COMMENTS CONCERNING THE PRESIDENT’S PROPOSAL TO CLARIFY THE DEFINITION OF NONQUALIFIED PREFERRED STOCK

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These comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility was exercised by Lisa M. Zarlenga. Substantive contributions were made by John P. Barrie, Erik H. Corwin, Stuart J. Offer, Mark J. Silverman, and Robert H. Wellen. The Comments were reviewed by Joseph M. Pari of the Section’s Committee on Government Submissions and by Terrill A. Hyde, Council Director for the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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COMMENTS ON THE PRESIDENT’S PROPOSAL TO CLARIFY
THE DEFINITION OF NONQUALIFIED PREFERRED STOCK

Executive Summary

Nonqualified preferred stock (“NQPS”) is treated as boot for purposes of several of the Code’s nonrecognition provisions. NQPS is defined as stock that (i) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, and (ii) has a dividend rate that varies with reference to an index, or, in certain circumstances, a put right, a call right, or a mandatory redemption feature. We believe that legislative action to clarify the definition of NQPS, as proposed by the Administration, is inappropriate and that administrative guidance is preferable.

We recommend that Treasury look to Treas. Reg. § 1.305-5(a) for guidance in defining meaningful participation in corporate growth through dividend and liquidation rights. However, another means for participating in corporate growth -- conversion rights -- is disregarded by Treas. Reg. § 1.305-5(a). We believe that disregarding all conversion rights in the section 351(g) context is inappropriate and inconsistent with the provision’s legislative intent. Conversion rights should instead be taken into account along with other relevant facts and circumstances in determining whether particular instruments are properly treated as NQPS.

General Background

The Taxpayer Relief Act of 1997 (“TRA 1997”) amended sections 351, 354, 355, 356, and 1036 to provide that NQPS is treated as property other than stock (i.e., as boot).

NQPS is defined in section 351(g)(2) as “preferred stock” that meets one of four conditions:

1. the holder of the stock has the right to require the issuer or a related person to redeem or purchase the stock (i.e., a put right);

2. the issuer or a related person is required to redeem or purchase such stock (i.e., mandatory redemption);

3. 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 that such right will be exercised (i.e., a call right that is more likely than not to 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 if the right or obligation referred to therein may be exercised within 20 years of the stock’s issuance, and such right or obligation is not subject to a contingency that, as of the issue date, makes remote the likelihood of redemption or purchase.
“Preferred stock” is defined as stock that is “limited and preferred as to dividends and does not participate in corporate growth to any significant extent.” Section 351(g)(3)(A). The legislative history refers to the role of a conversion privilege in determining whether stock qualifies as preferred stock under this test, stating that “[t]he 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.” H.R. Conf. Rep. No. 105-220, at 545 (1997).1

Once stock is classified as NQPS, it is treated as boot for purposes of taxing the recipient in transactions otherwise qualifying as tax free under sections 351, 354, 356, and 1036. However, until regulations are issued, the NQPS is treated as stock for all other purposes of the Code. H.R. Conf. Rep. No. 105-220, at 544.

The statute authorizes the Secretary to prescribe regulations “as may be necessary or appropriate to carry out the purposes” of sections 351(g), 354(a)(2)(C), 355(a)(3)(D), and 356(e). Section 351(g)(4). The Secretary is also granted authority to prescribe regulations, consistent with those sections, for the treatment of NQPS under other provisions of the Code. Id.

Proposal to Clarify the Definition of NQPS

In its fiscal year 2001 budget proposal, the Administration proposes to “clarify the definition of preferred stock to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and growth of the corporation is included.” Department of the Treasury, General Explanations of the Administration’s Fiscal Year 2001 Revenue Proposals, at 152 (Feb. 2000). The change is intended to prevent taxpayers from avoiding the characterization of certain instruments as NQPS by including illusory participation rights or including terms that create an “unlimited” dividend. Id. The Joint Committee on Taxation cites two examples of the targeted instruments:

1. A corporation that does not pay dividends either to its common or preferred shareholders may create instruments that have a preference on liquidation, but that are entitled to the same dividends as may be declared on common stock (but there are not expected to be any).

2. A corporation issues stock that entitles the holder to a dividend equal to the greater of seven percent or whatever the common shareholders receive, and in practice, the common shareholders are not expected to receive dividends greater than seven percent.

Staff of the Joint Committee on Taxation, 106th Cong., Description of Revenue Provisions Contained in the President’s Fiscal Year 2001 Budget Proposal 375 (Comm. Print 2000). The Joint Committee on Taxation description also notes that consideration should be given to

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1 The legislative history of section 351(g) also provides that stock that is convertible into stock of a corporation other than the issuer is not considered stock that participates in corporate growth to any significant extent. H.R. Conf. Rep. No. 105-220, at 545. In these comments, we refer only to conversion rights into stock of the issuer.
whether it is desirable to clarify the definition of preferred stock in other areas of the Code where a similar definition appears.

Discussion of Proposal

Guidance in other areas. As discussed above, the definition of preferred stock is critical to the application of section 351(g). For this purpose, preferred stock is defined as stock that is “limited and preferred as to dividends and does not participate in corporate growth to any significant extent.” Section 351(g)(3)(A). This definition tracks the language in section 1504(a)(4)(B), which describes stock that is disregarded in determining affiliation. See also Treas. Reg. § 1.305-5(a) (providing rules for distributions on preferred stock); Rev. Rul. 75-236, 1975-1 C.B. 106 (defining section 306 stock).

Although there is only limited guidance as to the meaning of the phrase “limited and preferred as to dividends and does not participate in corporate growth to any significant extent,” such guidance does exist. For example, Treas. Reg. § 1.305-5(a) adopts a 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

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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.

(Emphasis added).

In P.L.R. 8952046 (Oct. 2, 1989), for example, a cooperative association had issued and outstanding both common stock and nonvoting preferred stock. A coop shareholder could hold only one share of common stock. In order to sell their products to the coop, members were required to purchase preferred stock. The ownership of preferred stock was limited to common shareholders. The coop distributed its patronage net income to its shareholders based on the amount of products provided by each shareholder. The coop did not distribute earnings other than patronage earnings. The preferred stock was entitled to priority upon liquidation to the extent of its par value. The Internal Revenue Service (the “Service”) ruled that the preferred stock would be treated as common stock under Treas. Reg. § 1.305-5(a).

Courts have considered the meaning of the phrase “limited and preferred as to dividends” in the context of determining affiliation for purposes of section 1504(a). The courts have split, however, on whether to look only to the terms of the stock (as provided in the stock certificate or any other collateral agreements) or to the dividends actually paid during a particular period.²

For example, in Pioneer Parachute Co. v. Commissioner, 162 F.2d 249 (2d Cir. 1947), the terms of the Class B stock provided for noncumulative annual dividends at a rate of $.25 per share. However, pursuant to collateral agreements between the issuer and certain holders of Class B stock, the issuer promised to pay an additional dividend on the Class B stock equal to two-thirds of the dividend (if any) it paid on the common stock. The court held that the Class B stock would vary with the success of the business and the declaration of common dividends. Thus, the stock did not constitute preferred stock and precluded affiliation. The court specifically rejected the taxpayer’s argument that since no dividends were actually declared on the common stock during the period in question, the stock was in fact limited and preferred as to dividends, and the mere possibility that the holders might have received more does not prevent the stock from being preferred stock. See also United States v. Liberty Baking Corp., 25 F. Supp. 203 (S.D.N.Y. 1938). The Service adopted this view in Rev. Rul. 79-21, 1979-1 C.B. 290, in which it ruled that participating preferred stock is not limited and preferred as to dividends for purposes of section 1504(a).

² Although the case law predates 1504(a)(4)(B), it still appears relevant in the context of section 351(g) and the Administration’s proposal. The case law interprets "limited and preferred as to dividends," which appears in both sections 351(g) and 1504(a)(4)(B). Further, the addition to section 1504(a)(4)(B) of the language “and does not participate in corporate growth to any significant extent” did not seem to address the split in the courts (discussed below) as to whether you look to only the terms of the stock or to dividends actually paid. The Administration's proposal refers to meaningful participation in "earnings and growth" (emphasis added), which implies that its focus is on the entire phrase "limited and preferred as to dividends and does not participate in corporate growth to any significant extent."
Other courts have adopted the view that the dividends actually paid during a period are determinative of whether stock is limited and preferred as to dividends rather than the mere possibility that the stock might have received larger dividends during such period. For example, in Erie Lighting Co. v. Commissioner, 93 F.2d 883 (1st Cir. 1937), a class of preferred stock was entitled to an annual dividend of $2 per share. In addition, if such dividend were paid, and if the common stock received a dividend of $2 per share, then the two classes would share equally in any other dividends. The court held that because the corporation paid only the fixed $2 dividend per share on the preferred stock during the period, the stock was treated as limited and preferred as to dividends for the period in question. See also Vermont Hydro-Electric Corp. v. Commissioner, 29 B.T.A. 1006 (1934).

Analysis of Proposal. The Administration’s proposal to “clarify” the definition of preferred stock to ensure that only stock for which there is not a real and meaningful likelihood of actually participating in the earnings and growth of the corporation is included is intended to prevent taxpayers from avoiding the characterization of certain instruments as NQPS by including illusory participation rights. Although we do not know specifically how the Administration proposes to clarify the definition of preferred stock, we agree with the premise that taxpayers should not be permitted to avoid section 351(g) by including participation rights that lack substance.

However, the concept of real and meaningful participation rights is necessarily a fact intensive one, which requires a flexible rule. We believe that formal codification of such a rule is inappropriate and that administrative guidance in the form of regulations and/or rulings is preferable. Such guidance would be an appropriate exercise of the ample regulatory authority provided in section 351(g)(4). If the Administration is concerned with conflicting case law, the appropriate legislative response would be a directive to issue regulations. Moreover, issuing guidance in the form of regulations could mitigate the existence of potentially inconsistent definitions of the term “preferred stock” in the Code, or, as suggested by the Joint Committee on Taxation, the need to clarify the definition of preferred stock in other areas of the Code where a similar definition appears. We recommend that Treasury consider issuing consistent guidance under section 1504(a)(4)(B) so that similar rules apply to both sections 351(g) and 1504(a). It would be helpful if any such guidance would provide specific examples to illustrate what constitutes real and meaningful participation rights. See New York State Bar Association Tax Section, Report on Recently Enacted Nonqualified Preferred Stock Provisions (March 21, 1998) (also suggesting the need for illustrative examples) (hereinafter “NYSBA Report”).

Treasury and the Service have previously considered the issue of illusory participation rights in regulations that could be applied in the context of NQPS. Treas. Reg. § 1.305-5(a) provides the following test:

[S]tock ... which is entitled to participate ... 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.

By adopting a reasonable anticipation approach, the section 305 regulations appear to fall in between the two lines of cases under section 1504 -- they do not look solely to the terms of the preferred stock (as does the Pioneer Parachute line of cases), nor do they look to the amount of dividends actually paid (as does the Erie Lighting line of cases).

Although a reasonable anticipation approach may work in some cases to prevent taxpayers from avoiding characterization of instruments as NQPS, it may be difficult to apply in other cases. For example, where a company has historically paid substantial dividends, it may be reasonable to anticipate that the company will continue to pay similar amounts in the future. On the other hand, where the company is a start-up company with no dividend history, a reasonable anticipation test is more difficult to apply. We recommend a facts-and-circumstances approach similar to Treas. Reg. § 1.305-5(a), except that, instead of being the ultimate determination, reasonable anticipation would simply be one factor to consider.

However, we believe that the treatment of conversion privileges under Treas. Reg. § 1.305-5(a) is inappropriate and inconsistent with the purpose and legislative intent of section 351(g). See NYSBA Report (reaching a similar conclusion with respect to conversion rights). Treas. Reg. § 1.305-5(a) disregards conversion rights in determining whether stock is preferred for purposes of section 305. Although it may arguably be appropriate to disregard a conversion feature in determining whether a redemption premium could include a disguised dividend, a conversion feature should not automatically be disregarded in determining whether stock participates in corporate growth so as not to constitute boot. Section 305(b)(4) (to which Treas. Reg. § 1.305-5 relates) treats certain stock distributions with respect to preferred stock as taxable distributions. Congress enacted this provision because it concluded that, since preferred stock characteristically pays specified cash dividends, all stock dividends thereon are merely substitutes for cash dividends and should be taxable. See H.R. Rep. No. 91-413 (Part 1), at 113 (1969); S. Rep. No. 91-552, at 151 (1969); Staffs of the Joint Committee on Taxation and Committee on Finance, Summary of H.R. 13270, The Tax Reform Act of 1969 63 (Comm. Print 1969). The focus of section 305 is thus on the dividends paid on the preferred stock. Section 351(g) was enacted for a very different reason. Congress was concerned that investors were exchanging relatively risky assets also having upside gain potential for relatively secure, debt-like instruments with little or no upside gain potential in tax-free transactions. Congress believed that the receipt of such forms of investment should be viewed as taxable consideration because of their similarity to debt. H.R. Rep. No. 105-148, at 472 (1997). Preferred stock that is convertible into common stock presents similar risks, and has similar potential for upside gain, as the common stock and thus should not be treated as boot, unless such risks and upside gain potential are insignificant or illusory.

The type of stock commonly issued to venture capitalists provides an example of stock that meaningfully participates through a conversion feature. The typical venture capital preferred has a liquidation preference, but otherwise shares all risks and benefits of common stock. It is mandatorily convertible into common stock at the time of a qualifying event, such as an initial public offering, but is otherwise perpetual in term. The stock frequently has
antidilution provisions, ensuring an even greater likelihood that it will participate in corporate growth. In fact, the antidilution provisions generally are more favorable to the preferred stock than countenanced by section 305, so that an adjustment under the provisions could be taxable as a dividend in the unlikely event that the company has earnings and profits. As the issuing company generally does not pay dividends on any of its stock, the dividend rights provided in the preferred stock are, at the outset, often substantively meaningless. Even if the dividend rights are meaningless, however, the right to participate in corporate growth by reason of the conversion privilege is not meaningless. Thus, any regulatory or ruling guidance should clearly provide that this type of preferred stock is not NQPS. Any other result would be totally inconsistent with the economic bargain of the parties, which clearly ties the return on the preferred to the growth of the company’s business.

This conclusion is consistent with the legislative history of section 351(g), which suggests that meaningful conversion rights should constitute participation in corporate growth. 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.” H.R. 2014, § 1022(a). The Conference Committee removed the parenthetical phrase in response to concerns about illusory conversion rights, stating in the legislative history that “in no event will a conversion privilege automatically be considered to constitute participation in corporate growth to any significant extent.” H.R. Conf. Rep. No. 105-220, at 545 (emphasis added). The Conference Committee was clearly concerned that, as with dividend rights that lack substance, conversion rights that lack substance should not confer meaningful participation, a position with which we agree. Nevertheless, the Conference Committee’s statement contemplates that, in appropriate cases, conversion rights can and should be viewed as providing the requisite degree of participation in corporate growth. See NYSBA Report (discussing the legislative history regarding conversion rights).

In short, we believe that administrative guidance, rather than legislation, is the appropriate way to address participation rights that lack substance. Such guidance should adopt a facts-and-circumstances approach that considers, among other things, the existence of meaningful conversion rights.