PREFERRED YET NEGLECTED — A PLEA FOR GUIDANCE ON REDEMPTIONS OF C.F.C. PREFERRED STOCK IN THE WAKE OF U.S. TAX REFORM

Authors
Neha Rastogi
Andreas A. Apostolides
Stanley C. Ruchelman

Tags
Code §1248
Code §302
Code §245A
C.F.C.
Non-Voting Stock
Preferred Stock
Redemption

Neglected preferred stock! Yes, this article begins with an oxymoron. But as you read on, you will realize that Congress and the I.R.S. are capable of doing ANYTHING. If they can disturb the balance in the tax universe by introducing the Transition Tax and G.I.L.T.I., they can most certainly neglect one of the most desired investment instruments — preferred stock.

This article discusses the U.S. Federal income tax consequences of a redemption of non-voting preferred stock of a controlled foreign corporation ("C.F.C.") with an emphasis on the non-application of Code §1248, the redemption's effect on the C.F.C.'s earnings and profits("E&P"), and the lack of I.R.S. guidance on the subject.

REDEMPTION OF DOMESTIC STOCK

The U.S. Federal income tax treatment of a redemption of the stock of a corporation depends on whether the redemption is treated as a distribution in exchange for the stock or as a dividend.[1] Where the redemption qualifies for exchange treatment under Code §302(a), the amount of gain or loss realized by the shareholder is determined by removing the shareholder's adjusted basis in the redeemed shares from the sum of cash plus the fair market value of property other than cash received in the redemption. On the other hand, if the redemption does not qualify under Code §302(a), the distribution is treated as dividend to the extent of the company's E&P. To the extent the amount of the distribution exceeds E&P, the balance of the distribution is treated as the recovery of the shareholder's adjusted basis in the stock.[2] The portion of the distribution that exceeds the adjusted basis of the stock is treated as a capital gain.[3]

Typically, a payment in redemption of stock is accorded capital gains treatment if any of four tests identified in Code §302(b) is met. For purposes of applying these tests, explained further below, it is important to keep in mind that courts and the I.R.S. will apply the step transaction doctrine and Code §318 attribution principles.4

---

1 Code §302(a).

2 Code §301(c)(2).

3 Code §301(c)(3)(A). If the amount of the distribution does not exceed the adjusted basis of the stock redeemed, the regulations require that "proper adjustment" is made to the basis of the shareholder's remaining shares (Treas. Reg. §1.302-2(c)).

4 See, *e.g.*, *Merrill Lynch v. C.I.R.*, 120 T.C. 12 (2003), aff'd, 386 F.3d 464 (2d Cir. 2004), remanded, 131 T.C. 293 (2008), applying a "firm and fixed plan" standard to integrate cross-chain sales with a planned sale of a target affiliate to a third party. For a discussion of Code §318 in the Code §302(b) context, see *U.S. v. Davis*, 397 U.S. 301, reh'g denied, 397 U.S. 1071 (1970). The Court strenuously overrode the taxpayer's claim that Code §318 attribution should

Test 1: The Redemption Is "Not Essentially Equivalent to a Dividend"[5]

The Supreme Court has indicated that a redemption will be essentially equivalent to a dividend unless a "meaningful reduction" of the shareholder's ownership position has occurred.[6] Typically, this entails a significant reduction in the right to participate in the equity growth of the corporation and the management of the corporation as a result of the redemption. Neither of these conditions exists with respect to a non-voting preferred stock.[7] Therefore, a redemption of the non-voting preferred stock will be treated as an exchange for the stock and thereby the distribution will be taxed as capital gain.

Test 2: The Redemption Is Substantially Disproportionate Within the Shareholder Group[8]

An ordinary dividend does not disturb relative interests of shareholders in the assets and earning capacity of the corporation, whereas a non-*pro rata* redemption reduces the interest of some, but not all, shareholders. Consequently, Code §302(b)(2) treats a "substantially disproportionate" redemption as a distribution of cash or other property in exchange for the stock tendered by some, but not all, of the shareholders.

In order for the transaction to qualify as an exchange by a participating shareholder, the redemption must meet three requirements demonstrating a meaningful reduction in control, voting rights, and profits interest. In particular, immediately after the redemption has occurred, the tested shareholder must own

- less than 50% of the total combined voting power of all classes of voting stock,
- less than 80% of the percentage of voting stock held immediately before the distribution, and
- less than 80% of the percentage of common stock (both voting and non-voting) owned immediately beforehand.

If a shareholder owns both voting and non-voting stock, a redemption of only the non-voting preferred stock will not qualify as a "substantially disproportionate"

---

not be applied to the before and after snapshot approach of Code §302(b)(1), stating that to do so would nullify Congress's explicit directive.

5 Code §302(b)(1).

6 *U.S. v. Davis*, 397 U.S. 301. The Supreme Court (Justice Marshall opinion) analyzed the "not essentially equivalent" rule, observing the "morass" of decisions created under prior law, and remarking that the Code §302(b)(1) rule only made its way back into the Senate Finance version of the 1954 tax bill, with the Senate drafters specifically citing redemptions of preferred stock "which might be called by the corporation without the shareholder having any control over when the redemption may take place," as the extenuating rationale for maintaining this awkward language (citing S. Rep. No. 1622, 83d Cong., 2d Sess., at 44). In his heated dissent, Justice Douglas argued in favor of extending prior law, observing dryly that to apply the Court's narrow reading meant "that in the case of closely-held or one-man corporations a redemption of stock is 'always' equivalent to a dividend. I would leave such revision to Congress."

7 Treas. Reg. §1.302-2(a).

8 Code §302(b)(2).

redemption because the redemption will not reduce the shareholder's proportionate ownership of the voting stock and, thereby, the ability to control corporate affairs.[9] Thus, a redemption of only non-voting preferred stock will not meet the substantially disproportionate redemption test.

Test 3: A Complete Termination of the Tested Shareholder's Ownership Interests in the Redeeming Corporation[10]

This test is relatively straightforward. If a person is no longer a shareholder, the distribution reduces control, voting rights, and profits interest in a meaningful way.

Test 4: A Redemption in Partial Liquidation of the Company[11]

Without going into detail, this test is one with relatively limited application involving shareholders that are not corporations, such individuals and trusts. It also requires a termination of a significant business line as part of a corporate contraction.

In view of the above discussion, a C.F.C.'s redemption of its non-voting preferred stock will be able to qualify for exchange treatment only under the "not essentially dividend" test of Code §302(b)(1).

REDEMPTION OF C.F.C. STOCK

While Code §302 is a general provision applicable to redemptions of stock, the tax effect of a sale or exchange of the stock of a C.F.C. — including a redemption — is governed by the special provisions of Code §1248. Briefly, Code §1248 treats gain arising from the sale or exchange of C.F.C. stock, which otherwise would be treated as a capital gain, as ordinary dividends to the extent of the C.F.C.'s E&P that have not been previously taxed in the U.S. Code §1248 was enacted to ensure that U.S. multinationals did not repatriate deferred foreign earnings at favorable long-term capital gains rates in effect at the time by having their C.F.C.'s redeem stock or engage in either redemptions of their stock or taxable liquidations (allowing immediate basis offset under Code §302(b) or Code §331(a)).[12]

Based on prior law, Code §1248 thus provides a parity of tax treatment for U.S. shareholders who sell C.F.C. stock in the following two fact patterns:

- In the first, the C.F.C. is a corporation that distributes dividends regularly, providing its U.S. shareholders with a stream of potentially taxable dividends, as provided under U.S. tax law in effect at the time. When the stock of the C.F.C. is sold, the gain reflects solely the increase in value of the business of the C.F.C.
- In the second fact pattern, the C.F.C. is a corporation that accumulates its profits and pays no dividends. When the stock of the C.F.C. is sold, the

---

[9] Treas. Reg. §1.302-3(a).

[10] Code §302(b)(3).

[11] Code §302(b)(4).

[12] S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 703, 813. For a detailed analysis of Code §1248, read "Is the 100% Dividend Received Deduction Under Code §245A About as Useful as a Chocolate Teapot?" published in *Insights* Volume 6 Number 6.

gain reflects both the increase in the value of the C.F.C.'s business and the retained cash earnings. In a system where long-term capital gains are taxed at a more favorable tax rate, as was the case in 1962 when Code §1248 was enacted, the second fact pattern resulted in more favorable tax treatment

For purposes of Code §1248, a person is treated as having sold or exchanged any stock of a C.F.C. (and is therefore within the ambit of the rule's deemed dividend treatment) if such person is treated (within the provision of Subtitle A — which includes Code §302) as realizing gain from the sale or exchange of such stock.[13] In other words, if a distribution received in redemption of the C.F.C.'s stock would be treated as an exchange under Code §302, Code §1248 overrides Code §302's treatment by characterizing the gain as if it were a dividend to the extent attributable to the C.F.C.'s accumulated E&P.[14] However, if the redemption distribution fails to meet any of the four exchange tests under Code §302, the entire distribution is governed under Code §301 rather than Code §1248.[15]

Code §1248(a) provides:

> (a) General rule. If
>
> > (1) **a United States person** ["U.S. Person"] sells or exchanges stock in a foreign corporation, and
> >
> > (2) such person owns, within the meaning of §958(a), or is considered as owning by applying the rules of ownership of §958(b), **10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation** at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in §957),
>
> then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation. For purposes of this section, a United States person shall be treated as having sold or exchanged any stock if, under any provision of this subtitle, such person is treated as realizing gain from the sale or exchange of such stock. [emphasis added]

As the foregoing statutory language indicates, the tax treatment provided under Code §1248 continues to be applicable only to a U.S. Person who owns 10% or

---

13 Code §1248(a), last line.

14 Treas. Reg. §1.1248-1(b). See discussion below of previously taxed C.F.C. E&P.

15 Code §302(d). Therefore, the full amount of the redemption distribution is treated as a dividend, rather than the amount of gain.

more of a C.F.C.'s voting stock and not to a U.S. Person who owns 10% or more of the value of all classes of stock of the C.F.C.

In 2017, the Tax Cuts and Jobs Act ("T.C.J.A.") expanded the definition of a U.S. shareholder for the purposes of Subpart F, G.I.L.T.I., and the other international tax provisions to include persons owning 10% or more of the total value of stock.[16] This expanded definition (termed a "U.S. Shareholder"), created a disconnect between the trigger for Code §1248 treatment (10% of vote) and the trigger for tax under the international tax provisions.

"Code §1248 refers to a U.S. Person owning 10% or more of the C.F.C.'s voting stock . . . rather than to a U.S. Shareholder."

Code §1248 refers to a U.S. Person owning 10% or more of the C.F.C.'s voting stock ("Section 1248 shareholder"),[17] rather than to a U.S. Shareholder, which includes both a person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of a C.F.C. and a person who owns 10% or more of the total value of shares of all classes of stock of such foreign corporation.[18]

It is not clear whether the T.C.J.A.'s failure to amend Code §1248 to eliminate this baseless distinction between a Section 1248 shareholder and a U.S. Shareholder, with all its ensuing consequences for C.F.C. preferred stock redemption was a mere legislative oversight.[19] In any event, the law stands as enacted, and in the absence of a legislative fix, tax advisers are once again entrusted with the task of maneuvering through this thicket of disparate Code provisions to advise clients on an issue.

INTERACTION OF REDEMPTION RULES, CODE §1248, AND U.S. TAX REFORM

A U.S. Person owning non-voting preferred stock in a C.F.C. may be in a neglected position should those shares represent 10% or more of the value of all shares of the corporation. Even if the U.S. Person is a U.S. Shareholder under Code §951(b) by virtue of owning 10% or more of the total value of all classes of the stock of the C.F.C. and therefore subject to all other C.F.C. provisions of the Code, Code §1248 will not apply because of the absence of the voting rights. This may yield unexpected results when various Code provisions interact.

To illustrate, assume a U.S. corporation owns shares representing 10% or more of a C.F.C.'s voting rights. If those shares are sold at a gain, a portion of the gain will be treated as dividend income under Code §1248. Presumably, the amount treated as a dividend would qualify for the 100% dividend received reduction (the "D.R.D.") under Code §245A, subject to certain conditions.[20] However, if the shareholder owns only non-voting preferred stock, Code §1248 does not apply.[21] The entire

[16] T.C.J.A. §14214(a).

[17] Code §1248(a). The separate term Section 1248 shareholder is only used by the I.R.S. in formal guidance in the Treasury Regulations enacting Code §367 (*cf.* Treas. Reg. §1.367(b)-1(c)(2)(iv)(A)).

[18] Code §951(b).

[19] Also of note, the definition of U.S. Person is somewhat restricted for purposes of Subpart F, by providing special treatment for certain *bona fide* residents of Puerto Rico, Guam, American Samoa, and the Northern Mariana Islands.

[20] Code §1248(j).

[21] *Larry D. Barnette, et al. v. C.I.R.*, T.C. Memo 1992-371.

gain continues to be treated as capital gain and the D.R.D. under Code §245A is not available. The entire amount of the capital gain will be subject to corporate tax in the U.S. at 21%.

The D.R.D. under Code §245A is not available to non-corporate shareholders of a foreign corporation. However, the source rules for gains differ from the source rules for dividends. If the gain is taxable by the foreign country in which the C.F.C. is located and Code §1248 is not applicable, the entire gain recognized by the individual will be domestic-source gain in the absence of a favorable resourcing provision in an applicable income tax treaty. This is a significant problem for U.S. investors in Indian companies, for example, where Indian capital gains tax is imposed on the sale of an Indian company by a U.S. resident and the same gain is then liable to be taxed a second time in the U.S. without ability to claim the benefit of any foreign tax credits.[22]

REDEMPTION OF NON-VOTING STOCK: EFFECT ON E&P AND P.T.I. ACCOUNT

The Code and final regulations do not provide any guidance on the effect of a redemption of non-voting preferred stock of a C.F.C. on its E&P and on the redeemed shareholder's previously taxed E&P account ("P.T.I. Account"). While we expect to delve further into the intricacies of Code §959 in a future version of Insights, it is worth mentioning for now that the regulations under Prop. Treas. Reg. §1.959-3, released in 2006, (the "2006 Proposed Regulations") shed some light on the topic.[23] However, no final regulations have been issued to date. In addition, in early 2019, the I.R.S. indicated it intends to withdraw the 2006 Proposed Regulations.[24] Nonetheless, the 2006 Proposed Regulations remain helpful in understanding how future regulations might look at the issue if no material change is made to the underlying concepts.

The 2006 Proposed Regulations provide that the effect of a redemption on the shareholder's P.T.I. Account and on the E&P of the redeeming C.F.C. both depend on whether the distribution is treated as a payment in exchange for stock or as a distribution of property treated as a dividend under Code §301. Bringing us back to where we began, a redemption of the non-voting preferred stock of a C.F.C. (where the redeemed shareholder owns only non-voting preferred stock) is treated as a payment in exchange for the stock.

---

[22] In this case, Article 12 (Gains) allows India to impose the tax. Article 25 (Relief from Double Taxation) provides for a credit in the U.S. that is subject to the limitations of U.S. tax law. One such limitation is that credit is given only to reduce U.S. tax imposed on foreign-source income. Under Code §865(a)(1), such gain is treated as domestic gain for a U.S.-resident individual. Hence, the foreign tax credit limitation may be zero, and the foreign tax credit would provide no meaningful benefit. The only relief available is to claim a deduction under Code §164. Note, the $10,000 ceiling on the deduction of state, local, and foreign taxes does not apply to a foreign tax paid or accrued in carrying on a trade or business or an activity described in Code §212 (Code §164(b)(6)).

[23] REG-121509-00, 71 F.R. 51155 (August 29, 2006).

[24] See Notice 2019-1, I.R.B. 2019-01, at §2. The justification for this intended withdrawal was that the previously taxed E&P rules should be modified to account for the multiple new separate categories of previously taxed E&P under U.S. tax reform, including the Transition Tax and G.I.L.T.I.

Redemption Treated as Payment in Exchange for the Stock

Since a redemption of the U.S. Person's non-voting preferred stock in a C.F.C. will typically be treated as a payment in exchange for stock under Code §302(b)(1), we take a moment here to examine the effect of that redemption on the C.F.C.'s E&P and the shareholder's P.T.I. Account.

Effect on Redeeming C.F.C.'s E&P

The 2006 Proposed Regulations provide that if the redemption distribution is treated as a payment in exchange for stock under Code §302(a), the amount of the distribution chargeable to the corporation's E&P is determined under the general rules of Code §312(a), meaning that the C.F.C.'s E&P (including both previously taxed and non-previously taxed E&P) is reduced by the amount of the following:[25]

- Cash distributed in redemption
- The adjusted basis of the property distributed (Also, in the case of a distribution of an appreciated property, Code §312(b) first increases E&P by the unrealized appreciation and then reduces E&P by the amount of the fair market value.[26])
- The principal amount of the obligation distributed by the corporation

Once the amount of the distribution is determined, the pool of previously taxed E&P of the C.F.C. is reduced first. Any distribution in excess of the pool of previously taxed E&P reduces the pool of non-previously taxed E&P. These adjustments will be similar in principle to how Code §312 E&P is adjusted when the redeeming corporation is a domestic corporation.

Effect on Redeemed Shareholder's P.T.I. Account

Upon a redemption treated as an exchange, the P.T.I. Accounts related to the redeemed shares cease to exist, and any remaining P.T.I. balance in those accounts is reclassified as non-previously taxed E&P of the C.F.C.

CONCLUSION

When the T.C.J.A. failed to amend Code §1248 in a way that conforms to the definition of a U.S. Shareholder of a C.F.C. and the new rules enacted around the latter definition, a disconnect was created that has led to anomalous results when a U.S. Person's non-voting preferred shares in a C.F.C. are sold or otherwise redeemed.

While a shareholder owning 10% or more of the value in the C.F.C. will be subject to a number of provisions, like Subpart F, G.I.L.T.I., and C.F.C. reporting requirements (among others), the shareholder will face excessive taxation at the time the shares are sold or redeemed. The reclassification of the U.S. Person's P.T.I. Accounts to

---

[25] Prop. Treas. Reg §1.959-3(h)(2) subjects the reduction in the C.F.C.'s E&P to two ceilings.

[26] Code §312(b)(2). The interaction of the positive and negative adjustments causes a net reduction to E&P equal to the distributing corporation's basis in the property so distributed.

non-previously taxed E&P, as indicated above, is just one more discrepancy that will result from these split definitions.

For a corporation, the excessive tax arises from the loss of the D.R.D. For individuals, the excessive tax arises from potential loss of benefit under the foreign tax credit.

"A shareholder owning 10% or more of the value in the C.F.C. . . . will face excessive taxation at the time the shares are sold or redeemed."

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*