Index Number: 0302.01-04
0356.01-01

Control Number: TAM-106393-99
CC:DOM:CORP:B1
Number: **199934001**
Release Date: 8/27/1999

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director's Office: Northern California District

Date: May 4, 1999

Taxpayer's Name:

Taxpayer's Address:

Taxpayer Identification No.:

Year Involved

No Conference Held

Legend

Corporation =

Shareholder A =

Lead Underwriter =

Co-managing Underwriter =

Shareholder B =

Shareholder C =

Shareholder D =

Year 1	=
Year 5	=
Date I	=
Date II	=
Date III	=
Date IV	=
Date V	=
Date VI	=
Date VII	=
Date VIII	=
Date IX	=
Date X	=
Date XI	=
Date XII	=
Date XIII	=
d	=
e	=
f	=
n	=
o	=
p	=
q	=
r	=

s	=
t	=
u	=
v	=
w	=
x	=
y	=
z	=
pp	=
qq	=
uu	=
ww	=
xx	=
yy	=

ISSUE

When Shareholder A exchanged its Corporation Series A voting convertible preferred stock ("Series A Stock") for cash and Corporation common stock, should the cash (i.e. n cents per share) be taxable under section 356(a)(1) or should it be taxable under section 356(a)(2) because it had "the effect of the distribution of a dividend?"

CONCLUSION

Upon Shareholder A's exchange of its Series A Stock for common stock and cash, Shareholder A's receipt of the cash (i.e. n cents per Series A Stock share) was taxable to the extent of the gain as gain under section 356(a)(1) because Shareholder A's stock interest in Corporation was meaningfully reduced when the effects of the entire transaction, including the IPO, are take into account. See section 302(a) and (b)(1).

FACTS

In Year 1, Corporation issued for cash p million shares of Series A Stock. Approximately uu% of the Series A Stock, q million shares, was issued to Shareholder A. Approximately qq%, r million shares, of the Series A Stock was issued to Shareholder C. The remainder of the Series A stock, s%, (i.e. t shares) was issued to Management, including Shareholder D. Around the same time, Corporation acquired certain businesses and assets from Shareholder B in exchange for cash, an assumption of liabilities, and the issuance to Shareholder B of nonvoting redeemable preferred stock ("Preferred Stock"). At the time of this initial stock issuance, Corporation issued only the Series A Stock and the Preferred Stock. No stock denominated common stock was issued initially. Under its terms, each share of Series A Stock was convertible into one share of common stock at the option of the shareholder. In addition, Series A Stock was subject to automatic conversion into common stock upon consummation of a public stock offering. Series A Stock had certain special class voting rights, but, in general, voted together with the common stock on an as-if-converted basis (i.e. both Series A Stock and the common stock had one vote per share). The Series A Stock was entitled to receive non-cumulative dividends of d cents per share or, if greater, an amount equal to that paid on other shares of stock. During most of its existence, however, Corporation has not paid any dividends. On liquidation, Series A Stock was entitled to receive a preferential payment and then participated together with common stock on a pro rata basis.

Although no common stock was issued initially, Corporation did issue options to purchase common stock. At the beginning of Year 5, there were approximately f million shares of common stock outstanding and options to purchase additional shares of common stock, none of which stock or options were held by Shareholder A. On Date IX, there were ww shares of common stock outstanding.

In Year 5, a series of steps took place that significantly changed the capital structure of Corporation. Corporation began planning an IPO in the spring of Year 5 and by the summer of Year 5 had decided to take a number of actions directed toward facilitating the IPO. First, it simplified its capital structure by removing stock preferences that would have inhibited its ability to accomplish the IPO. Corporation exchanged its common stock (one share per Series A Stock share) plus n cents cash per Series A Stock share in exchange (the Exchange) for all shares of the Series A Stock outstanding. The n cents per share was the appraised value of the Series A Stock preferences. Shareholder A participated in the Exchange and the cash it received presents the issue addressed in this technical advice. To simplify its capital structure, Corporation also redeemed for cash all of the Preferred Stock held by Shareholder B. A second objective relating to the IPO concerned underwriter's advice received by Corporation that any excess cash held by Corporation would not be given adequate value in the IPO. Thus, Corporation distributed an o cents per share dividend to all of its common stock shareholders, including those who had received common stock in the Exchange. In addition, the distributions to the Series A Stock owners and Preferred Stock owners were done in part to support this second objective of reducing excess cash. On Date XI, pursuant to a Date X resolution, Corporation accomplished a two for three reverse stock split in which the common stock shareholders received two shares of common stock in exchange for three common stock shares previously held. Finally, on Date XIII, Corporation carried out the planned IPO.

That the Exchange, redemption of the Preferred Stock, two for three reverse stock split, and IPO were all part of an integrated plan is well established by the facts. An attachment to the Date I Board meeting minutes reveals that IPO planning was already well underway. This planning continued at the Date II Board meeting. By the Date III and Date IV Board meetings, there was already discussion of "a variety of alternatives for restructuring the company's balance sheet." At the Date V Board meeting, there was discussion of prior contacts with underwriters and the minimum acceptable IPO parameters. Also discussed was a possible purchase by Corporation of the Series A Stock from Shareholder C.

The final plan was put in motion on Date VI, when Corporation sent a letter to all Corporation shareholders announcing a proposal to take certain actions to facilitate Corporation's upcoming IPO. These actions were: (1) the Exchange; (2) the redemption of the remainder of the Preferred Stock owned by Shareholder B; and (3) a dividend of o cents per share on all common stock shares including those issued in the Exchange. The shareholders were urged by the Board to approve the plan, as the Board did as of Date VII. The shareholders did so effective Date IX. The Series A Stock owners and Corporation also executed an Exchange agreement for the Series A Stock Exchange, effective Date IX. The Corporation Board on Date VIII approved having an IPO before the end of the year and authorized the selection of the Lead Underwriter and Co-managing Underwriter. At the Date X Corporation Board meeting, the two for three reverse stock split was authorized whereby all holders of Corporation common stock received two common shares for each three common shares held. Finally, on Date XII, the Corporation Board approved the final pricing and number of shares of Corporation common stock to be sold on Date XIII (the next day). There were pp million common stock shares issued in the IPO.

Shareholder A exchanged q million Series A Stock shares for q million common stock shares plus nearly u million dollars in cash, the taxability of which is in issue. Shareholder A reduced its number of common stock shares to z million due to the two for three reverse stock split. Immediately prior to the Exchange, Shareholder A had x% of the Corporation vote. After the IPO, Shareholder A had xx% of the Corporation vote. Immediately prior to the Exchange, Shareholder A owned stock (its Series A Stock) possessing y% of the overall value of all Corporation stock. After the IPO, Shareholder A's percentage of overall value had dropped to xx%.

Before this series of integrated transactions, Shareholder A could control

Corporation by itself. After these integrated series of transactions, Shareholder A could not solely control Corporation but rather had to join with one or more other Corporation Shareholders in order to effectuate corporate action. There were at least two other substantial Corporation shareholders: Shareholder C that controlled over yy% of the Corporation vote and Shareholder D who owned stock possessing close to v% of the Corporation vote but also had significant influence with other Corporation shareholders as Chairman of the Board, CEO, and President. An example of this new reality was that Shareholder A had three Board members on the five member Board before these transactions, but had only two thereafter. In addition, the percentage of the value of Corporation which Shareholder A's stock possessed fell from above 50% to xx%, which is below 50% and constituted a drop of over 10% in the value percentage it previously owned. Taken together, Shareholder A's interest in Corporation was meaningfully reduced as a result of the integrated series of transactions.

APPLICABLE LAW

Section 354 of the Internal Revenue Code provides, in general, that no gain or loss is recognized if stock in a corporation which is a party to a reorganization is exchanged, in pursuance of the plan of reorganization, solely for stock in that same corporation or in another corporation which is a party to the reorganization. Section 368(a)(1)(E) provides that the term "reorganization" means, among other things, a "recapitalization." Section 356(a)(1) provides that property not qualifying for nonrecognition treatment, under section 354, is taxed to the extent of gain on the exchange. Section 356 (a)(2) provides that where the exchange has "the effect of the distribution of a dividend" the recognized gain will be taxed as a dividend to the recipient to the extent of the recipient's ratable share of the post February 28, 1913, undistributed earnings and profits of the corporation. Any excess gain is taxable as gain from the exchange of property.

Section 302(a) provides that a redemption satisfying the requirements of section 302(b) is treated as a distribution in exchange for stock. Section 302(d) provides that other redemptions are taxed as distributions under section 301. Section 302(b)(1) states that section 302(a) applies if the redemption is "not essentially equivalent to a dividend."

ANALYSIS

The issue presented in this technical advice is the proper tax treatment of cash received by Shareholder A when it exchanged its Series A Stock for cash and common stock on Date IX. This exchange was one part of a larger series of planned transactions culminating in a Corporation IPO on Date XIII. These transactions encompassed: (1) an exchange by the shareholders (including Shareholder A) owning Corporation Series A Stock of that stock for cash and Corporation common stock; (2) a redemption of all the Corporation Preferred Stock from the single holder thereof, Shareholder B; (3) a cash distribution of o cents per share to all common shareholders, including those receiving common stock issued in exchange for the Series A Stock; (4) a two for three reverse stock split; and, finally, (5) a Corporation IPO of pp million shares of Corporation common stock.

As a result of this series of transactions, Shareholder A's Corporation voting percentage fell from x% to xx%, that is, from above to below 50%. Therefore, Shareholder A had to join with one or more other shareholders if it wished to exercise control over Corporation, whereas prior to the transactions it could control Corporation on its own. For example, after the transactions Shareholder A's board membership fell from three to two seats on the five seat board. The percentage of the value of Corporation stock held by Shareholder A fell as a result of these series of planned transactions from y% to xx%.[1] Shareholder A's ownership interest in Corporation was meaningfully reduced as a result of this series of planned transactions.

The exchange by the Series A Stock owners, including Shareholder A, of their Series A Stock for cash plus common stock was a "recapitalization" within the meaning of section 368(a)(1)(E). The gain realized by Shareholder A on this exchange is not recognized to the extent of the value of the Corporation common stock (see section 354); however, it is taxable to the extent of the cash received (i.e., n cents for each Series A Stock share exchanged). Taxability of that cash is determined under section 356. The cash is taxable as gain to the extent of gain on the exchange as long as section 356(a)(1) is applicable. Section 356 (a)(1) is not applicable if section 356 (a)(2) would treat the gain recognized due to the receipt of this cash as a dividend to the extent of the recipient shareholder's (here Shareholder A's) ratable share of the post February 28, 1913, undistributed earnings and profits. However, section 356(a)(2) applies only if the receipt of the cash "has the effect of the distribution of a dividend."

In determining whether the receipt of cash (or other property not qualifying for nonrecognition under section 354) "has the effect of the distribution of a dividend," it is proper to analogize to section 302, especially as to single entity reorganizations, such as the "recapitalization" present in this case. See Rev. Rul. 84-114, 1984-2 C.B. 90; Rev. Rul. 93-62, 1993-2 C.B. 118. Furthermore, in applying section 302 to a reorganization, such as the recapitalization in this case, it is also appropriate to compare the Corporation stock ownership of the shareholder receiving the cash (here Shareholder A) at the start of the planned series of transactions and that shareholder's stock interest in Corporation at the end of the series. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); see Rev. Rul. 55-745, 1955-2 C.B. 223; Rev. Rul. 75-447, 1975-2

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[1]In determination the percentage value of the Corporation stock held by shareholder A before the transaction, we have assumed that the common stock had a fair market value of e dollars per share (the price at which it was then valued by Corporation for purposes of granting stock options), and that the Series A Stock had a fair market value of e dollars plus n cents per share (the value of the consideration it received in the exchange).

C.B. 113.

When that comparison is made in this case, Shareholder A's stock interest in Corporation underwent a meaningful reduction in that Shareholder A lost its ability to control Corporation by itself and had thereafter to join with one or more other shareholders of Corporation in order to take actions. Moreover, it lost its controlling position on Corporation's board (it went from three seats to two seats on a five person board). Furthermore, the percentage of the overall value of Corporation represented by Shareholder A's stock dropped from y% to xx%. Since only one class of stock (i.e. common stock) was outstanding after this series of transactions, Shareholder A's share of dividend and liquidation rights also had a meaningful reduction. As a result, Shareholder A would have qualified for exchange treatment on the receipt of the cash if this had been a redemption rather than a "recapitalization." See section 302(b)(1) which provides for section 302(a) exchange treatment where a redemption is "not essentially equivalent to a dividend." United States v. Davis, 397 U.S. 301 (1970), rehearing denied, 397 U.S. 1071 (1970), 1970-1 C.B. 62, held that section 302(b)(1) applies where the redemption causes a meaningful reduction in shareholder interest, as exists in this case. In this regard, see Rev. Rul. 75-502, 1975-2 C.B. 111, where a shift of stock ownership from 57% to 50% was viewed as meaningful because it significantly altered a stockholder's ability to control a corporation since the shareholder could no longer control the corporation by himself alone. At least as much can be said about the x% to xx% vote percentage drop and the y% to xx% value percentage drop in this case.

Applying the redemption rules of section 302 by analogy, the receipt of cash in this case did not have "the effect of the distribution of a dividend" under section 356(a)(2). Hence, the taxability of the cash is determined under section 356(a)(1), rather than under section 356(a)(2), and is taxable as realized and recognized gain under section 1001, to the extent of the gain on the exchange.

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