REPORT # 584

TAX SECTION

New York State Bar Association

Report on the Taxation of Shareholder Rights Plans

by The Committee on Corporations

July 25, 1988

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July 26, 1988

The Honorable O. Donaldson Chapoton
Assistant Secretary of the Treasury
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U. S. Treasury Department
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The Honorable Lawrence B. Gibbs
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, N.W.
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Shareholder Rights Plans

Dear Sirs:

Enclosed is a report on the Taxation of Shareholders Rights Plans prepared by our Committee on Corporations. The report was prepared by a subcommittee of the Committee consisting of David Einhorn, Jay Gayner, Stephen B. Land, Mark H. Leeds, Matthew Rosen, David Sicular and Jodi Schwartz. Mark H. Leeds coordinated the preparation of the report. Helpful comments were received Prom Craig A. Alexander, Martin B. Amdur, Gerard R. Boyce, Jonathan S. Brenner, William L. Burke, Herbert L. Camp, Peter L. Faber, Arthur A. Feder, Kenneth H. Heitner, Gordon D. Henderson, Lee S. Parker, James M. Peaslee, Richard L. Reinhold, Irving Salem, Michael L. Schler, David E. Watts and Ralph O. Winger. The report was approved at a meeting of our Executive committee on June 9, 1988.

The report considers the Federal income tax consequences of each stage in the life of a "poison pill" from adoption of the plan to the flip-in and flip-over provisions. The report also discusses certain collateral Federal income tax consequences, including the use of stock with attached "poison pill" rights in tax-free reorganizations, their effect on incentive stock option plans, certain ERISA considerations and the Section 382 implications of "poison pills".

Central to the report is the Committee's conclusion that adoption of a "poison pill" should not be treated as a distribution or an exchange and, therefore, should not result in any tax consequences to the issuer's shareholders. The report further concludes that separation of the "poison pill" from the underlying stock should be treated as a non-taxable stock dividend under Section 305(a) of the Code. Also, the report analyzes in some detail the consequences of a lapse of the issuer's redemption right, the flip-in, the flip-over and the redemption of a "poison pill".

Consistent with the conclusion that no distribution or exchange occurs on adoption, the report concludes that unmatured "poison pill" rights (i.e., existing prior to separation) are not property separate from the stock to which they relate and would not constitute boot in a reorganization.

The Tax Section of the New York State Bar Association is hopeful that this report will prove helpful in connection with the study the Treasury Department has undertaken regarding the taxation of "poison pills" and would be pleased to provide any additional assistance that you might request.

Sincerely,

Herbert L. Camp

Encl.

Copies w/encl. to Dennis E. Ross, Esq.,
Deputy Assistant Secretary
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Tax Report #584

NEW YORK STATE BAR ASSOCIATION

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In recent years, many public companies have adopted so-called shareholder rights plans, or “poison pills” (a “Rights Plan”), to protect shareholders from perceived hostile take-over abuses. [1/] Whatever the substantive merits of those plans, more companies presumably will adopt them in the future.

In view of the proliferation of Rights Plans, the Treasury Department has undertaken a study of the taxation of such Plans, and it has requested the views of this Committee.

[*/] This report was prepared by a subcommittee of the Committee on Corporations consisting of David Einhorn, Jay Gayner, Stephen B. Land, Mark H. Leeds, Matthew Rosen, David Sicular and Jodi Schwartz. Mark H. Leeds coordinated the preparation of the report. Helpful comments were received from Craig A. Alexander, Martin B. Amdur, Gerard R. Boyce, Jonathan S. Brenner, William L. Burke, Herbert L. Camp, Peter L. Faber, Arthur A. Feder, Kenneth H. Heitner, Gordon D. Henderson, Lee S. Parker, James M. Peaslee, Richard L. Reinhold, Irving Salem, Michael L. Schler, David E. Watts and Ralph O. Winger.

[1/] A survey of public records indicates that, as of March 23, 1988, over 500 companies had adopted shareholder rights plans, including 276 (or 28%) of the Business Week 1,000 companies, 191 (or 38%) of the Fortune 500 companies and 96 (or 48%) of the Fortune 200 companies.

I. Summary of Typical Rights Plans.

While the details vary, a Rights Plan generally has the following terms:

1. Distribution. The issuer enters into an agreement with an agent, and the issuer's Board of Directors declares a distribution of a non-voting right (a “Right”) for each outstanding share of common stock.

2. Initial Entitlement. Each Right entitles its holder, under certain specified circumstances, to buy one share (or a specified fraction of a share) of either common stock or a participating preferred stock of the issuer, at an exercise price that significantly exceeds the then current market price of such stock. The Rights generally expire ten years after they are issued.

3. Non-exercisability; Transferability. Unless and until a Triggering Event (as- defined below) occurs, the Rights are not exercisable, and are evidenced only by and must be transferred with the certificates for the stock with respect to which they were distributed. [2/]

[2/] The Rights Plan also provides that each share of common stock that is newly issued after the declaration of the distribution and prior to the Rights becoming exercisable (as described hereafter) will have a Right attached to it.

4. Triggering Event; Separation. A Triggering Event occurs if any person or group (the “bidder”) acquires or accumulates a threshold percentage (typically 20%) of the issuer's common stock, or commences a tender offer which, if successful, would result in the ownership of the same (or, in some cases, a higher) percentage. Absent Board of Director action, ten days after a Triggering Event has occurred, (i) the Rights agent is required to issue and mail separate and freely transferable Rights certificates to each holder of stock, including the bidder, of record at the close of business on the day that the Triggering Event occurred, and (ii) the Rights become exercisable, although the Rights may still be “out-of-the-money”, unless the price of the issuer's stock has risen substantially since the time that the Rights were issued.

5. Redemption. The issuer may redeem the Rights at a nominal price (typically, $.01 or $.05 per Right) at any time prior to or, under many plans, within ten days after a Triggering Event, usually subject to one or more extensions. Additionally, under certain recent plans, the Rights may be redeemed pursuant to a shareholder vote under certain circumstances.

6. Flip-in. A Flip-in Event occurs if a specified percentage (typically 30-50%, but often lower) of the issuer's common stock is acquired by the bidder, or the issuer is acquired

in a merger or other business combination in which the issuer is the surviving corporation and the common stock of the issuer is unchanged. In such event, if the Rights have not been called for redemption, each holder, other than the bidder, becomes entitled to purchase from the issuer, at the Right's exercise price, a number of shares of the issuer's common stock having a market value, as of the date of the Flip-in Event, equal to twice the exercise price of the Right (a “flip-in”). [3/]

7. Flip-over. If a Triggering Event has occurred and a “Flip-over Event” (defined below) occurs, each holder of a Right, other than the bidder, becomes entitled to purchase, at the exercise price of the Right, a number of shares of the surviving or acquiring corporation's common stock having a market value, as of the date of the Flip-over Event, equal to twice the exercise price of the Right. A Flip-over Event generally takes one of the foil owing three forms:

(a) The issuer is the surviving corporation in a

[3/] In The Bank of New York Company, Inc. v, Irving Bank Corporation, S. Ct., N.Y. County (July, 1988), the court granted a preliminary injunction against enforcement of a flip-in provision on the ground that it was likely that the provision violated Section 501(a) of the New York Business Corporation Law, which mandates equal treatment of shares of the same class.

merger and the Rights remain rights to purchase stock of the issuer, but the terms change (e.g.. the Rights may become rights to purchase common stock rather than participating preferred stock);

(b) The bidder is either the surviving corporation in a merger or purchases all of the issuer's assets, and the Rights become rights to purchase the bidder's common stock, exercisable against the bidder; or

(c) The bidder purchases a specified portion (generally 50%) of the issuer's assets,- and the Rights become rights to purchase the bidder's common stock, but the Rights remain exercisable against the issuer, to be satisfied with stock of the bidder provided to the issuer.

Variations of the foregoing include Rights which flip-in immediately upon the occurrence of a Triggering Event, Rights that eliminate the flip-in, but not the flip-over, in the event of a tender offer in which a bidder acquires at least 80% of the issuer’s common stock, and provisions which allow the issuer's Board of Directors to call the Rights (after a Flip-in Event has occurred but prior to the bidder's acquisition of 50% of the issuer's outstanding stock) in exchange for one share of the issuer's common stock (or preferred stock of comparable value).

Further variations are likely to occur in the future.

II. Conclusions.

We believe that the Federal income consequences of Rights Plans are as follows:

A. Adoption. The adoption of the Rights Plan should not be treated as a distribution or exchange and, therefore, should not result in any tax consequences to the issuer's shareholders.

B. Separation following a Triggering Event. No taxable income should result from separation, because the issuer's shareholders should be treated as though they received a distribution, nontaxable as a stock dividend under Section 305(a). [4/] That should be true even if the separation is simultaneous with a Flip-in Event, resulting in the distribution of “in-the-money” Rights.

C. Lapse of Redemption Right. With respect to those Rights Plans which permit an issuer to redeem Rights for a specified period of time after separation and distribution, the lapse of the issuer's redemption privilege may result in an additional distribution. Such distribution would be

[4/] All Section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

taxable under Section 305(b)(2) to the Rights holders, but only if the requisite property distribution has been, or will be, made with respect to the issuer's stock (any distribution within 36 months before or after such lapse under current Treasury Regulations).

D. 1. Flip-in following Separation. A change in the exercise price of the Rights pursuant to a Flip-in Event should not be considered a taxable exchange under Section 1001 but should be considered a Section 305 distribution, which would be taxable to the Rights holders if, but only if, there has been, or will be, a property distribution on the issuer's stock that satisfies the requirements of Section 305(b)(2).

2. Flip-in Simultaneous with Separation. A flip-in simultaneous with separation should be treated as a non-taxable distribution under Section 305(a).

E. 1. Flip-over with exercisability against issuer for its stock. Generally, a flip-over where the Rights remain exercisable against the issuer for issuer stock will result in no change in a Right (given prior flip-in) and no taxable event. If there were no prior flip-in, the Rights would be changed (the number of shares being increased), and in that case a similar result to that in D. 1, above, should follow.

2. Flip-over with exercisability against issuer for bidder stock. Where the Rights, although exercisable against the issuer, become exercisable for bidder stock, the fact that property obtainable upon exercise has changed should not cause the Rights holders to be considered to have exchanged their existing Rights for “new” Rights in a taxable transaction. However, the Rights holders may be considered to have received a distribution taxable under Section 301.

3. Flip-over with exercisability against bidder. A taxable exchange most likely occurs if, upon a Flip-over Event, the Rights become exercisable against the bidder.

F. Redemption. A redemption of Rights prior to separation will result in dividend income to the Rights holders. A redemption of Rights thereafter should result in capital gain or loss to Rights holders, but could result in ordinary income because of the absence of a sale or exchange.

G. Exercise of Rights. No gain or loss should be recognized on exercise of a Right.

H. Redemption of Rights for Stock of Issuer. A post flip-in redemption of Rights for stock of the issuer, although pursuant to the terms of the Rights, should result in gain or loss to a holder.

I. Other Consequences. Collateral Federal income tax consequences and note rights plans are discussed in sections III-I and IV of this Report, respectively.

III. Discussion.

A. Adoption of the Plan. The adoption of a Rights Plan could be characterized in at least six different ways, namely, (1) a non-event because of the contingencies precedent to separation and flip-in, (2) an addition of a new term to the issuer's stock that does not rise to the level of a deemed exchange of “old” stock for “new” stock, (3) a promise on the part of the issuer to pay, or the declaration of a dividend to be paid, in the future, (4) an addition of a term to the issuer's stock that is treated as an exchange of “old” stock (which does not incorporate the Right) for “new” stock (which does), (5) a distribution of the Rights as an item of property separate from the stock and (6) an exchange of old stock for a package consisting of new stock and separate Rights. Those alternatives are analyzed in more detail below. We note here, however, that none of those characterizations, except the sixth, would result in immediate taxation to the common stockholders.

1. The first three characterizations; non-event; non-exchange; Promise to pay a dividend.

A recent private letter ruling has taken the position that the adoption of a Rights Plan constitutes the distribution of a separate property interest for Federal income tax purposes. [5] The Committee believes, however, that under current law, the mere adoption of a Rights Plan prior to the occurrence of a Triggering Event should not be treated as a distribution of the Rights for Federal income tax purposes. Rather, at least until separation of the Right following a Triggering Event, the issuer's stock and the associated Rights should be treated as a single property interest. Although the Rights are considered separate outstanding property interests for corporate law purposes, they should not be so treated for Federal income tax purposes prior to separation. Until such time, the Rights (1) are not currently exercisable, (2) may never become exercisable except through the satisfaction of contingencies not within the control of the holders of the Rights or the issuer (and which the issuer can defeat through its right of redemption for a nominal amount), (3) are not separately transferable and (4) are redeemable for a nominal amount.

The fact that Rights automatically attach to and inhere in additional stock issued after the initial declaration (see footnote 2, above) also supports the conclusion that, prior

[5] P.L.R. 8808081 (December 3, 1987). See footnote 61 below; but see L. Sheppard, Poison Pills and Section 305, Tax Notes 803, 805 (May 16, 1988).

to separation, Rights are a mere term of the stock.

The adoption of a Rights Plan can also be analyzed as a contingent or anticipatory declaration of a dividend. The Rights remain redeemable for a nominal amount, and the redemption right may be regarded as tantamount to the power of a corporation to rescind a previously declared but unpaid dividend. The Right, like the declared but unpaid dividend, should not be viewed as property separate from the stock.

While there is no authority that directly addresses the Federal income tax treatment of the adoption of a Rights Plan, numerous authorities hold that certain contingent obligations are not taken into account as indebtedness for Federal income tax purposes. The Committee believes that those authorities provide a possible analogy supporting the conclusion that the adoption of a Rights Plan does not have any Federal income tax significance. For example, in Zappo v. Commissioner [6/] an obligation to make payments, in the event that contingent payments from another source were not received,

[6/] 81 T.C. 77, 88-90 (1983).

was held too contingent to constitute indebtedness of the obligor taxpayer. [7/]

The adoption of the Rights Plan resembles to some extent the situations described in the preceding paragraph. [8/] The conditions precedent to the separation of the Rights are entirely speculative and are not within the control of the Rights recipients.

The fact that the Rights are not separately transferable adds some force to the conclusion that the adoption of a Rights Plan prior to a Triggering Event is not a distribution for Federal income tax purposes. Certain older authorities held that stapled or locked interests will not be treated as separate property rights. [9/] However, modern authorities are contrary and hold that locked interests generally will be treated as two

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[7/] See also Brountas v. Commissioner, 692 F.2d 152 (1st Cir. 1982), rev'g on other grounds 73 T.C. 491 (1980) (similar for nonrecourse oil and gas indebtedness); Bailev v. Commissioner. 90 T.C. No. 37 (1988) (similar for a movie tax shelter).

[8/] Each of the foregoing cases dealt with the Commissioner's application of the substance-over-form doctrine, generally in the context of abusive tax shelters. As a result, the Committee recognizes that the precedential value of such cases may be limited.

[9/] DeCoppet v. Helvering, 108 F.2d 787 (2d Cir. 1940), cert. denied, 310 U.S. 646 (1940); Universal Castings Corporation v. Commissioner. 303 F.2d 620 (7th Cir. 1962).

separate property rights for Federal income tax purposes. [10/]

The Committee believes that the fact that adoption occurred in response to the threat of takeover or other Triggering Event should not alter the conclusion that adoption is not a taxable event. First, even if a Triggering Event appears imminent (for example, if a Form 13D is filed by a new shareholder who is perceived as a potential bidder), if it has not in fact occurred, the Rights remain contingent and the contingency is outside the control of the holders. In the realm of corporate takeovers, many perceived threats never materialize, and last minute changes are common. Second, analyzing the issue of whether a distribution of a property right has occurred in terms of how imminent the Triggering Event appeared at the time

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[10/] See e.g., Section 269B; Section 1273(c)(2); Rev. Rul. 70-108, 1970-1 C.B. 78 (right to purchase additional stock upon conversion of convertible preferred stock held a separate property right that prevented use of that convertible preferred stock in a “B” reorganization); Rev. Rul. 69-265, 1969-1 C.B. 109 (Situation 1) (right against parent corporation to convert subsidiary's convertible preferred stock to parent common stock held “other property” that prevented use of such stock in a “C” reorganization); Rev. Rul. 80-213, 1980-2 C.B. 101 (distribution of subsidiary stock stapled to parent stock a Section 301 distribution to parent's stockholders); cf. Farley v. Commissioner, 279 F.2d 701 (2d Cir. 1960) (participating loan held to be a combination of debt and equity); Richmond. Fredricksburg and Potomac R.R. v. Commissioner, 528 F.2d 917 (4th Cir. 1975) (same); see generally Canellos, “New Financial Products,” 63 Taxes 970, 973 (December, 1985).

the Rights Plan was adopted would be a very difficult rule to administer. Third, if such a rule is not adopted and the seemingly imminent Triggering Event occurs shortly thereafter, the distribution of a property interest for Federal income tax purposes will occur at that time.

Under any of the first three characterizations, the tax consequence should be no income to the shareholders as a result of adoption of a Rights Plan. As to the first and second characterizations, a modification of the terms of the stock that does not rise to the level of a deemed exchange does not involve a realization event or a distribution and thus, a *fortiori,* is not a taxable event. As to the third characterization, no taxable event would occur until the dividend were paid. Revenue Ruling 62-131, 1962-2 C.B. 94, and Treasury Regulation Section 1.301-1(b) provide that a distribution of property by a corporation to its shareholders is includible in the shareholders' gross income at such time as the property is either “received by, or unqualifiedly made subject to the demand of, [the] shareholders”. At adoption, the conditions precedent to such vesting are so substantial as to preclude the privileges inherent in the Rights from being “unqualifiedly subject to the demand of the [issuing corporation's] shareholders”.

2. The fourth characterization: Exchange.

As mentioned, the fourth characterization of adoption is a deemed exchange of “old” stock for “new” stock.

The Committee believes that no exchange should be deemed to occur unless the common stock coupled with the Right differs materially in either kind or extent from the common stock prior to the adoption of the Rights Plan. Generally, that should not occur because the common stock apart from the Right is unchanged and the Right itself has minimal value since the amount payable on the redemption of a Right prior to the occurrence of a Flip-in Event is nominal, and the probability that the Rights will be triggered or redeemed is entirely speculative. [11/]

If, contrary to the Committee's view, there were an exchange, it should be considered to be of stock for stock, not stock for stock and rights, for the same reasons as set forth in the discussion of the first two characterizations. As additional support for the view that new stock deemed issued should include the Rights, we note that in a context similar to the adoption of a Rights Plan, the Internal Revenue Service (the “Service”) has

[11/] Treas. Reg. § 1.1001-1(a) (an exchange has occurred only if the property received differs materially in either kind or extent).

ruled that the contingent right to receive additional property with respect to stock is a term inherent in such stock. In Revenue Ruling 75-33, 1975-1 C.B. 115, a corporation issued voting convertible preferred stock in a “B” reorganization. The preferred stock (but not the common stock into which the preferred stock was convertible) was entitled to a special cash dividend in the event that an unsuccessful bidder raised the dividend on the stock it had offered to the target shareholders. The Service found that the right to receive additional dividends was a right inherent in the preferred stock and, therefore, did not constitute separate property. [12] Similarly, in General Counsel's Memorandum 39103 (December 23, 1983), the Service held that a term of a preferred stock that entitled the holder to elect to receive distributions of common stock to satisfy dividend arrearages when two dividends had been missed was not a separate property right.

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[12] See Rev. Rul. 78-142, 1978-1 C.B. 111 (issuance of preferred stock with contingent rescission provisions did not involve “other property” for purposes of Section 356(a) since such provisions are not personal to former target shareholders); P.L.R. 8739053 (June 30, 1987) (Service reither ruled that right inherent in acquiring corporation's stock to purchase shares of participating preferred stock was boot in an “A” reorganization, nor reserved on the issue); but see P.L.R. 8808081, supra. footnote 5.

In addition, it is well established that a contingent right to receive additional stock in an acquisition is not separate consideration where the right does not trade separately from the stock initially issued in the acquisition. See. Section 3.03 of Revenue Procedure 77-37, 1977-2 C.B. 568, amplified by Revenue Procedure 84-42, 1984-1 C.B. 521. Further, a right in the holder of preferred stock to convert it, against the issuer, into common stock of another corporation is not a separate right from the preferred stock. See, Revenue Ruling 69-265, 1969-1 C.B. 109 (situation 2).

A deemed exchange of "old" stock for "new" stock should be tax-free under either Section 354 (as a Section 368(a)(1)(E) recapitalization [13/]) or Section 1036, or both.

[13/] The business purpose requirement applicable to all Section 368 reorganizations would appear to be satisfied in the case of the adoption of a Rights Plan. In P.L.R. 8819095 (February 17, 1988) and P.L.R. 8421062 (February 24, 1984), the Service held that divisive reorganizations, undertaken to make corporations less vulnerable to hostile take-overs, satisfied the business purpose requirement. The cases upholding Rights Plans have noted that such Plans benefit the issuers. See Moran v. Household International. Inc. 490 A.2d 1059 (Del. 1985). Moreover, adoption of Rights Plans is not tax motivated. See Treas. Reg. § 1,368-l(c).

As a result of recapitalization status of any deemed exchange, the question whether a deemed exchange occurred at adoption would have little practical significance except that, arguably, the corporation and its shareholders should file a copy of the Rights Plan with their tax returns. [14]

3. The fifth characterization: Distribution.

For the reasons expressed above, the Committee is of the view that adoption is a non-event, change in terms or promise to distribute, not a distribution. If, however, adoption were considered a distribution of Rights, the Rights should probably be viewed as a right to acquire the issuer's common stock, [15] the receipt of which would generally be non-taxable under Section 305(a). [16] The Right is, however, not only a right

[14] See Treas. Reg. § 1.368-3.

[15] Under some Rights Plans, the Rights are exercisable for participating preferred stock, but such stock will generally be treated as "common stock" for purposes of Section 305. Treas. Reg. § 1.305-5(a); see also Rev. Rul. 81-91, 1981-1 C.B. 123 (participating preferred stock is common stock for purposes of Section 306).

[16] Section 305(d) (stock rights are treated as stock for purposes of Section 3 05). Since no common shareholder or holder of convertible debt or convertible preferred stock has the option to receive, or in fact receives, other property or preferred stock in lieu of a Right, the only subsection of Section 305(b) that could possibly apply to the common shareholders is Section 305(b)(2), relating to disproportionate distributions.

to acquire issuer stock (the receipt of which alone would be non-taxable under Section 305), but also a right under certain circumstances to receive, either from the issuer or the bidder, stock of the bidder (the receipt of which is arguably taxable). As to that aspect, a majority of the Committee is of the view that, if adoption is a distribution, the fact that the Right allows the holder to receive stock of the bidder in some cases should not cause the Right distribution to be considered taxable insofar as it constitutes a right to acquire <u>issuer</u> stock.

Insofar as the Right represents the right to acquire <u>bidder</u> stock <u>from</u> <u>the</u> <u>bidder</u>, it is arguable that no distribution of property has occurred. The distributor (the Rights issuer) does not own the bidder stock and is not undertaking to transfer it should it become the owner of it. While arguably a liability is created, such liability by its terms is never that of the issuer, only that of the bidder. That part of the Right should not be analyzed as a property distribution, or right enforceable against the issuer, but rather as its undertaking not to merge into the bidder unless the bidder agrees to allow its stock to be issued according to the terms of the Rights. So viewed, that part of the Right should not be taxable upon adoption.

Insofar as the Right represents the right to acquire bidder stock from the issuer of the Right, it could be argued that if the Right has been issued at adoption (and the Committee is of the view that it has not), the value of that part of the Right is taxable to the recipients under Section 301. The better view, however, is that such part of the Right is so contingent and speculative that it should not be considered taxable. The Committee notes that in many instruments (convertible stock or debt, stock options), the right to acquire stock represented thereby is stated to be a right to acquire, from a third party, its stock if a merger into it occurs, yet such supplemental right is not treated as a separate property right (such as to constitute "boot" in a reorganization, or a taxable dividend under Section 305).

4. The sixth characterization: Receipt of new stock and warrants.

The sixth characterization is in our view not a correct one, because the "old" common stock is identical in all respects to the "new" common stock. [17/] On its face, that is the only alternative that might be taxable to the common stockholders,

[17/] Compare Treas. Reg. § 1.301-1(1); Bazley v. Commissioner. 331 U.S. 737, rehearing denied, 332 U.S. 752 (1947).

as the Rights presumably are neither "securities" for purposes of the reorganization provisions of the Code nor stock for the purposes of Section 1036.

B. Separation of the Stock Purchase Right From the Stock.

1. If Adoption of the Rights Plan Were Either a "Non-Event" or a Recapitalization Without Immediate Tax Consequences.

a. Distribution. If, as discussed above, the adoption of the Rights Plan is not itself treated as a distribution of separate property rights, separation following a Triggering Event should be considered to cause a distribution of the Rights at that time. In contrast to the adoption of the Rights Plan, upon separation the issuer's shareholders have "received" the right to purchase the issuer's stock. [18/] Upon separation after a Triggering Event, the shareholders can dispose of the Rights. Neither sale nor exercise would require the shareholder to dispose of the stock with respect to which the Rights were distributed. The Rights therefore should be considered to have been distributed as separate property when separation occurs.

[18/] See Rev. Rul. 88-31, 1988-19 I.R.B. 7 (contingent payment right (analogous to a put) that trades separately from the underlying stock is separate property and not an attribute of the stock).

In Revenue Ruling 88-31, supra, footnote 18, a corporation issued separately tradable contingent payment rights in connection with an issuance of stock. [19/] The Service held that such rights constituted separate property rights “because the Rights may be traded separately from the stock, a holder of a Right could receive payment on the payment date without owning a share of stock in the [issuing corporation].” Similarly, Rights trade freely after separation and, if the Rights are redeemed, the payment in redemption may be made to a person who does not own any stock.

Under most Rights Plans, the issuer's privilege to redeem the Rights for a nominal price continues for a limited period of time after a Triggering Event and an actual distribution of Rights certificates by the Rights agent. That should not change the conclusion that a distribution has occurred at separation. There are arguments, however, that in view of the nominal redemption price, even separation is not a taxable event. In discussing the lapse of the right in Revenue Ruling 88-31, the

[19/] Each contingent payment right entitled the holder, on the two-year anniversary of the Rights issuance, to receive, in cash and/or stock (at the issuer’s option), the greater of (l) the difference between a fixed dollar amount and the then current market price (subject to a cap) of the stock with which the right was issued or (2) $.10.

Service held that a right had lapsed for purposes of Section 1234A even though it was in fact redeemed for a nominal amount. By analogy, a Right distributed and remaining subject to redemption for a nominal amount would not be considered issued. [20/] If such argument were accepted, then lapse of redemption right, not separation, would be the first distribution event. The following discussion assumes, however, that separation is a distribution event.

b. Section 305. For purposes of Section 305, a distribution of stock includes a distribution of rights to acquire stock. [21/] While Section 305 distributions are

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[20/] In an analogous area, Rev. Rul. 68-601, 1968-2 C.B. 124, provides that an option or warrant will be considered to exist (for purposes of determining whether the option attribution rule of Section 318(a)(4) applies) if "there exist no contingencies" with respect to exercise. See also Rev. Rul. 77-201, 1977-1 C.B. 250 (convertible preferred stock is "substantially identical" to common stock within the meaning of Section 1091 when, among other things, "there were no restrictions" on the ability to convert); G.C.M. 35176 (December 19, 1972) (Section 318(a)(4) option attribution inappropriate in circumstances where "any contingencies with respect to an [option are subject to] serious precedent conditions which could result in a substantial risk of forfeiture of the right to exercise the option"); T.A.M. 8106008 (October 21, 1980); American Bar Ass'n Comm. on Affiliated & Related Corps., Committee Recommendations, 21 Tax Law. 921, 923 (1968) (proposing that Section 318(a)(4) option attribution is appropriate only where no substantial contingencies exist beyond the control of the grantee).

[21/] Section 305(d)(1).

generally excluded from gross income, Section 305(b)(2) treats a stock distribution as a distribution of property to which Section 301 applies, if the distribution has the result of (1) the receipt of property by some shareholders, and (2) an increase in the proportionate interest in the assets or earnings and profits of the corporation by other shareholders.

If the Rights issuer does not have any convertible instruments or classes of participating stock outstanding, [22/] other than the class of stock that received the Rights distribution, the Rights separation (even if it did increase the holder's interest in assets or earnings) will not be disproportionate within the meaning of Section 305(b)(2) because all shareholders will have received the Rights. Even if there are convertible instruments [23/] outstanding, common stock

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[22/] If the issuer has a class of nonparticipating preferred stock outstanding, the pro rata issuance of additional shares (or rights to purchase shares) of junior stock pursuant to the Rights Plan (generally, common) will not result in the holders of such common stock having increased their proportionate interest in the issuer. Treas. Reg. § 1.305-3(e) (ex. 2)

[23/] For purposes of Section 305(b)(2), convertible debt or equity instruments are treated as outstanding stock of the issuer. Treas. Reg. § 1.305-3(b)(5); P.L.R. 8811018 (December 16, 1987). Treasury regulations provide that if the Rights issuer has convertible instruments outstanding, the property distribution requirement of Section 305(b)(2)(A) would be satisfied by the payment of interest or dividends on such instruments. Treas. Reg. § 1.305-3(b)(3).

deliverable on conversion would presumably be accompanied by Rights (see footnote 2, above). It should be noted that, even if the Rights distribution upon separation is one described in Section 305(b)(2), the amount of the deemed dividend should be the fair market value of the Rights on the date of separation, as set forth in Treas. Reg. Section 1.305-l(b)(1).

C. Section 301. The distribution, insofar as representing the right to acquire issuer stock, would not be taxable as a dividend in kind under Section 301(a), because Section 317(a) excludes from the definition of property rights to purchase stock of the distributing corporation. As stated above in III A 3, distribution of the Rights insofar as they represent the potential to acquire a bidder's stock from the issuer may be taxable under Section 301, but the Committee believes that the better view is that, as in the case of adoption, the right to purchase a bidder's stock from the issuer is too speculative and remote to cause a taxable event upon separation. The contrary argument is that the potential to acquire bidder stock pursuant to the Right is of significant value and taxable under Section 301, but the Committee is of the view that it would be appropriate to disregard that element of the Right since it is unlikely ever to mature.

d. Basis. To the extent that separation of the Rights results in a non-taxable distribution, the shareholders' basis in the Rights will be determined in accordance with the relative fair market values of the Rights and the stock with respect to which the Rights were issued (provided the fair market value of the Rights exceeds 15% of the value of the stock with respect to which the Rights were distributed and the Rights are either exercised or sold). [24/] If the fair market value of the Rights following separation is less than 15% of the fair market value of the shares of stock with respect to which they were issued, the Rights will have a zero basis, unless a Rights holder timely elects to allocate his basis in accordance with the respective fair market values of the stock and the Rights. [25/] Similarly, if the Rights separation constitutes a non-taxable Section 305(a) distribution, a shareholder's holding period for the Rights will include the period during which the related stock was held. [26/]

[24/] Section 307(a).

[25/] Section 307(b).

[26/] Rev. Rul. 72-71, 1972-1 C.B. 99.

2. <u>If Adoption of the Rights Plan Were a Section 305 Distribution.</u>

If, contrary to the Committee's view, the adoption of the Rights Plan constituted a distribution of separate property, the separation of such property from the stock with respect to which it was issued should not result in any further tax consequences. As discussed in section III B 1 above, the Rights separation does not have the effect of a disproportionate distribution.

C. <u>Lapse of Issuer's Redemption Privilege.</u>

It is arguable that a valuable property right has been transferred to the holders of the Rights when the issuer's redemption privilege expires, because at that time the issuer can no longer deprive such holders of the value otherwise inherent in the Rights. If the redemption privilege lapses prior to the Rights becoming transferable, then the lapse should not be a taxable event, because, as discussed in III A, no distribution should be deemed to have occurred until separation. Also, even if lapse before separation were a distribution, such deemed distribution also should be considered to be a non-taxable Section 305(a) distribution for the same reasons that the distribution occurring at separation constituted a non-taxable Section 305(a) distribution.

On the other hand, if the lapse occurs following separation, there may be a Section 305 distribution which would be taxable to each holder of the Rights under Section 305(b)(2), provided the requisite property distribution occurs with respect to the issuer's stock. [27/] The amount taxable to the Rights holders would be equal to the increased value in the Rights attributable to the lapse of the redemption privilege. [28/]

D. Flip-in.

1. Flip-in Subsequent to Separation.

A Rights flip-in similarly may be taxable to holders of the Rights. The flip-in is an event which has occurred pursuant to the terms of the Rights and should not be considered a Section 1001 exchange of "old" rights, i.e., the Rights prior to flip-in, for "new" rights, i.e., the flipped-in Rights. However, Section 305(c) likely would treat the increase in the number of shares

[27/] Section 305(d)(1) defines stock to include rights to purchase stock for all purposes of Section 305, not only for determining whether a distribution of stock has occurred. Treas. Reg. § 1.305-1(d)(1). Thus, if the lapse of the redemption privilege constitutes an additional distribution of a right to acquire stock, such distribution, being made with respect to the Rights, will constitute a distribution of stock to some shareholders, i.e., the Rights holders.
See Treas. Reg. § 1.305-3(b)(4) (a property distribution will satisfy the property distribution requirement of Section 305(b)(2)(A) if made within 36 months before or after the date of the stock distribution).

[28/] Treas. Reg. § 1.305-1(b)(1). It would be artificial to treat the lapse of the issuer's redemption privilege as a redemption of the redeemable Rights for property, i.e., the nonredeemable Rights, so as to treat the Rights holders as having engaged in a taxable exchange.

purchasable under the Rights as a deemed stock distribution, if there have been, or will be, any requisite property distributions. [29/]

a. Exchange. In Revenue Ruling 87-19, the Service ruled that "[a]n adjustment to the interest rate on an issue of bonds pursuant to an interest adjustment clause does not result in an exchange under Section 1001 of the Code." [30/] The Rights flip-in is an event which occurs pursuant to the terms of the Rights Plan. As was the case under the interest adjustment clause described in Revenue Ruling 87-19, the Rights holders have realized an enhanced economic benefit pursuant to the terms of the instrument as originally issued. [31/] In such case, the benefit

[29/] Treas. Reg. § 1.305-7(a) (36 month rule). In such case, the amount of the distributions is the value of such additional shares, Treas. Reg. §§ 1.305-l(b)(3), 1.305-3(e) (ex. 6), not the increase in value of the Rights.

[30/] Rev. Rul. 87-19, 1987-11 I.R.B. 20. See also Treas. Reg. § 1.305-3(d)(1)(i) (change in conversion ratio in a convertible instrument to offset dilative stock issuances not an exchange of instruments).

[31/] In each of the situations where the Service determined that the change in the terms of an instrument were so substantial as to constitute an exchange of old instruments for new instruments, the change was initiated outside the terms of the instrument in effect when the instrument was issued. Rev. Rul. 87-19, 1987-11 I.R.B. 20 (waiver of interest adjustment clause not anticipated in original loan documents); Rev. Rul. 81-169, 1981-1 C.B. 429 (change in terms of debentures negotiated after issuer defaulted on bonds); G.C.M. 37002 (February 10, 1977); T.A.M. 7902002 (June 29, 1979); T.A.M. 7845001 (June 23, 1978).

realized by flip-in should not result in a deemed exchange of the Rights.

b. Section 305(c).

In a recent private letter ruling, the Service considered a debenture that provided (1) for an exchange privilege only if the issuer's common stock (which was publicly-traded) fell below a certain price for eight consecutive days and (2) for an exchange ratio that was determined at the time the exchange rights vested. [32/] The Service concluded that the fixing of the exchange ratio on a date subsequent to the issuance of the debentures did not result in a deemed Section 305(b) or (c) distribution to the debentureholders because, as to (c), (1) the method for determining the exchange ratio was specified in the indenture, (2) the exchange price was readily ascertainable as the stock was publicly traded, (3) once the exchange price was determined, it remained fixed over the remaining life of the debentures, [33/] and (4) the debentures were comparable to securities which are convertible into a fixed number of shares.[34/]

[32/] P.L.R. 8811018 (December 16, 1937)

[33/] Compare Treas. Reg. § 1.305-3(e) (ex. 6(ii)).

[34/] P.L.R. 8811018 (holding 3).

Flip-in is arguably different. P.L.R. 8811018 dealt with the initial (albeit delayed) establishment of a conversion rate, whereas a flip-in involves a change in exercise price. Section 305(c) authorizes Treasury regulations that treat a change in a conversion ratio and other transactions that result in a shareholder increasing his proportionate interest in the issuer's assets or earnings and profits as a stock distribution potentially taxable as a dividend. The regulations treat such a change as a taxable dividend if the transaction has the result described in paragraphs (2), (3), (4) or (5) of Section 305(b). [35/] The flip-in increases the Rights holders' proportionate interests in the issuer's assets or earnings and profits by allowing the Rights holders, without any additional consideration on their part, to receive a greater amount of stock upon exercise. [36/] Accordingly, because the Rights are

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[35/] Treas. Reg. § 1.305-7(a).

[36/] The flip-in most closely resembles a change in a conversion ratio that is not made to offset a dilutive issuance of stock. Treasury Regulation Section 1.305-7(a) treats "any transaction (including a recapitalization) having a similar effect on the interest of any shareholder" as a deemed stock distribution, provided that such deemed distribution has the result described in Section 305(b)(2), (3), (4) or (5). The reduction in the exercise price of a right clearly can result in a taxable distribution under Section 305(c). See Treas. Reg. § 1.305-7(b)(1).

treated as stock for purposes of Section 305, [37/] the value of the additional shares purchaseable will be taxable, but only if there are any property distributions made with respect to another class of the issuer's stock.

2. Simultaneous Separation and Flip-in.

Under certain Rights Plans, upon the acquisition of a specified percentage of the issuer's stock, the Rights not only become freely transferable, but also become exercisable into the issuer's stock at a bargain price. As discussed above, the separation alone is a sufficient event to find that a distribution of the Rights has occurred within the meaning of Section 305(a). Unlike the case where Rights have been trading prior to flip-in and the conversion price is adjusted at flip-in, however, a flip-in occurring simultaneously with separation should not result in a taxable Section 305(b) distribution to the Rights recipients, even if there are property distributions on common stock. That is because, as discussed below, the Rights not having previously separated, they are owned by the common stockholders, each of which, including the acquiror, will have received any property distributions that otherwise would trigger the application of Section 305(b)(2).

[37/] See footnote 21 above.

Section 305 treats a distribution of rights to acquire stock as a distribution of stock [38/] and therefore the distribution of Rights will be taxable only to the extent, if any, provided under that Section. A disproportionate distribution of stock will be taxable if other shareholders receive (or have received) the requisite property distributions. [39/] In general, it is not necessary that the property and stock distributions be related. [40/] Both the legislative history and the Treasury regulations promulgated under Section 305, however, appear to contemplate that the class of stock which received the stock distribution will not share in the property distribution. [41/] Although the distribution of stock and property

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[38/] Section 305(d)(1).

[39/] Section 305(b)(2); Treas. Reg. § 1.305-3(b)(4).

[40/] Treasury Regulation Section 1.305-3(b)(2) provides that regular quarterly cash dividends on a class of stock are sufficient to satisfy the property distribution requirement of Section 305(b)(2)(A), even if such cash dividends are "independent and unrelated" to the stock distributions. See also Treas. Reg. § 1.305-3(e) (ex.4(ii)) (interest paid with respect to convertible securities satisfies property distribution requirement of Section 305(b)(2)).

[41/] Both the House and Senate Reports accompanying the enactment of Section 305(b)(2) illustrate the application of the section with an example in which one class of stock receives stock dividends and another class receives cash dividends. H.R. Rep. No. 91-413, 91st Cong. 113 (1969), reprinted in 1969-3 C.B. 174, 270; S. Rep. No. 91-552, 91st Cong. 152 (1969). reprinted in 1969-3 C.B. 423, 521; see also Treas. Reg. § 1.305-3(e) (exs. 1, 3 and 6). Although example 13 in Treasury Regulation Section 1.305-3(e) could be interpreted to find that, absent the business purpose established to avoid the application of Section 305, pro rata dividends would have satisfied the property distribution requirement of Section 305(b)(2)(A), the Service has interpreted this example in a manner consistent with the position taken in the text. See G.C.M. 38357 (April 21, 1980).

need not be related, it would seem that the application of Section 305(b)(2) requires that some stockholders receive property and others receive no property and an increased proportionate interest in the issuer's assets or earnings and profits.

Upon a simultaneous Rights separation and flip-in, all shares of the issuer, including those held by the bidder, will be entitled to receive any property distribution payable thereon, i.e., regular dividend payments. [42/] If Section 305(b)(2), is, as suggested above, interpreted to require that some stockholders receive property and others no property but an increased proportionate interest in the issuer's assets or earnings and profits, the increased proportionate interest of those shareholders who may exercise the Rights after the simultaneous separation and flip-in should not be taxable under

[42/] See footnote 40 above.

Section 305(b)(2), because the regular dividend payable on the stock, being payable to all stockholders, will not satisfy the property distribution requirement of Section 305(b)(2)(A).

The simultaneous separation and flip-in should be contrasted with both the lapse of the issuer's redemption privilege following distribution of the Rights by the Rights Agent and a flip-in occurring pursuant to a “two event” Rights Plan. In both of those latter cases, the Rights and the issuer's outstanding stock may be viewed as constituting separate outstanding classes of “stock” for purposes of Section 305. Thus, in those cases, the deemed stock distribution with respect to the Rights and the property distribution with respect to the stock appear properly to be within the ambit of Section 305(b)(2). On the other hand, if the deemed stock distribution and the property distribution are made with respect to the same class of stock, Section 305(b)(2) should not apply.

The Committee recognizes that the current Treasury regulations do not expressly require that some stockholders receive the stock distribution and not the property distribution in order for Section 305(b)(2) to apply. Although it appears that a simultaneous separation and flip-in is not within the purview of Section 305(b)(2), [43/] Section 305(b)(2) and the current Treasury regulations were enacted and promulgated before Rights Plans came into common usage. Under a broad interpretation, Section 305(b)(2) would apply if all stockholders receive property and only some (i.e., all but the bidder) receive an increase in proportionate interests. Thus, for instance, under such an interpretation, a regular quarterly dividend declared and paid on the stock subject to the Rights Plan within 3 6 months before or after the Rights separation under a one- event Rights Plan might satisfy the property distribution requirement of Section 305(b)(2)(A), [44/] so that the simultaneous Rights separation and flip-in would be a taxable stock dividend under Section 305(b)(2).

The Committee believes that, based on the technical interpretation of Section 305 presented above, the simultaneous separation and flip-in should not result in a taxable distribution to the Rights holders. However, the Committee is cognizant of the fact that, at flip-in, one group of the issuer's shareholders has benefited at the expense of another (the bidder).

[43/] See footnote 41 above.

[44/] See Treas. Reg. § 1.305-3(b)(2).

If the issuer has any convertible securities outstanding, cash distributions made with respect to such instruments, e.g., interest on convertible debt or cash dividends on convertible preferred stock, will, according to the Treasury regulations, satisfy the property distribution requirement of Section 305(b)(2) (thereby resulting in a taxable stock distribution at the time the Rights simultaneously separate and flip-in), unless the convertible instruments make a full adjustment to compensate for the dilutive effect of the Rights flip-in, [45/] or unless the convertible securities holders would receive Rights, along with stock, upon conversion. [46/] If the issuer has non-convertible preferred stock outstanding, the Rights separation and flip-in would not result in the Rights holders increasing their proportionate interests, unless, in the extremely unusual case, the Rights were convertible into a class of stock which ranked senior to the previously outstanding preferred stock. [47/]

[45/] See Treas. Reg. § 1.305-3(d).

[46/] See footnote 2, above.

[47/] See Treas. Reg. § 1.305-3(e) (ex. 2).

E. "Flip-Over" upon Acquisition of the Issuer.

The following discussion assumes that, immediately before flip-over, the Rights were separately trading and are treated as separate from the stock for Federal income tax purposes.

In most, if not all, cases of flip-over, there will have been a previous Flip-in Event. That is because a bidder will most likely not be able to effect the merger or other transaction constituting a Flip-over Event without first accumulating sufficient stock of the Rights issuer to constitute a Flip-in Event. Accordingly, in most Flip-over Events, there will be no change in the exercise price or number of shares covered by a Right, but there can, depending upon the type of Flip-over Event involved, be a change in the type of stock issuable (bidder or Rights issuer) and the party obliged to issue (the same).

If the issuer survives the merger constituting the Flip-over Event, and the Rights remain exercisable against it for its stock, there will have been no change in the Rights and, therefore, there will be no taxable event. Even if, however, there were no prior Flip-in Event, the change in the Rights' exercise price or number of shares covered should, as discussed in subpart 1 below, not be a taxable exchange; but it should be treated as a distribution to the Rights holders, which would be taxable under Section 305(b)(2) only if there has been, or will be, the requisite property distribution with respect to the issuer's stock.

If the Flip-over Event causes the Rights to be exercisable against the issuer for stock of the bidder, and there were a prior Flip-in Event, there will be no change in the exercise price (or number of shares covered) or obligor of the Right, but a change in the medium, from issuer stock to bidder stock. As discussed in subpart 2 below, the Committee is of the view that the mere change in medium should not result in a taxable exchange, but that such a change might be considered a taxable distribution under Section 301.

As discussed in subpart 3 below, if the Rights become exercisable directly against the bidder, there most likely has been a taxable exchange of Rights.

1. <u>No Prior Flip-in Event and Rights Remain Rights to Acquire Stock of the Issuer.</u>

When the issuer is to be the surviving corporation in a merger and the Rights remain exercisable for issuer stock, there has not been a substantive change in the terms of the Rights as a result of flip-over and, consequently, there should not be an “exchange” for tax purposes under Section 1001, regardless of whether there is a formal exchange of certificates pursuant to the merger. [48/] Even if the Rights had originally been exercisable for issuer participating preferred stock and become exercisable for issuer common stock, the change should not constitute a taxable exchange if the participating preferred stock and the common stock do not differ “materially either in kind or in extent”. [49/]

2. Rights Become Rights to Purchase Stock of Bidder. Exercisable Against Issuer.

In this case, the obligor under the Rights does not change, and, assuming prior flip-in, nor does the exercise price or number of shares covered; but the property to be delivered upon exercise does.

a. Section 1001. In Revenue Ruling 79-155, 1979-1 C.B. 153, the Service ruled that an exchange of the target's convertible obligations occurred when, pursuant to a triangular merger, (i) the acquiror was added as a co-obligor, (ii) the obligations became convertible into stock of the acquiror rather

[48/] The Service has consistently determined whether an exchange of debt instruments has occurred by looking to substantive changes in the terms of the instruments rather than the presence of a formal exchange of certificates. Rev. Rul. 87-19, 1987-11 I.R.B. 20; Rev. Rul. 81-169, 1981-1 C.B. 429; Rev. Rul. 73-160, 1973-1 C.B. 196; Rev. Rul. 56-435, 1956-2 C.B. 506.

[49/] Treas. Reg. § 1.1001-(a).

than the target, (iii) the interest rate was increased from 8 to 9 percent and (iv) the remaining term of the obligations was shortened by five years. [50/] In Revenue Ruling 81-169, 1981-1 C.B. 429, the Service ruled that a change to a debt instrument's interest rate and maturity resulted in a deemed exchange for tax purposes. It is unclear that the change in the property obtainable upon conversion of the obligations was essential to the Service's conclusion in Revenue Ruling 79-155. There is no direct authority on the question whether a change in the property obtainable upon exercise of a conversion right, without more, is an “exchange” within the meaning of Section 1001.

In a related context, the Service has distinguished between conversion rights based on the entity against which the rights were exercisable. In Revenue Ruling 69-265, supra. footnote 10, an acquiring corporation issued preferred stock, to the target in a “C” reorganization, that was convertible into stock of the acquiror's parent. The Service ruled that the conversion feature would violate the “solely for voting stock” requirement if it were exercisable directly against the parent,

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[50/] On the facts of the Ruling, the exchange was tax-free under Section 354 because there was no increase in the principal amount of the obligations.

because the conversion right would be a right that was separate from the preferred stock itself. By contrast, the Service held that if the conversion right were exercisable against the acquiror, to be satisfied with stock supplied to the acquiror by its parent, the conversion right would be a term of the preferred stock and not other property that would violate the “solely for voting stock” requirement. Likewise, the adjustment of the property issuable on exercise of a Right without change in its obligor may not be sufficient to cause an exchange to occur.

Revenue Ruling 79-155 and Revenue Ruling 81-169 may, however, not govern an exchange of stock rights because the right to acquire stock contained in a convertible debt obligation is only one of the many rights inherent in the obligation; in the case of Rights, the entire value is attributable to the conversion feature. As a consequence, not unlike Revenue Ruling 81-169, a change in the nature of that right, even without a change in the obligor, could be viewed as having greater tax significance. On the other hand, given a prior Flip-in Event, the essential feature of the Right--the right to buy stock at 50% of market value--is unchanged. On balance, the Committee is of the view that no taxable exchange results.

b. Distribution. In this case, if the effect of flip-over is the distribution by the issuer of a right to acquire bidder stock, such distribution would be taxable under Section 301. See Rev. Rul. 70-521, 1970-2 C.B. 72. Section 3 05 would be inapplicable because that section deals only with distributions of the issuer's stock or rights to acquire such stock. While it is arguable that no distribution has occurred, because the right to acquire bidder stock was set forth in the original Right, the Committee believes, on balance, that the argument for Section 301 treatment is stronger.

c. Treatment of Issuer. In any event, if the issuer acquires stock of the bidder for delivery upon exercise of Rights directly from the bidder in a carryover basis transaction, it is the view of the Service that the issuer may recognize gain upon the delivery of such stock. [51/]

3. Rights Become Rights to Purchase Stock of Bidder, Exercisable Against Bidder.

In this case, both the obligor under the Rights and the property obtainable upon exercise change as a result of flip-over. In Revenue Ruling 78-408, 1978-2 C.B. 203, an acquiror, in conjunction with a “B” reorganization, issued its own warrants in exchange for previously-outstanding warrants of the target.

[51/] Rev. Rul. 74-503, 1974-2 C.B. 117.

The Service concluded that the exchange of warrants constituted an “exchange” under Section 1001, and was not eligible for nonrecognition under Section 354 because warrants are not “stock” for that purpose. [52/] A Rights flip-over of this type should be treated similarly, regardless of whether the acquisition is accomplished through merger into the bidder or a purchase of the issuer's assets.

F. Redemption of Rights.

The taxation of a redemption of Rights will depend on whether, at the time of the redemption, the Rights are an inherent feature of the stock or separate property for tax purposes.

1. Rights are Inherent in the Stock.

If the Rights are inherent in the stock, because (1) no “distribution” has yet taken place, (2) the Rights

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[52/] See also P.L.R. 8051145 (September 26, 1980); P.L.R. 7949056 (September 7, 1979); G.C.M. 39225 (April 27, 1984). Although the exchange of warrants is taxable, the exchange will not violate the “solely” for voting stock requirement of a “B” reorganization because the acquiror’s warrants were issued in exchange for the target's warrants rather than the target's stock. See G.C.M. 36789 (July 13, 1976). Cf. Special Committee on Reorganization Problems, N.Y. State Bar Ass'n, Tax Section, Report on Stock Warrants in Corporate Organizations and Reorganizations (July 29, 1968).

are treated as inherent in new stock issued in exchange for the pre-existing stock or (3) the Rights are viewed as a promise to make a future distribution, then any redemption of the Rights should be treated as a distribution by the issuer with respect to its stock, and taxable as a dividend to the extent of the issuer's earnings and profits.

If the original adoption is treated as an exchange of old stock for new stock with the Rights as an inherent feature, the redemption might be regarded as an exchange of the stock with Rights for stock without Rights plus cash. So viewed, the cash distributed would technically constitute “boot” under Section 356(a), which limits the amount taxable as a dividend to the amount of gain realized on the exchange. This limitation should not apply, however, to a recapitalization that simply accomplishes a distribution of earnings. [53/]

If the redemption occurs in connection with a disposition of the underlying stock (as in a cash merger), the cash received should be treated as part of the sales

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[53/] See Treas. Reg. § 1.301-1(1); Bazley v. Commissioner. supra footnote 17.

price for the stock to the extent that a dividend received in such circumstances would be so treated. [54/]

2. Rights Are Separate Property.

If the rights are separate property, then the redemption cannot be treated as a distribution with respect to the issuer's stock. That result makes sense if the Rights are trading separately from the stock, but if the redemption occurs before separate trading begins, the redemption payment is the functional equivalent of a distribution with respect to stock, and should be treated as such. (That further indicates that the Rights should not be treated as separate property before they are separately tradable.)

Upon the redemption of a separately-traded Right, each Rights holder should recognize gain equal to the amount. of the redemption payment less the holder's basis in the Right, which may be an allocated basis under Section 307(b) for an original distributee, and will be a cost basis for a subsequent purchaser.

[54/] See Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971); Steel Improvement and Forge Co. v. Commissioner, 314 F.2d 96 (6th Cir. 1963); Zenz v. Ouinlivan, 213 F.2d 914 (1954). But see Rev. Rul. 75-493, 1975-2 C.B. 108.

In general, a redemption of stock rights is not a "sale or exchange" (but is instead viewed as a payment to extinguish a contractual obligation). [55/] Section 1234A, however, provides that gain or loss recognized from the cancellation of a right or obligation with respect to "personal property" (as defined, in Section 1092(d)) is treated as capital gain or loss. Section 1092(d) defines personal property to include "any interest in stock". [56/] If the Rights are separately tradable, they may be considered an interest in stock pursuant to that definition, and hence, within the definition of personal property. In such event, if the Rights constitute a capital asset to a holder, any gain or loss recognized upon redemption would be capital. Treating the redemption payment as a sale or exchange appears to be more

[55/] Fairbanks v. United States. 306 U.S. 436 (1939); T.A.M. 8442005 (July 6, 1984); T.A.M. 8435006 (May 14, 1984); Bingham v. Comm'r, 105 F.2d 971 (2d Cir. 1939); KVP Sutherland Paper Co. v. United States, 344 F.2d 377, 382 (Ct. Cl. 1965); Watson v. Comm'r, 27 B.T.A. 463 (1932), acq. XII-1 C.B. 13; but see Turzillo v. Commissioner. 346 F.2d 884 (6th Cir. 1965); Commissioner v. Ferrer. 304 F.2d 125 (2d Cir. 1962).

[56/] The legislative history of Section 1808(c) of the Tax Reform Act of 1986 (which amended Section 1092(d)(3) to add "any interest in stock" to the definition of personal property) provides that an interest in stock includes "exchange traded stock options". H.R. 99-426, 99th Cong., 1st Sess. 910 (1985); Tax Reform Act of 1986 Explanation of Technical Correction Provisions, Staff of the Joint Committee of Taxation, p. 44.

consistent with the spirit of the provisions of Sections 1234 and 1234A described above, except possibly in the case where the Rights are still held by the issuer's stockholders in proportion to their stock ownership.

The issuer would recognize no loss on a redemption of separately traded Rights. Section 1032(a).

G. Exercise of Rights.

The exercise of a Right, whether before or after flip-in, should be governed by the general rules applicable to warrants. [57] No gain or loss is recognized to either the issuer or the holder upon exercise, and the holder's basis in the stock acquired is equal to the basis in the Right (if any) plus the amount paid upon exercise.

H. Redemption of Rights for Stock-of the Issuer.

The Rights Plan may give the Issuer the right, after flip-in, to redeem the Rights by what is in effect a forced exercise: each holder of a Right receives a share of common stock of the issuer in exchange for the Right, but without making any cash payment. Thus, instead of the holder buying two

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[57] *E.g.*, as set forth in Rev. Rul. 78-182, 1978-1 C.B. 265.

shares for the price of one, the holder receives one free share.

Viewed as a form of exercise of the Right, the tax consequence would be similar to an actual exercise. No tax would be imposed on the exchange, and the holder's basis in the Right would carry over to the stock. Another analogy would be to the conversion of a convertible debt obligation into stock, which is tax-free to both the holder and the issuer, and results in a carryover basis to the holder. [58/]

An alternate characterization of the exchange -- which seems more appropriate -- is as a taxable redemption of the Rights, payable in kind. The holder would realize gain or loss, as in a cash redemption, equal to the difference between the value of the stock and the holder's basis in the Rights. The holder's basis in the stock received would be its fair market value.

I. Collateral Consequences of Rights Plan.

1. Reorganizations.

The use of stock with attached Rights in a reorganization raises the issue as to whether the Rights, before

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[58/] See Rev. Rul. 72-265, 1972-1 C.B. 222. The conversion may not be entirely tax-free to the issuer if the value of the stock is less than the adjusted issue price of the obligation. Section 108(e)(10).

they detach, constitute "other property" for purposes of Section 356(a)(1). [59] Since the fair market value of attached Rights is presumably small (and therefore so is the amount of Section 356 boot), this issue is generally only significant in the context of a Section 368(a)(1)(B) reorganization, which is disqualified by the presence of any property other than voting stock, [60] or a reorganization under Section 368(a)(1)(C), which has a fairly narrow "boot relaxation" rule (contained in Section 368(a)(2)(B)). However, this issue can be significant in other contexts. [61]

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[59] At least one private letter ruling has been issued holding, without any analysis, that the Rights constitute other property. P.L.R. 8808081, supra, footnote 5. A General Counsel's Memorandum, which squarely considered the issue of whether a contingent right inherent in stock to receive additional stock was "boot", concluded to the contrary. G.C.M. 39103, supra. text following footnote 12. See also Note, The Solely for Voting Stock Requirement: Are Poison Pill Rights Permissible Attributes of Stock in a "B" Reorganization?, 41 Tax Law. 151 (1987); M.L. Dionne, IRS Ruling that Poison Pills Bar Some Tax-Free Reorganizations Stirs Controversy. Tax Notes, p. 679 (May 9, 1988).

[60] Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942) (purported "C" reorganization); Chapman v. Commissioner. 618 F.2d 856 (1st Cir. 1980), cert. dismissed, 451 U.S. 1012 (1981) (purported "B" reorganization); Heverly v. Commissioner. 621 F.2d 1227 (3rd Cir. 1980), cert, dismissed, 451 U.S. 1012 (1981) (same).

[61] See, e.g., Sections 355(b)(2)(C) and 368(a)(2)(E).

As discussed above, the mere adoption of a Rights Plan should not be viewed as a distribution of a separate property right with respect to outstanding shares. Thus, the Rights should not constitute “other property” when stock with attached rights is used to effectuate an otherwise tax-free acquisition. Prior to the date of separation, the Rights are not exercisable, are highly contingent and cannot be separately transferred. While the Service has held that a term of stock can be a separate property right for purposes of the “solely for voting stock requirement”, [62/] the Service has distinguished a right which is within the control of the holder from a contingent right, the exercisability of which is subject to a contingency outside the control of the holder. [63/] The Service has also held that rights which are inseparable from stock and not personal to the holder are not “boot” for purposes of Sections 356 and 368(a)(1)(B). [64/] Until the Rights trade separately, the Rights are contingent rights with respect to the related shares and are not

[62/] See Rev. Rul. 70-108, 1970-1 C.B. 78.

[63/] Compare G.C.M. 39103, supra. footnote 59, with G.C.M. 38125 (September 28, 1979) and Rev. Rul. 70-108, 1970-1 C.B. 78.

[64/] See footnote 12 above and accompanying text.

"personal" to any holder. Therefore, attached Rights should not be viewed as "other property".

2. Incentive Stock Options.

The adoption of the Rights Plan could, in certain circumstances, affect corporations which have issued options that are intended to qualify as "incentive stock options" under Section 422A ("ISOs"). If the adoption of a Rights Plan does not amount to a distribution of separate property, adoption should neither (1) constitute a grant of "additional benefits" to existing optionees (and therefore should not constitute a modification of outstanding ISOs merely because optionees will receive stock with attached Rights upon exercise) [65/] nor (2) result in the exercise being taxable in whole or in part. If the Rights separate and become freely-transferable after exercise of the ISO, the distribution of Rights with respect to stock acquired by exercise of an ISO should not constitute a disqualifying disposition, although the stock received upon

[65/] See Rev. Rul. 72-351, 1972-2 C.B. 229, and Rev. Rul. 64-116, 1964-1 C.B. 165 (a benefit which equates rights of employees holding unexercised options with all other shareholders does not constitute a modification).

exercise of the Rights would apparently be subject to the ISO holding period rules. [66/]

If an employee exercises an ISO after the Rights become separately transferable and receives only stock upon such exercise, ISO treatment should not be affected. An adjustment to the exercise price and number of shares subject to the ISO reflecting the value of the Right at the time of distribution should be permissible if the ISO plan provides for such an adjustment. If the ISO plan does not provide for such an adjustment, the exercise price and number of shares may arguably be adjusted under the rule permitting adjustments for stock dividends and stock splits. [67/]

If the employee receives stock and a separately transferable Right upon exercise of an ISO, the ISO is likely to be considered to be modified unless at the time of grant, the ISO or the ISO plan contemplated the possibility of a distribution to the optionee of additional property

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[66/] See Section 425(b).

[67/] See Treas. Reg. § 1.425-(1)(e)(5)(ii)(a); but see Rev. Rul. 69-335, 1969-1 C.B. 137 (adjustment of exercise price to reflect exercise by shareholders of stock rights constitutes a modification).

(such as the Rights) and the Rights have a readily ascertainable fair market value. [68/]

3. Qualified Plans.

Section 407(a)(1) of the Employee Retirement Income Securities Act of 1974 (“ERISA”) generally provides that a plan may not acquire or hold any employer security which is not a “qualifying employer security”. Section 406(a)(1)(E)of ERISA prohibits a fiduciary from knowingly causing a plan to engage in a transaction which constitutes a direct or indirect acquisition, on behalf of a plan, of any employer security in violation of Section 407(a), and Section 406(a)(2) prohibits a fiduciary who has authority or discretion to control or manage assets of a plan to permit the plan to hold any employer security if he knows or should know that holding such security violates Section 407(a),

Since the Rights are securities for purposes of Section 2(1) of the Securities Act of 1933 even prior to the date of their distribution, the Rights constitute a security for purposes of ERISA. [69/] Thus, in order to be held by a qualified plan, Rights with respect to common stock or preferred

[68/] Section 422A(c)(5); Section 83(e)(3); Treas. Reg. § 1.83-6.

[69/] ERISA § 3(20).

stock of the employer or an affiliate would have to constitute "qualifying employer securities". Under Section 407(d)(5) of ERISA, only stock and certain debt instruments constitute "qualifying employer securities".
Thus, holding the Rights may constitute a "prohibited transaction".

While causing the acquisition of, or permitting the holding by, an employee benefit plan of an employer security which is not a qualifying employer security is generally a prohibited transaction under Sections 406(a) and 407(a) of ERISA, it is believed that no acquisition or holding of a non-qualifying security by reason of adoption of a Rights Plan affecting employer stock held by an employee benefit plan has occurred until formal separation of the Rights occurs. A cautious Trustee or plan administrator might well arrange for anticipatory disposition of such Rights upon separation, perhaps by sale or perhaps by distribution to participants in a proper case. Arguments might be made, however, that separation of the Rights should not require consideration of the Rights as a security apart from the stock in respect of which issued for purposes of Sections 406(a) and 407(a). If so, exercise of Rights to acquire additional qualifying employer securities, whether of the Rights issuer or of the bidder, should create no problem, if the maximum limitation on qualifying employer security holdings is not thereby exceeded. Exercise of Rights to acquire stock of a company which is not an employer should not involve an ERISA problem.

4. Section 382.

For purposes of Section 382, the Rights may be considered to be an option to acquire stock. [70/] The Committee believes that prior to flip-in the Rights should not be considered to constitute an option for purposes of Section 382 because the application of Section 382 to a corporation upon the adoption of a Rights Plan appears to be unwarranted in light of the legislative purpose behind the enactment of the option attribution rules in Section 382(1)(3)(A)(iv) and produces illogical results. [71/] Moreover, prior to separation, the Rights should only constitute a term of stock or be considered a promise to make future distributions.

IV. Note Purchase Plans.

Sometimes the issuer will adopt a variant of a Rights Plan, pursuant to which the issuer will grant rights

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[70/] Prop. Treas. Reg. § 1.382-2T(h)(4).

[71/] *See* letter from Lester W. Droller and Dennis B. Drapkin to Thomas Wessel (January 25, 1988) (discussing application of Section 382 option attribution rules to Rights Plans); Notice 88-67, 1988-25 I.R.B. 44.

("Note Purchase Rights") to its stockholders which provide that, upon a Triggering Event, the stockholders will be entitled to exchange their shares for a specified amount of cash or issuer notes having a certain principal amount, interest rate and other terms. The amount of cash or the value of the notes are intended to reflect the issuer's view as to its shares' real value. As with a stock Rights Plan, the rights initially are evidenced by the already outstanding common stock certificates and memorialized by a summary of the Note Purchase Rights mailed to stockholders. They are not exercisable or transferable separately from the common stock until a Triggering Event occurs. Thereafter, the stockholders will be able to exercise their Note Purchase Rights or to sell their Note Purchase Rights and common shares separately.

A. Adoption of the Plan.

Unlike stock Rights Plans, Note Purchase Rights are not rights to acquire stock of the issuer and accordingly are not covered by Section 305. However, for the reasons described in Section III A above, a stockholder should not recognize any taxable income upon the adoption of a Note Purchase Rights plan.

The difficulty of valuing a Note Purchase Right should not be a controlling factor in determining whether adoption of the plan results in an immediate tax, but nonetheless should be taken into account in developing an administrable rule. If Note Purchase Rights are considered to be currently taxable at the time of the plan's adoption, how are they to be valued since they do not trade separately? This type or concern generally arises with a stock Rights Plan only in the context of an acquisition in which the bidder issues stock which incorporates a non-severable Right because stock Rights Plans otherwise enjoy protection under Section 305(a) (which a Note Purchase Rights Plan does not). With a Note Purchase Rights plan, however, the problem arises with respect to every plan's adoption. The issue is particularly acute if, as is frequently the case, the market value of the distributing corporation's stock declines upon the adoption of the Rights Plan, which argues for the proposition that the stockholders should not recognize taxable income unless and until the Note Purchase Rights are separately transferable. [72/]

[72/] See Rev. Rul. 70-521, 1970-2 C.B. 72, where the warrants are described as fully transferable; and Rev. Rul. 80-292, 1980-2 C.B. 104, which holds that nontransferable warrants to purchase stock of the distributing corporation's subsidiary are taxable to shareholders upon their distribution, but great emphasis is placed on the fact that a "when issued" trading market for the warrants immediately developed. See also Rev. Rul. 80-213, 1980-2 C.B. 101.

B. Upon Separation and Exercisability.

Assuming that the initial adoption of the Note Purchase Rights Plan is not taxable to shareholders, a dividend distribution under Section 301 should be recognized when the Note Purchase Rights subsequently become transferable, in an amount equal to their value at that time. A non-corporate stockholder would be taxed on the fair market value of the Note Purchase Right. As to corporate stockholders, Section 301(b)(1)(B) currently provides that a corporate stockholder is taxed on the lesser of (1) the fair market value of the interest received or (2) the distributing corporation's adjusted basis in the property (increased by the amount of gain recognized to the distributing corporation), which in the case of Note Purchase Rights would seem to be zero. Section 106(e)(10) of the Technical Corrections Bill of 1988 (H.R. No. 4333 and S. Rep. No. 2238) would, however, amend Section 301(b) to treat the amount of all dividends as the fair market value of the property distributed. Also, Treasury Regulation Section 1.301-l(d)(1)(ii) requires a corporate shareholder which receives a dividend distribution consisting of obligations of the distributing corporation to report the fair market value of the distribution as income.

Assuming a corporate shareholder is taxed on the fair market value of a Note Purchase Right, the holding period for such right would commence on the date the right becomes separated and exercisable.

C. Alternative Structure.

In some instances, the Note Purchase Rights plan will not provide for the Rights ever to become separately transferable. In such instances the Right, which always trades with the stock on which it is distributed, permits the holder to require the issuer to redeem the associated stock upon a Triggering Event in exchange for a specified amount of cash or a note having prescribed terms. In such instances, prior to the Rights becoming exercisable, there should be no taxable income to the holder for the reasons described in Section III A above.

Once a Triggering Event occurs and the Note Purchase Rights become exercisable, the arrangement would appear to constitute a unilateral offer by the issuer to purchase its shares on the specified terms, similar to a corporation making a self-tender which is binding on it for a specified period of time. Accordingly, the adoption of such a plan and the exercisability of the Note Purchase Rights should not result in any taxable income to shareholders who decline to exercise the put option and continue to hold their shares any more than a stockholder recognizes income when he declines the opportunity to sell shares to the issuer pursuant to a self-tender made at a premium over market. Similarly, such shareholders should not recognize a taxable loss upon the lapse of the Note Purchase Rights when the exercise period terminates. As to a shareholder who exercises his put right and receives cash or a note while continuing to own other shares which are not acquired by the company or otherwise disposed of, Section 302 should apply to determine the tax treatment of the proceeds received by the stockholder (even though the disposition of the shares to the issuer is pursuant to exercise of the put).