

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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subject: Whether preferred stock may be treated as common stock for purposes of I.R.C.  
section 302(b)(2)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Purchaser =

Business A =

Date 1 =

a =

b =

c =

d =

e =

### ISSUE

Whether the preferred stock described below should be treated as common stock for purposes of section 302(b)(2).

### CONCLUSION

The preferred stock in question is not limited or preferred as to dividends, it is not limited as to liquidating distributions, and it allows the holder thereof to participate in corporate growth to a significant extent. Moreover, there appears to be a real and meaningful likelihood that the holder will so participate. Thus, the preferred stock should be treated as common stock for purposes of section 302(b)(2).

### FACTS

Taxpayer is a closely held company that is engaged in Business A. Taxpayer is a profitable company that paid dividends (totaling approximately \$a) over three of the four years preceding the Transaction (defined below).

On Date 1, Taxpayer consummated a recapitalization transaction comprised of several steps (the "Transaction").<sup>1</sup> First, Taxpayer issued b shares of voting convertible preferred stock ("VCPS") to unrelated Purchaser in exchange for \$c. Second, pursuant to an exchange offer (the "Exchange Offer"), Taxpayer redeemed b of its d outstanding shares of common stock for approximately \$e in total consideration.

Under the terms of the VCPS, Purchaser is entitled to receive a dividend on each share of VCPS in an amount equal to the per-share dividend (if any) declared on Taxpayer's common stock. The VCPS are non-cumulative (i.e., unpaid dividends do not accrue). Upon Taxpayer's liquidation, Purchaser is entitled to receive a premium equal to the purchase price for the shares; thereafter, Purchaser will share in liquidation proceeds to the same extent as common shareholders. The VCPS also are voting shares, although they are subject to a partial and temporary voting restriction. Finally, each VCPS share is convertible into one share of a newly authorized class of common stock at Purchaser's election.

Taxpayer's non-U.S. shareholders treated the redemption of their common stock in the Exchange Offer as an exchange under section 302(b)(2). You have asked us to

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<sup>1</sup> This CCA does not address the federal income tax treatment of other transactions that may be considered part of the Transaction.

consider whether, for purposes of the section 302(b)(2) analysis, the VCPS should be treated as common stock.<sup>2</sup>

### LAW AND ANALYSIS

Section 302(a) provides that if section 302(b)(1), (2), (3), (4), or (5) applies to a corporation's redemption of its stock, then the redemption shall be treated as a distribution in part or full payment in exchange for the stock.

A redemption will be treated as an exchange under section 302(b)(2) if the distribution is substantially disproportionate with respect to the shareholder. Section 302(b)(2) further provides, in part, that a distribution in redemption of a shareholder's stock is substantially disproportionate only if the shareholder has a greater-than-20-percent reduction in its proportionate interest in both the voting stock and the common stock (whether voting or non-voting) of the corporation.

In determining whether the VCPS should be treated as common stock for purposes of section 302(b)(2), the fact that these shares are labeled "preferred stock" is one factor to consider, but it is neither the sole factor nor the controlling factor. See, e.g., *Est. of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1972) (listing 13 factors to consider in conducting a "debt versus equity" analysis, including the name given to the financial instrument).

Neither the Internal Revenue Code of 1986, as amended (the "Code") nor the Treasury regulations define the term "common stock." Several statutory or regulatory provisions within Subchapter C or the affiliated group rules do define the term "preferred stock," however. We believe that, for purposes of section 302(b)(2), "common stock" should include those types of stock that do not fall within the definition of "preferred stock."

By their terms, the VCPS contain no dividend limitation or preference; instead, holders thereof are entitled to receive dividends if and to the extent that common shareholders do so. In this regard, the VCPS differ from "preferred stock" as defined in the Code. See, e.g., section 305(e)(5)(B) (defining preferred stock as stock that is, among other features, "limited and preferred as to dividends"); section 351(g)(3)(A) (the term "preferred stock" means "stock which is limited and preferred as to dividends..."); section 1504(a)(4) (defining certain preferred stock as stock that is, among other features, "limited and preferred as to dividends"). After receiving a liquidation premium equal to the purchase price for the VCPS (with no additional premium for any unpaid dividends), VCPS holders also are entitled to share in liquidation proceeds to the same extent as common shareholders. In contrast, see section 305(e)(5)(B) (listing a "fixed redemption price" as a feature of preferred stock).

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<sup>2</sup> This CCA does not address other facets of the section 302(b)(2) analysis or the application of section 302(b)(1) to the stock redemption.

The terms of the VCPS thus allow holders thereof to participate in corporate growth to a significant extent. Moreover, there appears to be a real and meaningful likelihood that holders will participate in corporate growth, for Taxpayer is profitable and paid dividends in three of the four years preceding the Transaction. In this regard as well, then, the VCPS differ from “preferred stock” as defined in the Code and in Treasury regulations. See, e.g., section 351(g)(3)(A) (the term “preferred stock” means stock that “does not participate in corporate growth to any significant extent. Stock shall not be treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.”); § 1.305-5(a) (“The term preferred stock generally refers to stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges...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.”); see also Rev. Rul. 81-91, 1981-1 C.B. 123 (“[S]tock is other than “common stock” for purposes of section 306 not because of its preferred position as such, but because the preferred position is limited and the stock does not participate in corporate growth to any significant extent.”).

We conclude that, since the VCPS has no dividend preference and is not limited as to dividends or liquidating distributions, but rather participates in corporate growth to a significant extent (and there is a real and meaningful likelihood of such participation), the VCPS should be treated as common stock for purposes of section 302(b)(2).

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Our Office does not believe there are significant hazards with respect to the conclusion that, under the circumstances described herein, the preferred stock should be treated as common stock for purposes of section 302(b)(2).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-7750 if you have any further questions.