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Measuring Voting Power: Is It All in the Numbers?

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Many important tax considerations turn on whether or not one or more taxpayers own stock possessing 80% of the voting power of all classes of voting stock in another corporation. For example, the determination whether a corporation can file consolidated tax returns is premised on this level of ownership (together with ownership of a similar percentage of equity value). Ownership of the requisite 80% of the voting power is also one of the conditions that must be met to achieve a tax-free spinoff under Section 355. Plus, a determination of voting power is also relevant for many other purposes, including stock for stock (b) reorganization, and many other transactions.

Historically, the calculation of voting power was thought to be wholly mechanical: participation in management through the election of directors appeared to be the sole criterion of voting power. See Revenue Rulings 69-126, 1969-1 C.B. 218, and 84-6, 1984-1 C.B. 366. More importantly, intra-shareholder agreements, where voting power was ceded (through proxy arrangements), were considered harmless, because it did not detract from one's ownership of stock possessing the required degree of voting power.

Voting rights, of course, may arise with respect to a variety of different transactions, but the traditional right associated with voting stock is the power to have a voice in the election of directors. See Rev. Rul. 69-126, 1969-1 C.B. 218. Voting stock may be issued in classes, not all of which have equal voting rights. While some stock classes may have more limited voting power than other classes, stock will still constitute voting stock even if it only has the power to elect some of the directors. See Rev. Rul. 69-126, 1969-1 C.B. 218.

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When stock possesses only contingent voting rights, however, the stock will not be treated as voting stock unless those contingencies have already occurred. See Rev. Rul. 72-72, 1972-1 C.B. 104. The same holds true for instruments that are convertible into voting stock upon the occurrence of some contingency. See Rev. Rul. 69-91, 1969-1 C.B. 106. Similarly, warrants or stock rights do not constitute voting stock until they are actually exercised. The mere contingency occurring or the time for exercise arriving will not by themselves be sufficient to transform these instruments into voting stock. See *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), *rehearing denied*, 316 U.S. 710 (1942).

Weighted Voting?

Now, however, we find that measurement of voting power is no longer a mechanical proposition. Thus, in LTR 9252002, a corporation was able to elect directors who could cast 80% of the votes of the board. However, the corporate charter was concurrently amended to place certain matters beyond the board's power to decide through regular voting. In these specified cases, a majority vote of each *class* of directors was required. How should voting power be measured here?

The IRS concluded that where a board's powers are restricted, voting power cannot be determined mechanically. In such cases, the facts must be examined to determine whether the companies linked by such voting rights are, in substance, affiliated. In LTR 9252002, due to the restrictions imposed on the board's power, the companies were held not to be affiliated because the corporation with the "high vote" stock was unable to exercise management control of the investee.

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Letter rulings (such as No. 9252002), of course, may not be viewed as the bellweather of all tax authority, though they do routinely indicate IRS posture on issues. It may therefore be more significant that the Tax Court, in *INI, Inc. v. Commissioner*, T.C. Memo 1995-112, recently accorded significance to intra-shareholder voting arrangements for purposes of measuring ownership of voting power. In effect, the Tax Court in that case ruled that a subsidiary had departed from a consolidated group—even though the parent continued to own all its stock—where the parent had executed an irrevocable proxy (in favor of a third party) to vote the stock.

To be sure, the affiliation test under Section 1504(a) has long turned on the beneficial ownership of the stock, rather than on bare legal title. Corporations that are in effect one business unit because of their actual or beneficial ownership have been allowed to file a consolidated return, regardless of who is the record owner of the stock. See *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977). Indeed, perhaps fearful that the consolidation concept could be manipulated, the courts have indicated that if consolidation could turn on mere legal or record ownership, then corporations with no real common ownership or economic relationship could consolidate their income and deductions, in clear violation of the statutory purpose of the consolidation provisions. See *Lavenstein Corp. v. Commissioner*, 25 F.2d 375 (4th Cir. 1928). The question in the *INI* case was therefore whether beneficial ownership of stock had been transferred, and at what point.

Substance and Practical Control

The Tax Court's opinion in *INI* spends considerable time revealing principles of applicable state law, the effect of proxies, both revocable and irrevocable, and other such nitty-gritty. It may be relevant, as was argued in *INI*, how the parties treat the relationship. For example, in *INI*, the taxpayer corporation attempted to prove that there had been no deconsolidation before a particular date by establishing that one individual was still writing checks on a particular corporation's accounts after the pertinent date. Although the Tax Court did not accept this particular argument, many times the

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actions of the parties, and particularly conduct subsequent to an asserted cathartic and dispositive event, can be sufficient to influence the legal result of the event.

Judging from Letter Ruling 9252002 and *INI, Inc.*, a parent's claim to the filing of a consolidated return or to qualification for a spinoff may apparently now not merely be based on a mechanical showing of control. The ability to demonstrate the *substance* of control may now also be required. This appears to be only a one-way street at present, only hurting but never helping the taxpayer.

For example, if some kind of amorphous and nonmechanical voting test is employed, ought not a taxpayer be able to argue that the voting power must be evaluated in light of factors such as those mentioned in Letter Ruling 9252002? On the facts of that letter ruling, could not a company which wished to *avoid* 80% ownership adopt a structure like that outlined in Letter Ruling 9252002?

Perhaps with a little ingenuity, this less than mechanical voting rights assessment could be either a boon or a bust to the taxpayer. ■