

# Internal Revenue Service

Department of the Treasury

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Date:  
April 11, 2003

## Legend

Corp 1 =

Corp 2 =

Corp 3 =

Investment 1 =

Investment 2 =

Investment 3 =

Investment 4 =

Exchange =

a =

b =

c =

d =

e =

State A =

#aa =

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#bb =øcc =#dd =\$ee =#ff =\$gg =hh% =ii% =jj% =#kk =

Date 2 =

Date 1 =

Date 3 =

Month AA =

Year XXXX =

Variable Rate Preferred Stock Series X =

Dear :

This letter responds to your November 25, 2002 request for rulings regarding certain federal income tax consequences of a proposed transaction. The information submitted in that request and in later correspondences dated March 6, 2003 and March 18, 2003 is summarized below.

Corp1 owns 100% of all classes of stock of ten subsidiaries. These corporations together file consolidated tax returns. Corp 1 is a closely-held corporation which was incorporated in State A in Year XXXX.

Corp 1 engages in the business of acquiring, holding, and selling a. Corp 1 also invests in Investment 1, Investment 2, Investment 3, Investment 4 and other capital investments. Corp 1 provides a acquisition, management and collection services on a fee basis for its subsidiaries.

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Corp 1 holds #aa shares of the voting common stock of Corp 2. This represents all of the common stock outstanding of Corp 2. All of #bb shares of voting common stock of Corp 2 are authorized with a par value of ¢cc per share. In addition, #dd shares of preferred stock with a par value of \$ee per share have been authorized. Also, all of #ff shares of a new series of Corp 2's preferred stock entitled "Variable Rate Preferred Stock, Series X" ("Series X Preferred ") have been authorized for issue at \$gg per share. Those latter shares have no voting rights except in certain circumstances, described below.

As of Date 2, some shares of the Series X Preferred have been sold in a public offering, but remain in escrow pending approval of the listing of the Series A preferred stock on the Exchange.

Corp 1 is, and intends to continue as, the sole shareholder of the voting common stock of Corp 2. Corp 2 has no operating assets. It currently owns all of the common and preferred stock of Corp 3. Corp 3 engages in the offering and sale of b. The other members of the consolidated group of companies generate income from a variety of sources, including activities c, d and e.

Corp 2 will contribute all of the gross proceeds from the sale of its Series X Preferred stock to its subsidiary corporation, Corp 3, to be used for investment by that company. Corp 2 will receive Series B preferred stock of Corp 3 in exchange for those proceeds. Corp 2 is, and will continue to be, a non-operating holding company whose only business will be to hold the common stock and preferred stock of Corp 3.

#### Facts and Business Reasons Relating to the Transaction.

Corp 3 needs to increase its capital. Corp 3 is a regulated b company under the laws of State A, the stock of which must be assessable to pay corporate indebtedness. Because of Corp 3's status as a regulated b company, Corp 3 is severely limited in its ability to obtain capital from outside investors. To resolve this problem, Corp 2 was incorporated in Month AA of Year XXXX. Thereafter, the common shares of Corp 3 were transferred to Corp 2 by Corp 1. All of the common, voting shares of Corp 2 were originally purchased by Corp 1. Because Corp 2 is not a regulated b corporation it is not required to issue assessable shares of stock.

Following the incorporation of Corp 2, its Articles of Incorporation were amended to establish and designate a Variable Rate Cumulative Preferred Stock (Series X Preferred). The Board of Directors of Corp 2 authorized the issuance of Series X Preferred stock on Date 1.

In part, the Statement of Rights (hereinafter SOR) provides:

- a. Cash dividends on the Series X Preferred Shares will be payable before any cash dividends on any other classes of stock. Section 1(c) (SOR).
- b. Dividends on the Series X Preferred shares will be paid and determined monthly. Dividends will be equal to a percentage rate per annum based on the liquidation

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preference of  $\$gg$  per share. The percentage rate per annum will be equal to the "Five Year Constant Maturity Rate" plus  $hh\%$ . In addition, such rate will be adjusted upward by Corp 2's pricing committee if the pricing committee determines that the market dividend rate for the Series X Preferred is greater than the Five Year Constant Maturity Rate plus  $hh\%$ . The monthly determination of whether the market dividend rate for the Series X Preferred is greater than the Five Year Constant Maturity Rate plus  $hh\%$  will be based upon whether or not the issuance of the Series X Preferred at a dividend rate equal to the Five Year Constant Rate plus  $hh\%$  is providing adequate capital for Corp 2. If the issuance of the Series X Preferred at a dividend rate equal to the Five Year Constant Maturity Rate plus  $hh\%$  is not providing sufficient capital for Corp 2, Corp 2's pricing committee will adjust that dividend rate upward to market to induce investors to purchase the Series X Preferred. This determination will be done on a monthly basis.

- c. Corp 2 represents that when the dividend market rate for the Series X Preferred is greater than the Five Year Constant Maturity Rate plus  $hh\%$ , Corp 2 has paid the difference to its Series X Preferred shareholders. In no event will the monthly dividend be less than  $ii\%$  yearly or more than  $jj\%$  yearly of the  $\$gg$  per share liquidation preference. Dividends on the Series X Preferred will be cumulative. Section 1(a) (SOR).
- d. Holders of Series X Preferred shares will not be entitled to any dividend in cash, property or stock in excess of their full cumulative dividends. No interest will be payable with respect to any dividend payment which may be in arrears on Series X Preferred stock. Section 1(c) (SOR).
- e. Shareholders of Series X Preferred stock will not be entitled to vote for directors unless dividends payable on the stock are in arrears in an amount equal to  $kk\#$  full monthly dividends or more, per share. Section 4 (SOR).
- f. Shareholders of Series X Preferred stock will be entitled to vote on the issuance of additional senior Preferred stock or in changes in the rights, preferences or privileges of the stock. Section 4 (SOR).
- g. Series X Preferred stock will be redeemed, at the option of Corp 2, at a redemption price of  $\$gg$  per share, together with the payment of any dividends in arrears. Section 2(a) and 2(a)(i) (SOR).
- h. Shareholders can not redeem their stock without the consent of Corp 2. Section 2(b) (SOR). Redemption will be prohibited if there are any dividends in arrears unless all preferred shareholders are given the same opportunity to redeem their stock. No redemption will be possible, except in the case of death or major medical emergency of the holder, before Date 3. Section 2(d) (SOR).
- i. If Corp 2 is liquidated, the liquidation price of the Series X Preferred is  $\$gg$  per share. This is a preference before any payments or distributions are made to any other class of stock, including common stock and any preferred stock which

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is ranked junior to the Series X Preferred stock. Section 5(a) (SOR).

- j. Holders of Series X Preferred stock will have no pre-emptive rights to acquire additional shares of Corp 2. Section 8 (SOR).
- k. Series X Preferred stock will not be convertible into another class of stock. Section 3 (SOR).

You have requested the following ruling:

The Variable Rate Preferred Stock Series X to be issued by Corp 2 satisfies the provisions of §1504(a)(4) and therefore, is not “stock” within the meaning of § 1504(a).

### Law and Analysis

Section 1504(a) of the Code defines the term “affiliated group” to mean one or more chains of includible corporations connected through stock ownership with a common parent which is an includible corporation if-

(1) stock possessing at least 80% of the total voting power of the stock and at least 80% of the total value of the stock of each of the includible corporations (except the common parent corporation) is owned directly by 1 or more of the other includible corporations, and

(2) the common parent corporation owns directly stock possessing at least 80% of the total voting power of the stock and at least 80% of the total value of the stock in at least 1 of the other includible corporations.

Section 1504(a)(4) provides that only certain types of preferred stock are not stock for purposes of Section 1504(a). Section 1504(a)(4) sets forth, four, specific requirements to determine whether preferred stock is not “stock” for purposes of section 1504(a). Section 1504(a)(4) provides, in part, for preferred stock not to constitute “stock”, it must:

- A. Not be entitled to vote,
- B. be limited and preferred as to dividends and not participate in corporate growth to any significant extent.
- C. Have redemption and liquidation rights which do not exceed the issue price of the stock (except for a reasonable redemption or liquidation premium), and
- D. Not be convertible into another class of stock.

### A. Not be Entitled to Vote

Revenue Ruling 69-126, 1969-1 C.B. 218, holds that preferred stock that has the power

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to vote for directors is “stock” for purposes of Section 1504(a)(2). Preferred stock which can vote only if certain contingencies occur is not voting stock. The following decisional authority dealing with predecessor statutes to sections 1502 and 1504 so holds. Erie Lightning Co. v. Commissioner, 93 F.2d 883 (1<sup>st</sup> Cir. 1937) held that preferred stock that would obtain voting power in the event of certain contingencies was not voting stock until those contingencies occurred. Also, See Vermont Hydro-Electric Corp. v. Commissioner, 29 B.T.A. 1006 (1934). The Series X Preferred stock has no voting power unless certain enumerated contingencies relating to dividend arrearages occur. Since these contingencies have not occurred and are not expected to occur in the near future, the Series X Preferred stock is currently not voting stock.

B(a). Be Limited and Preferred as to Dividends

The Statement of Rights for Series X Preferred stock sets a dividend rate computed as a percentage of the liquidation preference of the stock. The liquidation preference of the Series X Preferred stock is the issue price of \$gg per share. The distribution rate for any monthly dividend cannot be less than ii% per year nor more than jj% per year of the \$gg per share liquidation preference. Therefore, the dividend rate on the Series X Preferred stock is limited as to dividends. No cash dividends may be paid to any other stockholders of Corp 2 while the Series X Preferred stock is outstanding. Therefore, the Series X Preferred stock is also preferred as to dividends.

B(b). Not Participate in Growth to any Significant Extent

Any upward adjustment in the dividend rate of the Series X Preferred stock to market has no relationship to either the earnings or asset appreciation of Corp 2. Therefore, the Series A Preferred shareholders will not share in the corporate growth of Corp 2.

C. Have Redemption and Liquidation Rights Which do not Exceed the Issue Price.

In order for the Series X Preferred stock to be considered “vanilla preferred stock” (and therefore, not “stock” within the meaning of Section 1504(a)(2)), the stock redemption and the liquidation rights that can be exercised by Corp 2 with respect to the Series X Preferred stock cannot exceed the issue price, except for a reasonable redemption or liquidation premium. (Section 1504(a)(4)(C)). The Series X Preferred stock redemption rights and the liquidation rights that can be exercised by Corp 2 each equate to the issue price of the stock (gg# per share) together with dividend arrearages. Section 2(a)(i) and 5 (SOR).

D. The Stock Must Not be Convertible Into Another Class of Stock.

The Series X Preferred stock will not be convertible into another class of stock. Section 3 (SOR). In addition, the Series X Preferred stock shareholders will not have pre-emptive rights. Section 8 (SOR).

Accordingly, based on the above facts and representations, we rule as follows:

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The Variable Rate Preferred Stock Series X to be issued by Corp 2 satisfies the requirements of § 1504(a)(4) and therefore, will not be “stock” within the meaning of §1504(a).

We express no opinion about the tax treatment of the transaction under any other section of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered in the above rulings.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

The ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be cited or used as precedent.

A copy of this ruling letter should be attached to the consolidated federal income tax return of the taxpayers involved for the taxable year in which the transaction is consummated.

In accordance with the Power of Attorney on file with this office, a copy of this letter ruling is being sent to the taxpayer.

Sincerely yours,

*Steven J. Hankin*

Steven J. Hankin

Senior Technician Reviewer, Branch 6  
Office of Associate Chief Counsel

(Corporate)