

## Catholic University Law Review

---

Volume 43  
Issue 4 Summer 1994

Article 3

---

1994

### Corporate Taxation's Square Peg: An Analysis of Possible Solutions to the Problem of Characterizing "Tracking Stock" for Tax Purposes

Charles A. Borek

Follow this and additional works at: <https://scholarship.law.edu/lawreview>

---

#### Recommended Citation

Charles A. Borek, *Corporate Taxation's Square Peg: An Analysis of Possible Solutions to the Problem of Characterizing "Tracking Stock" for Tax Purposes*, 43 Cath. U. L. Rev. 1107 (1994).

Available at: <https://scholarship.law.edu/lawreview/vol43/iss4/3>

This Article is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact [edinger@law.edu](mailto:edinger@law.edu).

# CORPORATE TAXATION'S SQUARE PEG: AN ANALYSIS OF POSSIBLE SOLUTIONS TO THE PROBLEM OF CHARACTERIZING "TRACKING STOCK" FOR TAX PURPOSES

Charles A. Borek\*

## I. INTRODUCTION

"Tracking stock"<sup>1</sup> is a class of corporate equity securities whose value is designed to track the performance of specific assets or groups of assets of a corporation.<sup>2</sup> As such, tracking stock splits the interest in the corporation vertically, unlike common and preferred stock, which traditionally divide the corporate interest horizontally.<sup>3</sup> Tracking stock may be issued for a variety of business purposes, including a desire to maximize stock trading price or a need for a specialized investment vehicle to facilitate a corporate acquisition.<sup>4</sup> Because this stock is unique in its vertical division

---

\* B.A., Mary Washington College, 1985; M.B.A., University of Baltimore, 1993; J.D., *summa cum laude*, University of Baltimore, 1993; Certified Public Accountant, State of Maryland; Associate, Thomas & Libowitz, P.A., Baltimore, Maryland; Adjunct Professor of Law, University of Baltimore. The author gratefully acknowledges the assistance of Professor Fred Brown in the preparation of this article.

1. The term "alphabet stock" is often used interchangeably with "tracking stock." "Alphabet stock" is derived from General Motors' creation of "E" and "H" stock to track its subsidiaries, Electronic Data Systems Corporation and Hughes Aircraft Company. Jeffrey T. Sheffield & Barbara M. St. Clair, *An Abecedarium on Alphabet Stock*, 66 TAXES 954, 954 n.1 (1988). For the sake of simplicity, the term "tracking stock" will be used exclusively in this article.

2. See *id.* at 956 (stating that the use of tracking stock to determine the performance of a certain portion of corporate assets has economic and tax advantages over regular distribution of stock).

3. See *New York State Bar Association Tax Section Corporations Committee and Reorganizations Committee Report Regarding "Tracking Stock" Arrangements*, 43 TAX L. REV. 51, 53 (1987) [hereinafter *Report*]. Typically, both common and preferred stock share the earnings of the entire corporation. *Id.* Tracking stock arrangements usually provide that dividends are to be paid out of a segregated portion of total corporate earnings. *Id.* The value of the tracking stock is usually designed to reflect the value of the underlying assets, not a portion of the corporation as a whole. *Id.* (stating that tracking stock involves a "vertical" division of rights to the corporate income and assets that it tracks).

4. Sheffield & St. Clair, *supra* note 1, at 957 (explaining the advantages of tracking stock in particular business scenarios).

of corporate interests, however, several questions arise as to whether it will be subject to various corporate tax provisions.<sup>5</sup>

The Treasury Department (Treasury) has not yet addressed the tax implications associated with the use of tracking stock.<sup>6</sup> While the lack of authoritative guidance has not prevented some businesses from using this equity device,<sup>7</sup> it certainly has discouraged some risk-sensitive corporate planners from using tracking stock to its fullest potential.<sup>8</sup> Through its inaction, the government may be indirectly impeding the legitimate use of this creative addition to the corporate equity lexicon. Furthermore, any eventual government action is likely to impact transactions that have already occurred or are currently being contemplated.

For tax purposes, it is important to determine whether tracking stock will be treated as stock of the issuing parent corporation. For example, Internal Revenue Code (Code) section 1032(a) provides that a corporation does not recognize gain or loss on the receipt of property in exchange for its stock.<sup>9</sup> Furthermore, Code sections 311(a)(1)<sup>10</sup> and 305(a)<sup>11</sup> allow a corporation to distribute its own stock to its shareholders without incurring tax liability. If tracking stock is considered to be something other than the stock of the parent, however, its issuance would be taxable in each of these situations.<sup>12</sup>

In determining the immediate tax consequences under these provisions, it is only necessary to determine whether the tracking stock constitutes stock of the parent corporation. If it does not, there is generally no

---

5. See *Report, supra* note 3, at 57-64 (addressing questions regarding the federal income tax treatment of tracking stock). The *Report* was written in response to the Internal Revenue Service (IRS) and Treasury Department request for proposals concerning the tax treatment of tracking stock. *Id.* at 52.

6. The Treasury Department currently has a "no ruling" policy with respect to tracking stock. Rev. Proc. 87-59, 1987-2 C.B. 765 (listing tracking stock as one of the "Areas Under Extensive Study in Which Rulings or Determination Letters Will Not Be Issued"); Rev. Rul. 93-3, 1993-1 C.B. 209 (listing revenue rulings that have become obsolete and not including tracking stock).

7. See *infra* part II.A. discussing General Motors' use of tracking stock and part II.B. reviewing the USX tracking stock transaction.

8. General Overview and Strategies in Representing Sellers, in *TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, FINANCINGS, JOINT VENTURES, REORGANIZATIONS, AND RESTRUCTURINGS 1991*, at 7, 278-79 (PLI Tax Law and Estate Planning Series No. 316, 1991).

9. I.R.C. § 1032(a) (1988). Specifically, the Code states that "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock . . . of such corporation." *Id.*

10. *Id.* § 311(a)(1).

11. *Id.* § 305(a).

12. *E.g., id.* § 311(a)(1). This section requires recognition of gain on a distribution of property that is "other than an obligation of such corporation". *Id.* § 311(b)(1)(A).

need to determine what the instrument actually *does* represent. When stock tracks a separately organized subsidiary, however, further questions are presented. Code section 355, for example, provides that neither the parent corporation nor a shareholder of the parent recognizes gain or loss when the parent distributes a controlling interest in the stock of a subsidiary.<sup>13</sup> Thus, if the tracking stock is characterized as stock of the subsidiary, Code section 355 should apply. Conversely, if the tracking stock is characterized as stock of the parent,<sup>14</sup> the corporation can avoid that section's statutory conditions while still achieving a tax-free spin-off.<sup>15</sup>

This Article addresses the concerns raised by the use of tracking stock and analyzes two competing conceptual frameworks that have been proposed. This Article concludes that the most logical method of treating tracking stock for tax purposes is the same approach that is used for state corporate law purposes—tracking stock should be treated as stock of the parent corporation.

## II. BACKGROUND

### A. *General Motors Corporation's Use of Tracking Stock*

The first well-documented use of tracking stock occurred when General Motors Corporation (GM) acquired Electronic Data Systems (EDS) in the summer of 1984.<sup>16</sup> Through a statutory merger,<sup>17</sup> EDS shareholders were given the option of receiving cash for their shares or a combination of cash, a contingent note, and shares of a newly created class of GM

13. *Id.* § 355.

14. An additional inquiry might be made as to whether the stock should be treated as common or preferred. *See infra* notes 58-68 and accompanying text.

15. The actual requirements for a tax-free distribution under Code § 355 are somewhat elaborate. For example, there must be a bona fide business purpose for the transaction. Treas. Reg. § 1.355-2(b) (as amended in 1992). After the distribution, one or more of the predistribution shareholders of the parent must continue to own 50% of the value of both the parent and the subsidiary. *Id.* § 1.355-2(c)(1). Also, immediately after the distribution, both the parent and the subsidiary must engage in the active conduct of a trade or business. I.R.C. § 355(b)(1)(B) (1988). Each trade or business existing subsequent to the distribution must have been actively conducted during the five years immediately preceding the distribution. *Id.* § 355(b)(2)(B). The distribution must not principally constitute a device for the distribution of earnings or profits. *Id.* § 355(a)(1)(B). The parent must control the subsidiary immediately before the distribution. *Id.* § 355(a)(1)(A). Finally, the parent must distribute at least a controlling interest in the subsidiary. *Id.* § 355(a)(1)(D).

16. Douglas H. Walter & Paul A. Strasen, *Innovative Transactions: General Motors Class E and Class H Common Stock*, 64 *TAXES* 365, 365 (1986). Although it is difficult to determine if GM was actually the first to use tracking stock, at least one source characterizes the transaction as "novel." *Id.* at 366; *see also* Sheffield & St. Clair, *supra* note 1, at 954 n.1 (establishing that the term "alphabet stock" originated during the GM transaction).

17. Walter & Strasen, *supra* note 16, at 366.

stock.<sup>18</sup> The new class of stock, denominated as "Class E" stock, was to receive dividends exclusively from a segregated pool of funds consisting of the paid-in capital and the net income attributable to the EDS subsidiary.<sup>19</sup> GM used a similar structure when it acquired Hughes Aircraft Company, resulting in the creation of GM "Class H" stock.<sup>20</sup>

GM's general counsel set forth two non-tax business reasons for the company's choice in structuring the transactions.<sup>21</sup> First, the shareholders of the acquired companies were accustomed to holding growth stock with a high price-to-earnings ratio, but the GM stock was trading at a low price-to-earnings ratio and had shown slow growth immediately preceding the acquisition.<sup>22</sup> Second, GM wanted to create an equity vehicle that would reflect the growth potential of the new subsidiaries without any dilution, which would occur if the new entrepreneurial acquisitions were combined with its traditional business.<sup>23</sup>

It is likely, however, that tax considerations also played a role in the decision. In both transactions, GM endeavored to create a market for its new stock by making a distribution of the new class to the holders of its regular common stock.<sup>24</sup> If the company had elected to issue the subsidiary stock itself, these distributions would not be tax free to the shareholders.<sup>25</sup> Furthermore, GM may have been unable to file consolidated returns with its subsidiaries if it had distributed subsidiary stock.<sup>26</sup>

Although GM's Class E and Class H tracking stock have unique attributes, in many ways they resemble traditional parent corporation stock.<sup>27</sup>

---

18. *Id.* Specifically, EDS shareholders could receive \$44.00 per share or \$35.20 per share plus a contingent note and two-tenths of a share of the new class of GM stock. *Id.*

19. *Id.*

20. *Id.* at 367 (claiming that GM used the tracking stock transaction again because of its success in the EDS merger).

21. *Id.* at 365 (citing Elmer Johnson, *Classes of Common Stock Achieve Key Goals*, LEGAL TIMES, Mar. 17, 1986, at 17).

22. *Id.*

23. *Id.*

24. *Id.* at 367.

25. The shareholder nonrecognition provision of Code § 305 only applies when the corporation distributes its own stock. I.R.C. § 305(a) (1988). A distribution of subsidiary stock would generally require the distributees to recognize the value of the stock as gross income. *Id.* § 301(b).

26. Only affiliated groups of corporations are eligible to file consolidated returns. I.R.C. § 1501 (1988). To achieve affiliated group status, the parent corporation must own 80% of the total voting power and 80% of the total value of the subsidiary. *Id.* § 1504(a)(2).

27. These similarities have persuaded some commentators to conclude that the GM Class E and Class H Stock should be treated as stock of the parent corporation for tax purposes. Walter & Strasen, *supra* note 16, at 367. See *infra* notes 30-32 and accompanying text (discussing the particular similarities).

For example, the holders of the tracking stock have voting rights similar to regular GM shareholders and share the liquidation proceeds with those shareholders in proportion to their relative voting rights.<sup>28</sup> Moreover, GM is free to terminate the arrangement any time after December 31, 1994, by causing an exchange of tracking stock shares for regular shares of GM common stock.<sup>29</sup>

### B. *USX Corporation's Tracking Stock Transaction*

More recently,<sup>30</sup> USX Corporation (USX) used tracking stock to effectively separate its two main lines of business.<sup>31</sup> USX is composed of two discernable businesses: steel manufacturing and energy interests.<sup>32</sup> By 1990, USX shareholders began looking for ways to divest the less profitable steel operations and to focus on the more dynamic energy business.<sup>33</sup> The company, however, did not want to engage in a traditional spin-off because the transaction would likely be taxable under Code section 355 and would eliminate its ability to use the net operating carryforward losses generated by the steel manufacturing business.<sup>34</sup> In May, 1991, the shareholders voted to create a new class of stock designed to track the results of the steel operations.<sup>35</sup> The shareholder action split the ownership of the company into two distinct equity interests.<sup>36</sup> The new class of stock was designated "USX—U.S. Steel Group Common Stock" (Steel Group Common) and the remaining stock became "USX—Marathon Group Common Stock" (Marathon Group Common).<sup>37</sup>

---

28. Walter & Strasen, *supra* note 16, at 367.

29. *Id.*

30. Although several corporations have used tracking stock, the GM and USX transactions are the only examples discussed in detail in this article. One of the most recent noteworthy proposed transactions involving this equity device was advanced by Kmart Corporation. See *Kmart to Create New Stocks Tied to 4 of Its Units*, WALL ST. J., Jan. 5, 1994, at A3. The stockholders of Kmart, however, failed to approve the transaction. Jay Mathews, *Shareholders Block Kmart Stock Issue*, WASH. POST, June 4, 1994, at B1.

31. USX Corporation, Proxy Statement and Prospectus, April 10, 1991 [hereinafter Proxy Statement]; see also Jeffrey D. Conway, *The USX Tracking Stock "Spin-Off": A Case of Split Personality*, 69 TAXES 383 (1991); Clare Ansberry, *USX Holders Clear Plan for New Stocks; Talks Under Way to Sell Part of Steel Unit*, WALL ST. J., May 7, 1991, at A4 [hereinafter *Holdings Vote*].

32. See Conway, *supra* note 31, at 383.

33. *Id.* (citing *One Year Ago in Corporate Financing Week*, CORP. FIN. WEEK, Apr. 15, 1991, at 12).

34. *Id.*

35. *Holdings Vote*, *supra* note 31, at A4.

36. See Conway, *supra* note 31, at 385 (stating that the distinction would give shareholders "an opportunity to separately evaluate and invest in each").

37. Proxy Statement, *supra* note 31, at 1.

While both the GM and USX transactions involved tracking stock, USX utilized the new equity instrument much more aggressively. Like GM's tracking stock, the Steel Group Common has general corporate voting power.<sup>38</sup> The voting power of the Steel Group Common, however, is not fixed; it fluctuates based on the relative market values of the two classes of stock.<sup>39</sup> Furthermore, the USX plan prohibits the corporation from using the proceeds from the disposition of one group's assets for the benefit of the other group without a two-thirds vote by the group whose assets are involved.<sup>40</sup> Thus, while the holders of the individual classes of USX stock do not directly control the management of their respective divisions, they do have some influence over management's utilization of corporate assets. Conversely, the GM transaction gives the board of directors unfettered discretion to shift assets between groups.<sup>41</sup>

The most significant difference between the two situations, however, concerns liquidation rights. Upon liquidation, there is a pro rata division of assets among the various classes of GM shareholders;<sup>42</sup> however, the various groups of USX shareholders share liquidation proceeds based on the relative market capitalizations of their respective divisions.<sup>43</sup> Consequently, USX shareholders may enjoy the economic benefit of any appreciation or suffer the economic detriment of any depreciation in the value of the stock in their respective divisions. This feature makes the two divisions look very much like separate entities.<sup>44</sup>

### III. THE CURRENT STATE OF THE LAW

As noted above, Treasury has not yet specifically addressed the tax consequences relating to the use of tracking stock.<sup>45</sup> It may be useful, however, to examine the treatment of similar investment vehicles in order to discern the likely approach by the government.

---

38. The GM plan mandated separate class votes on matters specifically affecting each class. Walter & Strasen, *supra* note 16, at 366. In comparison, the USX plan provides that the steel stock and energy stock generally will vote as a single class. Proxy Statement, *supra* note 31, at 3.

39. Proxy Statement, *supra* note 31, at 3. This scheme was created to require the purchaser to acquire of equivalent holdings in both classes of stock. *Id.* at 21.

40. *Id.* at 8.

41. Walter & Strasen, *supra* note 16, at 366.

42. *Id.*

43. Proxy Statement, *supra*, note 31, at 21.

44. Walter & Strasen, *supra* note 16, at 367-68. It should be noted, however, that this scenario assumes that a liquidation would leave assets available to the shareholders. Since a single corporate form is maintained, the assets of both groups are subject to the claims of the creditors of the corporation.

45. See *supra* note 6 and accompanying text.

### A. Series Funds

One possible analogy to tracking stock is the use of a "series fund" in the context of a regulated investment company.<sup>46</sup> This financial structure is commonly known as a mutual fund. The assets of such an entity consist of several distinct investments, or "series."<sup>47</sup> In *Union Trusteed Funds, Inc. v. Commissioner*,<sup>48</sup> the Tax Court ruled that each series of a series "fund"<sup>49</sup> does not constitute a separate corporate entity.<sup>50</sup> As justification for its conclusion, the court noted that Congress failed to specifically provide for separate corporate treatment of the series funds despite its presumed knowledge of their existence.<sup>51</sup> The court further observed that Treasury had not issued any regulations mandating such treatment.<sup>52</sup> Subsequently, Congress specifically overruled the Tax Court's decision in *Union Trusteed Funds* by enacting section 851(h) as part of the Tax Reform Act of 1986.<sup>53</sup>

Arguably, because the congressional response to *Union Trusteed Funds* was specifically limited to regulated investment companies,<sup>54</sup> the Tax Court's rationale may be applicable to tracking stock. Consequently, since neither Congress nor Treasury have suggested otherwise, tracking stock should be treated as ordinary parent corporation stock. The continued viability of *Union Trusteed Funds*' reliance on the justification of presumed congressional knowledge,<sup>55</sup> however, is questionable in the context of tracking stock. Tracking stock is a relatively recent phenomena, and a presumption of knowledge on the part of the national legislature might be misplaced.

Conversely, section 851(h) may offer insight into Congress' intent relative to the treatment of instruments similar to series funds. If the enactment of section 851(h) indicates a congressional inclination to treat these

---

46. See *Report supra* note 3, at 65-66 (discussing the judicial and legislative treatment of series funds in the context of a regulated investment company).

47. *Id.* at 65.

48. 8 T.C. 1133 (1947).

49. A series fund is defined as "a single entity . . . with several separate investment funds." *Report, supra* note 3, at 65. The entity issues multiple series of stock, with each series having dividend and liquidation rights corresponding to a specific investment fund. *Id.*

50. *Union Trusteed Funds*, 8 T.C. at 1137.

51. *Id.*

52. *Id.*

53. Code § 851(h)(1) provides: "In the case of a regulated investment company . . . having more than one fund [i.e., a series fund], each fund . . . shall be treated as a separate corporation . . ." I.R.C. § 851(h)(1) (1988).

54. The statute applies only to regulated investment companies as defined by the Investment Company Act of 1940, as amended. *Id.* § 851(a).

55. See *supra* note 51 and accompanying text.



instruments as distinct from their common parent, the conceptual resolution of the issue should focus on whether the tracking stock is sufficiently similar to the investment funds of a series fund.

Like the individual series of a series fund, tracking stock represents an investment in a segregated portion of the corporation's assets.<sup>56</sup> Moreover, like a mutual fund, tracking stock is not actually an interest in specific assets because holders of such stock ultimately share the assets of the entire corporation with the other shareholders.<sup>57</sup> Therefore, tracking stock *could* be construed as bearing a close resemblance to a series fund. Instead of tracking the tangible assets of a division, if the tracking stock tracked certain security investments of a corporation, it would operate very much like a series fund. Conceptually, therefore, there is support for the idea that tracking stock is sufficiently similar to a series fund to assume that the legislative policy rationale of Code section 851(h) is an indication of how Congress will ultimately view the tax implications of tracking stock.

### B. Common Stock vs. Preferred Stock

Even if tracking stock is treated as stock of the issuing parent for tax purposes, it is not clear whether it should be treated as common stock or preferred stock. This determination is important, for example, in the context of Code section 305.<sup>58</sup> That section provides a general rule that gross income will not include a distribution of stock that is made with respect to already outstanding stock.<sup>59</sup> The general rule does not apply, however, "[i]f the distribution . . . has the result of—(A) the receipt of preferred stock by some common shareholders, and (B) the receipt of common stock by other common shareholders."<sup>60</sup> Furthermore, the general rule will not apply to most distributions of preferred stock.<sup>61</sup> Thus, the classification of tracking stock as either common or preferred is imperative to this determination.

---

56. *Compare Report, supra* note 3, at 54-55 (discussing the correlation between tracking stock and the segregated assets of the corporation) with I.R.C. § 851(h)(2) (defining "fund" as "a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets").

57. *See* Walter & Strasen, *supra* note 16, at 336 (describing the GM Class E transaction).

58. I.R.C. § 305 (1988).

59. Section 305(a) provides: "Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock." *Id.*

60. *Id.* § 305(b)(3).

61. *Id.* § 305(b)(4).

Tracking stock is usually designated by the issuing corporation as a class of common stock.<sup>62</sup> Unlike typical common stock, tracking stock shares in the earnings of a particular portion of the corporation; if the particular assets tracked do not show a profit, the tracking stock holders will not receive a dividend, regardless of the overall performance of the corporation.<sup>63</sup> If the tracked assets do show a profit, however, holders of the tracking stock have priority over the other corporate shareholders for these earnings. This preference makes the stock appear more like preferred stock rather than common stock.

Although the government has not specifically addressed this distinction in the context of tracking stock, it dealt with a similar issue involving series stock and the application of Code section 1036. That section provides that no gain or loss will be recognized if, within the same corporation, common stock is exchanged for common stock or preferred stock is exchanged for preferred stock.<sup>64</sup> The government reviewed whether section 1036 permitted the tax-free exchange of one particular series stock for another series stock from the same corporation.<sup>65</sup> Interestingly, the Internal Revenue Service (IRS) ruled that series stock was *neither* common nor preferred, since both types of stock must share in the earnings of the entire corporation.<sup>66</sup> Arguably, tracking stock should be treated as neither common nor preferred stock for the same reason.<sup>67</sup> Consequently, the exceptions to section 305 tax-free distributions would not apply to transactions involving tracking stock.

### C. *Legitimacy of Approach*

In 1965, the United States Court of Appeals for the Ninth Circuit acknowledged the legitimacy of a tax planning device bearing a striking resemblance to tracking stock. In *Maxwell Hardware Co. v. Commissioner*,<sup>68</sup> a corporation issued a special class of stock that was

---

62. See Conway, *supra* note 31, at 384 (describing USX transaction); Walter & Strasen, *supra* note 16, at 366 (explaining the transaction used by GM).

63. See Sheffield & St. Clair, *supra* note 1, at 956-57.

64. I.R.C. § 1036(a) (1988).

65. Rev. Rul. 54-65, 1954-1 C.B. 101. Code § 851(h) later superseded this ruling. I.R.C. § 851(h) (1988). Section 851(h) mandates that each series of an investment company be treated as a separate corporate entity for tax purposes. *Id.* § 851(h)(1).

66. Rev. Rul. 54-65, 1954-1 C.B. 101, 103. The Revenue Ruling classified the stock as "special stock" and held that "an exchange of special stock for special stock of a different series represents a taxable exchange of property." *Id.*

67. The ruling, however, only addressed Code § 1036; there is no indication that the government wished to establish the hermaphrodite nature of series stock for all tax purposes.

68. 343 F.2d 713 (9th Cir. 1965).

designed to mirror the performance of certain real estate holdings.<sup>69</sup> This allowed two investors to establish a real estate division and to use the net operating loss carryovers to offset the income expected to be generated by the new division.<sup>70</sup> The Ninth Circuit, which was unable to find a legal reason to prohibit the restriction, upheld the scheme.<sup>71</sup>

The relevance of *Maxwell Hardware*, however, is not its impact on the law, but rather the insight it provides into how courts might consider tracking stock arrangements. While the Ninth Circuit ruled in favor of the taxpayers, it also suggested that the Commissioner could have reallocated income under the power conferred by Code section 482<sup>72</sup> so as to prevent tax evasion.<sup>73</sup> The Commissioner, however, failed to raise the applicability of section 482 in its Notice of Deficiency.<sup>74</sup> The court clearly was not comfortable allowing taxpayers to separate the stockholders' interests among specific assets of a single corporation.<sup>75</sup> The judiciary may take a similar position on tracking stock arrangements and, absent outright judicial rejection of the concept, may alert Congress to what may be perceived as a loophole in the present law.

#### IV. ALTERNATIVE APPROACHES

At least two commentators have presented rational proposals concerning the tax treatment of tracking stock. First, the New York Bar Association Tax Section (New York Bar Association) issued a Report in response to a study requested by the government.<sup>76</sup> Although the Report was published in 1987, Treasury has not yet acted on any of its recommendations. A second commentary, published by Jeffrey T. Sheffield and Barbara M.

---

69. *Id.* at 714.

70. *Id.* The investors sought to use the losses of an existing corporation to offset the income of a new corporation. *Id.* at 715. Thus, the stock purchased by the new investors acted very much like stock of a separate corporation.

71. *Id.* at 723. Congress subsequently amended Code § 382(a) in response to *Maxwell Hardware*. See *Report, supra* note 3, at 68. Under the current law, the original shareholders would not be considered to have owned stock for the purpose of determining whether there had been an "owner shift." *Id.* Thus, the use of net operating loss carryovers would have been limited, destroying the purpose for the transaction. See *id.*

72. Code § 482 provides, in part, that "the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among [related taxpayers], if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes." I.R.C. § 482 (1988).

73. *Maxwell Hardware*, 343 F.2d at 720-21.

74. *Id.* at 721.

75. *Id.* at 723. The court's discomfort is evident as it explained why the application of the statute must prevail. "Taxation is peculiarly a matter of statutory law, and in applying that law to the determination and computation of income and deductions, the Courts do not make moral judgments." *Id.*

76. *Report, supra* note 3.

St. Clair the following year, reached slightly different conclusions than the New York Bar Association Report.<sup>77</sup> A description of the two conceptual frameworks is set forth below.

### A. Correlation Analysis

The New York Bar Association has suggested that a "correlation analysis" should act as the benchmark for determining the tax treatment of tracking stock.<sup>78</sup> According to the Report, the most significant aspect of a tracking stock arrangement is the degree to which the corporation has created a correlation between the value of the stock and the value of the underlying assets.<sup>79</sup> This correlation is determined by a variety of factors, including dividend policy, conversion ratio, and the parent corporation's ability to unilaterally reduce the value of the assets tracked.<sup>80</sup>

The degree to which the tracking stock fails to reflect the value of the underlying assets is termed the "economic variance risk."<sup>81</sup> Thus, if an equity interest is viewed along a continuum, with complete economic variance at one end and perfect correlation at the other, tracking stock will reflect a point on the continuum according to the strength of its relation to the underlying asset. The closer the tracking stock is to the perfect correlation pole, the stronger the argument that it should be treated as other than stock of the parent for tax purposes.<sup>82</sup>

The New York Bar Association provides two justifications for treating most tracking stock arrangements as stock of the parent for tax purposes. First, in the typical tracking stock arrangement, shareholders share pro rata in the assets of the corporation upon liquidation.<sup>83</sup> Second, despite director assurances, the dividend policy may be subject to change.<sup>84</sup> Together, these factors indicate that the tracking stock is subject to an "eco-

77. Sheffield & St. Clair, *supra* note 1.

78. Report, *supra* note 3, at 70.

79. *Id.* at 58-59.

80. *Id.*

81. *Id.* at 64.

82. See *id.* at 70-71. The New York Bar Association further explained that "[w]here significant correlation in performance is present, holders of tracking stock will have acquired the functional equivalent of an economic interest in the tracked property, which interest, by hypothesis, differs greatly from a pro rata equity interest in [the parent corporation]." *Id.* (emphasis omitted).

83. *Id.* at 63.

84. *Id.*; see, e.g., MD. CORPS. & ASS'NS CODE ANN. § 2-309(a) (1993) ("If authorized by its board of directors, a corporation may make distributions to its stockholders . . ."); DEL. CODE ANN. tit. 8, § 170(a) (1991) ("The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends . . .")

conomic variance risk" that is significant enough to foreclose the possibility that it represents anything other than stock of the parent.<sup>85</sup>

Using this framework to define the correlation between the tracking stock and the underlying assets of the corporation, however, requires a tedious case-by-case analysis of several factors to determine if a particular issue represents something other than stock of the parent. To overcome this difficulty, the Report proposes certain objective criteria to govern the determination.<sup>86</sup> Specifically, if the parent adopts a dividend policy calling for significant distributions to tracking stock holders that are not pro rata to the parent's earnings *and* the tracking stock is either convertible to regular common stock or redeemable based on relative fair market values at the time of the conversion or redemption, the stock should be treated as other than parent corporation stock.<sup>87</sup>

The Report also provides a conceptualization for tracking stock interests that are determined to represent something other than stock of the parent under this analysis. In the New York Bar Association's view, tracking stock that is not properly characterized as the stock of the parent corporation should be interpreted as representing an interest in a fictional separate entity.<sup>88</sup> This interpretation divides the ownership of the entity between the parent corporation and the holders of tracking stock; the fictional entity is deemed to own the underlying assets.<sup>89</sup> If the underlying assets represent a separately incorporated subsidiary, the fictional entity would be viewed as owning 100% of that subsidiary.<sup>90</sup> Thus, in determining the parent's ability to file a consolidated return with the subsidiary, its relative ownership of the fictional entity would have to be considered.<sup>91</sup> If the tracking stock represented greater than a twenty percent interest in the fictional entity, an affiliated group status would not exist between the corporation and the subsidiary.<sup>92</sup> For the purposes of

---

85. *Report, supra* note 3, at 64.

86. *Id.* at 79 (suggesting that a distribution of tracking stock should be eliminated from consideration for tax-free status under Code § 305(a) when certain objective criteria are present).

87. *Id.*

88. *Id.* at 74-75.

89. *Id.*

90. *Id.*

91. *See* I.R.C. §§ 1501, 1504(a)(2) (1988).

92. I.R.C. § 1501. The Code provides that an affiliated group of corporations may file consolidated returns. *Id.*; *see supra* note 27 and accompanying text (discussing the criteria for consideration as an affiliated group).

other Code provisions, tracking stock would be treated as if it were the stock of a separate entity.<sup>93</sup>

In determining the basis of tracking stock deemed to be other than the stock of the parent, the Report suggests a fictional transaction to correspond to the fictional entity.<sup>94</sup> The Report proposes that the parent corporation should be viewed as transferring its interest in the tracked assets to the new entity in exchange for all of the stock of that entity.<sup>95</sup> Thus, the corporation would have a substituted basis in the fictional stock of the fictional entity.<sup>96</sup> The basis would then be allocated between the disposed fictional shares (which are transformed into real shares of tracking stock) and the fictional shares retained by the parent (represented by the fair market value of the tracked assets less the fair market value of the tracking stock).<sup>97</sup>

The Report's fictional transaction scheme is analogous to a situation in which the parent distributes the underlying assets. In such a case, the parent corporation would recognize gain,<sup>98</sup> and the recipients would recognize income equal to the fair market value of the property.<sup>99</sup>

The distribution analogy is useful in revealing the Report's purpose in designing this concept. If the tracking stock transaction is actually a transfer of assets by the parent corporation, then the tracking stock is not stock at all; it is merely a medium through which the distribution of the underlying assets is accomplished. At this point the analogy would fail without the Report's reliance on the fictional separate entity concept because the holders of tracking stock retain the insolvency risk associated with all forms of stock ownership.<sup>100</sup> The underlying assets, regardless of whether they are treated as having been distributed for tax purposes, remain assets of the parent, subject to the claims of the parent's credi-

93. *Report, supra* note 3, at 75 (citing Code § 1036 where tracking stock could not be characterized as stock of the parent corporation for tax-free treatment because it essentially is an interest in a separate entity).

94. *Id.* at 74-76.

95. *Id.* at 75.

96. *Id.* Code § 358 provides for a substituted basis upon such an exchange. I.R.C. § 358(a)(1) (1988).

97. *Report, supra* note 3, at 75.

98. I.R.C. § 311 (1988). The corporation would recognize gain to the extent that the fair market value of the property distributed by the corporation exceeds the adjusted basis of the property at the time it was held by the corporation. *Id.* § 311(b)(1)(B).

99. *Id.* § 301 (1988). This section provides that a shareholder must recognize as income any amount of property distributed by a corporation that constitutes a dividend. *Id.* A dividend is any amount of property that is distributed by a corporation out of its earnings and profits. *Id.* § 316(a) (1988).

100. *Report, supra* note 3, at 64.

tors.<sup>101</sup> Thus, ignoring the form of the transaction and treating a distribution of tracking stock as if it were a distribution of property will not work. For state corporate law purposes, the tracking stock retains its character as an equity interest in the parent corporation. The “fictional entity” concept resolves the dilemma of treating an instrument that is really the stock of the parent as something other than stock of the parent for tax purposes.

### B. *The Benefits/Burdens Theory*

Sheffield and St. Clair have developed a slightly different framework to analyze tracking stock for tax purposes.<sup>102</sup> They contend that the tax treatment of this equity instrument should be determined by whether it possesses the “essential attributes” of parent corporation stock.<sup>103</sup> This requires an analysis of the benefits and burdens attributable to holders of the tracking stock.<sup>104</sup> The analysis is based on the existence of four rights normally associated with common stock: dividend rights, liquidation rights, voting rights, and state law fiduciary rights.<sup>105</sup>

Like traditional parent corporation shares, tracking stock dividend payments are subordinated to the claims of all parent corporation creditors.<sup>106</sup> This gives tracking stock holders a downside risk, or burden, equivalent to the dividend risk taken by all other shareholders. The equivalency is not apparent, however, with regard to the benefits of sharing in the success of the entire corporation. Typically, dividends are payable to holders of tracking stock only out of the earnings of the assets tracked.<sup>107</sup> Holders of tracking stock, therefore, will be able to enjoy the economic success of the tracked assets without being diluted by the overall economic performance of the corporation. For this reason, Sheffield and St. Clair indicate that dividend rights alone do not constitute a suffi-

---

101. *Id.* Another feature of the insolvency risk is the possibility that the parent corporation “might be liquidated, with the value of [the subsidiary’s] appreciation after a certain date being dispersed among all [parent corporation] stockholders.” *Id.*

102. Sheffield & St. Clair, *supra* note 1.

103. *Id.* at 955. The commentators actually list seven categories of essential attributes, including dividends limited to a subset of corporate earnings dividend policy controlled by the parent corporation’s board of directors, shifting corporate earnings between subsets of assets, liquidation rights, conversion rights, voting rights, and state law rights and limitations. *Id.* at 955-56.

104. *Id.* at 958.

105. *Id.* at 958-60.

106. *Id.* at 962. Dividends on tracking stock, like stock of the parent corporation, are payable only after a decision by the board of directors and are subject to certain restrictions, such as the state surplus and insolvency laws. *Id.*

107. *Id.* at 954, 962.

cient sharing of economic benefits to warrant treating tracking stock as stock of the parent.<sup>108</sup>

The authors, however, recognize that the vertical division of equity interests in a corporation necessarily creates *two* classes of tracking stock.<sup>109</sup> Like the tracking stock itself, the value of the remaining stock of the parent is attributable to a segregated portion of the corporation's assets.<sup>110</sup> Thus, the typical tracking stock dividend policy limits the corporate earnings available for dividend payments to *both* the tracking stock and the remaining parent corporation shares. As a result, the tracking shares have no greater potential upside advantage of sharing revenue than their conventional parent stock counterparts. Therefore, the Sheffield and St. Clair notion that the dividend policies normally associated with tracking stock foster unequal sharing of economic benefits is not necessarily true. The facts and circumstances of each case must be analyzed to determine if the particular dividend rights meet Sheffield and St. Clair's economic benefits sharing threshold to warrant treatment of tracking stock as stock of the parent.

Sheffield and St. Clair categorically state that tracking stock "is indistinguishable from classic [parent] stock with respect to liquidation rights."<sup>111</sup> This, however, is not necessarily the case. The USX transaction, for example, fixes liquidation rights based on the relative fair market value of the shares at liquidation.<sup>112</sup> Since this value is based on a particular portion of the assets within the corporation, tracking stock liquidation rights, at least in this context, differ significantly from the rights of typical common stockholders, who divide the liquidated proceeds of the assets of the entire corporation after the creditors are paid.

In this sense, tracking stock resembles preferred stock with a liquidation preference rather than ordinary common stock. Stock with a liquidation preference, however, typically enjoys a preference as to all of the corporate assets. The corresponding preference held by tracking stock holders, on the other hand, may be worthless even if other assets of the corporation yield proceeds that can be distributed to shareholders.

---

108. *Id.* at 962. The commentators explain that tracking stock holders could share in the earnings of the other portions of the parent corporation indirectly. *Id.* The parent corporation would have to contribute to or withdraw assets from the subsidiary to allow tracking share holders to do so. *Id.* Thus, the connection between the tracking stock holders and the remainder of the corporate earnings with respect to dividends is weak. *Id.*

109. *Id.* at 964 n.58.

110. *Id.*

111. *Id.* at 962.

112. Proxy Statement, *supra* note 31, at 27. Note that the USX transaction took place subsequent to the publication of the Sheffield and St. Clair article. See *supra* part II.B. for a discussion of the USX transaction.



The results of the USX transaction also challenge the Sheffield and St. Clair assertion that the voting rights of tracking and parent corporation stock are identical.<sup>113</sup> The USX transaction employed state law that allows for differences between classes of stock with regard to voting rights.<sup>114</sup> For example, the number of votes attributable to the Steel Group Common fluctuates with market values.<sup>115</sup> Moreover, each of the two classes of stock has special voting rights with regard to certain transactions that impact their respective assets.<sup>116</sup>

It is undisputed, however, that the fiduciary rights of tracking stock holders, which are fixed under state law, are identical to those of other stockholders.<sup>117</sup> Unless the tracking stock is considered stock of a separate entity for state law purposes,<sup>118</sup> holders of tracking stock enjoy the same rights of duty, loyalty, and care, as well as the same derivative action rights, as do other shareholders.

#### V. ANALYSIS

While Sheffield and St. Clair maintain, based on an analysis of the benefits and burdens of stock ownership, that tracking stock will generally be viewed as stock of the parent, several of their presumptions can be challenged by the creative use of such stock, as demonstrated above. In particular, the USX transaction demonstrates the need to reevaluate the conceptual frameworks supporting both the correlation and benefits/burdens theories.

Under the correlation analysis, the USX tracking stock should not be viewed as stock of the parent for tax purposes. The USX dividend policy provides for dividends payable to holders of Steel Group Common that are not pro rata as to all of the corporation's earnings.<sup>119</sup> Furthermore, the redemption provision is based on the market value of the stock at the

---

113. See Sheffield & St. Clair, *supra* note 1, at 963 (noting that both types of stock "have the right to cast votes in the election of [the parent corporation's] Board").

114. Proxy Statement, *supra* note 31, at 27 (noting that Delaware law requires an approval of a shareholder majority for each class voting separately to alter or change the power of such class that would adversely affect them); see also MD. CORPS. & ASS'NS CODE ANN. § 2-507(a) (1993) (providing that the corporate charter may limit or deny voting rights to various classes of stock).

115. Proxy Statement, *supra* note 31, at 26-27.

116. *Id.* at 27. A vote of 66 2/3% of the outstanding Marathon Group Common is needed to approve any use of Marathon Group assets or earnings for the benefit of the Steel Group. *Id.* A similar framework governed the Steel Group voting procedures. *Id.*

117. *Id.*

118. Such a result is unlikely. Regardless of the outcome of the analysis for tax law purposes, state corporate law looks to the form of the transaction. If tracking stock is determined to be stock of the parent, state law will treat it as such.

119. Proxy Statement, *supra* note 31, at 23-24.

time of redemption.<sup>120</sup> According to the New York Bar Association proposal, therefore, there would be sufficient correlation between Steel Group Common and the steel group assets to warrant treatment of the USX tracking stock as stock of a separate entity.<sup>121</sup>

The benefits/burdens approach appears to yield the same result. While the ability to pay dividends to either class of stock is dependent on sufficient capital generated by all of the company's assets, the availability of dividends in the USX transaction is clearly designed to flow exclusively from the assets being tracked by the two classes of stock.<sup>122</sup> As noted above, the liquidation and voting rights of the two types of USX stock are not equivalent.<sup>123</sup> Therefore, under the Sheffield and St. Clair approach, the Steel Group Common does not share the same benefits and burdens as the Marathon Group Common to be considered stock of the same corporation for tax law purposes.

USX would be unable to achieve a tax-free reorganization under either the New York Bar Association framework or the Sheffield and St. Clair approach.<sup>124</sup> Both proposals are intended to demonstrate that "typical" tracking stock arrangements will not be viewed as creating anything other than stock of the parent. This necessarily means that the USX transaction "crosses the line" with regard to the use of this equity vehicle.

However, as Sheffield and St. Clair acknowledge, it is impossible to accurately determine the precise correlation between the value of USX's steel assets and the Steel Group Common's assets.<sup>125</sup> The value of the tracking stock may be "contaminated" by the value of the corporation as a whole. The goal of the New York Bar Association approach, therefore, is potentially unattainable, because the sufficiency of its objective-factor-based surrogate is impossible to evaluate. While the model treats the transaction as having sufficient correlation, there may in fact be a mini-

---

120. *Id.* at 24-26.

121. *See Report, supra* note 3, at 72-73 (describing the correlation analysis).

122. *See Proxy Statement, supra* note 31, at 22-24. The Proxy Statement mandates that "[t]he Board intends to declare and pay dividends on the Marathon Stock and the Steel Stock based on the respective financial condition and results of operations" of each group. *Id.* at 22.

123. *See supra* notes 111-17 and accompanying text.

124. Under either approach, the Steel Group Common would be considered something other than stock of the parent, and the exemption from recognition of gain or loss under Code § 311(a) would not apply. Sheffield & St. Clair predicted a similarity in the result of the two approaches when they stated that "[a]ny significant correlation between the economic performance of [tracking] stock and the tracked assets should exist only where the [tracking] stock does not share in the benefits and burdens of [the parent] as a whole." Sheffield & St. Clair, *supra* note 1, at 965.

125. *Id.* at 963.

mal relationship between the value of the stock and the value of the specified assets.

Similarly, the result reached by the benefit/burden approach seems to violate the theoretical foundation of that model. Sheffield and St. Clair concede that a "guiding principle" of their approach is that the existence of some economic participation in all of the assets of the parent corporation is indicative of parent corporation stock.<sup>126</sup> The Steel Group Common, however, shares a fundamental benefit and burden with the entire corporation: no dividends will be available to stockholders unless the corporation as a whole generates sufficient capital.<sup>127</sup> Moreover, the steel assets are ultimately available to all of the corporation's creditors before they may be distributed to the holders of Steel Group Common.<sup>128</sup> It seems anomalous that the application of the benefit/burden theory commands that the stock be treated as something other than stock of the parent corporation, while the Steel Group Common shares fundamental economic benefits and burdens with traditional parent stock.

Both proposals undervalue the significance of the insolvency risk associated with any stock that is considered parent corporation stock for state law purposes. A primary purpose of the corporate form is to limit liability. The fact that tracking stock does not limit the corporation's liability to the creditors of the non-tracked portion of the corporation is a compelling reason for treating tracking stock as stock of the parent in all situations. When investors choose to separately incorporate for non-tax business reasons, the tax law respects that choice; there is no theoretical justification for ignoring that principle when investors choose *not* to separately incorporate under state law.

## VI. CONCLUSION

The continued availability of tracking stock as a valuable equity device to corporate planners is contingent upon its proper tax treatment. As such, it is important for the government to resolve any lingering apprehensions by making a final determination.

While the New York Bar Association and Sheffield and St. Clair have made valuable contributions to the debate concerning how tracking stock ought to be treated for tax purposes, their conceptual frameworks are both flawed. The goals sought to be achieved by the former are impossi-

---

126. *Id.* at 969.

127. *See id.* at 962 (stating that dividends are only payable through a declaration of the board of directors of the parent corporation and that dividends are subject to prior creditor claims).

128. *Id.*

ble to evaluate, and the presumptions of the latter may not be accurate. A better method is based on fundamental concepts related to the ability to participate in earnings and the insolvency risk associated with the ownership of stock. Because state law dictates that both of these factors be determined by reference to the parent corporation as a whole, the only logical approach is to treat tracking stock as it exists under state law—as stock of the parent. If states wish to reconsider the effect of their corporate law in light of the use of this new equity vehicle, perhaps by allowing *de facto* separate incorporations, tax law should make a similar adjustment. Until that time, however, an irreconcilable clash between state corporate law and corporate tax law should be avoided.

