Distributing Stock Purchase Rights

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If a corporation distributes rights to acquire stock with respect to its existing outstanding stock, are those stock purchase rights taxable? You would think this would be an easy question to answer. Yet, as with so many tax questions, the answer may not be as clear as you might think. Plus, timing and other facts must be considered.

M&A TAX REPORT readers are presumably well aware that Section 305(a) of the Code specifies that distributions of stock on stock are excluded from gross income. That, of course, is the good news. The corollary bad news (there's always some, isn't there?) is that Code Sec. 305(b) takes away much of what Code Sec. 305(a) grants.

Indeed, Code Sec. 305(b) lists five exceptions to the exclusion:

1. **Distributions in lieu of money.** If the distribution is, at the election of any of the shareholders, payable, either in stock or in property.
2. **Disproportionate distributions.** If the distribution results in some shareholders getting property, while increasing the proportionate stock ownership interests of other shareholders.
3. **Distributions of common and preferred stock.** If the distribution results in some common shareholders receiving preferred stock, and other common shareholders receiving common.
4. **Distributions on preferred stock.** If the distribution is with respect to preferred stock (except for an increase in the conversion ratio of convertible preferred stock, solely to reflect a stock dividend or stock split on the stock into which the preferred is convertible).
5. **Distributions of convertible preferred stock.** If the distribution is of convertible preferred stock (unless it does not result in a disproportionate distribution).

Are Rights Distributions Disproportionate?

Suppose you distribute to all common shareholders a right to buy more common stock. How could that be disproportionate? Well, if you have some shareholders receiving increased stock, while others receive cash, isn't that a disproportionate distribution? It sure seems like it.

That may make an otherwise simple distribution of a right (for each common shareholder to purchase another share of stock) a little more complicated than first blush may suggest. Shareholders who exercise rights to purchase more stock will obviously increase their interests in the corporation relative to any shareholders who do not exercise such rights. On the surface, you would think that such an increase in proportionate interest should not be viewed as taxable to the shareholders that do make the rights purchase.

However, this is worth some further reflection. After all, consider Code Sec. 305(b)(5). This provision makes taxable the distribution of convertible preferred stock, unless the taxpayer can demonstrate that the distribution is not disproportionate. An example in the regulations indicates that a distribution in which recipients must exercise a conversion right to common in a short period of time (four months in one of the examples) can actually morph into a disproportionate distribution, thus triggering tax. [*See* Reg. §1.305-6(b), Example (2).]

Perhaps the same theory could hold here. If a distribution results in the receipt of property by some shareholders, and an increase in the proportionate interest of other shareholders, this is (axiomatically) taxable. One could argue that this happens *any* time you hand out rights to purchase stock. Some shareholders are going to purchase, and some are not.

If the purchase right represents any bargain element, it can be more readily valued. In such a case, arguably those who exercise get something. Or perhaps every distributee got something, but those who actually claim or exercise realize that benefit. The laws of probability suggest that some shareholders are going to exercise and others not. That means there may be disproportionality.

Interestingly, it appears that the duration of the exercise period can influence whether there is any tax impact to the rights distribution.

Most people probably would not guess that. However, consider what happens where the exercise period is extremely long, say 15 years? A short-term exercise window allows one to reasonably assume that some shareholders will exercise and others will not.

In contrast, the allowance of a long period of time for the exercise of the right arguably does not allow such a prediction either way. At a minimum, the long exercise period means it is impossible to assess the effects for a long time, until the time for exercise expires. One can do some-did-some-didn't calculation only at the close of the exercise period. Yet, paradoxically, the value of the distributed right may be greater the longer the permitted exercise period.

Regular Dividend Policies

As you mull over whether and to what extent a rights distribution may risk taxability, one should also consider the company's dividend policy and history. Cash distributions, or property dividends, that hit within 36 months on either side of a stock distribution are counted as property distributions related to a stock increase. [*See* Reg. §1.305-3(b).] Since 36 months is a significant window, many corporations that pay regular dividends could end up triggering Code Sec. 305(b)(2) if they distribute stock (or stock rights) on stock.

Short-Term Exercise

If stock rights are distributed and have a short-term exercise period, say a couple of months, you might think few tax issues could arise.

Your first inclination would be that a distribution of a right to purchase additional stock would not by itself be taxable. Actually, you might think that about stock rights regardless of the exercise period.

However, as with so many other gut reactions, temper this with a dose of caution. Surely, a distribution to common shareholders of rights to buy common shares *should* be tax free, but use care before you hit the "send" button.

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