REPORT #808

TAX SECTION

New York State Bar Association

Report on Proposed Regulation Section 1.305-5
Relating to Constructive Distributions
on Preferred Stock

November 3, 1994

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New York State Bar Association

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November 3, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Section 305 Proposed Regulations (CO-8-91)

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section on the proposed regulations under Code Section 305, relating to constructive distributions on preferred stock issued with a call premium.

The Report supports the position of the proposed regulations that a constructive distribution should not arise solely because of the existence of an issuer call right* but rather should arise only if it is more likely than not that the call right will be exercised (subject to a safe harbor precluding constructive distribution treatment if certain conditions are met). The Report suggests, however, a number of modifications and clarifications to the regulations, including the following:

(1) Additional examples should be provided of the "more likely than not" standard and the safe harbor.

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(2) The safe harbor as proposed applies when there are no arrangements or understandings that "effectively compel" exercise of the call. To avoid unintended results, the safe harbor should be narrowed to apply only when there are no arrangements or understandings that make it "extremely likely" (or, alternatively, "highly likely") that the call will be exercised.

(3) Clarification should be provided of the scope of the exception from constructive distribution treatment if a redemption premium is solely in the nature of a penalty for premature redemption.

(4) Clarification should be provided that immediately callable preferred stock issued before adoption of the final regulations is to be governed by the existing Section 305 regulations, even if the stock was issued subsequent to the enactment of Section 305(c)(2) in 1990.

Please let me know if the Tax Section can be of further help in this project.

Sincerely,

Michael L. Schler
Chair, Tax Section

Tax Report #808

November 3, 1994

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON CORPORATIONS

Report on Proposed Regulation Section 1.305-5 Relating to Constructive Distributions on Preferred Stock[*]

I. Overview.

This report comments on the proposed amendments to Reg. section 1.305-5 (the "Proposed Regulation")[1] relating to constructive distributions on preferred stock having a redemption price that is greater than its issue price (i.e., "discount preferred stock").

The Proposed Regulation would conform the general rule of Reg. section 1.3 05-5(b) to the amendments to section 305(c) enacted by the Revenue Reconciliation Act of 1990 (the "1990 Act"). Thus, under the Proposed Regulation, a redemption premium arising from a mandatory redemption provision or from a holder put right is treated as a constructive distribution (or series of constructive distributions) of additional preferred stock on preferred stock that is taken into account under principles similar to the

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* This report was prepared by a subcommittee consisting of Robert Kantowitz, Michael Mundaca, Deborah Paul, Yaron Z. Reich and Steven C. Todrys. Yaron Z. Reich, co-chair of the committee, was the drafter. Helpful comments were provided by Peter C. Canellos, Stephen B. Land, Richard L. Reinhold and Michael L. Schler.

1 59 Fed. Reg. 32160 (June 22, 1994). All section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the Treasury Regulations thereunder.

principles of section 1272(a) (subject to a de minimis exception based on the principles of section 1273(a)(3)). The preamble to the Proposed Regulation indicates that other issues raised by the 1990 Act will be addressed in subsequent guidance, and invites public comments regarding those issues.

Significantly, the Proposed Regulation would revise the treatment of preferred stock that is callable at a premium at the option of the issuer. Whereas under existing Reg. section 1. 305-5(b) such callable preferred stock generally gives rise to a constructive distribution, under the Proposed Regulation constructive distribution treatment is required only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to the call right is more likely than not to occur. Under a safe harbor, redemption pursuant to an issuer's right is not treated as more likely than not to occur if (A) the issuer and the holder are not related, (B) there are no arrangements that effectively require the issuer to redeem the stock, and (C) exercise of the right would not reduce the yield of the stock. The Proposed Regulation also contains an exception to constructive distribution treatment for any redemption premium on an issuer call right that is solely in the nature of a penalty for premature redemption paid as a result of changes in economic or market conditions.

In July 1991, the Tax Section submitted an extensive report on the issues that should be addressed in regulations implementing the 1990 Act changes to the treatment of discount preferred stock under section 305(c) (the "1991 Report").[2]

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[2] "Report on Regulations to be Issued Implementing the Changes to Section 305(c) Made by the Revenue Reconciliation Act of 1990" (July 3, 1991), reprinted in 52 Tax Notes 1199 (September 2, 1991).

Accordingly, while we again urge the Treasury and the IRS to promptly issue guidance on other important issues relating to the treatment of discount preferred stock as set forth in our 1991 Report, this report focuses on the Proposed Regulation.

The most significant recommendation in the 1991 Report was the elimination of the rule creating constructive distributions on preferred stock based solely on the existence of a right of the issuer to call the stock. We endorse the Proposed Regulation's implementation of that recommendation. The rest of this report comments on specific aspects of the Proposed Regulation's treatment of issuer call rights.

II. The “More Likely Than Not” Standard.

We agree with the adoption of a “more likely than not to occur” standard, coupled with a safe harbor, to delineate when an issuer's right to redeem preferred stock at a premium over its issue price gives rise to a constructive distribution. However, we recommend that additional examples be included to illustrate the application of the “more likely than not” standard, and that certain aspects of the standard be clarified.

Initially, it might appear that the “more likely than not” standard is too low a threshold to require inclusion of constructive distributions, and that it could lead to uncertainty for taxpayers and potential audit issues. Moreover, by analogy from the parallel provisions dealing with original issue discount (“OID”) debt instruments, contained in Reg. section 1.1272-1(c)(4), it might be contended that the correct rule in all cases should be that an issuer's call right gives rise to a constructive distribution only when it reduces the yield of the stock. On balance, however, we believe that the approach

of the Proposed Regulation is reasonable and sensible, for the following reasons.[3]

The safe harbor sets forth a "bright line" rule, whereby if the issuer and holder are not related and there are no arrangements that effectively require the issuer to redeem the stock, exercise of the call right will not be treated as more likely than not to occur if exercise would not reduce the yield of the stock. The safe harbor, either as presently proposed or as we suggest below that it be modified, will prevent a constructive distribution in the vast majority of situations in which preferred stock -- whether publicly or privately issued -- contains an issuer call right that, as a policy matter, should not give rise to a constructive distribution.

The typical situation in which preferred stock contains an issuer call right that, as a policy matter, should not give rise to a constructive distribution is one in which the issuer seeks a call right to preserve its flexibility to modify its capital structure in light of future circumstances but holders wish to preserve their bargained-for dividend flows in the face of, e.g., declining interest rates or enhancement of the issuer's creditworthiness. Often, the result is a call right that, as of the issue date, is not expected to be exercised and that can be exercised only at a premium (thereby resulting in an additional cost to the issuer and increasing the yield of the stock). As indicated, such a call right generally will be eligible for the safe harbor.

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[3] The Tax Section's recent report on the final OID regulations suggests, in part because of the Proposed Regulation, that further consideration be given to whether the OID regulations should be revised to provide more flexibility for putable or callable debt instruments. "Report on the Final Original Issue Discount Regulations," reprinted in 64 Tax Notes 1747 (Sept. 26, 1994).

The "more likely than not" standard appears adequate to handle appropriately, in a manner that is not achieved by a simple yield to maturity test, the various categories of situations that are not covered by the safe harbor. While some of these situations could be addressed through additional bright-line rules, the "more likely than not" standard appears to achieve the correct result without necessitating a multiplicity of rules.

- Where the safe harbor is not available because the issuer and the holder are related, we would expect (and suggest that an example be added to confirm) that in the absence of any other facts indicating a contrary result, if exercise of the call right would not reduce the yield of the stock, redemption will not be considered more likely than not to occur. On the other hand, in related party situations where such contrary facts exist, the effect of the "more likely than not" standard is to require the parties (if they wish to avoid a constructive distribution) to establish something more than merely that there are no arrangements that effectively require the issuer to redeem the stock -- namely, that redemption is not more likely than not to occur. Such a higher level of scrutiny for related party situations is not unreasonable, and it is reasonable for there not to be a bright line rule for related party situations. An example might be useful to illustrate factors that might be taken into account in these cases. Such factors might include (i) whether a substantial portion of the preferred stock is held by unrelated persons (especially if the call right must be exercised by lottery or proration) and (ii) whether there are bona fide business reasons for including the call right in the terms of the preferred stock.

- Where the safe harbor is not available because there are arrangements that effectively require the issuer to redeem the stock, the issuer call right will properly give rise to a constructive distribution notwithstanding the fact that exercise of the call right will increase the yield of the stock because the holder expects to receive (and, in all likelihood, has bargained for) the call premium.[4] Indeed, this situation is closely similar to a mandatory redemption obligation. This situation is nicely illustrated in Example 5, where failure to exercise the call right entitles the holder to appoint a majority of the issuer's board of directors and where it is reasonably anticipated that the issuer will have sufficient funds to redeem the stock.

- Where the safe harbor is not available because exercise of the issuer call right would reduce the yield of the stock, we understand (based on paragraphs (ii) and (iii)(A) of Example 7) that absent any other facts indicating a contrary result, the fact that exercise of the call right would reduce the yield of the stock indicates that exercise is more likely than not to occur. This should be explicitly stated in the text of the regulation. Nonetheless, especially where there are multiple redemption provisions, it appears to be appropriate to take into account additional factors other than effect on yield to determine whether a particular redemption provision (regardless of whether its exercise would increase or decrease the yield) is

[4] As discussed in Part III.B below, we recommend that the "no arrangements that effectively require" a redemption prong of the safe harbor be modified so as to deny safe harbor protection in other circumstances in which the holder expects to receive (and, in all likelihood, has bargained for) the call premium.

more likely than not to occur. Factors that appear to be relevant (and which might be included in an expanded set of examples) would include (i) whether the issuer is reasonably expected to have sufficient cash to redeem the stock; (ii) the effect of any restrictive covenants in the issuer's debt obligations that would preclude calling the preferred stock; (iii) in the case of convertible preferred stock, the relationship between the call right and the conversion right; (iv) if applicable, whether the relevant regulator is likely to permit a redemption; (v) the expected impact of a redemption on the issuer's credit rating or earnings per share; and (vi) the shape of the yield curve.

The regulation should clarify that the principles of the OID regulations generally apply to determine whether exercise would reduce the yield of the stock. Thus, for example, in the case of preferred stock providing for a dividend rate that is pegged to an index, the determination generally should be made based on the current rate under the index as of the issue date, pursuant to Reg. section 1.1275-5(e) (assuming the index qualifies under Reg. section 1.1275-5(a)(3)).

III. The Safe Harbor.

A. Related Persons.

For purposes of the safe harbor, the issuer and the holder are related if they are described in section 267(b) or 707(b). Prop. Reg. § 1.305-5(b)(3)(ii)(A). In general, this requires that the holder own, directly or constructively, more than 50 percent of the stock of the issuer. While this high threshold would permit a holder of a substantial, albeit less

than 50 percent, stock interest in a corporation who effectively controls the corporation (either alone or with other substantial shareholders) to qualify for the safe harbor, we do not believe that this high threshold is likely to lead to abuse in view of the other requirements of the safe harbor (particularly as we propose below that it be modified).

The regulation should clarify whether the preferred stock is to be taken into account in determining whether the issuer and the holder are related. We recommend that preferred stock that is described in section 1504(a)(4) should not be taken into account for this purpose.[5]

The reference to section 707(b) appears to be largely superfluous given that the issuer is a corporation.[6]

B. <u>No Arrangements That Effectively Require the Issuer to Redeem the Stock.</u>

The regulation should clarify that "arrangements that effectively require the issuer to redeem the stock" must relate to the call right; otherwise every preferred stock with a fixed

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[5] In this regard, we note that in the case of a corporate holder that is related to the issuer under sections 267(b)(3) and (f), nonvoting stock which is limited and preferred as to dividends (and certain other stock) is excluded by virtue of section 1563(c). Also in this regard, because of the severe detrimental consequences that may result from the deconsolidation of a subsidiary and the questionable policy underlying section 1504(a)(4)(C), we continue to support the recommendation in our 1991 Report that "reasonable redemption or liquidation premium" for purposes of section 1504(a)(4)(C) should not be determined by reference to the restrictive OID de minimis rule employed in the Proposed Regulation, but rather should incorporate a standard similar to section 1504(a)(4)(B) of whether the premium reflects a significant participation in corporate growth.

[6] While the reference would cover a situation in which the holder is a partnership in which the issuer owns, directly or indirectly, more than 50 percent of the capital interests such a situation is likely to be very uncommon as a result of Prop. Reg. section 1.337(d)-3.

maturity would fail to qualify for the safe harbor (a result that surely is not intended).

We assume that an understanding between the issuer and a holder (or a related person), even if not legally binding, that the issuer will exercise a call right at a premium will be treated as an arrangement (or, depending on the circumstances, as a mandatory redemption provision). The regulation should state this explicitly. In any event, the regulation should clarify that an understanding requiring the exercise of a call right will not be deemed to exist in the absence of a high level of proof as to such an understanding (assuming no unusual terms of the preferred stock itself), particularly where the original holder is unrelated[7] to the issuer or its officers or directors and has not engaged in transactions with them (other than concerning the preferred stock).[8]

In addition, we are concerned that the "no arrangements that effectively require" standard might be construed too literally by some taxpayers as precluding a constructive distribution on any stock where the issuer is not legally or economically compelled to call the stock. On that basis, some taxpayers might conclude that it is possible to rely on the safe harbor to issue preferred stock that is callable at a premium so long as the issuer is not effectively required to redeem the preferred stock, even if redemption is almost certain to occur as a practical matter. This would permit holders to defer the inclusion of income and to convert its character from ordinary dividend income to capital gain.

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[7] For this purpose, a lower threshold of relatedness (e.g., 20 percent) than applies under section 267(b) might be appropriate.

[8] Cf. Reg. § 1.1232-3(b)(4)(ii) (proof of intent to redeem an obligation before maturity under former section 1232).

We therefore recommend that the provision be revised to require that there be "no understanding or other arrangements between the issuer and the holder (or between any persons related to either or providing services to either in connection with the issuance of the stock) that make it [extremely/highly] likely that the call will be exercised;" we defer to the drafters of the regulation as to whether the standard should be "extremely likely" or "highly likely".

It would also be helpful if additional examples were added to illustrate what constitutes such an arrangement. Example 5 describes a situation in which the holder is entitled to appoint a majority of the issuer's directors. Presumably, the right to appoint 4 0 percent of the directors may also constitute such an arrangement in many circumstances. Similarly, the right to purchase key business assets (even at fair market value), or other terms that are unusual in conventional preferred stock issues, may also constitute such an arrangement. Another example might be a provision prohibiting common stock dividends if the call right is not exercised. On the other hand, the right to appoint one or two directors (constituting a small minority of the board), which is commonly found in conventional preferred stock issues (e.g., after several skipped dividends), generally should not constitute such an arrangement.

IV. Penalty for Premature Redemption.

The Proposed Regulation provides that even if redemption is more likely than not to occur, constructive distribution treatment will not apply if the redemption premium is solely in the nature of a penalty for premature redemption. Prop. Reg. § 1.305-5(b)(3)(i). Under the Proposed Regulation, "[a] penalty for premature redemption is a premium paid as a result of changes

in economic or market conditions over which neither the issuer nor the holder has control." Id.

The preamble further elaborates on the limited scope of this provision:

> Examples include changes in prevailing dividend rates or in the value of the common stock into which the stock is convertible. Calls in such cases reflect increases in the value of the holder's stock resulting from events that occur after the date of issuance, and the premiums paid thereon therefore represent a penalty for premature redemption rather than the equivalent of a periodic return on the stock.

The scope of this exception to constructive distribution treatment is not clear. Read narrowly, this exception would not apply to a call right that is exercisable at a modest premium (e.g., initially 5 percent) that is fixed at the outset and that declines ratably and vanishes after a reasonable period (e.g., 5 years), even if the premium reflects a premature redemption penalty under market conditions existing at the time of issuance. In other words, this exception could be read to apply only to the extent that the amount of the call premium is determined at the time of exercise by reference to changes in economic or market conditions between the issue date and redemption date (although in that case the exception is arguably unnecessary since, as of the issue date, it is unknown whether there will be a redemption premium or, if so, the amount thereof). Whether or not this narrow reading of the exception is intended, we recommend that the regulation itself be revised to incorporate the examples in the preamble and to clarify the intended scope of the exception, including in particular whether a fixed, declining premium schedule can qualify as a premature redemption penalty. Such clarification is especially appropriate because the existing

regulation contains a much broader exception for any premium that is in the nature of a penalty for a premature redemption.[9]

Furthermore, if this exception is given a narrow scope, we recommend that an example be added to the regulation that would involve a call right that is subject to a fixed, declining premium schedule that reflects a premature redemption penalty under market conditions existing at the time of issuance. The example should conclude that there is no constructive distribution because the stock satisfies the safe harbor (or, in the case of a related person, because exercise of the call right is not more likely than not to occur absent any other facts indicating a contrary result).

V. Scope of Section 305(0)(2).

As noted in the 1991 Report, for many years, including subsequent to the 1990 Act enactment of section 305(c)(2), it has generally been thought that there is no constructive distribution under existing Reg. section 1.305-5(b) where preferred stock is callable by the issuer immediately following its issuance because there is no time during which the stock cannot be called for redemption (the "immediately callable rule"). Section 305(c)(2) provides that "a redemption premium shall not fail to be treated as a distribution (or series of distributions) merely because the stock is callable." As noted in the 1991 Report, a fair reading

[9] Reg. § 1.305-5(b)(2) ("A redemption premium will be considered reasonable if it is in the nature of a penalty for a premature redemption of the preferred stock and if such premium does not exceed the amount the corporation would be required to pay for the right to make such premature redemption under market conditions existing at the time of issuance.") Thus, in contrast to the Proposed Regulation, under the existing regulation a redemption premium schedule that is fixed at the time of issuance clearly would qualify as a penalty for a premature redemption if it does not exceed market call premium rates prevailing at the time of issuance.

of the legislative history supports the conclusion that this provision applies only where there is a redemption premium issued after the adoption of the final regulation and that has an issuer call right, exercisable at a premium, that is more likely than not to be exercised should not be exempted from the constructive distribution rule merely because the stock is immediately callable attributable to a mandatory redemption provision or a holder put right, but not where the redemption premium results solely from an issuer call right. Nonetheless, in view of the proposed effective date of the Proposed Regulation,[10] we recommend that the IRS specifically confirm that section 305(c)(2) does not apply to such callable preferred stock, and that taxpayers may rely on prior law, for stock issued prior to the adoption of the final regulation. On the other hand, preferred stock that is issued after the adoption of the final regulation and that has an issuer call right, exercisable at a premium, that is more likely than not to be exercised should not be exempted from the constructive distribution rule merely because the stock is immediately callable.[11]

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[10] Under Prop. Reg. section 1.305-5(b)(6), the issuer call rule of the Proposed Regulation would apply to stock issued on or after the date final regulations are filed with the Federal Register, but the rules of sections 305(c)(1), (2) and (3) generally apply to stock issued on or after October 10, 1990.

[11] This varying interpretation of the scope of section 305(c)(2) is justified because the treatment of issuer call rights under the Proposed Regulation differs from the treatment contemplated in the legislative history of the 1990 Act (i.e., that callable preferred stock generally would give rise to a constructive distribution, as under the existing regulation). As discussed in the 1991 Report, the immediately callable rule might be defended as an antidote to the uneconomic treatment of callable preferred stock under the existing regulation, but is inappropriate under the approach of the Proposed Regulation. (The preamble to the Proposed Regulation provides a comparable explanation for the Proposed Regulation's replacement of the "reasonable redemption premium" exception under the existing regulation with the de minimis rule under section 305(c)(1).) As noted in the preamble, the legislative history of the 1990 Act indicates that Congress did not intend to limit the IRS' authority to modify the treatment of callable preferred stock but anticipated that any modifications would be prospective.