

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Treatment of Nonqualified Preferred Stock and Other Preferred Stock in Certain Exchanges and Distributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to nonqualified preferred stock. The regulations address the effective date of the definition of nonqualified preferred stock and the treatment of nonqualified preferred stock and similar preferred stock received by shareholders in certain corporate reorganizations and distributions. The regulations are necessary to reflect changes to the law concerning these types of preferred stock that were made by the Taxpayer Relief Act of 1997.

EFFECTIVE DATE: These regulations are effective October 2, 2000.

FOR FURTHER INFORMATION CONTACT: Richard E. Coss, (202) 622-7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On January 26, 2000, the IRS and Treasury published in the **Federal Register** a notice of proposed rulemaking (REG-105089-99, 2000-6 I.R.B. 580 [65 F.R. 4203]) relating to nonqualified preferred stock (as defined in section 351(g)(2) of the Internal Revenue Code)

(NQPS). The proposed regulations address the effective date of the definition of NQPS, and provide rules exempting from treatment as NQPS certain preferred stock received by shareholders in corporate reorganizations and distributions subject to sections 354, 355, and 356.

No comments responding to the notice of proposed rulemaking were submitted, and no public hearing was requested or held. However, one commentator suggested that the rule in the proposed regulations interpreting section 351(g)(2)-(C)(i)(II) (relating to preferred stock transferred in connection with the performance of services) should be expanded to include transactions subject to section 351.

The IRS and Treasury agree with this suggestion. Accordingly, these final regulations extend the exemption from treatment as NQPS in §1.356-7(c) to preferred stock received by shareholders in certain stock exchanges under section 351. The proposed regulations are adopted as revised by this Treasury decision.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Richard E. Coss of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding the following entries in numerical order to read in part as follows:

- Authority: 26 U.S.C. 7805 * * *
- Section 1.351-2 also issued under 26 U.S.C. 351(g)(4).
- Section 1.354-1 also issued under 26 U.S.C. 351(g)(4).
- Section 1.355-1 also issued under 26 U.S.C. 351(g)(4).
- Section 1.356-7 also issued under 26 U.S.C. 351(g)(4). * * *
- Section 1.1036-1 also issued under 26 U.S.C. 351(g)(4). * * *

Par. 2. Section 1.351-2 is amended by adding paragraph (e) to read as follows:

§1.351-2 Receipt of property.

* * * * *

(e) See §1.356-7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 921). See §1.356-7(c) for the treatment of preferred stock received in certain exchanges for common or preferred stock described in section 351(g)(2)(C)(i)(II).

Par. 3. Section 1.354-1 is amended by adding paragraph (f) to read as follows:

§1.354-1 Exchanges of stock and securities in certain reorganizations.

* * * * *

(f) See §1.356-7(a) and (b) for the treatment of nonqualified preferred stock (as defined in section 351(g)(2)) received in certain exchanges for nonqualified preferred stock or preferred stock. See §1.356-7(c) for the treatment of preferred stock received in certain exchanges for common or preferred stock described in section 351(g)(2)(C)(i)(II).

Par. 4. Section 1.355-1 is amended by adding paragraph (d) to read as follows:

§1.355-1 Distribution of stock and securities of a controlled corporation.

* * * * *

(d) *Nonqualified preferred stock.* See §1.356-7(a) and (b) for the treatment of nonqualified preferred stock (as defined in section 351(g)(2)) received in certain exchanges for (or in certain distributions with respect to) nonqualified preferred stock or preferred stock. See §1.356-7(c) for the treatment of the receipt of preferred stock in certain exchanges for (or in certain distributions with respect to) common or preferred stock described in section 351(g)(2)(C)(i)(II).

Par. 5. Section 1.356-7 is added to read as follows:

§1.356-7 Rules for treatment of nonqualified preferred stock and other preferred stock received in certain transactions.

(a) *Stock issued prior to effective date.* Stock described in section 351(g)(2) is nonqualified preferred stock (NQPS) regardless of the date on which the stock is issued. However, sections 351(g), 354(a)(2)(C), 355(a)(3)(D), 356(e), and 1036(b) do not apply to any transaction occurring prior to June 9, 1997, or to any transaction occurring after June 8, 1997, that is described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 921). For purposes of this section, preferred stock that is not NQPS is referred to as Qualified Preferred Stock (QPS).

(b) *Receipt of preferred stock in exchange for (or distribution on) substantially identical preferred stock—(1) General rule.* For purposes of sections 354(a)(2)(C)(i), 355(a)(3)(D), and 356(e)(2), preferred stock is QPS, even though it is described in section 351(g)(2), if it is received in exchange for (or in a distribution with respect to) preferred stock (the original preferred stock) that is QPS, provided —

(i) The original preferred stock is QPS solely because, on its issue date, either a right or obligation described in clause (i), (ii), or (iii) of section 351(g)(2)(A) was not exercisable until after a 20-year period beginning on the issue date, or the right or obligation was exercisable within the 20-year period beginning on the issue date but was subject to a contingency

which made remote the likelihood of the redemption or purchase, or the issuer's (or a related party's) right to redeem or purchase the stock was not more likely than not to be exercised within a 20-year period beginning on the issue date, or because of any combination of these reasons; and

(ii) The stock received is substantially identical to the original preferred stock.

(2) *Substantially identical.* The stock received is substantially identical to the original preferred stock if—

(i) The stock received does not contain any term or terms that, in relation to any term or terms of the original preferred stock, either decrease the period in which a right or obligation described in clause (i), (ii), or (iii) of section 351(g)(2)(A) can be exercised, or increase the likelihood that such a right or obligation will be exercised, or accelerate the timing of the returns from the stock instrument, including the timing of actual or deemed dividends or other distributions received on the stock; and

(ii) As a result of the exchange or distribution, exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the original preferred stock.

(3) *Treatment of stock received.* The stock received will continue to be treated as QPS in subsequent transactions involving such stock, and the principles of this paragraph (b) apply to such transactions as though the stock received is the original preferred stock issued on the same date as the original preferred stock.

(c) *Stock transferred for services.* For purposes of sections 351(g)(1), 354(a)(2)(C)(i), 355(a)(3)(D), and 356(e)(2), preferred stock containing a right or obligation described in clause (i), (ii) or (iii) of section 351(g)(2)(A) that is exercisable only upon the holder's separation from service from the issuer or a related person (as described in section 351(g)(3)(B)) will be treated as transferred in connection with the performance of services (and representing reasonable compensation) within the meaning of section 351(g)(2)(C)(i)(II), if such preferred stock is received in exchange for (or in a distribution with respect to) existing stock containing a similar right or obligation (exercisable only upon separation from

service) and the existing stock was transferred in connection with the performance of services for the issuer or a related person (and represented reasonable compensation when transferred). In applying the rules relating to NQPS, the preferred stock received will continue to be treated as transferred in connection with the performance of services (and representing reasonable compensation) in subsequent transactions involving such stock, and the principles of this paragraph (c) apply to such transactions.

(d) *Rights to acquire stock.* For purposes of §1.356-6, the principles of paragraphs (a), (b), and (c) of this section apply.

(e) *Examples.* In the examples in this paragraph (e), T and P are corporations, A is a shareholder of T, and A surrenders and receives (in addition to the stock exchanged in the examples) common stock in the reorganizations described. The following examples illustrate paragraphs (a), (b), and (c) of this section:

Example 1. In 1995, A transfers property to T and receives T preferred stock that is described in section 351(g)(2) in a transaction under section 351. In 2002, pursuant to a reorganization under section 368(a)(1)(B), A surrenders the T preferred stock in exchange for P NQPS. Under paragraph (a) of this section, the T preferred stock issued to A in 1995 is NQPS. However, because section 351(g) does not apply to transactions occurring before June 9, 1997, the T NQPS was not "other property" within the meaning of section 351(b) when issued in 1995. Under sections 354(a)(2)(C) and 356(e)(2), the P NQPS received by A in 2002 is not "other property" within the meaning of section 356(a)(1)(B) because it is received in exchange for NQPS.

Example 2. T issues QPS to A on January 1, 2000 that is not NQPS solely because the holder cannot require T to redeem the stock until January 1, 2022. In 2007, pursuant to a reorganization under section 368(a)(1)(A) in which T merges into P, A surrenders the T preferred stock in exchange for P preferred stock with terms that are identical to the terms of the T preferred stock, including the term that the holder cannot require the redemption of the stock until January 1, 2022. Because the P stock and the T stock have identical terms, and because the redemption did not become more likely than not to occur within the 20-year period that begins on January 1, 2000 (which is the issue date of the T preferred stock) as a result of the exchange, under paragraph (b) of this section, the P preferred stock received by A is treated as QPS. Thus, the P preferred stock received is not "other property" within the meaning of section 356(a)(1)(B).

Example 3. The facts are the same as in *Example 2*, except that, in addition, in 2010, pursuant to a recapitalization of P under section 368(a)(1)(E), A exchanges the P preferred stock above for P NQPS that permits the holder to require P to redeem the stock in 2020. Under paragraph (b) of this section, the P preferred stock surrendered by A is treated as QPS. Be-

cause the P preferred stock received by A in the recapitalization is not substantially identical to the P preferred stock surrendered, the P preferred stock received by A is not treated as QPS. Thus, the P preferred stock received is “other property” within the meaning of section 356(a)(1)(B).

Example 4. T issues preferred stock to A on January 1, 2000 that permits the holder to require T to redeem the stock on January 1, 2018, or at any time thereafter, but which is not NQPS solely because, as of the issue date, the holder’s right to redeem is subject to a contingency that makes remote the likelihood of redemption on or before January 1, 2020. In 2007, pursuant to a reorganization under section 368(a)(1)(A) in which T merges into P, A surrenders the T preferred stock in exchange for P preferred stock with terms that are identical to the terms of the T preferred stock. Immediately before the exchange, the contingency to which the holder’s right to cause redemption of the T stock is subject makes remote the likelihood of redemption before January 1, 2020, but the P stock, although subject to the same contingency, is more likely than not to be redeemed before January 1, 2020. Because, as a result of the exchange of T stock for P stock, the exercise of the redemption right became more likely than not to occur within the 20-year period beginning on the issue date of the T preferred stock, the P preferred stock received by A is not substantially identical to the T stock surrendered, and is not treated as QPS. Thus, the P preferred stock received is “other property” within the meaning of section 356(a)(1)(B).

Example 5. The facts are the same as in *Example 4*, except that, immediately before the merger of T into P in 2007, the contingency to which the holder’s right to cause redemption of the T stock is subject makes it more likely than not that the T stock will be redeemed before January 1, 2020. Because exercise of the redemption right did not become more likely than not to occur within the 20-year period beginning on the issue date of the T preferred stock as a result of the exchange, the P preferred stock received by A is substantially identical to the T stock surrendered, and is treated as QPS. Thus, the P preferred stock received is not “other property” within the meaning of section 356(a)(1)(B).

Example 6. A is an employee of T. In connection with A’s performance of services for T, T transfers to A in 2000 an amount of T common stock that represents reasonable compensation. The T common stock contains a term granting A the right to require T to redeem the common stock, but only upon A’s separation from service from T. In 2005, pursuant to a reorganization under section 368(a)(1)(A) in which T merges into P, A receives, in exchange for A’s T common stock, P preferred stock granting a similar redemption right upon A’s separation from P’s service. Under paragraph (c) of this section, the P preferred stock received by A is treated as transferred in connection with the performance of services (and representing reasonable compensation) within the meaning of section 351(g)(2)(C)(i)(II). Thus, the P preferred stock received by A is QPS.

(f) *Effective dates.* This section applies to transactions occurring on or after October 2, 2000.

Par. 6. Section 1.1036–1 is amended by adding paragraph (d) to read as follows:

§1.1036–1 Stock for stock of the same corporation.

* * * * *

(d) *Nonqualified preferred stock.* See §1.356–7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788, 921).

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

Approved September 25, 2000.

Jonathan Talisman,
*Acting Assistant Secretary
of the Treasury.*

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