on the class A stock payable in newly authorized class B preferred stock which is convertible into class A stock no later than 6 months from the date of distribution at a price that is only slightly higher than the market price of class A stock on the date of distribution. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period of time some shareholders will exercise their conversion rights and some will not. Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which section 301 applies. 

[T.D. 7281, 38 FR 18536, July 12, 1973]

§ 1.305–5 Distributions on preferred stock.

(a) In general. Under section 305(b)(4), a distribution by a corporation of its stock (or rights to acquire its stock) made (or deemed made under section 305(c)) with respect to its preferred stock is treated as a distribution of property to which section 301 applies unless the distribution is made with respect to convertible preferred stock to take into account a stock dividend, stock split, or any similar event (such as the sale of stock at less than the fair market value pursuant to a rights offering) which would otherwise result in the dilution of the conversion right. For purposes of the preceding sentence, an adjustment in the conversion ratio of convertible preferred stock made solely to take into account the distribution by a closed end regulated investment company of a capital gain dividend with respect to the stock into which such stock is convertible shall not be considered a “similar event.” The term preferred stock generally refers to stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest. Among the facts and circumstances to be considered are the prior and anticipated earnings per share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. The determination of whether stock is preferred for purposes of section 305 shall be made without regard to any right to convert such stock into another class of stock of the corporation. The term preferred stock, however, does not include convertible debentures.

(b) Redemption premium—(1) In general. If a corporation issues preferred stock that may be redeemed under the circumstances described in this paragraph (b) at a price higher than the issue price, the difference (the redemption premium) is treated under section 305(c) as a constructive distribution (or series of constructive distributions) of additional stock on preferred stock that is taken into account under principles similar to the principles of section 1272(a). However, constructive distribution treatment does not result under this paragraph (b) if the redemption premium does not exceed a de minimis amount, as determined under the principles of section 1273(a)(3). For
purposes of this paragraph (b), preferred stock that may be acquired by a person other than the issuer (the third person) is deemed to be redeemable under the circumstances described in this paragraph (b), and references to the issuer include the third person, if—

(i) This paragraph (b) would apply to the stock if the third person were the issuer; and

(ii) Either—

(A) The acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes (under section 304 or otherwise); or

(B) The third person and the issuer are members of the same affiliated group (having the meaning for this purpose given by section 1504(a), except that section 1504(b) shall not apply) and a principal purpose of the arrangement for the third person to acquire the stock is to avoid the application of section 305 and paragraph (b)(1) of this section.

(2) Mandatory redemption or holder put. Paragraph (b)(1) of this section applies to stock if the issuer is required to redeem the stock at a specified time or the holder has the option (whether or not currently exercisable) to require the issuer to redeem the stock. However, paragraph (b)(1) of this section will not apply if the issuer’s obligation to redeem or the holder’s ability to require the issuer to redeem is subject to a contingency that is beyond the legal or practical control of either the holder or the holders as a group (or through a related party within the meaning of section 267(b) or 707(b), disregarding, for this purpose, a separate mandatory redemption obligation described in paragraph (b)(2) of this section); and

(i) The issuer and the holder are not related within the meaning of section 267(b) or 707(b) (for purposes of applying sections 267(b) and 707(b) (including section 267(f)(1)), the phrase “20 percent” shall be substituted for the phrase “50 percent”); and

(ii) Exercise of the right to redeem would not reduce the yield of the stock, as determined under principles similar to the principles of section 1272(a) and the regulations under sections 1271 through 1275.

(iii) Effect of not satisfying safe harbor. The fact that a redemption right is not described in paragraph (b)(3)(ii) of this section does not affect the determination of whether a redemption pursuant to the right to redeem is more likely than not to occur.

(4) Coordination of multiple redemption provisions. If stock may be redeemed at more than one time, the time and price at which redemption is most likely to occur must be determined based on all
of the facts and circumstances as of the issue date. Any constructive distribution under paragraph (b)(1) of this section will result only with respect to the time and price identified in the preceding sentence. However, if redemption does not occur at that identified time, the amount of any additional premium payable on any later redemption date, to the extent not previously treated as distributed, is treated as a constructive distribution over the period from the missed call or put date to that later date, to the extent required under the principles of this paragraph (b).

(5) Consistency. The issuer’s determination as to whether there is a constructive distribution under this paragraph (b) is binding on all holders of the stock, other than a holder that explicitly discloses that its determination as to whether there is a constructive distribution under this paragraph (b) differs from that of the issuer. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder’s timely filed federal income tax return for the taxable year that includes the date the holder acquired the stock. The issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will provide the name or title and either the address or telephone number of a representative of the issuer who will provide the relevant information required for holders to comply with this provision of this paragraph (b).

(c) Cross reference. For rules for applying sections 305(b)(4) and 305(c) to recapitalizations, see §1.305-7(c).

(d) Examples. The application of sections 305(b)(4) and 305(c) may be illustrated by the following examples:

Example 1. (i) Corporation T has outstanding 1,000 shares of $100 par 5-percent cumulative preferred stock and 10,000 shares of no-par common stock. The corporation is 4 years in arrears on dividends to the preferred shareholders. The issue price of the preferred stock is $100 per share. Pursuant to a recapitalization under section 368(a)(1)(E), the preferred shareholders exchange their preferred stock, including the right to dividend arrearages, on the basis of one old preferred share for 1.20 newly authorized class A preferred shares. Immediately following the recapitalization, the new class A shares are traded at $100 per share. The class A shares are entitled to a liquidation preference of $100. The preferred shareholders have increased their proportionate interest in the assets and profits of corporation T since the fair market value of 1.20 shares of class A preferred stock ($120) exceeds the issue price of the old preferred stock ($100). Accordingly, the preferred shareholders are deemed under section 305(c) to receive a distribution in the amount of $20 on each share of old preferred stock and the distribution is one to which sections 305(b)(4) and 301 apply.

(ii) The same result would occur if the fair market value of the common stock immediately following the recapitalization were $20 per share and each share of preferred stock were exchanged for one share of the new class A preferred stock and one share of common stock.

Example 2. Corporation A, a publicly held company whose stock is traded on a securities exchange (or in the over-the-counter market) has two classes of stock outstanding, common and cumulative preferred. Each share of preferred stock is convertible into 75 shares of common stock. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. The issue price of the preferred stock is $100 per share. In order to retire the preferred stock, corporation A recapitalizes in a transaction to which section 368(a)(1)(E) applies and each share of preferred stock is exchanged for one share of common stock. The issue price of the preferred stock is $100 per share. Notwithstanding the fact that the fair market value of the common stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, the recapitalization is not deemed under section 305(c) to result in a distribution to which sections 305(b)(4) and 301 apply since the recapitalization is not pursuant to a plan to periodically increase a shareholder’s proportionate interest in the assets or earnings and profits and does not involve dividend arrearages.

Example 3. Corporation V is organized with two classes of stock, 1,000 shares of class A common and 1,000 shares of class B convertible preferred. Each share of class B stock may be converted into two shares of class A stock. Pursuant to a recapitalization under section 368(a)(1)(E), the 1,000 shares of class A stock are surrendered in exchange for 500 shares of newly authorized class C common. The conversion right of class B stock is changed to one share of class A stock and one share of class C stock for each share of class B stock. The change in the conversion right is
not deemed under section 305(c) to be a distribution on preferred stock to which sections 305(b)(4) and 301 apply.

Example 4. (i) Facts. Corporation X is a domestic corporation with only common stock outstanding. In connection with its acquisition of Corporation T, X issues 100 shares of its 4% preferred stock to the shareholders of T, who are unrelated to X both before and after the transaction. The issue price of the preferred stock is $40 per share. Each share of preferred stock is convertible at the shareholder’s election into three shares of X common stock. At the time the preferred stock is issued, the X common stock has a value of $10 per share. The preferred stock does not provide for its mandatory redemption or for redemption at the option of the holder. It is callable at the option of X at any time beginning three years from the date of issuance for $100 per share. There are no other plans, arrangements, or agreements that effectively require or are intended to compel X to redeem the stock.

(ii) Analysis. The preferred stock is described in the safe harbor rule of paragraph (b)(3)(i) of this section because X and the former shareholders of T are unrelated, there are no plans, arrangements, or agreements that effectively require or are intended to compel X to redeem the stock, and calling the stock for $100 per share would not reduce the yield of the preferred stock. Therefore, the $80 per share call premium is not treated as a constructive distribution to the shareholders of the preferred stock under paragraph (b) of this section.

Example 5. (i) Facts—(A) Corporation Y is a domestic corporation with only common stock outstanding. On January 1, 1996, Y issues 100 shares of its 10% preferred stock to a holder. The holder is unrelated to Y both before and after the stock issuance. The issue price of the preferred stock is $100 per share. The preferred stock is—

(1) Callable at the option of Y on or before January 1, 2001, at a price of $105 per share plus any accrued but unpaid dividends; and

(2) Mandatorily redeemable on January 1, 2006, at a price of $100 per share plus any accrued but unpaid dividends.

(B) The preferred stock provides that if Y fails to exercise its option to call the preferred stock on or before January 1, 2001, the holder will be entitled to appoint a majority of Y’s directors. Based on all of the facts and circumstances as of the issue date, Y is likely to have the legal and financial capacity to exercise its right to redeem. There are no other facts and circumstances as of the issue date that would affect whether Y will call the preferred stock on or before January 1, 2001.

(ii) Analysis. Under paragraph (b)(3)(i) of this section, paragraph (b)(1) of this section applies because, by virtue of the change of control provision and the absence of any contrary facts, it is more likely than not that Y will exercise its option to call the preferred stock on or before January 1, 2001. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply because the provision that failure to call will cause the holder to gain control of the corporation is a plan, arrangement, or agreement that effectively requires or is intended to compel Y to call the preferred stock. Under paragraph (b)(4) of this section, the constructive distribution occurs over the period ending on January 1, 2001. Redemption is most likely to occur on that date, because that is the date on which the corporation minimizes the rate of return to the holder while preventing the holder from gaining control. The de minimis exception of paragraph (b)(1) of this section does not apply because the $5 per share difference between the redemption price and the issue price exceeds the amount determined under the principles of section 1273(a)(3) ($5.0025 × $105 = $1.31). Accordingly, $5 per share, the difference between the redemption price and the issue price, is treated as a constructive distribution received by the holder on an economic accrual basis over the five-year period ending on January 1, 2001, under principles similar to the principles of section 1272(a).

Example 6. Corporation A, a publicly held company whose stock is traded on a securities exchange (or in the over-the-counter market) has two classes of stock outstanding, common and preferred. The preferred stock is nonvoting and nonconvertible, limited and preferred as to dividends, and has a fixed liquidation preference. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. In order to retire the preferred stock, corporation A recapitalizes in a transaction to which section 368(a)(1)(E) applies and the preferred stock is exchanged for common stock. The transaction is not deemed to be a distribution under section 305(c) and sections 305(b) and 301 do not apply to the transaction. The same result would follow if the preferred stock was exchanged in any reorganization described in section 368(a)(1) for a new preferred stock having substantially the same market value and having no greater call price or liquidation preference than the old preferred stock, whether the new preferred stock has voting rights or is convertible into common stock of corporation A at a fixed ratio subject to change solely to take account of stock dividends, stock splits, or similar transactions with respect to the stock into which the preferred stock is convertible.

Example 7. (i) Facts—(A) Corporation Z is a domestic corporation with only common stock outstanding. On January 1, 1996, Z issues 100 shares of its 10% preferred stock to
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C, an individual unrelated to Z both before and after the stock issuance. The issue price of the preferred stock is $100 per share. The preferred stock is:

(i) Callable for a period of 5 years from the issue date;
(ii) Callable at the option of Z on January 1, 2001, at a price of $110 per share plus any accrued but unpaid dividends; and
(iii) Mandatorily redeemable on January 1, 2004, at a price of $150 per share plus any accrued but unpaid dividends.

(B) If Z does not exercise its second option to call the preferred stock on July 1, 2002, then the $30 additional redemption premium that is payable on January 1, 2004, is treated as a constructive distribution received by the holder on an economic accrual basis over the period between January 1, 2001, and July 1, 2002, under principles similar to the principles of section 1272(a).

Example 8. (1) Facts. The facts are the same as in paragraph (i) of Example 7, except that, based on all of the facts and circumstances as of the issue date (including an expected lack of funds on the part of Z), it is unlikely that Z will exercise the right to redeem on either January 1, 2001, or July 1, 2002.

(ii) Analysis. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on either January 1, 2001, or July 1, 2002, because each call would reduce the yield of the stock. Under paragraph (b)(3)(ii) of this section, neither option to call is more likely than not to occur, because, based on all of the facts and circumstances as of the issue date (including an expected lack of funds on the part of Z), it is more likely than not that Z will exercise either option. The $50 per share redemption premium that is payable on January 1, 2004, is treated as a constructive distribution under paragraphs (b)(1) and (2) of this section, regardless of whether Z is anticipated to have sufficient funds to redeem on that date, because Z is required to redeem
the stock on that date. The de minimis exception of paragraph (b)(1) of this section does not apply because the $50 per share difference between the redemption price and the fair market value of the stock on that date exceed the amount determined under the principles of section 1273(a)(3)(c)(1) of the Internal Revenue Code.

Example 9. Corporation Q is organized with 100,000 shares of class A stock and 1,000 shares of class B stock. The terms of the class B stock require that the class B have a preference of $5 per share with respect to dividends and $100 per share with respect to liquidation. In addition, upon a distribution of $10 per share to the class A stock, class B participates equally in any additional dividends. The terms also provide that upon liquidation the class B stock participates equally after the class A stock receives $100 per share. Corporation Q has no accumulated earnings and profits. In 1971 it earned $10,000, the highest earnings in its history. The corporation is in an industry in which it is reasonable to anticipate a growth in earnings of 5 percent per year. In 1972 the corporation had earnings of $127,000. The corporation paid no dividends and in lieu of a $5 dividend to the class A stock, distributed one share of class B stock for every 10 outstanding shares of class B stock. Since, in 1972, it was reasonable to anticipate that both class A stock and class B stock would participate in the current and anticipated earnings and growth of the corporation beyond their preferred interests, neither class is preferred stock and the stock dividends are not distributions to which section 305(b)(4) applies.

Example 10. Corporation P is organized with 10,000 shares of class A stock and 1,000 shares of class B stock. The terms of the class B stock require that the class B have a preference of $5 per share with respect to dividends and $100 per share with respect to liquidation. In addition, upon a distribution of $5 per share to the class A stock, class B participates equally in any additional dividends. The terms also provide that upon liquidation the class B stock participates equally after the class A stock receives $100 per share. Corporation P has accumulated earnings and profits of $100,000. In that year the corporation paid a dividend of $5 per share to the class B stock, $5 per share to the class A stock, and it distributed an additional $1 per share to both class A and class B stock. In 1972 the corporation had earnings of $55,000. In that year it paid a dividend of $5 per share to the class B stock and $5 per share to the class A stock. In addition, the corporation declared stock dividends of one share of class B stock and one share of class A stock for every 10 outstanding shares of class B and class A stock, respectively.

(e) Effective date. The rules of paragraph (b) of this section and Examples 4, 5, 7, and 8 of paragraph (d) of this section apply to stock issued on or after December 20, 1995. For rules applicable to previously issued stock, see §1.305–5(b) and (d) Examples (4), (5), and (7) (as contained in the 26 CFR part 1 edition revised April 1, 1995). Although the rules of paragraph (b) of this section and the revised examples do not apply to stock issued before December 20, 1995, the rules of sections 305(c)(1), (2), and (3) apply to stock described therein issued on or after October 10, 1990, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Public Law 101–508 Stat.). Moreover, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Public Law 101–508 Stat.), with respect to stock issued on or after October 10, 1990, and issued before December 20, 1995, the economic accrual rule of section 305(c)(3) will apply to the entire call premium on stock that is not described in paragraph (b)(2) of this section if the premium is considered to be unreasonable under the principles of §1.305–5(b) (as contained in the 26 CFR part 1 edition revised April 1, 1995). A call premium described in the preceding sentence will be accrued over the period of time during which the preferred stock cannot be called for redemption.


§1.305–6 Distributions of convertible preferred

(a) In general. (1) Under section 305(b)(5), a distribution by a corporation of its convertible preferred stock or rights to acquire such stock made or