(2) provides that the earnings and profits of the acquiring corporation, then that of the issuing corporation, must be taken into account.

Note: The "to any extent" language of §306(c)(3) indicates that the entire amount of the stock, other than common stock, received will be treated as §306 stock, even if the combined earnings and profits of the transferor and transferee corporation are less than the fair market value of the other stock.

> *Example:* B is the sole shareholder of corporation (P) which has earnings and profits of $50. B forms a new corporation (N), to which he transfers P stock in a §351 exchange for N common stock worth $200, and N preferred stock worth $200. In determining whether the preferred stock is subject to the §306 taint, the earnings and profits of both corporations must be taken into account. Since P has earnings and profits, all of the preferred stock will be §306 stock, even though the fair market value of the stock exceeds the earnings and profits of the two corporations. Of course, if neither the transferor nor the transferee corporation has earnings and profits, the other stock received will not be §306 stock. Similarly, if the preferred stock is nonqualified preferred stock, within the meaning of §351(g), it should not constitute §306 stock for at least two reasons — first, there was no earnings and profits to treat the transaction as a dividend per §306(c)(3), and second, the basis of such stock would have had a fair market value basis.[535]

> *Example:* B the sole shareholder of corporation P (P) with earnings and profits of $100, forms a new corporation (N) to which he transfers all of the P stock in a §351 exchange for N common stock. B then forms another corporation (N1), to which he transfers, in a §351 exchange, the N stock for N1 common and preferred stock. The N1 preferred stock will not be §306 stock since neither N nor N1 has earnings and profits. If, however, B had received preferred stock from N in the first §351 exchange, such stock would have been §306 stock since the $100 in earnings and profits of P would have to be taken into account.

Another historic use of preferred stock is in corporate recapitalizations to accomplish an estate "freeze," under §368(a)(1)(E).[536] This technique has been significantly curtailed by the enactment of §2701 *et seq.* Nevertheless, if a preferred stock recapitalization is undertaken, because preferred stock will be issued in exchange for part or all of the shareholders' common stock in an estate freeze recapitalization, reference must be made to §306(c) to determine whether the preferred stock will be §306 stock. Such characterization of the preferred stock depends on whether the recapitalization has the effect of a stock dividend.[537]

Even before the enactment of §2701 *et seq.*, estate freeze recapitalizations, were to a large extent curtailed by the 1984 Act amendment to §306(c)(4), which requires the application of §318(a)(2)(C) and §318(a)(3)(C) (shareholder-to-corporation attribution rules) by substituting 5% for 50%.[538] Therefore, in an estate freeze, the shareholder's entire preferred stock interest will be §306 stock, if the shareholder retains a 5% or more common stock interest in the corporation.

Section 306 stock was also an attractive instrument for charitable gifts before the enactment of §170(e). The shareholder of a closely held corporation could donate the stock to a charitable organization without having to relinquish any voting power in the corporation. The stock would subsequently be redeemed, making the overall effect of the transaction similar to a cash contribution. This was possible because, in Rev. Rul. 57-328,[539] the IRS took the position that charitable contributions of §306 stock did not constitute a disposition within the meaning of §306(a)(1). Thus, the §306 taint would merely be transferred to the tax-exempt donee, which could dispose of the stock tax-free. However, §170(e) reduces the amount of the charitable deduction by the amount of the noncapital gain appreciation in the property.[540] In other words, where §306 stock is donated, the donor's charitable deduction is limited to the adjusted basis in the property because the gain is not long-term capital gain to the extent that §306 applies on sale.

As discussed above, in *Bialo v. Commissioner*,[541] the taxpayer owned in excess of 86% of the stock of a corporation which issued a pro rata dividend of preferred stock on common

[533] Taxpayers would also need to avoid §354(a)(2)(C) and the definition of family-owned corporation.

[534] Section 306(c)(3) is generally effective for transactions occurring after August 31, 1982, with the exception of distributions to bank holding companies, an application for the formation of which was filed with the Federal Reserve Board before August 16, 1982. Transfers from such bank holding companies before January 1, 1983 or, if later, 90 days after final regulatory approval, were not subject to the rule. TEFRA, §226(c)(2).

[535] *See* §306(c)(1)(C) and also the discussion at IV.C.5.c.(2), and IV.D.1., above.

[536] For discussion of recapitalizations, see 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations.*

[537] *See* discussion at IV.C.5.e., above.

[538] *See* §304(c)(3)(B).

[539] 1957-2 C.B. 229, *distinguished by* PLR 5911136570A.

[540] *See* §170(e)(1)(A). *See generally* 521 T.M., *Charitable Contributions — Income Tax Aspects. See also* Rev. Rul. 80-33, 1980-1 C.B. 69.

[541] 88 T.C. 1132 (1987). *See* discussion at V.D.4., above.

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stock. The contribution of the preferred stock to a charitable trust resulted in a reduction in the charitable contributions deduction by the amount of ordinary income which the taxpayer had to recognize. Accordingly, the charitable contribution deduction was limited to the stock's fair market value reduced by the amount of gain which would have been ordinary income had the stock been sold.

Similarly, in *Pescosolido v. Commissioner*,[542] the Tax Court considered the issue as to whether the disposition of §306 stock permitted an inference of a tax avoidance purpose. As discussed above, the court held that the substantial savings resulting from the contribution of the appreciated stock permitted an inference of a tax avoidance purpose.[543] Accordingly, the court limited the taxpayer's charitable contribution deduction to his cost basis under §170(e)(1)(A).

In a technical advice memorandum,[544] the National Office took the result in *Bialo* and *Pescosolido* one step further. In that ruling, the National Office took the position that a taxpayer who contributed §306 stock to a charitable organization was not allowed to claim a deduction for his cost basis in the stock.

Comment: The IRS's position appears to be that the deduction allowable for contributions of §306 stock is the fair market value of such stock at the time of contribution, reduced by the amount that would have been treated as ordinary income had the stock been sold. Where the issuing corporation has earnings and profits in excess of the fair market value of the §306 stock at the time of the distribution to the taxpayer, the ordinary income component of the stock reduces the taxpayer's charitable contribution deduction to zero.[545]

A more fundamental problem with the charitable gift of stock in a closely held corporation is that neither the charity nor the other shareholders may be interested in having the charity continue to own the stock. A minority interest in a closely held corporation may not be attractive to a charity. The remaining shareholders may desire that the stock be redeemed to prevent any exercise of the ownership rights, and to prevent disposition of the shares to an outsider. Thus, to make the transaction acceptable to both parties, it may be necessary to redeem the stock. Where the stock is redeemed after the charitable gift, it is as if the corporation has funded a cash gift to the charity, but the shareholder is claiming the deduction.

Clearly, there are some risks associated with this gift/redemption transaction. Because the cash, in effect, is coming from the corporation, the transaction might be viewed as a "charitable bailout." As a bailout transaction, it would appear to be subject to special scrutiny, under the principles of *Chamberlin*, *Humacid*, and *Rosenberg*.[546] The question is whether the redemption from the charity will be attributed back to the contributing shareholder.

Fortunately for taxpayers, the case law is markedly more favorable for the charitable bailout than it is for the noncharitable bailout.[547] Since the real beneficiary of the redemption is the charity, rather than the donor, the cases generally have upheld the charitable bailout, even where the subsequent redemption was almost a foregone conclusion.[548] In Rev. Rul. 78-197,[549] the IRS stated that, in most instances, it will follow the case law, and not attribute the redemption to the donor. However, if the donee is legally bound upon receipt of the stock to surrender the shares for redemption, or if the corporation can compel the charity to surrender the shares, the IRS will attribute the redemption to the donor.[550]

In certain relatively limited instances, §306 can be avoided at the time the preferred stock is issued. The best example is preferred stock issued at the time of original incorporation. A second example is any preferred stock issued at a time after original incorporation, but when the corporation has no earnings and profits, so that the §306(c)(2) exception would be applicable.[551] Additionally, nonqualified preferred stock issued in a §351 exchange would not be §306 stock because gain is recognized upon receipt of such stock.

Finally, preferred stock issued in a recapitalization in which the common shareholder gives up all common shares, and receives only preferred stock avoids the §306 taint. Such a transaction has no bailout potential because the shareholder no longer has an unlimited interest in the residual equity of the corporation. If properly structured, the recapitalization transaction will avoid §306 and accomplish other tax planning objectives. Preferred stock received in certain corporate reorganizations also may be free of §306. Where only preferred stock is received, it is not §306 stock. Such stock may, however, represent nonqualified preferred stock which is not ordinarily received tax free in a reorganization transaction.[552]

C. Use of Nonvoting Redeemable Common Stock

Preferred stock issued at the time of original incorporation can be used for a bailout, but only to the extent of the value of the original contribution for the preferred. To achieve the bailout of amounts in excess of the original contribution, a different device is necessary. Nonvoting redeemable common stock may succeed in the bailout of more dollars than was the case with preferred stock.

The key elements of this stock issue would be that (1) the common stock would be redeemable at the call of the corporation or the shareholder; (2) the stock would be nonvoting; and (3) the redemption price of the stock would be determined pur-

[542] 91 T.C. 52 (1988), aff'd, 883 F.2d 187 (1st Cir. 1989).

[543] *See* discussion at V.D.4., above.

[544] TAM 8930001.

[545] *Id. See* discussion at V.D.4., above.

[546] *See* discussion at V.E.3., above.

[547] *See generally* Lowe, *Bailouts: Their Role in Corporate Planning*, 30 Tax L. Rev. 357 (1975).

[548] *See, e.g.*, *Palmer v. Commissioner*, 62 T.C. 684 (1974), acq., 1978-2 C.B. 6, aff'd on another issue, 523 F.2d 1308 (8th Cir. 1975); *Behrend v. United States*, 73-1 USTC ¶9123 (4th Cir. 1972); *DeWitt v. United States*, 204 Ct.Cl. 274, 74-1 USTC ¶ 9369, 503 F.2d 1406 (Ct. Cl. 1974) (table); *Carrington v. Commissioner*, 30 T.C.M. 950 (1971), aff'd, 476 F.2d 704 (5th Cir. 1973); *Grove v. Commissioner*, 31 T.C.M. 387 (1972), aff'd, 490 F.2d 241 (2d Cir. 1973).

[549] 1978-1 C.B. 83, *distinguished by* FSA 1995 WL 1770829.

[550] *Id. See also* PLR 200821024 (charitable organization that intended to promptly sell donated stock was not used as prohibited conduit because charitable organization was under no legal obligation to sell such stock at time stock was contributed). For an analysis of PLR 200821024, see Willens, *PLR Respects Transaction's Form Despite Charity's Prompt Sale of Donated Stock*, 117 BNA Daily Tax Rpt. J-1 (June 18, 2008).

[551] *Note:* There may be local law restrictions as to the issuance of stock. The absence of any "surplus" may prevent the issuance of new stock as a stock dividend.

[552] §354(a)(2)(C).

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suant to a formula. An appropriate and reasonably workable formula provision would be book value at the time of redemption. An important feature of this stock would be the ability of the redemption price to increase in amount if the corporation prospered.

The bailout would be accomplished by a sale of the nonvoting redeemable common to a third party followed by a redemption by the corporation. The sale to the third party would be taxed as a capital gain; §306 would not apply because the stock is common stock not subject to §306. The redemption from the third party would generate little or no gain, and would qualify as a redemption under §302.

Another use of the nonvoting redeemable common stock would be in the context of a charitable bailout. The stock could be donated to a charity and the corporation then could redeem the shares. Once again, the corporation, in effect, is providing the funding for the donation. The advantage of using nonvoting redeemable common stock is that it would not be deemed §306 stock, thus the §170(e) reduction would not apply. Consequently, the charitable deduction would be the entire fair market value of the shares.

The nonvoting redeemable common stock could be issued at any time during the corporation's existence. The nonvoting redeemable common stock could be issued at the time of original incorporation, or issued mid-stream in the corporate life by means of an additional contribution of property to the corporation within §351. Another option would be to create a holding company under §351. The holding company could issue the stock.[553] Another manner in which the nonvoting redeemable common could be issued would be as a stock dividend on the outstanding common stock. Inasmuch as it would be a pro rata stock dividend on outstanding common stock, the distribution should be tax free under §305. The stock also might be distributed in a mid-life recapitalization of the corporation, under §368(a)(1)(E).

The key issue in evaluating the utility of this kind of stock is whether the stock will be treated as preferred stock or common stock.[554] The determination of whether the stock is preferred or common is made difficult by the feature of the nonvoting redeemable common stock. While the absence of voting rights may not be particularly significant, the fact that such stock is redeemable creates part of the definitional problem.[555] If the stock is redeemable at the call of the corporation, the common stock status, clearly, is in jeopardy. Conversely, if the stock is redeemable at the option of the shareholder, common stock classification might not be precluded because the shareholder has the unfettered ability to participate in residual equity.[556] Similarly, a corporation could have a right of first refusal without necessarily precluding common stock status.[557]

The redemption price formula feature of the stock creates another part of the definitional problem. Ordinarily, preferred stock has a fixed redemption price that does not change over time. Ordinarily common stock has no fixed redemption price; the common receives whatever residual equity there is at the time. Stock that is redeemable at book value, as it may be from time to time, seems to fall in between those two extremes.[558]

The conclusion as to whether the nonvoting redeemable stock is common or preferred is not clear. Such stock clearly has bailout potential. Thus, the problem in terms of statutory construction is a question of how literally the §306 definitional rules should be applied. Because of the bailout potential, it would seem that a strong policy argument could be made that §306 should apply to this kind of stock, and that the §306(c)(1)(A) and §306(c)(1)(B) common stock exceptions should be construed so as to be inapplicable. Until such time as the §306 status of such stock is resolved, however, it would seem that it should be used very cautiously.

D. Tracking Stock

The issuance of tracking stock may afford taxpayers an interesting planning tool to accomplish a type of bailout, and perhaps avoid the taint of §306. Tracking stock is stock whose dividends and/or liquidation proceeds track the performance of a specific division or subsidiary of a corporation. Where the stock only receives liquidation proceeds from a specific division or subsidiary, it can be said to be preferred as against one or more other classes of the corporation's stock. On the other hand, it does have an unlimited right to participate in the growth of a specific division of the company. Thus, it is like common stock. To the extent that such stock represents stock other than common stock, §306 will apply.[559]

Nevertheless, a distribution of tracking stock can effect a type of bailout. For example, assume X corporation (X) is engaged in two trades or businesses, manufacturing and retailing. X distributes as a stock dividend a new class of stock, which is entitled to all of the dividend distributions attributable to the operations of the retailing division. It is also entitled to all of the liquidation proceeds from such division. It has no entitlement to dividends or liquidation proceeds from the manufacturing division. The distribution of that stock would be tax-free to X under §311(a).[560] If such tracking stock constitutes common stock, the shareholders could effectively sell off either the retailing division or the manufacturing division, while retaining an interest in the other division. Moreover, X would not have recognized any gain on the distribution of the stock.[561]

[553] Since the stock would be nonvoting, the transaction could not be a §368(a)(1)(A) reorganization. *Cf.* Rev. Rul. 79-274, 1979-2 C.B. 131 (owners of a corporation organized a second corporation, to which all common stock of first corporation was transferred and received all voting preferred and voting common of the second corporation in a transaction meeting the requirements of §351(b)(1)(A) and §368(a)(1)(B); voting preferred was §306 stock).

[554] See the discussion of whether stock is other than common stock at IV.B.3., above. If the stock is deemed preferred stock, it could be subject to §306 depending on the circumstances of issuance. Section 306 would not apply to preferred issued at original incorporation (except under §306(c)(3)), but if such stock was issued subsequently, then §306(c) could apply.

[555] *See* Rev. Rul. 57-132, 1957-1 C.B. 115, *distinguished by* Rev. Rul. 76-386, 1976-2 C.B. 95.

[556] *See* Rev. Rul. 76-386, 1976-2 C.B. 95.

[557] *Id.*

[558] *See* Rev. Rul. 57-132, 1957-1 C.B. 115, *distinguished by* Rev. Rul. 76-386, 1976-2 C.B. 95.

[559] Of course, if the tracking stock were received in exchange for §306 stock, §306(c)(1)(C) or §306(c)(1)(B)(ii) could cause it to be treated as §306 stock. *See* discussion at V.C. and V.D., above.

[560] *See* discussion at III.I., above.

[561] Where the tracking stock tracks the performance of a subsidiary, there is an issue as to whether or not such a distribution is a distribution of stock of the issuing corporation. If it is not, such a distribution would be taxable to the corporation, pursuant to §311, and would be outside the scope of §305(a). More-

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Tracking stock may also be useful in connection with acquisitive reorganizations. Where the shareholders of the target company believe that the potential growth of the target is greater than the growth which the acquiring company expects the target to achieve, the issuance of tracking stock could be a creative solution to the impasse. However, if such stock is characterized as preferred stock by the IRS, it could potentially be §306 stock. If the stock is structured so that it enjoys a preference in earnings and/or liquidation proceeds of a specific division above a specified amount, and still participates in the growth of the corporation overall, it is likely that such stock would be characterized as common stock.

E. Disposition Planning

If it was not possible to avoid §306 classification of the stock when it was received, the issue then becomes one of how to minimize the tax cost of any disposition of the §306 stock. There are many possibilities. The tax consequences range from dispositions that are fully subject to §306, to transactions partially subject to tax, and ultimately to transactions completely free of any income tax.

One method of disposing of §306 stock that would generate no income tax to the donor is an inter vivos gift of the stock. A gift transfer is not a disposition for purposes of §306(b).[562] The donee could be either a charitable institution or a noncharitable donee. If the transfer is to a noncharitable donee, the stock will be §306 stock in the hands of the donee because of §306(c)(1)(C). Thus, the effect of the inter vivos gift is to transfer the §306 stock burden to the donee.[563] The stock will remain §306 stock in the hands of the donee, notwithstanding the death of the donor, if the §1015 adjusted basis rule applies to the donee.[564] While this gift disposition avoids any income tax to the donor, there will be gift tax consequences based upon the fair market value of the stock at the time of the gift.

If the donee of the gift is a charitable institution, the disposition will generate no gross income consequences to the donor. Rather, the question is the extent to which the donor will be allowed a charitable deduction under §170.[565] As discussed above, the §170(e) reduction will apply to gift of §306 stock and the amount of the deduction will be reduced.

The second example of an income tax-free disposition of §306 stock is a transfer after the death of the shareholder. Death is not an event of realization to the decedent, and distributions by estates generally do not cause the realization of gain to the estate. Because of the §1014 step-up in adjusted basis, the transferee will not be burdened by §306.[566] Accordingly, upon the transferee's sale of the stock, §306 cannot apply, and the §1014 step-up will have removed all pre-death appreciation in the stock. Alternatively, the stock could be redeemed by the corporation as long as either §302 or §303 would provide exchange treatment to avoid §301.

The third example of an income tax-free disposition of §306 stock is a disposition within §306(b)(3).[567] A nonrecognition disposition will prevent §306 from operating. This strategy accomplishes little, however, in that the §306 taint in the transferred property is preserved in the hands of the transferee by §306(c)(1)(C), and also because the stock received back by the transferor in the nonrecognition transaction will be subject to §306.

If the disposition transaction cannot be entirely income tax free, the next most desirable tax treatment during taxable years beginning after 2002 would be to allow §306 to operate. Any portion of gain that is treated as ordinary income is treated as a dividend received from the corporation for purposes of §1(h)(11).[568] This amount is, under §1(h)(11), taxed at the capital gains rate. For those taxpayers that affirmatively seek sale or exchange treatment in an effort to engage in a capital gain transaction, several planning techniques can be undertaken. The statute identifies several categories of transactions that will be treated as sale or exchange transactions. First, §306(b)(1) provides that §306(a) does not apply to certain transactions which accomplish termination of the shareholder's interest in the corporation.[569] In such a transaction, a capital gain could result, and §306 is avoided.

The second category of taxable dispositions that avoids §306 is identified by §306(b)(2), which applies to dispositions in partial or complete liquidation of the issuing corporation. The rationale is that no bailout is being accomplished if the corporation is liquidating completely or altering substantially the scope of its activities, so as to constitute a partial liquidation.[570] A complete liquidation transaction receives exchange treatment and can result in a capital gain but, because of §306(b)(2), the penalty of §306(a) cannot apply. A partial liquidation, which is a redemption under §302(b)(4), avoids the penalty of §306(a), pursuant to §306(b)(1)(B).

The final category of taxable dispositions that avoids §306 is prescribed by §306(b)(4), which applies to a disposition not having, as a principal purpose, the avoidance of federal income tax.[571] While there is some vitality to this exception, its utility as a planning device is severely restricted because of the general unwillingness of the IRS to rule on the question.

Where the disposition cannot be structured to avoid the operation of §306, the disposition should be structured to minimize the operation of §306. Normally, it would be disadvantageous to account for the entire §306 gain in a single taxable year. Spreading the §306 gain over a number of taxable years would provide some deferral of the tax liability, and would

over the IRS could, theoretically, attack such a transaction under its regulatory authority, pursuant to §337(d). That section directs Treasury to promulgate regulations to prevent the circumvention of the repeal of the General Utilities Doctrine.

[562] *See* Rev. Rul. 57-328, 1957-2 C.B. 229, *distinguished by* PLR 5911136570A.

[563] Assuming that the initial transfer to the donee is recognized for tax purposes, a disposition of the §306 stock by the donee will have no tax effect on the donor. *See* Rev. Rul. 57-328, 1957-2 C.B. 229, *distinguished by* PLR 5911136570A.

[564] If, however, §2035 applies to include the transfer in the gross estate of the donor, then §1014 will apply to the donee, and the §306 taint will disappear. Note that §2035 has very limited applicability after 1981.

[565] *See* V.D.4., above.

[566] *See* Reg. §1.306-3(e).

[567] *See* V.D.3., above.

[568] §306(a)(1)(D), as added by the 2003 Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, §302(e)(3). Section 306(a)(1)(D) was originally scheduled to sunset after 2010, but its application was made permanent by the 2012 ATRA, Pub. L. No. 112-240, §102.

[569] *See* V.D.1., above.

[570] *See* V.D.2., above.

[571] *See* V.D.4., above.

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avoid a bunching problem. If the corporation is to redeem the §306 stock, the payment terms could be structured so that §453 could be used.[572] Likewise, if the stock is to be sold to a third party, §453 could be relied upon.

An alternative strategy for dealing with §306 stock would be to engage in a transaction that removes the §306 taint from the stock without having §306 apply. After purging the §306 taint, the goal would be to dispose of the stock at a capital gain. There are several transactions that might be used to accomplish the purge. One method of purging would be a recapitalization in which the stock would be downgraded into common stock. The recapitalization would qualify as a §368(a)(1)(E) reorganization, so there would be no gain or loss recognized. The shareholder would surrender the §306 preferred stock, and receive common stock, which would not be §306 stock, under §306(c)(1)(B).[573] The downstream recapitalization into common stock would take away any bailout potential, allowing the new common to be disposed of free of §306.

The downstream recapitalization could be useful in several situations. One example would be where a shareholder owns §306 stock of the corporation, and a sale of stock to a §318(a) related party is contemplated. Even though the sale would terminate the shareholder's actual interest, §306(b)(1) would not apply to that transaction, because of the related party rules of §306(b)(1)(A)(ii) and §306(b)(1)(A)(iii).[574] If the preferred stock were to be converted into common stock in a downstream recapitalization, the subsequent sale of the common stock would not be subject to §306. Another circumstance in which the downstream recapitalization would be useful is in a gift of §306 stock. Under §306(c)(1)(C), the stock will be §306 stock in the hands of the donee. The donee may not be interested in owning the stock, and disposition of the stock may have been intended all along. Conversion of the donee's stock into common stock will allow a disposition that avoids §306(a).

There are a number of potential difficulties with the downstream recapitalization scheme. First, the stock must be classified as common stock for purposes of §306(c)(1)(B). Thus, if the new common stock differs in any material respect from the previously outstanding common stock, the IRS might allege that it is preferred stock subject to §306.

Another problem is whether the other common shareholders will consent to the downstream recapitalization. It is possible that the §306 stock resulted from a prior upstream recapitalization, in which certain shareholders surrendered their common, and received back the preferred. The other common shareholders may have no interest in allowing the preferred shareholders to become common shareholders again. Indeed, it is not unusual for the first recapitalization, the upstream recapitalization, to be the result of a desire to remove those shareholders from the ranks of the common shareholders. By reverting to common shareholders, they could participate in control of the business, and in future equity growth. Nonvoting common might be issued to avoid granting any voting control, but any limitation on equity participation would seem to jeopardize the classification of the stock as common stock.

The downstream recapitalization must have a business purpose in order to qualify as a reorganization.[575] If the justification for the recapitalization is solely to accommodate the tax planning needs of the shareholders, there might appear to be no corporate business purpose for engaging in the recapitalization. However, the courts have been fairly generous to taxpayers in this area.[576] A desire to simplify the corporate capital structure is a sufficient corporate business purpose,[577] and the downstream recapitalization usually would accomplish such a simplification.[578]

Another question with respect to the downstream recapitalization is whether §305(b)(4) might apply by construing the transaction as a stock dividend of common stock on outstanding preferred. If applicable, §305(b) could cause the fair market value of the common stock received to be treated as a dividend, under §301. Nevertheless, it appears that §305(b)(4) would not apply to the downstream recapitalization.[579] The transaction is not a stock dividend; it is a recapitalization, in which the preferred stock would be surrendered. Although the transaction would accomplish some reordering of interests in the corporation, the recapitalization would not be used to accomplish the disproportionate distributions about which Congress was concerned in revising §305 in 1969.[580]

A major concern with the downstream recapitalization strategy is the effect of a preplanned and immediate disposition, by redemption or sale, of the new common stock. The government might argue that under the step-transaction doctrine the recapitalization should be ignored and the transaction treated as a disposition of §306 stock. Where the disposition of the common was preplanned to occur immediately after the recapitalization, it does appear that the recapitalization is a mere formal step with little substantive content. Conversely, the taxpayer can make a compelling argument that the recapitalization is of substance because it has the effect of removing the bailout potential from the stock. The recapitalization converts preferred stock into common stock, and thereby terminates the bailout potential of the stock. Although the recapitalization is only an

[572] *See generally* 565 T.M., *Installment Sales*.

[573] *See* PLR 7850039.

[574] Such a disposition might qualify under §306(b)(4) depending on the circumstances. *See* V.D.4., above.

[575] *See generally* 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations*.

[576] Some cases indicate that shareholder business purposes (as opposed to corporate business purposes) are sufficient. *See Estate of Parshelsky v. Commissioner*, 303 F.2d 14 (2d Cir. 1962), *on remand*, T.C. Memo 1963-187; *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), aff'g and rev'g 5 T.C. 665 (1945). *Cf. Rafferty v. Commissioner*, 55 T.C. 490 (1970), aff'd, 452 F.2d 767 (1st Cir. 1971) (absent direct benefit to business of parent corporation and on showing that spin-off put saleable assets in hands of shareholders, transaction found to be a device for distributing earnings and profits to shareholders), *cert. denied*, 408 U.S. 922 (1972).

[577] *See* Rev. Rul. 77-238, 1977-2 C.B. 115; Rev. Rul. 76-387, 1976-2 C.B. 96.

[578] For requests received on or after January 2, 2024, the IRS will issue a comfort ruling as to whether a transaction constitutes a recapitalization within the meaning of §368(a)(1)(E), meaning a ruling will be issued even if the issue is "clearly and adequately addressed" by other published guidance. Rev. Proc. 2024-3, §1.02; Rev. Proc. 2025-1, §6.11. The information and representations described in Rev. Proc. 81-60, should be included in a letter ruling request. Rev. Proc. 2025-1, Appendix F, .01 (see §368(a)(1)(E) Checklist questionnaire).

[579] *See generally* Littenberg, *The Use of Recapitalizations in Estate Plans Under the 1976 Tax Reform Act, 30 Major Tax Planning*, 1978 S. Cal. Tax Inst. 719, 763–67 (1978); Lowell, *Section 306 Specter Hangs over E Recapitalizations Due to 1976 TRA*, 47 J. Tax'n 204 (1977).

[580] *See* discussion at III.E., above.

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intermediate step in the overall transaction, it is a major step in terms of §306 analysis of the transaction. Thus, on a policy basis, a strong argument can be made that §306 should not apply because after the recapitalization there is no bailout potential in the stock.

Another method by which the §306 taint might be purged would be to engage in a transaction that would step up the adjusted basis of the §306 stock to fair market value, so that the stock would no longer be subject to §306. The mechanics of such a transaction would be accomplished by a tax-free transfer to another entity, followed by a distribution of the §306 stock, that would be taxed as a capital gain. After the taxable distribution, the adjusted basis of the distributed stock would be its fair market value. Consequently, §306(c)(1)(C) would not apply, and the stock would no longer be §306 stock.

Also the §306 taint might be purged through a trust that would not be subject to the grantor trust rules of §671 §672, §673, §674, §675, §676, §677, and 678. The transaction would involve a transfer of the §306 stock, along with other funding assets, to the trust. The strategy would be to control the income of the trust so that it would be composed only of capital gains during the year the trust would distribute the §306 stock to the beneficiary.[581] The distributable net income[582] of the trust for that year would be composed solely of capital gains.[583] As a result of the distribution, the beneficiary would have to include in gross income the fair market value of the §306 stock (limited to the amount of distributable net income for the taxable year of the trust).[584] Because the distributable net income would be composed solely of capital gains, the beneficiary would report the distribution from the trust as a capital gain.[585] Under Reg. §1.661(a)-2(f), the adjusted basis of the stock in the hands of the distributee would be increased to fair market value. Arguably, the stock would no longer be §306 stock because §306(c)(1)(C) would not apply.[586] The effect of the transaction would be to purge the §306 taint at the expense of only a capital gain.

Several similarly oriented purge transactions might succeed. One variation would involve §306 stock, owned by a corporation, that is distributed in a transaction generating a capital gain to the shareholder. For example, a nondividend distribution of the §306 stock in a redemption[587] or a liquidation would cause the basis of the stock to be stepped up to fair market value. The §306 taint would arguably be purged. Likewise, §306 stock owned by a partnership could be purged of the §306 taint at the cost of a capital gain. If the partnership is dissolved, or the partner's interest terminated, the partner generally realizes a capital gain.[588] Section 732(b) provides that the basis of property other than money distributed in liquidation of a partner's interest, is equal to the partner's adjusted basis in the partnership interest, reduced by the amount of money distributed. Thus, the adjusted basis of the distributed stock would not be determined by reference to the adjusted basis of the partnership in the stock. Accordingly, the stock should not be §306 stock in the hands of the retiring partner.

A major and overriding problem with respect to all transactions that seek to purge the §306 stock of its taint is that the transaction may lack economic substance and be ignored for tax purposes. A major concern would be the amount of time that would be allowed to elapse between the purging of the §306 stock taint and the eventual disposition. Clearly, if the purging and disposition steps are preplanned and executed close together in time, the government could argue that the intervening steps should be ignored. The greater the time between those two events, the greater the chance that the transaction will be honored. In light of the tax avoidance motivations involved, there may be considerable uncertainty regarding the viability of these proposed purging transactions.

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581 For tax purposes, trusts are classified as either "simple" trusts or "complex" trusts. A simple trust is a trust that (i) provides that all income is required to be distributed currently, (ii) has no provision for charitable transfers, and (iii) does not distribute amounts other than current income. *See* §651. Care must be exercised to avoid causing recognition of gain to the trust when the stock is distributed. The distribution of property in discharge of a fixed-dollar obligation is a realization event under *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), aff'g 40 B.T.A. 824 (1939). Thus, distribution of the stock must be a discretionary distribution of a complex trust where capital gains are deemed (by statute or by the trust instrument) to be current income.

582 Distributable net income is defined in §643. Generally, distributable net income is equal to taxable income, adjusted for various specially taxed items, and ignoring the §651 or §661 distribution deduction.

583 With respect to gains realized by the trust within two years from the date of transfer by the settlor, see §644.

584 *See* §651, §661.

585 *See* §652(b), §662(b).

586 *See generally* Schnepper, *The Schnepper Trust: Eliminating the §306 Taint*, 31 U. Miami L. Rev. 63 (1976).

587 Appreciated property distributed by a corporation can cause the recognition of gain to the corporation, under §311.

588 Sections 736(b) and §731(a) generally provide the "sale or exchange" treatment necessary to achieve a capital gain. However, §751 can override those provisions, and mandate gain realized from certain sales, exchanges, or partnership distributions be treated as ordinary income. The §306 stock might trigger §751. However, there is a technical issue under §751(d)(2), because the statute refers to property which "would be considered property other than a capital asset and other than property described in §1231." Section 306 stock is subject to special rules upon disposition, but the stock would seem to remain a capital asset for other purposes. Thus, it is not clear that §306 stock would fall within §751(d)(2). *See generally* 720 T.M., *Partnership Transactions — Section 751 Property*.

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VII. Basis and Holding Period Issues

A. *Section 305 Distributions*

1. *Nontaxable Distributions*

a. *General Basis Rule*

Section 307(a) provides the general rule that a shareholder, who receives a nontaxable distribution of stock or stock rights, must allocate the basis of the stock, with respect to which the distribution is made, between such stock and the new stock or rights in proportion to the fair market values of each on the distribution date.[589]

Comment: If stock received as a dividend is all of the same character and preference as the stock with respect to which it was distributed, there is no need to determine fair market values on the distribution date. In such cases, the basis of the old stock is simply divided by the total number of old and new shares to ascertain the basis of each share.

The general rule also applies where only part of the distribution is not includible in the gross income of the shareholders. In such cases, a proportionate part of the basis of the old shares must be allocated to that part of the distribution which is not includible in gross income. Again, the allocation is based on the respective fair market values at the time of the distribution of the old stock and the new stock received tax free.[590] As to that part of the distribution which is includible in the gross income of the shareholders, the basis of the new stock or rights received is the fair market value on the date of distribution of the stock or rights.[591] Accordingly, the basis of that part of the old stock, with respect to which the taxable stock or rights are received, remains unchanged.

The general rule applies to nontaxable stock rights only if they are exercised or sold.[592] If they are sold, gain or loss will be realized, measured by the difference between the basis allocated to them and the amount realized. If they are exercised, that portion of the basis of the old stock allocated to them, as of the distribution date, is added to the subscription price of the new stock to determine its basis.[593] If they are allowed to lapse, they have no basis.[594]

Example: In Year 1, X purchased 1,000 shares of common voting stock of the M company (M), the only class of stock then outstanding, for $50,000. In Year 3, the stock was reclassified as Class A common voting stock and new Class B common stock was authorized. The Class B stock was identical to the Class A stock, except that it had no voting rights. M issued rights to its shareholders permitting them to acquire this new common stock at $60 a share on the basis of one share for each share of Class A common then held. X exercised his rights and acquired 1,000 shares of Class B common stock for $60,000. On the date of the distribution, the fair market values of the Class A stock excluding the stock rights, was $85,000, and the fair market value of the stock rights was $15,000. Thus, the stock rights were worth 15% of the combined value of the stock and the stock rights. Under the general rule of §307, allocation of his original cost of $50,000 between the old stock and the stock rights, and the determination of the cost of the new shares are made as follows:

Allocation of Cost:

Cost Allocated to Class B Rights (15% × $50,000)	$ 7,500
Subscription Price (1,000 shares at $60 per share)	60,000
Total Cost Basis for Class B Shares	$ 67,500
Allocated Cost Basis of Class A Shares (85% × $50,000)	42,500
Total Cost Basis for Class A and Class B Shares	$110,000

Note: When stock rights are issued, it is customary for the issuing corporation (especially in the case of publicly held corporations) to prepare and send to shareholders a brochure informing them how the rights are to be treated for federal income tax purposes.

[589] *See* Reg. §1.307-1(a).

[590] Reg. §1.307-1(a).

[591] Reg. §1.301-1(g), §1.301-1(b) as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(b)(1) in 1988.

[592] Reg. §1.307-1(a).

[593] *See* Reg. §1.307-1(b).

[594] *See* Rev. Rul. 74-501, 1974-2 C.B. 98; *Eastern Shores Corp. v. Commissioner*, 32 B.T.A. 608 (1935) (Revenue Act of 1928).

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b. Exception for Certain Distributions of Stock Rights

Section 307(b) provides an exception to the general rule requiring allocation of basis on a distribution of stock rights. It provides that where the fair market value of the rights at the time of their distribution is less than 15% of the fair market value of the stock with respect to which the rights were distributed, the basis of the rights will be zero, unless the shareholder makes an election to use the general allocation rule of §307(a). Reg. §1.307-2 requires that the election be made by the shareholder, with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of the distribution.

Note: Section 307(b) applies only if the rights are not includible in the shareholder's gross income, pursuant to §305(a).

An election made to allocate basis to the rights must be in the form of a statement attached to the shareholder's income tax return for the year in which the rights were received.[595] The election is irrevocable with respect to the rights for which it was made.[596] Furthermore, a shareholder who makes such an election must retain a copy of the election, and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of any of his stock, the basis of which was affected by the basis allocation.[597]

Comment: The taxpayer must also be able to substantiate the basis of the stock with respect to which the rights were issued, if a part of its basis was allocated to the rights at the time of the distribution, and there is a subsequent disposition of the old stock. The application of Reg. §1.307-2 is illustrated by the following example:

> *Example:* Y Corporation (Y) had outstanding Class A and Class B common stock, equal in all respects on a per share basis, except that the Class B stock was nonvoting. On December 15, Year 1, Y issued rights with respect to each class of stock entitling the holders to acquire one additional share of the particular class held for each share owned on the record date, December 15, Year 1. The rights would expire on January 31, Year 2.
>
> Shareholder R owned Class B stock, which he had acquired 10 years earlier at $50 a share, and Class A stock, which he had acquired eight years earlier at $100 a share. Under §307(b), he elected to allocate the basis of his old Class A stock between it and the rights pertaining thereto, but he made no election with respect to his Class B stock. In both instances, the fair market values of the rights, on the date of distribution, were less than 15% of the fair market values of the Class A and Class B stock, respectively. In both instances, R exercised the rights on January 15, Year 2. The rights were not subject to tax when received, or when exercised, under the general rule of §305(a). Since he made no election with respect to the rights on the Class B stock, their basis in his hands is zero, under §307(b)(1).
>
> The basis of the rights on the Class A stock and the basis of each old share and each new share of Class A or Class B stock are determined as follows:

	Fair Market Values on Distribution Date:			
	Class A		**Class B**	
1 share, ex-rights	$270	90%	$180	90%
1 Right	30	10%	20	10%
Total value	$300	100%	$200	100%
Basis Calculation:				
1 Right (allocated basis)	$10*		$-0-	
Subscription price	270		180	
Cost of each new share	$280		$180	
Cost of each old share after subscription	$90**		50 (orig. cost)	
Total investment	$370		$230	

* 10% of $100 (original cost)
** 90% of $100 (original cost)

c. Holding Period for Tax-Free Distributions

Where a shareholder receives stock or stock rights in a distribution which is nontaxable to him, he is permitted to "tack" the holding period of the old stock to that of the new. In other words, the holding period of the new stock or rights includes that of the old.[598]

However, under §1223(5), if stock rights are exercised, the holding period for the new stock begins with the date of exercise, whether or not the rights were taxable on distribution.[599] A shareholder is considered to have exercised his right when he expresses his assent to the terms of the rights offering, in the manner requested or authorized by the issuing corporation.[600] Ordinarily, this would be the date on which the taxpayer signs the form evidencing his right to buy stock.

Comment: Except for the provisions of §1223(5), new stock acquired by exercise of stock rights would have two acquisition dates to determine the holding period of the new stock, i.e., that portion attributable to the right would date back to the time of acquisition of the stock with respect to which the right was issued, and that portion attributable to the subscription price would date from the time the right was exercised.

[595] Reg. §1.307-2.
[596] *Id.*
[597] *Id.*
[598] §1223(4); Reg. §1.1223-1(e). This rule applies even if there is no allocation of basis to stock rights pursuant to the 15% rule of §307(b)(1). Reg. §1.1223-1(e) provides that "tacking" applies if the basis is determined under §307.
[599] *See also* Reg. §1.1223-1(f).
[600] Reg. §1.1223-1(f).

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Example 1:

Date old stock acquired June 15,	Year 1
Date of nontaxable stock dividend January 29,	Year 3

A part of the cost of the old stock is assigned to the new stock, under §307, in proportion to the respective fair market values on January 29, Year 3, but the acquisition date for each share of old and new is June 15, Year 1.

Example 2:

Date old stock acquired June 15,	Year 1
Date of issuance of stock rights January 29,	Year 3
Part of stock rights sold February 15,	Year 3
Part of stock rights exercised February 15,	Year 3

Allocation of cost is made between the old stock and the stock rights, as in the first example. The acquisition date for the rights that were sold dates back to June 15, Year 1. The acquisition date for any new shares acquired by subscription is February 15, Year 3.

2. *Taxable Distributions*

a. *Basis*

Where stock dividends or stock rights are taxable as a result of §305(b) or §305(c), the basis of the stock, with respect to which they are distributed, remains unchanged. Section 307 is inapplicable to such cases.

The amount of a taxable distribution of stock or stock rights — and hence the basis of the stock or rights received — is their fair market value.[601] Such value must be determined as of the date of distribution, regardless of when the shareholder must report it as income.[602] For example, if a corporation distributes a taxable stock dividend on December 31st of a given year, its fair market value on that date determines its basis, even though it is not received by a cash-basis, calendar-year shareholder (and therefore is not taxable to him) until January 2nd of the following year.

b. *Holding Period*

If the distribution consists of stock of the distributing corporation which is taxable to the shareholders under §305(b), the holding period for the stock begins on the date of acquisition. The tacking rules of §1223 also do not apply.

Stock rights, which are taxable under §301, are included in income at the time they are received, and their value is determined as of the distribution date.[603] There is no tacking of the holding period of the underlying stock when the rights are taxable.[604] Accordingly, the holding period for the rights begins on the date of acquisition. If the rights are exercised, the stockholder will have a new holding period for the stock thereby acquired, commencing on the date of exercise.[605]

3. *Special Problems*

a. *Valuation Issues*

The valuation of nontaxable stock rights, for the purpose of assigning to them a portion of the basis of the stock with respect to which the rights were issued, must be made as of the date of distribution of the rights.[606]

Where there is an established market value for the stock, which includes the value of the rights, but none for the stock and rights separately on the distribution date, the respective values may be determined under the method described in I.T. 2509,[607] declared obsolete by Rev. Rul. 69-43.[608]

Although I.T. 2509 has been declared obsolete, because it refers to the record date instead of the distribution date, the formula it sets forth is still valid:

> [A]ll that is necessary is to take the aggregate value, on the date which determines the shareholders who are entitled to the rights, of that number of shares of stock the ownership of which entitles a shareholder to subscribe to 1 new share, add to such aggregate value the full amount of the subscription price to be paid to acquire the new share of stock, and divide the sum by 1 plus the number of shares of stock whose aggregate value was used as a starting point. The quotient is the value attributable to 1 share of stock after the issuance of the rights, and the quotient less the subscription price is the value attributable to that number of rights which entitles a shareholder to subscribe to 1 new share of stock. The latter value divided by the number of rights involved is the value attributable to 1 right. The sum of the values attributable to a share of stock and a right under this formula will in all cases equal the value, on the date which determines the shareholders who are entitled to the rights, of a share of stock carrying with it the right created on that date. With the respective values of a share of stock and of a right on the date established, it is a simple matter to find the proper portion of the original cost or other basis of a share of stock which after the issuance of the stock rights is assignable to the stock and to the right respectively.

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[601] Reg. §1.301-1(g).

[602] Reg. §1.301-1(b).

[603] Reg. §1.301-1(b), §1.301-1(c). Before the effective date of the 1954 Code, stock rights were taxable (as dividends) at the time they were exercised or sold. *See Palmer v. Commissioner*, 302 U.S. 63 (1937), rev'g 88 F.2d 559 (1st Cir. 1937), vacating 32 B.T.A. 550 (1935), acq., XIV-2 C.B. 17 (1935); GCM 25063, 1947-1 C.B. 45.

[604] *See* §1223(4).

[605] §1223(5).

[606] *See* Reg. §1.307-1. Under prior law, the date of record was the date used. GCM 1394, VI-1 C.B. 35; I.T. 2474, VIII-1 C.B. 65; I.T. 2509, VIII-2 C.B. 78.

[607] VIII-2 C.B. 78.

[608] 1969-1 C.B. 310.

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Example: Shareholders received the right to buy one new share of stock for each four shares held. The subscription price was $100 a share. On the date of distribution of the rights, the value of the stock, including the value of the right, was $150 a share. Each share had an original cost basis of $60.

Computation:

Value of 4 shares including value of rights	$600
Add subscription price for 1 new share	100
Total value of 5 shares with the rights	$700
Value of 1 share ($700 divided by 5)	$140
Deduct subscription price of 1 share	(100)
Value of 4 rights	$ 40
Value of 1 right ($40 divided by 4)	$ 10
Proof: Value of 1 share shown above	$140
Value of old share including the right	$150
Allocation of Basis Cost:	
Value of 1 share of stock (140/150 × 60)	$ 56
Value of 1 right (10/150 × 60)	4
Total	$ 60

Where a stock is listed on a stock exchange, the stock will sell ex-rights as of the record date, and usually after that date, separate quotations are given for the stock and the rights so that it is not necessary to resort to the formula described above to determine the value of the rights on the date of distribution, which occurs after the record date. Problems arise where there are no sales of the stock or rights from which the respective values, as of the key date, may be determined, so that such values must be ascertained from other evidence than market quotations. I.T. 2509 states that in such cases the respective values must be determined from the facts in each particular case, since no general rule can be laid down that would apply in all cases. A typical example would be that of a closely held corporation where there had been no sales or transfers that would establish the value of the corporate stock on the date of distribution of rights.

With respect to the valuation of stocks of closely held corporations, see Rev. Rul. 59-60.[609] The ruling shows that no general formula may be given that is applicable to the many different situations arising in the valuation of stock of closely held corporations, but it does provide certain guides to be used in such valuations.[610]

Once the value of the stock has been determined under the guides provided in these rulings, the value of the stock rights can be determined under the formula set out in I.T. 2509.

Another problem related to the valuation of stock rights can arise if, due to economic conditions, the value of the stock of the corporation decreases to a point that is below the subscription price of stock to be acquired with the rights. Such problems arose late in 1929, after the stock market crash. Rights that had been issued prior to the crash became worthless before expiration of the subscription period. The Chief Counsel's Office considered such a case in GCM 11873[611] wherein the corporation offered to refund subscription prices that had already been paid with respect to rights. The IRS concluded that the issuance and receipt of the rights had no effect upon the corporation, or the interest of any shareholder. Therefore, no adjustment to the basis of the stock held should be made, regardless of whether a shareholder failed to sell, exercise, or surrender his rights, or surrendered his rights to the corporation, or attempted to exercise his rights and thereafter received a refund from the corporation of the subscription price.

The principles of GCM 11873 are equally applicable under §305, as Rev. Rul. 74-501,[612] makes clear. In that ruling, after a distribution of transferable subscription rights to shareholders of its single class of common stock, the rights declined from a value exceeding 15% of that of the common stock to no value on the subscription date. The corporation refunded all subscriptions received. The IRS ruled that no adjustment is required to the basis of stock held by a shareholder who: (1) failed to sell, exercise, or surrender his rights; (2) surrendered his rights; or (3) exercised his rights and received a refund the same taxable year.[613]

However, the above rulings do not discuss the consequences to a shareholder who had sold his rights prior to the date they became worthless. Presumably, the general rule would apply, so that there would be an apportionment of the basis of the stock with respect to which the rights were distributed in order to determine his tax liability as the result of the sale of the rights (unless the rights were deemed to have a zero basis because of §307(b)).

[609] 1959-1 C.B. 237, *superseding* Rev. Rul. 54-77, 1954-1 C.B. 187, *and modified by* Rev. Rul. 65-193, 1965-2 C.B. 370. See Rev. Rul. 80-213, 1980-2 C.B. 101, *amplifying* Rev. Rul. 59-60, concerning "stapled" stock and, in turn, itself, *amplified by* Rev. Rul. 83-120, 1983-2 C.B. 170.

[610] See also *Central Trust Co. v. United States*, 305 F.2d 393 (Ct. Cl. 1962), which involved the valuation of a closely held corporation's stock that had been the subject of gifts.

[611] XII-1 C.B. 124.

[612] 1974-2 C.B. 98 (*superseding and restating* GCM 11873).

[613] *Cf.* Rev. Rul. 80-58, 1980-1 C.B. 181, *distinguished by* GCM 38426 (in the context of a rescission of an agreement, no gain or loss is recognized if the parties return to the status quo in the same taxable year). *See also* PLR 200813028 (rescission transactions, which were intended to restore legal and financial arrangements with respect to transferred operations that would have existed had parties never entered into agreements, are respected because rescission occurred in same tax year as transaction that was rescinded).

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b. Combined Stock and Warrants Rights

Two rulings issued to cover special and rather rare situations serve to illustrate many of the principles involving allocation of basis, holding period, and other matters relating to stock rights.

In Rev. Rul. 56-572,[614] common stockholders were offered rights to acquire, in a single package, one share of common stock and one stock purchase warrant for each three shares of common stock held. The warrant entitled the holder to acquire one more share of common at a specified price during a period of several years. While the right and warrant had to be purchased together, they could be disposed of separately. The package was offered at a price substantially lower than the market price of the stock. The IRS reached the following conclusions:

(1) No income was realized by the stockholders upon exercise of the package rights, and the corporation had no gain or loss on issuance of such rights.

(2) If the fair market value of the package was 15% or more of the fair market value of the old stock at the time of distribution, the basis of the old stock had to be allocated in proportion to the respective fair market values. If such value is less than 15%, the basis of the rights and warrants would be zero, unless the shareholder elected, under §307(b), to allocate basis.

(3) If the package rights were exercised, the basis allocated to the package had to be further allocated between the stock rights and the warrant rights in proportion to their values on the date of distribution. For that purpose, the value of the stock right was an amount which bore the same ratio to the value of a package right as the value of one share of common stock bore to the value of one package consisting of one share of common and one purchase warrant. The remainder of the package right value was the value of the warrant right.

(4) Upon exercise of the package rights, it was necessary to allocate the subscription price between the stock and the warrants acquired, in proportion to the relative fair market values on the date of exercise. The basis of the new stock was the sum of the portion of the subscription price so allocated to the stock allocable to the stock rights (pursuant to conclusion (2), above), plus the portion, if any, of the basis of the old common stock allocable to the stock rights, determined as described above. The basis of the warrants was the sum of the portion of the subscription price allocable to the warrants, plus the portion, if any, of the basis of the old stock allocated to the warrants.

(5) If package rights were purchased then exercised, the basis of the stock and the warrants was determined in a similar manner. The cost of the package had to be allocated between rights and warrants, in proportion to their respective values when the package was purchased.

(6) The holding period of package rights sold by the stockholder began on the date the old stock was acquired.

(7) The holding period of stock and warrants acquired through exercise of the package rights began on the date the rights were acquired.

(8) The holding period of stock acquired through exercise of warrants began on the date they were exercised.

In Rev. Rul. 72-71,[615] common stockholders (of American Telephone and Telegraph Co.) were offered package rights entitling them to buy debentures, including a temporary certificate for two warrants to buy additional common stock. It required 35 rights (each package had only one) plus $100 to buy a $100 debenture, the fair market value of which was also $100. Therefore, any value the rights had was attributable solely to the warrants. The fair market value of the rights, on the date of distribution, was $1 each — less than 15% of the fair market value of one share of common. The IRS issued the following rulings:

(1) Under §305(d), the warrants were deemed to be stock. Since the value of the rights was attributable solely to the warrants, and since the distribution of the rights was made by the corporation with respect to its stock, the shareholders realized no income upon receipt of the rights, by virtue of §305(a).

(2) Because the rights were worth less than 15% of the value of the common stock, they had zero basis, unless the stockholders elected, under §307(b), to allocate the basis of the old stock in proportion to the respective fair market values of the stock and the rights. If the rights were neither sold nor exercised, their basis was zero.

(3) The holding period of the rights began on the date the old stock was acquired.

(4) The basis of each debenture acquired by exercising the rights was $100, and its holding period began on the date the rights were exercised.

(5) The basis of the warrants was equal to the basis (if any) allocated to the rights, plus the cost of any additional rights purchased.

(6) The holding period of the warrants began on the date the old stock was acquired.

(7) Exercise of the warrants gave rise to no gain or loss, but their expiration, without exercise, resulted in a loss to the extent of their allocated basis.

(8) The basis of stock acquired by exercise of the warrants equaled the basis (if any) of the warrants plus the subscription price paid.

(9) The holding period of the stock acquired began when the warrants were exercised.

c. Identification Issues

Where nontaxable stock rights are received, with respect to two or more lots of stock acquired at different times and at different prices, the necessity for identification may be important upon a subsequent sale of stock or of the rights. The IRS issued final regulations in October 2010 modifying the

[614] 1956-2 C.B. 182.

[615] 1972-1 C.B. 99.

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§1.1012-1(c) first-in, first-out rule for shares of stock.[616] Under the final regulations, as under the previous regulations, if a taxpayer sells or transfers shares of stock in a corporation that the taxpayer purchased or acquired on different dates or at different prices and the taxpayer does not adequately identify the lot from which the stock is sold or transferred, the stock sold or transferred is charged against the earliest lot the taxpayer purchased or acquired to determine the basis and holding period of the stock. The 2010 final regulations clarify that if the earliest lot purchased or acquired is held in a stock certificate that represents multiple lots of stock, and the taxpayer does not adequately identify the lot from which the stock is sold or transferred, the stock sold or transferred is charged against the earliest lot included in the certificate.[617]

The 2010 regulations also provide that a taxpayer must determine the basis of identical stock, which is stock with the same security identifier number, by averaging the cost of each share if the stock is purchased at separate times on the same calendar day in executing a single trade order and the broker executing the trade provides a single confirmation that reports an aggregate total cost or an average cost per share. However, the taxpayer may determine the basis of the stock by the actual cost per share if the taxpayer notifies the broker in writing of this intent.[618] He may not use as his basis the quotient of the total of the purchased stock by the total number of old and new shares.[619]

In *Perkins v. United States*,[620] the Court of Claims determined the amount of profit realized by the taxpayer on sales of stock, some of which he had acquired as original purchases at different times and prices, and some of which he acquired by exercising rights on stock held. The taxpayer averaged the cost for those shares sold by dividing his total cost for all shares by the number of shares held. The IRS determined the cost of each block of stock separately and applied the FIFO rule in computing the profit on the sales. The Court of Claims approved the use of the FIFO rule, pointing out that the regulations authorized the use of the average method applied only for (i) cases involving reorganizations, and (ii) cases not involving reorganizations where identification of shares sold cannot be determined under the rules.

Rev. Rul. 56-653[621] furnished an interesting example of identification accepted by the IRS. The ruling concluded that a shareholder who sold some of his stock in a corporation could identify the shares being sold if he had separate certificates for the various lots of stock. In addition, if, in a past stock split-up, he retained his originally acquired certificates, and received only one new certificate for all the additional stock distributed to him, he could identify the shares being sold, since he had kept proper records. The facts of the ruling are as follows:

Date Acquired	Lot Number	Shares
January 3, 1955	1	25
February 8, 1955	2	50
November 21, 1955	3	100
Total number of shares owned:		175
January 4, 1956: 3-for-1 Stock Split, one new certificate being issued for the additional shares (applicable to Lot 1, 50 shares; to Lot 2, 100 shares; to Lot 3, 200 shares)		350
Total shares owned before the sale		525

On October 18, 1956, the shareholder sold 40 shares and wanted to identify these shares as being out of Lot 2. Immediately after the sale, he sent in to the corporation the certificate of Lot 2 and the new certificate for 350 shares, and directed the corporation to issue new certificates (after issuing a certificate for the 40 shares to the buyer), as follows:

(i) A new certificate for 110 shares to cover the remaining shares applicable to Lot 2, *i.e.*, 50 shares + 100 shares – 40 shares sold.

(ii) A new certificate for the 50 shares issued in the stock split which were applicable to Lot 1.

(iii) A new certificate for the 200 shares issued in the stock split which were applicable to Lot 3.

This method was approved by the IRS as a proper identification. It should be equally applicable with respect to nontaxable stock dividends.

d. Estates and Trusts

If nontaxable stock dividends or stock rights are received by an estate during the course of administration, and the basis of property includible in the estate is determined by using the fair market value of the property on the date of the decedent's death, pursuant to §1014(a)(1), the general rule of §307 should apply. As a result, the basis of the stock with respect to which the distribution was received, will be allocated between the old and the new stock, or rights, in proportion to their respective fair market values on the date of distribution.[622] Note with the repeal of the estate tax after 2009, which lasted for only one year, the §1014 step-up in adjusted basis did not apply to estates of decedents dying during 2010.[623] The following discussion assumes the existence of the estate tax.

If the executor elects to use the alternate valuation date under §2032, rather than the date of decedent's death, and the distribution of the nontaxable stock dividend or stock right is received between the date of death and the alternate valuation date, the general allocation rule of §307 should not apply, since

[616] Reg. §1.1012-1, T.D. 9504, 75 Fed. Reg. 64072 (Oct. 18, 2010), applicable to taxable years beginning after Oct. 18, 2010.

[617] Reg. §1.1012-1(c)(1)(i).

[618] Reg. §1.1012-1(c)(1)(ii).

[619] Rev. Rul. 71-350, 1971-2 C.B. 176.

[620] 81 Ct. Cl. 898 (1935), cert. denied, 297 U.S. 710 (1936); *see also Keeler v. Commissioner*, 86 F.2d 265 (8th Cir. 1936), cert. denied, 300 U.S. 673 (1937).

[621] 1956-2 C.B. 185.

[622] I.T. 2527, 1X-1 C.B. 138, an early ruling on this point, held that when nontaxable stock rights were received by an estate, the fair market value on the date of death was the basis to be apportioned between the old stock and the rights. See also, I.T. 1922, III-1 C.B. 105, which held that where stock was selling "ex-rights" on the date of death, the value of the rights on that date was the basis for determining gain or loss on a sale of the rights by the executor.

[623] Former §1014(f).

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the assets in the estate, including the stock dividends or stock rights, will have a basis equal to their fair market values on the alternate valuation date.[624] However, if the distribution is received after the alternate valuation date, the general allocation rule should apply, with the result that the value on the alternate valuation date of the old stock will be allocated between it and the dividend stock or stock rights, in proportion to their respective values on the distribution date.

If a trust receives a distribution of nontaxable stock dividends or stock rights, the general allocation rule of §307 applies. If the stock, with respect to which the distribution was made, was transferred by gift or bequest, the rules set forth below apply.

(1) Inter Vivos Trust

(a) Where the original stock was transferred to the trust before 1921, the fair market value on the date of transfer (i.e., its basis under §1015(c) and Reg. §1.1015-3) is allocated, pursuant to Reg. §1.307-1(a), between the old and new stock in proportion to their respective fair market values on the date the nontaxable stock dividend is distributed.

(b) Where the original stock was transferred to the trust after 1920, the basis for determining gain and the basis for determining loss are different:

(A) *Gain:* Pursuant to §1015(b), the trustee's initial basis in the old stock is the same as the grantor's basis, increased by any gain, or decreased by any loss the grantor recognized on the transfer. This basis is then allocated between the old and the new stock, pursuant to Reg. §1.307-1(a), in proportion to their respective fair market values on the date the nontaxable dividend is distributed.

(B) *Loss:* Pursuant to §1015(a), if the basis of the old stock, at the time of the gift, was in excess of its fair market value at that time, then the fair market value is used as the basis of the old stock, for purposes of calculating loss.[625] This basis is then allocated between the old and the new stock, pursuant to Reg. §1.307-1(a), in proportion to their respective fair market values on the date the nontaxable dividend is distributed.

(2) Testamentary Trust

The fair market value used for estate tax purposes is allocated between the old and new stock, in proportion to their respective fair market values on the date the nontaxable stock dividend is distributed.[626]

(3) Trust Beneficiaries

The position of the IRS may be summed up as follows:

(1) The basis to the beneficiary of dividend stock received from a trust before 1921 is the fair market value of the stock at the time of its receipt by the beneficiary. This rule applies to both inter vivos and testamentary trusts.[627]

(2) Shares received after 1920, from the trustee of an inter vivos trust, retain the same basis in the hands of the beneficiary as in the hands of the trustee.[628] As outlined above, that basis differs, depending on whether the beneficiary disposes of the stock so received at a gain or at a loss.

(3) Shares received by a beneficiary from a testamentary trust also retain the same basis as in the hands of the trustee.[629] As outlined above, determination of this basis depends on whether the date-of-death value was used, or the alternate valuation date was selected. Of course, if the decedent had acquired the dividend shares before his death, both old and new shares would have as their basis, to both the trust and beneficiary, the fair market value of the stock as of the date of decedent's death (or alternate valuation date).

In *McCullough v. Commissioner*,[630] the Second Circuit held that the basis of stock received by a life tenant of an estate as a distribution from the estate was the fair market value of such shares on the date of distribution, even though such shares had been received by the estate as a stock dividend, and would have had an allocated basis in the hands of the estate. The court refused to accept the IRS's argument that the estate was, in effect, only a conduit and, therefore, that the stock in question had the same basis in the hands of the life tenant as it did in the hands of the estate. The court considered the stock to be income to the life tenant, even though the dividend shares did not constitute taxable income to the executors. The IRS has not accepted the Second Circuit's position.[631]

Generally speaking, a donee's basis for the stock received as a gift after 1920 is the same as the adjusted basis to the donor or the last preceding owner by whom it was not acquired by gift. However, for computing a loss upon the sale of gift stock, the fair market value on the date of gift is used if it is less than the donor's adjusted basis. The basis of such a gift, made on or after September 2, 1958, is increased by the amount of the federal gift tax paid with respect to the gift, but it may not be increased to more than the fair market value of the gift stock at the time the gift was made.[632]

In Rev. Rul. 67-117,[633] the IRS discussed the tax treatment of a trust and its beneficiaries, where the trust distributes cash in lieu of nontaxable stock dividends received by the trust. In the facts supplied, a corporation distributed to a trust a nontaxable stock dividend, which was "income" for trust accounting purposes under the particular state law involved. The terms of the trust provided that the income of the trust could, in the discretion of the trustee, be distributed to the income beneficiary, or accumulated.

[624] *See Estate of Schlosser v. Commissioner*, 277 F.2d 268 (3d Cir. 1960), aff'g 32 T.C. 262, cert. denied, 364 U.S. 819 (1960); Rev. Rul. 58-576, 1958-2 C.B. 625.

[625] *See* Reg. §1.1015-1.

[626] *See* Reg. §1.307-1, §1.1014-1.

[627] *See* §1015(c).

[628] *See* Reg. §1.1015-2(a)(1).

[629] *Id.*

[630] 153 F.2d 345 (2d Cir. 1946), rev'g and rem'g 4 T.C. 109 (1944).

[631] Rev. Rul. 24, 1953-1 C.B. 263. *See also* GCM 21532, 1939-2 C.B. 231; I.T. 3318, 1939-2 C.B. 232 and I.T. 1622, II-1 C.B. 135, *as modified by* I.T. 3181, 1938-1 C.B. 336.

[632] §1015. See the regulations under §1015 for more detailed rules concerning computation of a donee's basis.

[633] 1967-1 C.B. 161.

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The ruling first concludes that, under the provisions of §643(a), nontaxable stock dividends do not enter into the computation of distributable net income. Nevertheless, the ruling goes on to indicate that cash distributions in lieu of distributions of nontaxable stock dividends can result in the receipt of distributable net income to the trust beneficiaries, in the event that all such distributable net income has not been otherwise paid out to them.

Note: Presumably, distributions of the stock dividends themselves would not result in distributable net income to the beneficiaries, since the ruling is limited by its facts to situations in which cash is distributed in lieu of a nontaxable stock dividend.[634]

Comment: Although the ruling does not address a situation in which the trust's distributable net income equals, or exceeds, the cash distributed in lieu of the nontaxable stock dividends, the language and apparent theory of the ruling indicates that the entire distribution would be taxable to the recipient.

B. Section 306 Stock

1. Section 306(c)(1)(A) Stock

a. Basis

Preferred stock is within §306(c)(1)(A) if it is received tax free under §305(a). In PLR 9627009, the IRS ruled that the preferred shares a corporation issued tax-free to its common shareholders under §305(a) were "section 306 stock" within the meaning of §306(c) to the extent that a distribution of money, in lieu of the stock, would have been a dividend at the time of the distribution. The adjusted basis of such §306 stock is determined under §307. The general rule of §307(a) requires that the adjusted basis of the previously owned common stock is allocated between the previously owned common stock and the preferred stock received as a tax-free stock dividend. As noted above, §307(b) provides an exception from the general rule, if the fair market value of the distributed stock is less than 15% of the value of the old stock, unless the taxpayer makes an election to allocate basis. Reg. §1.307-2 provides that the allocation is based on the respective fair market values of the common and preferred shares.

> *Example:* Assume that in Year 1 taxpayer (T) acquired all 50 outstanding shares of common stock of corporation (C) at a cost of $10,000. Thereafter, C issued a tax-free stock dividend to T of 50 shares of preferred stock. After the issuance of the stock dividend, the fair market value of the C common stock was $800 per share ($40,000 total fair market value), and the fair market value of the C preferred stock was $200 per share ($10,000 total fair market value). Thus, the common shares represent 40,000/50,000, or 80%, of total fair market value, and the preferred shares represent 10,000/50,000, or 20%, of total fair market value. Consequently, §307 requires T to allocate 80% ($8,000) of the original $10,000 cost basis to the common, and 20% ($2,000) to the preferred.

[634] *See also* §643(a).

b. Holding Period

Since the basis of the preferred stock is determined under §307, the taxpayer is allowed to tack the holding period of the common onto the actual holding period of the preferred.[635]

2. Section 306(c)(1)(B) Stock

a. Basis

Preferred stock received in certain corporate reorganizations is treated as §306 stock, by virtue of §306(c)(1)(B).[636] The adjusted basis of such stock is determined by reference to §358, which provides adjusted basis rules for all corporate reorganizations. Where only qualifying nonrecognition property is received in the reorganization (i.e., no boot is received), §358 provides a substituted basis rule: the taxpayer's adjusted basis in the stock surrendered becomes the adjusted basis of the nonrecognition property received. For example, assume a corporation undergoes a §368(a)(1)(E) recapitalization, in which the sole shareholder surrenders his common stock, and receives back preferred stock and new common stock. The preferred stock clearly would be §306 stock, by virtue of §306(c)(1)(B).[637] Under §358 the basis in the old common stock would become the adjusted basis of both the new common and the preferred. Reg. §1.358-2(a)(2)(ii) provides that, to the extent the terms of the exchange specify that shares of stock or securities of a particular class are received in exchange for a particular share of stock or a particular class of stock, such terms shall control provided such terms are economically reasonable. However, if the terms of the exchange do not specify that the shares of stock or securities of a particular class are received in exchange for a particular share of stock or security or a particular class of stock or securities, then, for purposes of determining the basis of the shares received, a pro rata portion of the shares of stock and securities of each class received shall be treated as received in exchange for each share of stock and security surrendered, based on the fair market value of the stock and securities surrendered.[638]

Where both qualifying property and nonqualifying property (money or "boot") are received in a corporate reorganization, part or all of the gain realized will be recognized.[639] As a result, the §358 basis rule is adjusted to accommodate these changes. Specifically, where boot is received, the adjusted basis of the boot is its fair market value. The adjusted basis of the qualifying stock or securities received is an amount equal to the adjusted basis of the property surrendered, reduced by the amount of money received and the fair market value of boot received, and increased by the amount of dividend recognized plus the amount of other gain recognized. This remaining adjusted basis amount must be allocated among the various qualifying properties received. The preferred stock received in the reorganization will be treated as §306 stock, by reason of §306(c)(1)(B). The §306 stock will also be qualifying property, for purposes of the

[635] §1223(4).

[636] *See* discussion at IV.C.5., above.

[637] *See* discussion at IV.C.5.e., above.

[638] Reg. §1.358-2(a)(2)(ii).

[639] *See generally* 782 T.M., *Boot Distributions and Assumption of Liabilities.*

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§358 basis rule, because it is capital stock of the acquiring company. Consequently, the remaining adjusted basis must be allocated between the common and preferred stock. Reg. §1.358-1 and §1.358-2 provide that the allocation shall be based on either (i) the terms provided for in the exchange if such terms are economically reasonable, or (ii) if the terms of the exchange do not so provide, then a pro rata portion of the shares of stock of each class received and a pro rata portion of the "other property" and money received shall be treated as received in exchange for each share of stock surrendered, based on the fair market value of the stock surrendered.[640]

b. Holding Period

The holding period of §306 stock, received in a corporate reorganization, is subject to §1223(1), which provides a tacked holding period. Because the adjusted basis of the §306 stock will be determined in whole or in part by reference to the basis of the stock surrendered, the holding period of the common will be added to the actual holding period of the preferred.

3. Section 306(c)(1)(C) Stock

Stock that is treated as §306 stock by virtue of §306(c)(1)(C) must, by definition, have a carryover or substituted basis from stock that was §306 stock. Thus, no special adjusted basis rule is necessary. For example, a gift of §306 stock will cause the stock to be §306 stock to the donee, under §306(c)(1)(C), and the normal §1015 carryover basis rule will apply. Similarly, a §1036 exchange of §306 stock or a §351 transfer of §306 stock generates a substituted basis, under §1031(d), or §358, respectively. Again, because there is a substituted or carryover basis, a tacked holding period is allowed under §1223(1).

[640] Reg. §1.358-2(a)(2)(ii).

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