

1978

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Recommended Citation

William Y. Rodewald & Carl A. Cohen, *Preferred Stock Recapitalizations: A Basic Look at Some Tax Problems*, 17 Duq. L. Rev. 785 (1978).

Available at: <https://dsc.duq.edu/dlr/vol17/iss3/11>

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Preferred Stock Recapitalizations: A Basic Look at Some Tax Problems

*William Y. Rodewald**
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I. INTRODUCTION

In order to transfer the economic benefits of future growth in a closely held corporation, a recapitalization is often suggested in which the older shareholders exchange most or all of their common stock for newly issued preferred stock, leaving the growth potential, represented by common stock, largely or exclusively in the younger shareholders.

There are several advantages to such a recapitalization. If the corporation can afford to make the payments, the preferred stock will provide a steady source of income to the older shareholders. For income tax purposes, a recapitalization, which can be defined as the reshuffling of the capital structure of an existing corporation,¹ can be structured as a "tax-free" reorganization under the Internal Revenue Code.² Gift tax consequences can be minimized by taking pains to insure that the value of the preferred stock (or preferred and common stock) received in the exchange is generally equivalent to the value of the common stock surrendered.³ Finally, for estate tax purposes, any future appreciation in the value of the corporate stock will inure to the common stock held by the younger shareholders, not the preferred stock held by the older shareholders. The result is

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1. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942).

2. I.R.C. § 368(a)(1)(E). All section references herein are to the Internal Revenue Code of 1954, as amended.

3. If the preferred stock received has a value greater or less than the value of the common stock surrendered, the difference "will be treated as having been used to make gifts, pay compensation, satisfy obligations of any kind, or for whatever purpose the facts indicate." Rev. Rul. 74-269, 1974-1 C.B. 87. For instance, if the value of the common stock surrendered exceeds the value of the preferred stock received, the excess could be treated as a taxable gift by the recipient of the preferred stock to the other shareholders. I.R.C. §§ 2511(a), 2512(b).

that the value of the older shareholders' interest in the corporation is "fixed" as of the time of the recapitalization exchange, thereby saving the estate tax which would otherwise be paid on any future appreciation of common stock retained by the older shareholders until their death.

Several potential disadvantages do exist, however, and it is the purpose of this article to consider them. The problems arise from the application of sections 306 and 305 of the Internal Revenue Code.

II. TAX PROBLEMS ARISING FROM SECTION 306

If the preferred stock issued in a recapitalization is "section 306 stock,"⁴ disposition of that stock during the lifetime of the older shareholders will have serious adverse tax consequences.⁵ Moreover, unless certain provisions of the Tax Reform Act of 1976 (now held in abeyance until 1980) are changed, this "section 306 taint" will continue to exist even after the death of the older shareholders.⁶

A. *The Purpose and Effect of Section 306*

Congress enacted section 306 in order to eliminate what used to be an accepted technique for transforming ordinary income into capital gain, known as the "preferred stock bailout." The technique operated in the following manner. A corporation with only common stock outstanding would issue a nontaxable preferred stock dividend on the common stock. The shareholders would then sell the preferred stock to a third party, reporting the gain as capital gain. To complete the transaction, the corporation would redeem the preferred stock from the third party at a premium (the incentive for the third party to participate). This procedure enabled the shareholders to "bail out" corporate earnings and profits at capital gains rates without changing the proportionate interests of the shareholders. If a cash dividend had been paid to them in lieu of the preferred stock, they would have had ordinary income to the extent of the corporation's earnings and profits.⁷

Section 306 halts the use of the preferred stock bailout by defining

4. The definition of section 306 stock is found in I.R.C. § 306(c). See discussion in text accompanying notes 13-25 *infra*.

5. See discussion in text accompanying notes 7-9 *infra*.

6. See discussion in text accompanying notes 10-12 *infra*.

7. I.R.C. §§ 316(a), 301(c)(1).

section 306 stock so as to apply to preferred stock issued in bailout types of situations,⁸ and by directing that the sale or other disposition of section 306 stock generally gives rise to ordinary income rather than capital gain.⁹ Thus, the receipt of section 306 stock does not produce an immediate tax; it is the subsequent disposition upon which a heavy tax is imposed. Hence, section 306 stock is said to be tainted due to the adverse tax consequences attached to it.

B. *The Application of Section 306 to Recapitalizations*

One of the major disadvantages involved in issuing preferred stock in a recapitalization is the possibility that it may be considered to be section 306 stock. As such, its sale or other disposition would produce ordinary income rather than capital gain. Prior to the Tax Reform Act of 1976, the problem of section 306 stock could be minimized by having the older shareholder hold the preferred stock until his death, at which time the preferred stock received a new basis¹⁰ and thereby lost its taint.¹¹ However, under the carryover basis provisions of the 1976 Act, effective January 1, 1980, death would no longer "launder" section 306 stock.¹² It is impossible to predict with any confidence how Congress will ultimately decide to deal either with carryover basis or its effect on section 306 stock. Accordingly, it has become very important to determine whether preferred stock issued in recapitalizations will be characterized as section 306 stock, and to avoid that characterization if at all possible.

8. See note 4 *supra*.

9. I.R.C. § 306(a).

10. I.R.C. § 1014(a).

11. I.R.C. § 306(c)(1)(C) states:

(C) STOCK HAVING TRANSFERRED OR SUBSTITUTED BASIS.—Except as otherwise provided in subparagraph (B), stock the basis of which (in the hands of the shareholder selling or otherwise disposing of such stock) is determined by reference to the basis (in the hands of such shareholder or any other person) of section 306 stock.

Prior to the Tax Reform Act of 1976, the basis of preferred stock in the hands of younger shareholders was determined by reference to the value at the date of death of older shareholders from whom the preferred was obtained, not by reference to its basis in the hands of older shareholders (in whose hands the preferred was § 306 stock).

12. Under the carryover basis provisions, the basis of the preferred would be determined by reference to its basis in the hands of the older shareholder.

C. *Is the Preferred Stock Received in Recapitalizations Section 306 Stock?*

Section 306 stock can be created in three ways, of which only one is here applicable. Section 306(c)(1)(B) sets out four general conditions, all of which must be satisfied in order for the preferred stock to be characterized as section 306 stock:

- (1) The stock is not common stock;
- (2) It was received by the shareholder in a section 368(a) reorganization;
- (3) Gain or loss was not recognized on its receipt;
- (4) The effect of the transaction was substantially the same as the receipt of a stock dividend.

In the type of recapitalization with which we are here concerned, the first three conditions are satisfied. The difficult question is whether the fourth condition is satisfied. As to whether "the effect of the transaction is substantially the same as the receipt of a stock dividend," the Regulations state:

Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies *if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of section 356(b) or section 302(d).*¹³

Since section 356(b) is inapplicable to recapitalizations, the "cash substitution" test is satisfied only if cash received in lieu of preferred stock would have been treated as a dividend under section 356(a)(2) or as a distribution to which section 301 applies by virtue of section 302(d).

1. *The Cash Substitution Test: Section 356(a)(2)*

Section 356 governs the treatment of boot received in corporate

13. Treas. Reg. § 1.306-3(d) (emphasis added).

All Regulation references herein are to the Regulations under the Internal Revenue Code of 1954, as amended.

reorganizations. Section 356(a)(1) provides that gain which would otherwise not be recognized in a reorganization exchange shall be recognized to the extent of any boot received. Section 356(a)(2) provides that the gain recognized under section 356(a)(1) shall be ordinary income rather than capital gain if the exchange has the effect of the distribution of a dividend.¹⁴

The reference in the Regulation to section 356(a)(2) does not seem to advance the analysis: cash "would have been treated as a dividend" under Regulation 1.306-3(d) if it "has the effect of the distribution of a dividend" under section 356(a)(2). The meaning of the latter Code language, however, has had a long and involved history. For several decades following *Commissioner v. Estate of Bedford*,¹⁵ almost everyone assumed that if a continuing shareholder recognized a gain under section 356 or its predecessor, the gain would automatically be treated as a dividend to the extent of the corporation's accumulated earnings and profits. After losing a number of cases,¹⁶ however, the Internal Revenue Service abandoned this "automatic dividend" position in 1974.¹⁷ The test of dividend equivalence has apparently, by default, become about the same for section 356 (boot) as it is for section 302 (redemptions).¹⁸ This imported redemption test presumably includes the requirement that any non-dividend redemption must result in a "meaningful reduction" of the taxpayer's proportionate interest in the corporation.¹⁹

14. Section 356(a) states:

(a) GAIN ON EXCHANGES.—

(1) Recognition of Gain.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

15. 325 U.S. 283 (1945).

16. The final downfall of the "automatic dividend" rule came in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973).

17. Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121.

18. 482 F.2d at 605.

19. *United States v. Davis*, 397 U.S. 301 (1970).

Since the test for dividend equivalence under section 356 is approximately the same as the test under section 302 (and may be even more favorable to taxpayers because section 356 does not call for the application of the constructive ownership rules of section 318(a)), and since Regulation 1.306-3(d) directly refers to section 302, it seems reasonably clear that the older shareholders in the type of recapitalization now under consideration have little to fear from the Regulation's reference to section 356.

It is important to note, however, that if the older shareholders keep or get some common stock as well as preferred stock, the question of dividend equivalence under section 356 becomes more of a "judgment call," especially since views distressingly reminiscent of the old automatic dividend rule are still occasionally expressed.²⁰

2. *The Cash Substitution Test: Section 302(d)*

The other cash substitution test for dividend equivalence referred to by Regulation 1.306-3(d) is section 302. As was suggested previously, the section 356 test for dividend equivalence is now by default probably about the same as the section 302 test, which accordingly achieves a double significance.

Section 302(a) provides that a redemption of stock will be treated as an exchange, and not as a dividend, if the redemption falls into one of several "safe harbor" provisions listed in section 302(b). If a redemption does not fall within one of the safe harbor provisions, section 302(d) provides that the redemption will be subject to the normal dividend rules of section 301.

The safe harbor provisions of section 302(b) provide that a redemption will not be treated as a dividend (and hence the preferred stock will not be section 306 stock) if the redemption is not essentially equivalent to a dividend; if the distribution is substantially

20. *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978). *Shimberg* involved the determination of whether boot received in an (A) reorganization should be granted exchange treatment under § 356(a)(1) or be taxed as a dividend under § 356(a)(2). The Court found that the boot was taxable as a dividend. The Court reached this conclusion without stating the reasons for doing so. Although the Court stated that its decision did "not signal a return to the now discarded automatic dividend rule"; *id.* at 290; the lack of rationale supporting its decision is bothersome because it is reminiscent of the automatic dividend approach. However, the Court also stated that it did not "reject the relevance of principles developed in § 302 redemption cases" in situations where the transaction in question can be likened to a redemption (such as a recapitalization). *Id.* As such, *Shimberg* probably does not change the test under § 356(a)(2) in recapitalization cases. Section 302 principles should still apply.

disproportionate with respect to the shareholder; or if the redemption is in complete redemption of all the stock of the corporation owned by the shareholder.

On the facts of the recapitalization with which we are here concerned, the bare language of section 302(b)²¹ appears to make it quite clear that the "redemption" of the older shareholders' common stock, if it had been for cash, would not have been taxable as a dividend, and that accordingly the preferred should not be treated as section 306 stock. At least if the older shareholders do not keep or receive any common stock, the transaction would result in a "meaningful reduction" in their proportionate interest in the corporation and hence would satisfy the *Davis* test²² as to dividend equivalence. It would also be substantially disproportionate and consti-

21. I.R.C. § 302(b) states in part:

(b) REDEMPTIONS TREATED AS EXCHANGES.—

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) SUBSTANTIALLY DISPROPORTIONATE REDEMPTION OF STOCK.—

(A) IN GENERAL.—Subsection (a) shall not apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) LIMITATION.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) DEFINITIONS.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) SERIES OF REDEMPTIONS.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) TERMINATION OF SHAREHOLDER'S INTEREST.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

22. See note 19 and accompanying text *supra*.

tute a complete termination of their interest under the other two safe harbor provisions.

Unfortunately, however, section 302(b) might not be the only provision of section 302 involved in this analysis. Section 302(c) provides that, in determining ownership of stock for purposes of section 302, it is necessary to apply the constructive ownership rules of section 318(a). Under these constructive ownership rules, if, for example, a family owns most of the stock of a corporation, and the father's stock is redeemed, the father is still treated after the redemption as being the owner of the stock held by the remainder of his family. As such, the redemption would not result in a meaningful reduction of his interest in the corporation, would not be substantially disproportionate as to him, and would not be a complete termination of his interest. Therefore, the redemption would be treated as a dividend.

These constructive ownership rules pose a serious threat to the type of recapitalization under consideration. The cash substitution test of Regulation 1.306-3(d) provides that, if cash received in lieu of the preferred would be treated as a dividend, then the preferred is section 306 stock. If in making this determination under section 302 the constructive ownership rules of section 318(a) apply as a result of section 302(c), the cash hypothetically received by older shareholders of a family owned corporation would not result in a meaningful reduction of their interest, would not be substantially disproportionate as to them, and would not be a complete termination of their interest under section 302(b). As such, the cash hypothetically received would be treated as a dividend, and the preferred stock actually received by them would be section 306 stock. It is therefore very important to determine whether these constructive ownership rules apply to the Regulation's cash substitution test for defining section 306 stock.

3. *Do the Section 318(a) Constructive Ownership Rules Apply to the Definition of Section 306 Stock?*

Section 318(a) specifically provides that the constructive ownership rules will apply only to those provisions of the Internal Revenue Code "to which the rules contained in this section are expressly made applicable." Section 318(b) then refers to "section 306(b)(1)(A) (relating to disposition of section 306 stock)." Section 306(b)(1)(A) does indeed refer to section 318, but only in connection

with a special exception dealing with certain dispositions of section 306 stock to unrelated persons. Section 318 is nowhere "expressly made applicable" to section 306(c), which defines section 306 stock. We are here concerned with the definition of section 306 stock, not the sale of it to a stranger.

Regulation 1.306-3(d) in setting up the cash substitution test for determining whether preferred is section 306 stock does refer to cash which, if received in lieu of such stock, would have been treated as a dividend under section 356(a)(2) or 302(d). Hence, to the extent that the section 318(a) constructive ownership rules apply to those Code sections, it may be argued that they apply to the Regulation. If the Regulation draws a general analogy to another section of the Code, it refers to the whole section and not just to certain unspecified bits and pieces of that section. The short answer to this argument for applying the section 318(a) constructive ownership rules to section 306 is that they are not "expressly made applicable," and the Regulations cannot add a provision which has been deliberately omitted from section 306 of the Code by analogizing to a different Code section which does incorporate that particular provision.

Nor can it be effectively argued that the constructive ownership rules should apply in order to maintain logical consistency of treatment within the Code. Regulation 1.306-3(d) refers to the dividend equivalence rules of sections 356 and 302. The constructive ownership rules clearly apply to section 302²³ and almost as clearly do not apply to section 356.²⁴ Thus, the question is not whether to be consistent with the rest of the Code, but rather, which part of the Code to be consistent with. On the whole, the better view is that the constructive ownership rules should not apply, and that the preferred stock received by older shareholders in the recapitalization (at least if older shareholders do not retain or receive any common stock) should *not* be section 306 stock.

The Internal Revenue Service apparently agrees. Recent private letter rulings, at least, appear to be based on that assumption.²⁵ It

23. I.R.C. § 302(c).

24. They are not "expressly made applicable". Rev. Rul. 74-515, 1974-2 C.B. 118, 119; *but cf.* Wright v. United States, 482 F.2d 600 (5th Cir. 1973) and the dissent therein.

25. See, e.g., Letter Ruling No. 7907032 (November 15, 1978), in which a corporation has 160 shares of common stock outstanding. A owns 13 shares and the remaining 147 shares are owned equally by A's seven sons. Pursuant to a plan of recapitalization, A is to exchange all of his common stock for newly issued preferred stock. The seven sons are not to participate

is, however, very dangerous to assume that this is or will remain the law. No published case or ruling has clearly reached the result or employed the reasoning set forth above. And reliance on private letter rulings is hazardous at best, in view of the fact that both section 6110(j)(3) and a legend stamped onto each ruling clearly warn that the rulings "may not be used or cited as precedent."

D. Conclusion

In view of the uncertainty of the law and the apparent willingness of the Service to issue favorable private letter rulings, it seems clear that a ruling should be obtained if at all possible, to the effect that the preferred will not be section 306 stock, before taxpayers enter into a recapitalization of the type here under discussion. Currently rulings of this type can be obtained within about three months of the application. If for any reason a ruling cannot be obtained, the older shareholders should exchange *all* of their old common stock and thereafter hold only preferred stock and no common stock.

III. TAX PROBLEMS ARISING FROM SECTION 305

A. Problems Arising at the Time of the Recapitalization — Sections 305(b)(3) and 305(c)

Section 305 deals with the taxation of stock dividends and provides that they are not taxable except as otherwise provided in sections 305(b) and (c). The "dividend" important here is based on the provisions of section 305(b)(3), making taxable:

(3) DISTRIBUTIONS OF COMMON AND PREFERRED STOCK — If the distribution (or a series of distributions of which such distribution is one) has the result of —

(A) the receipt of preferred stock by some common shareholders, and

(B) the receipt of common stock by other common shareholders.

In a recapitalization in which older shareholders receive preferred

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in the exchange. The ruling holds that the preferred stock will not be § 306 stock.

The private rulings do not give any rationale for this result, but it seems reasonably clear that the Service is not applying the constructive ownership rules in determining whether cash paid in lieu of stock would be taxed as a dividend, and hence in determining whether the preferred is § 306 stock.

stock, condition (A) is satisfied. Where younger shareholders do not receive common stock, however, condition (B) is not satisfied and section 305(b)(3) appears to have been avoided.

Section 305(c) (the "deemed distribution" provision), however, operates to treat certain transactions as distributions to shareholders upon whom the transaction has the requisite effect, despite the fact that no actual distribution to them takes place.²⁶ All that section 305(c) by its terms requires is that the transaction have the effect of increasing the proportionate interest of the shareholders who are "deemed" to have received a distribution. In the type of recapitalization under discussion here, section 305(c) would appear to "deem" younger shareholders to be in receipt of common stock (because their proportionate interest is increased by the recapitalization) despite the fact that no common stock was actually distributed to them; condition (B) of section 305(b)(3) would thereby be satisfied, and taxability would ensue.²⁷

Despite the result which might be reached by a literal reading of the Code, there is evidence from a discussion on the floor of the Senate, when these provisions were being enacted in 1969, that Congress did not intend distributions of stock in such recapitalizations to result in tax.²⁸ The Regulations prescribed pursuant to the direc-

26. I.R.C. § 305(c) provides:

(c) CERTAIN TRANSACTIONS TREATED AS DISTRIBUTIONS.—For purposes of this section and section 301, the Secretary shall prescribe regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction.

27. Taxability would also ensue under § 305(b)(2), which states:

(2) DISPROPORTIONATE DISTRIBUTIONS.—If the distribution (or a series of distributions of which such distribution is one) has the result of—

(A) the receipt of property by some shareholders, and

(B) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

The discussion of taxability under § 305(b)(3) also applies to § 305(b)(2).

28. 115 CONG. REC. 37,902 (1969) contains the following colloquy:

Mr. AIKEN. At this point, Mr. President, I would like to ask the chairman of the Committee on Finance a question for the purpose of clarifying one section of the bill.

I notice that the bill — page 297, section 421 — taxes dividends in stock in all cases where there are two classes of stock outstanding and there are different distributions with regard to these two classes such as stock on one class and cash on the other class or preferred stock on one class and common stock on the other class.

tion in section 305(c) support this contention. Regulation 1.305-7(c) provides in part:

(c) *Recapitalizations.* (1) A recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which section 305(c) and this section apply if —

(i) It is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation, or

(ii) A shareholder owning preferred stock with dividends in arrears exchanges his stock for other stock and, as a result, increases his proportionate interest in the assets or earnings and profits of the corporation. An increase in a preferred shareholder's proportionate interest occurs in any case where the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization), exceeds the issue price of the preferred stock surrendered.

Revenue Ruling 75-93²⁹ confirms the implication of the Regulation that a recapitalization will result in a "deemed" distribution *only* if it is "pursuant to a plan to periodically increase a shareholder's proportionate interest" or if it involves preferred stock with dividends in arrears. Example 12 of Regulation 1.305-3(e) further confirms the view of the Service as to the non-applicability of section 305 to recapitalizations of the type with which we are here concerned.³⁰

However, I note that the bill also provides that under certain conditions a recapitalization may be treated as a distribution of stock or property. It is my understanding that there is no intention to alter the status of a recapitalization in which, for example, the older stockholders exchange some or all of their common stock for preferred stock and retire from the business while the younger stockholders exchange some or all of their preferred stock for additional common stock and continue to be active in the business. This has been a classic type of recapitalization which has always been considered tax free in the past. Am I correct in that there is no intention to change the status of a recapitalization of this type with a bona fide business purpose?

Mr. LONG. The Senator is correct. There is no intention to impose a tax on a bona fide recapitalization of this type, except to the extent stock is given in payment for dividend arrearages on the preferred stock.

29. 1975-1 C.B. 101.

30. Treas. Reg. § 1.305-3(e) (example 12):

Corporation R has 2,000 shares of class A stock outstanding. Five shareholders own 300 shares each and five shareholders own 100 shares each. In preparation for the retirement of the five major shareholders, corporation R, in a single and isolated

Finally, in numerous private letter rulings of the type referred to in Part II of this article, in which the Service held that preferred stock was not Section 306 stock, the Service also held that the exchange of common for preferred would not be treated as a distribution to which section 301 applies by reason of section 305(b) or (c). In one typical private letter ruling,³¹ the Service held that the exchange of A's common stock for the newly issued preferred stock would "not be treated as a distribution to which section 301 of the Code applies by reason of the application of section 305(b) and (c), provided that this transaction is isolated and not part of a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation."

Despite the present view of the Service, as rather clearly expressed in the Regulations, Revenue Ruling 75-93, and private letter rulings, the Code itself remains a threat. Since each case must be decided on its own facts, and since it is likely that a ruling will be sought in any event on the section 306 stock issue, it again seems quite desirable to seek a ruling that the recapitalization will not give rise to a dividend.

B. *Problems Arising Subsequent to the Recapitalization — Sections 305(b)(4) and 305(c)*

Another exception to the general (non-dividend) rule of section 305(a) is section 305(b)(4), making taxable:

(4) **DISTRIBUTIONS ON PREFERRED STOCK** — If the distribution is with respect to preferred stock, other than an increase in the conversion ratio of convertible preferred stock made solely to take account of a stock dividend or stock split with respect to the stock into which such convertible stock is convertible.

Before any but the most common and unimaginative provisions are included in the preferred stock distributed to older share-

transaction, has a recapitalization in which each share of class A stock may be exchanged either for five shares of new class B nonconvertible preferred stock plus 0.4 share of new class C common stock, or for two shares of new class C common stock. As a result of the exchanges, each of the five major shareholders receives 1,500 shares of class B nonconvertible preferred stock and 120 shares of class C common stock. The remaining shareholders each receive 200 shares of class C common stock. None of the exchanges are within the purview of section 305.

31. Letter Ruling 790732, discussed in note 25 *supra*.

holders in a recapitalization, section 305 and especially section 305(b)(4) must be carefully considered.

For example, where a redemption price in excess of a reasonable call premium exists with respect to a class of preferred stock and the other requirements of this section are also met, the distribution will be deemed made with respect to such preferred stock, in stock of the same class. Accordingly, the preferred shareholders are considered under sections 305(b)(4) and 305(c) to have received a distribution of preferred stock to which section 301 applies.³²

Somewhat more detailed guidance is provided by Regulation 1.305-5(b).³³

IV. CONCLUSIONS AND RECOMMENDATIONS

It now seems clearly possible to have a tax-free recapitalization in which older shareholders get preferred stock which will not be section 306 stock and younger shareholders retain their common stock without dividend treatment. Because of several unavoidable ambiguities, and because of the severely undesirable effects if the recapitalization results in (1) section 306 stock or (2) dividend treatment or (3) subsequent unexpected difficulties, great care should be exercised in composing the terms of the recapitalization, and a private letter ruling from the Service as to the tax consequences of the recapitalization is strongly recommended.

32. Treas. Reg. § 1.305-7(a).

33. *Redemption premium.* (1) If a corporation issues preferred stock which may be redeemed after a specified period of time at a price higher than the issue price, the difference will be considered under the authority of section 305(c) to be a distribution of additional stock on preferred stock which is constructively received by the shareholder over the period of time during which the preferred stock cannot be called for redemption.

(2) Subparagraph (1) of this paragraph shall not apply to the extent that the difference between issue price and redemption price is a reasonable redemption premium. A redemption premium will be considered reasonable if it is in the nature of a penalty for a premature redemption of the preferred stock and if such premium does not exceed the amount the corporation would be required to pay for the right to make such premature redemption under market conditions existing at the time of issuance. Such an amount can be established by comparing call premium rates on comparable stock paying comparable dividends. However, for purposes of this subparagraph, a redemption premium not in excess of 10 percent of the issue price on stock which is not redeemable for 5 years from the date of issue shall be considered reasonable.

Treas. Reg. § 1.305-5(b).