



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Convertible Pure Preferred Stock of Loss Corporation

This Field Service Advice responds to your memorandum dated May 17, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Year1 =
Date1 =
Date2 =
Date3 =
r% =

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ISSUE:

Whether so-called "convertible pure preferred stock" issued by Taxpayer in Year1 should be treated as "stock" of Taxpayer in determining whether, for purposes of I.R.C. § 382(h)(8), 80 percent or more of the stock of Taxpayer was acquired as a result of a series of related transactions that included the issuance of the convertible pure preferred stock.

CONCLUSION:

Under the facts presented, Taxpayer was entitled to elect under Treas. Reg. § 1.382-4(h)(2)(vi) to apply the rules of Temp. Treas. Reg. § 1.382-2T(a)(2)(i) and 1.382-2T(h)(4) for periods prior to May 17, 1994. Accordingly, Taxpayer's convertible pure preferred stock would not be treated as stock for purposes of applying I.R.C. § 382(h)(8) unless doing so would result in an ownership change. In the absence of more information concerning the transaction or transactions surrounding the ownership change in Year1, we are unable to determine whether the convertible pure preferred stock would be treated as stock.

FACTS:

In Year1, Taxpayer issued nonvoting preferred stock that was convertible into its common stock and purportedly elected, pursuant to Treas. Reg. § 1.382-2(b)(2)(ii) and Notice 88-67, to treat such stock as an option. The available information does not indicate precisely how and when Taxpayer made the purported election.

Also in Year1, Taxpayer experienced a change of ownership in which r% of Taxpayer's stock was acquired. According to the available information, an ownership occurred in Year1 without taking into account the convertible preferred stock. The facts related to the transaction or transactions giving rise to the ownership change are not included in your request. However, the available information indicates that, if the convertible preferred stock is treated as stock, more than 80 percent of Taxpayer's stock was acquired in Year1.

LAW AND ANALYSIS

Loss Limitation under Section 382

After amendment by the Tax Reform Act of 1986, I.R.C. § 382(a) generally limits the amount (the "section 382 limitation") of a loss corporation's taxable income in years after an "ownership change" that can be offset against the corporation's loss carryovers and built-in losses. The "section 382 limitation" is defined by I.R.C.

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§ 382(b) as the loss corporation's value (before the ownership change) multiplied by the applicable long-term tax-exempt bond rate (defined in I.R.C. § 382(f)).

A "loss corporation" is defined by I.R.C. § 382(k)(1) as a corporation with a net operating loss or "net unrealized built-in loss" (as defined by I.R.C. § 382(h)(3)). Under I.R.C. § 382(h)(3)(A), a "net unrealized built-in loss" means the amount by which the fair market value of the assets of a loss corporation immediately before an ownership change is less than the aggregate adjusted basis of such assets at that time. However, under the threshold requirement of I.R.C. § 382(h)(3)(B), if the net unrealized built-in loss is not greater than the lesser of (i) 15 percent of the fair market value of the corporation's assets (excluding cash items and certain marketable securities) immediately before the ownership change or (ii) \$10,000,000, then the net unrealized built-in loss is considered to be zero. For purposes of determining the net unrealized built-in loss, I.R.C. § 382(h)(8) provides a cap on the fair market value of the loss corporation's assets if 80 percent or more in value of the stock of the loss corporation is acquired in a single transaction or in a series of related transactions during any 12-month period. In that case, the fair market value of the corporation's assets shall not exceed the grossed up amount paid for such stock, properly adjusted for indebtedness of the corporation and other relevant items.

The pivotal event that triggers the operation of I.R.C. § 382 after 1986 is an "ownership change," which occurs under I.R.C. § 382(g) whenever, immediately after (i) an owner shift involving a 5-percent shareholder or (ii) any equity structure shift, the percentage of stock of the loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.^{1/} As provided in I.R.C. § 382(k)(6)(C), determinations of the percentage of stock held by any person is made on the basis of value. Under I.R.C. § 382(i), the testing period is generally the three-year period ending on the day of any owner shift involving a 5-percent shareholder or equity structure shift.

^{1/} An "owner shift involving a 5-percent shareholder" is any change in the respective ownership of stock of a corporation which affects the percentage of such stock owned by any person who is a 5-percent shareholder before or after such change. I.R.C. § 382(g)(2). An "equity structure shift" is defined in I.R.C. § 382(g)(3) to mean any reorganization (within the meaning of I.R.C. § 368) except for reorganizations described in subparagraph (E) or (G) of I.R.C. § 368(a)(1) not meeting the requirements of I.R.C. § 354(b)(1) or reorganizations described in subparagraph (F) of I.R.C. § 368(a)(1).

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Definition of Stock

The term "stock" is defined in I.R.C. § 382(k)(6)(A) to mean stock other than preferred stock described in I.R.C. § 1504(a)(4), except as provided in regulations and as provided in I.R.C. § 382(e) (relating to the value of the old loss corporation). For purposes of the affiliation requirements of I.R.C. § 1504(a), I.R.C. § 1504(a)(4) provides that the term "stock" does not include stock which (A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (D) is not convertible into another class of stock.

In connection with the definition of "stock," I.R.C. § 382(k)(6)(B) directs the Secretary to issue any necessary regulations to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock. In addition, I.R.C. § 382(l)(3)(A)(iv) states that, except as provided in regulations, an option to acquire stock is treated as exercised if such exercise results in an ownership change. Pursuant to I.R.C. § 382(k)(6)(B), in T.D. 8149, 1987-2 C.B. 85, the Service adopted Temp. Treas. Reg. § 1.382-2T(h)(4), which provides that, solely for the purpose of determining whether an ownership change occurs on a testing date, stock of the loss corporation that is subject to an option is treated as acquired by exercise of the option on that date if such deemed exercise would result in an ownership change. Under section 1.382-2T(h)(4)(v), an interest that is similar to an option is treated as an option. For this purpose, "an interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock."

Convertible Preferred Stock

1. 1987 Temporary Regulation

In the case of convertible preferred stock, the Service has taken opposing positions at various time regarding whether such stock is treated as stock for purposes of I.R.C. § 382. In T.D. 8149, 1987-2 C.B. 85, the Service adopted Temp. Treas. Reg. § 1.382-2T(f)(18)(a), which provided that "the term 'stock' means stock other than stock described in section 1504(a)(4)." Under this definition, any convertible preferred stock would be treated as stock since it would not meet the nonconvertibility feature described in section 1504(a)(4)(D).

2. Notice 88-67

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In Notice 88-67, 1988-1 C.B. 555, the Service announced its intention to issue regulations that would clarify that “convertible pure preferred stock” should be treated similarly to convertible debt (i.e., as an interest that is similar to an option) in determining whether an ownership change has occurred. For this purpose, “convertible pure preferred stock” is stock that, at the time the instrument is issued, would be described in section 1504(a)(4), disregarding paragraph (D) and ignoring the potential participation in corporate growth that the conversion feature may offer. The notice stated that amendments to the temporary regulations would generally be effective for stock issued on or after July 20, 1988, but taxpayers could affirmatively elect to treat the amendments as effective on and after May 6, 1986.

When Notice 88-67 was issued, Temp. Treas. Reg. § 1.382-2T(h)(4) contained the rules for option attribution. The general rule under Temp. Treas. Reg. § 1.382-2T(h)(4)(i), provided as follows:

Solely for the purpose of determining whether there is an ownership change on any testing date, stock of the loss corporation that is subject to an option shall be treated as acquired on any such date, pursuant to an exercise of the option by its owner on that date, if such deemed exercise would result in an ownership change.

Accordingly, under the rule announced by Notice 88-67, convertible pure preferred stock would be treated as converted into common stock on any testing date if such conversion would result in an ownership change on that date.

3. 1992 Proposed Regulations

The amendments described in Notice 88-67 were never issued. Rather, the Service proposed regulations on November 4, 1992, that would generally treat options as not exercised except for an option issued or transferred for an abusive principal purpose. See CO-18-90, Limitations on Corporate Net Operating Loss Carryforwards, 57 Fed. Reg. 52,743 (1992), (proposed Nov. 4, 1992), *reprinted at* 1992-2 C.B. 606, 607-608. In particular, the rulemaking proposed generally to treat convertible stock as stock and not as an option. *Id.* at 607. Acknowledging that the proposed rules differed from those described in Notice 88-67, however, the proposal would apply the rules of Notice 88-67 to testing dates and stock issued on or after July 20, 1988, and before November 5, 1992.

4. 1994 Final Regulations

Final regulations adopted in T.D. 8531, 1994-1 C.B. 121, included Treas. Reg. § 1.382-2(a)(3)(ii), which provides that the term “stock” includes any convertible

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preferred stock. In general, this rule applies with respect to any convertible stock. Treas. Reg. § 1.382-2(b)(2)(i). However, in the case of convertible pure preferred stock issued on or after July 20, 1988, and before November 5, 1992, Treas. Reg. § 1.382-2(b)(2)(ii) provides that such stock is treated as pure preferred stock described in section 1504(a)(4) – i.e., such stock is not treated as stock for the purpose of determining whether an ownership change occurs.

T.D. 8531 also adopted Treas. Reg. § 1.382-4(d), which provides a new rule for options. Under the general rule of Treas. Reg. § 1.382-4(d)(1), an option is not treated as exercised unless it is issued or transferred for an abusive principal purpose. Specifically, Treas. Reg. § 1.382-4(d)(2) provides that, for the purpose of determining whether an ownership change occurs, an option is treated as exercised if it satisfies either an ownership test, a control test, or an income test. This new rule for options generally applies for any testing date on or after November 5, 1992. Treas. Reg. § 1.382-4(h)(2)(i). However, Treas. Reg. § 1.382-4(h)(2)(vi)(A) permits a loss corporation to make an election under which the previous rules of Temp. Treas. Reg. §§ 1.382-2T(a)(2)(i) (relating to testing dates) and 1.382-2T(h)(4) (relating to option attribution), for purposes of determining whether an ownership change occurs, on any testing date on or before May 17, 1994. If a loss corporation makes such an election, Treas. Reg. § 1.382-4(h)(2)(vi)(B)(1) specifies the following consequence:

In determining whether any convertible preferred stock issued by the loss corporation during the period that the election is in effect is treated as stock or as an option, the convertible preferred stock is treated as if it were issued on November 4, 1992

In order to make this election, a loss corporation must attach a statement, as described in Treas. Reg. § 1.382-4(h)(2)(vi)(C), to its income tax return for the first taxable year ending after November 4, 1992, in which a testing date occurs, or if such return is filed on or before May 17, 1994, to the first return filed after May 17, 1994.

Taxpayer's Convertible Pure Preferred Stock

Under the patchwork of rules set forth above, the convertible pure preferred stock issued by Taxpayer in Year1 would be treated as stock under the general rule of Treas. Reg. § 1.382-2(a)(3)(ii), which treats any convertible preferred stock as stock for purposes of making an ownership change determination. However, Taxpayer was entitled to elect under Treas. Reg. § 1.382-4(h)(2)(vi) to apply the rules of Temp. Treas. Reg. §§ 1.382-2T(a)(2)(i) and 1.382-2T(h)(4) for such purposes prior to May 17, 1994. Under such an election, convertible preferred

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stock is treated as if it were issued on November 4, 1992. Accordingly, if Taxpayer made a proper election under Treas. Reg. § 1.382-4(h)(2)(vi), the convertible pure preferred stock that it issued in Year1 would be treated as issued on November 4, 1992, and would be treated as an option pursuant to the rule set forth in Notice 88-67.

Assuming Taxpayer made the election under Treas. Reg. § 1.382-4(h)(2)(vi), the option attribution rule of Temp. Treas. Reg. § 1.382-2T(h)(4)(i) would deem Taxpayer's convertible pure preferred stock to be converted to stock on testing dates in Year1 *if the deemed conversion would result in an ownership change*. Thus, under the option attribution rule that Taxpayer purportedly elected, there would not be a deemed conversion of Taxpayer's convertible pure preferred stock unless such a conversion would result in an ownership change.

According to the facts presented, r% of the stock of Taxpayer was acquired in Year1 without taking into account the convertible pure preferred stock that Taxpayer issued in Year1. Because the acquisition of r% of Taxpayer's stock by one or more 5-percent shareholders in Year1 could result in an ownership change under I.R.C. § 382(g), Taxpayer's convertible pure preferred stock would not necessarily be deemed as converted under Temp. Treas. Reg. § 1.382-2T(h)(4)(i) on the relevant testing date or testing dates. However, without knowing the facts related to the Year1 change of ownership, we are unable to determine conclusively whether Taxpayer's convertible pure preferred stock would be treated as stock.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The available information does not include the facts surrounding Taxpayer's issuance of the convertible pure preferred stock and the ownership change that occurred in Year1. If Taxpayer's stock was acquired in a single transaction, the convertible pure preferred stock would not be deemed converted to stock under Temp. Treas. Reg. § 1.382-2T(h)(4)(i) because the change in ownership of r% would result in an ownership change under I.R.C. § 382(g) without application of the option attribution rule.

On the other hand, if Taxpayer's stock was acquired in more than one unrelated transaction, and if the convertible pure preferred stock was issued before one or more of those transactions, it is possible to envision a scenario in which the convertible pure preferred stock would be deemed converted. For example, assume that A, B, and C did not own any stock of Taxpayer at the beginning of Year1. Assume further that the following acquisitions occurred:

1. Date1: A acquires 45 percent of Taxpayer's common stock.

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2. Date2: B acquire Taxpayer's newly issued convertible pure preferred stock, which would represent 10 percent of Taxpayer's common stock upon conversion.
3. Date3: C acquired 32 percent of Taxpayer's common stock.

If there had been no changes in the ownership of Taxpayer's stock for the three years before Year1, A's acquisition of 45 percent of the common stock on June 1 would not constitute an ownership change. However, under Temp. Treas. Reg. § 1.382-2T(a)(2)(i), B's acquisition of the convertible pure preferred stock on August 1 would be a testing date, and the option attribution rule of Temp. Treas. Reg. §§ 1.382-2T(h)(4)(i) would deem that stock converted because to do so would result in 55 percentage point change in the ownership interest of A and B. C's subsequent acquisition of 32 percent of the stock on December 1 would not result in another ownership change but would mean that a total of 87 percent of the stock was acquired during Year1, more than the 80 percent required under I.R.C. § 382(h)(8).

[REDACTED]

If you have any further questions, please call (202) 622-7930.

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