REPORT # 576

TAX SECTION

New York State Bar Association

Report Regarding "Tracking Stock" Arrangements

Table of Contents

Part I -- Background Regarding....4

Part II - Federal Income Tax Issues Potentially Raised by Subsidiary Tracking Stock....11

Part III -- Tax Law Precedents that Have Considered Tracking Stock Issues....25
- A. RIC Precedents....26
- B. PFIC Regulatory Authority....30
- C. Maxwell Hardware....32
- D. Farley Realty....35
- E. Analysis of Precedents....36

Part IV -- Tax Policy Issues Raised by....38
- A. Tax Policy Issues Raised....39
- B. The Correlation Analysis....42
- C. Tracking Stock -- An Interest in What?....44
- D. When Should Tracking Stock....50

Part V -- Possible Nature and Scope of....53
- A. Nature of Possible Action....53
- B. Need for Consistency Regarding....55

Appendix A....58
Appendix B....61
Appendix C....63

Tax Report #576

New York State Bar Association Tax Section

Corporations Committee

Reorganizations Committee

Report Regarding “Tracking Stock” Arrangements

This report[1] was prepared in response to a request from the Internal Revenue Service and the Treasury Department for views regarding the proper treatment, for federal income tax purposes, of transactions involving so-called "alphabet stock" or "tracking" stock -- special classes of stock of a parent corporation which share differently from other classes of common stock with respect to certain assets of the parent or another corporation.

These issues have been focused by the recent issuance by publicly traded corporations of stock intended to trade as if it were stock of an existing subsidiary of the parent corporation. This type of stock in a publicly traded corporation, which is linked to stock of a subsidiary, is referred to in this report as "subsidiary tracking stock." The broader class of stock of a parent corporation, which, for example, tracks ar. asset of the parent other than stock of a subsidiary, is referred to as

[1] This report was prepared by an ad hoc committee (the "Committee") composed of the following members of the Corporations Committee and the Reorganizations Committee: Jonathan S. Brenner, Katherine M. Bristor, Anthony J. Carbone, Kenneth H. Heitner, E. Bradford Holbrook, III, James A. Levitan, Lee S. Parker, Richard L. Reinhold, Matthew A. Rosen, Robert Rothman, Stanley I. Rubenfeld and Jodi j. Schwartz. The principal drafter of the report was Richard L. Reinhold. Helpful comments were received from Herbert L. Camp, Richard G. Cohen, John A. Corry, Donald Schapiro, Michael L. Schler and Ralph O. winger.

"tracking stock." Conceptually, subsidiary tracking stock represents a subset of a broader class of stock referred to herein as tracking stock.

The principal focus has been on subsidiary tracking stock issued by publicly traded corporations. Recognizing this, the report is divided into five parts.
Part I sets forth a general description of subsidiary tracking stock in the transactions in which it has been utilized to date.

Part II describes various federal income tax issues potentially raised by transactions involving subsidiary tracking stock and indicates the Committee's view as to the likely resolution of those issues under present law. It is concluded that, while there is an absence of authority that bears on the tax issues potentially raised by issuance of subsidiary tracking stock by public corporations, it appears unlikely that the transactions in question involve uncertainties under present law.

Part III describes approaches that have been taken in addressing the tax treatment of tracking stock-type arrangements under existing law, including the treatment of series funds of regulated investment companies, a new Internal Revenue Code

provision that provides regulatory authority regarding the use of tracking stock in the setting of a passive foreign investment company, and the decisions in Maxwell Hardware and Farley Realty.

Part IV begins with a discussion of the tax policy issues raised by tracking stock arrangements. It then goes on to describe the "correlation" approach that the Committee believes represents a proper theoretical framework for analysis of these arrangements. Consideration then is given to the conceptual nature of tracking stock. It is concluded that tracking stock may be seen to represent, in substance, a type of "joint venture" between the parent corporation and the holders of tracking stock, with the joint venture or separate entity holding the "tracked property." Part IV concludes with a discussion of circumstances under which it may be appropriate to treat tracking stock as other than stock of the parent corporation.

Part V then considers steps that might be taken by the Treasury Department and Internal Revenue Service to respond to the possible tax avoidance opportunities presented by tracking stock arrangements.

Part I -- Background Regarding Subsidiary Tracking Stock Transactions

In general, subsidiary tracking stock issued to date has involved a special class of common stock of a parent corporation ("P") that is linked, usually in multiple respects, to the performance of a P subsidiary corporation ("S"). Subsidiary tracking stock permits the issuance of an equity security of P, the market performance of which is intended to be linked to the performance of S.

In some cases, subsidiary tracking stock has been issued as one element of a package of consideration in the acquisition of S by P, either on a taxable basis or in a tax-free acquisitive reorganization. In other cases, subsidiary tracking stock has been distributed as a dividend on P stock to P shareholders.

Conceptually, subsidiary tracking stock (and tracking stock generally) involve the "vertical" division of rights to the income and assets of the issuing corporation. It therefore differs fundamentally from the usual "horizontal" division of interests in a corporation -- represented by common stock, preferred stock and warrants -- such horizontal interests reflecting a pro rata interest in all corporate income and assets but participating only above or below a give." threshold.

In evaluating the use of subsidiary tracking stock, there may be several reasons why it is not desirable to issue equity securities of S directly to third parties, or, in an acquisition setting, to leave S equity outstanding, including:

- -- The inconvenience and inefficiency of having a minority stock interest outstanding in a subsidiary corporation.
- -- If the minority stock interest exceeds 20% of the vote or value of the subsidiary, the inability to include S in P's consolidated federal income tax return.
- -- The inability to step up the tax basis of S assets via a Section 338[2] election if P fails to acquire at least 80% of the S stock. (The ability to make a Section 338 election is of limited significance following repeal of the General Utilities doctrine in the Tax Reform Act of 1986, however.)

The discussion of subsidiary tracking stock in this part of the report is confined to publicly traded equity securities. In each of the cases examined, there appears to be a practical assurance -- by way of a public commitment to share-holders, or otherwise -- that the stated dividend policy based on S performance will be carried out, even though such commitment may not be legally binding.

[2] "Section" references herein are to the Internal Revenue Code of 1986, as amended.

Typical characteristics of subsidiary tracking stock issues to date are as follows:

(i) Dividend Policy. P's Board of Directors adopts a policy that P will pay out as dividends on the subsidiary tracking stock an amount, such as 25%, of a hypothetical separate earnings base of S. The hypothetical separate earnings base is designed to represent the amount that would have been earned by S on a stand-alone basis, disregarding transactions between P and S that would vary the value of S from the value it would have as a free-standing public company. The dividend policy for the subsidiary tracking stock is expressly stated not to be binding on P's Board of Directors, although it is also stated that the Board has no present intention of changing the dividend policy. Among other things, the dividend policy could be altered to take into account changes in P's financial situation.[3]

(ii) Discrimination Among P Classes of Stock. P may be entitled, in its sole discretion, to pay dividends on the subsidiary tracking stock irrespective of the amount of the dividend paid (if any) on ordinary common stock of P that is also outstanding. Similarly, the level of dividend payout on ordinary P common shares may impose no requirement of a dividend payment on subsidiary tracking stock. In one case examined, however, no dividend may be paid on subsidiary tracking stock unless a dividend also is paid on ordinary P stock, although for a significant period of time there may be no fixed relationship between the dividend level on the two classes of stock.

(iii) Conversion Rights. P has the right (but not the obligation) to redeem outstanding subsidiary tracking stock by issuing ordinary P stock in exchange therefor. In some cases,

---

[3] Depending on the context in which the subsidiary tracking stock was issued, the issuing corporation may or may not be legally obligated to adhere to the stated dividend policy in the absence of any change in the operative facts.

such conversion may occur only after the subsidiary tracking stock has been outstanding for a minimum period of time, such as 10 years (except in the case of an earlier disposition of S, or substantially all of S's assets). The conversion ratio may be determined under a formula intended to reflect the relationship of (x) the value of the subsidiary tracking stock (and, therefore, S) at the time of conversion to (y) the then-current trading price of the ordinary P stock.[4] The right of P to effect the conversion may be dependent on P having met the dividend policy for the subsidiary tracking stock for a given period of time prior to the conversion. Conversion, generally on the basis indicated above, is mandatory if the S stock, or a substantial portion of the S assets, are disposed of. In no case do holders of subsidiary tracking stock have the right to force a conversion into ordinary P shares (or S shares).

(iv) Liquidation Rights. On liquidation of P, holders of subsidiary tracking stock are entitled to share pro rata in all assets of P with the ordinary P common stockholders according to a fixed allocation ratio. The ratio is generally reflective of the separate values of P at S at the time the ratio is fixed -- i.e., upon issuance of the subsidiary tracking stock.

(v) Minimum Value "Hedging" Obligation. In some cases, where subsidiary tracking stock has been issued as consideration for the acquisition of S, a contract may obligate P to make a

[4] The effect of this conversion ratio generally is to give holders of subsidiary tracking stock value in ordinary P stock approximately equal to the then-current value of the subsidiary tracking stock (and, in general, S). In one case examined, however, the "(y) element" of the conversion ratio is fixed at the time of issuance of the subsidiary tracking stock. In that case, subsequent fluctuations in value of ordinary P stock may result in holders of subsidiary tracking stock realizing more or less than the full value of S upon a conversion into ordinary P stock.

payment to certain holders of subsidiary tracking stock several years following issuance of the stock equal to the excess of (x) a prescribed value over (y) the then-trading price of the subsidiary tracking stock. This obligation provides an incentive for P to maintain the value of the subsidiary tracking stock through dividend payments (or otherwise).

Notwithstanding the intention that subsidiary tracking stock perform as though it were stock of S, there are several important differences between the subsidiary tracking stock issues examined and an actual equity interest in S:

(i) The insolvency of P would render the subsidiary tracking stock worthless, even though S itself had performed well and has significant value. In such a case, creditors of P would completely block holders of subsidiary tracking stock from their opportunity to realize on the value of S.[5]

(ii) The absence of adequate corporate surplus in P may prevent the payment of dividends on subsidiary tracking stock, notwithstanding the presence of earnings (and surplus) in S.[6]

---

[5] Of course, depending on the specific facts, the issue of P's insolvency might not be material as, for example, if P were a holding company without other assets except subsidiaries and had no liabilities.

[6] The surplus limitation may be avoidable under some circumstances, however. See note 19, infra.

(iii) The linkage in value between the subsidiary tracking stock and the actual common stock of S generally will be indirect and approximate. Particularly since P's Board of Directors generally is free to vary the level of dividends on subsidiary tracking stock, there may be no necessary relationship between the value of subsidiary tracking stock and the value of a direct corresponding proportionate interest in S. In addition, certain increases in S net asset value may never be reflected in appreciation in value of subsidiary tracking stock if such increases in value do not (1) result in increases in dividend distributions on subsidiary tracking stock, or (2) increase the value realized upon conversion of subsidiary tracking stock into ordinary P stock.

On the other hand, because linkage between the value of the subsidiary tracking stock and the intrinsic value of actual S stock -- without the disadvantages that would attend actual third-party ownership of S stock -- is likely to be the *raison d'etre* of the arrangement, an ongoing close relationship between the value of S and the value of the subsidiary tracking stock may be sought, and, in some cases, expected. Furthermore, some subsidiary tracking stock transactions contain economic disincentives to alteration of the stated dividend policy for the subsidiary tracking stock.[7] For example, failure to maintain the

[7] There may also be legal restrictions on the alteration c: the dividend policy. *See* note 3, *supra*.

stated dividend policy for a sufficient period of time may preclude P's conversion of subsidiary tracking stock into ordinary P stock.[8] Failure to maintain adequate value in the subsidiary tracking shares also may bring into play P's contractual price support obligation.[9] Although these factors suggest a relationship between the value of the subsidiary tracking stock and the value of S, since, by hypothesis, the stock of S is not publicly-traded, it is probably impossible factually to verify the expected co-incidence of value between S and the subsidiary tracking stock with any degree of accuracy.

(iv) Holders of subsidiary tracking stock generally have no specific property interest in the stock (or assets) of S. On a

---

[8] P generally will desire flexibility to force conversion of the subsidiary tracking stock and thereby shift the economic benefit of S ownership to the holders of ordinary P common stock, or simply eliminate the separate participation in S represented by the subsidiary tracking stock.

[9] See point (v), p. 7, supra. In one case examined, dividends on the subsidiary tracking stock are cumulative, and failure to pay dividends on the stock may prevent any payment of dividends on (or redemption of) ordinary P common shares. Moreover, continued failure to pay dividends or the subsidiary tracking stock permits holders of the subsidiary tracking stock, voting as a class, to elect a majority of the P Board of Directors. The obvious incentives for P to maintain the stated dividend policy on this subsidiary tracking stock clearly increases the likelihood that performance of that stock will be closely linked to S performance.

liquidation of P, holders of subsidiary tracking stock would receive only a pro rata portion of P's assets, in the same manner as the holders of ordinary P shares. Thus, upon liquidation of P, holders of subsidiary tracking stock have no special rights to appreciation in the value of S assets, but may benefit from an allocation formula that reflects the relative separate values of P and S when the subsidiary tracking stock was issued.[10]

(v) Holders of subsidiary tracing stock have no voting rights in S (except indirectly through any control they may exercise over P).[11] Predictably, however, holders of subsidiary tracking stock vote as a class, and majority approval of that class is required as to matters that would adversely affect their rights as holders of subsidiary tracking stock.

Part II - Federal Income Tax Issues Potentially Raised by Subsidiary Tracking Stock

Initially, two questions arise as to the federal

---

[10] See the description of the rights of holders of subsidiary tracking stock upon liquidation of P at point (iv), p. 7, supra.

[11] In one case examined, approval of a majority of the holders of subsidiary tracking stock, voting as a class, is required for any sale of the stock of S or a substantial portion of the assets of S.

income tax treatment of subsidiary tracking stock: (1) Is the interest created through issuance of subsidiary tracking stock a current equity interest? (2) If a current equity interest is created, in what entity is the interest created and what is the nature of the equity interest -- i.e., is it stock of P or stock of S, an equity interest other than stock in either, or an equity interest m some other asset or entity?[12]

The Committee believes it is clear that the forms of subsidiary tracking stock examined represent a present equity interest for tax purposes. The holder of such subsidiary tracking stock has no creditor or other non-equity rights in or against any entity.

---

[12] In Revenue Procedure 87-59, 1987-43 I.R.B. 23, the Internal Revenue Service added tracking stock to its list of '"Areas Under Extensive Study in Which Rulings or Determination Letters Will Not Be Issued Until the Service Resolves the Issue Through Publication of a Revenue Ruling, Revenue Procedure, Regulations or Otherwise." Rev. Proc. 87-3, § 5, 87-1 I.B.B. 27, 31 ("Areas Under . . . Study . . .") is supplemented as follows:

> "Section 7701 -- Definitions -- The classification of an instrument that has certain voting and liquidation rights in an issuing corporation but whose dividend rights are determined by reference to the earnings of a segregated portion of the issuing corporation's assets, including assets held by a subsidiary."

Rev. Proc. 87-59, § 2. It is understood that no substantive significance was intended by addressing this issue under Section 7701

Moreover, as a matter of non-tax law, the holder possesses each of, the three rights that are the hallmark of an equity interest in a corporation: the right to vote, the right to receive dividends, and the right to capital and surplus on liquidation of P.[13]

A more complex set of questions is presented as to the identity for tax purposes of the issuer of the subsidiary tracking stock.[14] Resolution of this question may depend on the Internal Revenue Code provision under consideration. The following issues have been mentioned as possibly implicated by the question as to the identity of the issuer of subsidiary tracking stock:

- May subsidiary tracking stock be sold by P without recognition of gain under Section 1032(a) or under some other section of the Code?
- If subsidiary tracking stock is distributed by P pro rata as a dividend to P shareholders, (i) is the distribution non-taxable to P shareholders under Section 305(a), and (ii) is the distribution free of tax to P under Section 311(a)(1) (or some other section)? Is Section 355 potentially applicable to the distribution?

---

[13] See Himmel v. Commissioner. 338 F.2d 815 (2d Cir. 1964).

[14] As a matter of corporate law, it is clear that P is the issuer of the subsidiary tracking stock.

- -- If subsidiary tracking stock is issued to S shareholders in a forward merger of S into a P subsidiary, does the subsidiary tracking stock represent non-qualifying subsidiary stock that renders the transaction taxable?[15]

- -- If subsidiary tracking stock is exchanged for ordinary P stock, is the transaction an exchange of common stock for common stock that qualifies as tax- free under Section 1036(a)?

- -- Following a distribution (or other issuance) of subsidiary tracking stock, do P and S constitute an affiliated group of corporations under Section 1504 eligible to file a consolidated federal income tax return?

In general, each of the above raises the question as to whether the subsidiary tracking stock should be characterized as other than stock of P.[16] The most important element of the legal analysis appears to be the extent of assurances that performance in the value of subsidiary tracking stock is equivalent to that of actual S stock. For these purposes, "performance" of stock

[15] Under Section 368(a)(2)(D)(i), if any stock of the acquiring subsidiary corporation is used, the transaction will fail to qualify as tax-free under that section.

[16] One possible characterization of tracking is as stock of S. Characterization of subsidiary tracking stock as stock of S presents no special conceptual problem to the extent the asset being tracked is stock of S. However, as discussed below, tracking stock, of which subsidiary tracking stock is only one class, could involve a tracking of assets other than stock of a single corporate subsidiary.

should be considered to include both the right to receive distributions of earnings as well as to participate in fluctuations in net equity value.

The exact structure of a given issue of subsidiary tracking stock will determine the extent to which performance of S will result in equivalent performance in the subsidiary tracking stock. Each term of the subsidiary tracking stock that has the effect of producing linkage in performance between the subsidiary tracking stock and S stock must be taken into account in evaluating the status of a given issue of a subsidiary tracking stock. Although not comprehensive, the following factors would likely be taken into account in determining the degree of this linkage:

-- The extent to which dividend policy for subsidiary tracking stock is linked to earnings of S, without regard to the earnings of P. To the extent that (i) the dividend policy with respect to the subsidiary tracking stock is dependent only on earnings of S (and not P), and (ii) the dividend policy calls for distribution of a significant proportion of S's earnings, the subsidiary tracking stock is linked in performance to the stock of S.

-- Whether the ratio for conversion of subsidiary tracking stock into ordinary P shares is determined at the time of issuance of the subsidiary tracking stock or instead floats with the values of ordinary P stock and the subsidiary tracking stock. A floating conversion ratio tends to show linkage; a fixed ratio does not.

-- If P's ability to withdraw cash from S is unrestricted, an absence of linkage is indicated -- unless the effect of such withdrawals is overridden by constructing a hypothetical S -- the hypothetical S not being affected by such withdrawals -- for purposes of effecting dividend policy, etc., on subsidiary tracking stock.

-- Whether holders of subsidiary tracking stock have the right to receive actual S stock in exchange for subsidiary tracking stock. Such a right would strongly tend to show linkage if the exchange ratio is fixed at the time of issuance of the

subsidiary tracking stock. (Depending on the nature of the rights of the holder of the subsidiary tracking stock to obtain stock of S, the subsidiary tracking stock could represent a debt claim instead of an equity interest in P.)

Also tending to show linkage to performance of S is the ability of holders of subsidiary tracking stock to control S -- and not P -- through the exercise of voting rights. The converse situation -- in which holders of subsidiary tracking stock are limited in their voting control to indirect control of S through voting of a class of P stock -- may not indicate an absence of linkage, however, where subsidiary tracking, stock holdings are widely dispersed.[17]

[17] A lack of direct control of S by holders of subsidiary tracking stock will generally affect the linkage bet veer, the subsidiary tracking stock and S stock.

The foregoing analysis of subsidiary tracking stock may be illustrated by examining a polar case, which differs significantly from the subsidiary tracking stock transactions described above. In the Committee's view, a clear case for treating subsidiary, tracking stock as other than stock of P (and, possibly, but not necessarily, an equity interest in S) would exist where the holder of the subsidiary tracking stock possesses, as a matter of legal entitlement, in all, or virtually all circumstances:[18] (1) the right to receive dividend distributions limited to earnings of S; (2) the right to realize on the net equity value of S upon a sale of all or part of S, or upon liquidation of S (or P), such net equity value being reduced only by dividend distributions described in (1) above; and (3) the right to force a liquidation or sale of S except in an unusual case where such right might not be a material aspect of the value of S.

The polar case does not assume that holders of the subsidiary tracking stock have the right to control S; it being concluded that the absence of this right of control should not defeat a finding of complete linkage, at least where the

---

[18] Note that the reference here is to a legally enforceable right, embodied either in the subsidiary tracking stock itself or in ancillary documents.

subsidiary tracking stock is widely held. In addition, the right to receive actual S stock in exchange for subsidiary tracking stock has not been regarded as necessary for complete linkage.

Thus, in the polar case, holders of subsidiary tracking stock would receive current distributions based on the earnings of S. In addition, to the extent not distributed, S earnings would increase the residual value that would be available to the holders of subsidiary tracking stock upon a sale of S (or its assets) or on liquidation of S (or P). Because such residual value ultimately will inure to the holders of subsidiary tracking stock, the market should reflect that residual value in the price at which the subsidiary tracking stock changes hands.

In the case where (1) both of the indicated economic rights in S performance -- the right to participate in S's current earnings (and not in the earnings of P as a whole), and the right to participate in S’s residual net equity value -- and (2) in situations in which it is relevant, the right to force a liquidation or sale of S are present as a matter of legal entitlement under all or virtually all circumstances, it would be difficult to conclude that a holder of subsidiary tracking stock is not, as a matter of substance, the holder of an equity

interest in S or in the stock of S (possibly even a stockholder of S).[19] It. is equally clear, of course, that the holder of this type of subsidiary tracking stock is not, as a matter of substance, a P shareholder.[20]

Returning to the issues noted on pp. 13-14, supra, the following consequences would result in this polar case (which, as noted above, differs significantly from the actual subsidiary tracking stock transactions discussed above):

-- If P sells subsidiary tracking stock, Section 1032(a) is inapplicable and the question of P's gain or loss on the transaction must be analyzed

---

[19] This conclusion would be inescapable if (i) the rights of a holder of subsidiary tracking stock vis-a-vis the stock and assets of S were superior to the rights of P creditors and (ii) corporate surplus restrictions in P could not impair participation by holders of subsidiary tracking stock. The practical equivalence of legal superiority to P creditors and the absence of surplus restrictions might be achieved through a holding company structure (in which the holding company has no liabilities and has assets consisting only of stock of subsidiaries), or, alternatively, if a term of the subsidiary tracking stock were that P incur no more than a predetermined level of liabilities, and maintain adequate surplus, and, upon failure to satisfy either condition, redemption of the subsidiary tracking stock was required. Similar restrictions have been employed in certain transactions. See Jassy, Issuances of Floating Rate Preferred Stock by Special Purpose Subsidiaries of Loss Corporations. 39 Tax Law. 519, 525-26 (1986).

[20] The possibility that a holder of subsidiary tracking stock is the owner of an interest in an entity that owns S is considered in part IV.C., infra.

under other provisions of the tax law.[21] If the subsidiary tracking stock is treated, in substance, as S stock, then P's basis in the subsidiary tracking stock would be that part of P's basis in its S stock allocable to the subsidiary tracking stock. If, however, the subsidiary tracking stock were considered a hybrid security that possessed sufficient characteristics of S stock to disqualify it as P stock but yet did not constitute stock of S, P would in theory have a zero basis in the subsidiary tracking stock.

-- The distribution of the subsidiary tracking stock to P stockholders is, in general, a distribution of property that is taxable to its stockholders as well as the distributing corporation. If S represented a five-year active business, the distribution might in theory qualify as a spin-off under Section 355.[22] Unless the distribution qualifies under Section 355, P would recognize gain based on the excess of the fair market value of the subsidiary tracking stock over its adjusted basis in the stock under Section 311(b)(1).[23]

---

21 Under a possible analysis, the transaction might be regarded as equivalent to the receipt of a deposit or the granting of an option, and, hence treated as an open transaction.

The possibility that Section 1032(a) should apply because the transaction represents a "primary"-type offering of an interest in an entity is discussed in Appendix B to this report.

22 Likely preventing spin-off treatment, however, would be P's continued formal ownership of 100% of the S stock, so that either the distributees of subsidiary tracking stock would not receive "control" of S, or P's stock retention might be considered to involve a tax avoidance plan in violation of Section 355(a)(1)(D)(ii).

23 Under an open transaction analysis, the tax consequences to P would be postponed as in the case of the issuance of an option by P to its stockholders.

-- If the subsidiary tracking stock is issued together with ordinary P stock as consideration in a forward subsidiary merger, and the subsidiary tracking stock is considered to represent stock of S, the merger would fail to qualify as tax-free under Section 368(a)(2)(D) due to the presence of stock of the acquiring subsidiary. The transaction perhaps could qualify as a Type C reorganization if the subsidiary tracking stock were considered stock of S. In that case, however, the P stock would constitute "boot," so that the overall transaction would have to satisfy the "boot relaxation" restrictions.[24]

-- The exchange of P common stock for subsidiary tracking stock would fail to qualify as tax-free under Section 1036(a).[25]

---

[24] Section 368(a)(2)(B).

[25] Even if the subsidiary tracking stock were viewed as a class of P stock, the question arises whether such stock represents common stock of P as required for a tax-free exchange for common stock of P under Section 1036(a). See Carnahan v. United States. 188 F. Supp. 461 (D. Mont. 1960), quoting Elko Lamoille Power Co. v. Commissioner, 50 F.2d 595, 596 (9th Cir. 1931), to the effect that "the common shareholder is an owner of the enterprise in the proportion that his stock bears to the entire stock, and is entitled to participate in the management, profit, and ultimate assets of the corporation . . . ." 188 F. Supp. at 466. The view apparently reflected in the quoted language is that a holder of common stock participates pro rata in all corporate distributions and upon liquidation, and, therefore, that a holder who does not fully participate on a pro rata basis does not hold common stock, at least for purposes of Section 1036(a). See also Rev. Rul. 54-65, 1954-1 C.B.101, discussed in the text at notes 35-37, infra. If the subsidiary tracking stock were viewed as stock of P and Section 1036(a) were considered inapplicable, the exchange of P stock for subsidiary tracking stock might nevertheless qualify as a tax-free recapitalization under Section 368(a)(1)(E).

-- The issuance of subsidiary tracking stock could prevent P from owning at least 80% of the value of the stock of S, at least if the subsidiary tracking stock is considered stock of S. In that case, the two corporations would not be considered affiliated and could not file a consolidated federal income tax return. Section 1504(a)(2)(B).

Several important characteristics separate the hypothetical polar case from the subsidiary tracking stock transactions reviewed previously. For example, in the subsidiary tracking stock cases examined, but not in the hypothetical polar case, upon a liquidation of P, holders of subsidiary tracking stock would participate pro rata with the ordinary P stockholders in any appreciation in value of S assets, rather than receiving alone the value of S assets.[26] Moreover, in the actual cases examined, the possibility exists that holders of subsidiary tracking stock may fail to participate in earnings of S, or in increases in value of S. Stated differently, the holders of such subsidiary tracking stock generally do not, for several reasons, have the legal or practical assurance of participating in S performance, notwithstanding the issuer's attempt to create stock that would closely track S performance:

---

[26] Correlatively, holders of subsidiary tracking stock would, in such cases, participate in appreciation of P assets other than S.

First, there may be market uncertainty regarding future dividend flows on subsidiary, tracking stock due to a possible change in policy by the P Board of Directors -- as a result, for example, of reverses in P's businesses other than S. Second, if, for any reason, market forces do not result in subsidiary tracking stock reflecting the value of S, a conversion of subsidiary tracking stock into ordinary P stock (even if based on the value of the subsidiary tracking stock on the con-version date) will not confer value on holders of subsidiary tracking stock equal to the value of S. The market value of the subsidiary tracking stock may diverge from the value of actual S stock due to the absence of an assured right for holders of subsidiary tracking stock to participate in appreciation in value of S's assets.[27] The inability to participate in growth in asset value may be wholly or partially neutralized, however, if increased asset value can be expected to be reflected in increased S earnings, and increased distributions on subsidiary tracking stock.[28]

---

[27] The presence of a contractual obligation of P to make payments to holders of subsidiary tracking stock where the value of subsidiary tracking stock does not reach a defined target (see the discussion of the "hedging obligation" at pp. 7-8, supra) probably works in a contrary direction, and indicates an economic incentive for P to have subsidiary tracking stock values reflect at least an expected value of S stock (although the expected value could differ significantly from an actual S stock value*.

[28] An interesting issue is raised by hypothesizing a case in which the subsidiary tracking stock does not participate in P's operations other than S and, yet, for one reason or another, the subsidiary tracking stock is not treated as stock of S. The Committee is not aware of any direct support in present law for treating stock nominally issued by a corporation as not in fact issued by that corporation based on the linkage to performance of a subsidiary, but the question of how such an equity interest ought to be characterized remains, and is discussed in part IV, below.

To summarize, the subsidiary tracking stock transactions of the type reviewed above have differences in major respects from the rights that a holder would possess through actual ownership of S stock. One major set of differences derives from (1) the right of P creditors to stand ahead of holders of subsidiary tracking stock in participation in the assets of S, (2) the possibility that an absence of P earnings might prevent distribution of S earnings, and (3) the possibility that P might be liquidated, with the value of S appreciation after a certain date being dispersed among all P stockholders (the "P insolvency/liquidation risk"). A second major set of differences between ownership of subsidiary tracking stock and ownership of S stock derives from (a) the potentially imperfect translation of S earnings into subsidiary tracking stock distributions, and (b) the potential absence of subsidiary tracking stock participation in growth in S net equity value (the "economic variance risk"). The economic variance risk derives from the absence of legal assurance (or

adequate practical assurance) that subsidiary tracking stock will perform equivalently to S stock, based, among other things, on the factors referred to at pp. 15-16, supra.

The Committee believes that the economic variance risk should -- at least for the subsidiary tracking stock transactions examined -- generally preclude a holding under current law that subsidiary tracking stock is in substance stock of S or not stock of P under present law.[29]

Part III -- Tax Law Precedents that Have Considered Tracking Stock Issues

As noted, no existing tax law precedents provide useful guidance in addressing subsidiary tracking stock issues under present law. This part of the report will review the circumstances in which the tax treatment of tracking stock has been considered to date in an effort to understand the approaches that have been taken and that might be taken in

[29] This conclusion is consistent with the decisions in Union Trusteed Funds, Inc. v. Commissioner, 8 T.C. 1133 (1947), acq., 1947-2 C.B. 4, and Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965), rev'g Beckett v. Commissioner, 41 T.C. 386 (1963), both of which are discussed in part III of this report. Neither decision is sufficiently close in point to provide meaningful guidance in the treatment of subsidiary tracking stock, however.

responding to tracking stock issues (if such a response is appropriate).

Consideration is given first to tracking stock issues in the regulated investment company ("RIC") context, the area in which tracking stock issues have been developed to the greatest extent. Discussed next is Section 1297(b)(4), which contains a grant of regulatory authority in the passive foreign investment company ("PFIC") setting, designed to prevent avoidance of the PFIC rules through use of tracking stock. Finally, the decisions in Maxwell Hardware and Farley Realty are discussed.

A. RIC Precedents

"Series funds" have long been utilized in the RIC context. In general, a series fund is a single entity (for present purposes, organized as a corporation), with several separate investment funds. The corporation then issues multiple series of stock, with each series having rights corresponding, both to dividends and on liquidation, to a given investment fund.

In Union Trusteed Funds, Inc. v. Commissioner,[30] the

[30] Supra note 29; see Rev. Rul. 56-246, 1956-1 C.3. 316; see also G.C.M. 28629 (January 25, 1955), holding a transfer of securities from one series fund to another non-taxable, relying on Union Trusteed Funds.

government argued that each "series" of a series fund should be treated as a separate corporate entity.[31] Noting that arguments favoring separate corporation treatment may have been both "logical" and "persuasive," the Tax Court rejected the government's position, stating that it felt constrained by (1) the failure of Congress to provide separate corporation treatment in light of its presumed knowledge of the common use of series funds, as well as (2) the Treasury Department's failure to mandate such treatment in regulations.[32]

In the Tax Reform Act of 1986, in response to a request by industry representatives, separate corporation treatment was provided legislatively -- and Union Trusteed Funds was overruled -- for series funds organized as corporations.[33]

---

[31] The most significant consequence of the government's position was that capital losses in one series could not be offset against capital gains in another series.

[32] 8 T.C. at 1137.

[33] Section 851(h), added by Tax Reform Act of 1986, Pub. L. No. 99-514, § 654(a), 100 Stat. 2298 (hereinafter, "Tax Reform Act of 1986"). Section 851(h) defines a "fund" subject to separate corporation treatment as follows:

> "[T]he term 'fund' means a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets."

Prior to the adoption of Section 851(h) in the 1986 Act, the Service had issued a number of private rulings holding that a series fund organized in the form of a trust would qualify for separate corporation treatment.[34] Of possible relevance to the pre-Act distinction is that, in the trust context, but not the corporate context, if one fund becomes insolvent, assets of other funds cannot be reached to pay creditors of the first fund.

In Revenue Ruling 54-65,[35] the Service was faced with the application of the precedessor of Section 1036 to the

---

[34] E.g., Priv. Ltr. Rul. 8422028 (February 23, 1984); Priv. Ltr. Rul. 8444011 (July 26, 1984); Priv. Ltr. Rul. 8444064 (July 31, 1984); Priv. Ltr. Rul. 8446029 (August 15, 1984); Priv. Ltr. Rul. 8451029 (September 14, 1984); Priv. Ltr. Rul. 8453058 (October 1, 1984); Priv. Ltr. Rul. 8501040 (October 5, 1984); Priv. Ltr. Rul. 8502019 (October 12, 1984); Priv. Ltr. Rul. 8502021 (October 12, 1984); Priv. Ltr. Rul. 8502022 (October 12, 1984); Priv. Ltr. Rul. 8506065 (November 13, 1984); Priv. Ltr. Rul. 8507013 (November 16, 1984); Priv. Ltr. Rul. 8509072 (December 4," 1984); Priv. Ltr. Rul. 8510013 (December 5, 1984); Priv. Ltr. Rul. 8512056 (December 27, 1984); see G.C.M. 39211 (January 13, 1984).

[35] 1954-1 C.B. 101.

exchange of shares of one series of a corporate series fund for shares of another series of the same fund. Plainly influenced by the opportunity for tax-free exchanges of non-like kind property if Section 1036 were to apply, the Service held that the stock of a series fund was a "special stock" that qualified neither as "common stock" nor as "preferred stock" of the corporation, stating:

> "The special stock in the instant case . . . is not common stock since the holders thereof do not share ratably either in the earnings of the corporation or in its assets on liquidation, it being specifically provided that the holders of shares of any designated series have no interest in the assets or income of any other series. Furthermore, the certificate of incorporation provides for the issuance of common stock, which stock has the normal characteristics of common stock and is entirely separate and distinct from any of the classes of special stock therein considered. Neither is the special stock a preferred stock since the holders thereof are not preferred as to dividends out of the entire earnings of the corporation and are restricted to the earnings of the segregated assets representing his particular class of special stock. Likewise the holder of special stock has no preference in the general assets of the corporation on liquidation, excepting the right to share ratably with other members of his class in the segregated assets representing that particular class of special stock. Consequently an exchange of special-stock for special stock of a different series represents a taxable exchange of property, the gain or loss from which would not be precluded from recognition for Federal income tax purposes by section 112(b)(2) [now Section 1036] of the Internal Revenue Code."[36]

---

[36] 1954-1 C.B. at 103. It is unclear from the Revenue Ruling whether any "common stock" of the RIC (in addition to the" stock of the various series) was in fact issued, or was simply authorized. Since, however, the holders of the special stock for each fund possessed all residual rights in the fund in question, the special stock in all respects resembled traditional common stock -- as regards the holders rights to participate in assets and earnings -- except that the rights extended only to a "vertical slice" of the RIC's assets. (Each share of special stock had voting rights pari passu.)

The noteworthy aspect of the ruling is its adoption of the premise -- at least for purposes of Section 1036 -- that only a stock interest evidencing a "horizontal" participation in all corporate earnings and assets may qualify as common or preferred stock of a corporation. On the one hand, no theory previously known in either non-tax corporate law or the tax law supports this premise.[37] On the other hand, the result under the ruling clearly seems correct as a policy matter.

B. PFIC Regulatory Authority

The Tax Reform Act of 1986 imposed a new regime of tax on United States shareholders of a PFIC. In general, a foreign corporation is a PFIC if either (1) 75 percent of its

---

[37] Although the broad language contained in Carnahan v. United States, note 25 supra, is to a similar effect, the issue for decision in that case did not involve the validity of vertical splitting.

gross income for the year is passive income or (2) the average percentage of the corporation's assets that produce, or are held for the production of, passive income is at least 50 percent.[38] Recognizing the possible opportunity to avoid PFIC status by (x) placing a passive investment portfolio in an operating company, so that neither the income nor asset tests would be satisfied, and (y) issuing a class of tracking stock linked to the investment portfolio, the following grant of regulatory authority was provided: "[u]nder regulations prescribed by the Secretary, where necessary to carry out the purposes of this part, separate classes of stock (or other interests) in a corporation shall be treated as interests in separate corporations."[39] To date, no regulations have been issued or proposed under this provision.

---

[38] Section 1296(a).

[39] Section 1297(b)(4). The legislative history of the provision states as follows:

> "A foreign corporation engaged in an active trade or business generally will not be a PFIC. If such a corporation issues a separate class of stock and uses the proceeds to invest in a PFIC or to invest directly in passive assets, the corporation will still probably not be a PFIC under the general definition. However, in these instances, it may be necessary for regulations to treat the separate class of stock as [sic] a separate corporation for this purpose. In that event, the separate corporation will in all likelihood be a PFIC and the attribution rules will attribute any lower-tier PFIC stock to the ultimate U.S. investors." Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 1032 (Comm. Print 1987)

C. Maxwell Hardware

The decision in Maxwell Hardware Co. v. Commissioner[40] involved an investment company (formerly engaged in the hardware business) that "rented" its net operating loss carryovers to two investors. The mechanism used was a special class of stock of the investment company linked in performance to the company's "real estate department," which was formed and run by the two investors.[41] The investors had, effectively, 100% of the

---

40 Supra note 29.

41 The class of stock in question was nominally non-voting preferred stock, which was purchased by the two investors for the amount needed to undertake the real estate project. The real estate department was accounted for separately from the balance of the corporation. By agreement, the corporation agreed not to discontinue the real estate operations for a period of six years, and the investors agreed not to sell their stock during the same period. After the six-year period, the investors had a put to the corporation and the corporation had a call from the investors; in either case, the purchase price was to be paid in kind in assets of the real estate department having a book value equal to the par value of the preferred stock plus 90% of the book value of the net assets of the real estate division in excess of such par value. One of the investors was appointed as Vice President of the corporation to have "complete control" and "full charge" of the real estate division. Dividends on the preferred stock were 6% of par value and were non-cumulative. In the event of liquidation, the preferred shareholders were to receive the par value of preferred stock plus (after payment of a fixed amount to the common shareholders) 80% of the corporation's remaining net assets. A five-year voting trust agreement was entered into by the common stockholders. The voting trust agreement did not transfer control to the investors; however, it was "understood" that one of the investors would be one of three directors. Shortly after the preferred stock was purchased, the corporation purchased from the investors the real property which was to be developed.

downside risk associated with the real estate department and 90% of the upside. The Tax Court attempted to deny the offset of the real estate department's income against the corporation's operating loss carryover, relying on the <u>Libson Shops</u> doctrine. The Ninth Circuit rejected the application of <u>Libson Shoos</u> (and Sections 269 and 382 as well), and, finding no other basis to attack the scheme, upheld it. Although the Court of Appeals warned that Section 482 could be used to combat a similar scheme in the future, it held that since the applicability of that section had not been raised by the Commissioner in its Notice of Deficiency, it could not be considered on appeal.

The legislative history of the 1986 Act amendments to Section 382(a) indicates an intention to respond to the net operating loss rental scheme in Maxwell Hardware by treating the stock held by the original shareholders as not constituting stock for purposes of determining whether an "owner shift" had occurred.[42] Under this approach, only the stock acquired by the "investors" would be treated as stock of the corporation, with the result that a 100% owner shift would result from the investors' purchase, thereby triggering a limitation on the utilization of the corporation's NOLs. The temporary regulations issued under Section 382 do not reach this result, however. Relevant here is Treas. Reg. § 1.382-2T(f)(18)(ii)(A) which deals with interests that would constitute stock, except that their participation in corporate growth is "disproportionately small."[43] Although the retained stock interest in

---

[42] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-173 (1986).

[43] The cited subclause provides in full as follows:

> "(A) As of the time of its issuance or transfer to (or by) a 5-percent shareholder, the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation . . . ."

The other two conditions to application of the rule treating stock as not stock -- whether an owner shift would occur if the putative stock interest were held not to be stock, and the corporation's NOL not being de minimis -- would be satisfied- under the facts of Maxwell Hardware.

Maxwell Hardware probably possessed a "disproportionately small" participation in. corporate growth, such was not true when the stock was issued or acquired by the original stockholders in Maxwell Hardware (since they held the only stock outstanding), and, as a result, the original investors' stock apparently would be treated as stock for purposes of Section 382.

D. Farley Realty

Farley Realty v. Commissioner[44] involved the tax treatment of an "equity kicker" arrangement. In addition to stated interest on a loan, a corporate debtor agreed to pay an amount equal to 50% of the appreciation in value of certain real property owned by the corporation,[45] the "kicker" right having no fixed termination date.[46] The Second Circuit held that a payment

[44] 279 F.2d 701 (2d Cir. 1960).
[45] Id. at 703.
[46] Id. at 705.

in satisfaction of the holder's right under the equity kicker did not represent deductible interest on the debt, and that the kicker represented an equity interest in the real property.[47] The Court found it unnecessary to address the Commissioner's argument that the kicker represented, in substance, a joint venture under New York law.[48]

E. Analysis of Precedents

Looking first at the case law precedents, both Union Trusteed Funds and Maxwell Hardware reflect a significant bias toward upholding the form of the tracking stock transaction -- probably an understandable response from the courts in the absence of any general pronouncements by the Treasury Department as to the proper treatment of the transactions. In so doing, Maxwell Hardware seems clearly to have confirmed the existence of a troublesome discontinuity in the tax law in the use of tracking stock. Of particular note in Union Trusteed Funds is the Tax Court's pointed references to the presumed Congressional awareness of, and failure to act with respect to, series funds, as well as the absence of guidance on the subject in the form of Treasury Regulations. Farley Realty provides limited guidance in

---

[47] Id. at 705-06.

[48] Id. at 706.

the present context, since there is no indication of the nature of the equity interest that was considered to exist.

Both the RIC and PFIC changes in the 1986 Act seem clearly to reflect a willingness to conform the tax treatment of tracking stock arrangements to their intended economic structure. In the PFIC area, the regulatory authority clearly contemplates that the government will disregard the effect of the insolvency/liquidation risk (discussed at p. 24, supra): inasmuch as assets of the "deemed" separate corporation would be available to meet claims of creditors of the corporation that nominally issued the tracking stock. The extent to which the economic variance risk may be disregarded in regulations to be adopted is not clear. In the RIC area, a series fund similarly is considered a separate corporation under Section 851(h) notwithstanding the insolvency risk: if fraud, or catastrophic losses in one series fund result in that fund's creditors reaching assets of another fund in the same corporation, holders of the first fund, treated as a separate corporation, would be affected by events occurring in another fund. The economic variance risk, as well as the risk of loss of value on liquidation of the RIC, would apparently not be present in a PTC series fund.

The approach taken in Revenue Ruling 54-65, supra, in applying the predecessor, of Section 1036 to a RIC series fund (prior to the effectiveness of Section 851(h)) is very far-reaching. In effect, the ruling holds that a participating interest in a corporation is not stock if it does not reflect a horizontal interest in all assets of the corporate issuer.

Part IV -- Tax Policy Issues Raised by Tracking Stock; Framework for Analysis

This part begins by considering the extent to which tracking stock arrangements present a tax policy concern. It is concluded that where a sufficiently high degree of correlation in performance exists between the tracking stock and the tracked property, a tax policy concern is present. There follows a discussion of two concepts that, in the Committee's view, may be helpful in developing rules in this area. First is the "correlation" analysis, which the Committee believes to represent the correct analytical framework for developing rules relating to tracking stock. Second, consideration is given to the nature of tracking stock. It is concluded that a tracking stock arrangement probably should be considered for at least certain purposes as if it gave rise to a separate entity for tax purposes -- with P and the holders of tracking stock each holding an equity interest in the entity that is considered to

own the tracked property. Finally, consideration is given to the circumstances under which tracking stock should be viewed as other than stock of P.

A. Tax Policy Issues Raised

A variety of transactions have occurred and may be expected to occur in which tracking stock issues are presented. It is submitted that the extent of the tax policy concern raised by any such transaction is a function of the degree of "correlation" in performance -- a concept considered in greater detail in Section B., below -- between (x) the tracking stock, and (y) the underlying or "tracked" property.[49] Where significant correlation in performance is present, holders of tracking stock will have acquired the functional equivalent of an economic interest in the tracked property, which interest, by hypothesis, differs greatly from a *pro rata* equity interest in P.

The view that significant correlation in performance between the tracking stock and the tracked property presents a tax policy concern arises from the divergence between the *form*

[49] The "tracked property" could, as discussed previously, include any corporate asset or group of assets -- stock of a subsidiary, an operating division or a single asset.

of the transaction (tracking stock is, of course, stock of P in form) and the transaction's substance, which involves the tracking stock holder having an economic interest in the tracked property, but not a pro rata interest in P's net assets (which a P shareholder would ordinarily have).

As an illustration of this proposition, consider a transaction in which P distributes, pro rata to its common shareholders, a class of tracking stock linked in performance to S. Assume that the rights accorded the holder of tracking stock assure a high degree of correlation in performance between the tracking stock and S. The policy premise under which this distribution would be tax-free to the distributees pursuant to Section 305(a) is that the shareholders have not altered their investment in P; they merely hold additional shares that evidence the same participation in the operations of P.[50] Upon receipt of the tracking stock, however, P share-holders have acquired an instrument that represents an equity participation in a single P asset, an interest that is qualitatively different from what would ordinarily be considered a share of P common (or preferred) stock.[51] The receipt of this participation right

---

50 E.g., S. Rep. No. 552, 91st Cong., 1st Sess. 150 (1969), reprinted in 1969 U.S. Code Cong. & Admin. News 2027, 2182.

51 The issue of when tracking stock should be regarded as other than stock of P for tax purposes is considered in greater detail in Section D, infra.

enables the P shareholder to vary its economic interest in P by disposing of either its P stock or the new participation right -- a possibility that does not arise where P stock is distributed on P stock.

Since the tax-free status of a distribution under Section 305(a) rests on the premise that P stock has been distributed, the qualification of the present distribution under Section 305(a) is thus called in question.

As a further illustration, consider the case where the tracked property is stock of S, and the ability of P and S to file a consolidated tax return is in question. Under Section 1504(a)(2)(B), P must hold at least 80% of the value of S (in addition to the requisite voting power) in order for P and S to file a consolidated tax return. If, due to the outstanding tracking stock, P has effectively transferred an equity interest in S -- a fact demonstrated by a significant degree of correlation in performance between the tracking stock and actual stock of S -- there is an obvious question as to the appropriateness of P-S consolidation. Moreover, where the tracked property is a division of P, there is a question whether any net operating losses or unused tax credits of P should be available to offset the income or attributable taxes of the division.

In the Committee's view, in cases where a sufficient degree of correlation between the tracking stock and the tracked property is present, it is appropriate to inquire whether the tracking stock more closely corresponds as a matter of substance to an equity interest in the tracked property (or, as discussed below, an interest in an entity that holds the tracked property), rather than a P stock interest. The transfer of an equity interest in the tracked property, or an interest in a separate entity that holds the tracked property, generally will have significantly different tax effects than the transfer of a P stock interest.

B. The Correlation Analysis

For analytical purposes, one can characterize a holder of tracking stock as owning an asset as to which there is some level of probability that the asset will perform in a manner that is related to the performance of the tracked property. The likelihood that the performance of the tracking stock will mirror the performance of the tracked property is referred to as the "correlation" in performance between the tracking stock and the tracked property. If there were a perfect, 100% correlation between the tracking stock and the tracked property, a holder would be indifferent between ownership of the two.[52] In such a case, P would, in substance, have the determination of the

---

[52] For the reasons discussed in part II of this report, in actual practice, the performance of tracking stock will seldom correlate perfectly with the performance of the tracked property. For example, the possiblity of P's insolvency almost always will affect correlation in performance, with the level of correlation decreasing as the likelihood of P insolvency increases. Additionally, where the tracked property is stock of S, if a holder of tracking stock does not have the right to vote for the election of S directors, or to force a sale of S assets, certain market participants -- e.g., those for whom the attractiveness of S is its break-up value -- will prefer s stock to tracking stock, thereby decreasing the correlation in performance between the two.

degree of correlation in any given case will depend entirely on the resolution of a factual question, and, in practice, the weighing of competing views of experts as to the degree of correlation present. The Committee believes such determinations would be time-consuming, expensive and uncertain for all parties.[53]

Having concluded that it is impractical to adopt the correlation approach directly as a standard for evaluating individual tracking stock arrangements, the Committee believes that an appropriate surrogate for such an approach would -- in the context of applying any given Code provision -- look to the presence of certain objective criteria in determining whether a given stock instrument may be expected to track the tracked property to a material or significant degree. Such criteria -- such as those set forth on pp. 15-16, <u>supra</u> -- reflect the rights of the tracking stock holder, and, thus represent the elements that would be taken into account in determining, as a matter of business reality, the correlation in performance

---

[53] Although, a determination of the degree of correlation present in each tracking stock transaction is concluded not to be practical, it should be borne in mind that the <u>qualitative</u> analysis called for under the correlation approach is not different from the type of analysis required in various other contexts in the tax law. Set forth in Appendix A to this report is a brief discussion of the analysis required in certain such contexts.

between the tracking stock and the tracked property. Under this approach, the presence of specified objective criteria in a given transaction would be considered sufficient to indicate that the requisite degree of correlation in performance was present, with the result that the tax treatment prescribed for tracking stock under a given Code section -- e.g., denial of Section 305(a) protection for distribution of such a tracking stock interest -- would be brought into play.

The manner in which these factors might be taken into account in the context of a variety of Code provisions is considered in Section D of this part.

C. Tracking Stock -- An Interest in What?

Once it is determined that a tracking stock interest represents a property right that differs materially from P common stock, one must then determine what the tracking stock interest *does* represent. Where the tracked property is stock of S, an obvious possibility is that the tracking stock represents stock of S. There are several difficulties in such an approach, however, which can be illustrated by reference to two examples previously discussed: First, referring to the tracking stock transactions described in part I, above, the P directors have broad flexibility in altering the dividend payout on the

tracking stock -- such an alteration potentially resulting in a shift in the participation in S from the tracking stock holders to the ordinary P shareholders. If the tracking stock holders actually possessed an interest in S, any reduction in their dividend payout would augment the residual value in which the shareholder participates; in fact, however, such augmentation seems unlikely in the cases examined, while it may be incorrect to say that the tracking stock holders hold an interest in P, it also seems incorrect to describe them as having an equity interest in S. Second, P's right to exercise voting control over the affairs of S is inconsistent with tracking stock being treated as S stock, since P could use such voting power to direct action by S in a manner inconsistent with the ownership of S by the tracking stock holders. If control of S is vested in P, it would seem improper to characterize the tracking stock holders as shareholders of S.[54]

[54] It should be noted that the differences between the rights of tracking stock holders and the rights of actual S shareholders as described in this paragraph do not arise in the context of the fictional entity suggested by the Committee. The rights of tracking stock holders in the fictional entity are precisely those accorded under the terms of the tracking stock instrument. The point is that it is not possible to describe tracking stock as having rights that resemble in any way the rights accorded any class of S shareholders under S's certificate of incorporation.

In the Committee's view, a more plausible conceptualization of a tracking stock arrangement would for most cases treat the tracking stock as if it represented an interest in a separate entity, with part of the interests in the entity being held by P, and the balance of the interests in the entity being held by the tracking stock holders.[55] This separate entity would be viewed as if it were the owner of the tracked property, whether it is stock of S, a P asset or assets other than stock (such as a P divisional business), or another asset.

In postulating the existence of a separate entity, the non-resemblance (as an economic matter) of the tracking stock to either a P stock interest or S stock interest is accurately

---

[55] The factors referred to in determining whether a given economic relationship constitutes a partnership for federal income tax purposes provide considerable support for the proposed separate entity characterization. Under the case law, a partnership is considered to exist if each of the following is present: (i) an enterprise is undertaken for the purpose of producing profits; (ii) the profits generated by the enterprise are shared jointly by two or more persons; and (iii) the persons sharing the profits do so as proprietors. E.g., Commissioner v. Culbertson, 337 U.S. 733 (1949); see 1 W. McKee, w. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners f 3.02(2] (1977).

reflected. Also more readily accommodated is the variable participation of P and the tracking stock holders.[56] Finally, the difficult issue of P's basis in the tracking stock may become soluble.

The application of the separate entity characterization is straightforward in most Code contexts. For purposes of applying the distribution rules, since the tracking stock is an interest in a separate entity, tax-favored treatment dependent

---

[56] Under the separate entity approach, a possible question--although, as discussed in part V.B., infra, one that does not affect the present analysis -- is the status of the deemed separate entity for federal income tax purposes. Referring to the criteria of the Section 7701 regulations, the entity would, in the first instance, be classified either as a partnership or as an association, given the presence of "associates" and an objective to carry on business for joint profit. Treas. Reg. § 301.7701-2(a)(2). The entity might be found to lack the corporate characteristics of limited liability and centralized management, but would presumably possess the characteristics of continuity of life and free transferability of interests. Thus, at least in some cases, partnership status would be indicated.

Under the approach taken by the Committee, however, there is not generally a need to reach the classification issue, since the Committee would not extend the separate entity analysis to the point of actually postulating an entity subject to Subchapter C or K. Moreover, it appears that if classification is required in any circumstance (see the discussion in Appendix B for an example), the Committee believes that the decision as to entity status probably is best made by reference to the exigencies of the analysis under the Code provision in question, rather than the Section 7701 regulation criteria. It would seem clearly within the Secretary's authority to alter the present Section 7701 regulation criteria by adoption of regulations applicable in a given case. See Larson v. Commissioner. 66 T.C. 159 (1976), acq, 1879-1 C.B. 1.

on characterization of the distributed stock as P stock would be unavailable.[57] The same is true in applying Section 1036. In the context of Section 1504, where the tracked property is a P subsidiary, it would be necessary for P to demonstrate its ownership of 80% of the value of the deemed separate entity (which, in turn, would be considered to own 100% of the stock of S) in order for affiliated group status to exist.[58]

Where a disposition of tracking stock results in a taxable transaction to P -- due, e.g., to the inapplicability of Section 1032(a) or 311(a)(1) -- the issue of P's basis in the tracking stock must be confronted.[59] An appropriate solution appears to be an allocation of P's basis in the tracked property. Assume, for example, that the tracked property is stock of S. If the tracking stock represents an interest in a fictional entity that owns 100% of the stock of S it is reasonable to treat P as having transferred the stock of S to the new entity solely in exchange for stock in the new entity, with P then taking a substituted basis in the stock of the

---

[57] E.g., Sections 305(a), 311(a)(1).

[58] P should, in the ordinary case, be considered to satisfy the 80% of voting stock test as to the deemed separate entity in light of its complete control over S.

[59] 59 The issues relating to the treatment of a sale of tracking stock under Section 1032(a) are considered in Appendix 3 to this report.

entity.[60] Such basis then would be-allocated between the shares disposed of (the tracking stock) and the shares retained by (the remainder of the shares of the fictional entity) based on their relative fair market values.

It is to be emphasized that the Committee views the separate entity that is deemed to be the issuer of tracking stock as a fiction whose purpose is to provide analytical consistency in the treatment of tracking stock arrangements. The Committee does not believe that the fictional separate entity should be subjected to tax (or, in general, treated as a pass-through entity whose owners are subjected to tax). With a few possible exceptions, the purpose of the fiction is to illustrate the nature of the transaction in question, and thereby to assist in the formulation of logical, consistent rules.[61]

---

[60] Section 358(a)(1). Even though the transfer to the fictional entity would take place only in connection with P's disposition of its tracking stock, it seems appropriate to characterize the incorporating transfer as having occurred previously, and as qualifying either as a Section 35; transaction or as a Type D reorganization notwithstanding the immediate disposition of shares of the fictional entity.

[61] It should be noted that, especially in view of the judgment that several aspects of the separate entity fiction would not have tax significance, other characterizations, not involving a separate entity, also could be appropriate. For example, the respective rights of the tracking stock holders and P could be viewed as a sharing or participatory interest which might or might not constitute a separate entity for tax purposes. The Committee believes that such alternate analyses can be made consistent with the separate entity analysis, which it believes to be both complete and correct.

To illustrate the approach suggested, tracking stock distributed as a dividend to P shareholders would be analyzed as a distribution of an interest in a separate entity -- rather than stock of P or S -- for purposes of applying Sections 305(a) and 311(b). Again, however, the fictional separate entity would not be subjected to tax under Section 11. Other simplifying assumptions -- such as treating distributions on the tracking stock as made from P's earnings and profits -- also are appropriate. The issue of the need for consistent tax treatment of tracking stock arrangements is considered further in part V.B, below.

D. When Should Tracking Stock be Treated as Not P Stock?

Where tracking stock is seen to represent a given level of probability that its holder will realize value equivalent to that which he would have realized had he held the tracked property directly, under what circumstances should tracking

stock be treated as stock that is not _P_ stock? To answer the question in the context of any given Code provision, in the Committee's judgment, the following considerations should be taken into account:

> (i) The nature and purpose of the Code rule or restriction in question.
>
> (ii) The presence of a good business purpose (or non-tax purpose) for the tracking stock structure.
>
> (iii) The likely correlation in performance between the tracking stock and tracked property under most circumstances.

Criteria (i) and (iii) require no explanation. In a sense, criteria (ii) is an obvious point of reference (_compare_ Section 269), although this test seems to have particular relevance in addressing the issue -- which is factual in nature -- whether stock nominally issued by P has so many characteristics not related to the value of P that the tax status of such stock as P stock is in question.

The Corporations Committee faced a somewhat similar issue when it considered the proper treatment of options and similar rights in the context of testing for affiliated group status under Section 1504(a)(4), as amended by the Tax Reform Act of 1984. That Committee rejected a so-called ambulatory approach that would inquire periodically whether it was likely

that an option or similar right would be exercised, taking into account fluctuations in value of the underlying stock (so that if the underlying stock had increased in value, rendering exercise of the option likely as an economic matter, the holder of the option would then be treated as the owner of the underlying stock, potentially terminating affiliated group status).[62] Instead, the Committee recommended an approach that looked to, among other factors, whether the feature in question was commonly found in commercial transactions.[63] Rather than reflecting any desire to prohibit novel business structures, the Committee's approach was designed to facilitate discrimination between commercially sound business transactions and non-commercial transactions that might exploit the factual ambiguity that results from significant but incomplete correlation in values among different types of instruments. The Committee believes that a similar analysis might profitably be adopted by the Treasury Department in assessing the treatment to be provided for tracking stock.

---

[62] New York State Bar Association Tax Section, Corporations Committee, Report on Tax Reform Act of 1984 Amendments to Section 1504(a), the Definition of "Affiliated Group", reprinted in 28 Tax Notes 895, 906, August 19, 1985.

[63] Id. at 904.

Three observations are appropriate regarding the application of the suggested analysis. First, as discussed in Section A., at some point, tracking stock transactions present an opportunity for tax avoidance. Second, tracking stock transactions have not been commercially typical. Third, there appears to be a significant question as to whether non-tax business motivations have given rise to tracking stock arrangements, and whether the arrangements might alternatively be implemented in a way that does not give rise to a tax avoidance opportunity (i.e. through the use of S stock instead of subsidiary tracking stock).[64]

Part V -- Possible Nature and Scope of Responses to Tracking Stock Arrangements

A. Nature of Possible Action

In the Committee's view, tax policy concerns with respect to tracking stock transactions are appropriately dealt with either through the issuance of Treasury Regulations or, possibly, through the vehicle of an Announcement or Revenue Procedure.[65] If there is a question as to the Treasury

---

[64] See pp. 4-5, supra; see also Maxwell Hardware, supra note 29.

[65] The decision in Union Trusteed Funds, supra note 29, implies that administrative action with respect to tracking stock would be respected if carried out through the issuance of regulations since (i) unlike series funds of a RIC (prior to the 1986 Act), there is no longstanding pattern of use of tracking stock arrangements, with Congressional inaction signaling a desire not to interfere with existing assumptions as to the tax treatment of these arrangements, and (ii) the decision clearly indicates that the Commissioner's argument for separate corporation treatment might have been accepted if his view had been reflected in Treasury Regulations. 8 T.C. at 1137.

In the context of any given Code section, ample authority to deal with tracking stock arrangements may be present in the regulatory authority provided under that section. E.g., Sections 382(k)(6)(B)(ii), 1504(a)(5)(A); see also Section 305(c).

Department's authority to deal with this issue administratively, the Committee recommends the adoption of suitable enabling legislation.[66]

Aside from any question of authority, the Committee believes that proceeding administratively is by far preferable to the adoption of statutory changes to respond to tracking stock arrangements for several reasons: First, a rule adopted in regulations can more easily target a single issue for resolution, without creating any implication as to the result in related areas (e.g., an interpretative regulation could hold Section 305(a) inapplicable to a distribution of tracking stock

66 A statute similar to Section 1296(b) would appear simplest and most straightforward.

on ordinary P common stock without necessarily dealing with, or prejudicing the resolution of issues relating to the use of tracking stock in a reorganization transaction). Second, a regulatory response likely could be more flexibly designed, and thereafter monitored and amended as necessary to accommodate situations where no opportunity for tax avoidance is present. Third, a regulatory approach would allow prompt action -- via revenue ruling or Announcement -- if necessary in a given situation.

As an alternative to the promulgation of regulations, the Service could, via Revenue Procedure, indicate safe-harbors within which arrangements with some characteristics of tracking stock would be treated consistent with the form of the transaction (i.e., as representing stock of P). Under this approach, the treatment of arrangements involving greater tracking stock characteristics might or might not be specified.

B. Need for Consistency Regarding Action Taken

As discussed in part IV.B., it is difficult, if not impossible, to prescribe standards that might be employed to determine, on a case-by-case basis, the degree of correlation that is present in a given tracking stock arrangement. As a result, the Committee's view is that the Treasury Department

might best proceed in this area (1) by considering the applicability of specific Code provisions to tracking stock arrangements, and (2) identifying objective criteria -- possibly on a non-exclusive basis -- that would be referred to in determining whether a proscribed tracking stock arrangement is present.

To illustrate the approach suggested, the Treasury Department might determine that, as a first step, it would consider the applicability of Section 305(a) to distributions of tracking stock as a dividend on ordinary P common stock. Having in mind cases where a material degree of correlation between the tracking stock and the tracked property is present, it could be concluded that a tracking stock issue will be held disqualified from Section 305(a) tax-free distribution status if the following two conditions are satisfied:

> (i) A written or publicly-announced dividend policy with respect to the tracking stock calls for a significant level of distributions that are not pro rata as to all P earnings sources.
>
> (ii) The tracking stock is (1) convertible into ordinary P stock based on the fair market value of the tracking stock and ordinary P stock at the time of conversion or (2) redeemable based on the fair market value of the tracking stock at the time of redemption.

A rule such as that described would reflect the generalization, or simplifying assumption, that since the

indicated characteristics are present, the tracking stock is sufficiently correlated, with the performance of the tracked property that it is not appropriate to regard the tracking stock as P common stock.[67] Instead, the stock is regarded -- at least implicitly -- as an equity interest in a separate entity, and, as such, would not be distributable to P shareholders free of tax under Section 305(a). As noted previously, there is no suggestion that the Treasury Department need implement this separate entity analysis further, by, for example, addressing the treatment of the deemed separate entity. At the same time, however, regulations might simultaneously address the applicability of Section 311(b) to distributions of the type in question, and might (but need not necessarily) employ the same criteria as that adopted for purposes of Section 305(a) in determining whether the distribution is taxable to the distributing corporation. Moreover, in the situation, where the tracked property is a division of P, the regulations might in specified cases restrict utilization of tax credits or net operating losses between P and the hypothetical separate entity.

To illustrate the type of approach suggested in this report, there is contained in Appendix C an outline of a regulation that might be adopted under Section 305(a) regarding the treatment of tracking stock interests distributed to P shareholders.

---

[67] This conclusion would, in the Committee's view, reflect the Treasury Department's application of the analysis called for in part IV.D., supra.

Appendix A

Analogues to Correlation Analysis[1]

In evaluating the significance of the correlation in performance between a tracking stock and the underlying, tracked property, it is useful to note other settings in which similar analyses have been made in the tax law. In these cases, the typical question for decision is the extent to which actual ownership of "A" will, through the likely operation of a business transaction, amount in effect to ownership of "B" -- where significantly different tax consequences attend ownership of A and B.

The following are illustrative in the context of statutory rules:

-- Section 1504(a)(5)(A), added by the Tax Reform Act of 1984, grants the Service authority to treat an in-the-money option to acquire stock as exercised, with the option holder thereby treated as the owner of the underlying stock, in order to

---

[1] The legislative history explains the analysis to be made as follows:

> "The first, and generally the most important, factor is whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture, while third parties generally receive payments which are not subject to this risk. Thus, an allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution, while an allocation and distribution provided to a service partner under the partnership agreement which involve limited risk as to amount and payment should generally be treated as a fee under section 707(a)."

Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 227 (Comm. Print 1984).

prevent avoidance of the 80% vote and value tests in the affiliated group context.

- -- Section 707(a)(2)(A), also added by the Tax Reform Act of 1984, allows the Service to construe a purported partnership allocation of income as a fee that is, for example, subject to capitalization --a partnership income allocation being distinguishable from a fee in large part by the likelihood of risk regarding the level of payments to be received.

Similar considerations have arisen in case law and in the administrative context:

- -- In situations where the putative owner of property holds a "put" that entitles him to sell the property to a second party at one price during a given period, and the second party holds a "call" that entitles him to buy the same property at a different price, during a different period, the question is whether the combined effect of the put and call equates to a present sale of the property. In analyzing this issue, the courts have inquired into the likelihood, as an economic matter, that circumstances might arise such that neither the put nor the call will be exercised.[2]

---

[2] E.g., Penn-Dixie Steel Corp. v. Commissioner. 69 T.C. 837 (1978). The Court in Penn-Dixie made the following analyses of the likelihood of exercise of either the put or the call:

> "We consider it more than a remote possibility that Phoenix might so prosper in the first 3 years that Union [the purported seller] would forego the exercise of its put and that the economic outlook for the steel industry could then change sufficiently in the following year to lead Continental [the purported purchaser] to decide not to exercise its call. Alternatively, changes in Continental's own situation might well lead to a change in its position with respect to its call. Finally, it seems likely that Continental would have resisted Union's attempt to exercise its put if Phoenix's plant had been destroyed in the interim.
>
> "In short, the put and call arrangement did not legally, or as a practical matter, impose mutual obligations on Union to sell and on Continental to buy."

69 T.C. at 844.

-- In Revenue Ruling 83-98,[3] a purported debt instrument was treated as representing, from the outset, the equity into which it was convertible in light of a finding that "[t]he [purported debt instrument] in this case [is] structured so that under most likely eventualities lit] will be [treated as] converted into [stock]."[4]

-- The issue in "builder-bond" transactions is whether the builder has disposed of installment obligations or merely financed the same. In making the analysis, the locus of risk of loss (credit risk and market risk) as well as opportunity for gain (aside from a typical lender's profit), and certain other factors such as the right to dispose of or pledge the obligations are taken into account in determining whether the builder has, in substance, parted with economic ownership of the underlying obligations.[5]

---

[3] 1983-2 C.B. 40.

[4] Id.

[5] See Cliff & Levine, Reflections on Ownership -- Sales and Pledges of Installment Obligations. 39 Tax Law. 37 (1985). This issue is significantly mooted for the future by Section 453A(d), added by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. _____, § 10202, _____ Stat.

Appendix B

Treatment of Tracking Stock Under Section 1032(a)

The issue arises as to the tax treatment of a sale of tracking stock by P under Section 1032(a). The Committee believes that two analytical models of the transaction are possible: a "primary" offering and a "secondary" offering.[1] it is possible that neither model will satisfactorily deal with all cases.

Under a secondary offering approach, P would be treated as having disposed of an interest in the tracked property -- or, as conceptualized in the report, an interest in an entity that holds the tracked property. In such a case, P would be required to recognize gain and Section 1032(a) would have no application.

The secondary offering characterization may not be appropriate in the case of a fact pattern such as that presented in Maxwell Hardware where (i) investors bought stock of P and (ii) the proceeds of the investment were devoted to a new business venture conducted by P.[2] Such a transaction more closely resembles a primary offering; as a result, the presence of a realization event, is less clear.[3] A difficult situation

---

1 In general, a "primary" offering involves a sale of securities by the issuing entity, whereas a "secondary" offering involves a sale of securities by a holder thereof (not, by definition, the issuing entity).

2 Partnership characterization of the fictional- entity would seem most appropriate in this case.

3 See. e.g., Sections 351(a), 721(a).

arises if primary (non-realization) treatment is accorded, however. To accommodate such characterization, it becomes necessary to monitor subsequent realization events, such as P's withdrawal of funds or assets from the venture in excess of its investment.[4] Since, in reality, the venture's assets are indistinguishable from P's other assets, policing such realization events might well present a difficult task. If, however, the venture were reflected as a separate entity (perhaps not more than an accounting entity), with all transactions between P and the entity stated on an arm's length basis, it could be possible to implement a primary offering approach.

The Committee believes that any rules developed under Section 1032(a) for dealing with tracking stock arrangements probably should reflect a significant presumption, at the least, of a secondary offering, with the result that Section 1032(a) generally would not apply to a sale of tracking stock. Such characterization certainly is appropriate if the tracked property is stock of a subsidiary.[5] The Committee reached no conclusion as to whether it would be appropriate, in certain circumstances, to provide primary offering characterization, with deferred gain recognition. Possibly, such transactions could be dealt with through a closing agreement or similar procedure, with transactions not so qualifying being subject to the secondary offering (i.e., currently taxable) rule.

---

[4] See Section 731(a)(1).

[5] A distinction might be drawn, however, where the proceeds of the offering are invested in the tracked subsidiary.

Appendix C

Outline of Possible Regulation Regarding Treatment
of Tracking Stock Distributions Under Section 305(a)

1. General rule. A “tracking stock interest” shall not be considered a common or preferred stock interest of the distributing corporation. Accordingly, the distribution of a tracking stock interest shall not be considered a distribution of stock to which Section 305(a) applies.

2. “Tracking stock interest.” A class of stock of a distributing corporation shall be treated as a “tracking stock interest” if [it provides for distribution or conversion rights such as those set out on page 57 of the report].

3. No inference. Nothing in this regulation shall be considered to indicate the treatment of tracking stock under any other provision of law.