REPORT #695

TAX SECTION

New York State Bar Association

Report on Regulations to be Issued
Implementing the Changes to
Section 305(c) Made by the
Revenue Reconciliation Act of 1990

July 1, 1991

Table of Contents

TAX SECTION
New York State Bar Association

July 3, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 2 0024

Dear Commissioner Goldberg:

I enclose our report on the regulations to be issued implementing the 1990 changes to Section 305(c) (relating to discount preferred stock). The author of the report is Richard L. Reinhold.

Our most significant recommendation is that the long-standing rule in the Section 305 regulations creating constructive distributions on preferred stock based solely on the existence of a right of the issuer to call the stock generally be eliminated. Since an issuer call right reduces rather than increases the holder's wealth, requiring holder income accruals because of the presence of such a right is hard to justify as a tax policy matter. Elimination of this requirement would significantly simplify and rationalize the operation of Section 305, and would remove opportunities for abuse. The report also makes a number of recommendations of a more technical nature.

We would be pleased to discuss the report and its recommendations with you or your staff.

Very truly yours,

James M. Peaslee
Chair

Identical letter to:

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20020

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

cc: Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

Thomas R. Hood, Esq.
Counsellor to the Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Roc 3316
Washington, D.C. 20224

Mary L. Harmon, Esq.
Special Assistant to Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3034
Washington, D.C. 20224

Maura A. Sullivan, Esq.
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 4238
Washington, D.C. 20224

Michael J. Graetz, Esq.
Deputy Assistant Secretary of
the Treasury for Tax Polic
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Robert R. Wootton, Esq.
Tax Legislative Counsel
Department of the Treasury
3064 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Deputy Tax Legislative Counsel
for Regulatory Affairs
Department of the Treasury
4206 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

J. Judge Kelley, Esq.
Office of Tax Legislative Counsel
Department of the Treasury
4021 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

TAX REPORT #695

NEW YORK STATE BAR ASSOCIATION TAX SECTION
CORPORATIONS COMMITTEE

Report on Regulations to be Issued Implementing the Changes to Section 305(c) Made by the Revenue Reconciliation Act of 1990

July 1, 1991

I. Introduction[1]

The purpose of this report is to provide suggestions concerning approaches that may be taken in implementing the changes to Section 305(c)[2] made by the Revenue Act of 19 9 0 (the ”1990 Act").[3]

Sections 305(b)(4) and 305(c) have, since 1969, required holders of preferred stock to treat as distributions of property on a periodic basis a pro rata portion of amounts attributable to the difference between (x) the issue price and (y) the redemption price of preferred stock (herein "preferred stock discount").[4] In this regard, the treatment of preferred stock discount bears a resemblance to the treatment accorded original issue discount ("OID") on debt instruments. Although the statutory regime applicable to holders of OID debt securities largely originated in the same 1969 enactment as Sections 305(b)(4) and (c),[5] the OID rules, now set forth in Sections 1271-75, were the subject of comprehensive amendments in 1982[6] and 1984,[7] as well as detailed

---

1 This report was drafted by Richard L. Reinhold. Helpful comments were received from Robert A. Jacobs, Robert N. Macris, Lee S. Parker, James M. Peaslee, Dennis E. Ross, Michael L. Schler, Kenneth Silbergleit, Andrew Sperling, Willard B. Taylor and Ralph O. Winger.

2 ”Section” references herein are to the Internal Revenue Code of 1986, as amended; references to ”Reg. § ____“ are to the Treasury regulations issued thereunder.

3 The 1990 Act represented Title VII of the Omnibus Budget Reconciliation Act of 1990, P.L. No. 101-508.

4 Tax Reform Act of 1969, P.L. 91-172 (herein the ”1969 Act”), § 421.

5 1969 Act, § 413(a).

6 Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 (herein the ”1982 Act”), § 231(a).

7 Deficit Reduction Act of 1984, P.L. 98-369, § 41(a).

proposed regulations issued in April 1986.[8] As a result, the statutory and regulatory provisions governing OID reflect a far more sophisticated economic analysis than the relatively primitive rules for preferred stock discount contemplated by Sections 305(b)(4) and (c), and implemented in Reg. §§ 1.305-5 and -7.

The amendments to Section 305(c) in the 1990 Act address three distinct issues relating to the computation and inclusion in income of preferred stock discount. Nonetheless, it is apparent that the broader focus of the changes is to improve the functioning of the preferred stock discount rules of Section 305 by importing the more finely-tuned and sophisticated analysis reflected in the OID rules. Our purpose in preparing this report is to provide assistance to the Treasury and Internal Revenue Service in revising the Section 305 regulations to the end that those rules may function in a rational and hopefully simplified manner.

Part II of this report summarizes the operation of the existing preferred stock discount rules, the OID rules, and the changes to Section 305(c) made by the 1990 Act. Part III provides a brief summary of our recommendations regarding the Section 305 regulations to be drafted in response to the 1990 Act. Part IV contains a detailed discussion of those recommendations.

II. Overview

A. Treatment of Preferred Stock Discount

(i) General background

[8] Proposed Reg. §§ 1.1271-1 - 1.1275-5, 51 F.R. 12022 (April 8, 1986), corrected, 51 F.R. 23431 (June 27, 1986).

The prime difference between taxable and non-taxable stock distributions is that the former generally represent a disproportionate increase in the holder’s rights to earnings or proceeds on liquidation, while the latter represent pro rata distributions that confer no increased participation in earnings or assets.

Structurally, Section 305(a) treats stock distributions as tax-free. Sections 305(b)(1) - (b)(5) describe categories of stock distributions that generally may be regarded as disproportionate; such distributions are excluded from Section 305(a) and are treated as distributions of property instead of non-taxable distributions of issuer stock. Most pertinent here is Section 305(b)(4), which treats as a distribution of property all distributions on preferred stock, other than an increase in the conversion ratio of convertible preferred stock made to take into account stock dividends or stock splits with respect to the stock into which the preferred stock is convertible. Section 305(c) enlarges the scope of Section 305(b)(4) by requiring the issuance of regulations that treat “a difference between redemption price and issue price ... 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 . . . difference . . .." Under Sections 305(b)(4) and (c) and the implementing Treasury regulations, preferred stock discount generally gives rise to deemed distributions of property to the holder over the life of the instrument.

There appear to be two separate policy underpinnings for the deemed distribution treatment of preferred stock discount. The first, which has its origins in Treasury regulations pre-

dating the 1969 Act changes,[9] is to regard all stock distributions on preferred stock as disproportionate since the effect of such distributions is to increase the interest of the preferred holders in the issuer's earnings and assets, at the expense of the common holders.[10] The second policy foundation is the view that redeemable preferred stock is a financial asset similar to debt; and that proper tax accounting for the holder of such an instrument requires current accruals of such discount, rather than income recognition only at the time of sale or redemption. This latter view was foreshadowed in the legislative history of the 1969 Act,[11] and later made clear in the

---

[9] Reg. § 1.305-3, T.D. 6152, 1955-2 C.B. 61 (December 2, 1955), amended by T.D. 6990, 1969-1 C.B. 95 (January 10, 1969).

[10] See Eustice, "Corporations and Corporate Investors," 25 Tax L. Rev. 509, 37-52 (1970); Note, "Discounted Preferred Stock under the New Section 305 Treasury Regulations: On Confusing Debt and Equity," 84 Yale L. J. 324, 325 (1974) (herein "Discounted Preferred Stock").

[11] The legislative history of the 1969 Act states as follows:

> "[A] corporation may issue preferred stock for $100 per share which pays no dividends, but which may be redeemed in 20 years for $200. The effect is the same as if the corporation distributed preferred stock equal to 5 percent of the original stock each year during the 20-year period in lieu of cash dividends. Your committee believes that dividends paid on preferred stock should be taxed whether they are received in cash or in another form, such as stock, rights to receive stock, or rights to receive an increased amount on redemption."

H. R. Rep. No. 90, 91st Cong., 1st Sess., reprinted in 1969 U.S. Code Cong. and Admin. News 1645, 1762.

legislative history of the 1990 Act.[12]

Obviously redeemable preferred stock is different from debt in at least one very significant respect: a holder of preferred stock has no claim against corporate assets for the failure to redeem stock unless there is adequate corporate surplus or dedicated capital.[13] Nonetheless, there is an economic similarity between the two types of instruments, and the tax law has long regarded "straight" preferred stock as representing a financial asset different from other corporate equity securities that confer a more meaningful right to share in the fortunes of the corporate issuer.[14] In general, the limitation of rights, rather than the preference, is apparently key; the same is true

---

[12] The 1990 Act legislative history describes the "Reasons for Change" for the Section 305(c) amendments as follows:

> "The committee believes that income from a financial instrument that is payable on a deferred basis generally is better measured by requiring the accrual of such income on an economic basis over the period during which payment is deferred. Accordingly, the committee believes that the economic accrual rules applicable to debt instruments issued with OID also should generally apply to certain preferred stock issued with a redemption premium if the stock will be redeemed, or if it can reasonably be assumed that the stock will be redeemed, on a fixed date. Also, the committee believes that certain preferred stock issued with a redemption premium resembles debt issued at a discount."

H. R. Rep. No. 881, 101st Cong., 2d Sess. 347 (1990) (herein "House Report"); S. Rep., 101st Cong., 2d Sess. 136 Cong. Rec. S15706, S15706 (daily ed. Oct. 18, 1990) (herein "Senate Report").

[13] E.g., Delaware Corporation Law § 160; see also Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 Tax Law Rev. 369, 420-21 (1971).

[14] E.g., Section 1504(a)(4) (straight preferred stock disregarded in testing for affiliated group status); Section 382(k)(6) (disregarding 1504(a)(4) preferred stock in determining ownership change under Section 382); see also Section 108(e)(10)(B) (denying use of stock-for-debt exception for "disqualified stock" that has a fixed redemption date or issuer or holder redemption right).

for preferred stock that is subject to Sections 305(b)(4) and 305(c).[15]

(ii) Technical treatment of preferred stock discount

Preferred stock discount generally equals the difference between (x) the price paid or other initial value of the preferred stock[16] and (y) the amount (exclusive of actual dividends) that the issuer must pay to redeem the stock, known as the redemption price. Preferred stock discount is required to be taken into account as a corporate distribution by the holder "over the period of time during which the preferred stock can-not be called for redemption."[17] Discount reflecting a reasonable redemption premium is excluded from this treatment, however.[18] Under the Section 305 regulations, a redemption premium was considered reasonable "if it is in the nature of a penalty for premature redemption of the preferred stock, and 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" (herein the "305 de minimis

---

15 Preferred stock with a bona fide participation feature does not constitute preferred stock that is subject to Section 305(b)(4). Reg. § 1.305-5(a).

16 Reg. § 1.305-5(d), Example 7.

17 Reg. S 1.305-5(b)(1).

18 In an important interpretation of the reasonable retirement premium standard, the Service has twice found a retirement premium to be reasonable where (i) a reasonable premium was present based on the value assigned to preferred stock by the parties to a corporate transaction and (ii) due to unforeseen circumstances arising between the time the agreement was struck and the time of actual issuance of the stock, the stock had a smaller value than that agreed to by the parties (and would have had an unreasonable premium but for the effect of the parties' agreement). Rev. Rul. 81-190, 1981-2 C.B. 84; Rev. Rul. 75-468, 1975-2 C.B. 115.

rule").[19] The current regulations also provide that preferred stock discount is considered earned on a "straight-line" basis.[20]

In defining preferred stock discount, the regulations treat as the redemption price the price "at which preferred stock may be redeemed after a specified period of time . . .."[21] As such, deemed distribution treatment extends not only to circumstances in which true discount -- representing an additional entitlement of the holder -- is present, such as where stock is issued for $70 and subject to mandatory redemption at $100 (the $30 retirement premium being assumed to exceed a reasonable retirement premium); but also to the case where stock is sold for $100 and there is an optional right of the issuer to redeem the stock following a period of time for, say, $111 (where some portion of the $11 premium exceeds a reasonable retirement premium) (herein "Issuer Call").[22] Where preferred stock is callable by the issuer immediately following its issuance, constructive distribution treatment is generally thought not to be applicable under the regulations, since there is no time

---

[19] Reg. § 1.305-5(b)(2). The regulations provide a safe-harbor equal to 10% of the issue price of stock that is non redeemable for a period of five years. Id.; see also Treas. Reg. § 1.305-5(d), Example 4 Where preferred stock can be redeemed at more than one price, the redemption price taken into account appears to be the highest of such amounts. See id.; Rev. Rul. 75-179, 1975-1 C.B. 103; Discounted Preferred Stock, 84 Yale L. J. at 340.

Although perhaps not clear from the regulations, the de minimis exception for a reasonable retirement premium applies whether the stock is optionally or mandatorily redeemable. Rev. Rul. 83-119, 1983-2 C.B. 57.

[20] Reg. § 1.305-5(d), Examples 5 and 7.

[21] Reg. § 1.305-5(b)(1) (emphasis added).

[22] Reg. § 1.305-5(b), -5(d), Example 5; Rev. Rul. 76-104, 1976-1 C.B. 90.

during which the stock cannot be called for redemption (herein the "Immediately Callable Rule").[23]

Preferred stock often provides for cumulative dividends, with unpaid dividends required to be paid together with the redemption price of the stock upon redemption of the stock or liquidation of the corporation. In general, (i) such dividends are taxable to a holder only when paid or made unqualifiedly subject to the shareholder's demand,[24] regardless of whether the holder uses the cash or accrual method of accounting[25] and (ii) while not completely clear, unpaid dividends should not be considered to result in an increase of the redemption price of the preferred stock, and therefore should not trigger deemed distribution treatment.[26] Some commentators have suggested that unpaid dividends may increase the redemption price of preferred stock -- effectively placing holders on the accrual method for dividends -- at least when there is a plan at the time of issuance not to pay the dividends; the failure to provide such a

---

[23] See Private Letter Ruling 8637143 (June 20, 1986); Technical Advice Memorandum 8430002 (no date given); General Counsel Memorandum 35824 (May 20, 1974).

[24] Reg. § 1.301-l(b).

[25] Rev. Rul. 78-117, 1978-1 C.B. 214.

[26] See Reg. § 1.305-5(d), Example 1 (dividend arrearage includable in income when recapitalized into new stock; by implication, arrearage not included in income previously); see also Cummins Diesel Sales Corp. v. U.S., 323 F. Supp. 1114 (S.D. Ind. 1971), aff'd per curiam, 459 F.2d 668 (7th Cir. 1972) (holding accrued but undeclared dividends to represent part of the amount realized on redemption of preferred stock, rather than as dividend income to the holder). In several private rulings, the Internal Revenue Service avoided the need to address whether cumulative dividends gave rise to an unreasonable redemption premium through taxpayer representations that the redemption premium satisfied the safe harbor. L.R. 8823113 (Mar. 18, 1988); L.R. 8803074 (Oct. 23, 1987); L.R. 8638073 (June 26,1986).

rule leading to a significant tax avoidance opportunity.[27] The legislative history of the 1990 Act does not appear to recognize such a rule, however.[28]

Like other corporate distributions, deemed distributions with respect to discount preferred stock under Sections 305(b)(4) and (c) are taxable to a holder as a dividend only in the presence of current or accumulated earnings and profits (herein "e&p").[29] Deemed distributions in the absence of e&p generally will have no tax effect, since the reduction in the holder's tax basis will be offset by additional basis for the stock deemed distributed.[30] If the deemed distribution exceeds the holder's tax basis (and the issuer is without e&p), the result is capital gain[31] and a basis increase; it appears that the basis increase is considered to arise subsequent to the distribution.

Although the general rule under Section 305 is that the amount distributed is the value of stock deemed distributed,[32] the amount of the distribution under Sections 305(b)(4) and (c) is a pro rata share of the retirement premium, apparently without

---

27 Kohl and Mar, "Venture Capital Equity: Selected Section 305 Issues," reprinted in 2 Tax Strategies for Corporate Acquisitions, Dispositions, Financings, Joint Ventures, Reorganizations, and Restructurings 1990, 693, 700-01 (PLI 1990).

28 House Report at 348; Senate Report at S15707.

29 Section 301(c)(1).

30 Section 301(c)(2); issues relating to the tax basis resulting from deemed distributions on discount preferred stock are considered infra.

31 Section 301(c)(3).

32 Reg. §§ 1.305—1(b)(1), -2(b), Example 1.

regard to the value of the stock.[33] There is no explicit rule governing the increase in a holder's basis by reason of deemed distributions; the general rule is that basis is increased by an amount equal to the fair value of the stock distributed.[34]

Unanswered questions under the Section 305 regime include: (i) the treatment of holders when actual distributions are made on stock as to which constructive distributions have been required; (ii) the treatment of unaccrued discount when preferred stock is retired prior to the close of the period over which the discount is includable; and (iii) the treatment of subsequent purchasers who acquire the stock at a premium, or at a price in excess of the instrument's issue price plus previously includable discount.

B. Treatment of Debt Securities Issued at a Discount

OID is defined as the difference between (x) the issue price and (y) the stated redemption price at maturity of a debt security. However, if the OID on an instrument is less than 1/4 of 1% of the stated redemption price at maturity multiplied by the complete number of years to the instrument's maturity, OID is deemed to be zero as to the holder, but not the issuer (herein the "OID de minimis rule").[35] Holders (and issuers) take the OID,

---

[33] E.g., Reg. §§ 1.305-3(e), Example 15, -5(d), Examples 5 and 7. Like OID debt, deemed distributions on discount preferred stock are not cut off by a convertibility feature contained in the instrument, and the resulting possibility that the redemption price may never be paid. Compare Rev. Rul. 72-348, 1972-2 C.B. 97 with Reg. § 1.305-3(e), Example 15; but see Scott Paper Co. v. Commissioner, 74 T.C. 137, 158-66 (1980); Rev. Rul. 74-127, 1974-1 C.B. 47.

[34] Section 301(d).

[35] Section 1273(a)(3), Section 163(e)(2)(B). Unlike the 305 de minimis rule, OID includes the total amount of discount, including the de minimis amount, if the OID de minimis tolerance is exceeded.

as so computed, into account under the constant interest rate or economic accrual method."[36] Prior to 1982, straight-line accounting was provided; the 1982 Act abandoned such treatment due to its failure to reflect accurately the accrual of discount.[37]

The "issue price" of a debt instrument depends on the circumstances of its issuance. If an instrument is issued for cash and is "publicly offered," the issue price is the "initial offering price to the public at which price a substantial amount of the debt instruments was sold."[38] If an instrument is issued for cash but is not publicly offered, the issue price is the price paid by the first buyer, regardless of the price paid for other securities in the issue.[39] In the case of instruments issued for property, the trading value of the security issued, or the stock or securities for which the security is issued, determines the issue price of the new security, if either the old or new instrument is considered publicly-traded on an established securities market (herein "publicly traded").[40] In cases where a

---

[36] Sections 1272(a), 163(e)(1).

[37] See Joint Comm. on Taxation, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, 159-60 (1982), setting forth an illustration of the interest re-lending model which underlies the constant interest rate computation. The formula assumes the annual or more frequent payment of accrued interest, followed by immediate re-lending of the same amount, utilizing a single interest rate. The result is increasing accruals of interest as the principal balance of the obligation increases to reflect successive re-lendings.

[38] Section 1273(b)(1); proposed Reg. §§ 1.1273-2(b)(1), -2(a)(2).

[39] Section 1273(b)(2); proposed Reg. § 1.127 3-2(b)(2).

[40] Section 1273(b)(3); proposed Reg. § 1.1273-2(c). The circumstances in which securities should be considered publicly traded are considered in detail in New York State Bar Association Tax Section, “Report of the Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges,” reprinted in 51 Tax Notes 79, 95-104 (1991) (herein “Debt-for-Debt Exchange Report”).

debt instrument is issued for property and neither the debt instrument nor the property for which it is issued is publicly traded stock or securities, the issue price is the stated principal amount of the instrument, unless the instrument fails to provide for stated interest (or discount) reflecting a yield at least equal to the "applicable federal rate" ("AFR").[41]

The "stated redemption price at maturity" of an instrument generally includes all amounts payable under the instrument, however designated, other than "qualified periodic interest payments" or "QPIPs" -- generally amounts unconditionally payable at fixed periodic intervals of not less than one year based on a fixed rate of interest, or a qualifying variable interest rate.[42]

The proposed OID regulations modify the foregoing computation of the stated redemption price at maturity (and make correlative adjustments to the yield and maturity date of an instrument) to reflect the presence of certain put or call options, and options to extend the debt (herein the "OID Put and Call Rule"). In general, the put or call exercise price is substituted for the stated maturity value (and the exercise date is substituted for the stated maturity date) if the party with the put or call right would be expected to exercise such right in order to (x) maximize its rate of return (in the case of a holder put) or (y) minimize its cost of funds (in case of an issuer

---

[41] Section 1274(a).

[42] Section 1273(a)(2); proposed Reg. § 1.1273-l(b)(1).

call).[43]

In the case of persons who acquire OID instruments at a cost in excess of the sum of (x) the original issue price plus (y) all OID accrued up to the date of acquisition (herein "revised issue price"), Section 1272(a)(7) and proposed Reg. § 1.1272-1(g) provide a "purchase allowance" equal generally to the excess of the purchaser's tax basis in the instrument over the revised issue price. The purchase allowance is recovered over the remaining life of the instrument through offsets against otherwise includable OID amounts.[44] In the case of a purchase of an instrument at a price in excess of the stated redemption price at maturity, the holder is not required to include OID in income.[45]

---

[43] Proposed Reg. § 1.1272-1 (f)(4)(iii). The preamble to the proposed regulations explains the rule as follows:

> "Yield of such a debt instrument is determined as of the issue date by assuming that the holder of the particular option will act in accordance with his own economic interest (as viewed from the issue date) in deciding whether to exercise the option. For example, if the issuer of a debt instrument has a call right and if the yield to the call date. (assuming exercise of the call option) would be less than the yield to maturity assuming no exercise of the call, it will be assumed as of the date of issue that the call option will be exercised. The maturity date and the stated redemption price at maturity are then determined according to the presumption of exercise."

Notice of Proposed Rulemaking, 1986-1 C.B. 820, 825

[44] The application of the purchase allowance rule in the con-text of tax-free reorganizations is discussed in the Debt-for-Debt Exchange Report, 51 Tax Notes at 105-106.

[45] Section 1272(c); proposed Reg. §§ 1.1272-l(a)(2), -1(f).

C. Section 305(c) Amendments -- 1990 Act

The 1990 Act added three new paragraphs to Section 305(c):

1. Section 305(c)(1) provides that the OID de minimis rule, rather than the 305 de minimis rule, will apply in cases where (i) the issuer is required to redeem preferred stock at a specified time (herein "Mandatory Redemption") or (ii) the holder has the right to require the issuer to redeem the stock (herein "Holder Put").

2. Section 305(c)(2) provides that a redemption premium shall not fail to be treated as a distribution (or series of distributions) merely because the stock is callable.

3. Section 305(c)(3) provides that in any case in which redemption premium is required to be taken into account as a distribution, the OID economic accrual rule will apply (the "Economic Accrual Rule").

The legislative history relating to the changes amplifies their intended operation as follows:

i. The OID de minimis rule will replace the 305 de minimis rule in the case of preferred stock that is subject to Mandatory Redemption or a Holder Put; the presence of an Issuer Call will not change this result.[46]

[46] House Report at 348; Senate Report at S15706.

ii. The 305 de minimis rule, rather than the OID de minimis rule, will apply to preferred stock that is merely subject to an Issuer Call.[47]

iii. Stock that is subject to an Issuer Call and either Mandatory Redemption or a Holder Put will be tested for an unreasonable redemption premium under the 305 de minimis rule, with respect to the Issuer Call, and under the OID de minimis rule as regards a Mandatory Redeption or Holder Put; with inclusions required if either (or both of the tolerances is exceeded.[48]

iv. The exception to deemed distribution treatment under the Immediately Callable Rule -- where deemed distributions arise solely due to an Issuer Call -- has apparently been preserved,[49] notwithstanding the seemingly contrary direction of the statute.[50]

v. The Economic Accrual Rule will apply to the entire amount of discount on preferred stock if the discount exceeds the applicable de minimis tolerance.[51]

vi. The principles of the OID Put and Call Rule will be utilized to determine the maturity date and redemption

---

47 House Report at 348; Senate Report at S15706.

48 House Report at 348; Senate Report at S15707.

49 House Report at 348; Senate Report at S15706.

50 Section 305(c)(2).

51 House Report at 348; Senate Report at 315706-7.

price of stock subject to a Holder Put.[52] Presumably, the same analysis will determine whether the Holder Put will be deemed exercised in the first instance.

vii. It appears that only preferred stock -- presumably as defined in the existing regulations -- was intended to be reached by the 1990 Act amendments to Section 305(c).[53]

The legislative history also describes subjects that may be addressed in regulations. For example, if at the time of issuance of cumulative preferred stock there is no intention for dividends to be paid currently, the Internal Revenue Service may regard such amounts as disguised redemption premium.[54] Additionally, stock that is in form subject only to an Issuer Call may be regarded as subject to Mandatory Redemption if "other arrangements effectively require the issuer to redeem the stock."[55]

The legislative history states that the Economic Accrual and OID de minimis rules are expected to be effective as of the effective date of the bill, October 10, 1990, regardless of when implementing regulations are issued.[56] The legislative history

---

52 House Report at 348; Senate Report at S15706.

53 See note 15 and accompanying text, supra; House Report at 348; Senate Report at S15707.

54 House Report at 348; Senate Report at S15707.

55 House Report at 348; Senate Report at S15707.

56 House Report at 348-49; Senate Report at S15707. Subject to transition relief and limitations described in the legislative history, the 1990 Act amendments apply to stock issued after October 10, 1990. 1990 Act, § 11322(b)(2).

then goes on to state that, except as otherwise provided in the legislative history, there is no intention to limit the authority of the Service "to promulgate regulations relating to the accrual of redemption premiums on callable preferred stock," and that such regulations are expected to be prospective.[57]

III. Summary of Recommendations

Our recommendations fall into two broad categories.

Our more far-reaching recommendation goes to a long-standing feature of the constructive distribution rules under the Section 305 regulations: we think it is highly appropriate to jettison the requirement of constructive distributions on preferred stock due solely to an Issuer Call, except in two circumstances: (i) where the call would be presumed exercised under the principles of the OID Put and Call Rule or (ii) possibly, where evidence exists that there is an understanding between issuer and holder that the call will be exercised notwithstanding that doing so is otherwise non-economic from the issuer's point of view.

As confirmed by the approach of the OID Put and Call Rule -- applicable to preferred stock by virtue of the 1990 Act -- the presence of an issuer right to call preferred stock at a price in excess of the redemption price of the stock confers no economic value or benefit upon a holder, and is completely inapposite as a basis for imputing periodic income to a holder. We think elimination of the Issuer Call rule (except in the indicated circumstances) would render the operation of Section 305 significantly simpler and more rational, and also would

[57] House Report at 349; Senate Report at S15707.

eliminate significant opportunities for abuse. Stated differently, the failure to eliminate the requirement of income inclusions based solely on the presence of an Issuer Call becomes especially difficult to defend once the significantly more sophisticated OID concepts are made applicable to discount preferred stock.

In addition to our recommendation regarding stock subject only to Issuer Calls, we make several technical suggestions concerning the application of OID-type economic accrual concepts to preferred stock, as directed by Sections 305(c)(1) and (c)(3). The suggestions are summarized below:

1. In the case of "publicly offered" preferred stock that is sold for cash, the issue price should be the initial offering price to the public at which a substantial amount of the instruments was sold, regardless of the actual price paid by a given purchaser. In other cases, the fair market value of the preferred stock -- taking into account trading values, where appropriate -- generally should govern. We would provide exceptions to the foregoing rule -- generally with the result that preferred stock discount would not be created -- (i) in cases involving tax-free exchanges of preferred stock for preferred stock and (ii) in circumstances where preferred stock unexpectedly drops in value between the date the par-ties reach agreement on terms and the actual issue date.

2. A "purchase allowance" rule similar to Section 1272(a)(7) should be adopted for secondary market purchasers; for those who buy on initial issue at other than the issue price; and for persons who receive

preferred stock in a tax-free exchange in which a new issue price is established. Similarly, accruals of discount should not be required for persons who purchase the stock at a premium over the redemption price, or at the redemption price.

3. In the case of preferred stock held by non-U.S. holders, withholding tax should be imposed on, and collected from, actual distributions (to the extent available); additional tax due should be collected from later payments or upon redemption.

4. If there is evidence at the time of issuance that dividends on cumulative preferred stock will not be paid when accrued, such dividends should be treated as part of the redemption price of the preferred stock and therefore give rise to preferred stock discount.

5. There should be no requirement that holders accrue preferred stock discount where, at the time of issuance, the issuer is not in a position to fund dividend payments, or to retire the preferred stock, without a significant increase in earnings or asset value.

6. Except to the extent related to implementation of the OID de minimis or Economic Accrual rules, the regulations should apply only to instruments issued following promulgation of the regulations.

IV. Discussion of Recommendations

A. General

We see the effort to import concepts that have been developed for the tax treatment of OID into the Section 305 treatment of preferred stock discount as a significant opportunity to simplify and rationalize an area of the law that has been uncertain and complex. We recommend that two principles be borne in mind in undertaking this effort: first, we think that it is appropriate to recognize the general soundness of the OID provisions as they apply to debt discount; and that to the extent discount accruals are required with respect to preferred stock, the OID rules generally represent an appropriate method of accounting for such discount.[58] Second, we think it is appropriate to bear in mind that the OID provisions -- especially as elaborated by the proposed regulations -- are extraordinarily complex, and that the complexity of those rules should be imported into the preferred stock context only to the extent necessary to achieve rules that are sensible and do not afford significant opportunity for abuse.

B. Issuer Calls

As discussed in part II.A.(i), supra, and as emphasized in the "Reasons for Change" relating to the 1990 Act amendments to Section 305(c),[59] the underlying premise of the preferred stock discount rules is that holders should account for preferred

[58] Our view as to the appropriateness of the OID provisions does not necessarily extend to the contingent interest rules of proposed Reg. §§ l.l275-4(e), (f) and, now, (g). In all events, however, the direction in Section 305(c)(3) to apply "principles similar to the principles of Section 1272(a)" to preferred stock discount suggests reasonably strongly that the contingent interest rules promulgated under Section 1275(d) were not intended to be imported into the preferred stock setting. As a single illustration of this principle, we would expect that a convertible preferred stock instrument that settles optionally in cash would not be subject to the "splitting" rules of proposed Reg. § 1.1275-4(g).

[59] See note 12, supra.

stock discount by applying the accrual method of accounting to income accretions. The same principle underlies the treatment of OID on debt. In light of that premise, we think it is indefensible to impose a requirement of income recognition on holders solely by reason of an Issuer Call that would not be presumed exercised under the operation of proposed Reg. § 1.1272-1(f)(4)(iii)(B).[60]

For reasons having nothing to do with taxes, issuers of preferred stock often reserve the right to re-acquire preferred stock pursuant to a call provision -- e.g., to preserve flexibility for undertaking corporate transactions. A holder desiring to assure its continued receipt of bargained-for dividend flows in the face of declining interest rates, enhancement of the issuer's creditworthiness or otherwise, may therefore negotiate a high call price to ensure that it is able to preserve the benefit of its bargain. An issuer may not strenuously resist a high call price, especially if it believes that the security is unlikely to be called. From the holder's viewpoint, the presence of an Issuer Call represents a limitation

[60] The requirement in the Section 305 regulations of holder accruals based solely on an Issuer Call has long been criticized. See, e.g., Minasian and Welz, "Guidelines for Determining when Discount on Preferred Stock Will Create Taxable Income," 53 Journal of Taxation 2, 4 (1980); Discounted Preferred Stock, 84 Yale L. J. at 340 ("The problems of discounted preferred stock with a no mandatory redemption agreement reflects perhaps the most substantial warp in the thinking that underlies the new preferred stock rules."); Wells, "RRA 90 Increases Constructive Dividend Risk on Preferred Stock," 74 Journal of Taxation 268 (1991) ("It is unclear how the forthcoming Regulations will deal with [stock redeemable only at the option of the issuer] because the underlying premise that the constructive dividend rules should apply is wrong."). The same view has been reflected in prior reports of the New York State Bar Association Tax Section. See "Report of the Committee on Corporations on the Proposed Clarification of Regs. § 1.305-5(b)," Report No. 187, June 20, 1978 ("In the Committee's view, it is fundamentally wrong to create dividend income out of a premium payable on a redemption that is optional with the issuer . . ."); "Report on the Tax Reform Act of 1984 Amendments to Section 1504(a), the Definition of 'Affiliated Group'," reprinted in 28 Tax Notes 895, 903 (1985) (herein "Section 1504(a) Report").

on the holder's rights rather than a right to income or wealth accretion.

Confronting this same issue, the proposed OID regulations hold that an issuer should be considered to exercise a call only if, from the vantage point of the date of issuance, it would lower its cost of funds by doing so. In that case, the issuer is presumed to exercise the call, and the call price and date are substituted for the nominal maturity price and date in determining the presence and amount of OID on the instrument.[61] Such a rule is sound from a policy perspective because it assumes that each party will act in accord with its economic self-interest.[62] Obviously, that policy applies equally to preferred stock discount and debt discount.

One may speculate that the Immediately Callable Rule was adopted and continued in effect at least in part due to recognition of the unsound premise that underlay the requirement of holder accruals by reason of an Issuer Call. Although the Immediately Callable Rule had some technical support in the 6 3 regulations,[63] the direction to eliminate the Immediately Callable Rule in Section 305(c)(2) requires policymakers to confront squarely the merits of requiring accruals based solely

---

61 Proposed Reg. § 1.1272-1(f)(4)(iii)(B).

62 See note 43 supra.

63 Effective disregard of an Issuer Call where stock is immediately callable was not the only interpretive option open to the Service: at least one commentator thought that the entire call premium would be taxed immediately. de Kosmian, “Taxable Stock Dividends Under New Section 305,” 28 Tax Law. 57, 70 (1974).

on the presence of an Issuer Call.[64]

The uneconomic nature of the requirement of holder accruals based solely or an Issuer Call appears to provide significant opportunities for taxpayer abuse. For example, a preferred stock instrument purchased for $100 and bearing dividends at a market rate might be made callable at the issuer's discretion for, say, $200. Although the circumstances under which the call would be exercised might be rare, the holder would nonetheless be considered to receive periodic property distributions. If the holder of the preferred stock were a tax-exempt entity, the deemed distributions might eliminate corporate e&p without tax effect, allowing the holder of the common stock to receive tax-free distributions under Section 301(c)(2). Other similar schemes doubtless could be envisioned.

Income accruals solely on account of an Issuer Call also have the potential for significant unfairness: a taxable holder can expect to have current ordinary income and deferred (potentially unusable) capital loss if the call is not exercised; in the context of a non-U.S. holder, the consequence apparently could be current withholding taxes and an unusable loss.

---

[64] As explained above, the legislative history of the 1990 amendments to Section 305(c) (as contrasted with the stat-ute) appears to contemplate the survival of the Immediately Callable Rule.

It is noted that a continued requirement of holder accruals based solely on an Issuer Call without relief under the Immediately Callable Rule will necessitate guidance as to the timing of holder accruals based on the presence of the Issuer Call. Possible outcomes include immediate income recognition, and reference to statistical data to determine a likely call date and accrual over the period between issuance and the statistically-determined call date. The first alternative either may be harsh or may lend itself to taxpayer abuse, depending on the setting; the second rule would seem difficult to apply in practice.

It should be noted that elimination of the requirement of holder accruals based solely on the presence of an Issuer Call would achieve a measure of simplification in that only a single de minimis standard (the OID de minimis rule) would then apply.

As previously indicated, we think that discount accruals based on the presence of an Issuer Call are appropriately required where the call would be presumed exercised under the principles of the OID Put and Call Rule. In addition, there could be some basis for requiring holder accruals by reason of an Issuer Call that is not presumed ercised if there were evidence that the call will nevertheless be exercised. We note, however, that the proposed OID regulations do not reflect a need for such protections, and that such a rule could well lead to practical uncertainties that outweigh any benefit. Nonetheless, if such a rule were adopted, we think it should demand a fairly high level of proof as to an understanding, such as an obligation to call the stock in a related document, or a statement of intention to exercise the call in a publicly-filed document. In this regard, we think the regulations under former Section 1232 generally took a sensible approach.[65] Nonetheless, we think the better course would be to follow the OID Put and Call Rule, and to apply such analysis with reference to the parties' contractual rights.

---

[65] See Reg- § 1.1232-3(b)(4)(ii); see also New York State Bar Association Tax Section, "Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations," reprinted in 34 Tax Notes 363, 366 (1987) (herein "1987 OID Report").

Although the legislative history of both the 1969 Act and the 1990 Act[66] assume a requirement of deemed distributions based on an Issuer Call, we think the Treasury Department's authority under Section 305(c) is broad enough to eliminate this requirement.[67] To summarize: we are not aware of a policy justification for this rule, and think that any effort to conform the operation of the OID and preferred stock discount rules should begin with elimination of this requirement, subject to the indicated exceptions.

C. Determination of Issue Price

As a general matter, we think it would be sensible to conform the issue price determination for preferred stock to the rules utilized in the debt setting. Thus, (i) in cases where stock is sold for cash in a public offering, it would the appropriate to fix a uniform issue price for the issue in a manner similar to the rule of proposed-Reg. § 1.1273- 2(b)(l)(i), and (ii) in cases where stock is issued for property and is publicly traded shortly following its issuance, or if not, but is issued for publicly-traded property, such trading values should provide the issue price for the stock issue, generally similar to the rules of proposed Reg. § 1.1273- 2(c)(1). In other cases, the fair market value of the preferred stock following issuance generally should continue to determine issue price.

---

66 As we read Section 305(c)(2), it instructs the Treasury and the IRS to overrule the Immediately Callable Rule in determining the presence of preferred stock discount when-ever such discount would arise -- e.g., by reason of an Issuer Call, a Mandatory Redemption or a Holder Put. See note 87, infra. Our suggestion that preferred stock discount not be created solely by reason of an Issuer Call is therefore not inconsistent with the direction of Section 305(c)(2).

67 H.R. Rep. No. 90, 91st Cong., 1st Sess., reprinted in 1969 U.S. Code Cong, and Admin. News 1645, 1762; House Report at 348; Senate Report at S15706.

However, there are two cases in which we think that issue price should be determined without regard to trading values (or otherwise determined fair market value).

First is the situation where new preferred stock is issued in exchange for outstanding preferred stock in a non-recognition transaction, with no increase in redemption price. Such a transaction could be tax-free to the holder under Section 1036(a) or under Section 354(a) and either Section 368(a)(1)(E) or one of the acquisitive reorganization provisions. In a case of this type, it would seem inappropriate to create preferred stock discount merely because the fair market value of the preferred stock being issued is less than the issue price of the preferred stock being surrendered.

We reach this conclusion -- which differs from the general rule in the debt context -- for two reasons. First, the issuer is not in a position to obtain any interest deductions (and will not recognize income from the cancellation of indebtedness (herein "COD")); thus, there is no need to create preferred stock discount to afford symmetrical treatment to issuer and holder. Second, the transaction does not produce any additional tax basis in assets or stock to the issuer, again suggesting the absence of any need to overrule the tax- free nature of the transaction to the holder. Lastly, given the weakness of the analogy to debt, we would draw no inference from the repeal of Section 1275(a)(4) as regards the treatment of

preferred stock.[68]

Second, we would preserve the holdings of Revenue Rulings 81-190, supra, and 75-468, supra, so that if the value of preferred stock declines unforeseeably subsequent to the parties' having reached agreement on the terms of the transaction, the issue price will nonetheless be the value originally agreed upon (at least if such value is supportable by expert valuation or the

---

[68] We note that in the absence of the rule we suggest significant amounts of preferred stock discount will be created in virtually every preferred stock exchange involving a troubled company, even though OID would not be created in the debt context. Generally, under Section 1273(b)(4), no OID will be created in a debt-for-debt exchange involving non-traded debt, as long as the new debt bears interest at least equal to the AFR, so that Section 1274 does not apply.

We also note that the fair market value issue price rule for preferred stock can lead to results that are arguably anomalous in cases where new preferred stock is exchanged for old debt, and the redemption price of the new preferred stock is equal to the principal amount of the old debt. If new debt were issued instead of new preferred stock, ar.i neither instrument were considered publicly traded, no COD income or OID would be created. Where the new instrument is preferred stock, however, (i) COD income arises based on the initial value of the new preferred stock (Section 108(e)(10)(A)), (ii) the stock-for-debt exception generally will not be available to prevent the reduction of net operating losses and other attributes where the issuer is insolvent or in bankruptcy (Section 108(e)(10)(B)) and (iii) preferred stock discount will be created with respect to the new preferred stock. On the one hand, this series of consequences obviously creates significant tax disincentives to deleveraging. On the other hand, the results can be defended at a theoretical level since, where debt is issued, the principal amount ultimately will be paid or COD will result; this is not true where preferred stock is issued. It is possible to view the current law (Section 108(e)(10)(A)) as giving income tax policy -- particularly the differences in the tax treatment of economically similar debt and redeemable preferred stock -- too much weight as compared with non-tax policy favoring the rehabilitation of bankrupt (and insolvent) debtors.

like).[69] While perhaps more favorable than the rule in the debt context, we think the considerations outlined above with respect to preferred stock exchanges apply here as well.

D. Purchase Allowance

The existing regulations do not indicate the treatment of holders that acquire discount preferred stock in a secondary transaction at a price in excess of the issue price plus accretions of discount to the date of purchase. In the case of a debt security (i) secondary market purchasers that buy at a price above the revised issue price obtain the benefit of a purchase allowance, and OID relating to the resulting "acquisition premium" is not included in income, and (ii) purchasers that buy at a price above the instrument's stated redemption price at maturity have no obligation to include OID in income. The logic of these rules applies with equal force to discount preferred stock. Moreover, such rules generally will favor the revenue in cases involving corporate holders, since such holders otherwise-would be able to over-accrue income subject to a 70% or 80% dividends-received deduction, and then claim a deductible loss.

E. Withholding Tax

Accrued OID on a debt instrument held by a non-U.S.

---

[69] As discussed in note 18, supra, the cited rulings base their holdings on the absence of an unreasonable retirement premium; such a conclusion would be more difficult to sustain following adoption of the mechanical OID de minimis rule. Nonetheless the policy considerations of not impairing corporate restructurings by creating preferred stock discount where none was considered to exist by the parties (see Revenue Ruling 81-190, 1981-2 C.B. at 85) continues to apply. In our view, that policy would best be implemented in the revised regulations by creating an exception to the generally-applicable issue price rule for situations such as those described in the rulings.

person generally is includible in income and subject to withholding only to the extent that the withholding tax on such income does not exceed the cash payments made on the instrument (reduced by any withholding tax on the cash interest payments), with any remaining amount includible in income upon receipt of later payments, or upon sale or exchange of the debt instrument.[70] Thus, if a debt instrument produces an OID accrual of $100 and an interest payment of $25, $58.33 (($25 - ($25 x.30))/.30) of accrued OID is includible in income and subject to withholding in connection with payment of the interest. The remaining $41.67 of accrued OID is includible in income as future payments are made or upon the sale or exchange of the instrument. Until regulations are issued, however, amounts paid upon a sale or exchange (to the extent of accrued OID), while includible in income, are not subject to withholding except with respect to amounts paid by the issuer.[71]

There is no exception to the general withholding obligation on deemed distributions with respect to preferred stock discount. It would seem appropriate to conform the treatment of debt discount and preferred stock discount on this point.

It should be noted that the withholding tax issue may have greater practical significance in the preferred stock setting than in the debt context, since the portfolio interest exemption and tax treaties frequently eliminate any withholding tax on interest. There is obviously no counterpart to the portfolio interest rule for dividends, however, and while some

---

[70] Sections 871(a)(1)(C), 881(a)(3), 1441(a), 1442(a).

[71] Rev. Rul. 68-333, 1968-1 C.B. 390.

tax treaties reduce the rate of withholding tax on dividends, none eliminate it.

F. Plan To Defer Dividends

It was recognized at the time that the Section 305 regulations initially were proposed in 1971 that deemed distribution treatment might be circumvented through the issuance of cumulative preferred stock in circumstances where the issuer did not intend to pay scheduled dividends currently.[72] In general, it seems apparent that this defect in the operation of the present regulations should be remedied.

The difficult issue is identifying the cases in which dividends are passed for a purpose that amounts to tax avoidance. Unlike QPIPs on a debt security, it will often not be possible to determine the bona fides of the issuer's intention to pay dividends from the documents. An amount qualifies as a QPIP, so that it may be excluded from the stated redemption price at maturity of a debt instrument, only if failure to pay the amount timely "results in consequences to the borrower that are typical in normal lending transactions.[73] Unfortunately, there is no concept in the preferred stock setting that may be relied upon as uniformly as default for failure to pay interest timely in the debt setting. While it is true that continued failure to pay dividends often gives preferred stock holders the right to elect members to the issuer's board of directors, we are not aware of any uniformity as regards the number of dividends that must be

[72] New York State Bar Association Tax Section, Committee on Corporations, "Comments on Proposed Regulations Under Section 305 of the Internal Revenue Code of 1954, as Amended by Sec. 421 of the Tax Reform Act of 1969," 49 Taxes 460, 487-88 (1971).

[73] Proposed Reg. § 1.1273-1(b)(1)(iii).

passed before voting rights take effect, the number of directors who may be elected by the preferred holders, etc. In any event, the consequences of nonpayment will be less severe for preferred stock than for debt.

Our recommendation would be to articulate the standard as one in which there is a plan to defer the payment of scheduled dividends; in such cases, dividends would be included in the redemption price, and the instrument would be treated in a manner similar to an installment obligation under the proposed OID regulations.[74] Examples could then be given of obvious circumstances in which a plan would be considered present: e.g., debt covenants restrict payments of dividends, or offering documents state an intention to defer dividends.

G. Uncertainty Concerning Issuer Ability to Pay Dividends or Redeem Stock

The question here addressed is the proper tax treatment of cases where scheduled dividends and redemption amounts are not expected to be paid absent a material improvement in the issuer's financial situation. At this point the legal difference between preferred stock and debt is of real significance: the holder is not in a position to sue for an amount due or place the issuer in bankruptcy if dividends cannot be paid or the stock cannot be redeemed due to a lack of surplus or (in the case of a redemption) applicable capital.

In such cases, preferred stock does not closely resemble a financial asset similar to debt; so that the policy basis for

[74] Proposed Reg. § 1.127 3-1(b).

current income accruals does not exist.[75] From a technical viewpoint, the likelihood that the holder will receive payment only in the event of significant growth in the issuer's earnings or assets may well render the stock "participatory, " and therefore outside the scope of Section 305(b)(4).[76] Thus, in cases where the issuer's ability to pay current dividends, or to fund the redemption price of the shares is uncertain, a requirement of dividend accruals, or accruals based on the presence of preferred stock discount, would seem inappropriate.[77]

One means of identifying cases in which accruals should not be required would be by reference to the standard in Section 1504(a)(4)(B) for stock that "does not participate in corporate growth to any significant extent." This standard would be met in cases in which there is a significant question as to the issuer's ability to pay dividends, or to retire the stock on the appointed redemption date, in the absence of a material increase in the issuer's earnings or assets.[78] As noted, such an approach also conforms closely to the principle of the present regulations under Section 305(b)(4), which apply only to preferred stock

---

[75] See the discussion at notes 11, 12, supra.

[76] See the discussion at note 15, supra.

[77] In our conception, the determination of whether accruals of discount will ever be required would be made at the time of issuance of the stock. We note, however, that if an issuer encountered financial difficulty, it may lack current or accumulated e&p, in which event deemed distributions may be non-taxable under Section 301(c)(2). Moreover, we assume that accruals of preferred stock discount will not be required if the financial condition of the issuer is such that a holder of a debt security with similar characteristics would not be required to accrue interest income.

[78] The Service has applied such a test under Section 1504(a)(4)(B) in two private rulings. Private Letter Ruling 8945055 (August 16, 1989); Private Letter Ruling 8940006 (April 20, 1989)

without meaningful participation rights.[79]

H. Application of Section 1272(a)

Making the Economic Accrual rule applicable to preferred stock discount appears to necessitate creating a concept of regular periodic dividends that may be excluded from accrual treatment. In the debt context, such payments are referred to as QPIPs; their counterpart in the stock setting will be referred to herein as "QDPs." In general, QDPs would represent periodic dividends payable at fixed intervals of not less than one year based on a fixed rate or a qualifying variable rate. QDPs would be taken into account when paid, and not under accrual rules.

The absence of a QDP concept would create an obvious opportunity for tax avoidance. For example, if the redemption price of stock simply excluded all amounts denominated as dividends, whenever payable, significant income deferral could result where scheduled dividends are backloaded. In the most extreme case, an instrument could provide for a single dividend payable on the maturity date of the instrument. In that case, the instrument's redemption price would ostensibly not exceed its issue price, and Sections 305(b)(4) and (c) would have no application.[80]

The application of a QDP concept will have the effect of shifting to the accrual method all arrangements involving non-

---

[79] See note 15, supra. Although the 1990 amendments to Section 305(c) do not expressly limit their scope to preferred stock, the legislative history seems clear on this subject. House Report at 348; Senate Report at S15707.

[80] The extraordinary dividend rules of Section 1059 would restrict efforts to backload dividends in some cases.

level preferred stock dividends, except to the extent that floating rate dividends are based on a qualifying variable rate index.[81] Since such arrangements may not necessarily be tax-motivated, it must be recognized that the more accurate accounting for income under the Economic Accrual rules is purchased at the cost of complexity and potential unfairness to holders of certain non-standard instruments.

The application of OID concepts provides a logical rule for the treatment of actual payments of dividends, in circumstances where accrual has been required under Sections 305(b)(4) and (c). In such a case, cash payments would (to the extent not representing a QDP) be treated as a payment of previously-accrued dividends.[82] In our view, this treatment s appropriate whether the distribution takes the form of a payment of a scheduled dividend (though not a QDP),or a redemption of stock that is treated as a dividend.[83]

I. Other Issues

(i) Information Reporting

An effective set of rules for the taxation of preferred stock discount must take into account the operation of the

---

[81] See proposed Reg. §§ 1.1273-l(b)(1)(ii), 1.1275-5; shortcomings in the OID variable interest rate formulation are discussed in the 1987 OID Report, 34 Tax Notes at 401-04.

[82] Proposed Reg. § 1.1272-1(e)(2)(ii) (last sentence).

[83] For example, assume that discount preferred stock is held by a person who also owns 100% of the common stock of the issuer, and that redemption of the preferred stock would otherwise trigger dividend income to the holder, equal to the amount received, under Section 302(d). In our view, such amount is properly regarded as a payment of previously-taxed income to the extent accruals of preferred stock discount have been included in the holder's income.

information reporting system. An important link in this system is adequate information in the hands of brokers and other middlemen, enabling them to provide accurate returns and reports to the IRS and holders. We think consideration should be given to creating a publication, similar to IRS Publication 1212 relating to OID debt securities, that would provide brokers and other middlemen with information as to the identity of preferred stock issues bearing discount, and the amount of the annual deemed distributions under Section 305. Issuers, in turn, would then need to provide appropriate information to the IRS.[84]

Two other issues, not directly pertinent to the regulations to be issued under Section 305, merit brief mention.

(ii) Section 1504(a)(4)(C) -- de minimis discount

Section 1504(a)(4)(C) conditions straight preferred stock status on the absence of preferred stock discount in excess of ”a reasonable redemption or liquidation premium." In a prior report, we questioned whether an exclusion from preferred stock status based on the presence of discount was well-considered from a policy standpoint.[85] Nonetheless, to the extent that the discount restriction continues in effect, we recommend that the safe-harbor be determined by reference to the 305 de minimis rule, rather than the more restrictive OID de minimis rule.

---

[84] Compare proposed Reg. § 1.1275-3(b).

[85] Section 1504(a) Report, 28 Tax Notes at 902.

(iii) Section 1059(e)(3) – Accruals of Qualified Preferred Dividends

Section 1059(e)(3) provides relief from the extraordinary dividend rules for cases involving "qualified preferred dividends," which, among other things, must be payable on stock providing for "fixed preferred dividends payable not less frequently than annually." Recognizing that the 1990 Act amendments to Section 305(c) may well have the effect of enlarging the number of situations in which dividend accruals are not accompanied by payments, we think it would be appropriate for regulations to confirm that dividends that accrue based on a level yield will not be treated less favorably than dividends that are payable on a similar basis.

J. Effective Date Issues

As discussed above, the legislative history of the 1990 Act amendments of Section 305(c) states that the regulations implementing the Economic Accrual Rule and the OID de minimis rule will apply to stock issued after October 10, 1990.

Consistent with the suggestion in the legislative history we think that in other respects the new regulations generally should be prospective from the time of their publication[86] -- i.e., such regulations should not apply to instruments issued prior to the adoption of the new regulations -- except to the extent the operation of the statutory rules

[86] See the discussion at note 57, supra.

is clear.[87]

We understand that there may be some desire to curb retroactively the avoidance opportunity that may be present where there is a plan to defer payment of cumulative dividends (see part IV.F., supra). We think such retroactivity would be inappropriate. Initially, if such an avoidance opportunity exists, it has, as discussed above, been present since the existing regulations were first proposed in 1971.[88] Moreover, it would appear that the failure to curtail the avoidance opportunity until now may have grown out of a concern that a strict accrual rule, that did not take into account the possibility that the issuer might be unable to service current dividends, might sweep too broadly. (That is our view, as discussed in part IV.G., supra.) Given the apparent need to strike a balance in this area -- and the absence of any indication in the legislative history or any pronouncement issued by the Service as to how such rules might operate -- we think a regulation that is effective prior to its promulgation would be unduly harsh.

---

[87] For example, the statute seems clearly to apply in a case where preferred stock discount would arise due to a Mandatory Redemption or Holder Put, but the stock is immediately callable. In such a case, we read Section 305(c)(2) and the legislative history to treat the repeal of the Immediately Callable Rule as effective October 11, 1990. Compare the discussion at notes 49, 50, supra.

[88] See the discussion at note 72, supra.