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#### Background

On June 22, 1994, a notice of proposed rulemaking (CO-8-91), amending regulations under section 305(c) of the Internal Revenue Code relating to constructive distributions on preferred stock, was published in the Federal Register (59 FR 32160). No public hearing was requested and none was held.

Written comments responding to the notice were received. After consideration of all the comments, the regulations proposed by CO-8-91 are adopted as revised by this Treasury decision. The principal revisions are discussed below.

#### Explanation of Provisions

The primary focus of the final regulations is on preferred stock callable at a premium at the option of the issuer. The final regulations retain the approach of the proposed regulations and require constructive distribution treatment with respect to an issuer call only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to the call right is more likely than not to occur.

**Safe harbor rule.** The proposed regulations provided a safe harbor, under which constructive distribution treatment does not result from an issuer call if the issuer and holder are unrelated, there are no arrangements that effectively require the issuer to redeem the stock, and exercise of the option to redeem would not reduce the yield of the stock. In response to comments, the final regulations make certain modifications to the safe harbor to clarify its scope.

Commentators suggested that the exclusion from the safe harbor where there are "arrangements that effectively require the issuer to redeem" is too narrow and will permit taxpayers who issue stock with "understandings" concerning redemption, whether or not legally enforceable, to qualify for the safe harbor. Commentators recommended safeguarding against abuse by changing the effectively requires redemption test to one that requires a lesser degree of probability. The IRS and Treasury intend that the safe harbor not be available where an issuer and a holder have an underlying understanding. Although the IRS and Treasury believe that the word "arrangement" is broad enough to include such understandings, in response to these comments, this prong of the safe harbor has been clarified.

To retain greater certainty for non-abusive transactions, however, the effectively requires redemption test has not been substantially modified. Instead, the final regulations safeguard against abuse by lowering the threshold for determining whether an issuer and a holder are related. The proposed regulations adopted a 50-percent threshold for determining whether an issuer and a holder are related. The final regulations lower this threshold to 20 percent. This threshold relates only to eligibility for the safe harbor, and not to the application of the general "more likely than not" test. When a holder's ownership interest exceeds this threshold, the IRS and Treasury believe it is appropriate to determine whether redemption is more likely than not to occur based on all of the facts and circumstances.

Commentators also suggested that the IRS and Treasury except preferred stock within the meaning of section 1504(a)(4) in determining whether the issuer and holder are related. The regulations do not adopt this suggestion. As noted above, the determination of whether the issuer and holder are related only governs eligibility for the safe harbor. The IRS and Treasury believe that when a holder's ownership interest in an issuer exceeds the threshold, even if all that the holder owns is preferred stock within the meaning of section 1504(a)(4), it is appropriate to determine whether redemption is more likely than not to occur based on all of the facts and circumstances.

In response to comments, the final regulations clarify that the "arrangements" that effectively require or are intended to compel the issuer to redeem the stock relate to the issuer call right, and not to a later mandatory redemption feature.

In testing whether a call right meets the yield prong of the safe harbor, the final regulations clarify that principles similar to the principles of section 1272(a) and the original issue discount regulations apply to determine whether exercise of the right to redeem would reduce the yield of the stock.

**Miscellaneous.** The final regulations expand the definition of issuer in certain circumstances. In particular, the regulations provide that if preferred stock may be acquired by a person other than the issuer (a third person), the term issuer includes such third person if the regulations would apply to the stock if the third person were the issuer, and acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes (under section 304 or otherwise). In addition, if the issuer and the third person are members of the same affiliated group, the term issuer includes the third person if a principal purpose of the arrangement is to avoid the application of section 305 and the final regulations. Furthermore, an agreement or other arrangement for a person other than the issuer of the stock to acquire the stock may create a conversion transaction within the meaning of section 1258.

The final regulations provide rules for the treatment of mandatory redemption obligations and put options that are subject to contingencies. Generally, premiums on such stock are not subject to constructive distribution treatment if the contingency renders remote the likelihood of redemption. For example, where an issuer issues stock that is mandatorily redeemable in the event of an initial public offering, the regulations require evaluation of the likelihood of the occurrence of the initial public offering. The regulations provide, however, that a contingency does not include the possibility of default, insolvency, or similar circumstances, or that a redemption may be precluded by applicable law due to insufficient capital.

The preamble to the proposed regulations requested comments on the appropriate treatment of unpaid cumulative dividends. Because of the complexity of this issue, the final regulations do not provide rules for those dividends. The IRS and Treasury will continue to consider the issue, as well as other issues involving the implementation of the amendments to section 305(c) made by the Revenue Reconciliation Act of 1990. The IRS and Treasury continue to invite public comments on these issues.