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The Definition of Voting Stock and the Computation of Voting Power Under Sections 368(c) and 1504(a): Recent Developments and Tax Lore

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I. INTRODUCTION

Although the concepts of "voting stock" and "voting power" are pervasive throughout the Code,[1] until recently, courts, commentators and the Service have devoted minimal energy to demystifying the confusion surrounding the definition of voting stock and even less to expanding upon the methodology of computing voting power. Recent developments, however, may prompt practitioners to take a second look at these terms. While a 1995 decision by the Tax Court adds little to the existing body of authority with respect to the determination of the owner of voting stock, the Service's analysis of the voting power requirement in a 1994 private letter ruling sheds new light on the method of computing voting power.

This article reviews and analyzes the current state of the law concerning the voting stock and voting power requirements in two areas of the tax law: section 368(c), which defines the level of stock ownership in a corporation that a taxpayer must possess in order to qualify for many forms of tax-free reorganizations, and section 1504(a), which requires a corporation attempting to form an "affiliated group" with a subsidiary corporation to own an amount of voting stock in the subsidiary having a specified level of voting power.

Part II of this article briefly explains the statutory requirements of both section 368(c) and section 1504(a). Part III reviews the case law and administrative precedents that have shaped the definition of voting stock and attempts to distinguish the ownership requirement of section 368(c) from the direct ownership requirement of section 1504(a). Accordingly, part III of this article

[1] Unless otherwise specified herein, all references to the Code or to a section of the Code are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder. All references to the Service are to the Internal Revenue Service.

also analyzes the Tax Court's most recent decision regarding the meaning of the term "direct ownership." Part IV examines the mechanical test developed by the courts and the Service for computing the voting power inherent in the stock of a corporation, explores ways in which taxpayers have attempted to manipulate a corporation's capital structure in order to satisfy the control requirement of section 368(c), and discusses the Service's latest pronouncement regarding the use of this mechanical test in measuring voting power. Finally, this article highlights the remaining ambiguities that continue to create uncertainty for taxpayers with regard to the voting stock definition and the voting power formula.[2]

II. SECTION 368(c) AND SECTION 1504(a)

Many important tax considerations depend on whether a taxpayer[3] owns the requisite percentage of the vote or equity value or both of another entity (generally, "control"). Under several provisions of the Code, this control requirement is satisfied where one taxpayer owns more than 50 percent of the equity interests in another taxpayer.[4] Both the ability of corporations to file

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[2] This article does not attempt to address the "solely for voting stock" requirement applicable to sections 368(a)(1)(B) and (C). The discussion herein analyzing the definition of voting stock, however, is extremely relevant to the analysis of whether a reorganization satisfies the "solely for voting stock" requirement of these sections. For an in-depth article discussing the "solely for voting stock" requirement, see Richard R. Dailey, *The Voting Stock Requirements of B and C Reorganizations*, 26 Tax L. Rev. 725 (1971).

[3] Depending on the context, the term "taxpayer," as used herein, may either refer to one individual or entity or to several individuals or entities acting together as a group.

[4] *See* I.R.C. § 267 (prohibiting a taxpayer from deducting either losses relating to the sale of property to a related party or interest or expenses incurred with respect to transactions with such related party. Many of the relationships defined in section 267 rely on a 50 percent value test.); I.R.C. §§ 318(a)(2)(C), (3)(C) (requiring a taxpayer to own 50 percent or more of the value of a corporation's stock in order for the attribution rules of section 318 to apply); I.R.C. § 269(a) (using a 50 percent vote or value standard in determining whether a party acquired control of another corporation for the purpose of evading or avoiding federal income tax); I.R.C. §§ 304(a), (c) (applying to transactions only if one or more persons is in control of each of two corporations and one of those corporations acquires stock of the other corporation from such person. Control, as used in this section, is defined as the ownership of 50 percent or more of either the vote or value of such corporations.); I.R.C. § 368(a)(1)(D) (allowing a corporation to transfer its assets to another corporation in a tax-free reorganization if, immediately after the transfer, the transferor, or one or more of its shareholders, is in control of the corporation to which such assets were transferred).

consolidated returns[5] and the ability of taxpayers to engage in tax-free reorganizations,[6] however, require one party to own at least 80 percent of the stock of another corporation in order to satisfy the control requirements described in sections 368(c) and 1504(a).

While the authorities that define the term voting stock and those that discuss the measurement of voting power under sections 368(c) and 1504(a) overlap in their discussions of such terms, the statutory requirements of these sections are quite different. Under section 368(c), control is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock (i.e., non-voting stock) of the corporation.[7] The section 368(c) definition of control

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[5] I.R.C. §§ 1501, 1504(a).

[6] *See* I.R.C. § 351 (providing that a contribution of property by one or more persons to a corporation in exchange for the stock of such corporation is a nontaxable transaction [i.e., no gain or loss is recognized] if immediately after the exchange such person or persons are in control of the corporation); I.R.C. § 355 (allowing a corporation to make a nontaxable distribution to its shareholders of stock or securities of a corporation it controls immediately prior to such distribution); I.R.C. § 368(a)(1)(B) (giving a corporation the ability to acquire the stock of another corporation on a tax-free basis if such exchange is solely for the voting stock of the acquiring corporation [or a corporation that is in control of the acquiring corporation] and the acquiring corporation is in control of the other corporation immediately after the acquisition); I.R.C. §§ 368(a)(2)(D), (E) (allowing for tax-free subsidiary reorganizations). In each case, the applicable Code section relies on the definition of control in I.R.C. § 368(c).

[7] The requirement that a party own at least 80 percent of the total number of shares of non-voting stock of another corporation has been interpreted to mean that such party must own at least 80 percent of the total number of shares of *each class* of non-voting stock of the controlled corporation. *See* Rev. Rul. 59-259, 1959-2 C.B. 115. There, the Service stated that "[t]he legislative history of section 368(c) of the Code indicates a congressional intent that ownership of *each* class of non-voting stock is required." *Id.* at 116. The Service discussed the importance of looking to the ownership of a specified percentage of each class of non-voting stock as opposed to the ownership of the total number of non-voting shares:

> Moreover, percentage ownership of the number of non-voting shares outstanding, as contrasted to percentage ownership of each class of non-voting shares, is ordinarily of no significance and can lead to results which are inconsistent with the statutory scheme and clear congressional purpose. Ownership of large numbers of non-voting shares in a multi-class stock structure would not necessarily assure, in itself, the continuation of substantial proprietary interests in modified corporate form as contemplated by the statute.

Id.

The Service has consistently held to this view of the definition of the term "all other classes of stock of the corporation." *See* Rev. Proc. 83-59, 1983-2 C.B. 575 (requiring that a taxpayer be "in control" of a transferee corporation within the meaning of section 368(c) and Revenue Ruling 59-259 before the Service will issue the taxpayer a private letter ruling that a transaction qualifies under section 351 or 355). *See also* P.L.R. 89-48-001 (July 21, 1989); P.L.R. 77-47-106 (Aug. 29, 1977); G.C.M. 39,264 (July 23, 1982); G.C.M. 34,122 (May 8, 1969);

does not, however, require that a shareholder own stock that participates in corporate growth (i.e., common stock) or that represents a certain percentage of the equity value of the corporation. Thus, for purposes of section 368(c), both non-voting preferred stock and "enhanced voting stock"[8] issued by a corporation are included in determining whether the control test is satisfied.

Section 1504(a) defines control differently. Corporations are members of the same affiliated group only if a common parent owns stock possessing at least 80 percent of the total voting power *and* representing at least 80 percent of the value of all of the stock of each corporation.[9] Unlike section 368(c), section 1504(a) generally ignores the existence of non-voting preferred stock in determining whether its requirements are satisfied.[10] Furthermore, because section 1504 uses both a vote and value test to determine affiliation, taxpayers have little ability to restructure the capital stock of a corporation (through, for example, the issuance of enhanced voting stock) in order to satisfy the voting requirements of section 1504(a).[11] On the other hand, the fact that the section

G.C.M. 33,712 (Dec. 21, 1967).

[8] Enhanced voting stock refers to stock issued by a corporation that possesses a greater number of votes per share than its underlying equity represents. For example, a corporation may issue two classes of common stock each representing 50 percent of the equity of such corporation. While a holder of shares of the first class of common stock has the ability to cast one vote in the election of directors (or other matters on which shareholders have the right to vote), a holder of shares of the second class of common stock may have the ability to cast multiple votes on the same issue. If, however, the vote-to-value ratio of one class of stock as compared to other classes of stock of the corporation is either too high or too low, the Service may inquire as to whether such stock is truly voting stock. *See infra* part IV.B.2.c.

[9] I.R.C. §§ 1504(a)(1), (2).

[10] Section 1504(a)(4) carves out from the definition of "stock" any stock which (i) is not entitled to vote, (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (iii) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (iv) is not convertible into another class of stock. Such stock is sometimes referred to as "plain, vanilla preferred stock."

[11] For tax years prior to 1985, the affiliated group requirement of section 1504(a) was satisfied if, as with section 368(c), one corporation possessed ownership of 80 percent of the voting power of all classes of stock and at least 80 percent of each class of non-voting stock. This requirement was changed by the Deficit Reduction Act of 1984 (the "1984 Tax Act") because of a concern that corporations were taking advantage of the benefits of consolidation even though they did not have a sufficient economic stake in their subsidiaries:

> The law is generally intended to permit two corporations to file a consolidated return if one corporation owns and controls at least 80 percent of the other. Unfortunately, the

368(c) definition of control is based primarily on the voting power that a taxpayer holds in a corporation gives taxpayers a great deal of flexibility in structuring a transaction in order to satisfy such control requirement.[12]

III. DEFINITION OF VOTING STOCK

A. Ability to Elect Directors

Although the statutory definition of control in section 368(c) differs from the statutory requirements of stock ownership for corporations to file consolidated returns under sections 1501 and 1504, the precedents that define voting stock and measure voting power under each of these sections are interrelated.[13] Thus, one could infer that the courts and the Service have determined that the section 368(c) "80 percent of the total combined voting power of all classes of stock entitled to vote" standard and the section 1504(a)(2) "80 percent of the total voting power of such corporation" standard have the same meaning despite slightly different phrasing.

> law, as written, is more generous than that. Taxpayers have been using creative capital structures so as to be eligible for consolidation in situations not appropriate for consolidation and to avoid consolidation in situations when it should not be avoided. Taxpayers have been filing consolidated returns in situations where one owns less than 30 percent in value of the other. As a result, corporations with substantial taxable incomes have been taking advantage of the consolidated return rules to use tax losses of the other corporation. In essence, the former are buying tax losses of the latter.

Senate floor amendment to H.R. 2163, 130 Cong. Rec. 8654 (Apr. 11, 1984).

It is presumed, however, that the amendments to section 1504 pursuant to the 1984 Tax Act do not impose on a corporation the requirement that the voting power and value of its stock be proportionate as such result would make the 80 percent vote and value tests redundant. *See* The New York State Bar Association Tax Section Committee on Corporations, *Report on Tax Reform Act of 1984 Amendments to Section 1504(a), The Definition of "Affiliated Group,"* 28 Tax Notes (TA) 895, 911 (Aug. 19, 1985). Thus, while a corporation that has a class of enhanced voting stock may satisfy the voting power requirement of section 1504(a)(2)(A), there is limited ability to use such stock to satisfy section 1504(a)'s stock ownership requirement.

[12] *See infra* part IV for examples of restructurings made prior to a tax-free transaction in order to satisfy the section 368(c) control requirement.

[13] *See, e.g.,* G.C.M. 38,951 (Jan. 17, 1983) (describing the requirement of section 1504(a) prior to 1985 as "functionally equivalent to the control requirement under section 368(c)"). *See also* G.C.M. 35,633 (Jan. 23, 1974); G.C.M. 34,979 (Aug. 8, 1972); G.C.M. 34,795 (Mar. 1, 1972); G.C.M. 31,020 (Dec. 5, 1958). *But see supra* text accompanying note 55.

Voting stock has been defined by both judicial and administrative authorities as stock having the power to vote for directors who control the management of the corporation.[14] These authorities have held that this power alone determines whether stock is to be considered voting stock for purposes of both section 368(c) and section 1504(a).

In Income Tax Ruling 3896, the Service determined that a shareholder that owned 100 percent of the common stock and 55.5 percent of the preferred stock of a subsidiary corporation could not consolidate with the subsidiary.[15] In reaching its conclusion, the Service held that preferred stock that entitled its holders to elect one of the corporation's seven directors was voting stock, even though the stock had only limited ability to vote on other matters. The Service stated that "[i]t is the opinion of this office, therefore, that any stock which participates in the election of directors is voting stock within the intendment of section 141(d) of the Code."[16] Ownership of a portion of the preferred stock by parties unrelated to the taxpayer prevented consolidation from occurring.

In Revenue Ruling 69-126, the Service ruled that preferred stock that had no voting power other than the ability to elect three out of eight directors of a corporation was voting stock for purposes of

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[14] The case most often cited for this proposition is *Erie Lighting Co. v. Commissioner*, 93 F.2d 883 (1st Cir. 1937). In *Erie*, however, the court never affirmatively defines voting stock; instead, it defines what is *not* voting stock for purposes of section 240(d) of the Revenue Act of 1926 or section 142(c) of the Revenue Act of 1928 (the predecessors to section 1504(a)). The court, citing *Schlafly v. United States*, 4 F.2d 195, 200 (8th Cir. 1925), stated that "[t]he Commissioner and the Board [of Tax Appeals] and the courts, however, prior to 1926, consistently construed these acts to mean that preferred stock not having the right to vote for directors was not 'voting stock.'" *Erie*, 93 F.2d at 884. *See also Rudolph Wurlitzer Co. v. Commissioner*, 29 B.T.A. 443, 448-49 (1933), *aff'd*, 81 F.2d 971, 974 (6th Cir. 1936), *cert. denied*, 298 U.S. 676 (1936), and *Vermont Hydro-Electric Corp. v. Commissioner*, 29 B.T.A. 1006, 1011 (1934), which also define the term voting stock by negative inference.

[15] 1948-1 C.B. 72. Although Income Tax Ruling 3896 was not specifically revoked or superseded, it was declared obsolete by the Service in Revenue Ruling 68-100, 1968-1 C.B. 572. The principles announced therein, however, have been consistently applied in determining whether stock issued by a corporation is voting stock and in determining the voting power inherent in a corporation's stock.

[16] I.T. 3896, 1948-1 C.B. at 74. Section 141(d), the predecessor to section 1504, required that one corporation own at least 95 percent of the voting power of all classes of stock and 95 percent of each class of the non-voting stock, excluding non-voting stock that is limited and preferred as to dividends, of another corporation in order for such corporations to be affiliated. I.R.C. § 141(d) (1939).

section 1504(a).[17] In its ruling, the Service relied on *Rudolph Wurlitzer Co. v. Commissioner*, which held that preferred stock that had the right to vote only for directors was voting stock within the meaning of section 141(d).[18] The Service held that "since the preferred stock in the instant case participates in the election of directors, it is voting stock for purposes of section 1504(a) of the Code."[19] Similarly, in Revenue Ruling 63-234,[20] the Service ruled that a class of preferred stock was voting stock for purposes of section 368(a)(1)(B) since it had the right to elect (as a class) two of the corporation's twelve directors.[21]

B. *Current Ability to Vote*

The authorities under sections 368(c) and 1504(a) have also held that only stock with the *current* ability to vote for directors qualifies as voting stock. For example, in *Rudolph Wurlitzer*, the court held that preferred stock which, by its terms, lacked the ability to vote unless dividends payable upon such stock were in arrears for more than one year, was voting stock for purposes of the consolidated return provisions of the Code. There, the court held that the voting restrictions imprinted on the preferred stock certificates were unconstitutional and, accordingly, regardless of whether the preferred stockholders actually voted their shares, they had the right to vote their stock had they chosen to do so.[22]

Similarly, in *Erie Lighting*, the First Circuit held that preferred stock was not voting stock for purposes of determining whether the taxpayer and its parent were members of the same affiliated group where the preferred stock had no power to vote in any election for directors unless the dividends on the stock remained unpaid for two

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[17] 1969-1 C.B. 218.

[18] 29 B.T.A. 443 (1933), *aff'd*, 81 F.2d 971 (6th Cir. 1936), *cert. denied*, 298 U.S. 676 (1936).

[19] Rev. Rul. 69-126, 1969-1 C.B. at 218.

[20] Rev. Rul. 63-234, 1963-2 C.B. 148.

[21] The transaction in Revenue Ruling 63-234, however, failed to qualify as a tax-free reorganization under section 368(a)(1)(B) as the Service held that the receipt of the voting preferred stock at issue was "transitory and without real substance" when the transaction was treated as one of two steps in a prearranged plan. Rev. Rul. 63-234, 1963-2 C.B. at 149.

[22] *Rudolph Wurlitzer*, 29 B.T.A. at 449.

quarters.[23] The court noted that "[i]t is admitted that the conditions have not arisen that give the preferred stock in this corporation a right to participate in the election of directors."[24] The court in *Erie Lighting* relied, in part, on the decision in *Vermont Hydro-Electric Corp. v. Commissioner*,[25] where the court similarly determined that preferred stock that had the ability to vote only if the issuing corporation was in default in the payment of dividends for four consecutive quarters was not voting stock for a period where the corporation was not in default. In so holding the court stated:

> The definitions of affiliation and of "stock" given in this section were designed, we believe, to establish a definite inflexible standard, to remove the uncertainties and obviate the variables constantly impeding efficient administration of prior statutes governing affiliation . . . . We think that *for any period* under this statute during which a claim for affiliation is not predicated on ownership of at least 95 percent of the actual outstanding voting stock, the claim must fail.[26]

In Revenue Ruling 72-72,[27] the Service held that acquiring corporation stock received in a reorganization by the shareholders of the target corporation was not voting stock for purposes of section 368(a)(1)(B) where such stock, by its terms, lacked the ability to vote for five years. There, *X*, a corporation wholly owned by individual *A*, desired to acquire all of the stock of corporation *Y* in exchange for *X* voting stock. Issuance of a sufficient amount of

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[23] Technically, in *Erie Lighting*, the court held that the preferred stock at issue was not stock for purposes of determining consolidation because it was non-voting preferred stock. *Erie Lighting Co. v. Commissioner*, 93 F.2d 883, 884 (1st Cir. 1937).

[24] *Erie Lighting*, 93 F.2d at 885.

[25] 29 B.T.A. 1006 (1934).

[26] *Vermont Hydro-Electric Corp. v. Commissioner*, 29 B.T.A. 1006, 1010-11 (1934) (emphasis added). *See Pantlind Hotel Co. v. Commissioner*, 23 B.T.A. 1207, 1210-11 (1931) (A corporation's preferred stock, which lacked the ability to vote except for such times as any dividends on the preferred stock remained unpaid for sixty days, was voting stock where the issuer of such stock was almost seventeen months in arrears in paying dividends. As a result, a taxpayer that owned almost all of the common stock but less than 25 percent of the preferred stock of the corporation was unable to file a consolidated return with the corporation for the taxable period involved.).

[27] 1972-1 C.B. 104.

X voting stock would have required *A* to relinquish voting control of *X* to the *Y* shareholders. In order to retain control of *X*, however, *X* and the *Y* shareholders agreed that *A* would retain an irrevocable right to vote the *X* stock received by the *Y* shareholders for five years. The voting restriction imposed by this arrangement was imprinted on the stock certificates received by the *Y* shareholders and was binding on all future recipients of the stock. After five years, any holder of such stock would be able to vote its stock without restriction. In concluding that the *X* stock received by the *Y* shareholders was not voting stock, the Service stated that:

> The arrangement prevented the shareholders of *Y* from voting their *X* stock on their own behalf for a period of five years and perpetuated *A*'s voting control over all of the outstanding stock of *X*. Such an arrangement is the same as if *X* issued non-voting common stock that automatically converted to voting common stock after five years. In either case the *X* stock is not "voting stock" within the meaning of section 368(a)(1)(B) of the Code.[28]

C. *Ability of Shareholder to Vote Shares*

1. Section 368(c)

If voting rights are inherent in the stock of a corporation, then such stock is treated as voting stock for purposes of section 368(c) regardless of whether the particular shareholder owning the stock actually has the legal right to vote its shares. In Revenue Ruling 73-28,[29] the Service held that a reorganization qualified under section 368(a)(1)(B) even though the recipient of voting stock could not, under state law, exercise the power to vote such shares. There, Corporation *X* owned all of the stock of Corporation *Y* which owned all of the stock of Corporation *Z*. *X* desired to own directly all of the stock of *Z*, and *X* acquired the *Z* stock from *Y* in exchange for *X* stock. Because, however, *Y* was a subsidiary of *X*, state law prevented *Y* from voting the *X* stock. The Service concluded that

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[28] *Id.*

[29] 1973-1 C.B. 187.

the *X* stock constituted voting stock notwithstanding *Y*'s inability to vote such stock.

In General Counsel Memorandum 34,979,[30] the Service clarified what appeared to be a contradiction between its characterization of the stock in Revenue Ruling 73-28 as voting stock and the stock in Revenue Ruling 72-72 as non-voting stock. The memorandum explained the different results by distinguishing between voting restrictions inherent in the stock and voting restrictions personal to the shareholder. Where voting restrictions are inherent in the stock, such stock should be characterized as non-voting stock. Where such restrictions only affect a particular shareholder, the stock retains its voting character.

According to General Counsel Memorandum 34,979, the Service appears to have based its conclusion in Revenue Ruling 72-72 on the holdings in *Erie Lighting* and *Vermont Hydro-Electric Corp.*, since both the courts and the Service focused their inquiry on "the effect of the particular arrangement upon the character of the stock issued rather than upon the capacity of the shareholder who received the shares in question."[31] In Revenue Ruling 73-28, however, the inability to vote the stock was not a characteristic of the stock generally; rather, it was particular to one shareholder. Thus, the Service stated that:

> If under the provisions contained in the share certificates or under a collateral contractual arrangement any shareholder who received such stock would be absolutely prohibited for a fixed period of time from voting the shares received, such stock is clearly not "voting stock."
>
> Insofar as the shares of stock involved in the instant case are concerned, the share certificates were invested with full voting rights upon receipt by the subsidiary corporation. No conditions or contingencies were attached to the share certificates nor to any collateral arrangement that would have the effect of limiting or altering the voting privileges conveyed to an owner of the

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[30] Aug. 8, 1972.

[31] G.C.M. 34,979. Revenue Ruling 72-72 cited no authority for its conclusion. The view of the Chief Counsel's Office that such decision relies upon these authorities appears to be correct.

> parent's stock. In the hands of any other stockholder except a subsidiary of the issuing corporation such shares would be unconditionally voteable.[32]

2. Section 1504(a)

Where a subsidiary owns stock issued by its parent and the subsidiary is unable to vote the stock, the issue is different under section 1504(a). Since the consolidated return provisions of the Code inquire as to whether one corporation owns the requisite amount of stock in another corporation to file a consolidated return, the issue is whether the stock owned by the subsidiary should be counted in determining whether another party owning stock in the parent satisfies the ownership requirements of section 1504(a). According to the Service, such stock should not be counted for this purpose.

In General Counsel Memorandum 38,422,[33] the Service determined that a parent corporation satisfied the voting power requirement of section 1504(a)(2) where it owned 68 percent of the voting stock of a subsidiary, since the subsidiary's remaining voting stock was held by a lower-tier subsidiary. The holding in General Counsel Memorandum 38,422 was based on a prior administrative memorandum that concluded that the stock of a corporation held by its subsidiary should be treated as the equivalent of treasury stock in determining the voting rights of the stock of the corporation.[34] Even though such stock is not treated as voting stock in determining the voting power of the corporation, "the controlling state law does not convert the stock into a class of 'non-voting stock' under section 1504(a)(2)."[35] The stock, therefore, should merely be disregarded when applying the affiliation test of section 1504(a).[36]

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[32] G.C.M. 34,979.

[33] June 25, 1980.

[34] *See* G.C.M. 34,979; O.M. 18,715 (Nov. 2, 1976). In General Counsel Memorandum 34,979, the Chief Counsel's Office stated that without more evidence it would not treat shares of a parent corporation held by a subsidiary as representing treasury shares or as in any way identical to canceled or unissued shares of the parent corporation, except that the shares could be treated as treasury shares with respect to voting rights.

[35] *See* G.C.M. 34,979; G.C.M. 38,422; O.M. 18,715.

[36] General Counsel Memorandum 38,422 also discusses the inconsistency that appears to arise when comparing its holding with Revenue Ruling 73-28, which, as discussed above,

D. Voting Trusts and Voting Agreements

1. Section 368(c)

The characterization of stock as voting stock generally looks to the inherent characteristics of the stock and is unaffected by agreements or arrangements made by the corporation's shareholders. The earliest authority for such statement is General Counsel Memorandum 2177,[37] in which the Service concluded that the type of ownership required to satisfy the control test is beneficial ownership of stock, regardless of who had the ability to vote the stock. There, a taxpayer was found to be the beneficial owner of stock even though the stock was placed into a trust that vested voting authority in court-appointed trustees.

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analyzes a similar issue under section 368(c). Such inconsistency arises because the "solely for voting stock" requirement of section 368 focuses on the nature of the consideration received by shareholders in a reorganization and attempts to tax transactions that technically fall under the reorganization provisions but are in effect sales (e.g., where non-voting preferred stock is issued), whereas section 1504(a) reflects the need for a "parent corporation to have voting control (through the right to elect directors) over its subsidiary. Accordingly, since section 1504(a)(2) is concerned with actual and exercisable voting power and [section 368] is not, the terms 'voting power' and 'voting stock' used in these sections are . . . distinguishable."

In spite of General Counsel Memorandum 38,422, one commentator suggests that the treatment of stock of an issuer held by its subsidiary for purposes of section 1504(a) remains unclear. *See* 1 Herbert J. Lerner, et al., Federal Income Taxation of Corporations Filing Consolidated Returns § 2.03[3] (1996). Lerner cites Revenue Ruling 58-308, 1958-1 C.B. 211, which relates to the affiliation requirements with respect to the grant of a pre-1964 restricted stock option. Lerner §2.03[3] at 2-42. In Revenue Ruling 58-308, the Service stated that if state law prohibits a subsidiary from voting stock that it owns in its parent corporation, such stock must be disregarded in determining whether the voting power tests of sections 425(e) and (f) are satisfied. *Id.* According to Lerner, however, the ruling does not address the issue of whether such stock is to be treated as treasury stock. Although Lerner expresses concern over whether Revenue Ruling 58-308 can be extended to the consolidated return area, he states that several other commentators generally agree that it does apply to the consolidated return area. *Id.* (citing, e.g., 1 Fred W. Peel, Jr., et al., Consolidated Tax Returns § 4.08 at 46 (3d ed.)).

[37] VI-2 C.B. 112 (1927). At the time General Counsel Memorandum 2177 was issued, control was defined as ownership of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation. *See* Revenue Act of 1924 § 203(i) (the predecessor to section 368(c)). Although the definition of control has been altered slightly since 1924, the analysis provided in General Counsel Memorandum 2177 continues to represent the Service's position on the level of control required by section 368(c).

In *Federal Grain Corp. v. Commissioner*,[38] acquiring corporation stock received by shareholders of the target corporation pursuant to a plan of reorganization was found to be voting stock. Accordingly, the target corporation's shareholders were determined to be in control of the acquiring corporation following the transaction even though the stock received by the shareholders was transferred to a trustee who had both the ability to vote the stock and an option to purchase such stock for five years.[39] The court held that the term "control" related solely to ownership and bore no relationship to the actual control that the shareholders had over the corporation. Since such shareholders enjoyed all of the fruits of ownership, except possibly the right to possession of the stock certificates and the right to vote for a period of five years, they were in control of the corporation within the meaning of the statute.[40]

In General Counsel Memorandum 35,633,[41] the Service analyzed the applicability of sections 368(a)(1)(D) and 355 to a reorganization and subsequent distribution of voting trust participation certificates. Pursuant to an antitrust decree, the taxpayer proposed to transfer assets relating to one of its businesses to a newly formed corporation, sell up to 20 percent of the new corporation's stock, place the remaining shares into a five-year voting trust and distribute the participation certificates received from the trust to its shareholders on a pro rata basis. The Chief Counsel's Office stated that, based on precedent,[42] it would

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[38] 18 B.T.A. 242 (1929).

[39] *Cf.* Rev. Rul. 72-72, 1972-1 C.B. 104, in which the voting rights associated with acquiring corporation stock issued in a reorganization were retained by the sole shareholder of the corporation prior to the reorganization.

[40] *Federal Grain Corp.*, 18 B.T.A. at 248.

[41] Jan. 23, 1974. G.C.M. 35,633 considers issues raised by the facts of Revenue Ruling 78-442, 1978-2 C.B. 143.

[42] The Service based its conclusion on a March 27, 1968, advisory letter in which the Service ruled that a plan of divestiture "substantially similar" to the one before it would qualify under sections 368(a)(1)(D) and 355. In that advisory letter, the Service relied on General Counsel Memorandum 2177, in which it concluded that a court-ordered spin-off effected through the use of a voting trust qualified under sections 203(c) and 203(h)(1)(B) of the Revenue Act of 1924. There, as in Revenue Ruling 78-442, "the shareholders of the distributing corporation received certificates of interest in the controlled corporation and could not acquire stock of the controlled corporation from the trust unless they no longer owned shares of the distributing corporation."

Furthermore, the Service noted that, in issuing its March 27, 1968, advisory letter, it had considered *Federal Grain Corp.*, 18 B.T.A. 242 (1929); *Peabody Hotel Co. v.*

not be justified in ruling adversely to the taxpayer; however, it recommended a reappraisal as to whether the use of a voting trust that separated beneficial interest from voting rights would violate the statutory control requirements of sections 355 and 368(c).[43] The Service, however, has never reversed its position.[44]

Commissioner, 7 T.C. 600 (1946) (the control requirement of section 113(a)(7) of the Revenue Act of 1934 [the predecessor to section 368(c)] was satisfied with beneficial ownership); and *National Bellas Hess, Inc. v. Commissioner*, 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955) (reaching the same conclusion under section 112(h) of the Internal Revenue Code of 1939).

[43] General Counsel Memorandum 35,633 concluded that, because of certain inconsistencies, the issue of whether the holder of voting trust certificates could continue to be in control (within the meaning of section 368(c)) of the corporation whose stock was held in trust needed to be reappraised. The Service believed that Revenue Ruling 72-72 created an inconsistency between the view that section 368(c) focuses solely on the ownership of the stock (as expressed in General Counsel Memorandum 2177 and *Federal Grain Corp.*) and the view that section 368(c) focuses on the nature of the stock at issue (the interpretation of Revenue Ruling 72-72 expressed in General Counsel Memorandum 35,633). However, because both sets of authorities focus on the inherent nature of the stock as voting or non-voting stock and not on whether a particular shareholder has the ability to vote such stock, these positions appear to be consistent.

Moreover, the Service believed that the ability to satisfy the control requirement of section 368(c) by distributing certificates in a voting trust was inconsistent with the law under section 1504(a) since voting stock has been defined under section 1504(a) as stock that has the power to elect directors and such definition has been held to apply equally in defining voting stock under section 368(c). *See* G.C.M. 34,795 (Mar. 1, 1972); G.C.M. 31,020 (Dec. 5, 1958). The author does not believe that the issuance of General Counsel Memorandum 35,633 leads to such an inconsistency. That the owners of certificates of beneficial interest in a trust holding the voting stock of a corporation do not have the right to vote the shares does not affect the conclusion that such shares have the inherent ability to vote on issues affecting the management of the corporation (either directly or through the election of the board of directors of the corporation). What the separation of the ownership of the stock and the right to vote the stock through the use of a voting trust does affect, however, is the ability to treat the owner of the stock as the "direct owner" of the stock for purposes of section 1504(a). *See infra* part III.D.2. The distinction between the requirement that a taxpayer receive voting stock and that a taxpayer has the ability to vote the stock it owns is a fundamental difference between the purposes of sections 368(c) and 1504(a). *See supra* note 36.

[44] Both the Service and the courts do, however, recognize the general principle that the right to vote stock is one of the characteristics of stock ownership. For example, in General Counsel Memorandum 38,951 (Jan. 17, 1983), the Chief Counsel's Office concluded that the transfer of assets by one corporation to two of its subsidiaries qualified for nonrecognition treatment under section 351 even though the stock of the subsidiaries held by the transferor corporation was pledged to creditors pursuant to a plan of bankruptcy reorganization. There, the Service stated that "pledged stock is considered the property of the pledgor rather than the pledgee if the pledgor retains the incidents of stock ownership such as the right to vote and to receive dividends." *Id.*, citing *Pauly v. State Loan and Trust Co.*, 165 U.S. 606, 621-24 (1897) and *Blair Holdings Corp. v. Bay City Bank & Trust Co.*, 234 F.2d 513 (9th Cir. 1956).

The Service's conclusion in General Counsel Memorandum 38,951 relied on the Fourth Circuit's decision in *Bondy v. Commissioner*, 269 F.2d 463 (4th Cir. 1959), where, in a

In Revenue Ruling 75-95,[45] issued the year following General Counsel Memorandum 35,633, the Service held that the continuity of interest requirement of section 368 was satisfied where the two shareholders of a corporation transferred the corporation's voting stock to a voting trust in exchange for trust certificates. Although the trustee held both legal title and exclusive voting rights to the stock, the shareholders were considered the owners of the stock since they retained the right to all dividends from the corporation and to receive their shares following the termination of the trust.

In Private Letter Ruling 86-49-011,[46] the Service ruled that a transaction qualified as a reorganization under section 368(a)(1)(B) even though contemporaneously with the reorganization certain shareholders of the target corporation agreed for three years following the transaction to vote any shares of acquiring corporation stock owned by them for a slate of directors designated by the management of the acquiring corporation. Implicit in the Service's decision was the conclusion that the stock received in the reorganization constituted voting stock notwithstanding the contemporaneous voting agreement. Private Letter Ruling 86-49-011 cites to Revenue Ruling 73-28 and Revenue Ruling 72-72 in reaching this conclusion.[47]

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transaction attempting to qualify under sections 368(a)(1)(D) and 355, a corporation transferred assets to a newly-formed subsidiary and distributed the stock of such subsidiary to its sole shareholder. Subsequently, the shareholder placed 60 percent of the subsidiary's stock into escrow as security for a support agreement with his former wife. The Service argued that the transaction did not qualify as a tax-free reorganization because the shareholder was not in control of the subsidiary within the meaning of section 112(g)(1) (the predecessor to section 368(a)(1)(D)) following transfer of the stock into escrow. The court disagreed, stating that:

> All the while, however, petitioner was the record owner. He reserved the right to vote the stock . . . . He would be entitled to all dividends on the stock. Indeed, the stock remained subject to a pledge for his own debt. Upon his death, semble, the stock would be liable to his creditors' claims. We find he was still in such control of the stock–and there was such a "continuity of interest"–as section 112(g)(1) demanded.

Bondy, 269 F.2d at 467.

[45] 1975-1 C.B. 114.

[46] Sept. 4, 1986.

[47] The ability to vote the stock received by the shareholders of the target corporation in Private Letter Ruling 86-49-011 was restricted only in the hands of the shareholders that entered into the shareholders agreement. Stock of the same class received by shareholders that did not enter into any separate agreement was entitled to full voting rights in the acquiring corporation. The restrictions imposed by the shareholders agreement were terminated when the stock was transferred to an unrelated party. Thus, while the inability

Finally, in Private Letter Ruling 91-24-061,[48] the Service held that an agreement by a private foundation not to vote stock it held did not convert the stock into non-voting stock that would be treated as permitted holdings for purposes of section 4943. Although the term "voting stock" in section 4943 is not defined by reference to section 368(c)'s definition of control, the Service relied, in part, on Revenue Rulings 72-72 and 73-28 in concluding that "whether stock is or is not voting stock generally depends upon inherent characteristics of the stock rather than upon such extraneous factors as a shareholders agreement."[49]

2. Section 1504(a)

For purposes of section 1504(a), the use of an arrangement such as a voting trust to separate beneficial ownership from the right to vote shares does not transform the shares into non-voting stock:

> For purposes of determining 'affiliation' under the consolidated return provisions [of the Code], the existence of certain types of limited arrangements such as the transfer of shares to a voting trust or an escrow arrangement resulting in the suspension of voting privileges with respect to the beneficial owners of the stock have been held not to change the character of the shares to non-voting stock.[50]

In *Kansas, Oklahoma & Gulf Railway Company v. Helvering*,[51] the court determined that stock of a subsidiary held in a voting trust and represented by unsurrendered trust certificates was outstanding voting stock for purposes of the predecessor of section 1504(a), and, accordingly, the parent corporation was unable to consolidate with such subsidiary. Even though the holders of the

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to vote the stock in Revenue Ruling 72-72 was an inherent characteristic of such stock, the voting restrictions imposed in Private Letter Ruling 86-49-011 were personal to a particular set of shareholders, similar to the restrictions imposed by state law in Revenue Ruling 73-28. *See supra* text accompanying notes 29-32.

48 Mar. 22, 1991.

49 G.C.M. 39,855 (July 19, 1991). General Counsel Memorandum 39,855 is the Service's support for Private Letter Ruling 91-24-061 (Mar. 22, 1991).

50 G.C.M. 34,979 (Aug. 8, 1972).

51 124 F.2d 460 (3d Cir. 1940).

trust certificates were unable to vote the underlying stock, the stock was endowed with the power to vote regardless of whether such stock was actually voted.[52]

Similarly, in *Standard Lumber Co. v. Commissioner*,[53] the court concluded that stock held in a voting trust constituted voting stock despite the taxpayer's argument that subsequent state law invalidating future trusts had suspended the voting rights of the stock held in the voting trust. In *Standard Lumber*, a trust with a term of 20 years was formed in 1952 to hold 25 percent of the stock of a corporation. The taxpayer, which owned 62 percent of the corporation's stock, argued that it held 82 percent (62 percent divided by the 75 percent of the corporation's stock not held in trust) of the corporation's outstanding voting stock during the period at issue (1954). Relying on a state statute (effective December 31, 1953) prohibiting the creation of voting trusts with a term greater than ten years, the taxpayer argued that the statute invalidated the trustees' right to vote the stock. Thus, according to the taxpayer, the certificate holders could not vote the stock until the stock had been reissued in their names, which did not occur until the trust was terminated in 1955.[54] The court disagreed and held that the statute could not invalidate the trustees' voting rights absent retroactive application of the law, which could not be made without clear evidence that the legislature intended such application of the statute.

While section 368(c) focuses on the nature of the interest received by a shareholder rather than on the shareholder's ability to vote such interest, section 1504(a) is concerned with a parent's ability to have voting control over its subsidiaries. Thus, while section 368(c) requires that one party simply own the voting stock of another, section 1504(a) requires a parent to have direct ownership and

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[52] *Kansas, O. & G. Ry. Co.*, 124 F.2d at 464.

[53] 35 T.C. 192 (1960), *aff'd*, 299 F.2d 382 (9th Cir. 1962) *acq.* 1961-2 C.B. 5.

[54] The taxpayer's brief to the Court stated its position as follows:

> Pending judicial clarification of the impact of this statutory provision upon a pre-existing voting trust, the voting trustees could not validly exercise their voting rights under the voting trust. Neither could the voting trust certificate holders exercise same until the stock was issued in their names. In the absence of a judicial determination, the matter could be resolved only through a *mutual* termination of the voting trust agreement.

35 T.C. at 197 (emphasis in original).

actual and exercisable voting power over the stock of its subsidiaries.[55] The issue under section 1504(a) is whether the owner of voting stock should be treated as the direct owner of such stock where the owner lacks either the legal title to or the voting rights inherent in such stock.[56] It is generally accepted that the term "owns directly" should not be taken literally and that a taxpayer will be treated as the direct owner of stock if it retains beneficial ownership of such stock, regardless of whether the taxpayer retains legal title. However, it is not entirely clear what constitutes beneficial ownership for purposes of section 1504(a). According to one commentator, beneficial ownership of stock transferred into a voting trust or other escrow arrangement is retained by the grantor where the grantor retains both discretion regarding voting rights in order to preserve its equitable interest in the stock and the right to terminate the trust and demand back the stock at any time.[57]

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[55] G.C.M. 38,422 (June 25, 1980). General Counsel Memorandum 38,422 states that, because of the different purposes behind sections 368(c) and 1504(a), the terms "voting stock" and "voting power" as used in such sections are distinguishable (i.e., such terms have different meanings). Moreover, General Counsel Memorandum 38,422 states that General Counsel Memorandum 34,979, *supra* note 30, had "the effect of modifying General Counsel Memorandum 31,020 to remove the implication that these terms are synonymous for tax purposes." The author agrees that these terms are not synonymous. Voting stock refers to the inherent rights of a class of stock in the issuing corporation, while voting power measures the ability of a shareholder to control a corporation because of such shareholder's stock ownership. The author does believe, however, that the terms "voting stock" and "voting power" have the same meaning regardless of whether such terms are used in section 368(c) or section 1504(a). Where the two sections differ is that section 368(c) requires ownership of stock, while section 1504(a) requires direct or, as discussed below, beneficial ownership of the same stock.

[56] One commentator frames the issue as follows:

> The 80 percent voting power and value test must be applied to the stock beneficially owned by the person, not to the incidents of stock ownership themselves–such as voting rights–that comprise beneficial ownership. Thus, by itself, the right to vote 80 percent of a corporation's stock would not satisfy the voting power prong of the 80 percent test, assuming that, standing alone, the right to vote stock does not confer beneficial ownership of the stock on the holder of the right. Furthermore, a person would satisfy the voting power prong if the person beneficially owned stock possessing at least 80 percent of the voting power, even though he lacked the right to vote the stock. The concern here is *whether a person can be the beneficial owner of voting stock if he lacks the right to vote the stock*.

Dick Yates, *The Effect of the Lack of Stock Voting Rights on Beneficial Ownership Under Section 1504(a)*, 18 J. Corp. Tax'n 3, 4-5 (1991) (emphasis added).

[57] Lerner, *supra* note 36, §2.03[3] at 2-43, citing Rev. Rul. 70-469, 1970-2 C.B. 179.

In Revenue Ruling 70-469,[58] the Service held that a parent corporation (*P*) was the direct owner of 80 percent of the stock of a subsidiary (*S*) even though one share of *S*, which represented a portion of the 80 percent, was held in the name of a nominee (*A*). Although *A* was entitled to vote the stock during the time he held legal title to it, *A* was legally obligated to hold and deal with the share in accordance with *P*'s directions. Furthermore, *P* was entitled to revoke the trust and regain legal title to the stock upon demand. In holding that *P* and *S* were affiliated, the Service stated that:

> The only thing lacking in *P*'s complete and absolute ownership of the share that is held by *A* is the legal title and this *P* may at any time obtain by a demand upon *A*. *P*, being possessed of the entire beneficial ownership of the share and thus owning it, owns it "directly" because of its direct power over the share possessed by *A*, a power exercisable and legally enforceable at all times, and as complete as the dominion exercisable by one having both beneficial and legal ownership.[59]

In Revenue Ruling 84-79,[60] the Service concluded that *P* was the direct owner of *S* stock even though such stock was contributed by

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[58] 1970-2 C.B. 179.

[59] Rev. Rul. 70-469, 1970-2 C.B. at 180. Revenue Ruling 70-469 supersedes General Counsel Memorandum 7331, VIII-2 C.B. 135 (1929). *See* 1970-2 C.B. VI at 180. In General Counsel Memorandum 7331, the Service held that where a parent corporation places the record ownership of stock in the hands of a nominee who is, at all times, legally obligated to hold and deal with the stock according to the orders of the parent corporation, the ownership of the stock by the parent corporation is direct within the meaning of section 141(d) of the Revenue Act of 1928. The Service's decision rested on the fact that "while the nominee is a technical trustee of the legal title, his relationship to the parent corporation is essentially that of an agent to his principal." G.C.M. 7331, VIII-2 C.B. at 135. Further, the Service noted that, while ownership through a nominee seemed to run contrary to the literal words of the statute, the direct ownership requirement was satisfied:

> The literal meaning of the term "directly" would seem to contemplate the ownership existing in the case under consideration. The parent corporation, being possessed of the entire beneficial ownership of the share and thus owning it, owns it "directly," because of direct power over the share possessed by the parent corporation–a power exercisable and legally enforceable by one having both beneficial and legal ownership. The ownership of the parent corporation, being sufficiently complete for all other purposes of the Revenue Act of 1928, is, therefore, "direct" within the meaning of section 141(d) of the Revenue Act of 1928.

G.C.M. 7331, VIII-2 C.B. at 135.

[60] 1984-1 C.B. 190.

P to a voting trust. Although the trustee had the power to vote the *S* stock, such power was limited since the trustee could not vote the stock either in favor of a sale of substantially all of *S*'s assets or in favor of *S*'s dissolution without *P*'s consent. Furthermore, *P* could amend or terminate the trust or appoint a new trustee at any time.[61] The Service, relying on Revenue Ruling 70-469, held that "*P*'s dominion over the *S* stock is 'as complete as the dominion exercisable by one having both beneficial and legal ownership,'" since *P* could request legal title to the *S* stock at any time by revoking the trust and could, through its ability to replace the trustee, control the trustee's vote with respect to the *S* stock.[62]

In Revenue Ruling 78-119,[63] the Service held that *S* was required to be included in *P*'s consolidated federal income tax return where *S*'s stock was placed in escrow and *P* lacked the ability to vote such stock. The Service concluded that "the escrowed stock was still voting stock even though the voting privilege had been temporarily suspended."[64] General Counsel Memorandum 37,333 affirmed the Service's conclusion in Revenue Ruling 78-119.[65] Neither authority, however, referred to the "complete dominion" standard of Revenue Ruling 70-469.

Similarly, the Service did not require complete dominion in order to find direct ownership in revenue rulings issued prior to Revenue Ruling 70-469. For example, in Revenue Ruling 63-104,[66] the Service held that an affiliated group of corporations was required to include in its consolidated return a member that was under the control of a bankruptcy trustee. The voting rights of the stock of

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[61] The trust agreement further provided that *P* would receive all dividends (except for stock dividends) paid by *S*.

[62] 1984-1 C.B. at 190-91.

[63] 1978-1 C.B. 277.

[64] *Id.* at 279, citing *Doernbecher Mfg. Co. v. Commissioner*, 80 F.2d 573 (9th Cir. 1935). In Revenue Ruling 78-119, corporation *M* acquired all of the voting stock of *X* from individual *A* in exchange for 100,000 shares of *M* voting stock in a transaction qualifying under section 368(a)(1)(B). Shortly thereafter, the value of the *M* stock (the consideration received by *A*) declined sharply. *A* filed a lawsuit against *M* seeking to rescind the transaction. The *X* stock was placed into the custody of the court and *M* was stripped of its ability to vote such stock pending the outcome of the litigation. Pursuant to a court-approved settlement, the *X* stock was returned to *A* in exchange for the *M* stock held by *A* in a transaction qualifying under section 355, while *M* was entitled to retain the dividends paid by *X* during the litigation.

[65] Nov. 28, 1977.

[66] 1963-1 C.B. 172.

the member were rendered meaningless by the imposition of the bankruptcy trustee.

In Revenue Ruling 55-458,[67] the Service held that a corporation could be included in an affiliated group where its stock was purchased by the parent of such group but was held in escrow as security for the purchase price of the stock. Although legal title for the stock was held by an escrow agent, the parent of the affiliated group was the beneficial owner of such stock since it had "all rights of ownership including voting of the stock and the receipt of the amount of dividends paid on the stock, unless and until an event of default shall have occurred and be continuing."[68]

In Revenue Ruling 68-623,[69] the Service ruled that the parent of an affiliated group (*N*) could not file a consolidated return with an unrelated corporation (*O*) whose stock was leased by *N* from a second unrelated corporation (*X*). *N* entered into a lease agreement with *X*, which provided for the leasing to *N* of certain properties owned by *X* (including the stock of *O*) for 99 years. *X* delivered to *N* all right, title and interest in the stock of *O*, including the right to vote the shares and the right to receive dividends. *N* had the right to sell, lease or otherwise dispose of the *O* stock only if such stock was not, in *N*'s opinion, necessary and useful. *X* was required to execute the necessary documents and was entitled to any proceeds received upon the disposition of the stock of *O*. The Service held that since, under the terms of the lease, *N* was not the owner of the *O* stock within the meaning of section 1504(a), *N* and *O* were unable to file consolidated returns as members of the same affiliated group.[70]

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67 1955-2 C.B. 579.

68 *Id.*

69 1968-2 C.B. 404.

70 The Service did not address whether *X*'s ownership of the *O* stock satisfied the ownership requirement of section 1504(a), thus allowing *X* and *O* to file a consolidated return. *Connecticut & Passumpsic Rivers R.R. Co. v. Commissioner*, 24 B.T.A. 394 (1931), on similar facts, held that the taxpayer and a subsidiary met the statutory requirements for affiliation, even though the taxpayer leased all of the rights inherent in ownership of the subsidiary's stock (including voting rights) to a third party for 99 years:

> Notwithstanding that under the terms of the lease certain rights constituting virtual control in the shares of the stock of Newport & Richford Railroad Company were released to the lessee for the period of the lease, the ownership of the stock remained with the petitioner . . . . On the basis of continued ownership by the petitioner of all of

The Service's position as to what constitutes beneficial ownership is less clear in private letter rulings. The most recent private letter rulings, however, leave the impression that a shareholder may continue to be the beneficial owner of stock even though it has restricted its ability to vote the stock by transferring the stock into a voting trust.

In one of the earliest rulings on this issue, the Service held that a parent and its subsidiary were affiliated, even though state insurance regulations required the subsidiary's stock to be held in trust. Although the parent was entitled to all dividends paid on the stock during the term of the trust, such stock was voted by the trustee, subject to instructions from the parent's shareholders. Also, the parent's shareholders, and not the parent, had the power to terminate the trust at any time, causing the stock to be returned to the parent. The Service held that, even though it did not retain all rights associated with the escrowed stock, the parent corporation retained beneficial ownership of such stock.[71]

In Private Letter Ruling 77-49-047,[72] the Service, relying on Revenue Ruling 70-469, held that a subsidiary was not includible in its parent's affiliated group because the parent did not own the subsidiary's stock directly, but rather owned it through a voting trust run by independent trustees pursuant to a railway reorganization plan. Since the parent had neither the ability to vote its subsidiary's stock nor the ability to reacquire legal title, it did not directly own such stock for purposes of section 1504(a). Conspicuously absent from the Service's analysis was any discussion of Revenue Ruling 63-104.[73] In Private Letter Ruling 92-

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> the stock of the Newport & Richford Railroad Company there was a literal compliance with the statutory requirement for affiliation.

Id. at 398. *But see United States v. Georgia R.R. & Banking Co.*, 348 F.2d 278 (5th Cir. 1965) (holding, on similar facts, that the lessor was not the beneficial owner of the stock for purposes of the dividends received deduction under section 243 and stating, in dicta, that if beneficial ownership of the leased stock resides anywhere during the lease term, it resides with the lessee).

Revenue Ruling 68-623 neither relied on nor referred to the courts' decisions in *Connecticut & Passumpsic Rivers R.R. Co.* and *Georgia R.R. & Banking Co.* Furthermore, it is unlikely that the Service would agree to follow either decision.

[71] P.L.R. 57-02-285770A (Feb. 28, 1957).

[72] Sept. 12, 1977.

[73] *See supra* text accompanying note 66.

46-031,[74] however, the Service held that an insurance company remained a member of a consolidated group even though control of such company was shifted from its parent to a state insurance commissioner during the time such company was in rehabilitation. Similarly, in Private Letter Ruling 85-44-018,[75] the Service held that a parent and its subsidiary remained affiliated during the time such subsidiary was under control of the state's insurance department liquidation bureau. The bureau was directed to liquidate the subsidiary's business, which required that all property be placed in the bureau's name, the subsidiary's corporate charter be dissolved and all of the subsidiary's employees become employees of the bureau. In both Private Letter Ruling 92-46-031 and Private Letter Ruling 85-44-018, the Service cited Revenue Ruling 63-104 in support of its conclusion, thus effectively reversing its position in Private Letter Ruling 77-49-047.[76]

In Private Letter Ruling 78-04-008,[77] *X* pledged all its shares in *M*, its wholly-owned subsidiary, to *Y*, an unrelated corporation, so that *M* could obtain financing. *X* also granted *Z*, the parent corporation of *Y*, an option to buy 50 percent of *M*'s stock. *Z* was given the right to assert direct voting control over the *M* stock, a right which *Z* never exercised. Although *X* continued to vote the *M* stock at all times, since such right could be displaced by *Z*, the Service determined that "*X* does not meet the stock ownership requirements of section 1504(a) of the Code with regard to its stock ownership in *M* and therefore, does not constitute an affiliated group eligible to file a consolidated return."

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[74] Aug. 18, 1992.

[75] July 20, 1985.

[76] *See* P.L.R. 91-02-104 (Oct. 11, 1990) (subsidiary placed into receivership by state banking commission was required to continue to file a consolidated return with its parent); P.L.R. 90-48-004 (Aug. 22, 1990) (subsidiary placed into receivership required to file consolidated return with its parent); P.L.R. 90-14-051 (Jan. 8, 1990) (subsidiary placed into FSLIC receivership must continue to consolidate with its parent); P.L.R. 89-14-023 (Dec. 29, 1988) (same); P.L.R. 88-02-031 (Oct. 15, 1987) (bankruptcy filing by a subsidiary does not affect affiliation with parent corporation); P.L.R. 87-13-005 (Dec. 10, 1986) (same); P.L.R. 84-44-063 (July 31, 1984) (assumption of control of a subsidiary by a trustee in bankruptcy does not affect section 1504 affiliation between a subsidiary and its parent).

[77] Oct. 14, 1977.

In contrast, in Private Letter Ruling 78-35-007,[78] the Service held that a corporation continued to remain affiliated with its subsidiary even though the stock of the subsidiary had been pledged to a creditor and the parent corporation was in default. The taxpayer-debtor had full voting rights in the stock subject to the pledge agreement until it defaulted on its obligation. Upon an event of default, the creditor was required to give the taxpayer thirty days notice before it could sell the stock, during which time the taxpayer could cure its default. The Service held that the taxpayer and its subsidiary remained affiliated during an eleven day period in which the taxpayer was in default.[79]

In Private Letter Ruling 79-39-042,[80] the Service ruled that a taxpayer that transferred a subsidiary's stock to an irrevocable voting trust in order to comply with United States Department of Defense security clearance requirements was not affiliated with its subsidiary. The Service held that the grantor did not satisfy the requirements of section 1504(a) because it retained neither voting discretion over the stock nor the right to terminate the trust at any time and regain legal title. Similarly, in Private Letter Ruling 80-40-054,[81] the Service ruled that a corporation (*B*), which purchased the stock of a second corporation (*C*), was not considered the beneficial owner of the *C* stock during the time such stock was held in trust. *B*, which had previously owned 50 percent of *C*'s stock, purchased the remaining 50 percent from an unrelated party. Under the Interstate Commerce Act, a shareholder that purchases a controlling interest in a regulated company must secure the approval of the Interstate Commerce Commission ("ICC") prior to the acquisition. Therefore, immediately following the execution of the purchase agreement, the selling shareholder delivered the *C* stock to an unrelated trustee, which was required to vote the *C*

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78 May 23, 1978.

79 *See also* P.L.R. 59-03-136060A (Mar. 13, 1959), in which the taxpayer was treated as the owner of the stock of a subsidiary even though legal title to the shares was held by a bank as security for a loan. Up until the time the taxpayer was in default on the loan, the taxpayer possessed all of the rights of ownership in the stock including the right to vote such stock and the right to receive dividends.

80 June 26, 1979. Private Letter Ruling 79-39-042 revoked an earlier ruling letter issued to the taxpayer's predecessor dated May 17, 1965 holding that the grantor of an identical trust retained beneficial ownership of stock transferred to the trust.

81 July 10, 1980.

stock without regard to the best interests of *B*.[82] Relying on Revenue Ruling 70-469, the Service held that *B* was not the owner of the *C* stock as required by section 1504(a) since *B* had neither the right to vote the *C* stock nor the right to terminate the voting trust (except upon a sale of the *C* stock to a party that would not require ICC approval prior to exercising control over such stock).

In contrast, more recent rulings find that the affiliation requirements to be satisfied even where a parent corporation's voting rights with respect to the stock of a subsidiary have been temporarily suspended through a voting trust or another similar arrangement. In Private Letter Ruling 86-10-018[83] and Private Letter Ruling 87-40-010,[84] the Service held that the grantors of trusts similar to the trust established in Private Letter Ruling 80-40-054 retained beneficial ownership of the stock deposited in such trusts.[85] The Service, in these rulings, found the following facts relevant: (i) the grantor could (with ICC approval) instruct the trustee on how to vote the stock; (ii) the grantor received all dividends; (iii) the grantor had the right to, at any time, sell or dispose of the stock and receive the proceeds; (iv) the grantor had the right, at the time the trust was to be terminated, to receive

[82] The purpose of establishing a voting trust was to ensure that *B* could not exercise any control over *C*'s business pending approval from the ICC. The trustee was required not to exercise its voting power in *C* (i) in a manner that would cause any dependence or intercorporate relationship between *B* and *C* and (ii) to elect as officers or directors of *C* any persons known to it to be officers or directors of *B* without the approval of the ICC. Furthermore, in order to ensure independent administration of the trust, the parties agreed that for the life of the trust (i) neither the trustee, nor any affiliate of the trustee, would have any officer or director that was also known to be an officer or director of *B* or any affiliate of *B*, (ii) neither the trustee, nor any affiliate of the trustee, would have any direct or indirect business arrangements or dealings, financial or otherwise, with *B* or any affiliate of *B*, other than dealings pertaining to the establishment and maintenance of the trust, and (iii) neither *B*, nor any affiliate of *B*, would communicate or try to communicate with the trustee, whether directly or indirectly, except to advise the trustee of the occurrence of an event that would terminate the trust.

[83] Nov. 29, 1985.

[84] July 1, 1987.

[85] While neither Private Letter Ruling 86-10-018 nor Private Letter Ruling 87-40-010 mention that such trusts were established to comply with ICC regulations, Private Letter Ruling 86-10-018 cites a case that upheld the legality of ICC voting trusts. *See Illinois Central R.R. Co. v. United States*, 263 F.Supp. 421 (N.D. Ill. 1966), *aff'd*, 385 U.S. 457 (1967). Presumably, Private Letter Ruling 87-40-010 also involved a voting trust established to comply with ICC regulations because of its factual similarities with Private Letter Ruling 86-10-018. *See* Yates *supra* note 56, at 11.

either legal title to the stock or the proceeds from the sale of the stock; (v) there was a valid business purpose for the trust and (vi) the trust was intended to last for only a short period of time.[86]

In Private Letter Ruling 89-19-014,[87] a foreign corporation entered into proxy agreements with respect to the voting rights of certain of its subsidiaries in order to satisfy federal regulations that limited the ability of foreign owned contractors to receive security clearance. Without clearance, the subsidiaries could not continue to perform research and development work for the government. Under the proxy arrangements, proxy holders were required to exercise independent judgment in voting the shares of the subsidiaries; however, the proxy holders were expected to "act in good faith as reasonably prudent persons to protect the economic interests" of the parent in its subsidiaries. Proxy holders could only be removed for gross negligence or willful misconduct and successors were to be appointed by a majority of the remaining proxy holders, not the parent corporation. Notwithstanding the broad authority granted to the proxy holders, such holders could not, without the consent of the parent corporation, undertake certain extraordinary corporate actions. In contrast to Private Letter Ruling 79-39-042, the Service held that the parent corporation maintained beneficial and direct ownership within the meaning of section 1504(a).

Finally, in Private Letter Ruling 91-40-013,[88] the Service held that a parent's transfer of its subsidiary stock to a trust left the parent and its consolidated group with "sufficient ownership in the transferred [subsidiary] stock to avoid disaffiliation of the [subsidiary]" from the group. Pursuant to a tender offer made by a member of the parent's consolidated group, the parent would have owned two companies operating similar businesses. In order to alleviate antitrust concerns, the parent agreed to appoint an independent trustee to sell either the existing subsidiary or the

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[86] Although these private letter rulings cite Revenue Ruling 70-469 and Revenue Ruling 84-79 for support, the Service has clearly moved away from the "complete dominion" standard of the revenue rulings. Although in both private letter rulings the taxpayers could dispose of the stock and were entitled to the disposition proceeds, the taxpayers did not have complete voting control over the stock or the ability to remove the trustee.

[87] Feb. 9, 1989.

[88] June 28, 1991.

competing business.[89] The parent executed a trust agreement that transferred its subsidiary stock into a trust under which all voting rights were to be held by an independent trustee.[90] The Service stated:

> We note that the Trust Agreement was to be of relatively short duration. Moreover, notwithstanding that the voting rights associated with the Sub stock have been placed under the sole control of the trustee, Parent retains all economic interest in the Sub stock through dividends and appreciation potential. Additionally, if Parent group should decide to sell Target Sub, Parent could terminate the trust and reacquire the voting rights in Sub . . . . Considering the above factors, the Parent affiliated group retains sufficient ownership in the transferred Sub stock to avoid disaffiliation of Sub.

The Service has rarely cited early case law concerning whether voting rights are necessary to have beneficial ownership of stock; such decisions generally extended the affiliation provisions of the Code to situations in which the Service's rulings would appear not to apply.[91] Current court decisions appear to be more aligned with the Service's public ruling policy. For example, in *Miami National Bank v. Commissioner*,[92] the Tax Court held that where an individual ("Transferor") transferred more than 80 percent of the stock of a corporation to his broker and such stock was held in a "subordinated securities account," he remained the beneficial owner of the stock. Thus, a sale of the stock to another corporation ("Parent") resulted in Parent acquiring beneficial ownership of the

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[89] The government's concerns presumably involved antitrust issues as the ruling stated that the transaction proposed in the ruling may have violated provisions of the Clayton Act.

[90] The trustee could, however, seek advice from the parent if it deemed the advice helpful in running the subsidiary's business.

[91] Moreover, it is unlikely that the earliest court decisions have any validity under current section 1504(a), except with respect to their most basic principles. At the time such cases were decided, the statute required that two or more corporations be "owned or controlled by the same interests" in order to satisfy the affiliation requirements. This language had been interpreted to require unity of either ownership or control of multiple corporations, but did not require unity of both ownership and control. *See Lavenstein Corp. v. Commissioner*, 25 F.2d 375, 377 (4th Cir. 1928). Congress later adopted an affiliation test based solely upon stock ownership. As discussed herein, this test is satisfied by beneficial ownership.

[92] 67 T.C. 793 (1977).

stock. After the sale, Parent directly owned a sufficient amount of the corporation's stock to file a consolidated return. The court held that even though the broker had legal title to the stock, such stock was subject to the claims of the broker's creditors and the broker could under certain circumstances sell the stock, the Transferor was the beneficial owner of the stock because it had all other rights associated with the stock, including voting rights and the right to receive dividends.[93] Moreover, the Transferor also had the right to withdraw the stock from the subordinated securities account at any time by substituting cash or other marketable securities of equal value. Furthermore, if the stock were sold, the Transferor had a claim against his broker based upon the value of the stock at the time of sale.[94] Therefore, the Transferor retained the benefit of any appreciation and the burden of any depreciation in the value of the stock.[95] While the court in *Miami National Bank* cites a number of the earliest cases in this area for support,[96] the court focuses on the right of the Transferor to vote the stock, receive dividends and reacquire legal title at any time–the factors relied upon by the Service in Revenue Ruling 70-469[97]–in holding that beneficial ownership was retained despite the absence of legal title.

3. INI, Inc. v. Commissioner

In the most recent decision addressing the issue of beneficial ownership under section 1504(a), the Tax Court held that a corporation ("Parent") that granted one of its shareholders an irrevocable proxy to vote the stock of a wholly-owned subsidiary ("Sub"), along with an agreement to distribute eventually the Sub stock to such shareholder, severed the affiliation between Parent and Sub.[98] Because of a disagreement between Parent's two shareholders, Jones and Cates, over the operation and management of the business, the shareholders agreed to divide the business by

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[93] *Id.* at 801, 804.

[94] *Id.* at 800-01.

[95] *Id.* at 801.

[96] *Id.* at 799 (citing, *inter al.*, *Lavenstein*).

[97] *See supra* text accompanying note 58.

[98] *INI, Inc. v. Commissioner*, 69 T.C.M. 2113 (1995).

distributing all of Sub's stock to Jones in exchange for his Parent stock. Cates would then own all the stock of Parent. The distribution was delayed, however, because of a preexisting agreement that limited the transfer of Parent stock for a period of time.[99] Desiring to divide the business as quickly as possible, Jones granted Cates a proxy to vote his Parent stock. Cates, in turn, had Parent grant Jones a proxy to vote the Sub stock. The distribution was completed at a later date.[100]

The Service argued that Parent's grant of the irrevocable proxy to vote the Sub stock to Jones ended the affiliation between Parent and Sub. The taxpayer argued that Sub did not leave the Parent's consolidated group until the Sub stock was distributed to Jones. The Tax Court agreed with the Service, holding that the execution of the irrevocable proxy to vote the Sub stock was sufficient to break consolidation between Parent and Sub.[101]

The court relied on *Miami National Bank*, concluding that "the ownership referred to in section 1504(a) is beneficial ownership regardless of the arrangement by which it is created."[102] Thus, the court determined that the relevant inquiry involved when a transfer of beneficial ownership occurred. Relying on state law[103] and the intent of the parties, the court concluded that the execution of an irrevocable proxy was sufficient to cause Parent and Sub to deconsolidate.[104]

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[99] The delay resulted from a standfast agreement with a third-party partnership in which Parent was a partner. Since the transfer of 50 percent or more of the stock of a corporate partner was considered to be a transfer of a partnership interest under section 708, the standfast agreement was entered into to prevent a transfer by Jones or Cates of their Parent stock from causing a termination of the partnership. *INI*, 69 T.C.M. at 2116.

[100] *Id.*

[101] *Id.* at 2121.

[102] *Id.* (citing *Miami Nat'l Bank*, 67 T.C. at 801).

[103] The court cited *Estate of Craft v. Commissioner*, 68 T.C. 249, 263 (1977), *aff'd*, 608 F.2d 240 (5th Cir. 1979) (A "fundamental principle of tax law [is] that State law creates legal rights and property interests while the Federal law determines what, and to what extent, interests or rights, so created, shall be taxed."). *INI*, 69 T.C. at 2121.

[104] *INI*, 69 T.C. at 2121. Under Georgia law, the beneficial ownership of a share of stock is transferred when an irrevocable proxy to vote such stock is transferred. The law provides that a proxy is revocable unless it is coupled with an interest and, by its terms, expressly provides that it is irrevocable. A proxy coupled with an interest is defined to include a proxy executed in favor of a person who has purchased or has agreed to purchase the underlying shares. *Id.* (citing Ga. Code Ann. § 14-2-722(d)(2) (1994)).

While at first glance *INI* appears to expand the definition of beneficial ownership, the decision is nothing more than an extension of the Service's prior rulings. The court in *INI* merely affirmed prior precedent that held that when a corporation relinquishes beneficial ownership of a subsidiary's stock, it no longer directly owns such stock and can no longer be considered a member of an affiliated group within the meaning of section 1504(a). In other words, legal title does not a direct owner make.

E. Conclusion

Although the definition of voting stock–stock having the current ability to vote for directors who control the management of the corporation–is the same under both section 368(c) and section 1504(a) of the Code, the policies underlying these two statutory provisions are very different. Hence their different application in case law and rulings. A taxpayer attempting to satisfy the control requirement of section 368(c) need only own stock possessing 80 percent of the voting power of the corporation–such taxpayer need not have the right or ability to vote such stock. It is the inherent characteristic of a class of stock to vote for directors that makes such stock voting stock. Shareholder voting agreements, proxies and voting trusts have no effect on the characterization of stock as voting stock for purposes of section 368(c).[105]

Because section 1504(a) requires a parent corporation to have voting control over its subsidiaries, the effect of arrangements that limit voting control requires a different analysis. While it appears that the courts and the Service have moved away from the rigid two-part test established in Revenue Ruling 70-469, inconsistent holdings by the Service in revenue rulings and private letter rulings have left practitioners puzzled as to whether a taxpayer who owns voting stock and enters into a shareholders agreement or other voting arrangement with respect to such stock will retain sufficient beneficial ownership in the stock to qualify for affiliation.

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[105] The stock may also be treated as voting stock if the owner of such stock is legally prohibited from voting its shares. *See* Rev. Rul. 73-28, 1973-1 C.B. 187. *See also* text accompanying notes 29-32 *supra*.

It is incumbent on the Treasury to issue regulations to clarify when the owner of voting stock may relinquish certain incidents of ownership and still be considered the direct owner of such stock.[106] The regulations should provide that the owner of voting stock will remain the beneficial owner of stock that is subject to a shareholders agreement or that is placed in a voting trust if (i) there is a valid business purpose for the agreement or trust, (ii) the agreement or trust is intended to operate for only a short period of time, (iii) under certain conditions, the owner of the stock could terminate the trust and regain legal title to the stock, (iv) the owner of the stock is entitled to receive all dividends (except for stock dividends) paid on the stock, (v) the owner of the stock is entitled, at any time, to sell or dispose of the stock and receive all cash proceeds and (vi) the owner of the stock would be entitled to regain legal title to the stock upon termination of the trust.

Absent such guidance by the Treasury, the Service should issue either a revenue procedure, providing guidelines which a taxpayer requesting a private letter ruling under section 1504 must satisfy, or further revenue rulings, providing safe harbor situations in which the owner of stock retains beneficial ownership of such stock after entering into a shareholders agreement or placing stock into a voting trust. Without such guidance, taxpayers attempting to satisfy the direct ownership requirement of section 1504(a) should either attempt to place themselves within the parameters provided by Revenue Ruling 70-469 or seek a private letter ruling from the Service.

IV. MEASUREMENT OF VOTING POWER

A. *Ability to Elect Directors*

Once it is determined that stock qualifies as voting stock and that a taxpayer is the owner of (or, for purposes of section 1504(a), directly owns) such stock, the next step is to determine whether the taxpayer owns stock possessing "at least 80 percent of the total

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[106] Section 1504(a)(5) grants the Treasury broad authority to prescribe regulations necessary or appropriate to carry out the purposes of the consolidated return provisions of the Code.

combined voting power of all classes of stock entitled to vote"[107] or owns directly "at least 80 percent of the total voting power of the stock of such corporation."[108]

Since, as previously discussed, voting stock is defined as stock that participates in the management of the corporation through the election of directors,[109] the most common method of measuring the voting power inherent in stock held by a taxpayer is to calculate the percentage of the directors of a corporation the taxpayer can elect. Where only one class of voting stock exists, this calculation is made by dividing the number of shares of stock held by the taxpayer by the total number of shares of voting stock outstanding.[110]

Where a corporation's equity consists of two or more classes of voting stock and the shares of each class have the same ability to vote for all directors, a taxpayer's voting power is similarly computed by dividing the number of shares of voting stock held by the taxpayer by the total number of shares of voting stock

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[107] I.R.C. § 368(c).

[108] I.R.C. § 1504(a)(2)(A).

[109] *See* Rev. Rul. 69-126, 1969-1 C.B. 218.

[110] In General Counsel Memorandum 34,795 (Mar. 1, 1972), the Service held that the ownership of 58 percent of the outstanding voting stock of a corporation did not constitute control within the meaning of sections 368(c) and 355 even though such stock represents de facto control since the owner of such stock could elect 100 percent of the corporation's board of directors. Since only one class of voting stock was outstanding, control was determined by computing the percentage of the total number of shares owned by the taxpayer. *See also Handy & Hardman v. Burnet*, 284 U.S. 136 (1931) (reaching a similar conclusion under the consolidated return provisions of the Code).

In Private Letter Ruling 97-14-002 (Dec. 26, 1996), the Service held that a taxpayer could not file a consolidated return with its subsidiary during the period it held only 74 percent of the votes inherent in the subsidiary's voting stock even though, because the subsidiary did not have cumulative voting for directors, the taxpayer could elect all of the members of the subsidiary's board. The Service found itself bound by the literal language of section 1504(a)(2)(A) which requires that a taxpayer *own* stock possessing 80 percent of the total voting power of a subsidiary corporation and not solely, as the taxpayer claimed, own sufficient stock to elect 80 percent of the subsidiary's board. The Service stated that the stock owned by the taxpayer would, if it were widely held, possess only 74 percent of its issuer's voting power:

> It is only the fact that [the taxpayer] owns 100 percent of the [subsidiary's] common stock and that [the subsidiary] employs cumulative voting that allows [the taxpayer] to elect at least 80 percent of [the subsidiary's] directors. This does not satisfy the requirements of the statute that [the taxpayer] (or members of its affiliated group) own stock possessing at least 80 percent of the total voting power of the stock of [the subsidiary]. Regardless of the actual effect of [the taxpayer's] ownership of the common stock, [the taxpayer] only owns stock possessing 74 percent of the voting power of [the subsidiary].

outstanding. For example, in *Pantlind Hotel Company v. Commissioner*,[111] the court held that a taxpayer was not entitled to file an affiliated return with its subsidiary where it owned 3,971 shares of the subsidiary's 3,989 shares of common stock and 1,016 of its 4,453 shares of preferred stock. During the period in question, both the common and preferred stock were entitled to vote for the subsidiary's directors. Thus, even though the taxpayer owned 99.55 percent of the voting common stock, it owned only 55.56 percent of all the voting stock of its subsidiary.

The calculation of voting power becomes more complex where a corporation has two or more classes of voting stock that either vote independently for their own classes of directors or have a different number of votes per share. In the former situation, the Service has generally looked to the voting power that each class of stock holds and then to the voting power that a shareholder holds in each class.[112] For example, in Income Tax Ruling 3896,[113] the Service held that where a taxpayer owned 100 percent of the common stock of a corporation, which had the ability to elect six of the corporation's seven directors, and 55.5 percent of the preferred

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[111] 23 B.T.A. 1207 (1931).

[112] In one case, however, the United States Claims Court discussed a different method of computing voting control. In *Hermes Consolidated, Inc. v. United States*, 14 Cl. Ct. 398 (1988), the court held that a taxpayer owned less than 50 percent of the voting power of the stock of a corporation (Hermes) for purposes of section 269 of the Code. There, the taxpayer (Hamilton) owned all 100,000 shares of Hermes' voting common stock while the corporation's other shareholder (H.P.I.) owned all 104,000 shares of Hermes' voting preferred stock. Hermes' board of directors consisted of three directors: one elected by the common shareholder, one elected by the preferred shareholder and a third elected by the majority of all shares voting as a single class. Although the court noted that the general method of computing voting power is the determination of the percentage of voting stock owned by the taxpayer (and under that methodology, Hamilton owned only 49.02 percent of Hermes' voting power (100,000/204,000)), the court computed Hamilton's voting power to be 33⅓ percent since Hamilton and H.P.I. each had the ability to elect one director to Hermes' board. Furthermore:

> [t]he third member of the board was elected from the majority of all the shares voting from a single class. Since H.P.I. had 104,000 shares and Hamilton only had 100,000 shares, H.P.I. had the power to elect independently the third member of the board. In measuring Hamilton's power to elect Hermes' board of directors then, Hamilton held a 33⅓% interest since it controlled only enough votes to elect one out of the three members.

Id. at 405-06.

The Service has rejected this "all-or-nothing" approach in determining the voting power inherent in a taxpayer's stock. *See supra* note 110.

[113] *See supra* note 15.

stock, which possessed the power to elect the remaining director, the taxpayer owned stock in its subsidiary possessing less than 95 percent of the voting power of the subsidiary, and thus the taxpayer and its subsidiary were not affiliated within the meaning of the Code. In determining the percentage of the voting power held by the taxpayer in the subsidiary corporation, the Service found that the common stock constituted six-sevenths, or 85.714 percent, and the preferred stock constituted one-seventh, or 14.286 percent, of the voting power of the subsidiary corporation. Thus, the parent corporation owned "stock possessing 85.714 per cent plus 7.929 per cent (55.5 per cent of 14.286 per cent), or 93.643 per cent of the voting power of all classes of stock." [114]

In Revenue Ruling 69-126,[115] the Service held that a taxpayer met the 80 percent voting power requirement for affiliation under section 1504(a) where the taxpayer owned 100 percent of the common stock and 50 percent of the preferred stock of a subsidiary corporation. The holders of common stock had the power to elect five of the eight directors, and the holders of preferred stock had the power to elect the remaining three directors. Because the common stock had the ability to elect five-eighths of the directors, those shares contained 62.5 percent of the voting power of the corporation. The preferred stock constituted three-eighths, or 37.5 percent, of the voting power of the corporation. Therefore, the taxpayer owned 62.5 percent plus 18.75 percent (50 percent of 37.5 percent), or 81.25 percent of all classes of voting stock of the corporation.

In Revenue Ruling 63-234,[116] the Service determined that a corporation owning 78 percent of the common stock of a subsidiary corporation, which stock entitled the holder to elect ten of twelve members of the subsidiary's board, and 100 percent of the preferred stock of the subsidiary, which entitled the holder to elect the remaining two board members, owned 81.67 percent of the voting power of all classes of stock of the subsidiary corporation.[117]

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[114] 1948-1 C.B. at 76.

[115] 1969-1 C.B. 218.

[116] 1963-2 C.B. 148.

[117] The common stock represented 83.33 percent of the voting power of the subsidiary (10/12), and the preferred stock represented 16.67 percent (2/12). Thus, the corporation

Where a corporation has multiple classes of stock with the power to elect the directors of the corporation and each class of stock has a different number of votes per share, a taxpayer's voting power in the corporation is calculated by dividing the number of votes held by the taxpayer by the total number of votes inherent in all of the voting stock of the corporation. Thus, for example, in *Anderson-Clayton Securities Corporation v. Commissioner*,[118] the court ruled in favor of a taxpayer who argued that because it owned 6,400 of the 10,000 shares of its subsidiary's common stock, which carried one vote per share or 6,400 votes, and all 4,800 shares of its subsidiary's preferred stock, which carried 50 votes per share or 240,000 votes, it owned 98.56 percent of its subsidiary's stock (246,400/250,000).[119] The Service had argued that the taxpayer owned only 75.67 percent of the subsidiary's stock (11,200 shares/14,800 shares). In holding for the taxpayer, the court determined that in requiring affiliation to be based upon the ownership of a percentage of a corporation's voting stock, Congress intended to focus on the voting power inherent in the stock and not merely ownership of a number of shares. Thus, the taxpayer was correct in determining its percentage ownership in its subsidiaries by looking to the votes it could cast instead of the number of shares it owned.[120] The Service has subsequently affirmed the court's holding by using the *Anderson-Clayton* methodology in computing voting power in private letter rulings.[121]

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owned 65 percent (78 percent of 83.33 percent) plus 16.67 percent, or 81.67 percent of the voting power of the subsidiary corporation.

[118] 35 B.T.A. 795 (1937).

[119] *Id.* at 797.

[120] *Id.*

[121] In Private Letter Ruling 82-21-112 (Feb. 26, 1982), the Service held that a taxpayer and its subsidiary could file a consolidated return where the taxpayer owned all 22,498 shares of its subsidiary's common stock, each entitled to one vote per share; while another group of taxpayers owned the subsidiary's 6,867 shares of Class B common stock, each entitled to 0.8 votes per share. The Service computed the voting power of the shares held by the taxpayer in the following manner:

> The instant case differs from Rev. Rul. 69-126 in that both the Common and Class B Common stock are entitled to vote in all matters, rather than one of the classes being restricted to voting for directors only. Accordingly, the voting power of the two classes does not initially have to be determined by reference to the number of directors which can be elected by each class. Rather the voting power is determined by reference to the votes allocated to each class. The 22,498 shares of Common stock owned entirely by Corp *P* have one vote per share. The 6,867 shares of Class B Common stock owned

B. Structuring the Voting Power of a Corporation's Shares

1. Recapitalization

The use of a mechanical test to determine voting power gives a corporation the ability to recapitalize its equity using voting stock with voting rights disproportional to its equity value in order to obtain the desired tax treatment in a subsequent transaction that is required to satisfy the control requirement of section 368(c).[122] The following examples provide situations where a restructuring is both a useful and necessary preliminary step in receiving the desired tax treatment.

> **Example 1.** Corporation *X*, which owns 70 percent of the stock of Corporation *Y*, wants to distribute the *Y* stock to its shareholders in a tax-free transaction qualifying under section 355. A distribution by *X* of the stock of a corporation which it does not control could give rise to a tax

entirely by *D* and *C*, and held in the voting trust, have 0.8 votes per share, and thus represent a total of 5,494 votes. The total number of votes held by all classes of voting stock is 27,992. Corp *P*'s ownership of the Common stock entitles Corp *P* to 80.4 percent of this total number of votes.

The Service also pointed to an amendment to the subsidiary's certificate of incorporation that provided the taxpayer with the ability to elect 15 out of the 18 members of subsidiary's board of directors and the right to vote proportionately to elect one of the three remaining members. The other two of the subsidiary's board members were to be elected by one of the shareholders of the Class B Common stock. The Service stated that this amendment to the certificate of incorporation served to increase the taxpayer's voting power in the subsidiary, making it clear that the taxpayer satisfied the voting power requirement of section 1504(a) of the Code. The taxpayer's ability to elect 15 of 18 board members, as well as the ability to participate in the election of one of the three remaining board members, gave the taxpayer 87.8 percent of the voting power in its subsidiary (15/18 + [.804 * 1/18]).

If the management of the subsidiary was vested in the subsidiary's board of directors, only the second method of computing voting power is relevant. It is possible, however, that the Service was attempting to use the facts of the ruling to distinguish the method of computing voting power where different classes of shares contain different voting rights from the computation where different classes of shares each independently elect the members of a company's board of directors. *See also* P.L.R. 97-14-002 (Dec. 26, 1996) (computing voting power based upon the number of votes held by the taxpayer, not the number of shares); P.L.R. 80-30-007 (Apr. 14, 1980) (computing voting power using the *Anderson-Clayton* methodology where one class of stock had six votes per share and the other class had one vote per share).

[122] A recapitalization is not useful, however, in attempting to qualify a group of corporations as affiliated corporations because section 1504(a) defines affiliation using both a vote and value test. *See supra* note 11 and accompanying text.

liability to both *X* and its shareholders. A recapitalization of *Y*, in which *X* receives all of a new class of stock that elects 80 percent of *Y*'s directors and in which the remaining shareholders receive a class of stock that elects 20 percent of *Y*'s directors, would give *X* control of *Y* within the meaning of section 368(c). A subsequent distribution by *X* of the *Y* stock would qualify under section 355.

Example 2. Corporation *A* has one class of stock owned entirely by Corporation *B*. *A* needs to raise capital and decides that the best way to do so is through a public offering. *A* wants to sell 40 percent of its equity; *B*, however, wants to retain the flexibility to later distribute the *A* stock to its shareholders in a tax-free manner. Here, a public offering by *A* of a new class of voting stock representing 40 percent of *A*'s equity, but less than 20 percent of *A*'s voting power, would satisfy the objectives of both *A* and *B*.

Example 3. Corporation *C* is a wholly-owned subsidiary of Corporation *D*. *C* wishes to acquire unrelated Corporation *E* using its common stock as consideration; however, *E* is larger than *C* and the issuance of *C*'s stock to the *E* shareholders would result in *D* losing control of *C*. By having *C* issue the *E* shareholders a second class of low-vote stock of *C*, *D* could retain voting control over *C*.

The Service has approved a recapitalization of a corporation as a first step in a larger transaction only where the recapitalization brings about a permanent realignment of voting power. For example, in Revenue Ruling 56-117,[123] Distributing owned all of the common stock and 12 percent of the non-voting preferred stock of Controlled.[124] Pursuant to a plan of reorganization, Controlled exchanged newly issued Controlled common stock for all of the

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[123] 1956-1 C.B. 180.

[124] For purposes of this section of the article, the terms "Distributing" and "Controlled" will refer to the distributing corporation and the controlled corporation in a spin-off transaction intending to qualify under section 355.

Controlled preferred stock not held by Distributing. This allowed Distributing to distribute its entire interest in Controlled (93 percent of Controlled's common stock and 100 percent of Controlled's preferred stock) in a non-pro rata spin-off that satisfied the control requirement of section 355.[125]

Similarly, in Revenue Ruling 69-407,[126] the Service held that the recapitalization of Controlled to provide Distributing with a greater number of shares of common stock with a lower par value gave Distributing control and constituted a reorganization within the meaning of section 368(a)(1)(E).[127] Since Distributing was in control of Controlled after the recapitalization, the distribution of the Controlled stock by Distributing qualified as a nontaxable distribution under section 355.[128]

In Revenue Ruling 69-407, the Service distinguished Revenue Ruling 63-260,[129] in which an individual, *A*, owned 30 shares of Controlled stock and all 100 shares of the stock of Distributing, which, in turn, owned the remaining 70 shares of Controlled stock. *A* transferred 10 shares of Controlled stock to Distributing in order to allow Distributing to distribute 80 shares of Controlled stock to him in a section 355 transaction. The Service held that the distribution did not qualify under section 355 because Distributing was not in control of Controlled immediately prior to the distribution except in "a transitory and illusory sense."[130] Since

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[125] It was necessary to recapitalize Controlled so that Distributing would own 80 percent of Controlled's voting stock and 80 percent of each class of Controlled's non-voting stock as required by section 355. *See supra* note 7 and the accompanying text.

[126] 1969-2 C.B. 50.

[127] In Revenue Ruling 69-407, Distributing exchanged 700 shares of Controlled common stock with a par value of $100 per share for 800 shares of Controlled common stock with a par value of $87.50 per share. Controlled's minority shareholders exchanged 300 shares of common stock with a par value of $100 per share for 200 shares of common stock with a par value of $150 per share. Accordingly, Distributing increased its voting power in Controlled from 70 percent to 80 percent.

[128] In General Counsel Memorandum 34,122 (May 8, 1969), which supports the Service's position in Revenue Ruling 69-407, the Service states that:

> [i]t has been held that the use of a recapitalization for the purpose of diluting the voting power of one class of stock in order to increase the voting power of another class, thereby shifting voting control to a different group of shareholders, is a sufficient purpose to qualify the exchange as a reorganization under section 112(g)(1)(E) of the 1939 Code [the predecessor to section 368(a)(1)(E)].

[129] 1963-2 C.B. 147.

[130] *Id.*

both immediately prior to and immediately after the transaction *A* owned the 10 shares of Controlled stock, the transfer of such stock to Distributing had no significance. The Service stated that "[s]ection 355 of the Code cannot be made to apply to a transaction in which an immediately preceding contribution to capital by the distributor corporation's shareholder is made solely to attempt to qualify the transaction as a nontaxable distribution under that section."[131] In Revenue Ruling 69-407, however, the recapitalization prior to the distribution was respected as it "resulted in a permanent realignment of voting control."[132]

In Revenue Ruling 76-223,[133] the Service respected a recapitalization of a corporation's non-voting preferred stock into voting preferred stock prior to an acquisitive reorganization since such recapitalization effected a permanent change in the voting rights of the corporation. There, Corporation *X* wished to acquire the stock of Corporation *Y*, which had 81 shares of common stock and 19 shares of non-voting preferred stock outstanding, in a transaction pursuant to section 368(a)(1)(B). *X*, however, did not wish to acquire the *Y* preferred stock. In order to qualify as a tax-free reorganization, *Y*'s charter was amended to give voting rights to the preferred stock. *X*'s subsequent acquisition of the common stock satisfied the control requirement.[134]

The Service has also ruled privately that a recapitalization should be respected where it constitutes the first step in a larger transaction. In Private Letter Ruling 95-47-049,[135] Distributing owned less than 80 percent of the voting power of Controlled. Pursuant to a plan of recapitalization, Distributing exchanged shares of Controlled common stock, which had one vote per share, for a new class of Controlled preferred stock, which had five votes per share. As a result, Distributing acquired control of Controlled,

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[131] *Id.* at 148.

[132] 1969-2 C.B. at 51.

[133] 1976-1 C.B. 103.

[134] Section 368(a)(1)(B) requires that, immediately after an acquisition, the acquiring corporation has control of the acquired corporation. Since following the recapitalization, the common stock represented more than 80 percent of the voting power inherent in *Y*'s stock and since there was no non-voting stock, *X*'s acquisition of the common stock resulted in *X* acquiring control of *Y* within the meaning of section 368(c).

[135] June 2, 1995.

allowing Distributing to distribute the Controlled stock to its shareholders tax-free under section 355.[136] In Private Letter Ruling 86-31-014,[137] the Service ruled that a distribution qualified under section 355 where, prior to the distribution, Controlled's common stock had been recapitalized into two classes of common stock, one with 0.6 votes per share and the other with 1.4 votes per share, in order to allow Distributing to acquire control of Controlled. Finally, in Private Letter Ruling 94-09-043,[138] the Service respected a recapitalization of Controlled's common stock into two classes of common stock, one with three votes per share and the other with one vote per share, as a preliminary step for a spin-off of Controlled. Distributing distributed Controlled's high-vote common stock to its shareholders tax-free under section 355. Controlled issued the low-vote stock to the public following the distribution, thereby allowing Controlled to raise additional capital without Distributing's shareholders losing control of Controlled.[139]

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[136] The published version of Private Letter Ruling 95-47-049 does not state the number of votes inherent in Controlled's common and preferred stock. This information is based upon the author's personal knowledge of the transaction.

[137] Apr. 28, 1986.

[138] Dec. 9, 1993.

[139] Although Distributing was in control of Controlled prior to the spin-off, Distributing's shareholders were required to be "in control" of Controlled after the distribution because the preliminary step of the transaction was the contribution of assets to a newly formed corporation (which qualified as a tax-free reorganization pursuant to section 368(a)(1)(D)) prior to the distribution under section 355. While Distributing needed only to "distribute control" of Controlled under section 355, section 368(a)(1)(D) required the transferor (or its shareholders) to be "in control" of the transferee corporation immediately after the exchange. Failure of Distributing's shareholders to remain in control of Controlled after the distribution would have caused the spin-off to have been taxable. This disparate treatment between spin-offs that are solely required to satisfy the "distribute control" requirement of section 355 and those that are required to satisfy the "in control" requirement of section 368(a)(1)(D) has been mitigated by section 1012(c) of the Taxpayer Relief Act of 1997.

See also P.L.R. 93-28-026 (Apr. 19, 1993) (conversion of preferred stock into common stock prior to spinoff); P.L.R. 91-29-056 (Apr. 25, 1991) (recapitalization prior to spinoff respected); P.L.R. 90-15-041 (Jan. 12, 1990) (recapitalization of Controlled's non-voting preferred into voting preferred to give Distributing control of Controlled prior to a spinoff); P.L.R. 89-39-015 (June 30, 1989) (same); P.L.R. 89-18-064 (Feb. 7, 1989) (same); P.L.R. 88-48-045 (Sept. 2, 1988) (recapitalization changing par value of stock so as to issue additional shares to give Distributing control of Controlled prior to spinoff); P.L.R. 88-36-046 (June 15, 1988) (recapitalization into high vote/low vote stock structure); P.L.R. 88-28-065 (Apr. 19, 1988) (recapitalization into high vote and low vote common stock to give Distributing control of Controlled prior to spinoff); P.L.R. 88-12-081 (Dec. 30, 1987) (recapitalization of non-voting preferred into voting preferred); P.L.R. 88-03-043 (Oct. 23, 1987) (recapitalization changing par value of stock so as to issue additional shares to give Distributing control of Controlled

2. Issues Raised by a Recapitalization

The authorities discussed above demonstrate that the Service will respect tax planning techniques that redistribute the voting power of a corporation as long as the redistribution results in a "permanent realignment of voting control."[140] In fact, it appears that Revenue Ruling 63-260 provides the only authority for a situation in which the Service disregarded an attempt to redistribute a corporation's voting power among shareholders as transitory and illusory.[141] Nevertheless, a recapitalization or other redistribution of the voting power inherent in a corporation's stock may be challenged by the Service where:

(i) the disproportionate voting power of stock is limited by time or certain events;
(ii) the voting power of the stock becomes proportionate upon the transfer of such stock; or
(iii) the voting power of the stock is greatly disproportionate to its equity value.

Each of these situations is discussed below.

a. Temporary Voting Power

Where a corporation issues disproportionate voting stock as a means of increasing or maintaining the voting power held by a particular shareholder, the remaining shareholders may require that such disproportionate voting rights be only a temporary arrangement.[142] Disproportionate voting stock may be converted

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prior to spinoff); P.L.R. 87-44-035 (Aug. 4, 1987) (recapitalization to give Distributing control of Controlled prior to spinoff); G.C.M. 34,795 (Mar. 1, 1972) (issuance of voting preferred to give shareholder control prior to spinoff).

[140] Rev. Rul. 69-407, 1969-2 C.B. at 148.

[141] *See supra* note 129 and accompanying text.

[142] Technically, a majority shareholder of a corporation may be able to effect a recapitalization of the corporation without the consent of the other shareholders; however, as a practical matter, the majority shareholder will likely seek the approval of the minority shareholders in order to prevent the minority shareholders from filing suit against the corporation. In order to induce the minority shareholders to approve a recapitalization that would reduce their voting power in the corporation, the majority shareholder may be required

into proportionate voting stock at a specific time in the future or as a result of the occurrence of a subsequent event.[143] The Service should respect these disproportionate voting rights when such rights are not transitory and illusory in nature but "result in a permanent realignment of voting control."[144]

Although there is no direct authority that defines the term "permanent" for these purposes, analogous authorities indicate that a disproportionate voting structure that remains in place for five years should be considered permanent. In Revenue Ruling 66-23,[145] the Service held that the continuity of interest requirement of section 368 was satisfied where shareholders of the target corporation were required by an antitrust decree to dispose of stock of the acquiring corporation received in a reorganization within seven years. The Service concluded that unrestricted ownership for such period of time was definite and substantial, notwithstanding the requirement to later dispose of the stock. The Service further stated that it would ordinarily "treat 5 years of unrestricted rights of ownership as a sufficient period for the purpose of satisfying the continuity of interest requirements of a reorganization."[146] Similarly, the Service has held that mandatorily redeemable preferred stock issued by an acquiring corporation in a

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to provide the minority shareholders with some form of compensation such as a promise by the majority shareholder to restore the voting rights of the corporation to proportionate voting after a set period of time, an increased equity interest in the recapitalized corporation or some combination of the two. For example, in one transaction with which the author is familiar, Controlled's majority shareholder exchanged Controlled common stock with a value of over $100 million for a new class of Controlled high-vote preferred stock with a liquidation preference and redemption amount of $15 million in order to acquire control of Controlled prior to a spin-off. Similarly, a recapitalization may be effected by having a corporation's minority shareholders exchange each share of common stock owned by them for 1.1 shares of a new class of low-vote common stock, thereby providing the majority shareholders with a larger percentage of the vote while providing the minority shareholders with a greater percentage of the corporation's equity.

[143] For example, following a recapitalization of a subsidiary's stock into high-vote and low-vote shares in order to allow the subsidiary's parent to consummate a spin-off or public offering, the subsidiary's corporate charter could provide that its high-vote stock will be converted into low-vote stock on the earlier to occur of (i) the fifth anniversary of a spin-off by the parent of the subsidiary, (ii) the completion of the public offering, (iii) the failure of the subsidiary to meet certain financial targets, or (iv) the failure of the parent to maintain a certain ownership level in the subsidiary.

[144] Rev. Rul. 69-407, 1969-2 C.B. at 51.

[145] 1966-1 C.B. 67.

[146] *Id.* at 68.

reorganization constituted valid consideration since such stock was not redeemable for five years.[147]

While one could argue that the five-year rule established by precedent dealing with the continuity of interest requirement is not applicable to determine whether a recapitalization results in a permanent realignment of voting control, such precedent is at least, by analogy, relevant. Both the continuity of interest requirement and the permanence requirement are designed to ensure that a shareholder has a real and meaningful interest in a corporation. In the case of the continuity of interest requirement, the real and meaningful interest is in the economic benefits and burdens of ownership of the stock of the corporation. In the case of a recapitalization, the permanence requirement focuses on whether a shareholder has a real and meaningful ability to influence the management of the corporation through the election of directors. Since, as discussed previously, voting power is determined by the ability to elect the directors of a corporation, five years should be a sufficient period of time to allow a shareholder to influence the management of the corporation.[148] Moreover, the Service has previously respected the disproportionate voting rights of a corporation's stock when such rights were to be eliminated after a fixed period of time.[149]

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[147] *See* Rev. Rul. 78-142, 1978-1 C.B. 111.

[148] In certain circumstances, disproportionate voting rights that are eliminated after five years may not satisfy the permanence requirement. For example, if a corporation had a staggered board where directors were elected over a period of seven years, disproportionate voting rights that were eliminated after five years would not fully give a shareholder a disproportionate ability to elect the board. In practice, however, even corporations that have staggered boards elect each member every three years. Thus, a shareholder owning stock with five years of disproportionate voting power would have the ability to vote disproportionately for each member of the board.

[149] *See* P.L.R. 95-47-049 (June 2, 1995) (preferred stock with six votes per share was redeemable by the issuer after six years); P.L.R. 94-09-043 (Dec. 9, 1993) (stock with three votes per share converted into stock with one vote per share automatically after five years); P.L.R. 80-34-089 (May 29, 1980) (valid reorganization even though voting stock automatically converted into non-voting stock after five years); P.L.R. 80-30-007 (Apr. 14, 1980) (common stock with six votes per share was to be automatically converted into common stock with one vote per share after six years).

Since the Service's issuance of a private letter ruling to C. Brewer and Company, Ltd. (P.L.R. 94-09-043), officials at the Service have privately expressed their reluctance to issue a similar ruling where disproportionate voting rights convert to proportionate voting rights for any reason within five years of a spin-off. To that end, tax practitioners have begun to structure transactions so that the disproportionate voting rights remain in place for at least

Where voting rights are to be readjusted upon the occurrence of a future event, the likelihood of the event occurring should be assessed to determine whether the disproportionate voting rights result in a permanent realignment of voting control. If proportionate voting power is restored upon the occurrence of an event which is likely to occur in the near future, the disproportionate voting power appears to be transitory and illusory. If, however, the event that restores proportionate voting power is speculative or is not likely to occur for a substantial period of time (i.e., five years), the disproportionate voting rights may be deemed to result in a permanent realignment of the voting power of the corporation.[150]

b. Nontransferable Voting Power

Where the ability to disproportionately elect directors is reversed by a subsequent transfer of the stock, the disproportionate voting rights appear to be transitory and illusory in nature. One may argue that such disproportionate voting rights are not an attribute of the stock. Where, however, the voting rights are not extinguished by transfer of the stock, such voting rights appear to be an attribute of the stock and should be respected.

In Revenue Ruling 78-142, the Service held that a rescission provision contained in preferred stock issued in a reorganization was not "other property" within the meaning of section 356 of the Code because "this provision is inherent in the *P* preferred stock and is not personal to the former *T* shareholders."[151] The Service relied on Revenue Ruling 75-33,[152] in which it held that additional dividends paid on convertible preferred voting stock issued in a reorganization was not other property but was an attribute of the stock. The additional dividend right was to be extinguished upon conversion of the preferred stock into the company's common stock,

five years without exception. *But see* P.L.R. 95-52-023 (Sept. 28, 1995) (where in a ruling issued subsequent to P.L.R. 94-09-043, the Service implicitly ruled that the high-vote inherent in stock that converted to low-vote stock upon any transfer following a spin-off should be respected).

150 *But see supra* note 149.

151 1978-2 C.B. 111, 113.

152 1975-1 C.B. 115.

but would not be extinguished if a shareholder disposed of its convertible preferred stock. The Service stated that:

> In order to be considered an attribute of stock, a right to dividends must be inseparable from the other rights inherent in the stock and not be personal to the shareholders. Since in the instant case, the right to receive additional dividends is a right inherent in the *M* stock and is not personal to the former *O* shareholder such right is an attribute of the *M* convertible preferred stock and does not constitute other property received by the former *O* shareholders in exchange for their *O* stock.[153]

Two commentators appear to be split on the issue of whether disproportionate voting power is permanent and an attribute of the stock where such additional voting rights are nontransferable. The first has stated that "any stockholder who has voting power that is personal to that shareholder (i.e., voting power that does not transfer with the shares) ought not to be treated as holding stock with voting power."[154] Such voting power arguably could be said to arise from a shareholders agreement between the shareholder receiving the voting rights and the other shareholders of the corporation. Since, as previously discussed, a shareholders agreement does not have any effect on the characterization of stock as voting stock, such an agreement should not affect the voting power inherent in a corporation's stock.[155]

The other argues that the Service's concern with transitory and illusory recapitalizations, such as in Revenue Ruling 63-260, stems from the recapitalization of a subsidiary in advance of a distribution of the recapitalized stock "to the very shareholders who participate in the recapitalization."[156] The recapitalization is

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[153] *Id.*

[154] Todd F. Maynes, *Getting Out the Vote: The Use of Voting Rights in Tax Planning*, 73 Taxes 813, 827 (1995). However, in a footnote, Maynes states that:

> The opposite view is also arguable. For example, one could argue that stock has voting power so long as the shareholder must own the stock in order to exercise the vote. The holder's voting power thus arguably is an attribute of the stock even if the voting power does not survive transfer of the shares.

Id. at 827 n.96.

[155] *See* text accompanying notes 46-49 *supra*.

[156] Robert Willens, *Strategies for Divesting Equity Stakes in a Hostile Tax Environment*, 81 J. Tax'n 88, 93 (1994).

transitory and illusory "because the shareholders who purportedly ceded voting power to the parent will promptly regain such voting power in the ensuing spinoff."[157] The recapitalization in Revenue Ruling 69-407, however, resulted in a more permanent realignment of voting power since it decreased the voting power of shareholders of the corporation who did not receive stock in the subsequent spin-off which restored their voting power to the previous level.[158] Accordingly, even if disproportionate voting power created through a recapitalization were to be eliminated upon a subsequent transfer of the corporation's stock, the commentator believes that such recapitalization should be respected.

The Service has ruled that the disproportionate voting power of a recapitalized corporation should be respected, even though a subsequent transfer of the recapitalized stock will return the stock's original proportionate voting.[159] The first commentator is troubled by this result, arguing that the voting rights are personal to the taxpayer and not inherent in the stock.[160] The second commentator, however, believes that "the prompt conversion of high vote stock to low vote stock, addressed in Letter Ruling 9409043, does not detract from the permanent realignment of voting control that the overall transaction features."[161] This interpretation of Private Letter Ruling 94-09-043 now seems questionable in light of the Service's own position on this ruling.[162]

The Service's position in Private Letter Ruling 95-47-049 stands on firmer ground. There, too, the Service respected disproportionate voting stock distributed in a spin-off which automatically converted to proportionate voting stock upon a subsequent transfer. In that ruling, unlike Private Letter Ruling 94-09-043, the stock distributed was generally not transferable for six years. Moreover, the distributing corporation in Private Letter Ruling 95-47-049 represented that it knew of no plan or intention on the part of its shareholders to dispose of the stock received in the

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[157] *Id.* at 93.

[158] *Id.*

[159] *See* P.L.R. 95-47-049 (June 2, 1995); P.L.R. 94-09-043 (Dec. 9, 1993).

[160] Maynes, *supra* note 154, at 827.

[161] Willens, *supra* note 156, at 93.

[162] *See supra* note 149.

distribution. Because the stock could not generally be transferred for six years, the loss of disproportionate voting rights would not likely occur for more than five years from the date of the distribution.

In issuing Private Letter Ruling 95-47-049, following its statements regarding Private Letter Ruling 94-09-043,[163] the Service must be relying upon the taxpayer's representation as to its shareholders' intentions with respect to the distributed stock. If the second commentator is correct that the Service is concerned with recapitalizations effectuated in order to allow a transaction to occur tax-free and, following such transaction, the voting rights of the parties are restored to pre-recapitalization levels, a recapitalization should be respected any time it affects the voting rights of the shareholders of the corporation where the shareholders have no intention of reversing the effects of the recapitalization.

c. Extreme Disproportion Between Vote and Value

Some commentators have expressed concern that the Service may attempt to disregard disproportionate voting rights where the vote-to-value ratio of one class of a corporation's stock is significantly different than the vote-to-value ratio of the corporation's other classes of stock. One commentator raising this concern states that:

> Assuming that there is some limit to the amount by which voting power can be cut down in this manner, it would be logical to require that the voting power of stock of the acquiring corporation given to shareholders of the acquired corporation be proportionate to their equity in the acquiring corporation in order to qualify as voting stock. Beyond the logic of the situation, however, there is neither support for such a rule nor any authority indicating what the law in this area may be.[164]

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[163] See *supra* note 149.

[164] *See* Richard R. Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 Tax L. Rev. 725, 737-38 (1971). Dailey bases this statement, in part, on remarks made by Senator George in 1936 when the definition of control applicable to the nonrecognition provisions of the Code was amended from "ownership of at least 80 per centum of the voting stock" to "80 per centum of the total combined voting power of all classes of stock entitled to

While this argument is logical, there are no cases or rulings in which either the courts or the Service have failed to respect the voting rights inherent in shares of disproportionate voting stock. Moreover, based upon both the administrative and judicial precedent respecting disproportionate voting rights, there is no foundation for the belief that disproportionate voting rights would be disregarded even in the most extreme cases. In *Anderson-Clayton Securities*, the court held that a taxpayer, which owned 100 percent of the preferred stock (fifty votes per share) and 64 percent of the common stock (one vote per share) of its six subsidiaries, could file a consolidated return with the subsidiaries.[165] Although Anderson-Clayton owned only 64 percent of the common stock, it owned stock with 98.56 of the voting power of the subsidiaries.[166]

Section 368(c), by its terms, allows for the satisfaction of the control requirement through the use of enhanced voting stock. As noted previously, Congress has revised the section 1504(a) test for affiliation to include both a vote and a value test, thus preventing the satisfaction of its requirements merely through the use of enhanced voting stock.[167] The section 368(c) definition of control could similarly be amended if Congress determined that the use of enhanced voting stock to satisfy the control requirement of the reorganization provisions of the Code presented similar issues. Absent such congressional action, the Service should respect the use of any enhanced voting stock to satisfy the section 368(c) definition of control.

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vote." *See* section 112(h) of the Revenue Acts of 1934 and 1936. This amendment, according to George, was intended to be "declaratory of existing law." *See* 80 Cong. Rec. 8799 (1936).

See also Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts* § 703.3, at 739 (July 1996) ("[T]here may be some concern, particularly in the case of classes of common stock, that when the voting power of a class is manifestly out of tune with its relative value, IRS will attempt to disregard 'excessive' and 'nominal' voting rights.").

[165] *Anderson-Clayton Securities Corporation v. Commissioner*, 35 B.T.A. 795 (1937).

[166] *Id.* at 797.

[167] *See supra* note 11.

C. *Private Letter Ruling 94-52-002*[168]

With the release of Private Letter Ruling 94-52-002,[169] the Service provided a fresh look into the manner of computing the voting power inherent in a corporation's stock that had been formulated in Income Tax Ruling 3896 in 1948.[170] Although the private letter ruling is limited to a discussion of the voting power requirement of section 1504(a), the Service's analysis of the law in this area directly relates to the determination of control under section 368(c).[171] In Private Letter Ruling 94-52-002, the Service held that, where the recapitalization of the stock of the subsidiary failed to result in the parent owning 80 percent of the subsidiary's voting stock, the taxpayer and its parent were not affiliated corporations, and thus could not file a consolidated return.[172]

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[168] Subsequent to the writing of this article, the Tax Court issued its decision in *Alumax, Inc. v. Commissioner*, 109 T.C. No. 8 (Sept. 30, 1997). In this case, the court was presented with the same issues upon which (and the same taxpayer to whom) the Service based its conclusions in Private Letter Ruling 94-52-002. The court in *Alumax* sided with the Service in holding that the petitioner and its parent were not members of the same affiliated group within the meaning of section 1504(a). The court's holding was based upon a rationale substantially similar to the one espoused by the Service in Private Letter Ruling 94-52-002.

[169] Aug. 26, 1994.

[170] 1948-1 C.B. 72.

[171] *See supra* note 13. Furthermore, one commentator has noted that:

> While affiliation is probably most important with respect to includability in a consolidated return, affiliated status is also significant in nonconsolidated contexts (i.e., it is required for a valid section 332 liquidation and necessary for deducting 100% of qualifying dividends under section 243(b)). Moreover, these developments may have a bearing in various non-section 1504 voting power contexts (e.g., with regard to worthless security losses under section 165(g)(3) and in determining "control" in reorganization transactions under section 368(c)).

William F. Huber et al., *IRS Offers Insight on 80%-of-Voting-Power Test for Affiliated Groups*, 83 J. Tax'n 12 (1995).

Another commentator states that:

> This is an issue of first impression that has implications beyond section 1504 and the ability to file a consolidated return. The message of [P.L.R. 94-52-002] also extends to section 351 transfers, liquidations under section 332, "B" and "D" reorganizations, section 269 and any other situation in which it is necessary to determine control of a corporation through ownership of voting stock.

KPMG Corporate Tax Update, Vol. 7, No. 1, Apr. 1995.

[172] The transaction presented to the Service in P.L.R. 94-52-002 arose prior to 1984, when section 1504(a)(2)(B) was added to the Code to require that a corporation also own 80 percent of the value of a subsidiary corporation in order to consolidate. Based upon the facts presented in the ruling, it does not appear that the value test would have been met through the restructuring of the subsidiary.

The facts of the ruling are as follows: Corporation *V* (Parent) initially owned all of the Class A common stock of Corporation *W* (Sub). Corporations *X*, *Y* and *Z* (Minority Shareholders) collectively owned all of Sub's Class B common stock. Each class of stock had the right to elect six of Sub's twelve directors. Pursuant to a plan of reorganization (the "Restructuring"), Parent exchanged all of its shares of Sub Class A common stock for the same number of shares of newly-issued Class C common stock. The structure of Sub's board of directors was altered so that after the Restructuring it consisted of only eight persons: four Class C directors, each with two votes, elected by the Class C shareholder (Parent); two Class B directors, each with one vote, elected by the Class B shareholders; and two non-voting directors, consisting of the president of Sub and an individual jointly chosen by the Class B and Class C shareholders. Thus, after the Restructuring, Parent had the ability to elect directors who could cast eight of the ten votes on the board (80 percent).

As part of the Restructuring, Sub's charter was also amended in three ways. First, a number of matters normally decided by a corporation's board of directors through its normal method of voting would thereafter require an affirmative vote by a majority of each class of Sub's shareholders and/or each class of Sub's directors (the "Restricted Matters").[173] Second, Sub was required to pay dividends on a quarterly basis on at least 35 percent of its net income. The dividends were to be paid 80 percent to the Minority Shareholders (the "Dividend Payout"). Finally, Sub's charter was amended to include a "call-or-convert" provision that gave the Minority Shareholders the right to purchase between 51 percent and 100 percent of Parent's Class C shares at a price equal to 50 percent of the book value of such shares upon the occurrence of certain events that jeopardized the Minority Shareholders's investment in Sub and the unconditional right to call Parent's Class C shares at any

[173] These Restricted Matters were:

(1) any acquisition or disposition of assets having a value of more than 5 percent of Sub's book value;
(2) any acquisition or disposition of more than 1.8 percent of Sub's assets;
(3) the selection or dismissal of Sub's chief executive officer;
(4) any merger involving Sub; and
(5) any transaction involving Sub and an affiliate of Sub in which Sub made a loan to the affiliate or which was not in the ordinary course of business.

time after five years. Such right, however, was subject to a prior right on the part of Parent to convert its Class C shares back into Class A shares. Thus, the "call-or-convert" provision allowed the Minority Shareholders to rescind the Restructuring (i) at any time if Sub's board attempted to take an action materially adverse to the Minority Shareholders' investment or (ii) after five years without cause.

The Service concluded that, based on the facts, Parent lacked the control over management required by section 1504(a) and, therefore, Parent and Sub were not affiliated during the years at issue.[174] Even though Parent technically owned stock possessing 80 percent of the voting power and equity value of Sub, the Service stated that "either directly or through their directors, the Class C and Class B shareholders continued to own stock possessing with respect to those Restricted Matters the same 50/50 voting powers after the Restructuring that they had possessed before the Restructuring."

According to the Service, affiliation is premised on "the existence of an *economic unity* between a parent corporation and its subsidiaries"[175] and "a parent corporation's *management control* over the subsidiary corporation."[176] The importance of economic unity and management control is displayed by focusing on a shareholder's ability to participate in the management of a corporation through the election of directors, and not by the ability of a shareholder to vote on traditional shareholder matters (e.g., mergers and the sale of all or substantially all of a corporation's

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[174] Although the taxpayer claimed that the Restructuring was done for "valid business purposes," it is clear that the real reason for the Restructuring was to allow Parent and Sub to consolidate, thereby allowing Parent's losses to offset Sub's income, producing substantial tax savings.

The Service notes that as part of the Restructuring, Parent and Sub entered into a tax sharing agreement, which provided that Sub would pay Parent 90 percent of its federal income tax liability, computed as if it were a separate consolidated group. Under this agreement, Parent would be paid for its net operating losses on a current basis, instead of accruing the losses until the time it had income against which the losses could be offset. The benefit to the Minority Shareholders resulted primarily from the Dividend Payout, which required that a minimum of 28 percent (35 percent * 80 percent) of Sub's quarterly net income would be distributed to them. Moreover, the Minority Shareholders also benefitted from Sub's ability to offset its income against Parent's losses.

[175] Emphasis in original.

[176] Emphasis in original.

assets). While the focus is on the ability to elect directors, such focus arises from the belief that it is the directors who manage a corporation. The Service cited Revenue Ruling 69-126, which stated that "participation in the management . . . through the election of the board of directors is the criterion of voting power . . . ." The Service noted that Income Tax Ruling 3896 has almost identical language.

While prior case law may have suggested that voting power is determined through the use of a mechanical test that looks solely at the right to elect directors, the Service pointed out:

> none of the cases that measured voting power by reference to the election of directors (1) noted the existence of restrictions on the board's ability to exercise material board powers or (2) required the approval of material board actions by a majority of the class of directors elected by shareholders who were not members of the affiliated group . . . . Where the powers of the board of directors are restricted to the point that the board cannot exercise management control over the corporation without the approval of nonmember shareholders (or where the powers of the directors selected by group members are limited by the need to obtain the approval of the directors selected by nonmember shareholders), the right to elect directors is not the exclusive measure by which to calculate voting power.

Once the Service determined that control over management, and not a mechanical calculation based upon the ability to elect directors, was the proper method for determining affiliation, the Service next considered whether the limitations placed on Parent's ability to exercise management control over Sub were sufficient to defeat Parent's claim of affiliation. The Service concluded that two different limitations restricted Parent's control of Sub: (i) the requirement that a majority of each class of shareholders approve the Restricted Matters and (ii) the requirement that a majority of each class of voting directors approve the Restricted Matters. Because Parent owned only Sub's Class C common stock, the Service concluded that Parent possessed only 50 percent of the voting power with respect to Restricted Matters.[177] Moreover, the

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[177] Either of these limitations standing alone would have resulted in the Service rendering

Service determined that while the restrictions imposed on Sub's board were generally permissible under corporate law, such restrictions "prevented the Board from exercising traditional board powers with respect to significant matters without the approval of the Class B shareholders . . . and/or the Class B directors." As such, the Service ruled that "[Parent] did not possess the power to control the management of [Sub] and did not own [Sub] stock possessing 80% voting power."

Furthermore, the Service found that both the Dividend Payout and call-or-convert provisions of Sub's amended charter placed substantial limitations on Parent's control of Sub. With respect to the Dividend Payout provision, the Service noted that, although such a limitation is legal, it is rarely imposed on a board of directors. The Service concluded that "the mandatory dividends preference limited [Parent's] control over [Sub] and thus undermined [Sub's] purported business purpose for the Restructuring."

The Service also found that the call-or-convert provision limited the discretion of the directors in managing Sub's business. The call-or-convert provision prevented Parent and Sub from conducting their businesses as a "business unit" since Sub's directors were prevented from pursuing the best interests of Parent and Sub where those interests diverged from the Minority Shareholders' interests.

Private Letter Ruling 94-52-002 reaches the correct result in holding that Parent and Sub were not affiliated within the meaning of section 1504(a). The taxpayer incorrectly assumed that voting power was computed through the use of a mechanical test,[178] where such a test, in fact, served solely as a shorthand device for the real method of computing voting power–determining whether a taxpayer has control over the management of the corporation. The

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the same conclusion.

[178] It is curious that Parent chose to restructure Sub to give itself the ability to elect directors that could cast a "controlling number" of votes on Sub's board instead of giving itself the ability to elect more than 80 percent of the number of directors. Under a very literal reading of the prior case law and rulings, Parent only had the ability to elect 50 percent of the members of Sub's board entitled to vote (4 of the 8 voting members) and 45 percent of all of the board members (4.5 of the 10 board members) even after the restructuring and, accordingly, Parent's stock contained no more than 50 percent of the voting power in Sub.

Service agreed, however, that, in the typical case, measuring voting power by reference to the ability to elect directors was proper:

> However, if the parent corporation's management control of the company is materially restricted through class voting requirements, the parent's election of directors is not an accurate measure of voting power. In such a case, the Service may look beyond the election of directors to determine more accurately the parent's voting power and the parent's ability to control the management of the subsidiary.

Thus, Private Letter Ruling 94-52-002 does not attempt to make new law; it simply expands upon prior law.[179]

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[179] Although the Service has primarily used a mechanical test for determining affiliation under section 1504(a) and control under section 368(c), determinations of voting power under other sections of the Code have employed different tests. In particular, in the foreign context, voting power is measured by using a "facts and circumstances test." Treasury Regulation section 1.957-1(b) (as amended in 1996) states that:

> In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage of total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case . . . . Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such corporation as a controlled foreign corporation under section 957.

For a discussion of the facts and circumstances test developed under section 957, see *Kraus v. Commissioner*, 490 F.2d 898 (2d Cir. 1974), *aff'g* 59 T.C. 681 (1973); *CCA, Inc. v. Commissioner*, 64 T.C. 137 (1975); *Estate of Weiskopf v. Commissioner*, 64 T.C. 78 (1975), *aff'd*, 538 F.2d 317 (2d Cir. 1976); *Garlock Inc. v. Commissioner*, 58 T.C. 423 (1972), *aff'd*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974).

D. Conclusion

Current law provides a good starting point for answering questions relating to the computation of voting power. The law provides that voting power is generally computed by use of a mechanical test that determines what percentage of a corporation's board of directors a particular shareholder can elect. However, as Private Letter Ruling 94-52-002 points out, such a test provides an inexact measurement where a corporation's board of directors is restricted in managing the corporation.

Many of the issues discussed in this article demand further attention from either the courts or the Service. For example, it is unclear what limitations on the authority of a corporation's board of directors are considered so severe that the mechanical voting power computation would be inapplicable. The restrictions on the board's power in Private Letter Ruling 94-52-002 provide a clear example of significant limitations on a board's power to manage a corporation; however, the Service should provide guidance as to what lesser limitations would affect a shareholder's nominal voting control and whether such limitations must have an all-or-nothing effect on the computation of voting power.[180] The Service could provide, for example, a list of safe harbor limitations that a corporation could impose on its board of directors (in favor of its minority shareholders) without affecting the ability to compute voting control through a mechanical computation.

The Service must also, in light of its comments with respect to Private Letter Ruling 94-09-043,[181] provide clarification concerning the treatment that should be afforded disproportionate voting rights that disappear after the passage of time or upon the happening of an event. While disproportionate voting rights that survive under all circumstances for a minimum of five years will clearly be respected, it is unclear whether an automatic conversion

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[180] For example, could some lesser restrictions on the management of Sub in Private Letter Ruling 94-52-002 have resulted in the Service finding some lesser reduction of the voting power inherent in Sub's stock? The author believes that the answer to this question should be no. The complexity that would result from taxpayers, the Service and the courts attempting to place a value on various aspects of management control would create an additional amount of unnecessary controversy.

[181] *See supra* note 149.

that could occur before the end of five years should cause the voting rights to be considered transitory and illusory. It is also unclear whether disproportionate voting rights that revert to proportionate voting rights upon the transfer of stock should be considered personal to a particular shareholder. Until the Service's position is better explained, corporations that recapitalize their stock in order to provide a shareholder with control must either be prepared to allow such recapitalization to remain in place for five years or to seek a private letter ruling from the Service.