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TRACKING STOCK MAKES NEWS (AGAIN)

by Robert W. Wood • San Francisco

Much has been said over the past few years about tracking stock. Shorn of its details, tracking stock is merely equity issued by companies that want to separate their typically higher growth or sexier divisions from their stodgier components. It is, in a way, a spinoff without a spinoff. If the tracking stock and the parent company's stock are traded separately, they should arguably be worth more than the stock of a single company.

Sounds an awful lot like spinoff analysis, doesn't it? And that's part of the Service's problem. Although tracking stock has been kicking around in the tax and financial literature for quite some time, America's love affair with tracking stock is now branching out into the general press. The use of tracking stock over the past few years has been monumental. A recent article counted roughly 36 tracking stocks on the market.

Four of them have been issued just this year, including giants like AT&T and Donaldson Lufkin & Jenrette. Other tracking stock issues expected shortly include J.C. Penney, DuPont, and Quantum. Even Walt Disney Co. and Microsoft are both said to be looking at tracking stocks, primarily to track (and enhance the value of) their internet subsidiaries. Plus, so-called brick-and-

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mortar retailers have launched online divisions. To try to keep up with some of the hype of the internet, some relatively staid companies (like Federated Department Stores, Inc. and Wal-Mart Stores, Inc.) are thought to be looking at tracking stocks as well. (For discussion, see Vickers, "Are Two Stocks Better Than One?" *Business Week*, June 28, 1999, p. 98.)

Tracking Value

From a financial point of view, a recent analysis of tracking stocks suggests they are doing exactly what they are designed to do: increasing value. However, the Internal Revenue Service and its authority over the corporate reorganization domain have been undercut if one views tracking stocks as a real alternative to spinoffs which must meet rather rigorous requirements.

Some argue that tracking stocks have nothing to do with alternatives to Section 355 while some argue the opposite. In any event, the standalone Section 355-spawned company can suffer from problems. Indeed, standalone internet companies (particularly of late) may have a hard time financing negative cash flow. Having a clear connection to a "mother ship" can have advantages. Tracking stock is therefore thought to offer the benefits of a spinoff without the risks. Plus, there are well-publicized difficulties getting an IRS spinoff ruling. Id.

Even from a financial viewpoint (aside from tax implications), tracking stock may not be a panacea. There have been a few notable cases where tracking stock has been issued and the parent company has suffered a blow in its stock price. Donaldson Lufkin & Jenrette, for example, took quite a hit earlier this year after the debut of its DLJDirect tracking stock in May of 1999. Perhaps because its tracking stock attracted all the attention, the "mother ship" looked more like an abandoned hulk. (For further details see Vickers, "Are Two Stocks Better Than One?" *Business Week*, June 28, 1999, p. 98.)

Taxing Tracking

The taxation of tracking stock has lately come into the limelight. The fiscal 2000 budget included many controversial revenue raisers, not the least of which was the proposal dealing with tracking stock. The budget proposal called for the issuance of tracking stock to be treated as a taxable event. The issuer of the tracking stock would be viewed as constructively selling the tracked assets for cash equal to the fair market value of the tracked assets.

The gain would be based on the excess of this value over the tax basis of the assets. Presumably the term "issuance" would encompass stock dividends and secondary offerings, as well as the use of tracking stock as acquisition currency. So the reach of this kind of change would be broad.

If this proposal were enacted, it would likely sound the death knell for tracking stock. It would be particularly onerous in cases where the issuance was not accompanied by the receipt of cash with which to pay the tax. A no-cash issuance is common, as where the stock is paid out in a stock dividend or in connection with an acquisition.

Due to the absence of grandfather protection in the budget proposal as it was written, it would severely penalize corporations that had already incurred the costs associated with adding tracking stock to their capital structures. The long effort that is often expended in setting up a tracking stock program would be wasted if the ability to utilize tracking stock was taken away by virtue of this proposal. It is possible a transitional window could be developed (much like the window is closing on pooling).

How Do You Spell Relief?

Fortunately, it may not matter that there is no grandfather relief. Many find tracking stock to be a perfectly legitimate corporate finance tool, and are

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convinced that tracking stock is not utilized for tax avoidance purposes. One Congressional and/or IRS concern is that tracking stock can be used in lieu of a spinoff that could not qualify under Section 355. Yet, the anti-tracking stock proposal has been roundly criticized by professional organizations, like the AICPA and the New York State Bar Association.

Perhaps in part due to such adverse reactions, the original budget's anti-tracking proposal does not appear in either the House or Senate budget submissions passed by each body. Accordingly, the use of tracking stock to achieve a myriad of corporate purposes (without tax!) seems likely to still flourish. Ironically, perhaps the President's proposal only underscored the uses (and perhaps even abuses) of tracking stock.

Tracking Rulings

Although the IRS has historically declined to rule on the tax consequences of transactions that feature tracking stock, a recent IRS pronouncement touches on one aspect. A spinoff will not qualify for tax-free treatment (at the distributing corporation level), if the spinoff constitutes a disqualified distribution within the meaning of Section 355(d). A disqualified distribution is one in which any person (or group of persons acting pursuant to a "plan or arrangement") holds, after the spinoff, a 50% or greater interest in either corporate party to the spinoff and the interest consists of disqualified stock—stock acquired, by purchase, within the five-year period preceding the distribution.

However, credit toward the five-year holding period is not earned for days on which the person has substantially diminished his or her risk of loss through the use of options, short sales and, according to the regulations, though the holding of a "special class" of stock. The regulations make it clear that tracking stock constitutes a special class of stock. Accordingly, if a person (or group acting pursuant to the requisite plan or arrangement) purchases tracking stock with a view toward the subsequent split-off of the tracked subsidiary after five years, the split-off apparently cannot qualify as tax-free because the ensuing distribution will be disqualified.

Oddly, the IRS may actually have aided issuers by creating a weapon they can use to fend off unwanted suitors who may have designs on a tracked subsidiary.

Liberty Media

Recently, Liberty Media, a subsidiary of AT&T whose performance is represented by a class of AT&T tracking stock, announced the acquisition (using tracking stock), of Todd-AO. Tracking stock as acquisition currency is one of its most valuable attributes. This is particularly true in cases where, as in the Liberty situation, the tracked subsidiary is part of a much larger entity. The shareholders of a prospective target may not be willing to accept stock of the larger entity because that stock will reflect the performance of all of its business endeavors rather than the performance of only the target.

The ability to offer a more focused variety of equity security can help to preserve the target's entrepreneurial spirit and ensure that the target's business is still a relevant factor in the performance of the security the target shareholders obtain. In this case, the acquisition will probably be effected by Liberty Media (it will function as the acquiring corporation), which will issue stock of its parent (AT&T's Liberty Media tracking stock) to the Todd-AO shareholders in exchange for their stock in the latter.

For tax purposes, this transaction constitutes a triangular B reorganization. It is an acquisition of the stock of a corporation (Todd), in exchange solely for voting stock of the acquiring corporation's parent. One of the requirements is that the acquiring corporation must have control of the acquired corporation immediately after the acquisition. Here, all the conditions for triangular B treatment seem to be satisfied.

That means that for the Todd shareholders, the exchange will be tax-free under Section 354. Interestingly, these conditions are met even though Liberty will own something less than 80% of the value of Todd's outstanding stock. Todd has two classes of outstanding stock, a high vote class and a low vote class. Liberty will own something less than 80% by value immediately after the acquisition. How can this be?

Vote vs. Value

The reason relates to the definition of control. The control requirement is still satisfied because Liberty will own in excess of 80% of the voting power of Todd's outstanding stock once the acquisition is consummated. As with the control requirement in a spinoff, the control requirement for a B reorganization is satisfied as long as the acquiring entity obtains the requisite amount of the target's voting power. The percentage of the value is not relevant as long as the requisite vote is present.