LEGEND:

Shareholder A =
Shareholder B =
Shareholder C =
Target =
Newco =
Lossco =
a =
b =
c =
Date J =
Date K =
Date L =
Product M =
N =
P =
Q =
R =
ISSUE:

Whether Shareholder A’s receipt of Newco preferred stock, which contains a liquidation preference effective upon Newco’s mandatory liquidation on Date L, is a taxable distribution of stock under § 305(b) and/or § 305(c) of the Internal Revenue Code?

CONCLUSION:

Shareholder A’s receipt of Newco preferred stock is not a taxable distribution of stock under § 305(b) primarily because Shareholder A’s proportionate interest in the assets or earnings and profits of Newco did not increase as a result of the distribution. Shareholder A’s receipt of Newco preferred stock is not a taxable distribution of stock under § 305(c) primarily because the preferred stock participates in corporate growth to a significant extent.

FACTS:

On Date K, Shareholder A was one of three unrelated individuals that collectively owned all the stock of Target. Target was a State X corporation whose outstanding stock consisted of one class of common stock and who was engaged in the business of supplying Product M. Shareholder A owned \( a \) percent of Target’s common stock, Shareholder B owned \( b \) percent of Target’s common stock, and Shareholder C owned \( c \) percent of Target’s common stock.

Target was formed about 7 years before Date K as a C corporation. On Date J, a date a little more than three months before Date K, Target had converted to S corporation status. By Date K, Target’s sole asset was one contract to provide a fixed quantity of Product M to one customer at a fixed price (the Target contract). The Target contract was due to expire on Date L, a date a little more than ten years after Date K.
Target has entered into hedging contracts to purchase Product M during the term of the Target contract, creating stable net income of approximately $P per year. On Date K, the estimated present value of the Target supply contract was $S.

Shortly after Date J, Lossco contacted Target to discuss a possible combination. Lossco is a publicly traded corporation with net operating loss carryovers. On Date K, Target restructured and Lossco acquired an interest in Target in the following steps of an integrated transaction:

1. Target recapitalized. Shareholders A, B and C purchased additional shares of Target common stock for $N. The shareholders’ ownership percentages remained unchanged.

2. Shareholders A, B and C created Newco, a State Y corporation, by transferring $Q to Newco in exchange for shares of Newco common stock. Shareholders A, B and C each held Newco common stock in the same percentage as their Target stockholdings.

Newco’s articles of incorporation require that Newco liquidate on Date L. Changing the articles of incorporation requires the consent of 85 percent of the outstanding voting common stock. Newco cannot declare a dividend on its common stock until it has funds sufficient to satisfy the preferred stock liquidation preference discussed in step 3.

3. Target merged with and into Newco pursuant to state law. The outstanding Target common stock converted into Newco preferred stock.

The Newco preferred stock is nonvoting, nonconvertible, receive no dividends and has a preference upon liquidation contingent upon the value of Newco’s assets on Date L. Shortly before Date K, Newco’s investment advisors estimated that, based upon an estimated value of $S for Newco, an unrelated third party purchaser of the Newco preferred stock would require that the preferred stock carry an aggregate liquidation preference of $T. Accordingly, Newco’s articles of incorporation provide that all Newco assets, up to $T, that are available for distribution to the Newco shareholders upon liquidation shall be distributed to the Newco preferred shareholders prior to any distribution to the Newco common shareholders. Newco cannot declare a dividend with respect to its common stock until it has funded the $T preferred stock liquidation preference. On Date K, neither Target nor Newco had earnings and profits.

4. Lossco purchased R shares of Newco common stock, which represent 80 percent of the outstanding shares of Newco common stock, from Newco in exchange for cash in the amount of $U and a note with a face value of $V. The note requires semi annual interest payments at a rate of W percent by Lossco and a balloon payment on Date L equal to the amount of unpaid principal and interest.

Shareholders A, B and C, collectively, have an option to purchase the Newco common
stock held by Lossco upon their payment to Lossco of the greater of the fair market value of the shares or the balance of the principal and accrued interest on the note. Immediately after Lossco’s purchase, Newco joined in the filing of a consolidated federal income tax return with Lossco and the other members of Lossco’s affiliated group. Pursuant to their tax sharing agreement, Newco pays to Lossco the amount of taxes Newco would owe if they filed separately.

**LAW AND ANALYSIS:**

Ordinarily, a distribution of property made by a corporation to a shareholder with respect to its stock is taxed according to § 301(c). Section 305(a) provides an exception to the taxation of distributions to shareholders under § 301(c) by providing that gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

Section 305(b) eliminates the exclusion from gross income contained in § 305(a) for distributions of stock that meet the requirements of paragraph (1), (2), (3), (4) or (5) of § 305(b). Section 305(b)(1) applies to distributions payable, at the election of any shareholders, either in stock or property. Section 305(b)(2) applies to disproportionate distributions in which the distribution has the effect of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Section 305(b)(3) applies to the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders. Section 305(b)(4) applies to distributions with respect to preferred stock. Section 305(b)(5) applies to a distribution of convertible preferred stock that have the effect of distributions described in § 305(b)(2).

An actual distribution of stock is not always necessary in order for a transaction to be taxed as a distribution of property to which § 301 applies. Section 305(c) can treat certain described circumstances as a deemed distribution of stock. Under § 305(c), a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price (i.e., a redemption premium), a redemption that is treated as a distribution to which § 301 applies, or any other transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to a shareholder where the distribution has the result described in paragraph (2), (3), (4) or (5) of § 305(b). Section 1.305-7(a).

Such distribution will only be deemed to be made with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction. Such distribution will be deemed to be a distribution of stock of the corporation to such shareholder with respect to his stock. Where, for example, a redemption premium exists with respect to a class of preferred stock under the circumstances described in § 1.305-5(b) and the other requirements of § 1.305-7(a) are also met, the distribution will be deemed made with respect to such preferred stock, in stock of the same class.
Accordingly, such preferred shareholders are considered under § 305(b)(4) and § 305(c) to have received a distribution of preferred stock to which § 301 applies. Section 1.305-7(a).

Application, § 305(b)

We believe § 305(b)(2) is the only possible avenue for applying § 305(b) to the distribution of the Newco preferred stock to Shareholder A. Section 305(b)(2) applies to distributions having the result of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

Before the Date K transaction, Shareholders A, B, and C owned 100 percent of the outstanding stock of Newco. In the Date K transaction, they received, pro rata, 100 percent of the Newco preferred stock and their common stock interest was reduced to 20 percent of the outstanding Newco common shares. Section 305(b)(2) does not apply to Shareholder A, B, or C because they did not increase their proportionate interest in the assets or earnings and profits of Newco in the transaction, either as a class of shareholders or relative to each other. See § 1.305-3(e), examples 1 and 2, which demonstrate that § 305(b)(2) does not apply to a distribution of additional common stock to a corporation’s common shareholders and property to the corporation’s preferred shareholders because the distribution does not increase the common shareholders’ proportionate interest, as a class, in the assets or earnings and profits of the corporation.

Perforce, the other exceptions under § 305(b) also are not satisfied. There is no evidence that the distribution of Newco preferred stock was payable in either stock or property, as required by § 305(b)(1).

Section 305(b)(3) is not satisfied because the transaction did not involve the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders. The Newco common shareholders, Shareholders A, B and C, received only preferred stock in the distribution.

Section 305(b)(4) is limited to distributions with respect to preferred stock. Prior to the distribution of Newco preferred stock, there were no Newco preferred shareholders with respect to which a distribution could be made.

Section 305(b)(5) requires a distribution of convertible preferred stock. The Newco preferred stock is nonconvertible preferred stock.

Application, § 305(c)

Section 305(c) reflects the principle that income from a financial instrument that
is payable on a deferred basis generally is better measured by requiring the accrual of such income on an economic basis over the period during which payment is deferred. H.R. Rep. No. 881, 101st Cong., 2nd Sess. at 98 (1990). Congress expressed its intention to not limit the authority of the Secretary and the IRS regarding the proper treatment of redemption premiums on preferred stock. Thus, the Secretary may determine what constitutes a redemption premium (or a disguised redemption premium). For example, if at the time of issuance of cumulative preferred stock there is no intention for dividends to be paid currently, the IRS may treat such dividends as a disguised redemption premium. H.R. Rep. No. 881, 101st Cong., 2nd Sess. at 99 (1990).

Shareholder A’s receipt of Newco preferred stock containing a liquidation preference greatly in excess of its issue price and with a mandatory liquidation date arguably should be treated as a difference between redemption price and issue price for purposes of § 305(c). If this redemption premium (assuming an ascertainable sum certain was assigned to the contingent liquidation right), is viewed as a deemed distribution with respect to Newco preferred stock, the deemed distribution is treated as a distribution of property to which § 301 applies. Section 1.305-5(a). As such, Newco is treated as having made deemed periodic distributions to its preferred shareholders with respect to their preferred stock under principles similar to those of § 1272(a) if the distribution has the result described in § 305(b), in addition to satisfying certain other requirements. Section 1.305-5(b).

Section 305(b)(4) is the most likely avenue for applying § 305(b) to a deemed distribution with respect to Newco preferred stock. A deemed distribution under § 305(b)(4) with respect to Newco preferred stock takes the form of a § 301 distribution of additional shares of Newco preferred shares to the Newco preferred shareholders. Section 1.305-7(a). Section 305(b)(4), however, is restricted to distributions with respect to preferred stock that has limited privileges and does not participate in corporate growth to any significant extent. Section 1.305-5(a). Because the preferred stock liquidation preference is based upon the value of the available Newco assets on Date L, up to $T, we believe the Newco preferred stock is not limited in its preferences or participation in corporate growth. Furthermore, because the preferred stock liquidation preference exceeds the current value of Newco’s assets and the value of all assets Newco is likely to accumulate by Date L, the Newco preferred stock significantly, if not entirely, participates in Newco’s growth.

The remaining exceptions under § 305(b) are also not satisfied. A deemed distribution under § 305(b)(2) must have the effect of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. This transaction does not involve a distribution of property to any Newco shareholders in their capacity as shareholders. Section 1.305-3(b)(3).
In addition, a deemed distribution of additional shares of Newco preferred stock to the preferred shareholders would not increase the preferred shareholders’ proportionate interest in the assets or earnings and profits of Newco. Prior to such deemed distribution, Shareholders A, B and C owned 100 percent of the Newco preferred stock. The Newco preferred stock participates in the $T preferred stock liquidation preference as a class. A deemed pro rata distribution of additional Newco preferred shares to Shareholders A, B and C would not affect their proportionate interest in the preferred stock liquidation preference or the size of the liquidation preference to be divided among the preferred shareholders and, thus, would not increase their proportionate interest in the assets or earnings and profits of Newco, as required.

Section 305(b)(3) requires the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders. The deemed §305(c) distribution takes the form of a §301 distribution of additional Newco stock to the Newco preferred shareholders. Section 1.305-7(a). Therefore, the deemed distribution does not satisfy the requirements of §305(b)(3).

Section 305(b)(5) requires a distribution of convertible preferred stock. The underlying stock in the deemed distribution is Newco nonconvertible preferred stock. As a result, there is no basis for deeming a distribution of convertible stock. Section 1.305-7(a).

Therefore, even if we treat the Newco preferred stock liquidation preference as a redemption premium, §305(c) does not apply to the transaction.

CAVEAT

We express no opinion concerning the federal income tax treatment of the transaction under other provisions of the Code or Regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings.

This Technical Advice Memorandum addresses the tax consequences of the transaction under §305 for Shareholder A, his wife and Target. We express no opinion as to the tax consequences of the transaction for any other parties to the transaction. In particular, we express no opinion concerning the effect of §269 on the parties to the transaction or whether Lossco and Newco are members of an affiliated group within the meaning of §1504(a)(4). For example, we express no opinion as to whether the Newco preferred stock constitutes stock for purposes of §1504(a).

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.