INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 21, 1999

Number: **200023003**
Release Date: 6/9/2000
Index (UIL) No.: 1059.11-00, 1059.12-01, 165.00-00, 446.01-00
CASE MIS No.: TAM-107545-99/CC:DOM:CORP:B4

Taxpayer's Name: =
Taxpayer's Address: =

Taxpayer's Identification No: =
Years Involved: =
Dates of Conferences: =

Taxpayer =

Target =

Acquiring =

Acquisition =

Convertible Preferred =

Convertible Debentures =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Date A =

Date B =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

ISSUES

1. Does § 1059(e)(1)(A)(ii) of the Internal Revenue Code (numbered § 1059(e)(1))(B) in the taxable year involved in this case) apply to a redemption of all of one class of preferred stock of a corporation, not accompanied by a redemption of the common stock of the corporation, because the redemption is "not pro rata as to all shareholders" although it is pro rata with respect to the class of stock being redeemed?

2. For purposes of determining whether § 1059(f)(2)(C) applies to preferred stock because the stock is structured to avoid the other provisions of § 1059 and to enable corporate shareholders to reduce tax through a combination of dividends received deductions and loss on the disposition of the stock, is it sufficient that the stock have the effect of producing the tax result described in § 1059(f)(2)(C), or must the issuer of the stock have had a purpose or motive of helping the shareholders achieve that tax result?

3. Is a loss on the disposition of convertible debentures and common stock, following an allocation of basis to those securities resulting from a redemption treated as a dividend, disallowed by the regulations under § 165, which require

that a loss be "bona fide" before it can be deducted?

4. Under the facts of this case, does the Commissioner's authority under § 446(b) to compute Taxpayer's income under a method of accounting that will clearly reflect Taxpayer's taxable income permit the Commissioner to change the amount of the distribution received by Taxpayer?

CONCLUSIONS:

1. The redemption of the class of preferred stock, not accompanied by a redemption of common stock, is "not pro rata as to all shareholders" because "all shareholders" refers to all shareholders of all classes of stock of the corporation.

2. For § 1059(f)(2)(C) to apply to preferred stock, the issuer of the stock must have had a purpose or motive of helping the shareholders achieve the tax result described in that provision.

3. We are not prepared to conclude that the capital loss claimed by Taxpayer upon the disposition of the convertible debentures is not bona fide in the absence of a briefing of the issue by the examining agent and Taxpayer and further factual development pertinent to the issue.

4. Under the facts of this case, the Commissioner's authority to compute Taxpayer's taxable income does not permit the Commissioner to change, under § 446(b), the amount of the distribution received by Taxpayer.

FACTS

Taxpayer, a corporation, made an investment in common stock and convertible preferred stock of Target, a corporation, beginning in Year 1. Before the time of the Acquisition, Taxpayer's interest in Target did not exceed a percent (less than a majority) on a fully diluted basis. Taxpayer was represented on Target's board of directors but gave up its seats on Target's board in a transaction a short time before the Acquisition.

In Year 2, Acquiring, a corporation, completed the acquisition of the stock of Target in a transaction treated as a purchase for federal income tax purposes (the Acquisition). In the Acquisition, Taxpayer and other Target shareholders received various forms of consideration, including convertible, exchangeable preferred stock of Acquiring (Convertible Preferred). The Convertible Preferred had a fixed dividend rate of b percent, was nonvoting, and could be converted by the shareholder into Acquiring

common stock. Also, Acquiring, at its option, could redeem the Convertible Preferred for cash or Convertible Debentures (described below). However, the stock generally could not be redeemed until Year 4. Taxpayer owned approximately c percent of Acquiring's Convertible Preferred. Because the Acquisition was treated as a taxable transaction, Taxpayer took a cost basis in the Convertible Preferred ($d).

In Year 3, Taxpayer purchased less than one percent of Acquiring common stock on the open market.

In Year 4, Acquiring redeemed all of the Convertible Preferred in exchange for issuing the Convertible Debentures to the Convertible Preferred shareholders, including Taxpayer. There was no redemption of Acquiring common stock.

The Convertible Debentures had a yield of b percent, the same yield as the Convertible Preferred, and permitted the shareholder to receive the same amount of Acquiring common stock that the shareholder would receive under the terms of the Convertible Preferred, based on the same conversion ratio. Taxpayer treated the redemption as one that did not change its proportionate interest in Acquiring due to the application of option attribution under § 318(a)(4). Accordingly, it treated the fair market value of the Convertible Debentures ($e) as a dividend under §§ 302(d) and 301. Taxpayer claimed the dividends received deduction of 70 percent of the distribution ($f) under § 243 and recognized taxable dividend income of $g. For purposes of this technical advice memorandum only, we assume that Taxpayer correctly treated the redemption as a dividend and properly claimed the dividends received deduction.

Taxpayer took a fair market value basis in the Convertible Debentures. Taxpayer also invoked the rule of § 1.302-2(c) of the Income Tax Regulations to allocate the basis of the redeemed Convertible Preferred ($d) to both the Convertible Debentures and its shares of Acquiring common stock, allocating basis between them based on their respective fair market values. This allocation increased the combined basis of the debt and stock to $h.[1]

---

[1] It is not certain that the allocation of basis to the Convertible Debentures is correct because these debt securities are not stock. Reg. § 1.302-2(c) does not explicitly

In a number of transactions later in Year 4, Taxpayer disposed of its entire investment in Acquiring. Taxpayer sold all of its Acquiring common stock for cash, and either sold or had Acquiring redeem all of its Convertible Debentures for cash. Taxpayer claimed a substantial loss ($i) on the sale or redemption of its Acquiring Convertible Debentures as a result of its allocation of basis from the redeemed Convertible Preferred to that debt.

The field determined that Taxpayer made a substantial economic gain ($j) on its investment in Acquiring, but is claiming an artificial loss. The field seeks to reduce or eliminate the loss claimed by Taxpayer (whether on the Acquiring stock or debentures) on alternative grounds: (a) the basis of the Convertible Preferred allocated to the Acquiring Convertible Debentures or Acquiring common stock should be reduced by the nontaxable portion of the dividend under § 1059; (b) no "loss" was realized within the meaning of § 165; or (c) the loss did not "clearly reflect income" under § 446(b).

LAW AND ANALYSIS:

Introduction to Section 1059

In the taxable years at issue in this case, § 1059(a) provided generally that if any corporation receives any extraordinary dividend with respect to any share of stock and such corporation has not held such stock for more than 2 years before the dividend announcement date, (1) the basis in such corporation in such stock will be reduced (but not below zero) by the nontaxed portion of such dividends, and (2) the corporation shall treat as gain from the sale or exchange of any stock for the taxable year in which the sale or other disposition of the stock occurs an amount equal to the aggregate nontaxed portions of any extraordinary dividends with respect to such stock which did not reduce the basis of such stock by reason of the limitation on reducing basis below zero. Under § 1059(b), the nontaxed portion of an extraordinary dividend is the amount of the dividend reduced by the taxable portion of the dividend after the application of the dividends received deduction of § 243.

Section 1059(e)(1)(A)(ii), which was numbered § 1059(e)(1)(B) in Year 4, provides that if a redemption is not pro rata as to all shareholders, any amount treated as a dividend under § 301 with respect to the redemption is treated as an extraordinary dividend without regard to how long the taxpayer held the stock.

Section 1059(f)(1) provides that any dividend with respect to "disqualified

---

authorize the allocation of basis to debt. That issue is not addressed in this technical advice memorandum. The field states that it would not make a difference in Taxpayer's tax liability whether the basis was allocated to the debt and the stock or entirely to the stock, because both were disposed of in the same taxable year.

preferred stock" is treated as an extraordinary dividend without regard to the period for which the taxpayer held the stock. "Disqualified preferred stock" is defined in § 1059(f)(2) as stock preferred as to dividends if (A) such stock has a dividend rate which declines (or can reasonably be expected to decline) in the future; (B) the issue price of such stock exceeds its liquidation rights or stated redemption price, or (C) the stock is otherwise structured to avoid the other provisions of § 1059 and to enable corporate shareholders to reduce tax through a combination of dividends received deductions and loss on the disposition of the stock.

Section 1059(a) does not apply directly to the redemption of the Convertible Preferred because Taxpayer held the stock for more than two years. However, if either § 1059(e) or (f) applies to the redemption of Taxpayer's Convertible Preferred stock in Acquiring for Convertible Debentures, the basis of the stock at the time of the redemption must be reduced by the amount of the dividends received deduction taken by Taxpayer.

Issue 1: Section 1059(e): meaning of "not pro rata as to all shareholders"

Section 1059(e) requires that a corporate shareholder's basis be reduced if a redemption of its stock that is treated as a dividend is "not pro rata as to all shareholders." In this case, all of the Convertible Preferred was redeemed in Year 4, but the common stock of Acquiring was not redeemed in Year 4. Taxpayer argues that the phrase "not pro rata as to all shareholders" is applied by looking only to the class of stock being redeemed (a class by class approach). Under that interpretation, the redemption is pro rata and § 1059(e) does not apply. We conclude, however, that the better interpretation is that "not pro rata as to all shareholders" refers to all shareholders of all classes of stock in the corporation (an aggregate approach). Under that interpretation, the redemption is not pro rata and therefore § 1059(e) applies.

The literal language of § 1059(e)(1)(B) is "not pro rata as to all shareholders." The use of "all shareholders," without limitation, strongly suggests that the phrase means pro rata with respect to all shareholders of the corporation. However, the words of a statute should be interpreted in light of the purpose of the statute indicated by the legislative history. We find the aggregate approach best carries out the legislative purpose of § 1059(e).

The legislative history to § 1059(e) does not indicate how it applies to a corporation with multiple classes of stock. The only available statement of legislative intent for § 1059(e)(1)(B) appears in the Conference Report on the Tax Reform Act of

1986:

> In general, a distribution in redemption of stock that is essentially equivalent to a dividend is treated as a dividend for tax purposes (sec. 302). A redemption of the stock of a shareholder is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. Apart from certain cases in which a shareholder's interest is completely terminated or is reduced by more than 20 percent, present law is unclear regarding what constitutes a meaningful reduction in interest. <u>The conferees understand that in some cases individual distributees take the position that a redemption is a sale or exchange, while corporate distributees take the position it is a dividend</u>.
>
> . . . .
>
> Finally, under the conference agreement the term extraordinary dividend includes any redemption of stock that is non-pro rata (again, irrespective of the holding period of the stock or the relative size of the distribution).

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-163, 166 (1986), 1986-3 (Vol. 4) C.B. 163, 166 (emphasis added).

The § 1059(e) legislative history indicates Congress intended for basis reduction to occur in redemptions if corporate shareholders can plausibly claim that a redemption is a dividend and individuals having a similar amount and proportion of stock redeemed can plausibly claim capital gain treatment. This situation can arise because of uncertainty regarding whether some redemptions result in a meaningful reduction of interest justifying exchange treatment under § 302(b)(1).

The meaningful reduction test to determine dividend equivalence under § 302(b)(1) is done on an aggregate of all classes basis. In <u>United States v. Davis</u>, 397 U.S. 301 (1970), shareholder A owned all of X corporation's preferred stock, and A and his wife and children together owned all of X's common stock. X redeemed all of A's preferred stock. The Supreme Court held that the redemption of preferred stock was equivalent to a dividend under § 302(b)(1) because A, under § 318, directly and constructively owned all of X's common stock (including stock owned by his wife and children), and therefore there was no meaningful reduction in the taxpayer's proportionate interest in the corporation. Because the meaningful reduction issue Congress expressed concern about in the § 1059(e) legislative history is analyzed using an aggregate approach, we find it appropriate to apply § 1059(e) using an aggregate approach.

At first blush, it might appear that the aggregate approach would make every redemption of an entire class of stock an extraordinary dividend. We note, however,

that § 1059 applies only to corporations. Further, § 1059(e)(1)(B) only applies to redemptions that fail the tests of § 302(b) and are, therefore, treated as distributions of property under §§ 302(d) and 301.

Issue 2: Section 1059(f): Substantive Issue

Section 1059(f)(1) treats a dividend with respect to disqualified preferred stock as an extraordinary dividend and requires the corporate shareholder to reduce basis under § 1059(a) without regard to the holding period of the stock. Under § 1059(f)(2)(C), "disqualified preferred stock" includes stock structured to avoid the other provisions of § 1059 and to reduce the shareholder's tax through a combination of dividends received deductions and loss on the disposition of the stock.

The field contends that § 1059(f)(2)(C) applies because the Convertible Preferred was structured to avoid other rules of § 1059 and to permit tax avoidance. They cite two features of the Convertible Preferred: (a) the stock was generally not redeemable within two years from the date of issuance, minimizing the likelihood it would be redeemed while the two-year holding period of § 1059(a) was in effect, and (b) the issuing corporation could redeem the Convertible Preferred for convertible debt, resulting in option attribution under § 318(a)(4). Option attribution allowed a corporate shareholder to claim distribution treatment under § 301, receive a dividends received deduction, and, by transferring basis, obtain a loss on the disposition of Acquiring common stock or the Convertible Debentures.

The legislative history of § 1059(f) does not provide examples of transactions § 1059(f)(2)(C) was intended to affect. The House Report states that § 1059(f) is not intended to apply to dividend rate declines caused by unforeseen downturns in the issuer's business. H. Rep. No. 247, 101st Cong., 1st Sess. 1233 (1989). A Senate Print from the Senate Finance Committee adds that the provision also should not apply to floating rate or auction rate preferred stock whose dividend rate declines due to prevailing market conditions. S. Prt. No. 56, 101st Cong., 1st Sess. 64 (1989). This legislative history indicates Congress intended for dividends on some preferred stock to escape basis reduction.

The redemption of the Convertible Preferred, if it is properly treated as equivalent to a dividend under §§ 302(d) and 301, provides both a dividends received deduction and an apparently artificial loss due to a transfer of the basis of the Convertible Preferred to either the Convertible Debentures or the Acquiring common stock using § 1.302-2(c). Therefore, the stock appears to have the tax reduction effect described in § 1059(f)(2)(C). However, § 1059(f) requires that the stock be "structured" to avoid the other provisions of § 1059 and to allow tax avoidance. The legislative history does not discuss the meaning of "structured," but the word connotes a purposeful design. For § 1059(f)(2)(C) to apply, the issuing corporation must have had a purpose or motive of helping the shareholders achieve a result of avoiding the other provisions of § 1059 and

reducing tax as described in § 1059(f)(2)(C).

It is not necessary for the shareholders receiving the preferred stock to have participated in developing the stock terms, so long as the issuer had a purpose or motive of helping them avoid taxes in the proscribed manner. In considering whether preferred stock was “structured to avoid,” one considers all facts and circumstances, including both the terms of the stock and the business and economic circumstances surrounding its issuance.

The facts presented in the request for technical advice and supplemental documents do not allow a current conclusion that the Convertible Preferred is described in § 1059(f)(2)(C). Additional facts that would tend to support a finding that the Convertible Preferred was “structured to avoid” might include evidence that the stock was distributed (or marketed) particularly to corporate shareholders or evidence that the terms of the stock were directed by Acquiring’s tax advisors with a view to giving its shareholders a combination of a dividends received deduction and a basis shift, setting up an artificial loss. On the other hand, evidence that the Convertible Preferred was issued to many noncorporate shareholders, or issued to all shareholders of all types who exchanged Target stock for Acquiring stock in the Acquisition, would tend to point away from a finding that the stock was described in § 1059(f)(2)(C).

Issue 4: Section 165

Section 165(a) permits the deduction of any loss sustained during the taxable year and not compensated by insurance or otherwise. Under §1.165-1(b), however, only a bona fide loss is allowable, and substance and not mere form shall govern in determining a deductible loss.

Although an argument could be made that the Year 4 capital loss realized by Taxpayer upon the disposition of Acquiring Convertible Debentures should be disallowed because it was not bona fide, we are not prepared to reach that conclusion in the absence of a briefing of the issue by the examining agent and Taxpayer and further factual development pertinent to the issue.

Issue 5: Section 446(b)

Section 446(b) provides that, if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Section 1.446-1(a)(1) provides that the term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item.

Section 1.446-1(a)(2) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Section 1.446-1(c)(1)(ii)(C) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

Section 1.446-1(c)(2)(ii) provides that no method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method.

Section 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting

includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in the computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

For purposes of analyzing the § 446(b) issue, we will assume that Taxpayer treated the transactions that are the subject of this technical advice memorandum in conformity with all of the applicable Code and regulation provisions.

As the field described the facts, for a period of time prior to Year 4 Taxpayer was a shareholder in Acquiring. In Year 4 Taxpayer liquidated its interest in Acquiring. If Taxpayer simply had sold the preferred stock in which it had a basis of $d for its fair market value on the date of distribution of $e, Taxpayer would have recognized a gain of $k.

Instead, the preferred stock was redeemed and Taxpayer reported a dividend of $e and a dividend received deduction of $f. Thus, Taxpayer had taxable income of $g as a result of the redemption. Taxpayer reported a basis in the debentures of $h, consisting of the fair market value of the debentures of $e increased by a portion of Taxpayer's basis in the preferred stock of approximately $d. If Taxpayer immediately sold debentures for their fair market value of $e, Taxpayer would have recognized a

loss of $d. The loss on the sale of the debentures netted against the taxable income from the redemption is $l. The difference between the net loss of $l and the gain of $k Taxpayer would have recognized had Taxpayer simply sold the preferred stock is $f, the amount of the dividend received deduction.

Thus, although Taxpayer disposed of its investment in Acquiring for an amount greater than its original basis in Acquiring, Taxpayer recognized a loss. The field argues that, under these facts, Taxpayer's income is not clearly reflected. Under the authority to compute Taxpayer's income under a method of accounting that will clearly reflect Taxpayer's taxable income, the field proposes to reduce the amount of the distribution by Taxpayer's basis in the preferred stock. Although the facts presented by the field on this point are not sufficient, presumably the field would then reduce the amount of the dividend received deduction, which will, in turn, increase Taxpayer's taxable income.[2]

The issue of "clear reflection of income" arises in the context of a taxpayer's method of accounting. If a taxpayer's method of accounting fails to clearly reflect its income, the Commissioner may compute the taxpayer's income under a method of accounting that will clearly reflect the taxpayer's income.

Although the phrase "method of accounting" is not defined in the Code or the regulations, it is generally understood to mean "any regularized practice or procedure for determining when to recognize items of income and expense." Stephen F. Gertzman, Federal Tax Accounting ¶ 2.01 (2d ed. 1993).

> Methods of accounting are the particular means for determining when to recognize assets, liabilities, and items of income and expense. Consistently, the underlying assumption of tax accounting is that a method of accounting determines the time when an item of income and expense is to be recognized or reported for tax purposes. It does not determine the aggregate amount of income or expense to be recognized from any particular transaction or series of transactions, which should be the same under any method of accounting. Gertzman, supra.

In the present case, the field's proposal would not change *when* Taxpayer will recognize the gain or loss on the disposition of its investment in Acquiring but it would permanently change the *amount* of Taxpayer's gain or loss. Therefore, the proposed adjustment of the amount of the distribution to be made by the field would not constitute a change in Taxpayer's method of accounting and, therefore, it would not be authorized under § 446(b). Section 446(b) authorizes the Commissioner to compute the taxpayer's

---

[2] In any event, we believe the field's concern in this case is with the amount of Taxpayer's income and not with the time for recognizing that income.

taxable income under a different method of accounting, which will alter the time when an item of income or expense will be recognized, but it does not authorize the Commissioner permanently to change the amount of the taxpayer's taxable income. Because we believe the field's proposal will change the amount of Taxpayer's gain or loss on the transaction and will not simply alter the time when the gain or loss will be recognized, we do not believe that the adjustment is authorized under § 446(b).

CAVEAT

A copy of this technical advice memorandum is to be given to the Taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.