

EFFECTIVE DATES. The regulations apply to stock issued on or after December 20, 1995. Although the regulations do not apply to stock issued before December 20, 1995, the rules of sections 305(c) (1), (2), and (3) apply to stock described therein issued on or after October 10, 1990, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Pub. L. 101-508 Stat.). Moreover, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Pub. L. 101-508 Stat.), with respect to stock issued on or after October 10, 1990, and issued before December 20, 1995, the economic accrual rule of section 305(c)(3) will apply to the entire call premium on stock that is not described in paragraph (b)(2) of this section if the premium is considered to be unreasonable under the principles of § 1.305-5(b) (as contained in the 26 CFR part 1 edition revised April 1, 1995). A call premium described in the preceding sentence will be accrued over the period of time during which the preferred stock cannot be called for redemption.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Kirsten L. Simpson of the Office of Assistant Chief Counsel (Corporate), IRS. However, other personnel of the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 as follows:

Authority: 26 U.S.C. 7805 * * * Section 1.305-3 also issued under 26 U.S.C. 305. Section 1.305-5 also issued under 26 U.S.C. 305. Section 1.305-7 also issued under 26 U.S.C. 305. * * *

Par. 2. Section 1.305-3 is amended as follows: 1. In paragraph (e), remove the parentheses from the numbers in the headings for *Examples (1) through (15)*.

2. In paragraph (e), *Example 15* is revised to read as follows:

§ 1.305-3 Disproportionate distributions.

* * * * *
(e) * * *

Example 15. (i) *Facts.* Corporation V is organized with two classes of stock, class A common and class B convertible preferred. The class B stock is issued for \$100 per share and is convertible at the holder's option into class A at a fixed ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. The class B stock pays no dividends but it is mandatorily redeemable in 10 years for \$200. Under sections 305(c) and 305(b)(4), the entire redemption premium (i.e., the excess of the redemption price over the issue price) is deemed to be a distribution of preferred stock on preferred stock which is taxable as a distribution of property under section 301. This amount is considered to be distributed over the 10-year period under principles similar to the principles of section 1272(a). During the year, the corporation declares a dividend on the class A stock payable in additional shares of class A stock.

(ii) *Analysis.* The distribution on the class A stock is a distribution to which sections 305(b)(2) and 301 apply since it increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation and the class B shareholders have received property (i.e., the constructive distribution described above). If, however, the conversion ratio of the class B stock were subject to full adjustment to reflect the distribution of stock to class A shareholders, the distribution of stock dividends on the class A stock would not increase the proportionate interest of the class A shareholders in the assets and earnings and profits of the corporation and such distribution would not be a distribution to which section 301 applies.

(iii) *Effective date.* This *Example 15* applies to stock issued on or after December 20, 1995. For previously issued stock, see § 1.305-3(e) *Example (15)* (as contained in the 26 CFR part 1 edition revised April 1, 1995).

Par. 3. Section 1.305-5 is amended as follows:

1. Paragraph (b) is revised.

2. In paragraph (d), remove the parentheses from the numbers in the headings for *Examples (1) through (9)*, redesignate *Examples 8* and *9* as *Examples 9* and *10*, respectively.

3. In paragraph (d), *Examples 4, 5, and 7* are revised, and *Example 8* is added.

4. Paragraph (e) is added.

The revisions read as follows:

§ 1.305-5 Distributions on preferred stock.

* * * * *

(b) *Redemption premium—(1) In general.* If a corporation issues preferred stock that may be redeemed under the circumstances described in this paragraph (b) at a price higher than the issue price, the difference (the redemption premium) is treated under section 305(c) as a constructive distribution (or series of constructive distributions) of additional stock on preferred stock that is taken into account under principles similar to the principles of section 1272(a). However, constructive distribution treatment does not result under this paragraph (b) if the redemption premium does not exceed a de minimis amount, as determined under the principles of section 1273(a)(3). For purposes of this paragraph (b), preferred stock that may be acquired by a person other than the issuer (the third person) is deemed to be redeemable under the circumstances described in this paragraph (b), and references to the issuer include the third person, if—

(i) This paragraph (b) would apply to the stock if the third person were the issuer; and

(ii) Either—

(A) The acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes (under section 304 or otherwise); or

(B) The third person and the issuer are members of the same affiliated group (having the meaning for this purpose given the term by section 1504(a), except that section 1504(b) shall not apply) and a principal purpose of the arrangement for the third person to acquire the stock is to avoid the application of section 305 and paragraph (b)(1) of this section.

(2) *Mandatory redemption or holder put.* Paragraph (b)(1) of this section applies to stock if the issuer is required to redeem the stock at a specified time or the holder has the option (whether or not currently exercisable) to require the issuer to redeem the stock. However, paragraph (b)(1) of this section will not