Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Applicability of Section 351(g)

LEGEND

Taxpayer or P	=	
Sub 1	=	
Sub 2	=	
Shareholder	=	
Bank	=	
<u>a</u>	=	
<u>b</u>	=	
<u>c</u>	=	
Tax Year 1	=	

Tax Year 2 =

Tax Year 3 =

This memorandum responds to your request for Chief Council Advice regarding the subject taxpayer. All section references are to the Internal Revenue Code of 1986 (the Code) and the regulations thereunder. This Chief Counsel Advice may not be used or cited as precedent.

ISSUE

You have requested legal advice regarding whether a taxpayer is entitled to a long term capital loss on the sale of certain Class A stock, as described in your request and generally below, of the taxpayer's subsidiary. The answer turns in part on whether the Class A stock is nonqualified preferred stock within the meaning of section 351(g)(2)(A) of the Code.

CONCLUSION

Based on the facts as presented in your request and subsequently supplemented, the Class A stock is nonqualified preferred stock within the meaning of section 351(g)(2)(A).

FACTS

Taxpayer (also referred to as P) is a domestic corporation and the common parent of a group of corporations that file a consolidated federal income tax return. Sub 1 is a member of the P consolidated group.

In your legal advice request, the transactions described are P's acquisition of all of the stock of Sub 2 from a third party and a few years later P's contribution of all the stock of Sub 2 to Sub 1 in exchange for shares of Sub 1's Class A Stock, Class B stock, and Sub 1's note payable (Note). The Note was issued under a credit agreement among Sub 1, P (as the initial lender), and the Bank (as the administrator). In Tax Year 1, P sold the Note to Bank for face value and sold the Class A stock to Shareholder for $a. Shareholder charged a fee and required collateral for the transaction due to concerns about Sub 1's financial health and structured the deal with a view towards a potential bankruptcy of Sub 1.

Features of the Class A and Class B Stock

The Class A stock is described as entitling the holder to elect one member to the board of directors and is ranked senior to the Class B stock and the common stock in dividend payments and at liquidation. Quarterly dividends, if declared, were payable based on varying percentages. The stock contained a floating rate dividend that was indexed to LIBOR and payable only if preferred dividends or participating dividends were in arrears. For the life of the Class A stock, the floating rate dividend has not been owed or paid.

As described by the taxpayer, the participating dividends are those which provide for a payment to be made to a Class A shareholder if, and only if, dividends are paid on the common stock of Sub 1. The amount is determined by multiplying dividends paid on the common stock by a fixed percentage. In Tax Year 2, Sub 1 accrued an amount as a participating redemption premium but determined that its cash-flow projections, growth-rate forecast, and revenue estimates were overstated. Thereafter, Sub 1 did not accrue a participating redemption premium. During Tax Year 3, Sub 1 made a payment to Shareholder and maintains that the payment was a participating dividend; however, no dividends were paid on the common stock.

At liquidation, dissolution, or winding up of the business, a Class A shareholder is entitled to the stated value of the Class A stock, any dividends in arrears, and what Taxpayer describes as a participating redemption premium computed at a fixed percentage multiplied by any appreciation in Sub 1's common stock.

The Class B stock is described as voting preferred stock with mandatory and optional redemption features, a remarketing option, and is senior in rank to the common stock but is junior in rank to the Class A stock in dividend payments and upon liquidation.

Taxpayer's classification of the Class A and Class B stock

Taxpayer treats the Class A stock as permitted property under section 351(a) and not as "other property" under section 351(b). Taxpayer claims the Class A stock participates in the growth of Sub 1 to a significant extent and is not preferred stock within the meaning of section 351(g)(3)(A) because it has a participating redemption premium and a participating dividend. Taxpayer treats the Class B stock as nonqualified preferred stock within the meaning of section 351(g)(2)(A) because it is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, within the meaning of section 351(g)(3)(A).

Taxpayer retained financial advisors to prepare valuation studies of the stock, finding that the Class A stock would yield approximately b percent over its life, based on estimates of the preferred dividends that may be paid on the stock. The rate also included an estimate of a negligible amount for the “participating dividends” at a rate of c percent per year.

Tax reporting of the transactions

In Tax Year 1, taxpayer reported the contribution of Sub 2 to Sub 1 as an exchange under section 351(a), treating the Class A stock as preferred stock other than nonqualified preferred stock within the meaning of section 351(g)(2)(A), and the Class B stock and Note as "other property" (i.e., boot). Taxpayer calculated the basis of the Note and the Class B stock as equal to their respective estimated fair market values.

Taxpayer reported a long term capital loss on the sale of the Class A stock to Shareholder. The capital loss offset capital gains in the Tax Year 1 consolidated federal income tax return. Sub 1 reported losses for the three-year period preceding Tax Year 1 and for the two-year period following Tax Year 1 (Tax Year 2 and Tax Year 3). Sub 1 made no dividend payments and reported negative retained earnings, for book purposes, for the entire period.

LAW

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 351(b) provides that if section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under section 351(a), other property or money, then—(1) gain (if any) to such recipient shall be recognized, but not in excess of—(A) the amount of money received, plus (B) the fair market value of such other property received; and (2) no loss to such recipient shall be recognized.

Section 368(c), in relevant part, provides that the term “control” means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 351(g)(1) provides that in the case of a person who transfers property to a corporation and receives nonqualified preferred stock--(A) section 351(a) shall not apply to such transferor, and (B) if (and only if) the transferor receives stock other than nonqualified preferred stock—(i) section 351(b) shall apply to such transferor; and (ii) such nonqualified preferred stock shall be treated as other property for purposes of applying section 351(b).

Section 351(g)(2)(A), in relevant part, provides that for purposes of section 351(g)(1), the term “nonqualified preferred stock” means preferred stock if—(i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock, (ii) the issuer or a related person is required to redeem or purchase such stock, (iii) 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, or (iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

Section 351(g)(2)(B) provides that sections 351(g)(2)(A)(i), (ii), and (iii) will cause an instrument to be nonqualified preferred stock only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

Section 351(g)(3)(A) provides that the term “preferred stock” means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Further, the Code states that 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. If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.

Section 1504(a)(4) provides that the term “stock” does not include any 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 making section 351(g) determinations, courts have generally looked to the regulations underlying section 305. See, for example, Gerdau Macsteel, Inc. v. Commissioner, 139 T.C. 67 (2012). Section 1.305-5(a), in relevant part provides:

> 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 section 305 regulations thus provide considerations to take into account in determining when stock has a meaningful probability of actually participating in the earnings and growth of the corporation and whether that participation is significant.

When Congress enacted section 351(g) in 1997, there was a split in the courts about whether to look only to the terms of the stock (as provided in the stock certificate or any other collateral agreements) or look to the dividends actually paid during a particular period to resolve whether stock was limited and preferred as to dividends for purposes of determining affiliation under section 1504(a). Section 1504(a)(4) defines certain preferred stock as stock that is, among other features, "limited and preferred as to dividends."

In United States v. Liberty Banking Corp., 25 F. Supp. 203 (S.D.N.Y. 1938), the court held that preferred stock of the conventional type is "limited and preferred as to dividends" by being entitled to a specific dividend in priority to any dividend on the common stock, but to nothing more in the way of dividends. The preferred stock in question was participating preferred stock, entitled not merely to receive the fixed preferred dividend in priority to common stock but also to share on parity with the common in any further distribution of earnings. The court concluded that the preferred stock was, therefore, not limited and preferred as to dividends. This view was adopted in Rev. Rul. 79-21, 1979-1 C.B. 290 (ruling that preferred stock which is entitled not only to receive a preferred dividend in priority to common stock but also to participate with the common stock in any further distributions of earnings is not limited and preferred as to dividends).

By comparison, in Erie Lighting Co. v. Commissioner, 93 F.2d 883 (1st Cir. 1937), the preferred stock was entitled to receive a $2 dividend. After all accumulated and accrued dividends on the preferred were paid, the common shareholders were entitled to get $2 per share dividend. Thereafter, the common and preferred would share equally in any further dividend payments. No further dividends were paid. The court held that the preferred stock was limited and preferred as to dividends based on the fact that no preferred dividends were paid, and provided:

> That it might share equally with the common stock under more favorable conditions is immaterial. It clearly did not during the period in question. . . . The mere possibility that the stock in some particular taxable period might be entitled to dividends in excess of 7 percent no more makes it unlimited as to dividends than the possibility that in some particular tax period it might be entitled to voting rights makes it voting stock.

Id. at 886-887. Commenters have interpreted that section 351(g) incorporates both versions of the common law in its reference to “real and meaningful” participation in earnings and growth and to “limited and preferred as to dividends and does not participate in corporate growth to any significant extent.” See, comments concerning the President’s proposal to clarify the definition of Nonqualified Preferred Stock, July 25, 2000, Zarlenga, Barrie, Corwin, Silverman, Wellen, et. al., at 4, 19 TMWR 1432, 2000 WL 1235669.

In Gerdau, 139 T.C. 67, the parties disputed whether certain class C stock issued by a subsidiary to its parent corporation was preferred stock within the meaning of section 351(g)(3)(A). The stock was issued in a recapitalization transaction that was followed by a purported section 351 transaction after which the class C stock was sold outside of the consolidated group. Prior to the recapitalization transaction, the subsidiary that issued the class C stock was an inactive company. Taxpayer sought to claim a loss on the sale of the class C stock to offset capital gain income. The resolution turned on whether, at the time the stock was issued, the class C stock participated in corporate growth to any significant extent. Id. at 159.

The court in Gerdau held that the stock at issue did not participate in corporate growth to any significant extent and thus was nonqualified preferred stock under section

351(g) and denied the capital loss. In reaching this conclusion, the Tax Court explained that neither the statute, the regulations, nor the legislative history of section 351(g) defines the phrase “participate in corporate growth to any significant extent” for purposes of section 351(g)(3)(A). Id. at 163.

Both parties had relied upon the regulations under section 305 to interpret the phrase “participate in corporate growth to any significant extent” for purposes of section 351(g)(3)(A). Id. at 161. The Commissioner argued that, when the preferred stock was issued, there was no reasonable likelihood that the stock would participate in corporate growth because there were no earnings in which to participate and the taxpayer had projected a deficit of $39 million that was expected to continue for several years.

The court ruled in favor of the Commissioner, finding that the preferred stock at issue was nonqualified preferred stock through reliance on section 351(g) and its legislative history, section 1504(a)(4), and section 1.305-5(a). The court held that, in lieu of giving its holders a significant interest in corporate growth, the class C stock gave its holders a guaranteed fixed annual income preference in the form of a set, cumulative dividend and, upon the stock’s redemption, a fixed payout that was not related to corporate growth. Id. at 163. This holding was based on the court’s finding that, at issuance, the reasonable likelihood was that the stock would fail to meaningfully participate in corporate earnings at all, given that the sub had no accumulated earnings when the class C stock was issued and that the sub was reasonably expected to have little to no earnings before the class C stock would most likely be redeemed. The court held that a deficit is not corporate growth.

ANALYSIS

Congress’ intention in enacting section 351(g) was to address its concern that holders of certain stock that has features that make the stock, in substance, more like debt than equity have received something akin to boot that should be taxed immediately. JCS-23-97, General Explanation of Tax Legislation Enacted in 1997, December 17, 1997 at 210. See also, General Explanation of Tax Legislation Enacted in the 108th Congress, Joint Committee on Taxation, March 1997, JCX-10-97 at 46. Congress considered the treatment of preferred stock that not only contained the customary liquidation and dividend preferences but also contained terms that significantly reduced any risk of loss of principal value. Congress viewed such preferred stock as more like debt than equity and provided that the receiver of such stock should be taxed on any associated gain and should be denied a loss where appropriate. The treatment of certain preferred stock as boot applies for purposes of section 351, 354, 355 and 356, among others.

The committee reports provide:

> Certain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayers may receive relatively secure instruments in exchange for relatively risky investments and that…. [t]he Committee believes that when such preferred stock instruments are received in certain transactions, it is appropriate to view such instruments as taxable consideration, since the investor has often obtained a more secure form of investment.

H.S. Rep. No 148, 105th Cong., 1st Sess. 472 (1997); S. Rep. 33, 105th Cong., 1st Sess. (1997).

Thus, for preferred stock to be treated as other than nonqualified preferred stock, evidence must exist to show that the preferred stock in question will participate in corporate growth to a significant extent. Merely describing the rights associated with the preferred stock in relation to how the common stock participates is not enough. The legislative history states that:

> Instruments that are preferred on liquidation and that are entitled to the same dividends as may be declared on the common stock do not escape being nonqualified preferred stock by reason of that right if the corporation does not in fact pay dividends either to its common or preferred shareholders.

General Explanation of Tax Legislation Enacted in the 108th Congress, Joint Committee on Taxation, May 2005, JCS-5-05 at 500.

Applying the law set forth above to the facts of the instant case, the Class A stock of Sub 1 is preferred stock that does not participate in the growth of Sub 1 to a significant extent. An illusory right to share in any appreciation in the value of Sub 1 does not evidence "a real and meaningful likelihood" that the Class A stock will actually "participate in the earnings and growth of the corporation" and provides no proof that "dividends beyond any limitation or preference will be paid."

Sub 1 had income in Tax Year 1 (the year of the purported section 351 transfer and distribution of the Class A stock) but paid no dividends within the meaning of section 316 of the Code. It is doubtful that Sub 1 reasonably expected the Class A stock to participate in any current and anticipated future growth of Sub 1. Sub 1 reported losses on its pro-forma tax returns during the years described in the facts and paid no dividends during that period. It had only one aberrational year of taxable income that was immediately followed by two consecutive tax years with net operating losses. These events occurred despite Sub 1's original forecast of positive cash flows and anticipated earnings, which Taxpayer admits were overstated.

As in Gerdau, so it is here-- at issuance, there was no real and meaningful likelihood the Class A stock would participate in the corporate growth of Sub 1 to any significant extent. There was no real and meaningful likelihood that dividends beyond any limitation or preference would actually be paid.

In addition, the Shareholder in the instant case was merely an accommodation party to the transaction and accepted payment in exchange for its purchase of the stock. Shareholder provides that it considered the stock to be preferred stock, but it required a substantial amount of collateral to insure that it would in no way lose on its purchase. Using collateral as a backstop to any potential loss on the Class A stock is evidence that Shareholder was protecting its investment from a probable downside.

For the above reasons, the Class A stock of Sub 1 is nonqualified preferred stock within the meaning of section 351(g)(2)(A).

Please call Lola L. Johnson at (202) 317-5024 or Benjamin M. Willis at (202) 317-5363 if you have any questions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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