(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Class of Stock: A Definition in Need of Refinement

By Scott M. Levine

Scott M. Levine is a partner with Jones Day's Washington office. The author would like to thank Lori A. Hellkamp of Jones Day for her significant contributions to this article. The opinions expressed in this article are solely those of the author and do not necessarily reflect the viewpoints of Jones Day.

On January 21, 2009, Treasury and the IRS published proposed regulations providing a comprehensive set of rules to address shareholders' determination of stock basis.[1] The proposed regulations primarily focus on determining basis recovery in specific distribution, redemption, and reorganization transactions. This effort is to be largely applauded. However, the proposed regulations have also brought to the fore some unresolved issues and created ambiguities that will need to be addressed, either as part of a final regulatory package or in the form of separate guidance. One of those unresolved issues — the definition of a class of stock — is the subject of this article. Specifically, this article addresses the definition of a class of stock as set forth in the proposed regulations and then looks to analogous guidance in an effort to determine how a class of stock should be defined for purposes of the proposed regulations. As will be discussed, for purposes of the proposed regulations, a class of stock should be defined using a principle-based approach patterned after the approach taken in the subchapter S context for analogous problems of ''classification.''

A. Scope of the Class of Stock Definition

While guidance on what constitutes a class of stock may have been of little use in the subchapter C context before the introduction of the proposed regulations,[2] those regulations, if finalized, will fundamentally change the way some subchapter C transactions are viewed. Additional guidance on the definition will be critical for taxpayers to comply with the regulations, as the proposed regulations themselves do not provide sufficient guidance.

Prop. reg. section 1.302-5(b)(2) provides that a class of stock ''is defined with respect to *economic rights to distributions* rather than the labels attached to shares or rights with respect to corporate governance.''[3] (Emphasis added.) This same definition is made expressly applicable to sections 354, 355, and 356, though not section 301.[4] Prop. reg. section 1.358-2(a)(2) offers an even more vague definition of a class of stock, providing that shares ''which differ . . . because the rights attributable to them differ . . . are considered different classes of stock.''[5] The proposed regulations use this definition when applying the basis allocation rules in exchanges or distributions to

---

[1] *See* REG-143686-07, *Doc 2009-1129*, *2009 TNT 11-15*.

[2] There are several provisions in subchapter C that contain the term ''class.'' Those provisions, with seemingly only one exception, do not require that the term be defined. *See* sections 301(e)(2)(A), 302(b)(2), 304(c)(1), 351(g)(2)(C)(ii)(I), 355(d)(4), 368(a)(2)(F)(iii), and 382(l)(3)(C). Under sections 301(e)(2)(A), 302(b)(2), 304(c)(1), 355(d)(4), and 368(a)(2)(F)(iii), any reference to class should not require a definition because the reference is to ''all classes,'' so delineating between or among classes is unnecessary. Under section 351(g)(2)(C)(ii)(I), provided any shares of the issuing corporation are publicly traded, that requirement would presumably be satisfied. Under section 382(l)(3)(C), any reference to class should not require a definition because the provision ignores an event and, thus, delineating between purported classes is not necessary. *But see* section 355(d)(6)(B)(iii) (in determining whether stock or securities are acquired during the five-year period, the holding period is suspended for any period that the shareholder's risk of loss concerning the stock or securities or regarding any portion of the corporation's activities is (directly or indirectly) substantially diminished by *any special class of stock*); section 368(c) (under section 368(c) and confirmed in Rev. Rul. 59-259, 1959-2 C.B. 115, in determining whether control exists, 80 percent of the total combined voting power of all classes of voting stock and 80 percent of *each class* of nonvoting stock must be held). Under section 355(d)(6)(B)(iii), the term ''special class of stock'' generally refers to stock providing for special rights or risks ''with respect to the earnings, assets, or attributes of *less than all* of the assets or activities of a corporation or any of its subsidiaries.'' (Emphasis added.) Reg. section 1.355-6(e)(5)(iv). However, that stock (commonly referred to as tracking stock) is easier to classify in light of the holder's special rights or risks to less than all the issuing corporation's assets or activities. Section 368(c), then, is perhaps the only other provision in subchapter C in which providing a definition for class would have meaningful use.

[3] *See* prop. reg. sections 1.354-1(d)(1), 1.355-1(e)(1), and 1.356-1(b).

[4] *Id*. The proposed section 301 regulations do not provide any definition for the term ''class of stock.'' Prop. reg. section 1.301-2(a).

[5] The definition of class under prop. reg. section 1.358-2(a)(2) looks to all rights concerning a share of stock. Thus, unlike the definition of class under prop. reg. section 1.302-5(b)(2), which specifically provides that voting power is not to be taken into account in determining whether two purported classes of stock should be respected as such, the definition under prop. reg. section 1.358-2(a)(2) could be read to take into account voting rights in addition to distribution rights.

which sections 354, 355, or 356 apply.[6] However, the preamble and the proposed regulations themselves are silent as to why ''class'' is minimally and somewhat inconsistently described in a regulatory package aimed at devising a comprehensive scheme for consistent treatment of economically similar transactions.

Despite those vague (and perhaps inconsistent) definitions, the class distinction permeates the proposed regulations. Without having a better understanding of its definition, however, taxpayers and practitioners will face obstacles in applying the proposed regulatory scheme. The following discussion and related examples illustrate the importance of the class distinction between shares of stock.

First, the preamble instructs taxpayers to treat a section 301 distribution as being received ''on a pro rata, share-by-share basis with respect to *the class of stock* upon which the distribution is made.''[7] (Emphasis added.) Thus, in determining the appropriate tax treatment of a section 301 distribution, one must first determine whether a purported class of stock should be treated as a separate class of stock vis-à-vis any other class of stock.

> **Example 1 — Section 301 distribution.** X, a corporation, has two classes (in form) of stock outstanding, class A and class B. C, the sole shareholder of X, owns 100 shares of class A stock with a basis of $1 per share and 100 shares of class B stock with a basis of $10 per share. In a year when X has no current or accumulated E&P, X distributes $1,000 on C's class B stock.

Under the proposed regulations, if the class A and class B stock were respected as separate classes of stock, C would have no gain as a result of the $1,000 distribution, and his basis in his class B stock would be reduced to $0 per share.[8] Alternatively, if the class A and class B stock were treated as separate blocks of the same class of stock, under the proposed regulations, X would be treated as distributing $5 on each of the 200 shares of X stock outstanding.[9] C would recognize gain of $400 as a result of the $1,000 distribution.[10] C's basis in his class A stock would be reduced to $0 per share, and his basis in his class B stock would be reduced to $5 per share.

Similarly, for purposes of a section 302(d) dividend-equivalent redemption (and some deemed redemptions under section 304), one must first determine whether different classes exist. That is because each share in a redeemed class is to be treated as receiving a pro rata portion of the distribution, while shares outside the redeemed class are treated as receiving nothing.[11] The classes of stock that will be respected (or created) for tax purposes can fundamentally change the anticipated result.

> **Example 2 — Dividend-equivalent redemption.** X, a corporation, has two classes (in form) of stock outstanding, class A and class B. C, the sole shareholder of X, owns 100 shares of class A stock with a basis of $1 per share and 100 shares of class B stock with a basis of $10 per share. In a year when X has no current or accumulated E&P, X redeems C's 100 shares of class B stock in exchange for $400.

Under the proposed regulations, if the class A and class B stock were respected as separate classes of stock, the redemption of C's 100 shares of class B stock would result in a deferred loss of $600 taken into account on the ''inclusion date.''[12] Alternatively, if the class A and class B stock were treated as separate blocks of the same class of stock, under the proposed regulations, X would be treated as distributing $2 on each of the 200 shares of X stock outstanding.[13] As a result, C would recognize a gain of $100. C would have 50 shares of class A stock with a basis of $0 per share and 50 shares of class B stock with a basis of $16 per share.[14]

In a dividend-equivalent reorganization exchange, a shareholder's receipt of solely nonqualified property with respect to a class of stock will be treated as having been exchanged on a pro rata basis with respect to the shares within the designated class.[15] Class is thus of particular importance in the reorganization context because a shareholder holding two blocks of target corporation stock engaging in a dividend-equivalent reorganization exchange could have significantly different tax consequences depending on whether the two blocks were treated as one class of stock or two.[16]

> **Example 3 — Dividend-equivalent reorganization exchange.** X, a corporation, had two classes (in form) of stock outstanding, class A and class B. X had no other stock outstanding. In a qualifying reorganization, X merged with and into P, also a corporation. Under the merger agreement, holders of class A stock received cash and holders of class B stock received P stock. C, an X shareholder, held both class A and class B stock. In a dividend-equivalent exchange, C transferred his sole block of class A stock with a basis of $80 and an FMV of $100 in exchange for $100 and his sole block of class B stock with a basis of $120 and an FMV of $100 in

---

[6] Prop. reg. section 1.358-2(a)(1).

[7] *See* 74 *Fed. Reg*. 3509-3513 (Jan. 21, 2009) (preamble to prop. reg. section 1.301-2).

[8] *See* section 301(c)(2); prop. reg. section 1.301-2(a).

[9] *See* prop. reg. section 1.301-2(a).

[10] *See* section 301(c)(2) and (3).

[11] Prop. reg. sections 1.302-5(a) and 1.304-2(a)(5).

[12] *See* prop. reg. section 1.302-5(a)(3). Prop. reg. section 1.302-5(b)(4) defines the inclusion date as:

> the earlier of — (A) The first date on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2), or (3), if the facts and circumstances that exist at the end of such day had existed immediately after the redemption; or (B) The first date on which all classes of stock of the redeeming corporation become worthless within the meaning of section 165(g).

[13] *See* prop. reg. section 1.302-5(a)(1).

[14] *See* prop. reg. section 1.302-5(a)(2).

[15] Prop. reg. section 1.354-1(d)(1). The shareholder may not, however, designate particular shares within the class as receiving the nonqualified property. *Id*.

[16] *See* prop. reg. sections 1.354-1(d)(1) and 1.358-2(e)(1); preamble, 74 *Fed. Reg*. 3511.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

exchange for 50 shares of P stock worth $100. C's ratable share of X's E&P was in excess of $100.

If the class A and class B stock were respected as separate classes of stock, section 302(d) would apply to C's transfer of his class A stock in exchange for $100. As a result, C would have a dividend of $100 under sections 302(d) and 301(c)(1).[17] Alternatively, if the class A and class B stock were treated as two blocks of the same class of stock, section 356 would apply and C's dividend income would be limited to $20.[18]

Example 4 — All boot D reorganization. X, a corporation, had two classes (in form) of stock outstanding, class A and class B. X had no other stock outstanding. C, an individual, owned all 100 shares of class A stock. C had a basis of $1 in each share of class A stock. C also owned all 100 shares of class B stock. C had a basis of $5 in each share of class B stock. In a qualifying reorganization, X merged with and into Y, a corporation also wholly owned by C. At the time of the merger, X had an FMV of $1,000. Under the merger agreement, C received $500 in exchange for his 100 shares of class A stock and $500 in exchange for his 100 shares of class B stock. X had E&P in excess of $1,000. What are the appropriate tax consequences to C under the proposed regulations?

If the class A stock and the class B stock are treated as one class for purposes of the proposed regulations, C's receipt of $1,000 appears to be subject to section 356(a)(2) and C would have $400 of dividend income.[19] At first blush, such a conclusion may appear inconsistent with prop. reg. section 1.354-1(d)(2) which provides that to the extent a target corporation shareholder receives solely nonqualified property in a dividend-equivalent reorganization exchange, such shareholder will be taxed under section 302 and not section 356. After all, C solely received nonqualified property (that is, $1,000) in a dividend-equivalent reorganization exchange. In Rev. Rul. 70-240,[20] however, the IRS concluded that where one *first-tier* subsidiary corporation (target) sold all of its operating assets to another *first-tier* subsidiary corporation (acquiring) for an amount of cash equal to the FMV of the operating assets, the common shareholder's receipt of the sale proceeds upon the liquidation of target was determined pursuant to section 356(a)(2).[21] In the revenue ruling, the IRS concluded that the common shareholder "is treated as having received [acquiring] stock since he already owned all the [acquiring] stock."[22] Thus, consistent with Rev. Rul. 70-240, C would be treated as receiving Y shares for purposes of determining whether C should be taxed pursuant to section 356(a)(2) or 302(d) under prop. reg. section 1.354-1(d)(1) and (2). C should be taxed pursuant to section 356(a)(2), because C should be treated as receiving Y stock and nonqualified property in exchange for a single class of X stock.

However, if the class A and class B stock are respected as separate classes of stock, the tax consequences to C on the receipt of $1,000 become less clear. Rev. Rul. 70-240 does not address a situation in which the target corporation has more than one class of stock outstanding. As stated above, the revenue ruling merely provides that the common shareholder "is treated as having received [acquiring] *stock* since he already owned all the [acquiring] stock."[23] (Emphasis added.) The revenue ruling does not address which stock the common shareholder should be treated as having received if the target has more than one class of stock outstanding. If, for example, the class A stock is treated as subordinated to the class B stock, arguably C would be deemed to receive only Y stock (in addition to the consideration actually received) in exchange for the most junior class of X stock (the class A stock). C would not be deemed to receive any Y stock in exchange for the class B stock. Under that analysis, C would have $400 of dividend income resulting from the exchange of his class A stock for $500 under section 356(a)(2), and $500 of dividend income resulting from the exchange of his class B stock for $500 under sections 302(d) and 301(c)(1).[24]

Example 5 — All boot D reorganization of a lower-tier target subsidiary. C, an individual, wholly owned X, a corporation. Z, also a corporation, had two classes (in form) of stock outstanding, class A and class B. Z had no other stock outstanding. X owned all 100 shares of class A stock. X had a basis of $1 in each share of class A stock. X also owned all 100 shares of class B stock. X had a basis of $5 in each share of class B stock. In a qualifying reorganization, Z merged with and into Y, a corporation also wholly owned by C. At the time of the

[17]*See* prop. reg. section 1.354-1(d)(1) and (2). *Compare* Rev. Rul. 74-515, 1974-2 C.B. 118 (where a minority target corporation shareholder received acquiring corporation stock in exchange for his common stock and cash in exchange for his preferred stock in a qualifying reorganization pursuant to section 368(a)(1)(A), gain was recognized under section 356 and not section 302).

[18]*See* prop. reg. section 1.354-1(d)(1); *see also* Rev. Rul. 68-23, 1968-1 C.B. 144 (when a target corporation shareholder transfers two blocks of target corporation stock (one block with a built-in loss and one block with a built-in gain) in a reorganization, in determining the gain or loss in the reorganization, each block must be considered separately, so the loss on one block may not offset the gain on the other block).

[19]*See* prop. reg. section 1.354-1(d)(1). *Cf.* Treasury Department, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" 36 (May 2009), *Doc 2009-10664, 2009 TNT 89-44* (proposal would repeal the "boot within gain" limitation of section 356(a)(2) in which the acquiring corporation is *foreign* and the shareholder's receipt of nonqualified property has the effect of the distribution of a dividend under section 356(a)(2)).

[20]1970-1 C.B. 81.

[21]*See also American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970); *Wilson v. Commissioner*, 46 T.C. 334 (1966); *S. Tex. Rice Warehouse Co. v. Commissioner*, 43 T.C. 540 (1965); *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964).

[22]*Id. See also Commissioner v. Morgan*, 288 F.2d 676 (3d Cir., 1961), *cert. denied*, 368 U.S. 836 (1961); *Wilson v. Commissioner*, 46 T.C. 334 (1966).

[23]Rev. Rul. 70-240, 1970-1 C.B. 81.

[24]*See* prop. reg. section 1.354-1(d)(1) and (2).

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

merger, Z had an FMV of $1,000. Under the merger agreement, X received $500 in exchange for his 100 shares of class A stock and $500 in exchange for his 100 shares of class B stock. Z had E&P in excess of $1,000. What are the appropriate tax consequences to X under the proposed regulations?

Whether or not the class A and class B stock are treated as one class of stock for purposes of the proposed regulations, X's receipt of $1,000 arguably is subject to section 302(d),[25] and X would have $1,000 of dividend income.[26] Rev. Rul. 70-240 applies only when there is ''complete shareholder identity''[27] (when the acquiring corporation and the target corporation are wholly owned by the same direct shareholder). In this case, Y and Z do not have the same direct shareholders and, as a result, the issuance of Y shares would *not* have been meaningless. Although reg. section 1.368-2T(l)(2)(i) provides that a nominal share of stock is deemed issued in an ''all boot D reorganization,'' the deemed nominal share issuance is for purposes of the section 354(b)(1)(B) distribution requirement. Reg. section 1.368-2T(l)(2)(i) does not explicitly provide that the issuance of a nominal share should be deemed to occur for all purposes of sections 354 and 356. In fact, section 368 is merely a definitional provision and does not address the tax consequences to shareholders in a reorganization. Those determinations are under the purview of sections 354, 355, and 356. Query whether Treasury and the IRS desire that result.[28]

Lastly, for purposes of section 351 contributions in which stock of the transferee corporation is deemed to be received, the proposed regulations instruct that those transactions be viewed as if, in accordance with a recapitalization under section 368(a)(1)(E), the shareholder exchanged all his shares in the class (including the shares deemed to be received) for the actual number of shares remaining in the class and held by the shareholder after the transaction.[29] Beyond the obvious need to understand which classes of stock will be respected for tax purposes when engaging in the deemed recapitalization, class will be a consideration to the extent that the (deemed) receipt of stock must ''be consistent with the economic rights associated with each class of stock.''[30]

Example 6 — Capital contribution of nonstock property. A, the sole shareholder of X, a corporation, owns 100 shares of X stock with a basis of $1 per share. A makes a capital contribution of real property with a basis of $10 and an FMV of $1,000 to X. Immediately after the capital contribution, X is worth $2,000. In a year in which X has no current or accumulated E&P, X distributes $100 to A on A's X stock.

Under an aggregated basis approach, A would have 100 shares of X stock with a basis of $1.10 per share. Under section 301(c)(2), the distribution of the $100 to A would be treated solely as a return of basis, so A would not recognize any gain or loss. Alternatively, under a tracing approach, A would have 50 shares of X stock with a basis of $2 per share and 50 shares of X stock with a basis of $0.20 per share. Thus, the distribution of the $100 to A would result in a $40 capital gain.

Under current law, the tracing approach does not apply to determine the basis of stock received in an exchange described in section 351 if: (1) the shareholder exchanges property for stock in an exchange to which neither sections 354 nor 356 applies; or (2) liabilities of the shareholder or security holder are assumed.[31] Instead, when a shareholder transfers property to a corporation in an exchange that satisfies the requirements of section 351 but not sections 354 or 356, the shareholder allocates his basis in the transferred property evenly among his existing shares in the transferee corporation.[32] If, in the example above, A had transferred 100 percent of the stock of Y (instead of real property) to X as a capital contribution, and X had only voting common stock outstanding, the tracing approach would apply, because A would have exchanged property for stock in an exchange to which section 354 applied.[33]

---

[25]Query whether X's receipt of the $1,000 should be subject to section 302(a) by reason of section 302(b)(3) because X completely terminated its interest in Z as a result of Z ceasing to exist under local law.

[26]*See* prop. reg. section 1.354-1(d)(2).

[27]1970-1 C.B. 81. *Compare Warsaw Photographic Assocs., Inc. v. Commissioner*, 84 T.C. 21 (1985) (stating in dicta that the exception to the distribution requirement applies only where the issuance of stock would not have been meaningless (i.e., where the stock ownership of the transferor corporation and the acquiring corporation is identical)); *but see* reg. section 1.368-2T(l)(2)(iii) (''de minimis variations in shareholder identity or proportionality of ownership'' ignored for purposes of determining whether ''all of the stock of the transferor and transferee corporations [held] in identical proportions'').

[28]*See* 74 *Fed. Reg.* 3509, 3513 (Jan. 21, 2009) (stating that the proposed regulations ''may heighten the importance of whether the nominal share deemed issued in [an all boot D reorganization] is received in respect of particular shares surrendered by the exchanging shareholder''). Interestingly, even if reg. section 1.368-2T(l) could be read to provide for a deemed issuance of a nominal share for purposes of section 356, would X be treated as receiving a nominal share (or perhaps a segment of a nominal share) in exchange for each class of stock or, alternatively, only in exchange for the most junior class? If the latter, assuming the class B stock is senior to the class A stock, X would have $400 of dividend income resulting from the exchange of its class A stock for $500 under section 356(a)(2) and $500 of dividend income resulting from the exchange of its class B stock for $500 under sections 302(d) and 301(c)(1). *See* prop. reg. section 1.354-1(d)(1) and (2).

[29]Prop. reg. section 1.358-2(g)(3).

[30]*Id*.

[31]Reg. section 1.358-2(a)(2)(viii).

[32]*See, e.g.*, T.D. 9244, 71 *Fed. Reg.* 4264 (Jan. 26, 2006), *Doc 2006-1335, 2006 TNT 15-5*:

> The IRS and Treasury Department are continuing to study the possible application of a tracing approach more broadly [(i.e., the approach currently applicable in section 354 and 356 exchanges),] to exchanges described in section 351. In the meantime, these final regulations retain those limitations on the application of the basis tracing approach to exchanges described in section 351 that were included in the proposed regulations.

[33]*See* reg. section 1.358-2(a)(2)(iii).

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Currently, shareholders contributing stock in a corporation to another corporation as a capital contribution in a section 351 exchange may avoid the tracing approach by issuing a sufficient amount of nonqualifying consideration (cash or nonvoting stock). Under the proposed regulations, however, the tracing approach would generally be imposed in that situation.[34]

Despite the extension of the tracing approach to additional categories of qualifying section 351 transactions, if the proposed regulations are finalized, taxpayers will still have the opportunity to minimize gains from future distributions under the share-by-share approach. Under the proposed regulations, by issuing a new class of stock in future qualifying section 351 and section 354 exchanges, future distributions can be managed to maximize the amount of basis recovery (to the extent those distributions are not supported by E&P) before recognizing any gain.

> **Example 7 — Capital contribution for a separate class of stock**. C, the sole shareholder of X, a corporation with one class of stock outstanding, class A, owns 100 shares of class A stock with a basis of $1 per share. C transfers 100 percent of the stock of Y with a basis of $10 and an FMV of $1,000 to X in exchange for 100 shares of a second class of stock, class B. Immediately after the transfer of the Y stock, X has an FMV of $2,000. In a year in which X has no current or accumulated E&P, X distributes $100 to C on the class A stock.

C would have 100 shares of class A stock with a basis of $1 per share and 100 shares of class B stock with a basis of $0.10 per share.[35] As a result, under section 301(c)(2), the distribution of the $100 to C on the class A stock would be treated solely as a return of basis, so C would not recognize any gain or loss.[36]

> **Example 8 — Recapitalization of block of stock into separate class of stock.** C, the sole shareholder of X, a corporation, owns two blocks of X class A common stock: block 1, consisting of 50 shares with a basis of $1 per share, and block 2, consisting of 50 shares with a basis of $10 per share. In year 1, when X has no current plan or intent to make a distribution to C but for the sole purpose of being able to distribute cash to C in the future without recognizing gain, C transfers his block 1 shares to X in exchange for 50 shares of class B common stock. In year 5, X distributes $500 with respect to the class A common stock.

The year 1 exchange is described in sections 368(a)(1)(E) and 1036(a). Although there is a business purpose requirement for a recapitalization to be treated as a reorganization under section 368(a)(1)(E),[37] section 1036 does not appear to contain that requirement.[38] Section 1036 generally permits the tax-free exchange of common stock for common stock or preferred stock for preferred stock of the same corporation. Such an exchange may take place between shareholders or between a shareholder and the issuing corporation.[39] Thus, provided C is afforded nonrecognition treatment under section 1036(a) for the year 1 exchange, C would have 50 shares of class A common stock with a basis of $10 per share and 50 shares of class B common stock with a basis of $1 per share.[40] As a result of the Year 5 $500 distribution on the class A common stock, C's basis in his class A common stock would be reduced to $0 per share pursuant to section 301(c)(2) and C would not recognize any gain under section 301(c)(3).[41]

As illustrated by these examples, which are typical corporate transactions, whether two purported classes of stock are respected as separate for purposes of the proposed regulations can have a significant effect on the federal income tax consequences for shareholders. Without a clear definition of class, taxpayers cannot engage in these and other common transactions with certainty as to their tax consequences. Further, to the extent the concept of class is subject to manipulation, the underlying policies of the proposed regulations may be frustrated.

Accordingly, if a workable definition of a class of stock can be developed, there is no reason why that definition should not apply across the spectrum of provisions affected by the proposed regulations. Indeed, the very purpose of the regulatory package is ''to harmonize the tax treatment'' of the pertinent provisions by adopting a ''single model'' for use in the context of sections 301 and 302(a), ''regardless of whether [they] apply by reason of section 302(d), 304 or 356.''[42] In pursuit of the same objective, the proposed regulations also define the scope of a reorganization exchange and offer a method for determining gain under section 356 and basis under

---

[34]Prop. reg. section 1.358-2(g)(3). *But see* prop. reg. section 1.358-2(g)(2) (providing that tracing regime, with respect to qualifying-section 351 transactions, is limited to exchanges where the transferee corporation does *not* assume any liabilities).

[35]*See* prop. reg. section 1.358-2(g)(1).

[36]*See* prop. reg. section 1.301-2(a) (providing that ''that portion of a distribution which is not a dividend shall be applied pro rata, on a share-by-share basis, to reduce the adjusted basis of each share of stock held by the shareholder *within the class of stock* upon which the distribution is made'') (emphasis added).

[37]*See* reg. section 1.368-1(b) (requiring ''business exigencies''); *Golden Nugget v. Commissioner*, 83 T.C. 28 (1984); Rev. Proc. 81-60, 1981-2 C.B. 680 (lists ''business purpose'' among the items required for a ruling related to section 368(a)(1)(E)).

[38]GCM 39088 (Dec. 7, 1983) (''Section 1036 . . . has no business purpose requirement, while section 368(a)(1)(E), as one of the reorganization provisions, does''); *see also* Rev. Rul. 72-199, 1972-1 C.B. 228 (concluding stock exchange qualified for tax-free treatment under section 1036 despite no discussion of facts suggesting business purpose); LTR 9616028 (Jan. 19, 1996), *Doc 96-11808, 96 TNT 79-35* (similar); LTR 9207022 (Nov. 18, 1991) (similar).

[39]Reg. section 1.1036-1(a).

[40]*See* prop. reg. section 1.358-2(b)(1) and (f)(2) (providing that prop. reg. section 1.358-2(b)(1) ''shall apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 1036 and section 354 or 356'').

[41]*See* prop. reg. section 1.301-2(a).

[42]74 *Fed. Reg*. 3509-3510.

section 358.[43] Because the proposed regulations are intended to advance a "comprehensive approach to produce consistent results among economically similar transactions,"[44] there is no compelling argument against a uniform definition of class to assist taxpayers in understanding and complying with the proposed regulations.

B. Defining a Class of Stock

1. Little guidance exists. As stated above, prop. reg. section 1.302-5(b)(2) defines a class of stock "with respect to economic rights to distributions rather than the labels attached to shares or rights with respect to corporate governance." The preamble also suggests that different classes of stock possess "distinct legal entitlements that are respected for federal income tax purposes."[45] Otherwise, taxpayers must look beyond the proposed regulations to determine what constitutes a class of stock.

Just as there is little guidance provided by the proposed regulations, there is little authority on what constitutes a class of stock for purposes of subchapter C. There is, however, an abundance of authority addressing the related distinction between common and preferred stock. These authorities provide a useful starting point because they instruct how the IRS distinguishes between two particular categories of stock. To illustrate, reg. section 1.305-5(a) defines preferred stock as stock that generally enjoys dividend and liquidation preferences but does not participate in corporate growth to any significant extent. Rev. Rul. 81-91[46] similarly concludes that participation in corporate growth to a significant extent is the hallmark of common stock (or rather, its absence is the hallmark of "stock other than common stock") for purposes of section 306.[47] Similarly, for purposes of section 1036, courts have held that common stock and preferred stock are to be distinguished by reference to the shareholder's rights: Common shareholders share pro rata in the profits and eventual liquidation proceeds of the corporation and participate in management (although voting rights are not determinative),[48] whereas preferred shareholders are generally characterized by a payment preference and a periodic return on their investment.[49]

Taxpayers, however, need guidance on what constitutes a class of stock beyond the common-versus-preferred distinction. Being able to distinguish between these two categories of stock is insufficient to understand how a class is delineated along the spectrum of possible shareholder rights. An approach based on bright-line distinctions will likely never keep pace with corporate ingenuity. However, by adopting a principle-based approach, Treasury and the IRS would enable taxpayers to more accurately anticipate the federal tax consequences of their activities.

The relative benefits of a principle-based definition of class is illustrated by analogous "class" authorities outside the subchapter C context — mainly, section 562(c) (in the regulated investment company context) and section 1361(b)(1)(D) (in the subchapter S corporation context).

2. A class of stock for purposes of section 562(c). RICs and REITs are generally treated as passthrough-type entities. Unlike partnerships, however, the mechanism that affords RICs and REITs passthrough tax treatment is the dividends paid deduction provided under section 562. Generally, to the extent that a RIC or REIT annually distributes its income to its shareholders, that RIC or REIT is not subject to a corporate-level tax. Section 562(c), however, provides an exception to the dividends paid deduction for preferential dividends. Specifically, section 562(c) provides:

> The amount of any distribution shall not be considered a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with *no preference to one class of stock as compared with another class* except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference. (Emphasis added.)

To determine whether one class of stock has a preference vis-à-vis another class of stock for purposes of section 562(c), one must first determine what constitutes a class of stock. The House report addressing the issue of relative preference between classes of stock states:

> No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stock holdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance. The preference which prevents the allowance of a dividends-paid credit may be one in favor of one class of stock as well as one in favor of some shares of stock within one class. The provision has been expanded in this bill so as to leave no uncertainty as to its purpose in this respect. . . . The Committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stock-holding interests, should

[43]*Id.*

[44]*Id.*

[45]*Id.* at 3511.

[46]1981-1 C.B. 123.

[47]*See also* Rev. Rul. 82-191, 1982-2 C.B. 78 (concluding that preferred stock that was nonredeemable, was limited and preferred as to dividends, had a fixed liquidation preference, and whose holder was not entitled to any further participation in the issuing corporation beyond those payments was "section 306 stock").

[48]*See, e.g., Carnahan v. United States*, 188 F. Supp. 461 (D. Mont. 1960).

[49]Section 1244 also implicates the distinction between common stock and other categories of stock. More specifically, reg. section 1.1244(c)-1(b) provides that only common stock may qualify as "section 1244 stock." Little guidance exists, however, for determining whether a particular class of stock is common stock for those purposes. *See, e.g.*, *Cutler v. Commissioner*, 67 T.C. Memo. 1994-90, *Doc 94-2375, 94 TNT 40-11*; *Miller v. Commissioner*, 57 T.C. Memo. 1989-153.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

be regarded as preferential by reason of minor differences in valuation of property distributed.[50]

This legislative history suggests that, for purposes of section 562, ''class'' contemplates core units of ownership possessing identical rights regarding dividends. The House report evinces a low tolerance for disproportionate distributions: Preferences of any variety — among or within classes — will preclude a RIC or REIT from taking the dividends paid deduction. At first blush, the language about intraclass variations seems to suggest that variations within classes may be permissible; however, the more plausible interpretation is that this legislative history reflects Congress's intent to eliminate ambiguity.

The IRS has addressed the concept of class in determining whether class-specific expenses resulted in preferential dividends. In LTR 8850055,[51] in determining whether class A and class B stock were separate classes of stock for purposes of section 562(c), the IRS stated:

> In order to avoid preferential dividends, the Class A and Class B shares must belong to different classes of stock for purposes of the deduction for dividends paid. According to the [taxpayer], each class of stock will be treated as a separate class of stock under applicable state law, and each class of stock will have separate and distinguishable rights attached to it. Moreover, the Class B shares will have sole voting rights pertaining to the Rule 12b-1 plan. The shareholders of the different classes will be entitled to different dividend payments because of the Rule 12b-1 plan charges payable by Class B shareholders. Finally, the Class A and Class B shareholders will have different liquidation and redemption rights, because if Class B shares are redeemed within some predetermined period after purchase, the redeemed shares will be subject to a [contingent deferred sales charge]. Thus, in each instance, the Class A and Class B shares . . . will have separate voting, dividend, and liquidation rights. Therefore, the two classes of stock are separate classes of stock for purposes of the deduction for dividends paid.

The language in this letter ruling reiterates the above formulations of class and helps identify the distinctions that the IRS may consider dispositive in determining interclass boundaries. This example may be overbroad, however, because it does not purport to provide a minimum threshold for a separate class of stock but indicates instead that when voting, dividend, and liquidation rights are distinct, separate classes exist. This letter ruling might also be read to suggest that separate classes of stock for state law purposes do not necessarily create separate classes of stock for federal income tax purposes because the state law classification was omitted from the ultimate analysis of the class of stock issue.

More recently, in Rev. Proc. 99-40,[52] the IRS concluded that ''class-specific expenses'' (that is, RIC expenses allocated solely to one class of RIC stock) generally will not violate the section 562(c) prohibition on preferential dividends. Before the release of that revenue procedure, however, the IRS had issued many letter rulings addressing whether class-specific expenses resulted in preferential dividends. In each of those rulings, the IRS defined a class as:

> A group of shareholders whose rights are so closely aligned and so different from other shareholders' rights as to warrant a conclusion that members of the group should all be treated the same and should be protected against the infringement of shareholders outside the group with respect to distributions.[53]

While somewhat helpful, the principle articulated is so abstract that it would provide little in the way of concrete guidance if adopted in the context of the proposed regulations. Resorting to a ''know it when you see it'' test is unlikely to resolve the many uncertainties that arise concerning the differences between classes of stock.

Similarly, the legislative history to section 562(c), which emphasizes objective determinations of economic rights and treats even minimal deviations therefrom as violating the no-preference principle, could provide a useful starting point for developing a usable definition of class for purposes of the proposed regulations. However, treating *minimal* differences between objective economic rights as giving rise to separate classes of stock is unlikely to advance the purpose of the proposed regulations.

3. A 'class' of stock for purposes of section 1361(b)(1)(D). The guidance under section 1361, which limits an S corporation to only one class of stock (the one-class-of-stock rule),[54] provides a more meaningful foundation on which to build an appropriate definition of class for purposes of the proposed regulations. The remainder of this article makes the case that the definition of class for purposes of the proposed regulations should be predicated on the principles already developed in the S corporation context.

a. Economic rights. Most significantly, just as under section 1361, a class of stock for purposes of the proposed regulations should arise whenever there are material differences in the economic rights of shareholders. For purposes of section 1361, all stock is of a single class if each share outstanding confers ''*identical* rights to distribution and liquidation proceeds.''[55] (Emphasis added.) In

---

[50]H.R. Rep. No. 1860, 75th Cong., 3d Sess. 23 (1938), 1939-1 C.B. 728, 744 (Part 2).

[51]Sept. 21, 1988.

[52]1999-2 C.B. 565.

[53]*See, e.g.*, LTR 9649025 (Sept. 6, 1996), *Doc 96-31525, 96 TNT 238-44*; LTR 8903073 (Oct. 26, 1988).

[54]Section 1361(b)(1)(D).

[55]Reg. section 1.1361-1(l)(1). For example, if two series of preferred stock that rank *pari passu* as to dividends, except one series is cumulative and the other series is noncumulative, they have different economic rights to distributions, so they should be treated as separate classes of stock for purposes of the proposed regulations. The different economic rights may be illustrated in the situation in which the issuing corporation does not have the wherewithal to pay any dividends in a given year, thus requiring it to accrue the undeclared cumulative preferred dividend but not the noncumulative preferred dividend. That accrual would entitle the holders of the cumulative preferred

(Footnote continued on next page.)

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

determining whether all outstanding shares have identical rights to distributions and liquidation proceeds, the regulations look to the corporation's charter, its articles of incorporation and bylaws, applicable state law, and any binding agreements (collectively, the governing provisions).[56] Some types of binding agreements as well as applicable state laws may be disregarded, however, when determining whether stock confers identical economic rights. It is the *rights* to receive distributions and liquidation proceeds — not the actual amounts received — that are dispositive when testing for a single class of stock.[57]

Example 9 — Identical rights pending future issuances. X, a corporation, has (in form) two classes of stock, class A and class B. The class A stock, of which there are 20 shares issued and outstanding, is entitled to 20 percent of X's earnings as a class and 20 percent of X's assets on liquidation as a class. The class B stock, of which there are 80 shares issued and outstanding, is entitled to 80 percent of X's earnings as a class and 80 percent of X's assets on liquidation as a class. Distributions may not be made with respect to one class without making a proportionate distribution with respect to the other class.

On first blush, it would appear that the class A and class B stock should be treated as the same class of stock because a distribution would entitle the holder of each share of X stock (regardless of class) to receive the same amount at the same time.[58] However, what if X could issue additional shares of class A stock without issuing a proportionate amount of class B stock (or vice versa)? While the actual issuance of stock under these circumstances would violate the one-class-of-stock rule, even the possibility of an issuance may be sufficient to treat the class A and class B stock as separate classes of stock with the 20 percent and 80 percent earnings and liquidation percentages remaining the same.[59]

If applicable state law creates a difference in shareholders' rights to receive distributions or liquidation proceeds, a second class of stock will generally be found for subchapter S purposes.[60] For example, a second class of stock may be created when state law requires that shareholders who contribute cash to a corporation obtain a preferred right to dividends over shareholders who contribute noncash property.[61] A second class of stock would also be created if a binding agreement between an S corporation and its shareholders modified the corporation's distribution policy to increase distribution amounts to those shareholders who bore heavier state tax burdens — despite a formulaic adjustment being in place to ensure all shareholders received equal after-tax distributions.[62] This result is consistent with the emphasis on rights conferred by the governing provisions rather than distribution amounts ultimately received. This rule captures the most significant and least manipulable aspect of equity ownership and can be meaningfully translated to the subchapter C context: A disparity in the economic rights of shareholders creates a new class of stock.

i. Disproportionate distributions. While differences in rights to distributions and liquidation proceeds should give rise to different classes of stock for purposes of the proposed regulations, disproportionate distributions, whether actual or deemed, should not — just as under section 1361 generally. Because the section 1361(b)(1)(D) regulations focus on rights conferred rather than distributions received, non-pro-rata distributions will not necessarily violate the one-class-of-stock rule. The ostensible leniency of this rule is actually quite limited, however.[63] Disproportionate distributions to shareholders will generally create a second class of stock unless (i) the corporation's governing provisions expressly confer equal and identical rights to all shareholders, and (ii) remedial distributions are used to equalize any disproportionate distributions made.[64]

---

stock to receive their accrued dividend before the payment of any future dividends on either series. Also, there may be tax consequences to the holders of the cumulative preferred stock outside the scope of the proposed regulations that differ from the tax consequences to the holders of the noncumulative preferred stock. For example, if the issuing corporation fails to declare a dividend on the cumulative preferred stock, the holders of that stock could be deemed to have received a distribution under section 305(c). The holders of the noncumulative preferred stock would not be treated similarly.

[56]Reg. section 1.1361-1(l)(2)(i).

[57]*See* reg. section 1.1361-1(l)(1) and (2)(i).

[58]For example, if X had $100 of earnings and distributed the $100 to its shareholders, $20 would be distributed on the class A stock and $80 would be distributed on the class B stock. Stated another way, each share of class A stock and each share of class B stock would receive $1.

[59]Of course, this situation would likely arise only in the context of related-party ownership, because an unrelated shareholder may not be willing to purchase a class of stock so vulnerable to subsequent dilution in favor of another class of stock.

[60]Reg. section 1.1361-1(l)(2)(ii).

[61]Reg. section 1.1361-1(l)(2)(vi), Example 1; *see also Paige v. United States*, 580 F.2d 960 (9th Cir. 1978) (similar facts); Rev. Rul. 71-522, 1971-2 C.B. 316, *obsoleted by* Rev. Rul. 95-71, 1995-2 C.B. 323, *Doc 95-9239, 95 TNT 195-1* (similar facts).

[62]Reg. section 1.1361-1(l)(2)(vi), Example 6.

[63]Even when a corporation is treated as having only one class of stock, any distributions that differ in timing or amount are still to be given appropriate tax effect in accordance with the facts and circumstances. Reg. section 1.1361-1(l)(2)(i).

[64]*See, e.g.*, LTR 200802002 (Sept. 28, 2007), *Doc 2008-638, 2008 TNT 9-26*; LTR 200125091 (Mar. 29, 2001), *Doc 2001-17371, 2001 TNT 122-72*; LTR 9519048 (Feb. 14, 1995), *95 TNT 94-50*; LTR 9519036 (Feb. 14, 1995), *95 TNT 94-51.* In each of these letter rulings, an S corporation made disproportionate distributions to shareholders, either for tax or other reasons, and the IRS ruled that the one-class-of-stock rule had not been violated. None of the corporations in the letter rulings made the disproportionate distributions under a governing provision, and each of the corporations provided for identical distributions in its governing provisions and made subsequent, remedial distributions to equalize the cumulative per-share distribution amounts to all shareholders. If in those letter rulings the disproportionate distributions were in accordance with a governing provision, a second class of stock would likely have been found. The letter rulings appear to be merely rulings of administrative grace in light of unintentional foot faults. A non-pro-rata distribution

(Footnote continued on next page.)

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

In general, deemed and constructive distributions that effectively result in non-pro-rata distributions also do not violate the one-class-of-stock rule (although they are still to be given appropriate tax effect in accordance with the facts and circumstances). For example, suppose an amount paid to a shareholder-employee under a binding employment contract is "unreasonable" and effectively constitutes a disguised distribution on his stock. Provided the two requirements discussed above are satisfied, the one-class-of-stock rule should not be violated, even though the distribution will be treated as constituting excessive compensation not deductible by the corporation.[65] Adopting this exception for purposes of the proposed regulations would provide a useful clarification of the "economic rights to distributions" requirement now articulated in those regulations. Allowing for minor deviations across classes would alleviate uncertainty about whether a new class of stock is created any time a corporation errantly makes a disproportionate distribution, including when it inadvertently triggers a deemed distribution.[66]

ii. Timing of distributions. Differences in the timing of distributions should not be treated as giving rise to a new class of stock under the proposed regulations, just as those differences do not per se violate the one-class-of-stock rule if the timing delays are not the result of a binding agreement concerning distribution or liquidation proceeds.[67] For example, if a corporation has two 50 percent shareholders and one shareholder receives a distribution on his stock up to a year later than the other shareholder, the one-class-of-stock rule is not violated provided the timing difference is not the product of a binding agreement regarding distribution proceeds.[68] Deemed distributions resulting from asymmetrical state withholding requirements imposed on the S corporation's shareholders also should not result in a violation of the one-class-of-stock rule.[69] Further, the timing of remedial payments made to equalize (past) disproportionate distributions should not give rise to additional classes of stock. In the subchapter C context, an allowance for distribution timing discrepancies would provide further certainty that some "minor" deviations in how or when shareholder distributions are made do not create new classes of stock.

But what if a timing difference is actually a different distribution right or even a disguised distribution preference? It is not always clear when a difference in timing becomes sufficiently meaningful to create a separate class of stock.

> **Example 10 — Timing difference of 12 months.** X, a corporation, has (in form) two classes of stock, class A and class B. The class A and class B stock share *pari passu* with respect to both earnings and liquidation proceeds. X's articles of incorporation provide that, for distributions, when X declares a distribution with respect to the class A stock, X must wait 12 months before declaring a proportionate distribution with respect to the class B stock.

Based on the principles of reg. section 1.1361-1(l), the class A and class B stock would be treated as separate classes of stock because the timing disparity was specifically provided for in X's governing provisions. This result also may be appropriate because of potential intervening events (for example, X's bankruptcy) resulting in the holders of the class B stock failing to receive some or all of a distribution.

But how little of a timing difference should be tolerated while still respecting the two purported classes as separate? Should the result be any different if a corporation is wholly owned?[70] In all, for purposes of the proposed regulations, differences in the timing of distributions should not result in a second class of stock, as long as those differences are (i) not the result of a binding agreement concerning distribution or liquidation proceeds, and (ii) no greater than 12 months.

iii. Redemption rights. For redemption rights, the proposed regulations should generally follow the pattern established in the S corporation context. Variations in redemption rights should generally *not* create a second class of stock for purposes of the proposed regulations. The regulations under section 1361(b)(1)(D) provide that redemption agreements are generally disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights, unless (i) a principal purpose of the agreement is to circumvent the one-class-of-stock rule, *and* (ii) the agreement establishes a purchase price that, when the agreement is entered into, is significantly more or less than the FMV of the stock.[71] To illustrate, consider LTR 9404020,[72] in which the IRS ruled that a section 302(d) redemption resulting in a constructive, non-pro-rata distribution did

---

will also not violate the one-class-of-stock rule if it is the result of a midyear change in stock ownership in the corporation. Reg. section 1.1361-1(l)(2)(iv).

[65]*See* reg. section 1.1361-1(l)(2)(vi), Example 3.

[66]*See*, *e.g.*, section 7872(a) and (c)(1)(C); reg. section 1.301-1(j); Rev. Rul. 69-630, 1969 C.B. 112.

[67]Reg. section 1.1361-1(l)(2)(vi), Example 2. *See also* LTR 9519048 (Feb. 14, 1995), *95 TNT 94-50* (similar where disproportionate distributions were the result of a misunderstanding).

[68]Reg. section 1.1361-1(l)(2)(v), Example 2(i).

[69]Reg. section 1.1361-1(l)(2)(ii).

[70]Courts have respected the existence of a second class of stock when the stock was both issued and redeemed when the corporation was owned by a *single* shareholder. *See*, *e.g.*, *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986) (where one corporation (P) that owned all the common and preferred stock of another corporation (S) — representing the only two classes of stock outstanding — received assets in complete liquidation with an FMV less than the preferred stock's liquidation preference, the court held that the predecessor of section 332 did not apply, because nothing was received by P in exchange for its S common stock). The IRS has also respected a second class of stock issued by a corporation with the same *sole* shareholder since its formation. *See*, *e.g.*, LTR 200829005 (Apr. 4, 2008), *Doc 2008-15810, 2008 TNT 140-56* (where the sole shareholder held both common and preferred stock, the IRS concluded that the issuing corporation's S corporation election was ineffective because it had two classes of stock).

[71]Reg. section 1.1361-1(l)(2)(iii)(A).

[72]Oct. 28, 1993, *94 TNT 20-46*.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

not give rise to a second class of stock as a result of unequal distribution rights. The corporation and its three shareholders had entered into an agreement providing for the redemption of the shareholders' stock over a period of years. The facts set forth in the letter ruling provide that the redemptions would *not* qualify for sale or exchange treatment under section 302(a), but that under section 1368(b)(1), the distribution proceeds would result only in a return of basis.[73]

Because redemption agreements are generally disregarded in determining whether the one-class-of-stock rule is satisfied, put rights, call rights, and mandatory redemption features, as well as reasonable transfer restrictions, should also be disregarded for purposes of defining class under the proposed regulations. The exception for some redemption agreements under reg. section 1.1361-1(l)(2)(iii)(A) was promulgated because, even though some parties to a redemption agreement may have specific liquidity rights (or transfer restrictions), those parties had identical ''rights to profits and rights in the assets of the corporation'' as the shareholders that did not possess those rights (or were not subject to such restrictions).[74] Consistent with both prop. reg. sections 1.302-5(b)(2) and 1.358-2(a)(2), and reg. section 1.1361-1(l)(2)(iii)(A), put rights, call rights, mandatory redemption features, and other redemption rights generally should not result in different classes of stock because those rights do not change a shareholder's economic rights to distributions vis-à-vis other shareholders of the same class of stock. The same rule should also apply to transfer restrictions. Thus, for purposes of the proposed regulations, redemption agreements generally should be disregarded in determining whether a corporation's outstanding shares of stock confer identical economic rights to distributions unless the agreement establishes a purchase price that, when the agreement is entered into, is significantly in excess of or below the FMV of the stock. The additional requirement under reg. section 1.1361-1(l)(2)(iii)(A) that ''a principal purpose'' for entering into the agreement be the circumvention of the one-class-of-stock rule should not be adopted for purposes of determining class under the proposed regulations. Depending on a shareholder's specific facts and circumstances, that shareholder may be better or worse off if, for example, his put right results in treating his underlying stock as a separate class.

Reasonable arguments exist that those rights (or restrictions) should give rise to a second class of stock. Those rights (or restrictions) may afford the holders of the underlying stock disparate ''economic rights'' (for example, a liquidity right) vis-à-vis other shareholders of the same class of stock. Under this line of reasoning, those rights and restrictions would result in a separate class of stock, even if the right establishes a purchase price that, when the underlying agreement is entered into, is *not* significantly in excess of or below the FMV of the issuing corporation's stock. For example, for a shareholder possessing a put right that other shareholders of the same class of stock do not possess, that shareholder possesses a liquidity right that the other shareholders do not possess. On balance, however, for purposes of the proposed regulations, put rights, call rights, mandatory redemption features, and other redemption rights (as well as transfer restrictions) generally should not result in the creation of a separate class of stock, because those rights and restrictions do not alter a shareholder's economic rights to *distributions* vis-à-vis other shareholders of the same purported class.

> **Example 11 — Redemption agreement.** X, a corporation, has (in form) one class of stock outstanding (that is, common stock). A and B each own 50 of the 100 shares of X common stock outstanding. A enters into an agreement with X whereby, at A's election, X is required to redeem up to 25 of A's shares of X common stock at a price of $100 per share at any time after the signing of the agreement. On the date that the agreement was entered into, each share of X common stock was worth $75.

For purposes of the proposed regulations, consistent with reg. section 1.1361-1(l)(2)(iii)(A) and the proposed regulations' focus on economic rights to distributions, A should be treated as holding two classes of stock — 25 shares of the same class of stock as the 50 shares held by B (the class A stock), and 25 shares of a second class of stock in which each share possesses an embedded put right (the class B stock) — because the agreement establishes a purchase price that, when the agreement was entered into, was significantly in excess of the FMV of the X common stock.

b. Voting rights. Differences in voting rights should not give rise to different classes of stock for purposes of the proposed regulations, just as those differences do not violate the one-class-of-stock rule.[75] Thus, although voting and nonvoting stock might be treated as different classes of stock under state law, that distinction will not

[73]Section 1368(b)(1) provides that a distribution of property on stock that would otherwise be subject to section 301(c) will not be subject to section 301(c) but will instead result in a return of the shareholder's basis to the extent such S corporation does not have any C corporation E&P.

[74]Rev. Rul. 85-161, 1985-2 C.B. 191 (redemption agreement subjecting one shareholder to a transfer restriction did not result in a second class of stock); *see also* LTR 8735013 (May 26, 1987) (agreement granting one shareholder a put right did not result in a second class of stock, because the put right did not ''affect the shareholders' rights in [the corporation's] profits and assets'').

[75]*See* section 1361(c)(4). The distinction between permissible differences in voting rights and impermissible differences in economic rights is not always immediately obvious. In LTR 9112017 (Dec. 21, 1990), for example, class A shares had broad voting rights on key issues but no right to operating or liquidating distributions while class B shares were entitled to operating and liquidating distributions but had narrower voting rights on fewer issues. The IRS ruled that not only did the disparate voting terms not preclude S corporation status, but the corporation had only one class of stock outstanding, because despite the classes' facially disparate economic rights, the class A shares had been created solely for the purpose of providing (additional) voting rights to its shareholder and did not constitute an equity interest.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

violate the one-class-of-stock rule. The definition of class provided in prop. reg. section 1.302-5(b)(2) appears to similarly ignore differences in voting rights by not taking into account ''rights with respect to corporate governance.''[76]

c. Stock options. Similarly, just as stock options on S corporation stock generally do not violate the one-class-of-stock rule, stock options should not be treated as giving rise to separate classes of stock under the proposed regulations. Commercial contractual agreements, such as employment and loan agreements, are usually disregarded for purposes of analyzing the one-class-of-stock rule. Taxpayers cannot circumvent the one-class-of-stock rule, however, by creating what is, in effect, an economic right for an equity interest by means of a side agreement. Thus, if a corporation, with the principal purpose of using a contractual arrangement to accomplish what it cannot do through its governing provisions, attempts to so evade the one-class-of-stock rule, the IRS is authorized to treat those arrangements as ''governing provisions'' and treat the corporation's status accordingly.[77] For example, much like some redemption rights, stock options may constitute a second class of stock if, taking into account all the facts and circumstances, the instrument is effectively a means of providing (additional) distributions to a shareholder. Specifically, reg. section 1.1361-1(l)(4)(iii)(A) provides that if the option is substantially certain to be exercised, and has a strike price substantially below the FMV[78] of the underlying stock on the date the option (i) is issued, (ii) transferred to an ineligible shareholder, or (iii) materially modified, the option will be treated as a second class of stock.[79]

In contrast to the stock option rules under reg. section 1.1361-1(l)(4)(iii), there is considerable authority concluding that stock options are not treated as stock in various subchapter C contexts. Much of this authority is in the reorganization context. In *Helvering v. Southwest Consolidated Corp.*,[80] for example, the target corporation's shareholders transferred their common and preferred stock in a target corporation in exchange for vested acquiring corporation out-of-the-money warrants. The target corporation creditors received acquiring corporation common stock in exchange for their target corporation claims. The Supreme Court held that the transaction was not a reorganization under the predecessor to section 368(a)(1)(C) because the ''solely for voting stock'' requirement was not satisfied. In arriving at this conclusion, the Court found that the warrants were not stock for purposes of the solely-for-voting-stock requirement because, on the date of the exchange, the warrant holders did not have rights akin to a shareholder. Later decisions also found that rights to acquire stock were not stock for purposes of section 354(a). In *Bateman v. Commissioner*,[81] the Tax Court held that out-of-the-money warrants were not stock in a section 368(a)(1)(A) reorganization for purposes of section 354(a). The court found that warrant holders must affirmatively perform (that is, pay an amount) to receive the underlying stock.[82] Also, in Rev. Rul. 78-408,[83] the IRS concluded that the exchange of target corporation warrants for acquiring corporation warrants under a stock-for-stock exchange did not violate the solely-for-voting-stock requirement of section 368(a)(1)(B) when there were ''large numbers of [target] stockholders who did not own [target] warrants.'' In arriving at this conclusion, the IRS treated the warrant-for-warrant exchange as a ''separable transaction.''[84]

As stated above, the stock option rules under reg. section 1.1361-1(l)(4)(iii) treat stock options as a separate class of stock if the options are substantially certain to be exercised and have a strike price substantially below the FMV of the underlying stock on the date the option is (i)

[76]*But see supra* note 5.

[77]Reg. section 1.1361-1(l)(2)(i).

[78]The preamble to the final one-class-of-stock regulations provides that ''the Service and Treasury believe that deep-in-the-money options effectively confer rights to corporate equity and should be taken into account for purposes of the one class of stock requirement.'' T.D. 8419, 1992-2 C.B. 217, 219. In determining whether a strike price is ''substantially'' below FMV, the regulations provide some guidelines. *See* reg. section 1.1361-1(l)(4)(iii)(C) (a stock option will not be treated as a second class of stock if the strike price of such option is at least 90 percent of the FMV of the underlying stock on the date the option is (i) issued, (ii) transferred to an ineligible shareholder, or (iii) materially modified, as the case may be); *compare* reg. section 1.1361-1(l)(4)(v), Example 1 (a strike price equal to only 50 percent of FMV is substantially below that value).

[79]Notwithstanding that a stock option is substantially certain to be exercised and has a strike price substantially below the FMV of the underlying stock on a relevant date, some options will *not* be treated as a second class of stock. *See* reg. section 1.1361-1(l)(4)(iii)(B)(1) (exception for stock options issued to certain lenders in connection with certain lending transactions); reg. section 1.1361-1(l)(4)(iii)(B)(2) (exception for certain stock options issued to employees or independent contractors in connection with the performance of services).

[80]315 U.S. 194 (1942).

[81]40 T.C. 408 (1963).

[82]*Cf. Estate of Miller*, 43 T.C. 760 (1965) (in holding that the corporation was a foreign personal holding company, the court found that warrants were stock when warrant agreement stated warrants were to be treated as stock, holders of warrants were entitled to dividends, there was no additional cost to convert warrants into stock, and warrant holders were permitted to vote provided simple administrative procedures were followed before the shareholders' meeting); Rev. Rul. 82-150, 1982-2 C.B. 110 (deep-in-the-money option to acquire stock on the date of issuance was treated as stock for purposes of determining whether a U.S. person was the actual owner of stock for purposes of sections 551 and 951); *but see Graney v. United States*, 258 F. Supp. 383 (S.D. W. Va. 1966), *aff'd*, 377 F.2d 992 (4th Cir. 1967) (deep in-the-money option not treated as stock *ab initio* when optionee could purchase up to 100 shares of stock per year for five years, vote stock, and receive dividends on stock but the underlying stock was placed in an escrow account for five-year period).

[83]1978-2 C.B. 203.

[84]*See also* Rev. Rul. 98-10, 1998-1 C.B. 643 (when there is disproportionality between debenture holders and stockholders, a debenture-for-debenture exchange under the same plan as a stock-for-stock exchange is treated as separate); *Smith v. Commissioner*, 63 T.C. 722 (1975), *acq*. 1976-2 C.B. 2 (warrants held not to be stock).

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

issued, (ii) transferred to an ineligible shareholder, or (iii) materially modified. That rule appears focused on stock options issued as a means of providing (additional) distributions to shareholders. Outside the one-class-of-stock rule context, however, for a warrant to be recharacterized as already exercised (that is, as stock), the authorities have generally concluded that there must be an intention on the date the option is issued to economically treat the warrant as stock. In both *Estate of Miller* and Rev. Rul. 82-150, the taxpayers intended to have a stock ownership in the respective issuing corporations *ab initio* but purchased warrants to prevent certain tax consequences. That said, the above authorities are solely focused on whether the holders of stock options should be treated as owning the underlying stock. There appears to be no authority in the subchapter C context under which holders of options to acquire shares of one class of stock are treated as owning shares of a separate class of stock. Thus, as the holders of stock options are not entitled to distributions until those options are exercised (if ever), a rule that does not treat stock options as stock for purposes of the proposed regulations is consistent with both the subchapter C authorities discussed above and the definition of class under prop. reg. section 1.302-5(b)(2).

> **Example 12 — Treatment of stock options in a dividend-equivalent redemption.** X, a corporation, has two classes of voting common stock outstanding, class A and class B, whereby each share, regardless of class, possesses one vote. C owns 75 shares of class A common stock with a basis of $2 in each share, and all 100 shares of the class B common stock with a basis of $5 in each share. D, unrelated to C, owns the remaining 25 shares of class A common stock. X has no other stock outstanding. C also owns 100 stock options, whereby each option gives C the right to acquire one share of class B common stock. C acquired each option for $1 when the underlying class B common stock had an FMV of $3 per share. Each option has a strike price of $1. In a year when X has no current or accumulated E&P, X redeems C's 100 shares of the class B common stock in exchange for $300. The redemption does *not* qualify for section 302(a) treatment. What are the appropriate tax consequences to C under the proposed regulations?

If the options are not treated as shares of class B common stock (or as a separate class of X stock under the principles of reg. section 1.1361-1(l)(4)(iii)),[85] C would have $300 of basis recovered under section 301(c)(2). C would have $200 in excess basis after the redemption of all his class B common stock, which would *not* shift to his class A common stock. The $200 of excess basis would be treated as a deferred loss until the inclusion date.[86]

If the options are treated as shares of class B common stock (for example, under the principles of Rev. Rul. 82-150), C would have two blocks of class B common stock — block 1, consisting of 100 shares with a basis of $5 per share (representing the 100 shares of class B common stock redeemed), and block 2, consisting of 100 shares with a basis of $1 per share (representing the 100 options). For his block 1 shares, C would be treated as receiving $1.50 per share, resulting in a basis recovery of $150 under section 301(c)(2).[87] For his block 2 shares, C would also be treated as receiving $1.50 per share, resulting in a basis recovery of $100 under section 301(c)(2) and a gain of $50 under section 301(c)(3).[88] After the redemption, C would have one block of class B stock consisting of 50 shares with a basis of $7 per share and a second block of class B stock consisting of 50 shares with a basis of $0 per share.[89]

4. A class of stock for purposes of the proposed regulations.

a. Principal focus on economic rights. For the class of stock issue, basing an approach on the regulations under section 1361(b)(1)(D) is consistent with the definition established in the proposed regulations. The proposed regulations appear to use similar principles to those in section 1361(b)(2)(D) and in the legislative history to section 562(c) — that is, focusing primarily on economic rights and not voting rights. As stated above, prop. reg. section 1.302-5(b)(2) defines a class of stock "with respect to economic rights to distributions rather than the labels attached to shares or rights with respect to corporate governance." As outlined in *Himmel v. Commissioner*,[90] stock possesses three potentially relevant interests: the right to vote; the right to receive dividends; and the right to receive liquidation proceeds. Although the right to elect members of the corporation's board of directors and participate in extraordinary corporate matters is fundamental to the control of a corporation, it is also generally the easiest and most palatable of the three *Himmel* rights to manipulate. As such, to accommodate the business reality of needing to provide some differentiation among classes of stock while preserving the integrity of the principles underlying the proposed regulations, Treasury and the IRS appear to have interpreted class of stock as hinging, for purposes of the proposed regulations, on the two "economic" *Himmel* rights.[91]

---

[85]The 90 percent safe harbor under reg. section 1.1361-1(l)(4)(iii)(C) would not be available, because the cost of the stock option ($1) plus the strike price of such option (an additional $1) is less than 90 percent of the FMV of the underlying stock on the date the options were issued (approximately 67 percent).

[86]*See* prop. reg. section 1.302-5(a)(3).

[87]*See* prop. reg. section 1.302-5(a)(1).

[88]*Id*.

[89]*See* prop. reg. section 1.302-5(a)(2).

[90]338 F.2d 815 (2d Cir. 1964).

[91]This is also consistent with authorities under sections 305 and 306. *See, e.g.*, Rev. Rul. 79-163, 1979-1 C.B. 131 (when class A common stock and class B common stock share *pari passu* with respect to dividends but only the class B common stock is entitled to receive liquidation proceeds beyond its par value, the IRS concluded that the class A common stock was not common stock for purposes of section 306(c)).

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

b. Differences between rationale for one-class-of-stock rule and rationale for class focus in the proposed regulations do not preclude using the regulations under section 1361(b)(1)(D) as a foundation. The legislative history to section 1361 does not explain why the one-class-of-stock rule was included among the subchapter S requirements. Nor has Congress expounded on the meaning of a class of stock, except to say that ''the outstanding shares of the corporation must continue to be identical as to the rights of the holders in the profits and in the assets of the corporation.''[92] As discussed in *Portage Plastics Co., Inc. v. United States*, however, the legislative history to section 1361(b)(1)(D) suggests that the purpose of the one-class-of-stock requirement ''was to avoid the administrative complexities which would arise in general in the allocation of earnings or losses among several classes of stock, and in particular in allocation when there was a payment of dividends on preferred stock in excess of earnings.''[93] On appeal, the Seventh Circuit echoed this sentiment, concluding that the one-class-of-stock rule served to make the passthrough rules practicable by staving off complications certain to arise when corporations attempted to pass profits through to shareholders possessing varying distribution preferences.[94] Fundamentally, enacting subchapter S into the code was intended to aid small businesses by providing a simple, more tax-advantageous business form.[95]

Although the apparent rationale for the one-class-of-stock rule (that is, simplicity) is different from the ostensible rationale of the proposed regulations (that is, theoretical coherence, and attempting to prevent taxpayers from manipulating basis allocations under the fundamental unit approach), there is little reason why future guidance for the various provisions implicated by the proposed regulations would depart significantly from the guidance issued under section 1361(b)(1)(D). The one-class-of-stock rule should provide a reasonable starting point because the guidance is based on corporate law notions of class — the same law on which *Himmel* and its progeny were based. In addition, from an enforcement perspective, although taxpayers' incentives for defining a class under the two regimes may be different (shareholders of an S corporation may be motivated to maximize the differences between classes and still be treated as having a single class of stock, while shareholders of a C corporation may be incentivized to claim that minor differences give rise to different classes of stock), the IRS's goal of policing the two regimes is the same: The number of shareholder classes, in form, should accurately reflect the number of shareholder classes existing in substance. As such, section 1361(b)(1)(D) and the authorities thereunder should provide useful guidance (taking into account the modifications discussed below) for taxpayers in determining the parameters of a class of stock for purposes of the proposed regulations.

c. One-class-of-stock rule guidance should generally be adopted by the final version of the proposed regulations with some modifications. In summary, the issue of separate classes of stock goes to the core of the proposed regulations. The proposed regulations, however, minimally define class by reference to ''economic rights to distributions,'' and provide no further guidance except to ignore voting rights. Given the diversity of shareholders' rights in corporate stock, this minimal definition is inadequate and will inevitably lead to considerable confusion. The principles developed for determining the existence of distinct classes of stock in S corporations, which are consonant with the minimal definition in the proposed regulations, can and should be adopted, with some modifications, as a supplement to the proposed regulations. More specifically, the proposed regulations should adopt the following guidelines when defining a class of stock:

- Only shares that confer identical rights (as determined under the issuing corporation's governing provisions) to distributions *and* liquidation proceeds should be considered part of the same class.
- Disproportionate distributions resulting from deemed or constructive distributions should not result in a second class of stock, provided remedial distributions are made such that, in the aggregate, the distributions are pro rata.
- Differences in the timing of distributions should not result in a second class of stock, so long as those differences (i) are not the result of a binding agreement relating to distributions or liquidation proceeds, and (ii) are no greater than 12 months.
- Voting rights should not be taken into account in determining whether a second class of stock exists.
- Put rights, call rights, mandatory redemption features, and other redemption rights, as well as reasonable transfer restrictions, should not result in a second class of stock unless the agreement establishes a purchase price that, when the agreement is entered into, is significantly in excess of or below the FMV of the stock.
- Stock options should not result in a second class of stock. Deep-in-the-money stock options (for example, that satisfy the standard set forth in Rev. Rul. 82-150) should be treated as the same class of stock as the stock underlying the stock option and not as a second class of stock.
- The same rules should apply to widely held corporations and wholly owned corporations.

In all, investors in corporate enterprises routinely fine-tune their respective rights for ordinary and proper

---

[92] S. Rep. No. 640, 97th Cong., 2d Sess. 8 (1982), *reprinted in* 1982-2 C.B. 718, 721.

[93] 301 F. Supp. 684, 691 (W.D. Wis. 1969), *aff'd in relevant part by* 486 F.2d 632 (7th Cir. 1973); *see also* S. Rep. No. 1622, 83d Cong. 2d Sess. 119, 453-454 (1954); S. Rep. No. 830, 88th Cong. 2d Sess. 146 (1964).

[94] *Portage Plastics*, 486 F.2d at 637.

[95] *See* S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), *reprinted in* 1958-3 C.B. 922, 1137; S. Rep. No. 640, 97th Cong., 2d Sess. 8 (1982), *reprinted in* 1982-2 C.B. 718, 720 (''Congress enacted subchapter S to minimize the effect of Federal income taxes on choices of the form of business organization and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels''); *see also Gamman v. Commissioner*, 46 T.C. 1, 7-8 (1966).

business reasons. That fine-tuning should not, to the extent possible, give rise to unforeseen tax consequences. Adopting the above principles will go a long way toward alleviating confusion and furthering the sound purpose of the proposed regulations.

Royalties Can Satisfy Research Credit Trade or Business Criterion

By Charles J. Medallis

Charles J. Medallis is director of R&D Tax Incentives with the KPMG LLP Research Credit Services Group. He is based in Los Angeles.

The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. The article represents the views of the author only and does not necessarily represent the views or professional advice of KPMG LLP.

To be eligible for the research credit, a taxpayer's research activities must satisfy a trade or business requirement.

The IRS issued an interesting technical advice memorandum in 2007 concluding that a corporate joint venture that derived royalty income from licenses of its inventions was entitled to the research credit for its development expenses.[1] Although the corporation had used third parties to develop the technology and derived its income from the licensing of the inventions, the IRS concluded that the corporation was carrying on a trade or business and was allowed to take a section 41 research credit for the contract research costs because, in addition to the licensing activity, it used the technology and inventions in further research.

Facts

In the memorandum, Taxpayer, a U.S. corporation, is owned by a non-U.S. corporation and a U.S. corporation in the same industry, each of which holds a 50 percent interest. Taxpayer was formed to allow the two owners to jointly develop and commercialize its inventions. The two owners contributed capital, in-process research and experimentation, and other intangible assets to Taxpayer. Some of Taxpayer's research is conducted by third parties under contract.

Taxpayer retains ownership of all production and marketing rights to its inventions developed from its successful research activities. (Not all of its intended inventions are successfully developed.) Before it is known whether the research is successful, Taxpayer grants licenses to its two owners to exclusively use the inventions in their respective territories, and the two owners pay royalties to Taxpayer. Taxpayer also licenses some of its inventions to other parties for use in other territories.

In most instances, Taxpayer continues research and development of the inventions even after they have been

[1]TAM 200811020 (Dec. 3, 2007), *Doc 2008-5659*, *2008 TNT 52-15*.

(C) Tax Analysts 2009. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.