REPORT #898

TAX SECTION

New York State Bar Association

Report on Proposed Regulations on Treatment of Stock Rights Under Sections 354, 355 and 356 of the Internal Revenue Code

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TAX SECTION
New York State Bar Association

April 15, 1997

Honorable Donald C. Lubick
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Ave., N.W. Room 3120
Washington, DC 20220

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

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to enclose a Report prepared by the Committee on Reorganizations of the Tax Section of the New York State Bar Association, commenting on the Proposed Regulations dealing with the treatment of stock rights under Sections 354, 355 and 356 of the Internal Revenue Code. As stated in an earlier report of the Tax Section, dated July 26, 1996, the Tax Section strongly supports the Government's efforts to modernize the treatment of stock rights in reorganization and Section 355 transactions.

The enclosed Report contains suggestions about how the Proposed Regulations might be modified in order to allow them to carry out their goals of rationalizing the tax treatment of warrants while at the same time preventing abusive transactions. In particular,

the Report recommends that the definition of stock rights be limited to instruments in the nature of physically-settled call options. The Report also discusses the treatment of stock-for-warrant exchanges and presents the Tax Section's views on the questions raised in the Preamble to the Proposed Regulations, such as the proper treatment of stock rights under Section 302 and Section 306.

Please let me know if we can be of further assistance in the finalizing of the. proposed regulations.

Very truly yours,

Richard O. Loengard, Jr.
Chair

CC: Kenneth J. Krupsky
Deputy Assistant Secretary
(Tax Policy)
United States Treasury

Jonathan Talisman
Tax Legislative Counsel
United States Treasury

Hon. Stuart L. Brown
Chief Counsel
Internal Revenue Service

This report[1/] of the Committee on Reorganizations of the Tax Section of the New York State Bar Association comments on the recently proposed regulations (the "Proposed Regulations") [2/] dealing with the treatment of stock rights under Sections 354, 355 and 356. [3/] The Proposed Regulations were issued on December 23, 1996, and generally provide that, for purposes of the reorganization and tax-free spinoff, split-off and split-up provisions of the Code (i.e., Sections 368 and 355), stock rights [4/] will be treated as zero principal amount securities, with the result that such rights can generally be received and/or exchanged without the recognition of gain (or loss) by the relevant taxpayer.

The Committee enthusiastically supports the Treasury Department and the Internal Revenue Service (collectively, the "Government") in issuing the Proposed Regulations for the reasons elucidated in our earlier report, dated July 26, 1996 (the "Earlier Report"). As stated in the Earlier Report,

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[1/] The principal drafter of this Report was Lewis R. Steinberg. Members of the Committee who participated in the drafting of this report were Susan Goldbaum, Bertram Kessler, Annaliese Kambour, Aliza Levine, Jay Milkes, Dale Ponikvar, Gayle Sered, Eric Solomon and Linda Swartz. Helpful comments were received from Kimberly Blanchard, Walter Cliff, Mark Colabella, Martin Ginsburg, Harold Handler, Richard Loengard, Michael Meisler, David Miller, Michael Miller, Erika Nijenhuis, Richard Reinhold, Michael Schler, Robert Smith, Linda Swartz and Steven Todrys.

[2/] Prop. Treas. Reg. §§ 1.354-l(e), 1.355-l(c), 1.356-3(b).

[3/] All references are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[4/] Stock rights for this purpose are defined to mean rights issued by a party to the reorganization to acquire its stock (in the case of a reorganization under Section 368) or rights to acquire the stock of the distributing or controlled corporation (in the case of a tax-free distribution or exchange under Section 355).

we believe that allowing tax- free treatment of stock rights under Sections 354, 355 and 356 would constitute a helpful and appropriate modernization of the Subchapter C tax rules. The remainder of this report contains detailed comments on the Proposed Regulations.

1. Lack of Definition of "Stock Rights". The Proposed Regulations do not contain a definition of the term "rights to acquire stock." [5/] As discussed in the Earlier Report (see pages 13-15 thereof), the Committee believes that it would be premature to accord tax-free treatment to exchanges involving cash-settled warrants, options and similar instruments. Similarly, as noted in the Earlier Report (see pages 15-16, 20-22 thereof), certain instruments styled as stock rights may, even if physically-settled, constitute debt under general tax principles or might be more appropriately treated as positive principal amount securities.

[5/] The Preamble to the Proposed Regulations states that "[f]or this purpose, the term 'rights to acquire stock' of an issuing corporation has the same meaning as the term has in sections 305(d)(1) and 317(a) . . . [and] does not include rights exercisable against persons other than the issuer of the stock, or rights that relate to property other than stock of the issuer of the rights." See also Section 361(c)(2)(B) ("qualified property" that may be distributed tax-free incident to a reorganization includes rights to acquire stock).

Although the Committee generally supports a consistent definition of the term "stock rights" throughout Subchapter C of the Code, but see Section 7 infra, given the paucity of authority defining what constitutes a stock right for purposes of Sections 305(d)(1) and 317(a), we believe that an explicit definition of the term in the Proposed Regulations is imperative. Similarly, even a cash-settled warrant or option might be considered to be a right that "relates" to issuer stock; as discussed infra, however, the Committee believes that nonrecognition treatment of cash-settled stock rights is inadvisable without further study.

The Preamble also notes that a conversion privilege contained in a stock or debt instrument will generally not be treated as a separate property right received in the reorganization, citing Rev. Rul. 69-265, 1969-1 C.B. 109. The Committee agrees with this treatment of conversion privileges and suggests that it be embodied in the Proposed Regulations as finalized.

The Committee therefore recommends that the Proposed Regulations, when issued in final form, contain an explicit definition of "rights to acquire stock." For this purpose, we would suggest that a stock right be defined as a financial instrument in the nature of a "call option" [6/] issued by a party to the reorganization or the distributing or controlled corporation, as the case may be, with respect to its own stock and that can only be settled pursuant to its terms in stock of the issuer. [7/] Whether a particular financial instrument constitutes a stock right for this purpose should turn on its substance and not on whether it is documented as a stock right, option, warrant or other financial instrument.

The Committee recognizes that some may argue that the proposed definition is overly restrictive. The Committee believes, however, that adopting such a definition would allow for tax-free rollover treatment for the great bulk of warrants and options extant today while preventing tax abuse. Nevertheless, as discussed in the Earlier Report (see pages 14-15 thereof), the Committee believes that many types of non-"plain vanilla" stock rights, including those providing for cash settlement, also are deserving of nonrecognition treatment. The Committee would appreciate the opportunity to assist the Government by suggesting in a future report additional

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[6/] A call option is a right to acquire stock at a predetermined price (the "strike price"). The value of a call option at expiration depends on the underlying stock price at such time.

[7/] The Committee believes that a call option should constitute a stock right for this purpose even if, in lieu of having the holder pay the strike price and the issuer issue stock upon exercise of the option, the issuer may (whether at its option, the option of the holder, or pursuant to the terms of the call option itself) simply pay the option spread (i.e., the difference between the number of shares of issuer stock issuable upon exercise of the call option and the strike price) in the form of issuer stock, valued at such stock's fair market value. The Committee believes that treating such instruments as stock rights for purposes of Sections 354-356 would be consistent with the intent of the Proposed Regulations.

amendments to the Proposed Regulations that would accommodate such instruments without generating tax abuse potential.

2. Treatment of Stock-for-Warrant Exchanges. As noted in the Earlier Report (see note 6 thereof), an exchange in which a target shareholder receives solely acquirer stock rights (or acquirer stock rights and "boot") in exchange for his or her stock (a "stock-for-warrant exchange") may arguably not qualify for nonrecognition treatment under a literal interpretation of Sections 354 and 356. [8/] However, as stated-in the Earlier Report and echoed in the Preamble to the Proposed Regulations, [9/] we believe that treating such exchanges as tax-free would be fully consistent with the principles underlying the reorganization provisions of the Code. Moreover, we believe that well-advised taxpayers who seek nonrecognition treatment for a stock-for-warrant exchange may be able to resort to a technical solution to deal with the technical problem in the statute. In order to meet the literal statutory requirements, the acquiring corporation would issue a single share of its stock along with its warrants in exchange for the taxpayer's target stock.

This type of formalism creates traps for the unwary and has the effect of making the tax treatment of the exchange optional with taxpayers. Hence, it does not, in our view, represent good tax policy. Furthermore, while it might be possible for the final version of the Proposed Regulations

[8/] See Sections 354(a)(2)(A)(ii) and 356(a)(1)(receipt of solely securities in exchange for stock seemingly not eligible for nonrecognition treatment); see also Treas. Reg. § 1.354-1(d), Ex. 3 (target shareholder who receives solely debt securities in exchange for stock not eligible for Section 3 54 treatment; example suggests that Section 3 02

[9/] "Although a right to acquire stock is not stock, the IRS and Treasury believe that it may generally represent a form of investment in the capital structure of the corporation that justifies nonrecognition treatment as a security under sections 354 and 355."

to specifically sanction such a technical solution, e.g., by appropriate examples, the Committee recognizes that the Government may be reluctant to sanction a rule that would give meaning to the de minimis issuance of stock.[10/]

For these reasons, the Committee, despite its concerns about the statutory language, encourages the Government to consider explicitly sanctioning in the final version of the Proposed Regulations nonrecognition treatment for stock-for-warrant exchanges without requiring taxpayers to resort to the issuance of a single share of stock. [11/] In any event, the Committee would strongly support legislation that would amend Sections 354 and 356 to make stock-for- warrant exchanges clearly tax free.[12/]

[10/] The Committee, however, does not believe that adoption of such a solution by the Government would necessarily provide a precedent for abusive transactions. Adoption of a single share of stock approach accords with both the literal language of Section 356 and its intent and purpose. The Government would therefore not be stopped from challenging de minimis stock issuances in other contexts that, while literally complying with the relevant Code provisions, were inconsistent with the spirit of such provisions.

[11/] It should be noted that, in a somewhat similar context, the Government reached a result that accorded with good tax policy notwithstanding the literal language of the statute. Under Section 453(f)(6), a note received in "an exchange which is described in section 356(a) and is not treated as a dividend" will qualify for installment sale treatment (assuming the other requirements of Section 453 are satisfied). Prop. Treas. Reg. § 1.453-1(f)(2)(iv), Ex.2, deals with a situation in which a target shareholder ("B") receives only an installment note issued by the acquirer's parent ("P") in a forward triangular merger qualifying as a reorganization under Section 368 (a)(2)(D). The example notes that Section 356 does not apply to determine B's tax consequences (but, rather, that Section 302 principles apply to determine the treatment of B); thus, technically, Section 453(f)(6) would appear not to apply. Nevertheless, the example holds that B can treat the transaction as a direct sale of his target shares to P in exchange for the P note, thus achieving the eminently sensible result that B can account for the transaction using the installment method.

[12/] If the Government declines, to accord nonrecognition treatment to stock-for-warrant exchanges absent a statutory amendment, the Committee strongly urges the Government to so state in the final version of the Proposed Regulations (thus averting a potential trap for the unwary).

3. Effective Date. The Proposed Regulations are proposed to be effective for transactions occurring on or after the date that is 60 days after the Regulations are published in final form. According to the Preamble, this is because " [t]he [P]roposed [R]egulations change a longstanding regulatory position . . . [and the prospective effective date is therefore necessary] [t]o afford taxpayers the opportunity to plan for the change . . . ."

In general, the Committee does not object to the proposed effective date. The Committee notes, however, that because the Proposed Regulations will generally result in favorable consequences to taxpayers, [13/] the need for a prospective effective date to accommodate taxpayers' tax planning activities is somewhat limited. Nevertheless, we recognize that allowing for a retroactive effective date, either on a mandatory or elective basis, could, under certain circumstances, undo the settled expectations of the parties to the reorganization or Section 355 transaction in question. [14/] Furthermore, given the lack of any "natural" retroactive cutoff date, any retroactive provision would generally have to apply to all open tax years of the affected taxpayers, which could result in substantial administrative burdens for both the Internal Revenue Service and taxpayers.

[13/] Some taxpayers, such as those with expiring losses, may of course prefer the full gain recognition provided under current law. Nevertheless, it is believed that such cases are extremely rare in practice.

[14/] For example, in a merger under Section 368(a)(1)(A) in which part of the consideration consists of stock rights, the target shareholders may have negotiated a higher price for their target shares in order to compensate for the immediate taxability under current law of the receipt of the acquirer's stock rights. Allowing retroactive application of the Proposed Regulations to such a transaction could, assuming the economic terms of the deal will not be renegotiated, result in a windfall economic benefit to the target shareholders.

4. Continuity of Proprietary Interest. As explicitly noted in the Preamble to the Proposed Regulations, stock rights are not to be taken into account for purposes of determining whether the continuity of proprietary interest doctrine is satisfied (and thus whether the overall transaction qualifies as a reorganization or tax-free distribution or exchange under Section 355). As discussed in the Earlier Report (see pages 27-29 thereof), the Committee believes that (at the very least) certain types of long-maturity stock rights possess enough equity-like characteristics that they should be considered to confer a proprietary interest on the part of the holder for continuity purposes. However, as also stated in the Earlier Report, the Committee recognizes that the purposes underlying Sections 354, 355 and 356 may differ sufficiently from those underlying the continuity of interest doctrine that it would be inappropriate at this time to expand the continuity doctrine to encompass stock rights. Again, the Committee would support further discussion with and analysis by the Government of this issue.

5. Interrelationship with Section 83. The Preamble to the Proposed Regulations clarifies that the proposed rules have no effect on other provisions of the Code, citing in particular the rules under Sections 83 and 421-424 dealing with compensatory stock options and warrants. The Committee agrees with this position.

The taxation of compensation-related stock options and warrants presents unique issues concerning the timing, amount and character of income (and deductions) that bear no relationship to the principles underlying the reorganization provisions of the Code. Sections 83 and 421-424 contain an integrated and consistent framework for dealing with these issues and are the appropriate provisions for determining the tax consequences

to holders of compensatory stock rights who participate in a Section 368 or 355 transaction. The Committee believes that an express statement in the Proposed Regulations that the rules contained therein are not intended to, and do not supplant, the rules contained in the compensation-related provisions of the Code would be helpful in this regard. [15/]

[15/] The Preamble also notes that comments are invited with respect to "the need for additional guidance or special rules to address transactions involving exchanges, substitutions, or assumptions of compensation related stock options." Given the Committee's view that the Proposed Regulations, in essence, should not apply to compensatory stock rights (and that resolution of issues relating to such stock rights should turn on the principles embodied in Sections 83 and 421-424, rather than on those underlying the nonrecognition provisions of Subchapter C), we believe that issuing any such guidance as part of the Proposed Regulations would be potentially misleading and inappropriate.

The Committee, of course, would support the issuance of relevant guidance under Sections 83 and 421-424. In general, the Committee believes that exchanges, substitutions, or assumptions of nonqualified stock options as part of a reorganization transaction should be treated either as continuing "open transactions" or as assumptions of liabilities by the acquirer which, in either case, should not give rise to current taxation to the holder of the option. See, e.g., Rev. Rul. 68-637, 1968-2 C.B. 158 (holding that substitution of target stock with acquirer stock under terms of employee stock options issued by target qualified as an assumption of liability under Section 368(a)(1)(C) of the Code); Letter Ruling 8941069 (July 19, 1989) (conversion of nonstatutory stock options into acquirer stock options in Section 368(a)(2)(E) reorganization does not result in income, gain or loss to holders of such options); Letter Ruling 8808032 (Nov. 27, 1987) (providing similar result in a Section 368(a)(1)(B) reorganization); Letter Ruling 9644080 (May 16, 1996) (according nonrecognition treatment in a Section 355 transaction upon exchange of nonqualified stock options of the distributing corporation for nonqualified stock options in shares of a newly-created, spun-off subsidiary). Nonrecognition to the holder of compensatory stock options is also the rule in taxable acquisitions. See, e.g., Mitchell v. Comm'r, 65 T.C. 1099 (1976), aff'd, 590 F.2D 312 (9th Cir. 1979) (providing nonrecognition treatment for holder in a taxable acquisition upon substitution of nonstatutory stock option exercisable into acquirer stock for similar option on target stock because acquirer stock option had no readily ascertainable fair market value). Of course, the treatment of incentive stock options incident to a reorganization or Section 355 transaction is subject to the special rules of Section 424.

Factual issues will remain, of course, as to whether a particular target shareholder who is also an employee of the target and who receives stock rights as part of a reorganization or Section 355 transaction is receiving such rights in a compensatory or non-compensatory capacity. This issue, of course, is not unique to the treatment of stock rights.

6. Effect on "B" Reorganizations. As discussed in the Earlier Report (see pages 25-27 thereof), the Committee believes that Revenue Ruling 78-408, 1978-2 C.B. 203, precludes tax-free rollover treatment for warrant exchanges in reorganizations described in Section 368(a)(1)(B). While some on the Committee believe that Revenue Ruling 78-4 08 constitutes an overly restrictive interpretation of the nonrecognition provisions of Subchapter C, our understanding is that the Revenue Ruling accurately reflects the Government's position with respect to the issues discussed therein. Accordingly, the Committee recommends that the Internal Revenue Service publish a Revenue Ruling at the same time it finalizes the Proposed Regulations holding that exchanges of (noncompensatory) stock rights incident to a "B" reorganization will not qualify for tax-free rollover treatment under Sections 354 and 356.

7. Treatment under Section 302 of Cash Repurchases of Stock Rights. The Preamble to the Proposed Regulations invites comments on "whether [s]ection 302 should apply to the cash settlement or repurchase of a stock right. . ."

The treatment of cash repurchases of noncompensatory stock rights under current law is not entirely clear. Although most practitioners believe that such repurchases are not subject to Section 302, [16/] it is not entirely clear whether such a repurchase will give rise to capital gain or loss

[16/] The Internal Revenue Service apparently agrees with this view. See, e.g., Letter Ruling 8644002 (July 17, 1986) (technical advice memorandum rejecting the District Director's argument that Section 302 should apply to a repurchase of warrants by the issuing corporation, holding that Section 302 only applies to the redemption of "stock"). The Proposed Regulations, by treating stock rights as securities rather than stock, are consistent with this view.

under Section 1234A [17/] or possible ordinary income or loss treatment under general tax principles.[18/]

If repurchases of stock rights give rise to capital gain (or loss), distributions of such rights might be used under current law to bailout corporate earnings and profits at preferentially taxed rates. For example, a corporation could distribute stock rights to acquire its common stock on a tax-free basis under Section 305(a).[19/] Subsequently,

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[17/] Section 1234A(1) treats gain or loss attributable to the cancellation, lapse, expiration or other termination of "a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer" as capital gain or loss. Applying this Section to characterize gain or loss attributable to the repurchase of rights on publicly-traded stock as capital gain or loss is consistent with other positions taken recently by the Internal Revenue Service. Cf. Prop. Treas. Reg. § 1.1092(d)-2(d), Ex., ¶ (2)(ii) (equity swap treated as position with respect to personal property for purposes of Section 1092 since it constituted an interest in actively-traded stock).

The Clinton Administration has proposed to expand Section 1234A. Under the Clinton proposal, repurchases of stock rights would give rise to capital gain or loss so long as the underlying stock would constitute a capital asset in the holder's hands (regardless of whether such stock is or is not publicly-traded). See Department of the Treasury, General Explanation of the Administration's Revenue Proposals, Feb. 7, 1997, reprinted in Highlights & Documents, Feb. 7, 1997 at 1711, 1729.

Alternatively, even absent Section 1234A, a repurchase or cash settlement of a stock right (with respect to either publicly-traded or non-publicly-traded stock) might be treated as a sale or exchange under general income tax principles, in which case Sections 1234(a) and/or 1234 (c) (2) would generally characterize any resulting gain or loss as capital. See GCM 39144 (March 1, 1984) (sale of warrant by holder to issuer treated as sale of capital asset that gives rise to capital gain or loss under Section 1234); cf. Rev. Rul. 88-31, 1988-1 C.B. 302 (cash settlement of put right on issuer stock treated as sale or exchange); Israel Estate v. Commissioner, 108 T.C. No. 13 (April 1, 1997) (closing transactions in forward contracts on U.S. government securities give rise to capital losses.)

[18/] Some practitioners think that Section 1234A does not apply to repurchases of stock rights (on the ground that the underlying stock cannot constitute "personal property" by virtue of Section 1092(d)(3)(A)) and that the "termination of contract right" analysis might cause the issuer's repurchase of stock rights to fail to satisfy the sale or exchange requirement for capital gain or loss treatment.

[19/] See Section 305(d)(1).

those rights could be repurchased by the corporation in a transaction that the holder, applying Section 1234A, would claim gave rise to long-term capital gain. [20/]

Similarly, a bailout might be effected under current law through a repurchase by a corporation of its own stock in exchange for stock rights. Section 302(a) only applies to situations in which "a corporation redeems its stock (within the meaning of Section 317(b))." Section 317(b), in turn, defines a redemption to be a circumstance in which a "corporation acquires its stock from a shareholder in exchange for property," and Section 317(a) excludes from the definition of property "stock in the corporation making the distribution (or rights to acquire such stock)." Accordingly, a repurchase by a corporation of its own stock in exchange for stock rights would arguably be taxable under Section 1001 (rather than Section 302) and therefore automatically give rise to capital gain or loss if the repurchased stock is a capital asset in the stockholder's hands. [21/]

[20/] Of course, to the extent the stock right were treated as issuer stock under general principles, cf. Rev. Rul. 82-150, 1982-2 C.B. 110 (holder of 70 percent deep-in-the-money stock option treated as owner of the underlying stock for purposes of the foreign personal holding company provisions of the Code), the repurchase would be subject to Section 302.

Repurchases of rights to acquire preferred stock will generally be subject to Section 306, see Section 306(d)(1), thereby preventing their use to bailout corporate earnings and profits.

[21/] Note that even if such a transaction were analyzed as a recapitalization under Section 368(a)(1)(E), it would not qualify for nonrecognition treatment under current law. See note 8 supra.

Alternatively, the repurchase might be viewed as a "distribution of the stock of ... [the repurchasing] corporation made by such corporation to its shareholders with respect to its stock", in which case the repurchase might qualify for tax-free treatment not be taxable under Section 305(a). In such case, the stock repurchase would afford an opportunity to bailout corporate earnings and profits at capital gains rates to the same extent as described in the text with regard to other Section 305(a) transactions.

Thus, even under current law, there is potential for the use of stock rights to bail out corporate earnings and profits at capital gains rates. The Proposed Regulations, however, might be viewed as enhancing the opportunities for using stock rights for bailout purposes by expanding the circumstances under which such rights can be received tax-free.

The Committee generally believes that, as a matter of tax policy, repurchases of stock rights should be subject to Section 302 in order to stop their potential use for bailout purposes. The Committee's belief that Section 302 principles should apply to the repurchase of stock rights, however, does not rest solely on the proposed expansion of Sections 354, 355 and 356. As described above, even current law may provide ample opportunity for creative taxpayers to use stock rights to effectuate bailouts. Moreover, even the cash repurchase of a warrant or noncompensatory stock option originally issued for cash creates bailout potential, just as does the cash redemption of a share of stock originally issued for cash: In each case, increases in the value of the instrument may simply reflect the amount of undistributed corporate earnings and profits that should appropriately be taxed at ordinary income rates. Accordingly, for purposes of applying Section 302 principles to stock rights, the Committee recommends that a broader definition of the term be used than that described above with respect to the Proposed Regulations. Such definition should encompass cash-settled instruments. [22/]

[22/] See also Preamble to the Proposed Regulations (inviting comments on whether Section 3 02 should apply to the cash settlement of a stock right).

While the Committee endorses the broadening of the ambit of Section 302, the Committee believes that, given the clear language of Section 302 itself, any application of Section 3 02 to stock rights would require an amendment to the Code and cannot be done through regulations or other nonstatutory guidance. In particular, the Committee notes that when Congress wished to include stock rights within the definition of the term "stock," it knew how to do so with clarity and precision. [23/]

The Preamble to the Proposed Regulations, however, suggests that the application of Section 302 to stock rights could be accomplished by viewing the holder of a cash- settled or repurchased stock right as "having purchased the stock pursuant to the terms of the right and the issuer as having then redeemed that stock for cash." The Committee believes that such an analysis would be contrary to the prevailing view of most practitioners and commentators (and would thus represent a significant departure from current practice), would be inconsistent with general tax principles [24/] and, at least in the case of cash-settled stock rights, would not accord with the actual terms of the instruments in question.

[23/] Compare Section 306(d)(1)(explicitly providing that "Section 306" stock includes stock rights in order to further anti-bailout statutory purpose) see also Sections 305(d)(1) (treating stock rights as stock for purposes of Section 305); 317(a) (excluding stock rights, as well as stock, from the definition of property); 361(c)(2)(B) (treating both stock and stock rights as "qualified property").

[24/] In general, taxpayers are not treated as owning cash or property that they are under a binding obligation to immediately dispose of. See, e.g., American Bantam Car Co. v. Comm'r, 11 T.C. 397, 406 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950) (where transferor of assets is under binding obligation at time of transfer to dispose of transferee corporation's stock, transferor will be treated as if he never owned the stock in question). This, of course, is simply a manifestation of the step transaction doctrine that unnecessary intermediate steps will be ignored in analyzing the tax consequences of a transaction.

Moreover, treating the repurchase of a stock right as a deemed issuance and redemption of the underlying stock would result in any resulting gain or loss (as determined under Section 302(b)) being characterized as short-term capital gain or loss. Thus, repurchases of stock rights would in many cases result in worse tax consequences to the holder than repurchases of comparable direct ownership interests in the underlying stock. If the purpose of subjecting repurchases of stock rights to the Section 302(b) tests is to harmonize the treatment of stock rights and stock itself, it is hard to see how such a result is justified. Accordingly, while the Committee would strongly support legislation to amend and broaden the scope of Section 3 02, the Committee would object to any attempt to apply Section 3 02 to stock rights through nonstatutory means. [25/] [26/]

[25/] If Section 302 were amended to encompass stock rights, a number of questions would have to be resolved, including: whether rights to acquire voting stock and rights to acquire common stock should be treated as the underlying stock for purposes of applying Section 302(b)(2) and the other Section 302(b) tests; whether in-the-money (i.e., where the value of the underlying stock exceeds the strike price of the rights), at-the-money (i.e., where the value of the underlying stock equals the strike price of the rights) and out-of-the-money (i.e., where the value of the underlying stock is less than the strike price of the rights) stock rights should all be treated the same for Section 302(b) purposes; whether Section 1059 should apply to a repurchase of stock rights treated as a dividend under Section 302(d); how Section 302 should apply to a taxpayer who holds both stock and stock rights where only the stock (or alternatively the stock rights) are repurchased; and whether the repurchase or retirement of a convertible debt instrument should be treated as subject to Section 302 to the extent the proceeds thereof are attributable to the conversion feature.

[26/] As discussed supra, see Section 2, the Committee is concerned that the receipt of a stock right in exchange for stock in a reorganization transaction (including a Section 368(a)(1)(E) reorganization) may continue to be ineligible for nonrecognition treatment even if the Proposed Regulations are adopted. Accordingly, without an amendment to the definition of property in Section 317(a) (so as to include stock rights) (or, alternatively, an expansion of the nonrecognition provisions to allow for tax-free stock- for warrant exchanges), even an expansion of the scope of Section 302 might not prevent corporations from bailing out earnings at capital gains rates by repurchasing their own stock in exchange for stock rights, as described above.

Notwithstanding the possibility that the Proposed Regulations might increase taxpayers' ability to use stock rights to effectuate bailouts, the Committee believes that, in practice, the number of transactions in which stock rights are so used is extremely limited. Far more commonly, the Proposed Regulations would provide nonrecognition relief to the many transactions involving stock rights that are consummated for good commercial reasons without abusive purposes. Accordingly, the Committee urges the Government to finalize the Proposed Regulations without waiting for any legislative "fix" to Section 302. On balance, the Committee believes that the salutary effects of the Proposed Regulations far outweigh any heightened potential for tax abuse they might afford.

8. Application of Section 306 to Common Stock Rights Eligible for Nonrecognition Treatment Under Sections 305 or 354. The Preamble to the Proposed Regulations invites comments on "the application of section 306 to the transfer of a right to acquire common stock if the right is received tax-free pursuant to section 305 or 354." Under current law, rights to acquire common stock distributed to shareholders in a transaction qualifying under Section 305(a) will not constitute Section 306 stock. The Committee strongly objects to any attempt to broaden the definition of Section 306 stock to include common stock rights.

Congress recognized the potential for using the tax-free dividend rules for bailout purposes when it added Section 306 to the Code. [27/] Notably, Section 306 polices the disposition of non-common stock (including rights to acquire such stock) that is received as a tax-free dividend (under Section 305)

[27/] For a discussion of the legislative purpose for Section 306 and the post-1954 amendments thereto, see generally Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders (6th Ed. 1994) ¶¶ 8.40-8.42.

or as tax-free consideration in a reorganization or Section 351 transaction. By excluding common stock (and rights to acquire common stock) from the ambit of Section 306, Congress clearly determined that such stock did not afford sufficient bailout potential to necessitate application of the complex rules of that Section. [28/]

It is difficult to see why the careful policy judgment reached by Congress should be upset by the Government's proposal to expand Sections 354, 355 and 356 to cover stock rights. [29/] While such expansion will increase the circumstances under which common stock rights may be received tax-free, they do not enhance the bailout potential of common stock or common stock rights. [30/]

[28/] See H.R. Rep. No. 1337, 83d Cong., 2d Sess., at 36 (1954) (noting that Section 306 was intended to "eliminate the use of the preferred stock bailout" (emphasis supplied)); see Bittker & Eustice, supra note 27, at ¶ 8.62[5][d] ("The exceptions for common stock. recognize that such stock is ordinarily not a promising instrument for effecting a bailout.").

As discussed above, even common stock (or common stock rights) can be used to effectuate a bailout of corporate earnings. For this reason, Section 302 applies to redemptions of both common and non-common stock. In Section 306, however, Congress made a different judgment and exempted common stock (and common stock rights) from the application of that Section.

[29/] That common stock rights do not afford greater bailout potential than the underlying common stock is perhaps easiest to see in the case of rights that are either in-the-money or at-the-money. Even in the case of out-of-the money common stock rights, however, sales of such rights divest the holder of an opportunity to participate in the future appreciation of the issuer's business and assets and should therefore not be subject to Section 306.

[30/] Under current law, the receipt of preferred stock rights in a Section 368, 355 or 351 transaction would be taxable; thus, currently, use of preferred stock rights as part of a bailout scheme necessarily involves a tax-free stock dividend under Section 305. Notably, however, even though the ability to achieve such a bailout using preferred stock rights is relatively limited under current law, Congress provided that such preferred stock rights should be subject to the anti-bailout provisions of Section 306. See Section 306(d)(1). Thus, the fact that common stock rights (like common stock) are not subject to Section 306 represents a considered tax policy judgment by Congress about such rights' relative lack of abuse potential, and not merely a reflection of the limited circumstances in which such common stock rights can be received tax-free under current law, a judgment that should be unaffected by the Proposed Regulations.

Accordingly, the Committee sees no merit in any suggestion that Section 306 should be amended to include common stock rights under the definition of "Section 306 stock." [31/]

[31/] Such a suggestion is particularly perverse in that common stock rights would be subject to Section 306, while common stock issued tax-free under Section 354 or 355 would not.