Tax Report #925

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

NYSBA

FEDERAL EXPRESS

April 1, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W. Room 3120
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W. Room 3000
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I enclose a report of the Tax Section of the New York State Bar Association addressing issues raised by the provisions of the Taxpayer Relief Act of 1997 dealing with nonqualified preferred stock ("NQPS"). The report includes the following recommendations for guidance concerning NQPS:

1. Stock with a meaningful conversion feature should be treated as participating in corporate growth and, therefore, should not be NQPS.

2. A right of a holder to put preferred stock to the issuer on a "change of control" or similar event should generally be viewed as a remote contingency disregarded in determining the term of the preferred stock.

3. A provision that resets the dividend rate on preferred stock to a current market rate should not cause the stock to be NQPS if the frequency of the reset is limited.

4. NQPS should be treated as stock for purposes of determining whether a transaction otherwise qualifies for nonrecognition treatment under section 351 and 368 of the Code.

5. NQPS issued in a reorganization should be tested for dividend treatment under section 356(a)(2) in the same manner as other "boot" received in a reorganization.

6. An exchange of NQPS-for-NQPS should generally be tax-free without regard to "comparability" of the two issues. In addition, consideration should be given to permitting tax-free treatment, if possible, for certain exchanges of preferred stock that is not NQPS for preferred stock that would be NQPS.

7. The treatment of NQPS for purposes of section 302 and 304 should be clarified.

8. The principles of the installment sale provisions should be extended to the reporting of gain on the receipt of NQPS.

Please let me know if we can be of any further assistance to you in addressing these issues.

Very truly yours,

Steven C. Todrys

Enclosure

cc: Honorable Jonathan Talisman
Clarissa Potter, Esq.
Karen G. Gilbreath, Esq.
Honorable Stuart L. Brown
Philip J. Levine, Esq.
William Alexander, Esq.

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on Recently Enacted Nonqualified Preferred Stock Provisions[1]

March 31, 1998

In August, 1997, Congress enacted the Taxpayer Relief Act of 1997 (the "1997 Tax Act").[2] Under its provisions, certain types of preferred stock that Congress viewed as being relatively secure instruments are designated as nonqualified preferred stock ("NQPS") and are treated as property other than stock ("boot") for certain purposes under a number of nonrecognition provisions of the Internal Revenue Code.[3] Specifically, the new provisions treat NQPS as "boot" for purposes of Sections 351, 354, 355, and 356.[4] Additionally, the nonrecognition rules of Section 1036 no longer apply to exchanges involving NQPS.

1/ The principal drafters of this report were David R. Sicular and Joseph B. Mann. Substantial contributions were made by Peter Canellos, James T. Chudy and Patrick Gallagher. Helpful comments were made by Samuel J. Dimon, Robert A. Jacobs, Glen A. Kohl, Gil Marnin, Michael Schler, Lucian Spatoliatore, and Steven C. Todrys.

In December of 1995 the Tax Section of the New York State Bar Association prepared comments on the NQPS provisions as proposed by the administration at that time. New York State Bar Association Tax Section, Technical Comments on Certain of the Administration's Tax Proposals of December 7, 1995, Tax Report No. 857, 8-11.

2/ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

3/ All "Section" and "Code" references are to the Internal Revenue Code of 1986 and the Treasury regulations promulgated thereunder, as amended to date.

4/ Recently promulgated temporary regulations extend this treatment to rights to purchase NQPS. See Temp. Reg. Section 1.356-6T.

This report comments on the recently enacted NQPS provisions and discusses a number of issues that should be addressed in future regulations.

I. Summary of Nonqualified Preferred Stock Provisions.

For stock to be considered NQPS, it must first be "preferred stock," defined for this purpose as stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Preferred stock, as so defined, is NQPS if it meets any one of four conditions:

(1) the holder of the stock has the right to require the issuer or a person related to the issuer to redeem or purchase the stock,

(2) the issuer or a person related to the issuer is required to redeem or purchase the stock,

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

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

Clauses (1), (2) and (3) apply only in the case of rights that are exercisable or obligations that are to be performed within 20 years of the stock's issuance and are not subject to contingencies that as of the issue date make remote the likelihood of redemption or purchase. In addition, such rights and obligations are not taken into account in certain circumstances involving non-public companies or stock issued in the compensatory context.

Once stock is classified as NQPS, it is generally treated as property other than stock for purposes of taxing the recipient of the NQPS in transactions otherwise subject to Sections 351, 354, 355, 356 and 1036, but apparently is treated as stock for all other purposes, including the taxation of other participants to the same transaction. This somewhat schizophrenic approach muddies the waters of subchapter C at a time when it appeared they were on their way to becoming clearer and more straightforward to navigate.[5/] Thus, we believe it is important that the Internal Revenue Service (the "Service") issue guidance to clarify both definitional issues and the scope of applicability of the new NQPS rules.[6/]

The Secretary has been authorized to prescribe regulations for the treatment of NQPS under any provision of the Code.[7/] The Conference Report states

---

5/ Recent improvements in subchapter C include the new continuity of interest rules under Treas. Reg. Sections 1.368-1 and 1.368-2, and the rules addressing the treatment of warrants in a reorganization under Treas. Reg. Sections 1.354-1(e), 1.355-1(c), and 1.356-3(b).

6/ In this regard, we note that guidance on the NQPS rules does not appear in the 1998 Business Plan, Treasury Department-Internal Revenue Service 1998 Business Plan Listing Priorities for Tax Regulations, Other Administrative Guidance, Daily Tax Rep. (BNA), March 4, 1998, at L-1, and that certain Service officials have suggested that taxpayers who are thinking of issuing NQPS should issue debt instead. Issue Debt, Not Debt-Like Stock, Government Panelists Tell Practitioners, Daily Tax Rep. (BNA), Mar. 13, 1998, at G-7. We believe that preferred stock has a legitimate role to play in U.S. capital markets and that, therefore, it remains important for the Service to clarify the rules applicable to NQPS.

7/ See Section 351(g)(4).

that "[u]ntil regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code."[8]

II. Definitional Issues.

A. Definition of Preferred Stock--Circumstances under which stock will be considered to "participate in corporate growth to any significant extent."

Critical to the application of new Section 351(g) and related provisions is the definition of "preferred stock" as "stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent."[9] This language tracks the Section 1504(a)(4)(B) definition of limited and preferred stock which, if also non-voting, non-convertible and lacking certain liquidation and redemption rights, is disregarded in determining affiliation. As in that context, the Section 351(g) definition is intended to isolate stock that is functionally similar to debt by virtue of its limited participation in growth. We believe that standard should be applied in an economically realistic fashion, taking into account all related facts and circumstances, to prevent the application of the new statutory provision to cases in which holders retain a meaningful participation in the corporate venture's prospects.

We do not believe the concept of significant participation is susceptible to formal codification. Rather, we believe guidance such as that provided in Section 1.305-5(a) of the Treasury regulations is generally appropriate (except with respect to

---

[8] H.R. Conf. Rep. No. 105-220, 105th Cong., 1st Sess. 544 (1997); Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, 212-13 [hereinafter '97 Bluebook].

[9] Section 351(g)(3).

convertible preferred stock), to the extent it applies a realistic facts and circumstances approach:

> The term "preferred stock" generally refers to stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of "preferred stock" for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest. Among the facts and circumstances to be considered are the prior and anticipated earnings per share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. The determination of whether stock is preferred for purposes of section 305 shall be made without regard to any right to convert such stock into another class of stock of the corporation. The term "preferred stock", however, does not include convertible debentures.

Unfortunately, relatively limited specific guidance has been provided in the 27 years since the promulgation of this regulation to illustrate the circumstances in which an instrument is considered to meaningfully participate in corporate growth. In light of the expanded importance of this concept under the NQPS provisions, it would be helpful for the Service to provide examples of meaningful participation in the NQPS context (that presumably would also apply in the Section 305 area). While a facts and circumstances approach may be the most guidance that the Service can provide, it would be helpful to clarify what facts are relevant. For example, we believe that a meaningful participation in dividends could be sufficient, even without participation in liquidation, including a participation in a portion of the dividends payable on an equivalent value of common stock. We also assume that a relevant factor to consider is the portion of the market value (presumably determined at issuance) of the preferred stock that is attributable to its participation features.

In one major respect, however, Treas. Reg. Section 1.305-5(a) departs from an economically realistic approach in disregarding, ipso facto, "any right to convert such stock into another class of stock of the corporation." Whatever the merits of that limitation under Section 305, we do not believe that Congress intended to apply the new provision to tax the receipt of garden-variety convertible preferred.

Garden-variety convertible preferred plays an important business role in many major acquisition transactions by reducing the acquiror's earnings-per-share dilution. By substituting convertible preferred with, say, a 10 percent conversion premium, the earnings per share dilution of the transaction is reduced correspondingly. Issuers of garden-variety convertible preferred fully expect the stock to convert, and are willing to pay a fixed dividend higher than that paid on common to secure reduced dilution. Issuers and holders do not expect the stock to be redeemed (except as a mechanism to force conversion) and the convertible preferred stock participates in corporate growth in every meaningful respect.

Nothing in the statutory language of Section 351(g)(3) precludes an interpretation that stock may participate in corporate growth to a significant extent through a conversion feature. Moreover, the legislative history of the new provision strongly supports the conclusion that meaningful conversion rights (at least into common stock of the same issuer) are taken into account. Thus, the House Bill defined "preferred stock" as "stock which is limited and preferred as to dividends and does not participate (including through a conversion privilege) in corporate growth to any significant extent." [Emphasis added]. In commenting on the statutory proposal, our December 22, 1995 report raised the following concern:

> As we read the proposal, stock that includes a conversion privilege will be treated as participating in corporate growth and thus will not be treated as Disqualified Preferred. (This differs from Section 305(b)(4) and the regulations thereunder, which treat convertible preferred as preferred.) More clarification of this rule is, however, needed. Is the description of preferred stock as "stock that is limited and preferred as to dividends" intended to be identical to the language of Section 1504(a)(4)(B)? Consideration also should be given to providing guidance as to the treatment of conversion features that lack substance and thus may be disregarded. See Reg. Section 1.305-5(a). [Emphasis added].

In response to concerns about illusory conversion rights, the Conference Committee eliminated the parenthetical phrase "(including through a conversion privilege)," reasoning as follows:

> The conference agreement also clarifies the treatment of certain conversion or exchange rights, by deleting any statutory reference to the existence of a "conversion privilege." The conferees wish to clarify that in no event will a conversion privilege into stock of the issuer automatically be considered to constitute participation in corporate growth to any significant extent. The conferees also wish to clarify that stock that is convertible or exchangeable into stock of a corporation other than the issuer (including, for example, stock of a parent corporation or other related corporation) is not considered to be stock that participates in corporate growth to any significant extent for purposes of the provision. [Emphasis added].

The Conference Report excerpt, particularly the reference to "automatically," and its history strongly support the sensible result that rights to convert into other stock of the issuer are taken into account like other rights in determining whether stock participates in corporate growth to any significant extent. Conversion rights that are not meaningful (e.g., because of very high conversion premium), like other non-meaningful participation rights, may not suffice; those that are meaningful should suffice. In each case, an aggregate facts and circumstances test should be applied, with the value of the conversion feature being a factor in the consideration.

We believe this result is sufficiently clear under the statute and legislative history that it can be reached even absent affirmation by the Service. We note, however, that spokespersons from the Service have recently referred to using the concepts reflected in the Section 305 regulations in applying the new provision. While we believe this is generally appropriate, as noted above, we do not believe the reference was meant to exclude conversion rights from the analysis of substantial participation. Nevertheless, to avoid creating uncertainty as to pending transactions, we believe the Service should confirm promptly that it does not consider it appropriate to exclude conversion rights from this analysis but rather expects those conversion rights, together with other rights, to be subjected to a facts and circumstances analysis.

While the justification for ignoring rights to acquire stock of a party other than the issuer is not entirely apparent in every context (e.g., conversion into the stock of issuer's subsidiary or parent would seem to be participation in the issuer in some sense), we can understand the distinction between those cases and more straightforward conversion rights. The rules of subchapter C already treat these two situations differently in other contexts. (For example, the conversion of convertible preferred stock into common stock of the same issuer is not a taxable event, whereas the exchange of exchangeable preferred stock into common stock of another company is taxable unless a specific nonrecognition provision applies.) In any event, although a number of transactions may be affected,[10] we believe the practical impact of non-issuer conversion rights is relatively small, and dealing with this issue is relatively insignificant compared with the importance of confirming promptly the treatment of garden-variety convertible preferred stock as stock that participates meaningfully in corporate growth.

B. <u>Circumstances under which a right to redeem or purchase stock is considered to be "subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase."</u>

The existence of certain redemption or purchase rights may cause preferred stock to be treated as NQPS only if those rights are not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

One contingency that is seen with particular frequency in the market is the so-called "change of control" put, which gives the holder the right to require the company to repurchase the stock in the event that certain events occur that are

---

[10] It has not been uncommon, for example, for exchangeable stock to be used in acquisitions of Canadian companies by US acquirors that seek to achieve both pooling of interests accounting and tax-free exchange treatment for Canadian tax purposes.

considered to cause a change in control. Those events include, among others, an acquisition by a person or group of a specified percent of the company's voting stock, a merger of the company into another person, and a sale by the company of substantially all of its assets. The change of control rights provide an investor with a guaranteed exit from the investment if some of the principal factors relied upon in making the investment, i.e., the ownership and management of a company, undergo substantial change. Generally, changes in control are neither anticipated nor desired when the stock is issued. Moreover, in the event a change of control is thought to be a non-remote possibility, securities laws require that fact to be included in the offering materials for the preferred stock when it is issued. For these reasons, the Committee believes the Service should provide through regulation a safe harbor (or at least a presumption) for change of control puts that will cause them to be deemed to be subject to a contingency on the day of issuance that makes remote the likelihood of exercise if the underlying stock is issued pursuant to a registration statement, private placement memorandum or other offering circular ("disclosure document") unless the disclosure document indicates that the contingency is not remote. A similar safe harbor may also be appropriate for contingencies such as an initial public offering of the issuer, liquidation or insolvency of the issuer, or sale of the issuer's assets.

C. Circumstances under which an issuer's right to redeem stock will be considered "more likely than not" to be exercised.

Preferred stock is NQPS if the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not the right will be exercised. The Section 305 regulations have a similar requirement relating to the treatment of redemption premium. Under Section 1.305-5(b)(3) the Section 305 redemption premium provisions apply to stock with respect to which the issuer has a redemption right, but only if redemption pursuant to that right is more likely than not to occur. The Section 305 regulations then provide a safe harbor within which a right to redeem stock will not be treated as more likely than not to occur. Generally included in the safe harbor is redeemable stock if (i) the issuer and holder are not related, (ii) there exist no arrangements to compel the issuer to redeem the stock, and (iii) exercise of the right to redeem would not reduce the yield of the stock.

The "more likely than not" language of Section 351(g) is substantially the same as the language in Section 1.305-5(b)(3), and there does not appear to be an obvious rationale for applying them differently. The Committee believes the NQPS regulations should include the safe harbor of Section 1.305-5(b)(3) in its description of when a right of redemption will be treated as more likely than not to be exercised. We believe this inclusion would be best accomplished through direct reference to Section 1.305-5(b)(3) by the NQPS regulations, which inclusion would ensure consistency in the application of the safe harbor under both provisions.

The Committee also urges clarification of the application of the more likely than not test to stock with rights subject to non-remote contingencies. For example, assume a transaction involves preferred stock with a right of redemption that will become effective upon the occurrence of a contingency. There exists a 25 percent probability of the contingency occurring. If the contingency does occur, there is a 60 percent probability that the right to redeem will be exercised. In determining the likelihood of eventual redemption, if we calculate the probability that both the contingency occurs and the right is exercised, the likelihood of redemption would be 15 percent (25 percent times 60 percent) and the redemption would not be considered more likely than not to occur. However, if the probability of the contingency occurrence is not included in the calculation, the likelihood of redemption is 60 percent. The Committee believes the former is the proper interpretation of the "more likely than not" test, and feels that it would be helpful for the Service to provide examples of its application.

D. Circumstances under which a stock's dividend rate varies with reference to interest rates, commodity prices, or other similar indices.

Preferred stock generally will be treated as NQPS if it has a dividend rate that varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. While the application of this test is clear in some circumstances (e.g., auction rate preferred stock whose dividend rate is reset every 49 days), its application in other circumstances is unclear. Assume preferred stock has a dividend rate that will be reset one time by reference to an actual borrowing of the issuer within 12 months of the stock's issuance. That one-time dividend rate reset would not create sufficient similarity between the stock and the type of relatively secure instrument at which the NQPS rules are aimed to warrant treatment of the stock as NQPS. If a one-time reset will not cause preferred stock to be treated as NQPS, how many resets could be provided until NQPS treatment is imposed? Perhaps not more than three, no two of which would occur in any four-year period. We believe further clarification regarding the application of Section 351(g) would be helpful.

III. Ambiguities in application of the NQPS Provisions.

As mentioned above, the Conference Report states that until regulations are issued NQPS will be treated as stock under Code provisions unless the Code specifically provides otherwise.[11] Because of the interaction and cross-referencing of different Code sections, however, the application of this principle is not always clear.

A. Circumstances under which NQPS will be considered "comparable" to other NQPS.

Under Sections 354, 355, and 356, no gain recognition is required with respect to certain transactions involving stock or securities. NQPS received either "in exchange for" or "with respect to" "stock other than [NQPS] ... shall not be treated as stock or securities" for purposes of these sections and therefore is treated as boot.[12] The Conference Report accompanying the new provisions states that "certain exchanges of [NQPS] for comparable [NQPS] of the same or lesser value" are to be excluded from gain recognition.[13] [Emphasis added.] The application of this apparent requirement that the NQPS surrendered and received must be "comparable"

---

[11] See H.R. Conf. Rep. No. 105-220 at 544; '97 Bluebook at 212-13.

[12] Sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Committee notes that NQPS is treated as property other than stock for purposes of Sections 351 and 1036, regardless of whether the NQPS was received in exchange for other NQPS. While this result is inconsistent with NQPS treatment under Sections 354, 355, and 356, and therefore seems incorrect, it is not clear that the discrepancy could be remedied through regulation.

[13] H.R. Conf. Rep. No. 105-220 at 544; See also '97 Bluebook at 212.

to avoid boot treatment is unclear. Moreover, while the limitation "same or lesser value" is grounded in the statutory language (any excess NQPS is presumably issued in exchange for something else), the comparability requirement is not. The Committee strongly recommends that the comparability requirement be eliminated in future regulations. If it is not eliminated, we would recommend that the Service clarify the features of the instruments that need to be comparable.

B. Dividend Treatment Under Section 356(a)(2).

Section 356 treats NQPS received in exchange for stock other than NQPS as property other than stock, i.e., boot. If a taxpayer receives boot under Section 356, and the overall exchange has the effect of the distribution of a dividend, then all or a portion of any gain recognized could be treated as a dividend to the distributee.[14] Though Section 356 makes no direct reference to Section 302, the Supreme Court has held that the principles of Section 302 apply in determining whether an exchange has the effect of a distribution.[15]

Section 302 provides that if a corporation redeems its stock, and one of four requirements is met to establish the redemption does not have substantially the same effect as a dividend, the redemption will be treated as a distribution in exchange for the stock. Otherwise the redemption will be treated as a distribution of property by the corporation to the redeeming shareholder. In applying the principles of

[14] See Section 356(a)(2).

[15] See Commissioner v. Clark, 489 U.S. 726 (1989) (applying the principles of Section 302 to a deemed post-reorganization redemption to determine the receipt of boot did not have the effect of the distribution of a dividend); Rev. Rul. 93-61, 1993-2 C.B. 118.

by the corporation to the redeeming shareholder. In applying the principles of Section 302 to Section 356, the taxpayer is treated as having first received stock permitted to be received under Section 354 or 355 without the recognition of gain or loss. The taxpayer will then be treated as having exchanged a portion of that stock for the property other than stock.[16/]

Because no regulations to the contrary have yet been adopted, NQPS is to be treated under all circumstances as stock under Section 302. Therefore, Section 302 apparently would not apply to the receipt of NQPS in exchange for other stock. This raises the question as to whether Section 356(a)(2) can treat the receipt of NQPS as a dividend under the principles of Section 302. While it seems that as a policy matter the receipt of NQPS treated as boot under Section 356 should be taxed as a dividend under the same principles as apply to other boot, it is not clear that this treatment applies absent regulatory action. Because of this ambiguity, the Committee suggests the Service confirm that dividend treatment may apply with respect to the receipt of NQPS.[17/]

If dividend treatment cannot apply to the receipt of NQPS in a reorganization, a bailout potential is created. If gain were recognized with respect to such stock in a reorganization, in certain circumstances such stock would not be

16/ Id.

17/ We note that, if the receipt of NQPS is treated as a dividend under Section 356(a)(2), it could be argued that Section 305(a) would then permit the distribution to be excluded from income. Such an exclusion under Section 305(a) is inappropriate, and we would suggest that this be clarified through future regulation.

considered Section 306 stock.[18] Therefore, it would be possible to structure a transaction in which the receipt of NQPS would have the effect of a dividend, but be subject only to capital gains rates.[19]

C. Sections 351 and 368.

The Committee understands that, although NQPS is generally not treated as stock for purposes of determining the tax treatment of a taxpayer who receives the NQPS in a transaction otherwise qualifying under Section 351 or 368, the NQPS will be treated as stock in determining whether or not the transaction as a whole qualifies under those sections and, at least pending the issuance of regulations to the contrary, will be treated as stock for all purposes of all other sections of the Code. This result is clearly implied by the fact that the NQPS provisions of the Code were enacted in very precise places in the Code and is strongly supported by the legislative history of the NQPS provisions.[20] To avoid confusion, however, we urge the Service to issue prompt interim guidance confirming that this is the case. Such

---

18/ Section 306 stock may include preferred stock received in a reorganization, "with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized...but only to the extent that either the effect of the transaction was substantially the same as the receipt of a stock dividend." Section 306(c)(1)(B).

19/ We note that such NQPS bailout potential does not appear to exist with respect to NQPS received in a Section 351 transaction, regardless of whether gain was recognized. Section 306 stock includes any preferred stock acquired "in an exchange to which Section 351 applied if the receipt of money (in lieu of the stock) would have been treated as a dividend to any extent." Section 306(c)(3).

20/ See H.R. Conf. Rep. No. 105-220 at 544; '97 Bluebook at 212-13.

guidance would not, of course, preclude the Service from subsequently providing prospective regulations that deviate from this principle.

1. Section 351.

The general principle espoused above may lead to some anomalous results when NQPS is compared with the issuance of other types of boot. In the Section 351 context, these results would follow from application of the rule that a taxpayer who transfers property to a corporation in exchange for NQPS will be treated as a transferor for purposes of determining whether the transaction as a whole qualifies under Section 351, even though the answer to that question may have little or no effect on the taxation of the shareholder in question.[21] By contrast, the issuance of boot to a transferor has no effect, under current law, on whether the transaction qualifies under Section 351. This discrepancy in treatment could cause a transaction either to qualify or fail to qualify under Section 351 under circumstances that may seem somewhat surprising.

As an illustration of the unusual results possible under the new NQPS rules, assume that A and B each contribute property to a newly formed corporation X in exchange for voting common stock. At the same time, C contributes property to X

---

[21] It may, however, affect the corporation. The House of Representatives passed legislation currently being considered in the Senate, providing that under Section 351, if a transferor receives no stock other than NQPS, the transferor will recognize full gain or loss and the transferee will obtain a fair market value basis in the assets, although the NQPS will still be considered stock for purposes of determining whether a transaction qualifies under Section 351(a). (The legislation also addresses the statutory period for deficiency assessment with respect to certain transactions involving family-owned corporations.) H.R. 2676, 105th Cong., 1st Sess. Section 609(c) (1997); see also H.R. Rep. No. 105-356, 105th Cong., 1st Sess. 31-32 (1997).

in exchange solely for nonvoting NQPS. Prior to C's contribution, she has entered into a binding contract to sell 25 percent of her stock to D. Because the NQPS is not treated as stock for purposes of applying Section 351 to C, C must recognize full gain (or, at least if pending technical corrections legislation passes, loss) on the property that she has contributed to the corporation, and she is therefore indifferent as to whether the overall transaction qualifies under Section 351. However, because NQPS is still considered stock for purposes of the Section 351 control requirement, and because C received 100 percent of the nonvoting stock of the corporation, her decision to enter into a binding contract to sell 25 percent of her stock will cause the entire transaction to fail to qualify under Section 351.

NQPS can also be used to cause a transaction to qualify under Section 351. Assume, for example, that A and B each contribute property to a newly formed corporation Y in exchange for voting common stock, resulting in each holding 40 percent of the vote. C also contributes property to Y, this time in exchange for voting NQPS that holds the remaining 20 percent of the vote. As before, C must recognize full gain on the transaction. Assuming that C retains the NQPS after the transaction, A and B together may make binding commitments to sell up to 25 percent of their stock without adversely affecting Section 351 treatment, whereas if no NQPS had been issued to C, A and B would have been limited to selling 20 percent of their holdings.[22]

---

[22] For somewhat analogous results in the Section 355 context, see Examples 9 and 10 in Gilbert D. Bloom, Certain Preferred Stock Gets the 'Boot'—But Does It Fit?, 88 J. Tax'n (WGL) 69, 73 (1998).

2. Reorganizations.

Clarification of the scope and impact of the NQPS rules under the reorganization rules of subchapter C is particularly critical, given the wide range of implications that treatment of an instrument as stock has under those provisions. Although the new language in Sections 354-356 appears to be narrowly drafted to affect only an exchanging shareholder who receives NQPS, the reorganization provisions are sufficiently complex that the new language, as well as future regulations characterizing NQPS as property under other provisions of the Code, could create interpretive problems.

We urge the Service to exercise its regulatory authority to characterize NQPS as other than stock narrowly and only as necessary to achieve the stated goal of the NQPS provisions. As we understand it, that goal was to tax currently (or possibly on an installment basis) exchanging target shareholders who receive "relatively secure instruments in exchange for relatively risky instruments."[23] The promulgation of expansive regulations would create substantial uncertainty for the other stakeholders in tax-free reorganizations, including the target corporation, the acquiring corporation and those target shareholders who receive stock that is not NQPS.[24]

---

[23] H.R. Rep. No. 105-148, 105th Cong. 1st Sess. 472 (1997); '97 Bluebook at 209.

[24] For a parade of horribles see, e.g., James S. Eustice, 'Debt-Like' Equity and 'Equity-Like' Debt: Treasury's Anti-Hybrid Proposals, 71 Tax Notes 1657, 1663-70 (1996).

In accordance with the goal of narrowly targeting exchanging target shareholders, the forthcoming Treasury regulations should clarify that NQPS is "stock" for all purposes of Part III of subchapter C other than the specific portions of Subparts A and B (Sections 351-358), that expressly provide otherwise. That solution would resolve any lingering anxiety about whether NQPS of the target is "stock" for purposes of the control requirement of Section 368(c)[25] (and the related issue of whether control has been acquired solely for voting stock) and whether NQPS provides continuity of interest.[26] In either case, if NQPS is not stock, taxpayers (other than exchanging target shareholders who receive NQPS) could recognize gain in what, under current law, is a tax-free reorganization.

One example of this problem would arise if voting NQPS were not counted towards acquiring control under Section 368(c). In that case, target shareholders receiving solely voting common stock may recognize gain in transactions that would constitute "B" reorganizations under current law. For example, assume company T has outstanding 100 shares of voting common stock possessing one vote per share, and 100 shares of NQPS also possessing one vote per share. Company A exchanges its voting common stock for all of the NQPS and 70 shares of the common. If NQPS is to count in determining whether A has acquired Section 368(c) control, then A has obtained 85 percent of the vote, and the transaction will qualify as

---

[25] The Conference Report states in an example clarifying Section 351 treatment that NQPS is treated as stock for purposes of Sections 351(a) and 368(c), unless and until Treasury regulations are issued to the contrary. H.R. Conf. Rep. No. 105-220 at 545; '97 Bluebook at 210.

[26] See Treas. Reg. Section 1.368-1(b); Treas. Reg. Section 1.368-1(e).

a "B" reorganization. If NQPS does not count in determining whether A has acquired Section 368(c) control, then A has obtained only 70 percent of the vote, and the transaction fails as a "B" reorganization. Conversely, if NQPS of the target possesses 80 percent of the vote, an acquisition of the common stock only, which can be outvoted by the NQPS, would qualify as a "B" reorganization.

A second, more drastic, set of consequences could arise if NQPS is issued in an intended "A", "C" or "D" reorganization, or a forward subsidiary merger under Section 368(a)(2)(D), that is found to fail on the grounds that NQPS does not carry continuity of interest genes. In that event, the failed reorganizations would result in a taxable liquidation of the target corporation, possibly triggering tax to target as well as the target shareholders.[27] Corporate-level gain could also arise in asset-type reorganizations if NQPS is the only consideration issued and is found not to constitute "stock or securities" under Section 361.[28] Under a slightly different analysis, the "C" reorganization boot relaxation rules of Section 368(a)(2)(B) would be more difficult to satisfy if NQPS were "other property" for that purpose.

It may not, however, be possible to expel all of the definitional gremlins lingering in Sections 361 and 368 by treating NQPS as "stock" for all

---

[27] <u>See</u> Rev. Rul. 69-6, 1969-1 C.B. 104.

[28] Section 361(b)(1) requires target to receive "stock or securities," in addition to boot, for target to avoid gain recognition on the boot, even if the boot is distributed to target's shareholders. If the only consideration were NQPS, which is not "stock or securities" under Section 354(a)(2)(C), target might appear to have made a taxable sale. Because of the exceptions to recognition for certain categories of NQPS exchanges (<u>e.g.</u>, NQPS for comparable NQPS of the same or lesser value), the type of consideration tendered by an exchanging target shareholder could determine whether target would recognize gain.

purposes of Part III other than the specific portions of Subparts A and B that expressly provide otherwise. For example, "D" and "G" reorganizations require "stock or securities" of the acquiring corporation to be distributed pursuant to Sections 354, 355 or 356. If NQPS is not "stock" for those purposes (and it would appear not to be under the internal logic of those sections), then a "D" or "G" reorganization could be achieved only if good stock (even a de minimis amount) is provided in addition to the NQPS.[29]

We see no compelling policy justification for putting target, the acquiring corporation or other target shareholders at risk if the parties to a transaction use NQPS as consideration in an otherwise tax-free reorganization. Consequently, the Service should exercise its Congressionally delegated authority to confirm NQPS is stock for these purposes and thus avoid creating additional traps for the unwary in an already tangled set of rules.[30]

One final note on reorganizations involving recapitalizations. The 1997 Tax Act does not apply the NQPS rules to tax-free distributions under Section 305, but it does reach recapitalization exchanges under Sections 368(a)(1)(E) and 1036. Consequently, it may be possible to avoid the reach of the gain recognition rules for

---

[29] Because the "D" and "G" reorganization anomaly follows from the existing statutory language, it may require regulations or even a statutory amendment to achieve tax-free treatment (that is, if the 100 percent NQPS reorganization transaction is deemed worthy of tax free treatment at the corporate level).

[30] We note that this approach produces some odd results, similar to those discussed above in the Section 351 context. For instance, if an acquiring corporation issues voting NQPS in exchange for 21 percent of a target's common stock, and common stock for the remaining 79 percent of target's stock, although the NQPS is treated as boot, the exchange would qualify as a "B" reorganization.

NQPS by using nontaxable dividends in the form of NQPS. For example, assume that a target shareholder were to receive a NQPS dividend on common stock that was tax-free under Section 305(a).[31] That shareholder could then exchange the NQPS (and the previously held common) for an acquiror's similar NQPS (and common) in a tax-free reorganization.[32] The possible use of Section 305 as an end-run around the NQPS rules could be addressed by forthcoming regulations that might provide that if NQPS is distributed under Section 305(a), and that stock is exchanged for NQPS in a subsequent reorganization, the nonrecognition rules of Sections 354 and 356 would not apply to the latter exchange.

IV. Future Regulations.

Although the NQPS provisions directly affect only a few sections of the Code, the Service has authority to promulgate regulations under every section of the Code prescribing NQPS treatment. The Committee believes several Code sections would benefit from the Service promulgating regulations specifically addressing NQPS treatment. Those Code sections, as well as certain other suggestions for future regulations, are set forth below. The Committee also believes there should be no distinction made between NQPS and other stock for purposes of any other Code section.

---

[31] The NQPS would likely be Section 306 stock, which may or may not be a problem for the target shareholder. Further, the dividend may be impractical if there are a large number of shareholders because a distribution of preferred to some shareholders and common to others is taxable to all. See Section 305(b)(3).

[32] Step transaction and other substance over form rules would be relevant here.

A. Exchanges of Preferred Stock.

A right of redemption or purchase (or right to require redemption or purchase) will cause stock to be treated as NQPS only if the right or obligation may be exercised within 20 years of the stock's issue date. Literal application of this rule produces some unfair results the Committee believes should be addressed in regulations. For instance, assume preferred stock is issued today with a mandatory redemption in 25 years. Assume further that in 10 years the stock is exchanged for similar preferred stock possessing a 15-year maturity. Because the old stock could not be NQPS while the new stock could, is the replacement transaction taxable? The Committee believes that the answer should be no. We acknowledge that this situation is superficially similar to another situation encountered under Section 354, involving the requirement that "securities" received in a reorganization be exchanged for "securities" in order to qualify for tax-free treatment. Since, as a rule of thumb, debt instruments need to have a maturity date of at least 5 years to qualify as a "security,"[33] Section 354 would not apply tax-free treatment to an exchange of an instrument with an initial maturity of greater than 5 years for a new instrument with a maturity of less than 5 years. However, this situation is distinguishable from that

---

[33] Short-term notes do not qualify as "securities" for purposes of the reorganization provisions. See, e.g., Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). The courts seem to consider "[a] term of five years or less ... to be too short to qualify a note as a security." Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.41[3] (6th ed. 1997). See also, e.g., Harrison v. Commissioner, 24 T.C. 46 (1955), aff'd 235 F.2d 587 (8th Cir. 1956), cert. denied 352 U.S. 952 (1956) (stating that "securities have been held to be such obligations as bonds, debenture notes, and subscription rights, but short-term notes for 3, 4, and 5 years are not deemed securities").

involving NQPS for at least two reasons. First, under Treas. Reg. Section 1.1001-3, a debt-for-debt swap often will not be a taxable event even if the new debt is not a "security" because it has less than 5 years to maturity; by contrast, it is not clear whether the section 1.1001-3 rules, or similar principles, apply to preferred stock. Second, restructuring a transaction to solve this problem in the NQPS context may require extending the desired maturity of the new security for a much longer period (up to 20 years) than would be necessary in the debt area, which may be very disruptive to a legitimate business transaction. Because of these two reasons, an exchange of preferred stock-for-NQPS is subject to different (generally worse, if gain is involved) tax results than an exchange of debt-for-debt. The Committee believes there is no policy reason for this to be the case. Ideally, the Committee would suggest that the Service promulgate regulations treating exchanges similar to those described above as exchanges of NQPS for NQPS under the current NQPS provisions, assuming that it feels it has statutory authority to do so. Alternatively, a partial solution to the problem could be achieved through the promulgation of regulations under Section 1001.

Similar concerns can arise with respect to stock issued before the effective date of the NQPS provisions. For instance, assume preferred stock with a 13-year maturity was issued 8 years ago and is replaced this year with similar preferred stock with a 5-year maturity. Although the 13-year maturity preferred stock was issued before the effective date of the NQPS provisions, the provisions literally apply to "transactions after June 8, 1997."[34] It should therefore be possible to treat

---

[34] Taxpayer Relief Act of 1997, Section 1014(f).

stock issued prior to that date as NQPS, so that the exchange described above could qualify as an exchange of NQPS for NQPS. The Committee would suggest that future regulations confirm this result.

B. Sections 302 and 304.

When a corporation exchanges its own stock for property (other than its own stock or rights to acquire its own stock), Section 302 is applied to determine whether the corporation's distribution of property is to be considered a dividend, or whether it is a payment in exchange for the stock. In cases in which one or more persons control two corporations, and one of the corporations receives stock of the other corporation from that person or persons in exchange for property, Section 304 provides that for purposes of Section 302 the property will be treated (and tested) as a distribution in redemption of the stock exchanged. Because the Service has not yet adopted regulations to the contrary under these provisions, NQPS currently would be treated as stock under Sections 302 and 304 under all circumstances. If no nonrecognition provision applied, the exchange of stock for NQPS would be a taxable sale or exchange.

While we believe that the Service should exercise restraint in adopting regulations prescribing special treatment for NQPS under various sections of the Code, treating NQPS as stock may, in some circumstances, cause a subsequent exchange of NQPS to be subject to the provisions of Sections 302 and 304. For example, if a taxpayer receives NQPS in a transaction in which the NQPS is treated as boot (and may be taxed as a dividend)[35] it may not be appropriate to tax the redemption of that stock in a subsequent transaction as a dividend. The Committee suggests that, although NQPS should generally be treated as stock under Sections 302 and 304, when NQPS was received by a taxpayer in a prior transaction in which it was treated as boot, the Service should provide that NQPS will not be treated as stock for purposes of applying Sections 302 and 304 with respect to that taxpayer.

C. Application of Installment Sale-Type Rules.

1. In general.

Section 351(g)(4) authorizes the Treasury to issue regulations concerning the treatment of NQPS under other Code provisions. The Conference Report states that this includes "regulatory authority to apply installment sale-type rules to [NQPS] in appropriate cases."[36] The extension of installment sale-type rules to NQPS is important to ensure that the receipt of NQPS in a Section 351 transaction or reorganization exchange is treated no worse than the receipt of comparable debt.

To date, no regulatory or other guidance has been issued with respect to installment sale treatment of NQPS. The Conference Report states that "[u]ntil regulations are issued, [NQPS] shall continue to be treated as stock under other provisions of the Code."[37] This statement, in addition to making it fairly clear that

---

35/ See supra Part III.B.

36/ H.R. Conf. Rep. No. 105-220 at 544; '97 Bluebook at 212-13.

37/ H.R. Conf. Rep. No. 105-220 at 544; '97 Bluebook at 212-13.

no installment method deferral is currently available for NQPS, raises concerns that any installment sale-type rules ultimately adopted may not be retroactive.

The absence of regulatory or other guidance on this issue, coupled with concerns over possible non-retroactivity of future guidance, create serious phantom income problems (i.e., tax on the receipt of NQPS, but no receipt of cash with which to pay it) that have induced taxpayers to abandon the use of conventional preferred stock in many circumstances where the use of comparable debt would permit gain deferral under the installment method. As a result, taxpayers often must either substitute debt for preferred stock, or create hybrid preferred securities that include a significant participation feature (and hence, are not treated as NQPS). Either approach may require departing from the parties' desired economics.

To minimize continuing disruption of the private equity market resulting from this issue, we urge the Service to issue promptly a notice or other guidance to the effect that (1) forthcoming regulations will apply the principles of Section 453, Section 453A and Section 453B and the regulations thereunder (including Prop. Reg. Section 1.453-1(f) (1984)) to exchanges of property for NQPS, (2) the regulations will be retroactive to the effective date of Section 351(g), and (3) pending the issuance of the regulations, taxpayers may report gain from the receipt of NQPS in any reasonable manner consistent with the principles of Sections 453, 453A and 453B and the regulations thereunder.

2. <u>Technical Comments</u>.

As indicated above, we suggest that any extension of installment sale-type rules to NQPS be consistent with the principles of Section 453 (including treatment of preferred stock that is payable on demand or readily tradable as receipt of payment), Section 453A (interest-charge and anti-pledging rules), Section 453B (disposition of installment obligations), and the regulations thereunder, including Prop. Reg. Section 1.453-1(f) (installment obligations received in nonrecognition exchanges).

In addition, given the concern expressed in the legislative history regarding the use of debt-like preferred to obtain a tax-free basis step-up at death,[38] the principles of Section 691(a)(4) (treating deferred installment gain as income in respect of a decedent) and Section 691(a)(5) (triggering deferred gain on an installment obligation transferred to the obligor or canceled at death) should apply.

The installment method determines when "gross profit" on the exchange (i.e., "selling price" less basis of property surrendered) is taken into account.[39] For this purpose, "[n]either interest, whether stated or unstated, nor original issue discount, is considered to be part of the selling price."[40] The interest component of installment debt is generally determined under Section 483, and the Original Issue Discount ("OID") rules. Because these rules apply only to debt, extending installment sale-type rules to NQPS requires developing analogous principles to distinguish preferred principal from preferred yield and thereby accurately identify the selling price and gross profit in the exchange.

---

[38] See H.R. Rep. No. 105-148 at 472; '97 Bluebook at 209.

[39] Section 453(c); Temp. Reg. Section 15A.453-1(b)(2).

[40] Temp. Reg. Section 15A.453-1(b)(2)(ii).

Example 1. NQPS is issued in a Section 351 exchange for property with a $20 basis. The NQPS has a principal amount and fair value of $100 and pays a cash dividend of $8 annually, a market rate. If the installment method does not apply, the holder should report (under new Section 351(g)) immediate gain of $80 and, thereafter, dividend income on the preferred yield. If the installment method does apply, (a) the selling price should be $100 and should exclude the stated dividends on the preferred (which are analogous to "stated interest" on an installment note), (b) the gross profit should be $80 (i.e., $100 selling price less $20 tax basis) and should be included in income only when "principal" payments are made on the NQPS, and (c) the stated dividends should be taxed as dividend income (to the extent of earnings and profits under the normal rules of Section 301).

Example 2. Same as the preceding example, except the NQPS is a zero-coupon instrument with a principal amount of $130 and a fair market value at issuance of $100. If the installment method does not apply, the holder should report immediate gain of $80 and, thereafter, dividend income of $30 (equal to the redemption premium on the instrument) on a constant yield-to-maturity basis under Section 305(c) and Treas. Reg. Section 1.305-5(b). If the installment method does apply, (a) the selling price should be $100 and should exclude the $30 redemption premium, (b) the gross profit should be $80 and should be included in income only when payments are made on the NQPS, and (c) the $30 redemption premium should be accrued as dividend income over the life of the instrument under Section 305(c).

Example 3. Same as Example 1, except that the $8 dividend accumulates, no dividends are declared, and the $100 stated value and all accumulated dividends are paid at maturity. Under current law, in contrast to the treatment of interest under the OID or Section 483 imputed interest rules, generally (1) the accumulating but undeclared dividends are not includible in the holder's income until paid at maturity,[41] and (2) to the extent accumulated but undeclared preferred dividends have not previously been includible in the holder's income, any resulting gain on a sale or redemption of the preferred stock is treated as capital gain (assuming Section 302 exchange treatment applies).[42] The timing and character of the yield inclusion, however, should not affect the application of the installment method, which should continue to tax the holder on $80 of gain upon maturity as in Example 1.

All of the above cases would seem to be correctly addressed by a rule similar to Temp. Reg. Section 15A.453-1(b)(2)(ii), which would exclude from the selling price (1) any stated dividends (regardless of the timing and character of their income inclusion under current law) and (2) any redemption premium taken into

---

41/ See Treas. Reg. Section 1.301-1(b) (a dividend generally is includible in income only when it is "unqualifiedly made subject to" the shareholder's demand). This rule applies to both cash and accrual method shareholders. See Tar Products Corp. v. Commissioner, 130 F.2d 866 (3rd Cir. 1942); Commissioner v. American Light & Traction Co., 156 F.2d 398 (7th Cir. 1946); Dynamics Corp. of America v. United States, 392 F.2d 241 (Ct. Cl. 1968). The Treasury, of course, has regulatory authority to change this result under Section 305(c) under appropriate circumstances.

42/ See Rev. Rul. 69-131, 1969-1 C.B. 94; Cummins Diesel Sales Corp. v. United States, 323 F. Supp. 1114 (S.D. Ind. 1971), aff'd, 459 F.2d 668 (7th Cir. 1972).

account under Section 305(c) and Treas. Reg. Section 1.305-5(b). Such a rule, while less sophisticated and comprehensive than the OID and Section 483 imputed interest regime applicable to debt, should work in most cases. Special rules, including a general anti-abuse provision, could be adopted to address anomalous cases. For example, where NQPS is issued at a premium (i.e., its fair market value at issuance exceeds its principal amount), a portion of stated dividends on the preferred might be properly characterized as return of principal.[43] Conversely, whether NQPS is issued at a discount that should be excluded from the selling price and instead amortized under Section 305(c) might be determined by testing the "adequacy" of stated dividends against a base rate such as the applicable federal rate under Section 1274(d).[44]

D. Treatment of NQPS under other sections of the Code.

The distinction in treatment between NQPS and other stock under certain provisions of the Code is one that could theoretically be carried to great length through Treasury regulation. For example, should NQPS be treated as "stock" under Section 267, 318(a)(2), 382, 551, 957, 1504, or the "passive foreign investment company" provisions? The list of potentially affected Code sections is practically endless. In each case, perhaps, arguments can be made that "the type of relatively secure" instrument that NQPS represents should be treated differently then other stock. We urge the Service (1) to confirm that, in the absence of regulations, this

---

[43] Cf. Section 171 (amortizable bond premium); IRS Notice 97-21, 1997-11 I.R.B. 9 (anti-abuse rules concerning certain "fast-pay" preferred).

[44] Cf. Temp. Reg. Section 15A.453-1(b)(2)(ii); Sections 483, 1274.

result will not obtain, and (2) to move cautiously in promulgating any such regulations.