

Regulations on Stock Rights and Nonqualified Preferred Stock

by Robert W. Wood • San Francisco

The Service has released two sets of regulations, the first being final regulations under Sections 354, 355 and 356, and the second being temporary and proposed regulations under the same sections. In the first set of regulations, T.D. 8752, the IRS treats the receipt of rights to acquire stock of a corporation that is party to a reorganization. This release adopts, with some modifications, proposed regulations that were published in December 1996. (For discussion of the 1996 proposed regulations, see Wood, "Stock Rights Connected With Reorganization Subject of Proposed Regs," Vol. 5, No. 7 *M&A Tax Report* (Feb. 1997), p. 7.)

As with the proposed regulations, these final rules confirm that Section 354 does not apply to a shareholder's receipt solely of securities that are rights to acquire stock in exchange for stock. The final regulations also state explicitly that they apply to rights to acquire stock only for purposes of Sections 354 through 356. Thus, the stock rights remain subject to other provisions of the Code, including Section 83 and Sections 421 through 424.

Effective Date and More Guidance

The delayed effective date of the regulations, March 6, 1998, should give taxpayers additional time to react to these new rules. Interestingly, the final regulations do not address the tax issues of rights to

Continued on Page 7

STOCK RIGHTS

Continued from Page 6

acquire stock under Sections 302, 305, 306 and 351. Perhaps more importantly, they also do not include a more explicit definition of "rights to acquire stock" apart from merely cross-referencing Sections 305 and 317(a).

Lastly, the final regulations were released with guidance from the IRS that it had already issued temporary and proposed regulations under Section 356(e) to coordinate the final regs with the treatment of rights to acquire nonqualified preferred stock, as well as new Sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Service indicates that it will issue guidance on exchanges of rights to acquire stock as part of a larger transaction that includes a stock-for-stock reorganization under Section 368(a)(1)(B).

Nonqualified Preferred Stock

The temporary and proposed regulations concerning nonqualified preferred stock (T.D. 8753; REG-121755-97) outline when nonqualified preferred stock will not be treated as stock or securities under Sections 354, 355 and 356. Except as specified in Section 1014(f)(2) of the Taxpayer Relief Act of 1997, this set of temporary and proposed regulations applies to nonqualified preferred stock (or rights to acquire it) that is received in connection with a transaction occurring on or after March 6, 1998.

A right to acquire nonqualified preferred stock that is received in exchange for stock other than

nonqualified preferred stock (or the right to acquire it) will not be treated as a security under these temporary regulations. Likewise, the new rules provide that nonqualified preferred stock received in exchange for stock other than nonqualified preferred stock (or a right to acquire stock other than nonqualified preferred stock) will not be treated as a stock or security.

More Guidance?

The temporary and proposed regulations certainly do not attempt to answer all of the questions and issues related to the exchange or receipt of nonqualified preferred stock. However, the Service states that it will issue further guidance in the future on these questions. Indeed, the Service has requested comments on the types of guidance needed, as well as on the temporary and proposed regulations, and other issues under Section 351(g) and related provisions.

The public hearing on the temporary and proposed regulations is set for May 5, 1998 at 10:00 a.m. Requests to testify and outlines of topics to be discussed are due by April 14, 1998. Comments on the temporary and proposed regulations are due by April 6, 1998.

Stock Rights Not Boot

The practical impact of the new treatment of stock rights should not be lost on practitioners. In a tax-free reorganization, an exchanging shareholder must still recognize gain to the extent he or she receives boot in addition to stock in a deal. If the requirements for continuity of interest and other technical rules of a reorganization are met, this still does not excuse the shareholder's receipt of nonqualifying property, generally referred to as "boot."

Historically, stock rights or warrants have been regarded as boot when received in an otherwise tax-free reorganization or spinoff. Now, however, for exchanges and distributions occurring after March 6, 1998, stock rights will be treated as securities, and thus not as boot. This is good. Perhaps even more importantly, these stock rights are considered to have no principal amount. This means that they can be received tax-free in a reorganization exchange or spinoff.

TAXATION OF COMPENSATION AND BENEFITS
by David J. Cartano

Over 900 pages of material, covering everything from nonqualified deferred compensation and phantom stock to cafeteria plans, split dollar life insurance and reasonable compensation. A veritable compendium! Softbound, \$99 (plus \$10 shipping and handling and \$8.42 California sales tax on California orders).



TAX INSTITUTE
235 Montgomery Street #972
San Francisco, CA 94104
e-mail: info@taxinstitute.com
(800) 852-5515 Fax (415) 834-1888

Continued on Page 8

STOCK RIGHTS

Continued from Page 7

Exceptions and Special Rules

To be sure, there are some exceptions to this rule. Thus, a shareholder who exchanges stock solely for stock rights will not be able to receive the stock rights on a tax-free basis. However, where there is a combination of instruments involved (such as a shareholder exchanging his shares of stock for a combination of actual stock and stock rights), that transaction will be looked at quite differently.

Furthermore, the term "stock and securities" does not include "nonqualified" preferred stock (or rights to acquire it) that is received in exchange for (or in a distribution with respect to) stock or a right to acquire stock. (For further discussion of the likely rise of stock options in transactions, see Willens, "Dealing with Stock Options: Two Uses, Two Consequences," Vol. 6, No. 4 *M&A Tax Report* (Nov. 1997), p. 1.) ■

THE M&A TAX REPORT

Yes! Enter my subscription to *The M&A Tax Report* at the price of only \$375 for twelve full issues, including postage and handling charges. I enclose full payment by check or credit card. For Mastercard and Visa orders, enter card information below or call (800) 852-5515. Full money-back guarantee applies to unused part of subscription.

Yes! Enter my subscription for \$375 and bill me.

Name _____

Title _____

Firm _____

Street _____

City/State/Zip _____

Telephone (____) _____

For Credit Card Orders:

Mastercard # _____ Exp. _____

Visa # _____ Exp. _____

Authorized Signature _____



TAX INSTITUTE

235 Montgomery Street #972

San Francisco, CA 94104

e-mail: info@taxinstitute.com

(800) 852-5515

Fax (415) 834-1888