

THE TAX LAW PUZZLE OF PREFERRED STOCK:

SOME MINIMAL GUIDANCE COULD BE THE MISSING PIECE

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I. INTRODUCTION TO THE OVERALL COMMENT¹

This Article is designed to explain why the current U.S. federal tax system's approach to preferred stock versus common stock is inadequate. Currently, there is no definition of "common stock" enumerated within the Internal Revenue Code ("IRC") or U.S. Treasury regulations.² Plus, there are only some broad, ambiguous definitions of "preferred stock."³ The differences between preferred stock versus common stock can have impacts upon the tax consequences in a variety of transactions, which is especially important from a practical business standpoint because tax laws, corporate laws, and securities laws do not

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¹This Article will focus upon U.S. federal tax concepts, perspectives, and ramifications of common stock versus preferred stock. Thus, this Article assumes that the reader holds basic knowledge and understandings of corporate finance, financial instruments, microeconomics, state corporate law, and U.S. federal tax law because this Article does not attempt to define or elaborate upon basic concepts and terminology within these fields.

²*See infra* Part II.B.

³*See infra* Part II.C.

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necessarily coincide with one another.⁴ Thus, in order for taxpayers to understand what is “preferred stock” under the U.S. federal tax laws, and the significance of preferred stock versus common stock, the Internal Revenue Service (“IRS”) must take action consistent with the financial, economic, and business realities in which preferred stock is utilized by a corporation.

This Article will begin by exploring and understanding the general overview of U.S. federal tax law regarding stock (both common stock and preferred stock). Next, this Article attempts to define “common stock” and “preferred stock” as utilized under the IRC (including Treasury regulations and IRS revenue rulings), and explain how the IRC’s differentiation between common stock and preferred stock creates particular tax consequences under the U.S. federal tax laws. Under the current U.S. federal tax law, the reoccurring theme for differentiating between common stock versus preferred stock is the phrase “does not participate in corporate growth to any significant extent,” which will consist of a significant portion of the analysis within this Article.⁵

Moreover, this Article will examine two recent documents from 2012, which addressed the issue of discerning between common stock and preferred stock under the U.S. federal tax laws: (1) IRS Chief

⁴See generally EUGENE F. BRIGHAM & JOEL F. HOUSTON, FUNDAMENTALS OF FINANCIAL MANAGEMENT 298-322, 502-26, 676-81, 692-700 (13th ed. 2013); STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & BRADFORD D. JORDAN, FUNDAMENTALS OF CORPORATE FINANCE 234-56, 590-616 (8th ed. 2008) (discussing the economic and financial characteristics, valuation, requirements, dividends, and applications of preferred stock). See also JAMES D. COX & THOMAS L. HAZEN, TREATISE ON THE LAW OF CORPORATIONS §§ 18:1-:17 (3d ed. 2013) (discussing the general state corporate law surrounding the characteristics, issuance, and rules of preferred stock).

⁵Currently, the IRC contains four separate definitions of “preferred stock.” See I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4) (2012); Treas. Reg. § 1.305-5(a) (as amended in 1995). All these definitions of preferred stock are highly dependent upon the phrase within the definitions of “does not participate in corporate growth to any significant extent,” as all four of the definitions make use of this phrase. E.g., Treas. Reg. § 1.305-5(a). Consequently, this Article will spend significant time analyzing this phrase and will attempt to create a simple, accurate, and effective definition of this phrase for use within all “preferred stock” definitions.

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Counsel Memorandum 201236025 (June 4, 2012);⁶ and (2) *Gerdau Macsteel, Inc. v. C.I.R.*, 139 T.C. 67 (2012). Subsequently and lastly, this Article supplies the author’s recommendations and solutions for the IRS (or the U.S. Treasury Department) to provide meaningful guidance to all taxpayers and practitioners regarding the treatment of common stock and preferred stock under the U.S. federal tax laws.

II. PREFERRED STOCK V. COMMON STOCK—WHAT IS TRULY AT STAKE?

Prior to diving into the definitions of “common stock”⁷ and “preferred stock”⁸ under the U.S. federal tax laws, this Section will briefly discuss the general application of the U.S. federal tax laws as it applies to stock (whether preferred stock or common stock). After this background information has been presented, then it is proper to analyze

⁶I.R.S. Gen. Couns. Mem. 36,025 (Sept. 7, 2012), *available at* 2012 WL 3876396.

⁷*See* COX & HAZEN, *supra* note 4, §§ 18:1, :4. From a financial or economic perspective, common stock is the fundamental equity investment in a corporation, as common stock poses the greatest risk of loss, but simultaneously the highest opportunity for gain. *See id.* In other words, common stock has the potential for unlimited gain based upon the fortunes of the corporation going forward. *See id.* Also, this signifies that common stock holds the potential risk for loss equal to the full amount invested within a corporation (i.e., the total amount of value paid for the common stock), which is especially likely if the corporation becomes insolvent because the owners or holders of the common stock hold financial rights and claims behind both the preferred stock and debt instruments. *See id.*; RICHARD A. BOOTH, FINANCING THE CORPORATION § 2:3 (2012 ed. 2012).

⁸*See* BOOTH, *supra* note 7, §§ 2:4, :6, :36. From a financial or economic perspective, preferred stock has no set, predetermined characteristics; however, preferred stock can be differentiated from common stock in two major, generic aspects: (1) preferred stock has a greater claim to the corporation’s assets and earnings, and (2) the system of dividends under preferred stock is structured differently from that of common stock. *See id.* Thus, a good (and logical) way to think about preferred stock is that the preferred stock is a security with characteristics somewhere in-between debt instruments (e.g., bonds) and common stock—meaning preferred stock is a hybrid instrument. *See id.* While it will not be discussed in depth within this Article, preferred stock maintains many characteristics similar to debt instruments, and can lead to an ambiguous differentiation between the corporation’s preferred stock and debt instruments. *See id.*; COX & HAZEN, *supra* note 4, §§ 18:5, :7, :8, :11.

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the U.S. federal tax law definitions of “common stock” and “preferred stock” with an eye toward the phrase “does not participate in corporate growth to any significant extent.” Finally, this Section would not be complete without thoroughly discussing the situations under the U.S. federal tax law when the differentiation between common stock and preferred stock materializes into great importance—as the differentiation between common stock and preferred stock can carry manifest and sweeping U.S. federal tax consequences.⁹

A. General Overview of U.S. Federal Tax Law Regarding Stock

As a general statement, there is no difference from a U.S. federal tax perspective for dividends paid or received, or capital gains generated, upon common stock versus preferred stock.¹⁰ However, if the preferred stock is recharacterized from an equity instrument to a debt instrument, then the dividend payments will be recharacterized as interest payments, so that the interest is deductible to the corporate

⁹Before going forward, note that the goal of preferred stock is generally stated as twofold. Spencer G. Feldman, *Preferred Stock: Overview*, PRAC. LAW, Dec. 2010, available at WestlawNext, Practical Law Practice Note 2-504-1419. First is the goal of “[f]ixed income returns and a more stable value than common stock.” *Id.* This is frequently a more prevalent characteristic “for an investment in public companies, in which case investors typically favor dividend-paying preferred stock.” *Id.* Second is the goal of “capital appreciation with downside protection superior” to that offered by common stock. *Id.* This is frequently a more prevalent characteristic “for venture capital investments, in which case investors typically favor convertible preferred stock.” *Id.* Consequently, investors most ordinarily utilize preferred stock in two types of situations: (1) when the preferred stock is issued by an already existing public company in which the investors’ principal concern is stable, guaranteed dividend payments; and (2) when the preferred stock is issued by a newly created startup company in which the investors’ dominant concern is a liquidation preference in case the company financially deteriorates, plus convertibility rights (meaning the preferred stock is convertible into common stock) in case the corporation’s business operations excel and generate abundant revenues and profits going forward into the future. *Id.*; see Spencer G. Feldman, *Preferred Stock: A Privileged If Peculiar Class*, PRAC. LAW., June 2012, at 58, 59. Lastly, preferred stock is routinely utilized in business succession and estate planning situations. See, e.g., David Maloney & Sally Jones, *The Role Preferred Stock Can Play In Income Tax and Estate Tax Planning: Nothing To Lose For a Closely-Held Family Corporation*, 30 CORP. TAX’N 17 (Mar./Apr. 2003).

¹⁰See, e.g., I.R.C. §§ 1(h), 11, 61(a)(7), 243(a) (2012).

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payor, and it is taxable to the recipient owner or holder at ordinary income tax rates (maximum rate of 39.6% for individuals and 35% for corporations).¹¹ But, if the preferred stock is recharacterized from preferred stock to common stock (both being forms of equity instruments), then the treatment is the same as if the preferred stock remains unchanged, with the dividends paid not being deductible by the corporate payor, and taxable to the recipient owner or holder at preferred tax rates if the recipient is an individual, and at ordinary income tax rates if the recipient is a corporation (but the recipient corporation will be eligible for the corporate dividends-received deduction).¹²

As to capital gains upon the sale of the preferred stock, if the preferred stock is recharacterized from an equity instrument to a debt instrument, then there may be an issue with original issue discount (“OID”) and qualified stated interest (“QSI”), which may alter the amount of capital gain versus ordinary rate gain for owners or holders that are individuals (but irrelevant for any corporate owners or holders

¹¹*Id.* §§ 1, 11, 61(a)(4), 163(a). If the financial instrument is classified as a debt instrument, then the owners or holders (whether an individual or a corporation) will receive interest payments taxed at ordinary tax rates. *See id.* §§ 1, 11, 61(a)(4). However, the issuing corporation would prefer to classify the financial instrument as a debt instrument in order to receive the interest paid deduction (which does not exist for dividends paid). *Id.* § 163(a).

¹²*Id.* §§ 1(h), 11, 61(a)(7), 243(a). Both individual and corporate owners or holders of the financial instrument would likely prefer to classify the financial instrument as an equity instrument so that the issuing corporation could treat any distributions as dividends. *Id.* § 1(h)(11). Individual shareholders receiving dividends can qualify for the reduced preferential tax rates for “qualified dividend[s].” *Id.* Corporate shareholders receiving dividends can qualify for the intercorporate dividends received deduction. *Id.* § 243. Note that Congress has enacted no specific provision stating that dividends are not deductible by the payor corporation; however, the nondeductibility of such dividends is to be inferred from the absence of such a provision permitting a deduction for them. *See id.* §§ 62, 161, 163, 243, 246(a).

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of the instrument).¹³ And if the preferred stock is recharacterized from preferred stock to common stock (both being forms of equity instruments), then the treatment is the same as if the preferred stock remains unchanged, requiring the taxpayer (whether an individual or corporation) to look at § 1221 to determine if the stock is a capital asset.¹⁴

These aforementioned U.S. federal tax issues demonstrate that, at a general level, there is no difference between preferred stock and common stock in regards to dividends paid or received, and the gains generated from the sale or exchange of the stock.¹⁵ Nonetheless, the differences between preferred stock and debt instruments, from a U.S. federal tax perspective, can lead to drastic differences (sometimes with

¹³*Id.* §§ 1272(a)(1), 1273, 1275(a)(1); Treas. Reg. § 1.1273-1(c) (as amended in 1996). For a more in-depth discussion regarding OID and QSI, *see generally* DAVID GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS §§ 2.01-2.05, 5.01-5.16 (6th ed. 2010). Also, when the owner or holder of the debt instrument receives principal payments from the corporation, these debt principal payments will ordinarily be treated as tax-free recoveries of basis; and additionally, will produce capital gain if such payments exceed the adjusted basis of the debt instrument. *See* I.R.C. §§ 1001(a), 1011(a), 1221(a), 1222; Treas. Reg. § 1.1001-1(a) (as amended in 2007).

¹⁴I.R.C. §§ 1(h), 11, 61(a)(3), 1221(a), 1222. The stock (whether preferred stock or common stock) will be a capital asset in the hands of the taxpayer (whether an individual or corporation) so long as the stock is not treated as inventory or stock-in-trade in relation to the taxpayer. *See id.* § 1221(a)(1). Also, and in contrast to debt instruments, dividend distributions in redemption of the equity instrument are often taxed as dividends to the owner or holder of the preferred stock. *See id.* §§ 301, 302, 317. Under § 302(a), a redemption of stock is treated as an “exchange” if it falls into any one of four categories described in § 302(b), which are discussed later within this Article. *See id.* § 302(a)-(b). A redemption falling outside these four categories is treated as a distribution under § 301—essentially, the distribution is treated as a dividend to the extent of current and accumulated earnings and profits, and then as a return of capital or capital gain to the extent of any remaining balance. *See id.* § 301.

¹⁵*See, e.g., id.* §§ 1, 11, 61, 243, 1221.

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unexpected and negative differences) in U.S. tax treatment.¹⁶ Consequently, do keep these basic, general similarities between preferred stock and common stock, and the differences between preferred stock and debt instruments, in perspective because this Article will now begin exploring the situations when the U.S. federal tax laws differentiate between common stock and preferred stock (and therefore, demonstrating that these basic, general similarities between preferred stock and common stock quickly vanish for a tax scheme that is much more complicated, ambiguous, and at times bewildering).

B. The IRS Definition of Common Stock

Currently, there is no explicit or precise definition of “common stock” within the IRC (or within the Treasury regulations and IRS revenue rulings).¹⁷ Therefore, common stock is considered to be everything that is not defined as “preferred stock,” although the IRC specifically delineates (throughout many provisions) that there is a difference between common stock and preferred stock.¹⁸ This signifies that the default rule under the U.S. federal tax law treats stock as common stock, unless the characteristics of the stock (and the terms governing the stock) cause such stock to fall under one of the specific

¹⁶*Compare id.* §§ 163, 165, 166 (2012), *with id.* §§ 1(h), 11, 243. So, as demonstrated above within the text and footnotes, there are inherent adverse tax attributes and interests between the investor (i.e., the owner or holder of the financial instrument) and the investee (i.e., the issuing corporation) regarding the differences between debt instruments and preferred stock. *See supra* Part II.A.

¹⁷*See, e.g.*, I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6 (stating that “[n]either the Internal Revenue Code of 1986, . . . nor the Treasury regulations define the term ‘common stock’”).

¹⁸*See, e.g.*, I.R.C. §§ 305(b)(3), 351(g); *see also* Prop. Treas. Reg. § 1.108-1, 57 Fed. Reg. 52601-1 (Nov. 4, 1992) (stating that “[t]he proposed regulations require that common stock and preferred stock be tested separately under the two provisions of § 108(e)(8). Common stock is all stock other than preferred stock or disqualified stock. Preferred stock is any stock (other than disqualified stock) that has a limited or fixed redemption price or liquidation preference and does not upon issuance have a right to participate in corporate growth to a meaningful extent.”).

definitions of preferred stock.¹⁹

C. *The IRS Definition of Preferred Stock*

There is no one specific and established definition of “preferred stock” within the IRC, or within the Treasury regulations and IRS revenue rulings.²⁰ Rather, “preferred stock” definitions are mentioned in several different locations within the IRC and Treasury regulations.²¹ These definitions of (and references to) preferred stock will be discussed within the ensuing paragraphs—and it is time to indicate that

¹⁹*See, e.g.*, I.R.C. §§ 305(e)(5)(A)(B), 351(g)(3)(A), 1504(a)(4). The Tax Court has previously held that ownership of stock will typically involve three important rights: “(1) to vote, and thereby exercise control, (2) to participate in current earnings and accumulated surplus, and (3) to share in net assets on liquidation.” *Himmel v. Comm’r*, 338 F.2d 815, 817 (2d Cir. 1964) (reversing the Tax Court’s opinion in *Himmel v. Comm’r*, 41 T.C. 62 (1963)). Ownership of common stock generally involves all three of these factors. *Id.* On the other hand, “[o]wnership of preferred stock generally involves the last two [factors], but only to limited extents, unless otherwise provided” by the parties to the transaction. *Id.*; *see also* Rev. Rul. 85-106, 1985-2 C.B. 116. These general statements are rather accurate because the typical, basic features of common stock, from a financial or economic perspective, consist of the following: (1) unlimited upside gain potential (i.e., no preference or limitation on dividend payments); (2) unlimited downside risk (i.e., no liquidation preferences or limitations); (3) full voting rights (i.e., no limitations or restrictions on the voting of the shares, plus full control of voting for management personnel); and (4) last claim of right to the corporation’s assets or earnings (behind both the debt instruments and preferred stock). *See* ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 245-49 (8th ed. 2008). On the other hand, the typical, basic features of preferred stock, from a financial or economic perspective, consist of the following: (1) limited upside gain potential (i.e., preference and limitation on dividend payments); (2) limited downside risk (i.e., liquidation preferences or limitations); (3) limited voting rights (typically preferred shares can vote for a select number of persons on the board of directors, or voting is permitted only if the corporation fails to pay dividends); (4) redemption of stock by the corporation (and with these redemption rights being exercisable by either the corporation or the shareholder); (5) convertibility into common stock, either at a fixed or floating rate (i.e., convertibility rights); and (6) middle claim of right to the corporation’s assets or earnings (after debt instruments, but before common stock). *See id.*

²⁰*See, e.g.*, I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5 (as amended in 1995).

²¹*See, e.g.*, I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5.

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all of the subsequent definitions of preferred stock contain the phrase “does not participate in corporate growth to any significant extent,” which is the fundamental motif for the remaining discussion and analysis of “preferred stock” under the U.S. federal tax laws.²²

The first section within the IRC discussing and defining the term “preferred stock” is § 351(g).²³ While § 351 is a nonrecognition provision dealing with the transfer of property into the corporation in exchange for the corporation’s stock, the definition of “preferred stock” under § 351(g)(3)(A) is adopted throughout multiple other sections of

²²The most utilized method, and arguably the most accurate method, for valuing stock (both common stock and preferred stock) is the discounted dividend method. This discounted dividend method of valuation accounts for the financial circumstances of the issuing corporation through the utilization of the factor “g” in the formula. The “g” is the expected growth rate of dividend payments as predicted by the stockholder, and the discounted dividend method of stock valuation can be adjusted as needed in order to accurately represent the characteristics of the stock being valued. So this “g” factor will depend upon the specific characteristics of the stock being valued, and will vary depending upon the issuing corporation’s current financial situation and its future financial prospects. See BRIGHAM & HOUSTON, *supra* note 4, at 678-81; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 234-56; see also BOOTH, *supra* note 7, §§ 1A:12, 2:6, 2:36. What is notable about this discounted dividend method for valuing stock is that the formula is heavily dependent upon this “g” term, which represents the expected growth rate of dividend payments. Thus, it should then come as no surprise why all four of the subsequent definitions for preferred stock under the U.S. federal tax law make use of a phrase that focuses upon whether the investor or shareholder will “participate in corporate growth to any significant extent.” See I.R.C. §§ 305(e) (5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a).

²³This section states the following:

The term “preferred stock” means stock which is limited and preferred as to dividends *and* does not participate in corporate growth to any significant extent. Stock shall not be treated as participating in corporate growth to any significant extent *unless* there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation. If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.

I.R.C. § 351(g)(3)(A) (emphasis added).

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the IRC.²⁴ This definition of preferred stock requires three elements in order to have preferred stock: (1) “limited and preferred as to dividends,” (2) “does not participate in corporate growth to any significant extent,” and (3) “there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.”²⁵

Another section within the IRC discussing and defining the term “preferred stock” is § 305.²⁶ Under § 305, the IRC is concerned with a corporation paying dividends to its shareholders in the form of its own stock (or rights to acquire stock).²⁷ This definition of preferred stock contains three elements that must be satisfied in order to have preferred stock: (1) “limited and preferred as to dividends,” (2) “does not participate in corporate growth to any significant extent,” and (3)

²⁴*See, e.g., id.* §§ 45D(b)(6), 354(a)(2)(C), 355(a)(3), 356(e), 1036(b).

²⁵*Id.* § 351(g)(3)(A). Under § 351(g), the IRC treats certain nonqualified preferred stock as other property, meaning there is a need to recognize gain under § 351(b) to the extent of the fair market value of the nonqualified preferred stock. Thus, the nonrecognition rule stated in § 351(a) is overridden by § 351(b) when there is nonqualified preferred stock within the transaction. The purpose of § 351(g) is to treat preferred stock, which contains significant characteristics similar to debt instruments, as nonqualified preferred stock. *See* PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR. & DANIEL L. SIMMONS, *FEDERAL INCOME TAXATION OF CORPORATIONS* 90 (3d ed. 2006). The legislative history of § 351(g) states that the congressional concern leading to the adoption of this provision was that “[c]ertain preferred stocks have been widely used in corporate transactions to afford taxpayers non-recognition treatment, even though the taxpayer may receive relatively secure instruments in exchange for relatively risky instruments.” H.R. REP. NO. 105-148, at 472 (1997); S. REP. NO. 105-33, at 150 (1997).

²⁶I.R.C. § 305(e)(5)(B). “Stock is described in this section if such stock—(i) is limited and preferred as to dividends *and* does not participate in corporate growth to any significant extent, *and* (ii) has a fixed redemption price.” *Id.* (emphasis added).

²⁷I.R.C. § 305(a)-(b). Under § 305(b), the IRC places limitations upon the general rule excluding stock dividends from gross income as stated in § 305(a). *Id.* Three of these limitations within § 305(b)(3)-(5) specifically speak in terms of common stock and preferred stock, drawing a distinction between the two types of instruments. *Id.*

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contains a “fixed redemption price.”²⁸ Following under § 305, the Treasury regulations, under § 1.305-5(a), also provide a rather extensive definition for preferred stock.²⁹ It is this definition that the Tax Court adopts as the quintessential definition of preferred stock under the U.S. federal tax laws.³⁰ Under § 1.305-5(a), the defining characteristics of preferred stock is that it (1) contain “certain limited rights and privileges (generally associated with specified dividend and liquidation priorities)”; and (2) it cannot “participate in corporate growth to any significant extent.”³¹

The last section within the IRC discussing and defining the term “preferred stock” is § 1504(a)(4).³² While § 1504 is the definitional section regarding affiliated corporate groups, the definition of preferred

²⁸*Id.* § 305(e)(5)(B). Under § 305(e), the IRC is concerned with “stripped preferred stock.” This provision relating to “stripped preferred stock” is concerned with a separation in ownership between the actual preferred stock and any dividends to be paid upon the preferred stock. *See id.* § 305(e)(5).

²⁹Treas. Reg. § 1.305-5(a) (as amended in 1995). Treas. Reg. § 1.305-5(a) states the following:

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. The distinguishing feature of *preferred stock* for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited, and that such stock does not participate in corporate growth to any significant extent.

Id.

³⁰*See, e.g.,* Gerdau Macsteel, Inc. v. Comm’r, 139 T.C. 67, 159-65 (2012).

³¹Treas. Reg. § 1.305-5(a).

³²I.R.C. § 1504(a)(4).

For purposes of this subsection, the term “stock” does not include any stock which—(A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (D) is not convertible into another class of stock.

Id. (emphasis added).

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stock under § 1504(a)(4) is another popular definition that the IRC applies in several provisions.³³ This definition of preferred stock contains five elements, but note that this definition is determining what is not “stock” rather than what the IRC particularly deems preferred stock. Under § 1504(a)(4), the IRC defines preferred stock as follows: (1) is nonvoting, (2) “is limited and preferred as to dividends,” (3) “does not participate in corporate growth to any significant extent,” (4) contains a set redemption price and liquidation rights that do not exceed the issue price, and (5) is not convertible into other stock.³⁴ Essentially, and in other words, this provision is declaring what is preferred stock through an exclusionary-type rule stating what the IRC does not consider common stock.³⁵ Finally, several IRS revenue rulings denote factors that are utilized to distinguish common stock from preferred stock.³⁶ While all these IRS revenue rulings deal with “section 306 stock,” they do shed some light on what the IRS deems to be common stock versus preferred stock—although the differentiation between common stock and preferred stock is far from apparent.³⁷ The reoccurring theme is that if the stock is nonvoting, holds a fixed limitation and preference as to dividends or assets upon liquidation, and does not participate in corporate growth to any significant extent, then

³³*See, e.g., id.* §§ 172(h)(3)(E), 243(c)(2), 246A(c)(4), 355(g)(2)(B)(iv)(III), 382(e)(1).

³⁴*Id.* § 1504(a)(4). Under § 1504, the IRC seeks to determine whether or not a link (or chain) of corporations are so interrelated via direct ownership of stock as to treat the corporations as one affiliated group for U.S. federal tax purposes—meaning the corporations are to be treated as affiliated with one another if they are members of this specific group connected through stock ownership. *See id.* § 1504(a)(1); Treas. Reg. § 1.1502-1(j) (as amended in 1999).

³⁵*See* I.R.C. § 1504(a); *see also* MCDANIEL, MCMAHON, JR. & SIMMONS, *supra* note 25, at 462-64.

³⁶*E.g.,* Rev. Rul. 57-132, 1957-1 C.B. 115; Rev. Rul. 75-236, 1975-1 C.B. 106; Rev. Rul. 76-386, 1976-2 C.B. 95; Rev. Rul. 76-387, 1976-2 C.B. 96; Rev. Rul. 79-163, 1979-1 C.B. 131; Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 82-191, 1982-2 C.B. 78.

³⁷The term “section 306 stock” means any stock that meets the requirements of § 306(c)(1). I.R.C. § 306(c), (e); Treas. Reg. § 1.306-3 (as amended in 1978).

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the stock will be treated as preferred stock.³⁸ Again, this same phrase of “does not participate in corporate growth to any significant extent” arises without any clarification as to what is meant by the use of that specific phrase in defining preferred stock.³⁹

Under the definitions of § 351(g), § 305(e), and § 1504(a), plus the Treasury regulations and IRS revenue rulings, the phrase “does not participate in corporate growth to any significant extent” is constantly repeated, yet this phrase is not expressly clarified or defined.⁴⁰ This aforementioned phrase is the topic of the discussion and analysis later within this Article, and this phrase possesses an ambiguous standard of application for taxpayers, practitioners, and the IRS.⁴¹

D. When Does the Common Stock v. Preferred Stock Analysis Apply?

The meaningful question arises as to under what transactions and circumstances the taxpayer must consider the common stock versus preferred stock differentiation.⁴² There are many provisions within the IRC in which the difference between common stock versus preferred stock is highly imperative to determine the U.S. federal tax consequences.⁴³ This subsection of the Article will briefly discuss these

³⁸*See, e.g.*, Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 82-191, 1982-2 C.B. 78.

³⁹*See, e.g.*, I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a) (as amended in 1995); Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 82-191, 1982-2 C.B. 78.

⁴⁰I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a); Rev. Rul. 81-91, 1981-1 C.B. 123.

⁴¹*See* I.R.C. § 351(g)(3)(A); Treas. Reg. § 1.305-5(a); *Gerdau Macsteel, Inc. v. Comm’r*, 139 T.C. 67, 160 (2012); I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

⁴²Please note that this Section of the Article is a brief summation of many intricate IRC provisions, and only focuses upon the provisions (or rather at times, only the subsections within certain sections) that can be described or articulated as differentiating between preferred stock and common stock (either expressly or implicitly, or even accidentally).

⁴³*E.g.*, I.R.C. §§ 243, 246A, 302, 305, 306, 332, 338, 351, 354, 356, 368, 382, 1036, 1059, 1361, 1503, 1504, 1563.

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IRC provisions so that a practitioner is aware of (and understands) the tax law concerns when a corporation finances its venture utilizing common stock, preferred stock, or both.

Under § 351, the IRC permits the incorporation of a business venture without the recognition of gain or loss.⁴⁴ Under § 351, the IRC does not recognize gain or loss on the transfer of property to a corporation solely in exchange for stock within this corporation if the transferor (or transferors) own at least 80% of the stock of the transferee corporation immediately after the transaction.⁴⁵ However, certain types of preferred stock do not constitute “stock” for the purposes of § 351 transactions.⁴⁶ The definition of “preferred stock” for purposes of § 351 is stock that is “limited and preferred as to dividends and does not participate in corporate growth to any significant extent.”⁴⁷ If the transferor (or transferors) utilizes such preferred stock within the § 351 transaction then the transferor (or transferors) may be required to recognize gain (but never loss) upon such transaction.⁴⁸

Generally, § 301 governs all distributions of property (including money) by a corporation to its shareholders, when acting in their capacity as shareholders.⁴⁹ Corporations may treat such distributions to the shareholders as dividends, a return of invested capital, or capital

⁴⁴*See id.* § 351(a). Also under § 351, property may be placed into an existing corporation (with current operations) in exchange for its stock, and the taxpayers involved within the transaction will not recognize any gain or loss. *Id.* § 351(b).

⁴⁵*Id.* §§ 351(a), 368(c).

⁴⁶*Id.* § 351(g).

⁴⁷*Id.* § 351(g)(3)(A).

⁴⁸*Id.* § 351(b), (g).

⁴⁹*Id.* § 301(a), (b)(1).

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gains.⁵⁰ However, for corporate shareholders there is the possibility that a dividend distribution may be treated as an “extraordinary dividend.”⁵¹ The dividend will be treated as extraordinary if “the amount of such dividend equals or exceeds the threshold percentage of the taxpayer’s adjusted basis in such share of stock.”⁵² This “threshold percentage” of the taxpayer’s adjusted basis in such share of stock varies in amount depending upon whether the stock is common stock or preferred stock.⁵³

Still relating to extraordinary dividends under § 1059, take notice of the fact that § 1059(e)(3) applies a special rule to preferred stock that pays dividends at a fixed rate not less often than annually (provided that the corporate shareholder did not obtain the preferred

⁵⁰*Id.* §§ 301(a), (c), 316(a). Under § 301(a), a distribution of property from a corporation to a shareholder, as defined under § 317(a) and with respect to the corporation’s stock, is tested under a three-step rule. *Id.* §§ 301(a), 317(a). The three-step rule is defined as follows: (1) the distribution is treated as a dividend to the extent of the corporation’s current or accumulated earnings and profits; (2) then amounts distributed in excess of the corporation’s current or accumulated earnings and profits are applied against the shareholder’s basis held in its stock in order to reduce the stock basis; and (3) then to the extent the amounts distributed exceed the shareholder’s basis in its stock, the excess amounts are treated as a gain from the sale or exchange of the stock. *Id.* § 301(c)(1)-(3).

⁵¹*See id.* § 1059(a), (c). Under § 1059, the IRC requires that a corporate shareholder, who receives an extraordinary dividend on stock that it has not held for more than two years before the dividend announcement date, must reduce the basis of the stock (but never below zero) by the amount of the untaxed portion of the dividend received. *Id.*

⁵²*Id.* § 1059(c)(1)-(2). Under § 1059(c), the IRC defines an “extraordinary dividend” in terms of the size of such dividend in relation to the corporate shareholder’s adjusted basis within its stock, subject to an alternative test utilizing the fair market value of the stock rather than the adjusted basis (at the election of the taxpayer). *Id.* § 1059(c)(4).

⁵³*Id.* § 1059(c)(2). Essentially, the distribution is treated as an extraordinary dividend if the aggregate dividends exceed 10% of the basis of the common stock; in comparison, the distribution is treated as an extraordinary dividend if the aggregate dividends exceed 5% of the basis of the preferred stock. *Id.*

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stock at a time when the dividends were in arrears).⁵⁴ Also, dividends paid upon preferred stock will be treated as extraordinary dividends in their entirety if, according to the terms of the stock, the dividend rate declines over time or the issue price of such preferred stock exceeds the liquidation value or the redemption value of such preferred stock.⁵⁵

A corporate shareholder (acting in its capacity as a shareholder) is eligible for an intercorporate dividends-received deduction when it receives dividend distributions from the payor corporation.⁵⁶ This intercorporate dividends-received deduction is equal to 80% of the dividends received if the corporate shareholder owns at least 20% of the stock of the payor corporation.⁵⁷ The 20% of the stock ownership requirement is not satisfied by certain types of preferred stock.⁵⁸ Moreover, § 246A will reduce the amount of the intercorporate dividends-received deduction by the percentage of the corporate shareholder's portfolio stock that was financed (and acquired) through the utilization of debt.⁵⁹ Thus, for § 246A to apply, the corporate shareholder must be holding "debt-financed portfolio stock," which is defined as all stock *except* when the corporate shareholder owns at least

⁵⁴*Id.* § 1059(e)(3). If the corporate shareholder owns the preferred stock for more than five years then none of the dividends received will be treated as extraordinary dividends given the annualized dividend rate does not exceed 15%. *Id.* § 1059(e)(3) (C). Further, if the actual rate of return from the received dividends does exceed the 15% limitation, then all the dividends are treated as extraordinary dividends. *Id.*

⁵⁵*See id.* § 1059(f).

⁵⁶*See id.* § 243. The general rule is that the corporate shareholder is entitled to a 70% dividends-received deduction regardless of the amount of stock owned by the corporate shareholder. *Id.* § 243(a)(1).

⁵⁷*Id.* § 243(c). There is also a 100% intercorporate dividends-received deduction if the corporate shareholder is a member of the affiliated corporate group containing the payor corporation. *Id.* § 243(a)(3), (b). The definition of preferred stock under § 1504(a)(4) applies to this § 243 situation indirectly, because the 100% intercorporate dividends-received deduction expressly adopts the meaning of "affiliated group" from § 1504(a). *See id.* §§ 243(a)(3), (b)(2), 1504(a).

⁵⁸*Id.* § 243(c)(2). The preferred stock that is excluded from the 20% stock ownership calculation is the preferred stock defined under § 1504(a)(4). § 1504(a)(4).

⁵⁹*Id.* § 246A(a).

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50% of the total value and the total voting power of the outstanding stock of the payor corporation.⁶⁰ However, the 50% of the stock ownership requirement is not satisfied by certain types of preferred stock.⁶¹

The general rule under § 302 distinguishes between redemptions of stock by the issuing corporation that is entitled to capital gains treatment from those redemptions, and for those redemptions that resemble dividends.⁶² If the stock redemption under § 302 satisfies one of the four tests outlined within § 302(b), then the redemption is a capital gain (or capital loss) transaction for the redeemed shareholder.⁶³ For example, a redemption is “substantially disproportionate”⁶⁴ if it satisfies a mathematical calculation: (1) immediately after the redemption the shareholder must own less than 50% of the total combined voting stock of the redeeming corporation; (2) immediately after the redemption the shareholder’s percentage ownership of voting stock must be less than 80% of the shareholder’s percentage ownership of voting stock immediately before such redemption; and (3) immediately after the redemption the shareholder’s ownership of

⁶⁰*Id.* § 246A(c)(1)-(2).

⁶¹*Id.* § 246A(c)(4). The preferred stock that is excluded from the 50% stock ownership calculation is that preferred stock that the IRC defines under § 1504(a)(4). *Id.* § 1504(a)(4).

⁶²*See id.* § 302(a).

⁶³*See id.* § 302(a)-(b). So, if the redemption does not satisfy one of those four tests outlined within § 302(b), then the amounts distributed by the issuing corporation in redemption of the stock will constitute dividends, given the issuing corporation has current or accumulated earnings and profits. *See id.* §§ 301(a), (c), 302(d). Note that under this provision, the rules governing constructive ownership of stock (under § 318) apply and can destroy one of the four safe harbor provisions under § 302(b). *See id.* §§ 302(b)-(c), 318(a).

⁶⁴*Id.* § 302(b)(2). To qualify for sale or exchange treatment, and for the stock redemption proceeds to be taxed as capital gains, a stock redemption generally must result in a substantial reduction in the shareholder’s ownership interest within the corporation. In the absence of this substantial reduction in the shareholder’s ownership interest, the stock redemption proceeds are taxed as dividend income. *See id.* § 302(a), (b)(2), (c)(1); Treas. Reg. § 1.302-3 (1960); Rev. Rul. 87-88, 1987-2 C.B. 81.

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common stock (whether voting or nonvoting) must be less than 80% of the shareholder's percentage ownership of *common stock* immediately before such redemption.⁶⁵ This "substantially disproportionate" test under § 302(b)(2) expressly utilizes the term "common stock," but this provision fails to define what the term means in regards to § 302 stock redemptions.⁶⁶ Furthermore, a redemption of nonvoting stock (whether nonvoting common stock or nonvoting preferred stock) may qualify under § 302(b)(2) only if there is a simultaneous redemption of voting stock (whether voting common stock or voting preferred stock).⁶⁷

Continuing with the analysis of stock redemptions under § 302, the stock redemption is a capital gain (or capital loss) transaction under § 302(a) if "the redemption is not essentially equivalent to a dividend."⁶⁸ The main focus of the analysis under the "not essentially equivalent to a dividend" redemption of § 302(b)(1) is whether the shareholder experienced a meaningful reduction in voting control of the

⁶⁵I.R.C. § 302(b)(2).

⁶⁶*See id.* § 302.

⁶⁷*See id.* § 302(b)(2); Treas. Reg. § 1.302-3. Under the precise language of § 302(b)(2)(C), there is no requirement that common stock be redeemed in all types of transactions to satisfy § 302(b)(2). I.R.C. § 302(b)(2)(C) ("For purposes of this paragraph [i.e., 302(b)(2)(C)], no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence."); *see also* Treas. Reg. § 1.302-3(a) (stating that stock containing voting rights only upon the happening of some specific event is not considered voting stock until the stated event actually occurs; and also stating that a redemption solely for nonvoting stock will never satisfy the requirements of § 302(b)(2); but, any redemption that otherwise does satisfy § 302(b)(2) will permit a simultaneous redemption of nonvoting stock to be treated as a sale or exchange transaction); Rev. Rul. 81-41, 1981-1 C.B. 121 (holding that § 302(b)(2) could apply to a redemption solely of voting preferred stock if the shareholder did not own any common stock immediately before or after the redemption transaction).

⁶⁸I.R.C. § 302(b)(1).

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corporation caused by such stock redemption.⁶⁹ The focus upon voting control of the corporation necessarily distinguishes between common stock and preferred stock.⁷⁰ So if the shareholder does not own any amount of voting common stock, then a redemption of nonvoting preferred stock will satisfy § 302(b)(1).⁷¹ Consequently, in order to properly evaluate a stock redemption under § 302(b)(1), there must be a distinction made between common stock and preferred stock (with a

⁶⁹United States v. Davis, 397 U.S. 301, 313 (1970); *Roebing v. Comm’r*, 77 T.C. 30, 51 (1981); *Benjamin v. Comm’r*, 66 T.C. 1084, 1106 (1976), *aff’d*, 592 F.2d 1259 (5th Cir. 1979); *see also* Rev. Rul. 81-289, 1981-2 C.B. 82 (holding that in order to determine if a redemption satisfies § 302(b)(1), three elements of the shareholder’s interest within the corporation are considered: (1) the right to vote and exercise control over the corporate affairs, (2) “the right to participate in current earnings and accumulated surplus,” and (3) “the right to share in net assets upon liquidation of the corporation”).

⁷⁰*See* Rev. Rul. 75-502, 1975-2 C.B. 111 (describing a shareholder’s interest in the corporation via common stock to include: (1) the right to vote and thereby exercise control; (2) “the right to participate in current earnings and accumulated surplus,” and (3) “the right to share in net assets upon liquidation of the corporation”); *see also Benjamin*, 66 T.C. at 1111-12 (holding that the stock redemption of voting preferred stock did not qualify under § 302(b)(1) because of the shareholder’s continuing voting control over the corporate affairs after the stock redemption. The fact that the shareholder’s interest in the net worth of the corporation, and the right to participate in earnings, were reduced because of the redemption was not sufficient because the “retention of absolute voting control in the present case outweighs any other consideration.”).

⁷¹Rev. Rul. 77-426, 1977-2 C.B. 87; *see also* Treas. Reg. § 1.302-2(a) (as amended in 1997) (stating that a redemption of stock from a shareholder owning solely nonvoting preferred stock is not “essentially equivalent to a dividend” because the shareholder does not have the ability to exercise control over the corporation). However, if the shareholder owns both preferred stock and common stock, and continues to own some common stock, then the analysis returns to the shareholder’s voting control within the corporation. *See, e.g., Hays v. Comm’r*, 30 T.C.M. (CCH) 378 (1971); Rev. Rul. 85-106, 1985-2 C.B. 116 (holding that a reduction in voting power and control of the corporate affairs is the key factor to determine if § 302(b)(1) applies to the redemption).

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focus upon the voting rights of the stock in question).⁷²

Continuing onwards to another section of the IRC, § 305, there is a blanket exclusion in which gross income does not include any distribution of stock when the corporation pays such stock dividend to its shareholders.⁷³ However, there are five exceptions to this aforementioned rule, and three of the five exceptions involve the differentiation between common stock versus preferred stock.⁷⁴ As previously discussed, § 305(e)(5)(B) of the IRC and § 1.305-5(a) of the Treasury regulations define “preferred stock” for the purposes of § 305.⁷⁵ Additionally, the shareholder can obtain a constructive dividend when the effect (or result) is that certain shareholders increase their proportionate interest in the corporation at the expense of other

⁷²The main reason that § 302(b)(1) creates such a distinction between common stock and preferred stock is because, in general, common stock contains unlimited voting rights and preferred stock contains limited (or zero) voting rights. *See* ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 245-49. *But see* Rev. Rul. 75-236, 1975-1 C.B. 106 (holding that the class A stock was not common stock and did not participate in corporate growth to any significant extent because such class A stock was limited and preferred as to dividends, and has limited rights upon liquidation, although the class A stock was the only outstanding stock of the issuing corporation with unlimited voting rights). Consequently, § 302(b)(1) creates an implicit (and perhaps inconspicuous) distinction between common stock and preferred stock in a large majority of situations. ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 245-49.

⁷³I.R.C. § 305(a). Essentially, this general nonrecognition rule states that the shareholder taxpayer’s gross income will not include dividends paid by the corporation in the form of the corporation’s stock, meaning that stock dividends are tax-free when paid by the corporation to the recipient shareholder “[e]xcept as otherwise provided in this section [305].” *See id.* § 305(a)-(b).

⁷⁴*Id.* § 305(b). Taxation might be imposed upon stock distributions when some of the shareholders receive common stock while other shareholders receive preferred stock. *Id.* § 305(b)(3). Taxation might be imposed upon all stock dividends when the stock dividend is made (and received) in regards to preferred stock. *Id.* § 305(b)(4). Taxation might be imposed upon all stock dividends when the stock dividend is paid in the form of convertible preferred stock. *Id.* § 305(b)(5).

⁷⁵*Id.* § 305(e)(5)(B); Treas. Reg. § 1.305-5 (as amended in 1995). By implication, the definition of “common stock” is all the stock that does not satisfy the definition of “preferred stock” as expressly stated within § 305(e)(5)(B) of the IRC and § 1.305-5(a) of the Treasury regulations. I.R.C. § 305(e)(5)(B); Treas. Reg. § 1.305-5(a).

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shareholders.⁷⁶ For example, if a shareholder (owning one class of stock) increases its claim on assets, earnings, or profits of the corporation at the expense of another class of stock, then there is a disproportionate distribution taxable under § 305(b)(2).⁷⁷ Essentially, § 305 is concerned with the tax consequences of a corporation being able to arrange its dividend policy to attract those investors who desire current cash distributions and also those investors who seek an increase in the value of a stock investment through corporate growth.⁷⁸

Stock that the IRC labels as “section 306 stock” will generate ordinary income, but never any losses, upon the disposition of such stock, subject to certain exceptions.⁷⁹ Some confusion stems from the definition of “section 306 stock”—essentially, “section 306 stock” is stock with the potential for bailing out earnings and profits inherent within the stock received in a tax-free distribution.⁸⁰ In other words,

⁷⁶See I.R.C. § 305(b)(2), (c). Some examples of ways in which shareholders can increase their proportionate interest in the corporation include (1) when there is a change in the conversion ratio or redemption price of the preferred stock, (2) certain redemptions of preferred stock for an amount that is substantially in excess of the issue price, or (3) a recapitalization of the corporation. Treas. Reg. § 1.305-3(d)(1)(i).

⁷⁷See Treas. Reg. §§ 1.305-3(b)(6), (e), 1.305-7(a) (Examples 3-4). So if a corporation has only one class of common stock outstanding, and then decides to issue a stock dividend of preferred stock, the distribution of preferred stock to the common stock shareholders is tax-free under § 305(a). See I.R.C. § 305(a)-(b) (stating that gross income will not include dividends paid in the form of the corporation’s stock “[e]xcept as otherwise provided in this section [305]”). However, if a corporation has both common stock and preferred stock (two classes of stock total) outstanding, then a stock dividend of preferred stock given to the common stock shareholders (but not to the preferred stock shareholders) will be taxable under § 305(b)(2). See *id.* § 305(b).

⁷⁸See, e.g., I.R.S. Tech. Adv. Mem. 16,002 (Apr. 20, 2001), available at 2001 WL 400216.

⁷⁹See I.R.C. § 306. Under § 306(a)(1), the IRC treats the entire amount realized upon the sale of the “section 306 stock” as ordinary income to the extent of the stock’s ratable share of the issuing corporation’s earnings and profits at the time of the distribution of the stock by the corporation to the shareholder. See *id.* § 306(a)(1). Also, § 306(a)(2) treats the entire amount realized upon the redemption of the “section 306 stock” as a distribution subject to § 301. *Id.* § 306(a); Treas. Reg. § 1.306-1(b) (as amended in 1978); see I.R.C. § 306(b) (listing the exemptions from § 306(a)).

⁸⁰See I.R.C. § 306(c).

“section 306 stock” is any stock other than common stock received as a tax-free stock dividend under § 305(a) by the shareholder who is disposing of the stock.⁸¹ There is minimal (and unclear) guidance as to what is “common stock” under § 306, except that common stock that is convertible into other common stock is not to be treated as common stock.⁸² Therefore, as this Article previously discussed in detail, a practitioner must look to IRS revenue rulings in order to understand the meaning of common stock.⁸³ While attempting to decipher the difference between common stock and preferred stock under § 306, one must keep in mind the main policy aspect of § 306: the policy places taxation upon preferred stock dividends at ordinary income tax rates (at the time the shareholder disposes of such preferred stock) in order to eliminate the income tax avoidance potential inherent within such stock received as a tax-free dividend.⁸⁴

Carrying on to a new IRC section, when a parent corporation completely liquidates a subsidiary corporation, there is no gain or loss recognized to the parent corporation if such parent corporation controls the subsidiary corporation.⁸⁵ The IRC defines “control” as the parent corporation holding both: (1) 80% or more of the voting stock of the

⁸¹*See id.* § 306(c)(1)(A). However, stock that would otherwise have been labeled as “section 306 stock” will not be treated as such stock if the issuing corporation had no current or accumulated earnings or profits at the time the stock dividend was made to the shareholder. *See id.* § 306(c)(2).

⁸²*See id.* § 306(e)(2); *see also* Treas. Reg. § 1.306-3. Moreover, the label of “section 306 stock” may be applied to stock rights to purchase stock if the stock had been issued directly as a stock dividend, including the stock that is eventually purchased pursuant to such stock purchase rights. *See* I.R.C. § 306(d); Treas. Reg. § 1.306-3(b). But, when the stock is convertible solely into the common stock of the issuing corporation, then the label of “section 306 stock” may be removed from such stock. *See* I.R.C. § 306(e).

⁸³*See, e.g.*, Rev. Rul. 82-191, 1982-2 C.B. 78; Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 79-163, 1979-1 C.B. 131; Rev. Rul. 76-387, 1976-2 C.B. 96; Rev. Rul. 76-386, 1976-2 C.B. 95; Rev. Rul. 75-236, 1975-1 C.B. 106; Rev. Rul. 57-132, 1957-1 C.B. 115.

⁸⁴*See* *Pescosolido v. Comm’r*, 91 T.C. 52, 56-60 (1988), *aff’d*, 883 F.2d 187 (1st Cir. 1989).

⁸⁵*See* I.R.C. § 332(a)-(b); Treas. Reg. § 1.332-2(d) (1960).

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subsidiary corporation, and (2) 80% or more of the total value of all stock of the corporation (excluding certain preferred stock).⁸⁶ Also, in order for § 332 to apply to the transaction there must be some distribution applicable to the common stock so as to supply the “cancellation or redemption of all [the] stock.”⁸⁷ So there is an inherent need to differentiate between common stock and preferred stock, especially if any portion of the liquidating distribution is made upon the liquidating corporation’s preferred stock.⁸⁸

Under another section of the IRC, U.S. domestic corporations may elect to be an S corporation.⁸⁹ While a corporation must satisfy several requirements in order to elect S corporation status, one of the requirements is that an S corporation is only permitted to have one class of stock.⁹⁰ However, this one-class-of-stock rule has some exceptions and leeway imbedded within it.⁹¹ There is permitted stock with differences in voting rights without violating the one-class-of-stock rule, so long as all the outstanding stock is identical with respect to the rights and claims of the owners and holders to the earnings, profits, and assets of the issuing corporation.⁹² In other words, the issuing corporation will have one class of stock if all of the outstanding shares

⁸⁶See I.R.C. §§ 332(b)(1), 1504(a)(2). The type of preferred stock that is excluded from the 80% control test is preferred stock that is nonparticipating, nonconvertible, and nonvoting. *See id.* § 1504(a)(4).

⁸⁷*Id.* § 332(b)(2).

⁸⁸*See, e.g.,* H.K. Porter Co. v. Comm’r, 87 T.C. 689, 690-93 (1986); *see also* Prop. Treas. Reg. § 1.332-2(b), 70 Fed. Reg. 11908 (Nov. 26, 1960) (stating that § 332 only applies to those cases in which the recipient shareholder receives at least partial payment for each class of stock that the corporate shareholder owns within the liquidating corporation).

⁸⁹*See* I.R.C. § 1361; Treas. Reg. § 1.1361-1 (as amended in 2008).

⁹⁰I.R.C. § 1361(b)(1)(D).

⁹¹*See id.* § 1361(c); Treas. Reg. § 1.1361-1(l).

⁹²I.R.C. § 1361(c)(4). In other words, this provision permits variations in voting rights among the shares of common stock, including the issuance of nonvoting common stock (but not nonvoting preferred stock), without creating a second class of stock and violating the one-class-of-stock rule. *Id.*

of stock of the corporation confer identical rights and claims as to current distributions and liquidation proceeds, while disregarding the differences in voting rights.⁹³ Additionally, there is a safe harbor for debt instruments to ensure that the financial instrument will not be reclassified as an equity instrument and thus, will avoid being treated as a second class of stock.⁹⁴ For the debt instrument to qualify under the § 1361(c)(5) for safe harbor, the debt must: (1) be an unconditional written obligation to pay a fixed sum on demand or on a specified date; (2) not be convertible into an equity interest within the issuing corporation; (3) be held by a person or trust that is eligible to be an S corporation shareholder; and (4) not be contingent upon the earnings or profits of the issuing corporation (meaning the timing, amount of the interest payments, or principal are not contingent upon the issuing corporation's financial success).⁹⁵ Consequently, electing the S corporation status requires that a taxpayer be observant of the terms and characteristics of both the equity and debt instruments issued by the corporation (especially because it is not always easy to differentiate preferred stock from common stock or debt instruments).⁹⁶

To determine if a group of corporations are all members of a controlled group, the corporations must satisfy an objective control test delineated under § 1563 of the IRC.⁹⁷ However, certain stock is

⁹³Treas. Reg. § 1.1361-1(l)(1).

⁹⁴I.R.C. § 1361(c)(5). This provision is commonly called the "straight debt" safe harbor. *Id.*

⁹⁵*Id.*; Treas. Reg. § 1.1361-1(l)(5)(i); S. REP. NO. 97-640, at 3260 (1982). Note that a subordination of the debt instrument to other corporate debts does not prevent its treatment as satisfying § 1361(c)(5) safe harbor. Treas. Reg. § 1.1361-1(l)(5)(ii).

⁹⁶See generally William Rands, *The Closely Held Corporation: Its Capital Structure and the Federal Tax Laws*, 90 W. VA. L. REV. 1009 (1988) (discussing the differences between preferred stock, common stock, and debt instruments).

⁹⁷See I.R.C. § 1563(a). There are three objective control tests to determine if the corporations become members of the controlled group. See *id.* § 1563(a)(1)-(3). All three tests involve an ownership chain between two or more corporations connected through stock ownership in which a certain stock ownership percentage threshold is satisfied (i.e., held by the one corporation) via the stock voting power or the value of all classes of outstanding stock. *Id.*

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disregarded from consideration in determining whether the corporations are members of the controlled group.⁹⁸ The objective control test under § 1563 does not include stock that is nonvoting, limited, and preferred as to dividends.⁹⁹ Furthermore, § 1501 provides that all members of an affiliated group of corporations may elect to file a consolidated return.¹⁰⁰ An affiliated group consists of the common parent corporation and one or more chains of other corporations connected through stock ownership in which the common parent corporation owns stock of at least one other corporation that represents at least 80% of the total voting power of all the stock of the corporation *and* has a value equal to at least 80% of the total value of all the stock of the corporation.¹⁰¹ In addition, each includible corporation must be connected to the common parent corporation, or to one or more corporations owned by the common parent corporation, through the requisite 80% of voting power and value tests outlined above.¹⁰² However, certain stock that possesses more debt-like characteristics than equity characteristics (i.e., common stock characteristics) is not included within the calculation of the 80% voting power and value

⁹⁸*See id.* § 1563(c). The idea and policy behind this provision is to make it easier to establish the true existence of control by one corporation over another corporation (and stock that more closely resembles debt instruments, rather than equity instruments, will be disregarded for the purposes of this provision). *Id.*

⁹⁹*Id.* § 1563(c)(1)(A). Also, treasury stock and certain “excluded stock” described in § 1563(c)(2) are not included within the objective control test under § 1563. *See id.* § 1563(c)(1)(B)-(C).

¹⁰⁰*Id.* §§ 1501, 1504(a).

¹⁰¹*Id.* § 1504(a)(1)-(2). If a member of the affiliated group pays dividends upon nonvoting preferred stock held by shareholders outside the affiliated group, taxable income of the distributing corporation equal to the dividends paid is effectively insulated from being offset by losses or credits of the remainder of the affiliated group. *See id.* § 1503(f). Specifically, if a subsidiary distributes dividends upon applicable preferred stock, then the subsidiary faces limitations on losses and credits. *See id.* § 1503(f)(1), (3). “Applicable preferred stock” is nonvoting, nonparticipating, nonconvertible preferred stock of the subsidiary that was issued after November 17, 1989, and is held by a person other than a member of the affiliated consolidated group. *Id.* § 1503(f)(3)(D).

¹⁰²*See id.* § 1504(a)(1)-(2).

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tests.¹⁰³ Consequently, stock for purposes of § 1504 does not include nonvoting stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, if its liquidation and redemption rights do not exceed its issuance price (except for a reasonable premium), and it is not convertible into another class of the issuing corporation's stock.¹⁰⁴

In order for a taxpayer to make an election under § 338 (i.e., an acquisition of a corporation via stock purchase), the purchasing taxpayer must make a qualified stock purchase.¹⁰⁵ The IRC defines "qualified stock purchase" as an acquisition by purchase (within a twelve-month period) of 80% or more of the voting stock *and* 80% or more of the total value of all the stock of the corporation (excluding one specific type of stock).¹⁰⁶ The excluded type of stock from this 80% test is the stock described under § 1504(a)(4), and includes stock that is nonvoting, nonconvertible, restricted as to redemption and liquidation rights, "limited and preferred as to dividends," and "does not participate in corporate growth to any significant extent."¹⁰⁷

The issuance of preferred stock also becomes relevant under the provisions governing tax-free corporate reorganizations.¹⁰⁸ There are

¹⁰³*See id.* § 1504(a)(4).

¹⁰⁴*Id.* § 1504(a)(4). Also, § 1504(a)(5) authorizes regulations that will treat certain convertible instruments as not constituting stock for reasons of § 1504. *See id.* § 1504(a)(5).

¹⁰⁵*Id.* § 338(a).

¹⁰⁶*Id.* §§ 338(d)(3), 1504(a)(2).

¹⁰⁷*Id.* § 1504(a)(4).

For purposes of this subsection [i.e., § 1504(a)], the term "stock" does not include any stock which—(A) is not entitled to vote, (B) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (C) has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and (D) is not convertible into another class of stock.

Id.

¹⁰⁸*See id.* §§ 354-56, 368.

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certain tax-free corporate reorganizations that require the utilization of voting stock to effectuate the transaction.¹⁰⁹ While the voting rights of the stock, alone, do not differentiate between preferred stock and common stock, one of the definitions of preferred stock under the IRC expressly states that preferred stock must be nonvoting stock.¹¹⁰ Thus, the distinction between preferred stock and common stock can be quite important under certain types of tax-free corporate reorganizations.¹¹¹ Furthermore, there are certain tax-free corporate reorganizations (or select portions of the transactions) that implicate, in whole or in part, a fixed control percentage of stock ownership in reference to the target or acquired corporation.¹¹² The definition of this stock ownership “control” requirement for the tax-free corporate reorganization provisions is “possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote *and* at least 80 percent of the total number of shares of all other classes of stock of the corporation.”¹¹³ It is this phrase “at least 80 percent of the total number of shares of all other classes of stock” where there is direct and definitive congressional intent to draw a line between dissimilar types of stock, such as preferred stock versus common stock.¹¹⁴ Again, the distinction between preferred stock and common stock is certainly

¹⁰⁹*Id.* § 368(a)(1)(B)-(C), (2)(E).

¹¹⁰*Id.* § 1504(a)(4). Please note that other definitions of preferred stock under the IRC do not expressly list the voting characteristics of the stock as a factor for differentiating between preferred stock and common stock. *See id.* §§ 305(e)(5)(B), 351(g)(3)(A); Treas. Reg. § 1.305-5(a) (as amended in 1995). However, the IRS revenue rulings strongly suggest that the nonvoting characteristic of the stock is a feature of preferred stock because common stock is typically voting stock. *See, e.g.*, Rev. Rul. 81-91, 1981-1 C.B. 123; Rev. Rul. 82-191, 1982-2 C.B. 78.

¹¹¹*See, e.g.*, I.R.C. § 368(a)(1)(B)-(C), (2)(E).

¹¹²*Id.* § 368(a)(1)(B)-(D), (2)(C)-(E), (2)(H), (b).

¹¹³*Id.* § 368(c) (emphasis added). There is one exception to this definition of “control,” which is the type (D) reorganizations under § 368(a)(1)(D). Under the tax-free corporate reorganization delineated in § 368(a)(1)(D), essentially the 80% amount is changed to 50%. *See id.* § 368(a)(2)(H) (cross-referencing the definition of “control” as stated under § 304(c)).

¹¹⁴*See id.* § 368(c).

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important under certain types of tax-free corporate reorganizations.¹¹⁵

Under § 368(a)(1)(E) reorganization, more colloquially called a “recapitalization,”¹¹⁶ a tax-free corporate reorganization is one in which there is a “reshuffling of a capital structure within the framework of an existing corporation,”¹¹⁷ and it includes transactions involving exchanges of one class of stock or securities in a corporation for another different class of stock or securities issued by the same corporation.¹¹⁸ For example, if the tax-free corporate reorganization transaction involves preferred stock, and if the tax-free corporate reorganization transaction has the effect that is substantially the same as a receipt of a stock dividend, then any newly issued preferred stock may be “section 306 stock.”¹¹⁹ As considered previously, labeling preferred stock as

¹¹⁵*See, e.g., id.* § 368(a)(1)(B)-(D), (2)(C)-(E), (2)(H), (b); *see also* Rev. Rul. 76-223, 1976-1 C.B. 103 (involving the manipulation of the characteristics of the target or acquired corporation’s nonvoting preferred stock, by granting the preferred stock full voting rights, in order for the stock ownership “control” requirement under § 368(c) to be satisfied by the acquiring corporation).

¹¹⁶I.R.C. § 368(a)(1)(E).

¹¹⁷*Helvering v. Sw. Consol. Corp.*, 315 U.S. 194, 202 (1942).

¹¹⁸*See, e.g.,* Treas. Reg. § 1.368-2(e) (as amended in 2010); Rev. Rul. 84-114, 1984-2 C.B. 90. For example, exchanging preferred stock for common stock, or exchanging debt instruments for preferred stock, are forms of recapitalizations under § 368(a)(2) (E). *See* Treas. Reg. § 1.368-2(e).

¹¹⁹*See* I.R.C. §§ 306(c)(1)(B), 356(a)(2); Treas. Reg. § 1.306-3(d) (as amended in 1978). More specifically, if pursuant to the tax-free corporate reorganization transaction the shareholders of the target or acquired corporation surrender their common stock and receive both common stock and preferred stock in the acquiring corporation, then the preferred stock will be characterized as “section 306 stock” pursuant to § 306(c)(1)(B) if “the effect of the transaction [was] substantially the same as the receipt of a stock dividend.” *See* Treas. Reg. § 1.306-3(d). But, if pursuant to the tax-free corporate reorganization transaction the shareholders of the target or acquired corporation surrender their preferred stock and receive only newly issued preferred stock in the acquiring corporation, then the preferred stock will not be labeled as “section 306 stock,” unless (1) the newly issued preferred stock is of greater value than the preferred stock surrendered, or (2) the surrendered preferred stock was labeled as “section 306 stock” in the past. *See* I.R.C. § 306(c)(1)(C); Treas. Reg. § 1.306-3(d) (Example 2); Rev. Rul. 88-100, 1988-2 C.B. 46; Rev. Rul. 82-118, 1982-1 C.B. 56.

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“section 306 stock” will allow the owner or holder to treat the gains generated from a future disposition of such preferred stock as ordinary income.¹²⁰

While this example applies to many types of tax-free corporate reorganizations or corporate divisions, it frequently arises under the § 368(a)(1)(E) reorganizations.¹²¹ Lastly, the tax-free corporate reorganization provisions treat certain nonqualified preferred stock as boot¹²² for purposes of § 354 and § 356.¹²³ The nonqualified preferred stock is treated as boot, requiring gain recognition under § 356(a), if such stock is received within a tax-free corporate reorganization other than in exchange for other nonqualified preferred stock of the target or acquired corporation.¹²⁴ Hence, if the nonqualified preferred stock is exchanged for substantially identical nonqualified preferred stock, then the newly received nonqualified preferred stock is treated as stock for

¹²⁰*See* I.R.C. § 306(a). Although the overall transaction is a tax-free corporate reorganization, § 305 treats the “section 306 stock” as a taxable dividend. *See id.* § 356(a)(2).

¹²¹For an example of a situation under § 368(a)(2)(E) in which the preferred stock received the “section 306 stock” label, see Rev. Rul. 56-654, 1956-2 C.B. 216 (stating that a change in the preferred stock’s liquidation value resulted in a recapitalization as a constructive exchange of outstanding preferred stock and common stock for newly issued preferred stock in which the increase in value of the preferred stock from the change in the liquidation value is labeled as “section 306 stock”). *See also* Rev. Rul. 66-332, 1966-2 C.B. 108, *modified by*, Rev. Rul. 81-91, 1981-1 C.B. 123.

¹²²The term “boot” is commonly defined as the extra money, unrelated or non-like-kind property, or assumption of liabilities included in an otherwise nontaxable exchange or transaction; and thus, the boot is subject to income tax. BLACK’S LAW DICTIONARY 208 (9th ed. 2009).

¹²³*See* I.R.C. §§ 354(a)(2)(C), 356(d)-(e). The definition of “nonqualified preferred stock” is found within § 351(g). *See id.* § 351(g)(2)(A). Preferred stock is “nonqualified” only if the preferred stock: (1) is redeemable within a twenty year period, *or* (2) contains a variable dividend rate directly linked and dependent upon certain financial prices or indices. *See id.* § 351(g)(2)(A)-(B). Stock is “preferred stock” only if the stock (1) “is limited and preferred as to dividends,” (2) “does not participate in corporate growth to any significant extent,” *and* (3) “there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.” *Id.* § 351(g)(3)(A).

¹²⁴*Id.* §§ 354(a)(1), 354(a)(2)(C), 356(a)(1), 356(e)(2).

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purposes of the tax-free corporate reorganization and the nonrecognition
rule applies to such received preferred stock.¹²⁵

Under § 382(a), the IRC limits the amount of a corporation's loss carryovers and built-in losses that can be offset against another corporation's taxable income in the years following an ownership change.¹²⁶ Under § 382, an "ownership change" occurs whenever:

immediately after any owner shift involving a 5-percent shareholder or any equity structure shift—(A) the percentage of the stock of the loss corporation owned by 1 or more 5-percent shareholders has increased by more than 50 percentage points, over (B) the lowest percentage of stock of the loss corporation (or any predecessor corporation) owned by such shareholders at any time during the testing period.¹²⁷

For this provision regarding the limitations placed upon net operating loss carryforwards and certain built-in losses following ownership change, the term "stock" is defined to mean all types of stock other than the preferred stock described in § 1504(a)(4) of the IRC.¹²⁸ Consequently, and in line with what this Article has discussed several times previously, the IRC separates and distinguishes this plain, vanilla preferred stock from common stock based largely upon the characteristic that such preferred stock does not "participate in corporate growth to any significant extent."¹²⁹

¹²⁵*Id.*; see Treas. Reg. § 1.354-1(f) (as amended in 1979); Treas. Reg. § 1.356-7(b) (2000).

¹²⁶See I.R.C. § 382(a), (b).

¹²⁷See *id.* § 382(g)(1).

¹²⁸*Id.* § 382(k)(6)(A). The U.S. Treasury Department has the authority to promulgate regulations in order to treat certain forms of stock or stock interests as "stock" for purposes of § 382. See *id.* § 382(k)(6)(B). For example, convertible preferred stock is treated as "stock" for purposes of § 382. See Treas. Reg. § 1.382-2(a)(3)(ii) (as amended in 1999).

¹²⁹See, e.g., I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a) (as amended in 1995).

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When common stock of a corporation is exchanged solely for common stock of the same corporation, or if preferred stock of a corporation is exchanged solely for preferred stock of the same corporation, then the corporation does not recognize a gain or loss on the transaction.¹³⁰ However, nonqualified preferred stock, as defined under § 351(g)(2), is not treated as preferred stock under this provision of § 1036; thus, if § 351(g) preferred stock is exchanged solely for newly issued preferred stock of the same corporation, the nonrecognition rule does not apply to the exchange transaction.¹³¹

III. IRS CHIEF COUNSEL MEMORANDUM¹³²

A. *Introduction to the IRS Chief Counsel Memorandum*

On September 7, 2012, the IRS issued an advisory memorandum in which the issue involved whether to treat certain newly issued stock as common stock or preferred stock under § 302(b)(2) of the IRC.¹³³ The facts of this IRS chief counsel memorandum are stated as follows. The transaction involves a profitable closely-held U.S. corporation.¹³⁴ The corporation has paid dividends over three of the four preceding years.¹³⁵ The corporation “consummated a recapitalization transaction” comprised of multiple steps.¹³⁶ First, the corporation issued shares of voting convertible preferred stock (“VCPS”) to an unrelated purchaser in exchange for cash money.¹³⁷ Second, pursuant to an exchange offer, the corporation redeemed some (but not all) of its outstanding shares of

¹³⁰I.R.C. §1036(a).

¹³¹*Id.* §§ 351(g)(2), (3)(A), 1036(b).

¹³²I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹³³*Id.*

¹³⁴*Id.*

¹³⁵*Id.*

¹³⁶*Id.*

¹³⁷*Id.*

common stock for cash money.¹³⁸

Under the terms of the VCPS, the unrelated purchaser “is entitled to receive a dividend on each share of VCPS in an amount equal to the per-share dividend (if any)” declared upon the corporation’s remaining and outstanding common stock.¹³⁹ “The VCPS are noncumulative (i.e., unpaid dividends do not accrue).”¹⁴⁰ Furthermore, upon the corporation’s liquidation, the VCPS entitles the unrelated purchaser “to receive a premium equal to the purchase price” of the VCPS shares; and thereafter, the unrelated purchaser “will share in [the] liquidation proceeds to the same extent as [all the] common shareholders.”¹⁴¹ Also, the VCPS “are voting shares, although they are subject to a partial and temporary voting restriction.”¹⁴² “Finally, each VCPS share is convertible [(at the unrelated purchaser’s election)] into one share of a newly authorized class of common stock.”¹⁴³

Some of the corporation’s common shareholders treated the redemption of their common stock as an exchange under § 302(b)(2).¹⁴⁴ Thus, the issue was whether the IRS should treat VCPS shares as common stock or preferred stock for purposes of § 302(b)(2).¹⁴⁵

This IRS chief counsel memorandum concluded that the VCPS shares are not limited or preferred as to dividends, are not limited as to liquidating distributions, and allow the unrelated purchaser to participate in corporate growth to a significant extent.¹⁴⁶ Moreover, the

¹³⁸*Id.*

¹³⁹*Id.*

¹⁴⁰*Id.*

¹⁴¹*Id.*

¹⁴²*Id.*

¹⁴³*Id.*

¹⁴⁴*Id.*

¹⁴⁵*Id.*

¹⁴⁶*Id.*

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memorandum stated that there appears to be a “real and meaningful likelihood” that the unrelated purchaser will participate in corporate growth to a significant extent.¹⁴⁷ Therefore, the IRS determined that these VCPS shares should be treated as common stock (and not as preferred stock) for purposes of § 302(b)(2).¹⁴⁸

B. Analysis of the IRS Chief Counsel Memorandum

1. Debt versus Equity—“Substance Over Form”

The IRS stated that the label of preferred stock is not controlling, citing to the case of *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (establishing thirteen factors that are analyzed to determine if a financial instrument is debt or equity).¹⁴⁹ While it is true and accurate for the IRS to look behind the transaction’s form in order to analyze the true substance of the transaction, this IRS chief counsel memorandum is a case of common stock versus preferred stock (both are equity instruments), and not one of equity versus debt instruments

¹⁴⁷*Id.*

¹⁴⁸*Id.*

¹⁴⁹*Id.*; *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972). Note that case law has established a multitude of factors for attempting to discern the dissimilarities between debt instruments and equity instruments. *See, e.g.*, *Hewlett-Packard Co. v. Comm’r*, 103 T.C.M. (CCH) 1736, 19-20 (2012) (listing eleven factors); *Slaphey Drive Indus. Park v. United States*, 561 F.2d 572, 582 (5th Cir. 1977) (listing thirteen factors); *In re Uneco, Inc.*, 532 F.2d 1204, 1207-08 (8th Cir. 1976) (listing ten factors); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) (listing sixteen factors). All these factors are to be utilized solely to guide the analysis, and are never determinative standing alone; but rather, the factors are to be utilized to establish the true economic substance of the transaction. *Hewlett-Packard Co.*, 103 T.C.M. (CCH) at 20; *Slaphey Drive Industrial Park*, 561 F.2d at 582; *Fin Hay Realty Co.*, 398 F.2d at 697. Accordingly, the analysis of whether an instrument is to be characterized as debt or equity is a facts and circumstances situation aimed at scrutinizing the substance of the transaction over its mere form. *See, e.g.*, *PepsiCo P.R., Inc. v. Comm’r*, 104 T.C.M. (CCH) 322, 17-20 (2012); *Bowman v. Comm’r*, 73 T.C.M. (CCH) 1859, 2-6 (1997); *Full Serv. Beverage Co. & Subsidiaries v. Comm’r*, 69 T.C.M. (CCH) 2221, 4-10 (1995). This is the exact same approach taken by the IRS within its IRS chief counsel memorandum for differentiating common stock from preferred stock. I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

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(which was the issue within *Estate of Mixon*).¹⁵⁰ It is readily agreed that the IRS can utilize the “substance over form” analysis in these types of situations, but utilizing a case involving debt versus equity (and then only citing to one of the thirteen factors discussed within the case of *Estate of Mixon*) is not the proper method for analyzing this common stock versus preferred stock situation.¹⁵¹ Rather, the IRS should have utilized (and cited to) sources distinguishing between common stock and preferred stock, or used this opportunity to create a new set of standards or factors for making such a common stock versus preferred stock determination.

2. No dividend preference or limitation

Under the facts, the unrelated purchaser who obtained the VCPS shares will receive identical dividends (in frequency and amount) that will be received by the holders of the common stock.¹⁵² The IRS makes a conclusory statement that the VCPS shares will “participate in corporate growth to a significant extent” without explaining why this is true under the given facts of the IRS chief counsel memorandum.¹⁵³ The IRS states that there “appears to be a real and meaningful likelihood that holders will participate in corporate growth” because the corporation has a recent history of distributing dividends to the common

¹⁵⁰See *Estate of Mixon*, 464 F.2d at 398; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6. Certain factors within the debt-equity analysis provide some (but still minimal) assistance in determining the difference between common stock and preferred stock, and perhaps there is some guidance in (1) the name given to the instrument, (2) the source of the funds utilized to make distributions, (3) the “presence or absence of a fixed maturity date” (e.g., redemption date or expiration date), (4) the right to enforce payments upon default (e.g., demand payment of accrued but unpaid dividends), (5) the participation in management activities, (6) who are the creditors or shareholders, and (7) what are the pro-rata holdings (within the corporation) of a creditor versus that of a shareholder. See, e.g., *Hewlett-Packard Co.*, 103 T.C.M. (CCH) at 20; *Slappey Drive Industrial Park*, 561 F.2d at 582; *Estate of Mixon*, 464 F.2d at 402; *Fin Hay Realty Co.*, 398 F.2d at 696.

¹⁵¹*Estate of Mixon*, 464 F.2d at 402; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁵²I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁵³*Id.*

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stockholders.¹⁵⁴ But it seems as if this conclusion is based solely upon the fact that the corporation is closely held (and not a publicly-held corporation); yet, the IRS does not make any factual determination that the corporation will likely continue to have similar financial success in the near future.¹⁵⁵ Through this minimal analysis by the IRS, there is no statement of the significance of the two phrases “participate in corporate growth to a significant extent” and “real and meaningful likelihood [of] participat[ion] in corporate growth”—the IRS’s definitions of these two phrases remains a mystery to taxpayers.¹⁵⁶ However, the IRS’s conclusion that preferred stock resembles common stock (in regards to dividend payments) is relatively accurate because the preferred stock contains no preferences or limitations regarding dividend payments, which is a typical characteristic of common stock.¹⁵⁷

3. Liquidation preference

The VCPS shares contain a liquidation premium equal to the purchase price of such VCPS shares, and after the liquidation premiums are satisfied, then the owner or holder (i.e., the unrelated purchaser) of these VCPS shares will share in any remaining liquidation proceeds to the same degree as the common shareholders.¹⁵⁸ This seems like the

¹⁵⁴*Id.*

¹⁵⁵*Id.*

¹⁵⁶*Id.* The phrase “a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation” utilized under § 351(g)(3)(A) of the IRC was designed to ensure that the characteristics contained within the stock are not illusory in regards to the shareholder’s participation in corporate earnings and growth; but rather, the stock’s characteristics (regarding the shareholder’s participation in corporate earnings and growth) are truly substantive in nature (i.e., it is a substance over form analysis). See S. REP. NO. 108-192, at 185-86 (2003); see also I.R.C. § 351(g)(3)(A) (2012) (utilizing the phrase “a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation”); Treas. Reg. § 1.305-5(a) (as amended in 1995) (utilizing the phrase “a real and meaningful probability of actually participating in the earnings and growth of the corporation”).

¹⁵⁷See BOOTH, *supra* note 7, §§ 2:3-:4; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 234-56.

¹⁵⁸I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

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preferred stock contains a standard liquidation preference (at least from a financial or economic perspective), and is typically entitled to a participating preferred stock.¹⁵⁹ This IRS chief counsel memorandum ignores this rather standard liquidation premium by stating that there is a liquidation preference within the VCPS shares, but not a liquidation limitation, without declaring why the IRS deems a liquidation preference to be of less importance than a liquidation limitation when making the determination of whether stock is common stock or preferred stock.¹⁶⁰ On the other hand, the IRS cites to § 305(e)(5)(B), which defines preferred stock as stock containing a fixed redemption price, signifying that the liquidation preference contained within the stock is an important factor for defining preferred stock.¹⁶¹ The IRS fails to assert why the VCPS shares do not contain a fixed redemption price when the facts expressly state that such VCPS shares contain a liquidation premium set equal to the purchase price of the VCPS shares (essentially, a liquidation preference equal to the purchase price of the VCPS shares that must be satisfied by the corporation before the common stock is entitled to any distributions from the liquidation process).¹⁶²

4. Limited voting preference

The facts within the IRS chief counsel memorandum pronounce that the VCPS shares are voting stock but “subject to a partial and temporary voting restriction.”¹⁶³ However, within the law and analysis section, the IRS does not mention this voting characteristic; rather, the IRS focuses its attention solely upon the dividend and liquidation

¹⁵⁹See BOOTH, *supra* note 7, §§ 2:4, :5, :39; COX & HAZEN, *supra* note 4, §§ 18:4, :10, :11.

¹⁶⁰I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁶¹*Id.* The facts under this IRS chief counsel memorandum contained exactly what is described under § 305(e)(5)(B) as a “fixed redemption price,” but the IRS does not address this issue, although it cites to § 305(e)(5)(B). *Id.*; I.R.C. § 305(e)(5)(B).

¹⁶²I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁶³*Id.*

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characteristics and completely ignores such voting characteristic.¹⁶⁴ This is an odd response by the IRS (to ignore the voting characteristic in its entirety) because § 1504(a)(4) explicitly lists nonvoting as a characteristic of preferred stock.¹⁶⁵ So the question arises as to how the IRS accounts for the limited voting rights held by the preferred stockholders. This question is ever more important because it is typical practice for preferred stock to hold such a limited voting right characteristic under certain situations.¹⁶⁶

5. Convertibility into common stock

The facts within the IRS chief counsel memorandum articulate that the VCPS shares are convertible into the issuing corporation's common stock on a one-to-one basis (at the election of the VCPS shareholders).¹⁶⁷ However, within the law and analysis section, the IRS does not mention this convertibility characteristic; rather, the IRS focuses its attention solely upon the dividend and liquidation characteristics and completely ignores such convertibility characteristic.¹⁶⁸ Again, this is an odd response by the IRS (to ignore the convertibility characteristic in its entirety) because § 1504(a)(4) explicitly lists convertibility as a characteristic of stock not being treated as preferred stock.¹⁶⁹ The IRS's ultimate conclusion that the VCPS shares should be treated as common stock appears to be correct (and highly accurate) given that the VCPS shares are convertible into the issuing corporation's common stock; however, the IRS fails to state that the convertibility element influenced the IRS's ultimate conclusion

¹⁶⁴*Id.*

¹⁶⁵I.R.C. § 1504(a)(4)(A).

¹⁶⁶See BOOTH, *supra* note 7, § 2:4; COX & HAZEN, *supra* note 4, § 18:12; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57, 60; *Preferred Stock: Overview*, *supra* note 9.

¹⁶⁷I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁶⁸*Id.*

¹⁶⁹I.R.C. § 1504(a)(4)(D).

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within this IRS chief counsel memorandum.¹⁷⁰ So the question remains
unanswered as to how the IRS accounts for the convertibility feature
contained within the preferred stock. This is such an imposing question
because it is customary to find a convertibility feature within many
types of preferred stock.¹⁷¹

6. The ultimate conclusion of the IRS chief counsel memorandum

While the ultimate conclusion appears to reach the correct result,
the analysis conducted by the IRS is certainly ambiguous, misguided,
and inconsistent with the realities of the finances and economics of
preferred stock.¹⁷² The IRS's ultimate conclusion states as follows:

We [the IRS] conclude that, since the VCPS [i.e.,
preferred stock] has no dividend preference and is not
limited as to dividends or liquidating distributions, but
rather participates in corporate growth to a significant
extent (and there is a real and meaningful likelihood of
such participation), the VCPS [i.e., preferred stock]
should be treated as common stock for purposes of
section 302(b)(2).¹⁷³

In other words, the ultimate conclusion is that the preferred
stock is to be recharacterized as common stock because (1) the
preferred stock “participates in corporate growth to a significant extent”
because the dividend for the preferred stock is exactly equal to that of
the common stock (i.e., there is no dividend preference or limitation);
(2) the preferred stock “participates in corporate growth to a significant
extent” because there is no liquidation limitation (only a liquidation
preference); *and* (3) the preferred stock holds a “real and meaningful
likelihood of the shareholder actually participating in the earnings and
growth of the corporation” because the corporation has a recent history

¹⁷⁰I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁷¹*See* BOOTH, *supra* note 7, §§ 2:4, :25, :27; COX & HAZEN, *supra* note 4, §§ 18:4, :
15, :17; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57, 61.

¹⁷²*See* I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁷³*Id.*

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of paying dividends upon the common stock.¹⁷⁴ This conclusion reached by the IRS, coupled with its minimal analysis of the law and facts surrounding the VCPS shares, leads to several inferences.¹⁷⁵

The first inference, and because the phrase “participate in corporate growth to a significant extent” is not defined under the IRC, is if the preferred stock states an explicit dividend amount (e.g., 5% of par value) and the preferred stock is strictly limited to such dividend preference (i.e., the preferred stock does not receive any dividends or distributions beyond that set, predetermined dividend amount), then it is likely that the “preferred stock” label will be honored by the IRS.¹⁷⁶ It seems quite clear from the IRS’s analysis that the most important (and most relevant) factor in distinguishing preferred stock from common stock is the dividend preferences and limitations.¹⁷⁷

It is correct to focus attention upon the preferences and limitations regarding dividends when differentiating between common stock and preferred stock; however, the dividend preference or limitation alone will not accurately depict whether the preferred stock “participates in corporate growth to a significant extent.”¹⁷⁸ For

¹⁷⁴*See id.*

¹⁷⁵*See id.* Note that the IRS chief counsel memorandum expressly states that the analysis of preferred stock versus common stock is only applicable (and limited) to a stock redemption under § 302(b)(2). *Id.* However, the IRS adopts random provisions and explanations from the IRC, Treasury regulations, and IRS revenue rulings in order to conduct its incoherent analysis, making it very reasonable to believe that the IRS could certainly attempt to employ such an analysis again in the future in the context of other IRC provisions. *Id.*; *see, e.g.*, Treas. Reg. 1.305-5(a) (as amended in 1995).

¹⁷⁶*See* I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6; *see also* BOOTH, *supra* note 7, §§ 2:3, :4; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 590-616.

¹⁷⁷*See* I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁷⁸*Id.* As subsequently demonstrated in this Article, there are multiple factors to consider when making a determination of whether the preferred stock “participates in corporate growth to a significant extent.” *See infra* Part IV. Also, as previously discussed in great detail, from a state corporate law perspective, the combinations of characteristics and features that can be selected and utilized to create preferred stock are rather abundant; and therefore, from a state corporate law perspective, fairly useless when differentiating between common stock and preferred stock.

example, a corporation can raise a certain amount of capital by issuing preferred stock—the corporation can alter both the dividend preferences and limitations and the liquidation preferences and limitations in order to create multiple versions of the same preferred stock, which carry the same fair market value when such stock is issued or sold into the marketplace. Thus, the IRS’s result within the IRS chief counsel memorandum is lacking sufficient guidance, detail, and analysis as to how exactly dividend preferences and limitations will affect whether the preferred stock will “participate in corporate growth to a significant extent.”¹⁷⁹

Second, the fact that the preferred stock holds a preference regarding liquidation rights is not sufficient in order for the IRS to honor the “preferred stock” label.¹⁸⁰ But rather, the preferred stock cannot be participating preferred stock (i.e., the preferred stock must be limited in its liquidation preference solely to the amount of the liquidation price or premium).¹⁸¹ Consequently, the IRS promotes the inference that a liquidation preference alone is irrelevant in determining whether the preferred stock will “participate in corporate growth to a significant extent.”¹⁸² Rather, without a set, predetermined limitation (i.e., a fixed and specific dollar amount) being placed upon the liquidation rights of the preferred stock, the preferred stock will likely

¹⁷⁹I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6 (“The terms of the VCPS thus allow holders thereof to participate in corporate growth to a significant extent.”). Also, the document concludes that “[t]he preferred stock in question is not limited or preferred as to dividends, it is not limited as to liquidating distributions, and it allows the holder thereof to participate in corporate growth to a significant extent.” *Id.*

¹⁸⁰*See id.*

¹⁸¹*See id.*; *see also* BOOTH, *supra* note 7, §§ 2:4, :5, :39; COX & HAZEN, *supra* note 4, §§ 18:4, :10, :11.

¹⁸²*See* I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

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“participate in corporate growth to a significant extent.”¹⁸³ On the surface, this may seem acceptable, but, for example, if the owner or holder of the preferred stock is seeking a return on investment through the increase in the fair market value of the preferred stock via capital appreciation (with the liquidation rights acting as a back-stop should the corporation fail and dissolve) because the dividend rate is low (e.g., a below-the-market dividend rate) or nonexistent, then this current IRS examination will likely lead to an incorrect result.¹⁸⁴

Third, because the IRC does not define the phrase “real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation,” if the issuing corporation has a recent history of being profitable and paying dividends upon the common stock, then it is likely that the IRS will not honor “preferred stock” label.¹⁸⁵ It seems logical that the IRS would acknowledge and evaluate financial data regarding the issuing corporation’s ability (or inability) to pay dividends to stockholders going forward in the future, but there is no such inference contained within the text of this IRS chief counsel memorandum.¹⁸⁶ Therefore, it is wise to think of the preferred stock as providing its owners or holders with a real and meaningful likelihood of participation in corporate earnings and growth if the issuing corporation has a recent history of generating profits and making distributions to stockholders.¹⁸⁷ Obviously, this is not a logical and practical result—every corporate entity strives to generate profits going forward into the future but cannot guarantee financial success. A

¹⁸³*See id.* The IRS chief counsel memorandum also suggests that the larger the amount of a liquidation premium paid to the preferred stock shareholders upon the corporation’s dissolution, then the more likely that the preferred stock will “participate in corporate growth to a significant extent” because this large liquidation premium implies that there is no authentic liquidation limitation placed upon the preferred stock. *Id.*

¹⁸⁴*See id.*; *see also* BRIGHAM & HOUSTON, *supra* note 4, at 298-322; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 590-616.

¹⁸⁵*See* I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁸⁶*See generally id.* (excluding discussion regarding a corporation’s ability to pay dividends).

¹⁸⁷*Id.*

corporation's financial situation may change from year-to-year (and sometimes the changes are rather abrupt and drastic); thus, relying solely upon the historical profitability and dividend payment history of the corporation can lead to highly erroneous results.¹⁸⁸

Fourth, the fact that the preferred stock holds limited voting rights seems to be of minimal importance to the IRS when determining if the preferred stock will "participate in corporate growth to a significant extent."¹⁸⁹ This is the correct result. For example, most preferred stock is going to be nonvoting in character; however, it is commonplace to find limited voting rights attached to preferred stock that vest if (and typically only if) the corporation fails to make dividend payments for a certain, fixed time period.¹⁹⁰ It is only if the preferred stock contains unlimited voting rights does the preferred stock contain a voting characteristic that coincides with that of common stock.¹⁹¹

Fifth, and lastly, the fact that the preferred stock is convertible into the same issuing corporation's common stock appears to be of minimal importance to the IRS when determining if the preferred stock

¹⁸⁸See BRIGHAM & HOUSTON, *supra* note 4, at 298-322; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 590-616. The stock valuation formulas utilized in the field of finance and economics account for the fact that any corporation's financial situation may change from year to year. BRIGHAM & HOUSTON, *supra* note 4, at 298-322; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 590-616. These stock valuation formulas apply the factors of "D" (i.e., the dividend a stockholder expects to receive at the end of the given time period) and "g" (i.e., the expected growth rate of dividend payments as predicted by the stockholder). BRIGHAM & HOUSTON, *supra* note 4, at 298-322; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 590-616. These factors can be adjusted to account for the corporation's current and projected future financial circumstances. See BRIGHAM & HOUSTON, *supra* note 4, at 298-322; ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 590-616.

¹⁸⁹See I.R.S. Gen. Couns. Mem., 36,025, *supra* note 6.

¹⁹⁰See BOOTH, *supra* note 7, § 2:4; COX & HAZEN, *supra* note 4, § 18:12; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57; *Preferred Stock: Overview*, *supra* note 9.

¹⁹¹See ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 245-49; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57; *Preferred Stock: Overview*, *supra* note 9.

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will “participate in corporate growth to a significant extent.”¹⁹² This is an incorrect result. The ability of the owner or holder of the preferred stock to convert all the preferred stock into the common stock of the issuing corporation is the most (and should be treated as the most) important factor when determining if the preferred stock “participates in corporate growth to a significant extent” (followed closely in importance by the dividend preferences or limitations and the liquidation preferences or limitations). The convertibility feature within the preferred stock signifies that the owner or holder of the preferred stock (in its true economic substance) holds the benefits (but likely not the risks) of the common stock of the issuing corporation.¹⁹³

The owner or holder of the preferred stock will convert the preferred stock into common stock only if the corporation is experiencing financial success.¹⁹⁴ Otherwise, if the corporation is

¹⁹²I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁹³*See* Treas. Reg. § 1.246-5 (1995). This Treasury regulation discusses and reduces the holding period of stock for any of the intercorporate dividends-received deduction, and that the holding period of stock is reduced for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property. *See* I.R.C. § 246(c)(4)(C) (2012); Treas. Reg. § 1.246-5(a). So a taxpayer is treated as diminishing his or her risk of loss by holding substantially similar or related property if he or she engages in certain transactions (or the substantial equivalents) in regards to convertible preferred stock. *See* Treas. Reg. §§ 1.246-5(c)(2), (e)(2). In other words, the Treasury regulations treat taxpayers as diminishing their risk of loss by holding substantially similar or related property if the taxpayers (1) engage in a “short sale of common stock while holding convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related;” or (2) “[has a] short sale of convertible preferred stock while holding common stock.” *See id.* § 1.246-5(c)(2)(ii). Essentially, this Treasury regulation is recognizing that the values of convertible preferred stock and common stock (of the same corporation) are inextricably linked to one another. *See id.* §§ 1.246-5(a), (c)(2), (e)(2); *see also* I.R.C. §§ 305(d)(2), 385(b)(4) (demonstrating the two examples of when the owner or holder of a convertible instrument will be deemed to hold the underlying property into which the convertible instrument may be converted).

¹⁹⁴*See* BRIGHAM & HOUSTON, *supra* note 4, at 692-98; *see also* BOOTH, *supra* note 7, §§ 2:4, :25, :27; JAMES D. COX & HAZEN, *supra* note 4, §§ 18:4, :15, :17; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57; *Preferred Stock: Overview*, *supra* note 9.

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experiencing poor or slumping financial success (and facing ongoing financial problems and obstacles), then the owner or holder will continue to hold the preferred stock (and not exercise the convertibility feature) in order to maintain the liquidation and dividend privileges and benefits of such preferred stock.¹⁹⁵ Consequently, the convertibility characteristic permits the owner or holder of the preferred stock to fully reap the benefits of the corporation's financial success without limitation via the common stock conversion, while simultaneously limiting the downside risk exposure via the owner or holder's ability to make an election to keep the preferred stock unchanged and let the convertibility feature expire.¹⁹⁶ The IRS's analysis within the IRS chief counsel memorandum does not even attempt to acknowledge and address such possibilities by taxpayers (even though the facts specifically stated that the VCPS shares contained a convertibility feature permitting conversion into common stock on a one-to-one basis).¹⁹⁷ Hence, the ability to maximize benefits and gains, while concurrently minimizing risks and losses, is the epitome of the preferred stock "participat[ing] in corporate growth to a significant extent."¹⁹⁸

IV. THE TAX COURT CASE OF *GERDAU MACSTEEL, INC. V. COMMISSIONER*

Recently on August 30, 2012, the Tax Court issued an opinion in which one of the issues within the case involved whether to treat certain newly issued stock as nonqualified preferred stock under § 351(g) of the

¹⁹⁵See BRIGHAM & HOUSTON, *supra* note 4, at 692-98; *see also* BOOTH, *supra* note 7, §§ 2:4, :25, :27; COX & HAZEN, *supra* note 4, §§ 18:4, :15, :17; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57; *Preferred Stock: Overview*, *supra* note 9.

¹⁹⁶See BRIGHAM & HOUSTON, *supra* note 4, at 692-98; *see also* BOOTH, *supra* note 7, §§ 2:4, :25, :27; COX & HAZEN, *supra* note 4, §§ 18:4, :15, :17; *Preferred Stock: A Privileged If Peculiar Class*, *supra* note 9, at 57; *Preferred Stock: Overview*, *supra* note 9.

¹⁹⁷See I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

¹⁹⁸See *id.*

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IRC.¹⁹⁹ This issue turned on whether (or not) the newly issued stock (i.e., the class C preferred stock) “participate[d] in corporate growth to any significant extent” within the meaning of § 351(g)(3)(A).²⁰⁰ As observed earlier within this Article, the phrase of “participate in corporate growth to a significant extent” is the heart of the preferred stock discussion and analysis.²⁰¹

A. The Facts of the Case

The basic, relevant facts of this case are as follows. Quanex (the parent corporation) wanted to create a multimillion-dollar tax loss to shelter the capital gains that it was going to generate in the near future.²⁰² In order to report the desired tax loss to shelter Quanex’s taxable capital gains from U.S. federal income tax, Quanex engaged in several interrelated transactions. The interrelated transactions included, among many others, (1) a recapitalization of Quanex Wire, Inc. (“QW”) (which is then renamed as Quanex Health Management Company “QHMC”) by authorizing the creation and issuance of new classes of stock, (2) Quanex’s transfer to Chapman Schewe, known as Quanex Steel, Inc. (“QS”) of certain contingent liabilities valued at \$37,989,000 plus \$38 million of cash in exchange for QS stock, and (3) QS’s transfer of this \$38 million of cash and the contingent liabilities to QHMC in exchange for newly issued class C preferred stock.²⁰³ Quanex reported that the transfers to QW qualified for nonrecognition treatment under §

¹⁹⁹*Gerdau Macsteel, Inc. v. Comm’r*, 139 T.C. 67, 158-62 (2012). There were several issues within this case; however, the concern of this Article is to focus solely upon the treatment of the stock under § 351(g) of the IRC.

²⁰⁰*Id.* at 158-59; *see also* I.R.C. § 351(g)(3)(A) (2012).

²⁰¹I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6; *see supra*, Part III.

²⁰²*Gerdau Macsteel*, 139 T.C. at 74-76. Quanex later changed its name to Gerdau Macsteel. *Id.* at 72 n.1.

²⁰³*Id.* at 87-105. Quanex had a group benefits plan under which it provided health and welfare benefits to its eligible employees and their dependents and deducted the costs of those benefits as ordinary and necessary business expenses. *Id.* at 76-77. It is this obligation to pay medical plan benefits (“MPBs”) under its benefits plan equal to \$37,989,000, which forms the certain contingent liabilities transferred to QHMC. *Id.* 87-105. Also, QS and QHMC valued this class C preferred stock at \$37,989,000). *Id.*

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351(a) of the IRC; plus, that QS's basis in the class C preferred stock was determined by taking into account the contingent liabilities transferred to QHMC, currently valued at approximately \$38 million.²⁰⁴

“Each share of class C [preferred] stock was entitled to receive [set] annual dividends of \$9.50 and was not [permitted] to receive any other dividend [payments].”²⁰⁵ “Upon the class C [preferred] stock's redemption” (which both QHMC and the class C preferred stock shareholders could respectively launch at time intervals of five and seven years after the stock's issuance), “the class C [preferred stock] shareholders were entitled to receive” (for each share of stock) the greater of: (1) \$125; or (2) “an amount equal to the lesser of a percent of any cumulative cost savings.”²⁰⁶ “The transactions were structured in such a way that it was highly likely [that] when the class C [preferred] stock was issued that the class C [preferred] stock would be redeemed” at either the five-year or seven-year time periods, “and that the redemption payment would be \$125 per share.”²⁰⁷ Shortly after the transfers by QS to QHMC in exchange for the class C preferred stock, QS sold its class C preferred stock to a former employee of Quanex for \$11,000 (the difference between the \$38 million cash and the \$37,989,000 value of the liabilities).²⁰⁸ Quanex then claimed that “QS realized a \$37,989,000 short-term capital loss” upon the sale of the class C preferred stock, and then Quanex “used that loss to offset [Quanex's] unrelated capital gains totaling a similar amount.”²⁰⁹

B. The Issue in Regards to the Class C Preferred Stock

The issue in regards to the class C preferred stock is whether this

²⁰⁴*Id.* at 114-18.

²⁰⁵*Id.* at 67.

²⁰⁶*Id.*

²⁰⁷*See id.* at 67-68.

²⁰⁸*Id.* at 105-07, 124-25.

²⁰⁹*Id.* at 68. The reason that Quanex could utilize the short-term capital loss generated by QS is because Quanex is the common parent corporation of the affiliated group, via § 1504(a), including QS and QHMC. *Id.* at 74.

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class C preferred stock is considered “preferred stock” within the meaning of § 351(g)(3)(A).²¹⁰ The determination of whether the class C preferred stock is “preferred stock” within the meaning of § 351(g)(3)(A) is dependent upon whether the class C preferred stock (at the time QHMC issued it) will “participate in corporate growth to any significant extent.”²¹¹ “If the class C [preferred] stock participate[s] in QHMC’s corporate growth to a significant extent, then [such] class C [preferred] stock is not ‘preferred stock’ (and thus, is not nonqualified preferred stock) for purposes of [§] 351(g).”²¹² [However], if the class C [preferred] stock [will] not so participate [in QHMC’s corporate growth to a significant extent], then [such] class C [preferred] stock is ‘preferred stock’ [(and thus, is nonqualified preferred stock)] for purposes of [§] 351(g).”²¹³ So what this means is that if the class C preferred stock is “preferred stock” (and thus, is nonqualified preferred stock) for purposes of § 351(g), then the basis in the class C preferred stock is equal to \$11,000 (rather than the claimed basis of \$38 million) at the time of the sale by QS to the former employee of Quanex; and therefore, such sale of the class C preferred stock does not result in the claimed short-term capital loss of approximately \$38 million.²¹⁴

²¹⁰*Id.* at 159.

²¹¹*Id.* Keep in mind the legal policy behind § 351(g), and that is if the class C preferred stock does “participate in corporate growth to any significant extent,” then the class C preferred stock is more like common stock than preferred stock, so that the class C preferred stock is not treated as “preferred stock” (and thus, it cannot be nonqualified preferred stock). See I.R.C. § 351(g)(1), (2)(A), (3)(A) (2012). Consequently, the class C preferred stock is actually considered common stock under § 351(g); and therefore, the transaction would permit the short-term capital loss claimed by Quanex because the class C preferred stock takes an exchanged basis of \$38 million via the nonrecognition of any gain or loss on the transaction. See *id.* §§ 351(a), 351(g)(1), 358(a)(1).

²¹²*Gerdau Macsteel*, 139 T.C. at 159-67.

²¹³*Id.* at 159-67.

²¹⁴*Id.* Note that tax-free treatment does not apply where the stock received is nonqualified preferred stock. I.R.C. § 351(g)(1)(A). If the taxpayer receives stock other than nonqualified preferred stock then the nonqualified preferred stock is treated as other property (i.e., boot). *Id.* § 351(g)(1)(B).

C. Characteristics of the Class C Preferred Stock

The class C preferred stock holds a par value of \$100 per share.²¹⁵ The class C preferred stock is entitled to “cash dividends of \$9.50 per share per annum, payable quarterly.”²¹⁶ Also, these cash dividends are cumulative and payable for the current year, and payable for all previous fiscal years during which any class C preferred stock remained outstanding.²¹⁷ Additionally, the class C preferred stock is not entitled to receive any dividends or share of profits (whether payable in cash, stock, or other property) in excess of these fixed cash dividends.²¹⁸ In other words, the class C preferred stock may only share in QHMC’s income or gains to a maximum of an annual \$9.50 cash dividend per share.²¹⁹

The class C preferred stock holds a liquidation preference equal to the greater of: (1) \$125 per share; or (2) the formula value per share.²²⁰ The formula value per share is based upon (1) a percentage of the savings generated by QHMC, or (2) the net equity shown on the books of QHMC.²²¹ However, as stated by the Tax Court, there was a strong and realistic possibility that the formula value per share would be equal to zero, so that the liquidation preference is equal to \$125 per share.²²² Furthermore, once the class C preferred stock receives its liquidation preference (in whatever amount), then this class C preferred stock will have no other rights or claims to any of the remaining assets of QHMC (i.e., the class C preferred stock is nonparticipating preferred

²¹⁵*Gerdau Macsteel*, 139 T.C. at 113.

²¹⁶*Id.* at 114.

²¹⁷*Id.*

²¹⁸*Id.*

²¹⁹*Id.*

²²⁰*Id.* at 114-15.

²²¹*Id.* at 115.

²²²*Id.* at 164.

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stock).²²³

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The class C preferred stock holds unlimited voting rights in regard to actions taken by QHMC, meaning that the class C preferred stock is entitled to one vote per share “in all proceedings in which action might be taken by the QHMC shareholders.”²²⁴ Additionally, the class C preferred stock holds the absolute right to elect one of the nine directors of QHMC.²²⁵

The class C preferred stock contains redemption rights.²²⁶ QHMC holds the right to redeem the class C preferred stock from the owner or holder by paying a cash price equal to the greater of: (1) \$125 per share, or (2) the formula value per share.²²⁷ Also, the owner or holder of the class C preferred stock holds the right to demand and force QHMC to redeem the class C preferred stock by paying a cash price equal to the greater of: (1) \$125 per share; or (2) the formula value per share.²²⁸ However, there is no convertibility feature contained within the class C preferred stock.²²⁹

D. Analysis of the Case

The Tax Court ultimately decided to treat class C preferred stock as “preferred stock” (and thus, as nonqualified preferred stock) for purposes of § 351(g)—signifying that the nonrecognition within § 351(a) does not apply to the transaction involving the issuance of the class C preferred stock—and the basis held within the class C preferred

²²³*Id.* at 114-15.

²²⁴*Id.* at 116.

²²⁵*Id.*

²²⁶*Id.*

²²⁷*Id.*

²²⁸*Id.* at 116-17.

²²⁹*See id.* at 111 (discussing the convertibility features contained in class A and class B stock, but not in class C stock).

stock is equal to \$11,000.²³⁰

Before the Tax Court addressed an analysis of the facts of the case, it stated the following:

Neither the statute, the regulations, nor the legislative history of section 351(g) defines the phrase “*participate in corporate growth to any significant extent*” for purposes of section 351(g)(3)(A).²³¹ However, the regulations under section 305, which detail the tax consequences of certain distributions of stock and stock rights, use the same phrase to define the term “preferred stock” for purposes of section 305.²³²

The Tax Court also stated the following:

[T]he definition of the term “*preferred stock*” as set forth in section 351(g)(3)(A) mirrors the text of section 1504(a)(4)(B), which is part of the description of preferred stock that is deemed not to be stock for purposes of determining the members of an affiliated group. [This Court] understand[s] the principle there to be that “stock” described in section 1504(a)(4) has a limited claim on the earnings and equity of the issuer and, thus, is more akin to debt than to equity.²³³

So, prior to the Tax Court conducting an analysis and reaching a

²³⁰*Id.* at 159-60, 184.

²³¹*Id.* at 161 (emphasis added); *see* I.R.C. § 351(g)(3)(A) (2012).

²³²*Gerdau Macsteel*, 139 T.C. at 161 (emphasis added). The Tax Court cites to the legislative history of § 351(g), stating that “[t]he special rule for [nonqualified preferred stock] was included in section 351 to remove from that non-recognition provision ‘certain exchange transactions’ where an ‘investor has . . . obtained a more secure form of investment’ in the form of ‘preferred stock.’” *Id.* at 160 (citing H.R. REP. NO. 105-148, at 472 (1997)). Thus, § 351(g) is concerned with differentiating equity instruments from debt instruments when these equity instruments contain characteristics that are more akin to debt than to common stock. *See* I.R.C. § 351(g).

²³³*Gerdau Macsteel*, 139 T.C. at 161 (emphasis added); *see* I.R.C. § 351(g)(3)(A), 1504(a)(4).

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conclusion, the Tax Court scrupulously acknowledges that the term “preferred stock” and the phrase “participate in corporate growth to any significant extent” pose serious interpretive problems when making a differentiation between common stock and preferred stock under the IRC (and the Treasury regulations).²³⁴

The Tax Court utilizes § 1.305-5(a) of the Treasury regulations in order to analyze the phrase “participate in corporate growth to any significant extent.”²³⁵ The topic and issue of corporate growth (in regards to preferred stock) relates to the corporation’s earnings and profits coupled with the shareholder’s rights and claims upon liquidation of the corporation.²³⁶ Also, what is relevant is the true substance of a shareholder’s right to participate in corporate growth, which controls over any mere written declarations that the shareholder is allowed to so participate (i.e., substance controls over form).²³⁷ Moreover, under the facts and circumstances surrounding the stock, the shareholder cannot “meaningfully participate in corporate earnings and growth beyond the stock’s preferred limited interests.”²³⁸

For this purpose, a corporation’s earnings and growth are best evidenced through the corporation’s payment of dividends and an increase in the corporation’s equity (e.g., through a retention of earnings, asset appreciation, or contributions), and the ability of a class of stock to participate in its [corporate] issuer’s earnings and growth is best evidenced through the extent to which the stock is entitled to receive dividends and liquidation (including by way of the stock’s redemption) proceeds representing the corporation’s increased equity.²³⁹

²³⁴See *Gerdau Macsteel*, 139 T.C. at 161-62.

²³⁵*Id.*; see Treas. Reg. § 1.305-5(a) (as amended in 1995).

²³⁶*Gerdau Macsteel*, 139 T.C. at 161-62.

²³⁷*Id.* at 162.

²³⁸See *id.*

²³⁹*Id.*

Consequently, and because preferred stock is more akin to a debt instrument than common stock, the Tax Court is declaring that preferred stock must enjoy limited rights and privileges with regard to the corporate issuer's dividends and liquidation proceeds in order for the preferred stock to not "participate in corporate growth to any significant extent."²⁴⁰ This is a logical conclusion.

Applying this aforementioned law to the facts of the case, the Tax Court asserted that the class C preferred stock "does not participate in [the corporation's corporate] growth to a significant extent" because this class C preferred stock "enjoys set, pre-established limited rights and privileges as to dividends and liquidation proceeds."²⁴¹ The class C preferred stock gives its owner or holder "a guaranteed fixed annual income preference in the form of a set, cumulative dividend;" plus, upon that class C preferred stock's redemption (including if the redemption is incident to the corporation's liquidation), there is "a fixed payout that is unrelated to [the corporation's] corporate growth" equal to the price of the stock at the time the stock was issued (which is very "likely to be \$125 per share").²⁴² Therefore, the Tax Court held that "the expected return on each share of class C [preferred] stock, when viewed as of the time [when] the stock was issued, was capped at, and was intended and understood to be, 9.5% annually" via dividends, "and

²⁴⁰*Id.*

²⁴¹*Id.* at 163.

²⁴²*Id.*

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\$125 upon its redemption [by the corporation] in five to seven years.”²⁴³

Moreover, the class C preferred stock shareholder’s right to receive the corporation’s earnings annually is “preferred, fixed, and limited.”²⁴⁴ The class C preferred stock shareholder’s ability to participate significantly in corporate growth rests solely on the redemption rights delineated within the class C preferred stock (i.e., the callability and putability of such stock).²⁴⁵ However, these redemption rights do not give the class C preferred stock shareholder a meaningful interest in the corporate earnings, profits, or growth because upon redemption of the stock, it is reasonably foreseen (at the time when the stock was issued) that the class C preferred stock entitles a shareholder to receive only a preferred and limited amount of the corporation’s assets equal to \$125 a share.²⁴⁶

Consequently, the Tax Court’s analysis focused upon whether the preferred stock contained fixed, pre-established preferences *and* limitations as to dividends *and* liquidation proceeds.²⁴⁷ Furthermore, these fixed, pre-established preferences and limitations must represent genuine substantive preferences and limitations (as opposed to mere

²⁴³*Id.* The Tax Court determined that the redemption price of the class C preferred stock is very likely to be \$125 per share and stated that:

[T]he formula value will not operate to allow those shareholders to receive more than that set amount. The formula value is simply a clever facade disguising the fact that the class C shareholders have no meaningful rights to the liquidation proceeds of QHMC beyond the \$125-per-share preferred amount In fact, as we conclude from the record at hand, when the class C [preferred] stock was issued, the reasonable likelihood was that the stock would fail to meaningfully participate in corporate earnings at all, given that QHMC had no accumulated earnings when the class C [preferred] stock was issued and that QHMC was reasonably expected to have little to no earnings before the class C [preferred] stock was most likely to be redeemed.

Id. at 164.

²⁴⁴*Id.* at 163.

²⁴⁵*Id.* at 163-64.

²⁴⁶*Id.* at 164.

²⁴⁷*See id.* at 162-67.

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written preferences and limitations lacking bona fide economic substance).²⁴⁸ Therefore, to have preferred stock under the rationale of this *Gerdau Macsteel, Inc. v. Commissioner* case, the stock must embody economically substantive dividend preferences, dividend limitations, liquidation gain preferences, *and* liquidation gain limitations.²⁴⁹ But also observe and understand that the Tax Court fails to mention any other characteristics of the class C preferred stock, such as a convertibility feature (i.e., the preferred stock is convertible into common stock).²⁵⁰ Thus, the Tax Court assumed that the class C preferred stock did not contain any other characteristics different from those specifically stated within the facts of the case.²⁵¹ So what practitioners (and taxpayers) really need to appreciate is that it remains unclear as to how the Tax Court would handle such characteristics (e.g., convertibility feature) under its current preferred stock analysis.²⁵²

Furthermore, and lastly, the Tax Court did not specifically address the language within § 351(g), which states that the “[s]tock shall *not* be treated as participating in corporate growth to any significant extent *unless* there is a *real and meaningful likelihood* of the shareholder actually participating in the earnings and growth of the corporation.”²⁵³ The Tax Court ultimately treated the class C preferred stock as “preferred stock” for purposes of § 351(g); however, it never directly discussed the phrase “real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation,” although this aforementioned phrase is an essential piece

²⁴⁸*See id.*

²⁴⁹*See id.*

²⁵⁰*See id.* at 113-17, 162-67.

²⁵¹*See id.*

²⁵²*Id.* at 116. The class C preferred stock holds unlimited voting rights in regards to actions taken by QHMC; plus, the class C preferred stock holds the absolute right to elect one of the nine directors of QHMC. *Id.* However, the Tax Court does not discuss the voting characteristic within its common stock versus preferred stock analysis, implying that the voting characteristic does not appear to be of much importance to the Tax Court. *See id.* at 113-17, 162-67.

²⁵³I.R.C. § 351(g)(3)(A) (2012) (emphasis added).

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of the analysis of whether the stock “participate[s] in corporate growth to any significant extent.”²⁵⁴ However, it seems implicit (and quite clear) from the Tax Court’s analysis that if the preferred stock contains fixed, pre-established preferences and limitations regarding both dividends and liquidation proceeds (and these preferences and limitations are true in substance and not merely in form), then it is virtually impossible for the preferred stock to hold a real and meaningful likelihood of participating in the earnings, profits, and growth of the corporation.²⁵⁵

E. IRS Chief Counsel Memorandum Versus Gerdau Macsteel, Inc. v. Commissioner

The IRS chief counsel memorandum and *Gerdau Macsteel, Inc. v. Commissioner* reach different conclusions; however, both appear to undergo an equivalent analytical process. Both focus on the legal analysis of whether stock is preferred stock or common stock upon the dividend and liquidation proceeds’ characteristics of the stock.²⁵⁶ The Tax Court and the IRS both clearly agree with one another that the focal point of the preferred stock analysis needs to revolve around the dividend and liquidation proceeds’ characteristics of the stock, and that voting characteristics are of minimal importance.²⁵⁷ The IRS was quick to ignore (or rather, overlook) the fact that the preferred stock contained a convertibility feature.²⁵⁸ However, it is highly questionable whether the Tax Court would make the same determination regarding convertibility features because the preferred stock (as implied from the facts within the case) did not contain such a characteristic; thus, the Tax Court did not have to address the issue surrounding a convertibility

²⁵⁴*Id.*; *Gerdau Macsteel*, 139 T.C. at 159, 167.

²⁵⁵*See Gerdau Macsteel*, 139 T.C. at 159-162.

See id. at 162-68; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁵⁶*See Gerdau Macsteel*, 139 T.C. at 162-68; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁵⁷*See Gerdau Macsteel*, 139 T.C. at 114-17, 161-63; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁵⁸*See I.R.S. Gen. Couns. Mem. 36,025, supra* note 6.

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feature imbedded within the preferred stock.²⁵⁹ Although the IRS's
treatment of preferred stock containing limited voting rights and
convertibility features seems established and unyielding, practitioners
(and taxpayers) must certainly be leery of the Tax Court's potential
treatment of preferred stock containing convertibility characteristics.
Nevertheless, both the Tax Court and the IRS ostensibly will be
satisfied that the stock is legitimately "preferred stock" if such stock
contains substantive dividend preferences, dividend limitations,
liquidation gain preferences, *and* liquidation gain limitations.²⁶⁰

V. AUTHOR'S RECOMMENDATIONS AND SOLUTIONS²⁶¹

All the definitions of preferred stock (for purposes of the IRC)
require that the preferred stock not "participate in corporate growth to
any significant extent."²⁶² It is this phrase (which is currently not

²⁵⁹See *Gerdau Macsteel*, 139 T.C. at 113-18, 159-68.

²⁶⁰See *id.* at 114-17, 167-68; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁶¹This Article does not provide an in-depth analysis or suggestions as to universal U.S. federal tax definitions of common stock and preferred stock. An example of a practical and basic universal definition for "common stock" is "an equity interest in a corporation that contains: (1) unlimited voting rights, (2) unlimited rights to current and accumulated earnings or profits, and (3) unlimited residual financial rights." An example of a practical and basic definition for "preferred stock" is "an equity interest in a corporation that contains: (1) a preference as to dividends, (2) a preference as to liquidation proceeds, (3) does not participate in corporate growth to any significant extent, and (4) contains a fixed and specific par value." Both of these universal definitions would supply practitioners and taxpayers a basic framework, and reference point, from which they can plan any business or financial transaction. Moreover, note that the antecedent definitions of both common stock and preferred stock are at the opposite ends of a common stock-preferred stock continuous spectrum, and leave a breadth of many options and opportunities under which the stock may fall. Therefore, these two definitions could be designed as safe harbor provisions, and any stock that fails to strictly meet either one of these two safe harbor standards will fall into the current facts and circumstances analysis as applied by the IRS and the Tax Court. See, e.g., *Gerdau Macsteel*, 139 T.C. at 191; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6. However, the determination of these common stock and preferred stock definitions under the IRC is worthy of an entire scholarly article of its own.

²⁶²See I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4) (2012); Treas. Reg. § 1.305-5(a) (as amended in 1995).

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defined by the IRC, Treasury regulations, or IRS revenue rulings) that demands a comprehensive definition in order for the IRS, practitioners, and taxpayers to hold a solid understanding of where the line is drawn (or is likely to be drawn) in regards to resolving the preferred stock versus common stock jigsaw puzzle.²⁶³

A. *The Taxpayer's Intent and Labeling of the Stock*

First, should the taxpayer place a label upon the stock, then this label must be controlling upon the taxpayer (going into the future) so that such taxpayer cannot attempt to treat the financial instrument as

²⁶³*See supra* note 256; *see infra* note 271 and accompanying text. Because preferred stock is considered to be a hybrid instrument falling somewhere between common stock and debt, it is not unlikely to find many types of preferred stock that contain characteristics that are more akin to debt instruments than common stock. *See* ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 249. Consequently, and notwithstanding this discussion on common stock versus preferred stock, the preferred stock instrument always runs the risk of being recharacterized as a debt instrument instead of an equity instrument (depending upon the characteristics and features given to the preferred stock). *See, e.g.*, PepsiCo P.R., Inc. v. Comm'r, 104 T.C.M. (CCH) 322, 19 (2012). There are currently no bright-line classifications or distinctions between debt instruments and equity instruments, and the IRS has permitted the courts to handle the issue of differentiating between debt instruments and equity instruments via case law. *See, e.g.*, Cerand & Co. v. Comm'r, 254 F.3d 258, 261 (D.C. Cir. 2001); Hardman v. United States, 827 F.2d 1409, 1411-12 (9th Cir. 1987); Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630 (6th Cir. 1986); Slappey Drive Indus. Park v. United States, 561 F.2d 572, 581-82 (5th Cir. 1977); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972); Fin Hay Realty Co. v. United States, 398 F.2d 694, 696-97 (3d Cir. 1968); Hewlett-Packard Co. v. Comm'r, 103 T.C.M. (CCH) 1736, 30 (2012). *But see* I.R.C. § 385(a)-(c). Thus, practitioners and taxpayers must always keep the debt instrument classification in perspective when structuring a financial instrument labeled as preferred stock, and prior to structuring the terms of a financial instrument, the parties must consider the tax consequences of debt versus equity in order to ensure that they create an instrument that achieves the desired tax (and nontax) results. *See id.* § 385.

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something other than what the label signifies.²⁶⁴ Notwithstanding, the taxpayer's label placed upon the financial instrument will never bind the IRS; so the IRS is free to reclassify the instrument in order reflect the true substance of the transaction.²⁶⁵

This aforementioned rule follows the logic utilized within the multifactor analysis for determining whether a financial instrument is equity or debt.²⁶⁶ Two of the factors are the taxpayer's intent and the label affixed to the financial instrument; hence, the taxpayer intended to give the financial instrument a specific classification for a distinct reason (and it could likely be that the reason is not related to the U.S.

²⁶⁴*See id.* § 385(c)(1). Under state corporate law, the taxpayer may be required to give the stock a specific label depending upon the preferences, limitations, features, and relative rights designated to that class of stock. *See, e.g.*, FLA. STAT. § 607.0601 (2012); MODEL BUS. CORP. ACT § 6.01(a) (2008). In the State of Florida, the statutory provisions expressly note the difference between preferred stock and common stock by stating: "Shares which are entitled to preference in the distribution of dividends or assets shall not be designated as common shares. Shares which are not entitled to preference in the distribution of dividends or assets shall be common shares and shall not be designated as preferred shares." FLA. STAT. § 607.0601(5). However, this same statutory provision declares that the corporation may issue stock with any number (and combination) of designations, preferences, limitations, and relative rights. *Id.* §§ 607.0601(3)-(4).

²⁶⁵*See, e.g., Gerdau Macsteel*, 139 T.C. at 169. For example, if the taxpayer (either the corporation as the issuer or the person owning or holding the financial instrument) labels the instrument as preferred stock, then three years later the taxpayer cannot reclassify this preferred stock as common stock in order to suit the taxpayer's U.S. federal tax planning and objectives; in other words, the taxpayer is locked into the preferred stock label. *See* I.R.C. § 385(c)(1). However, the IRS can freely reclassify this preferred stock to be either a debt instrument or common stock should the IRS conclude that the form (of the financial instrument) does not accurately reflect the substance, especially to prevent (or minimize) tax avoidance schemes. *See Gerdau Macsteel*, 139 T.C. at 169.

²⁶⁶*See, e.g., Cerand & Co.*, 254 F.3d at 261; *Hardman*, 827 F.2d at 1411-12; *Roth Steel Tube Co.*, 800 F.2d at 630; *Slaphey Drive Indus. Park*, 561 F.2d at 581-82; *Estate of Mixon*, 464 F.2d at 402; *Fin Hay Realty Co.*, 398 F.2d at 696; *Hewlett-Packard Co.*, 103 T.C.M. (CCH) at 30; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6; I.R.S. Tech. Adv. Mem. 14-66-041 (Feb. 5, 1992), *available at* 1992 WL 1466041.

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federal tax laws).²⁶⁷ Consequently, the taxpayer's classification of the financial instrument reflects the taxpayer's intent at the time the financial instrument was created, valued, issued, sold, or purchased within the market, and such label must remain controlling upon the taxpayer to prevent (or minimize) tax avoidance schemes.²⁶⁸

B. Definition of "Participate in Corporate Growth to Any Significant Extent"

All the current definitions of "preferred stock" contain a statement that the stock cannot "participate in corporate growth to any significant extent."²⁶⁹ Although this phrase is of such great significance to the U.S. federal tax law definition of "preferred stock," this ever-important phrase is not clearly ascertained under the IRC, Treasury regulations, or IRS revenue rulings.²⁷⁰ Appropriately, a promulgation of an official definition of "does not participate in corporate growth to any significant extent" should be of the utmost concern of the IRS (or the

²⁶⁷See, e.g., *PepsiCo*, 104 T.C.M. (CCH) at 19. The Tax Court has boiled down the question of whether the financial instrument is a bona fide debt (rather than an equity instrument) to analyzing the objective circumstances surrounding the intent of the parties. *Id.* In other words, in order for the taxpayer to treat the financial instrument as debt (rather than equity), there must be a genuine "intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship." *Id.*

²⁶⁸See I.R.S. Tech. Adv. Mem. 14-66-041, *supra* note 267; *Gerdau Macsteel*, 139 T.C. at 169.

²⁶⁹See I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a) (as amended in 1995).

²⁷⁰See I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a). Regardless of the definition of preferred stock applied under the U.S. federal tax law, this phrase of "does not participate in corporate growth to any significant extent" is the backbone of the preferred stock definition and demands a clear, precise, and functional definition. See, e.g., § 305(e)(5)(B) (defining "preferred stock" as stock that "does not participate in corporate growth to any significant extent").

First, the preferred stock will “participate in corporate growth to [a] significant extent” if the preferred stock is not limited as to dividends and liquidation proceeds.²⁷² What this means is that if the preferred stock encompasses unlimited dividends (i.e., the same dividends as common stock) and unlimited rights to the corporate assets upon liquidation (i.e., participating preferred stock), then such preferred stock must be “participat[ing] in corporate growth to [a] significant extent” because the preferred stock holds the same financial and economic benefits as held by common stock.²⁷³ This one seems rather obvious, but the IRS (or the U.S. Treasury Department) should expressly announce this rule to avoid any potential confusion and eliminate the taxpayer’s capability to formulate arguments to the contrary.²⁷⁴

Second, the preferred stock will “participate in corporate growth

²⁷¹One side note is that, in general, “shareholders place their money ‘at the risk of the business’ while lenders seek a more reliable return.” *Slappey Drive Indus. Park*, 561 F.2d at 581 (stating that “[c]ontributors of capital undertake the risk because of the potential return, in the form of profits and enhanced value, on their underlying investment. Lenders, on the other hand, undertake a degree of risk because of the expectancy of timely repayment with interest.”). This standard utilized when differentiating between preferred stock and debt instruments seems rather dubious because both types of investments seek reliable, fixed returns and both place their money at risk of the business to a certain extent. *See Gerdau Macsteel*, 139 T.C. at 162 (stating that “preferred stock is generally more akin to a secure form of debt than it is to a less secure form of equity in that preferred stock characteristically is entitled to receive without regard to corporate profits a set share of corporate earnings and/or liquidation proceeds . . .”). Consequently, and in reality, all financial instruments (whether common stock, preferred stock, or debt) are dependent, to some extent, upon the issuing corporation’s performance and growth, and all will participate in corporate growth, with the only question being whether such participation in growth is “significant.” *See id.*

²⁷²*See, e.g., Gerdau Macsteel*, 139 T.C. at 162-63; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁷³*See Gerdau Macsteel*, 139 T.C. at 162-63; *see also* I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁷⁴*See, e.g., I.R.S. Gen. Couns. Mem. 36,025, supra* note 6.

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to [a] significant extent” if the preferred stock is convertible into common stock of the issuing corporation.²⁷⁵ The reason that convertible preferred stock (if convertible into common stock, but not if convertible into debt instruments of the issuing corporation) will “participate in corporate growth to [a] significant extent” is because the owner or holder of the preferred stock will not exercise the convertibility feature unless the issuing corporation is experiencing financial success (and thus, the common stock is simultaneously experiencing financial success).²⁷⁶ In other words, convertible preferred stock permits the owner or holder to participate in the financial success and growth of the corporation (in the same manner as the common stock); however, the preferred stock provides the owner or holder with some limited downside protection should the corporation experience

²⁷⁵See ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 249; *see also* BOOTH, *supra* note 7, §§ 2:3, :4. Congress once stated in a committee report that a debt treatment may be recharacterized as an equity instrument in circumstances where this debt instrument provides for “payments that are dependent to a significant extent (whether in whole or in part) on corporate performance” H.R. REP. NO. 101-247, at 1235-36 (1989). This concept of the financial instrument’s performance (i.e., return) being linked to a “significant extent on corporate performance” is also the main concern when differentiating between common stock and preferred stock. *See, e.g.*, I.R.C. §§ 305(e)(5)(B), 351(g)(3)(A), 1504(a)(4); Treas. Reg. § 1.305-5(a); *Gerdau Macsteel*, 139 T.C. at 162-63. This differentiation between debt and equity (and even within the equity category between common stock and preferred stock) is especially iffy when the instrument is convertible into common stock because preferred stock (or a debt instrument) can have significant access to the corporate earnings or profits (or future corporate growth) despite the instrument appearing (on the surface) to not have such significant access to corporate earnings, profits, or future corporate growth. *See, e.g.*, *Gerdau Macsteel*, 139 T.C. at 163; BOOTH, *supra* note 7, § 2:4. The owner or holder of the financial instrument (whether preferred stock or debt) need only convert the instrument into common stock in order to gain significant access to corporate earnings or profits, or corporate growth and expansion. *See* BOOTH, *supra* note 7, § 2:4.

²⁷⁶See BRIGHAM & HOUSTON, *supra* note 4, at 692-98.

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poor or slumping financial performance.²⁷⁷ Essentially, the convertible preferred stock is the best-of-both-worlds situation for the owner or holder.²⁷⁸ Also, the owner or holder of the preferred stock would not be interested in obtaining or purchasing the convertibility characteristic if the owner or holder did not realistically believe that the convertibility feature would reap future financial benefits.²⁷⁹

Third, the preferred stock will “participate in corporate growth to [a] significant extent” if the preferred stock contains unlimited voting

²⁷⁷*See id.* This convertible preferred stock also bestows some advantages onto the issuing corporation. *Id.* First, the convertible preferred stock offers the issuing corporation the opportunity to sell the preferred stock with below-market interest rates (i.e., a below-market dividend rate) in exchange for the purchaser’s opportunity to potentially participate in the issuing corporation’s financial successes in the future. *Id.* Second, the convertible preferred stock provides the issuing corporation with the ability to sell the corporation’s common stock at a price that is above the current market price because the convertibility feature holds financial and economic benefits and commands a price within the financial markets. *Id.*

²⁷⁸*Id.*; *see, e.g.*, I.R.C. § 385(b)(4) (stating that if a debt instrument is convertible into stock of the issuing corporation, then this feature or characteristic of the debt instrument is a factor demonstrating that the debt instrument is truly, in substance, an equity instrument); I.R.C. § 305(d)(2) (stating that for purposes of § 305(b) and § 305(c), the definition of “shareholder” includes all those persons who own convertible securities, such as preferred stock, which is convertible into common stock). *But see* Treas. Reg. § 1.305-5(a) (stating that 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 [i.e., convertible unsecured debt instruments]”).

²⁷⁹*See* BRIGHAM & HOUSTON, *supra* note 4, at 692-98.

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rights.²⁸⁰ The reasoning that voting preferred stock (if it contains unlimited voting rights equal to that of common stock—“one share, one vote” on any and all corporate matters that require a vote by shareholders) will “participate in corporate growth to [a] significant extent” is because the owner or holder of the preferred stock will hold the same control over the corporate affairs as that held by the common stockholders.²⁸¹ Consequently, the preferred shareholder will (naturally) vote in relation to the corporate affairs in such a manner that will maximize the preferred shareholder’s financial and economic benefits of owning or holding the preferred stock.²⁸²

Fourth, the preferred stock will “participate in corporate growth to [a] significant extent” if the consideration paid or exchanged for the preferred stock is less than a certain percentage below the fixed, pre-

²⁸⁰*See infra* text accompanying notes 282-83. From a state corporate law perspective, the one limitation (or maybe better stated as an obligation) placed upon the issuance of shares is that the corporation must authorize and issue at least one class of stock with (1) unlimited voting rights, and (2) unlimited residual financial rights. *See, e.g.*, FLA. STAT. §§ 607.0601(2), .0603(3) (2013); MODEL BUS. CORP. ACT §§ 6.01(b), .03(c) (2008). The unlimited voting rights characteristic is a feature most typically found within common stock, not preferred stock. *See Himmel v. Comm’r*, 338 F.2d 815, 817 (2d Cir. 1964) (reversing the Tax Court’s opinion in *Himmel v. Comm’r*, 41 T.C. 62 (1963)); Rev. Rul. 85-106, 1985-2 C.B. 116; *see also* ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 245-49.

²⁸¹*See* I.R.C. § 351(g)(3)(A); Gregory A. Barber, *Valuing Common Stock In Development-Stage Companies*, VALUATION STRATEGIES, Sept.-Oct. 2000, at 36, 39 (discussing the use of convertible preferred stock by privately owned, development stage companies during the venture capital stages of financing).

²⁸²*See supra* text accompanying notes 281-82. In other words, the preferred shareholder will flex its unlimited voting muscles to generate (for itself, and not necessarily for other shareholders or investors) the largest share of corporate assets, income, earnings, profits, rewards, compensation, and other tangible or intangible benefits. *Id.*

established par value.²⁸³ An example of the percentage threshold is one set at 20%, signifying that if the consideration paid or exchanged for the preferred stock is below the fixed, pre-established par value, then the preferred stock will “participate in corporate growth to [a] significant extent.”²⁸⁴ This standard is derived from the well-known ideal of “substance over form”—if the features and characteristics of the preferred stock genuinely reflect the economic substance embodied within the preferred stock, then the market value of such stock (i.e., the price the investor is willing to pay) should roughly approximate the par value of the preferred stock.²⁸⁵ This standard inherently assumes that the market value of the stock is designed to mirror the par value of such stock, and the issuing corporation needs to understand this standard or

²⁸³See BRIGHAM & HOUSTON, *supra* note 4, § 2:6, :13. Note that the stock will contain a fixed and pre-established par value if such stock expressly states a dollar amount per share of par value, which cannot be altered and is authorized under the issuing corporation’s articles of incorporation. From a state corporate law perspective, many states do not require that common stock or preferred stock be given a par value. *See, e.g.*, FLA. STAT. § 607.0202(2)(b)(4); MODEL BUS. CORP. ACT § 2.02(b)(2)(iv). However, preferred stock is typically known for having a stated par value and will likely be given such par value for practical purposes, such as expressly stating (and calculating) the preferred stock’s dividend payments or the amount of the preferred stock’s liquidation preference or limitation. *See* COX & HAZEN, *supra* note 4, § 18:11.

²⁸⁴For example, the par value of the preferred stock is legally set to be equal to \$100 per share. If the percentage threshold is set at 20%, and the preferred stock were to be sold in the market for consideration valued at less than \$80 per share, then the preferred stock will be treated as “participat[ing] in corporate growth to [a] significant extent.” The idea or policy behind this rule is that because the par value of the stock is so much greater than the market value of the stock, some (or all) of the features, preferences, limitation, rights, and characteristics included within the preferred stock must be lacking true financial and economic value (and are therefore, illusory).

²⁸⁵*See supra* text accompanying note 156. The problem (or opportunity) is that valuation of stock of a closely-held corporation is far from an exact science, and generally stock values can vary widely depending upon many factors. *See* ROSS, WESTERFIELD & JORDAN, *supra* note 4, at 234-56. Thus, a major problem is designing preferred stock that, given a fixed par value, will actually be found to have such value. *See, e.g.* Rev. Rul. 83-119, 1983-2 C.B. 57; Rev. Rul. 83-120, 1983-2 C.B. 170; *see also* Hall v. Hall, 125 P.3d 284, 288-89 (Wyo. 2005) (holding that the evidence of the fair market value of the husband’s preferred stock did not appropriately measure the “real, actual value” of such preferred stock, and therefore the court instead utilized the preferred stock’s par value as the more fair and reasonable value of such preferred stock for marital property distribution purposes).

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assumption and plan the transaction accordingly (or risk the stock being reclassified and labeled as common stock rather than preferred stock).²⁸⁶

Fifth, the preferred stock will “participate in corporate growth to [a] significant extent” if the preferred stock contains more factors weighing in favor of “participat[ing] in corporate growth to [a] significant extent” than those factors weighing against such participation.²⁸⁷ This is a facts and circumstances analysis, and it is the final opportunity for the IRS (or Tax Court) to make the determination of whether the preferred stock will genuinely “participate in corporate growth to [a] significant extent.”²⁸⁸ Also, it is important to understand that this multifactor analysis (as outlined below) is utilized solely to determine whether the stock “participate[s] in corporate growth to any significant extent,” and not whether the stock is to be generally classified as common stock versus preferred stock (as that is a separate and distinct facts and circumstances analysis).²⁸⁹ Lastly, the list of factors within this multifactor analysis must be purposefully exclusive and exhaustive so that taxpayers, practitioners, and the IRS can evaluate

²⁸⁶See, e.g., Rev. Rul. 83-120, 1983-2 C.B. 170. This standard eliminates the need for the phrase “a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation,” which appears in substance under both § 351(g)(3)(A) of the IRC and § 1.305-5(a) of the Treasury regulations. I.R.C. § 351(g)(3)(A); Treas. Reg. § 1.305-5(a) (as amended in 1995). This aforesaid phrase was added to the definition of preferred stock under § 351(g)(3)(A) in 2004 because there was congressional concern that taxpayers might attempt to avoid the characterization of an instrument as nonqualified preferred stock under § 351(g) by including illusory participation rights or including terms that taxpayers could argue create an “unlimited” dividend. See S. REP. NO. 108-192, at 185-86 (2003). The standard of requiring that the par value of the stock roughly approximate the market value of the stock at the time of sale forces the issuing corporation to design the stock with features and characteristics that hold bona fide economic substance. Otherwise, the par value will not roughly approximate the market value of the stock, leaving the preferred stock open to reclassification by the IRS under the current common stock versus preferred stock facts and circumstances analysis. See, e.g., I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

²⁸⁷See *infra* text accompanying notes 292-304.

²⁸⁸See *infra* text accompanying notes 292-304.

²⁸⁹See, e.g., *Gerda Macsteel, Inc. v. Comm’r*, 139 T.C. 67, 159-67 (2012); I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6.

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the stock (and the transaction) with positive assurance.²⁹⁰

The factors weighing in favor of the stock “participat[ing] in corporate growth to [a] significant extent” are the following: (1) there is no limitation upon dividends; (2) there is no limitation upon liquidation proceeds; (3) there is a variable or floating dividend rate that is tied to internal, subjective, corporate indices;²⁹¹ (4) the dividend rate is an above-market dividend rate by a certain percentage;²⁹² (5) the redemption price (and therefore, the redemption premium) is greater than a certain percentage above the stated par value;²⁹³ (6) the dividends

²⁹⁰The weighing of the factors within this multifactor analysis should be a simple numerical calculation of counting those factors that weigh in favor of the stock “participat[ing] in corporate growth to [a] significant extent” in contrast to those factors weighing against such participation. If more factors (by numerical count) weigh in favor of the stock “participat[ing] in corporate growth to [a] significant extent,” then such stock does so participate (without question or ambiguity). This numerical calculation ensures that the list of factors remains exclusive and exhaustive, and that there is some form of clarity and certainty embedded within the result of the multifactor analysis.

²⁹¹*See supra* notes 273-75 and accompanying text. Three of such internal, subjective, corporate indices may include: (1) corporate income, earnings, revenues, or profits; (2) returns generated on corporate assets; or (3) corporate cost savings or expense reductions.

²⁹²*See supra* text accompanying notes 284-87. The percentage amount would need to be determined in advance, and it may be an arbitrary number for simplicity reasons. For example, say the certain percentage rate is arbitrarily set to equal 5%. Also, assume that the current dividend rate in the market for substantially similar stock is equal to 8%. This means that if the dividend rate given to the issued stock is greater than 13%, then this stock’s dividend rate is an above-market dividend rate and is of such a level that it demonstrates the stock is “participat[ing] in corporate growth to [a] significant extent.”

²⁹³*See supra* text accompanying notes 284-87. The percentage amount would need to be determined in advance, and it may be an arbitrary number for simplicity reasons. For example, say the certain percentage rate is arbitrarily set equal to 20%. Also, this assumes that the stated par value of the stock is equal to \$100. This means that if the redemption price of the stock is greater than \$120, then this stock’s redemption premium (i.e., \$20 total premium) is of such a level that it demonstrates the stock is “participat[ing] in corporate growth to [a] significant extent.”

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are cumulative;²⁹⁴ (7) the stock is redeemable upon demand by the shareholder (i.e., the stock is puttable to the corporation);²⁹⁵ and (8) the stock is convertible and exchangeable into debt instruments or senior preferred stock (of the issuing corporation) at a time when this issuing corporation is experiencing financial problems or difficulties.²⁹⁶

The factors weighing in favor of the stock not “participat[ing] in corporate growth to [a] significant extent” are the following: (1) there is a limitation upon dividends; (2) there is a limitation upon liquidation proceeds; (3) there is a variable or floating dividend rate that is tied to external, objective, market indices;²⁹⁷ (4) the dividend rate is approximately equal to current market dividend rates, or is less than a certain percentage ceiling or cap of an above-market dividend rate;²⁹⁸

²⁹⁴See DONALD H. KELLEY, ET AL., ESTATE PLANNING FOR FARMERS AND RANCHERS § 13:71 (2012) (stating that the IRS currently holds the position that preferred stock with noncumulative dividends will likely have a substantially lower market value than preferred stock containing cumulative dividends).

²⁹⁵See, e.g., I.R.C. § 351(g)(2)(A)(i) (2012) (stating that the term “nonqualified preferred stock,” which is preferred stock containing characteristics more similar to debt than equity, includes preferred stock in which the shareholder “has the right to require the issuer or a related person to redeem or purchase the [preferred] stock”).

²⁹⁶See *supra* text accompanying notes 276-80. There would need to be a definition for the phrase “experiencing financial problems or difficulties,” but this factor still sends the warning to taxpayers and practitioners that designing stock with limited downside risk through the use of providing the stockholder the ability to gain financial priority over and above the other investors (should the corporation suffer bankruptcy and liquidate) will demonstrate the stock is “participat[ing] in corporate growth to [a] significant extent.”

²⁹⁷See *supra* text accompanying notes 273-75. Three of such external, objective market indices may include: (1) the S&P 500 Index, (2) the LIBOR, or (3) a regional or industry index (e.g., the FTSE 100 Index or the AMEX Oil Index).

²⁹⁸See *supra* text accompanying notes 284-87. The percentage ceiling or cap would need to be determined in advance, and it may be an arbitrary number for simplicity reasons. For example, say the percentage ceiling or cap rate is arbitrarily set to equal 5%. Also, assume that the current dividend rate in the market for substantially similar stock is equal to 6%. Consequently, this means that if the dividend rate given to the issued stock is equal to, or less than, 11%, then this stock’s dividend rate is approximately equal to the current market dividend rates, demonstrating that the stock is not “participat[ing] in corporate growth to [a] significant extent.”

(5) the redemption price (and therefore the redemption premium) is reasonable and equal to, or less than, a certain percentage above the stated par value;²⁹⁹ (6) the dividends are not cumulative; (7) the stock is redeemable upon demand by the corporation (i.e., the stock is callable by the corporation);³⁰⁰ (8) the stock is convertible and exchangeable into debt instruments (of the issuing corporation) with substantially the same value, terms, and characteristics;³⁰¹ (9) the stock is convertible and exchangeable into preferred stock (of the issuing corporation) with

²⁹⁹*See supra* text accompanying notes 284-87. The percentage amount would need to be determined in advance, and it may be an arbitrary number for simplicity reasons. For example, say the certain percentage rate is arbitrarily set to equal 20%. Also, this assumes that the stated par value of the stock is equal to \$100. Consequently, this means that if the redemption price of the stock is equal to, or less than, \$120, then this stock's redemption premium (i.e., a \$20 maximum total premium amount) is reasonable and demonstrates the stock is not "participat[ing] in corporate growth to [a] significant extent."

³⁰⁰*See, e.g.*, I.R.C. § 351(g)(2)(A)(ii) (stating that the term "nonqualified preferred stock," which is preferred stock containing characteristics more similar to debt than equity, includes preferred stock in which the corporate issuer "is required to redeem or purchase such [preferred] stock").

³⁰¹*See supra* text accompanying notes 276-80. A debt instrument has been described as an "unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." *Gilbert v. Comm'r*, 248 F.2d 399, 402 (2d Cir. 1957). One court has stated that "[i]n order for an advance [i.e., investment] of funds to be considered a debt rather than equity, the courts have stressed that a reasonable expectation of repayment must exist which does not depend solely on the success of the borrower's business." *Lane v. United States*, 742 F.2d 1311, 1314 (11th Cir. 1984) (citing *Am. Processing & Sales Co. v. United States*, 371 F.2d 842, 856 (1967)). More recently, the Tax Court has boiled down the question of whether the financial instrument is bona fide debt (rather than an equity instrument) to analyze the objective circumstances surrounding the intent of the parties. *See, e.g.*, *PepsiCo P.R., Inc. v. Comm'r*, 104 T.C.M. (CCH) 322, 19 (2012) (stating that for the taxpayer to treat the financial instrument as debt, rather than equity, there must be a genuine "intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship").

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substantially the same value, terms, and characteristics;³⁰² and (10) the stock contains no voting rights, or limited voting rights.³⁰³

The weighing of the factors (and solely the aforementioned factors) within this multifactor analysis should be a simple numerical calculation of counting those factors, which weigh in favor of the stock “participat[ing] in corporate growth to [a] significant extent” in contrast to those factors weighing against such participation. If more factors (by numerical count) weigh in favor of the stock “participat[ing] in corporate growth to [a] significant extent,” then such stock does so participate (and vice versa). This numerical calculation ensures that the list of factors remains exclusive and exhaustive; plus, this list ensures that there is some form of clarity and certainty embedded within the result of the multifactor analysis.

VI. CONCLUSION TO THE OVERALL ARTICLE

This Article (hopefully) has demonstrated that the current U.S. federal tax system’s approach to preferred stock versus common stock is

³⁰²See *supra* text accompanying notes 276-80. This concept stems from the continuity-of-interest requirement under tax-free corporate reorganizations. Treas. Reg. § 1.368-1(b), (c), (e) (1960); *Sw. Natural Gas Co. v. Comm’r*, 189 F.2d 332, 334-35 (5th Cir. 1951). Essentially, there is continuity-of-interest if (1) the transferor retains “a substantial proprietary stake” in the business enterprise that is “represented by a material interest in the affairs of the transferee,” and (2) “such retained interest represents a substantial [portion] of the value of the property transferred.” *Sw. Natural Gas Co.*, 189 F.2d at 334.

³⁰³See *supra* text accompanying notes 190-92.

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inadequate and puzzling.³⁰⁴ Because the difference between preferred stock and common stock can have extensive impacts upon the U.S. federal tax consequences of any given transaction, there is a great need for a clear and explicit definition of “participate in corporate growth to any significant extent” within the IRC (or within the Treasury regulations, or even the IRS revenue rulings). Creating such an explicit definition of this phrase within the IRC will, at a minimum, provide some fixed standards and certainty to practitioners and taxpayers as to what is precisely common stock and preferred stock under the U.S. federal tax laws. Moreover, and regardless of the definition of preferred stock applied under the U.S. federal tax law, this phrase of “does not participate in corporate growth to any significant extent” is the backbone of the preferred stock definition and demands a clear, precise, and functional definition. Consequently, in order for taxpayers and practitioners to accurately understand what is preferred stock under the U.S. federal tax laws, and the significance of preferred stock versus common stock, the IRS (or the U.S. Treasury Department) must take immediate action consistent with the financial, economic, and business realities in which preferred stock is created, issued, valued, sold, and purchased within the financial marketplace.

In the meantime, practitioners and taxpayers should understand

³⁰⁴*See, e.g.,* *Gerdau Macsteel, Inc. v. Comm’r*, 139 T.C. 67, 159-67 (2012); I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6. Just a final reminder that as it currently stands, the distinction between common stock versus preferred stock contains a balancing of all the facts and circumstances—which is the current test applied by both the IRS and the Tax Court. *See, e.g., Gerdau Macsteel*, 139 T.C. at 159-67; I.R.S. Gen. Couns. Mem. 36,025, *supra* note 6. The taxpayer and the IRS are free to consider and examine all facts, circumstances, intentions, aspects, characteristics, limitations, preferences, features, rights, and obligations surrounding the stock (and the transaction) in order to make a determination of whether the stock is to be properly classified as common stock or preferred stock. Also, if the financial instrument is not truly stock, then the financial instrument risks being reclassified by the IRS as a debt instrument under the current facts and circumstances analysis. *See, e.g.,* I.R.C. § 385; *Hewlett-Packard Co. v. Comm’r*, 103 T.C.M. (CCH) 1736, 19-20 (2012); Rev. Rul. 83-98, 1983-2 C.B. 40; *see also* Treas. Reg. § 1.351-1(a)(1) (as amended in 1996) (defining the term “stock,” for purposes of § 351, to not include stock rights, stock warrants, or preferred stock as defined under § 351(g)(3)(A)). Taxpayers and practitioners must always keep in mind the equity-debt analysis and distinctions when planning the purchase, sale, or exchange (or any other transaction) utilizing preferred stock.

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that preferred stock likely “does not participate in corporate growth to any significant extent” if such stock contains substantive dividend preferences, dividend limitations, liquidation gain preferences, and liquidation gain limitations.³⁰⁵ However, the effects of voting rights, a convertibility feature (from preferred stock into common stock), and other select characteristics and features upon the determination of whether the preferred stock will “participate in corporate growth to any significant extent” are currently ambiguous and unsettled in the realm of U.S. federal tax law.

³⁰⁵*Gerdau Macsteel*, 139 T.C. at 159-67.