CCH

CAP Exchange

News & Information about CCH Capital Changes

Issue 7 ◆ Fall 2003

Understanding Code Sec. 302

From time to time a tax opinion on a corporate action includes those mysterious words, "subject to the tests of Code Sec. 302." What does it mean? What should you do? This article will answer these questions and maybe a few more you never even thought of.

Looking for redemption

Code Sec. 302 only applies when a corporation redeems its stock. In this context a redemption occurs when a company acquires some or all of its stock from shareholders in exchange for property. It does not matter whether the company calls the acquisition of its stock a redemption. In fact, 302 may apply to a corporate action, like a merger, reverse split or spin-off, that does not appear at first glance to involve a redemption, but for purposes of the Code it is still a redemption. *See, e.g., Granite State Bankshares,* CCH Capital Changes Rep. (2-28-2003); *Jefferson Smurfit Group PLC,* CCH ADR/Global Capital Changes Rep. (9-3-2002).

Whether or not a corporate action is called a redemption, the common thread in any 302 situation is that the shareholder gives up some or all of its stock in a company and receives something in return, whether cash or some other property. So what happens when there is a corporate action, like a merger, where shareholders give up their stock and receive something in return? What's all this about a test?

A test of character

The first thing to remember about the receipt of property under 302 is that it is taxable. The purpose of the test is to determine if the property received in consideration for the redeemed security is treated as a dividend or as a capital gain or loss.

Let's take a closer look at the first transaction cited above. In *Granite State Bankshares* the company merged into Chittenden Corp. and shareholders could elect to receive either stock, cash or a combination of stock and cash. If a shareholder received solely stock in the exchange, it would be nontaxable and 302 would not apply. If, instead, the shareholder only received cash in the exchange, it would be taxable, subject to the tests of 302. In other words, the cash received would be treated as a dividend or as capital gain or loss, but either way it would be taxable. The third scenario was a little trickier. Receipt of both stock and cash resulted in no loss recognized, but gain could be recognized to the extent of the cash received or the total gain realized, whichever was less. Under 302, the gain recognized would be treated as a capital gain if it passed any one of the following tests.

Are we graded on a curve?

Pop quiz — What does a redemption have to do to get a drink around here ... sorry, to be treated as a sale? The short answer is: if it looks like a sale or exchange, it qualifies for capital gains treatment; otherwise, it gets taxed as a dividend. There are four tests under Code Sec. 302 to determine if a redemption looks sufficiently like a sale to get capital gains treatment. If it passes any one of them ... bingo.

1. Not essentially equivalent to a dividend

The first test is that the redemption must not be essentially equivalent to a dividend. It sounds fairly straightforward, but in practice this rule has produced uncertain results and has been given limited application. Basically, only meaningful redemptions are deemed to meet this test; i.e. redemptions that result in a substantial reduction of the shareholder's participation in the company.

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Inside this issue

Depositary Receipts

CCH provides corporate action information for depositary receipts (DR's) representing companies all over the world. This is the first in a series that takes a closer look at DR's and how they work.

The basics

A DR is a negotiable instrument, issued by a bank acting as the depositary, representing a specific number of underlying shares in a company. The company is usually incorporated in a country other than where the DR is traded. The underlying shares are technically owned by the depositary, but DR holders have a beneficial interest in them. As a result, DR holders have virtually the same corporate and economic rights as the company's shareholders, with some important exceptions that will be covered later.

In the United States, the most common form of DR is the American Depositary Receipt (ADR), which is how the stock of many international companies are traded here. The primary benefit of ADR's is that they make it easy for U.S. investors to purchase and hold securities of non-U.S. companies. ADR's trade in U.S. dollars, pay dividends in U.S. dollars and settle through U.S. clearing houses, allowing investors to avoid costly currency conversions.

DR's can be sponsored or unsponsored. Unsponsored DR's are created and offered to investors by one or more depositaries without any involvement by the company issuing the underlying shares. One consequence of this is when distributing proceeds to investors different depositaries may pay out different amounts depending on how much each depositary realizes on the sale. *See, e.g., Western Areas Ltd.*, CCH ADR/Global Capital Changes Reporter (1-16-2003).

In a sponsored program, the company chooses the depositary, and their relationship is governed by a depositary agreement. This gives the company some control over the terms of the depositary program. It also allows the company to raise capital and choose how the DR's are traded, depending on the level of the program.

The different levels

Level one sponsored DR's are the most basic DR's available to companies that do not want to raise capital and do not want to or cannot list on an exchange. Level one DR's are traded on the Over-the-Counter (OTC) market. This type of program does not require full SEC registration. An F-6 registration statement is enough to establish the program. Going forward, level one companies are exempt from regular SEC reporting requirements under Rule 12g3-2(b). This exemption only requires the company to provide summaries of documents made public or provided to shareholders or exchanges in its home market. Level one programs do not have to report accounts under U.S. Generally Accepted Accounting Principles (GAAP).

Level two sponsored DR's are traded on U.S. securities exchanges (NYSE or AMEX) or quoted on NASDAQ. This gives the program more visibility and generally, more active trading. Full SEC registration is required to establish the program. The company

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On the lighter side

Do CCH editors have too much time on their hands? For the grisly details check out the latest corporate action for Transylvania Blood Banks International (10-31-2003).

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2. Complete termination

The next test is that the interest of the shareholder in the security being redeemed must be completely terminated. This one is a lot easier to apply. The shareholder must not have anything left of the old security. One way a shareholder could run afoul of this test is under the rules of constructive ownership, as when a shareholder divests his direct interest in a company but keeps an indirect interest through a spouse or child. Also, a divesting shareholder must be careful not to reacquire an interest in that company for ten years.

This test can also cause problems when a company offers to buy back a limited number of shares. An individual shareholder may tender all of his shares, but if the offer is oversubscribed, the company may prorate the shares it accepts, leaving the shareholder with a portion of his holding. *See e.g. AMN Healthcare Services, Inc.,* CCH Capital Changes Rep. (10-8-2003); *Descartes Systems Group Inc. (The),* CCH ADR/Global Capital Changes Rep. (7-11-2003). By the same token, a shareholder might choose to tender only a portion of his holdings and the result would be the same — there would not be a complete termination of interest.

3. Substantially disproportionate

Even if there is no complete termination of interest, if a shareholder has a substantially disproportionate amount of his shares redeemed, the redemption may qualify for capital gains treatment. This test might help the shareholder whose shares were prorated in the previous paragraph. Unfortunately, the criteria for meeting this test are fairly complicated and involve ratio comparisons of voting power, voting stock and common stock before and after the redemption.

One problem that might arise under this test is when a company redeems only one class of shares. In *Apartment Investment and Management Co.* CCH Capital Changes Rep. (4-18-2002), for example, the company redeemed its 8% class K convertible preferred in exchange for its class A common. Shareholders who held class A common before the redemption could fail this test since the ratio of common stock owned after the redemption would probably increase.

4. Partial liquidation

The final test focuses on the effect of the redemption on the company. If the company liquidates part of its business and distributes the proceeds to its shareholders, the redemption is treated as a sale. *See, e.g., PLM International, Inc.,* CCH Capital Changes Rep. (11-3-2000). However, the distribution must not be essentially equivalent to a dividend and it must be pursuant to a plan and occur within the taxable year that the plan was adopted or within the following year. Although there are other criteria the company must meet, the key is that there should be a genuine contraction of the company's business and a corresponding reduction in the capital used.

Can you flunk?

Sure, but what's so bad? Generally, if property received in a redemption does not qualify for sale treatment under any of the four rules discussed above, it is treated as a dividend distribution that is taxed as ordinary income to the extent of the company's current and accumulated earnings and profits, with any excess treated as return of capital in reduction of basis (but not below zero) and then as capital gain.

The good news is that, for individuals receiving dividends from 2003 through 2008, dividends may be taxed at capital gains rates if the shareholder held the stock for at least 60 days. On the other hand, because of the dividends received deduction rule, coporate shareholders would rather receive dividends, in which case dividend treatment is good news!

Constructive advice

An article on redemptions would not be complete without a brief discussion of constructive ownership. Sometimes a shareholder must consider whether he has any underlying interests that are attributable to him under the Code. If a spouse, parent, child or grandchild holds the same stock as the shareholder, their holdings are deemed to be constructively owned by the shareholder receiving a distribution on that stock. So while it may appear that the shareholder's interest has been completely terminated, he is still deemed to hold interests through his family members. Similar rules may apply to options and interests of entities, such as corporations, partnerships, LLCs and trusts.

Final report card

In the world of corporate actions, Code Sec. 302 pops up in many, and sometimes unexpected,

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Depositary Receipts

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registers and reports under the Securities Exchange Act of 1934 by filing an initial registration statement and annual reports on Form 20-F. The company also reconciles financial statements according to U.S. GAAP.

Level three sponsored DR's are essentially the same as level two but level three allows the company to raise capital by offering new securities to U.S. investors. Level three DR's require the same SEC registration and reporting as level two DR's. In addition, the company must file an F-1 registration statement for the underlying securities being offered in the United States for the first time through the depositary program.

SEC Rule 144A allows a company to raise capital in the United States by issuing DR's as restricted securities placed only with qualified institutional buyers (QIB's). QIB's are sophisticated institutional investors that own or manage at least $100 million in securities. Rule 144A offerings can be made with any class of shares not listed on a U.S. exchange or issued by a company that meets the definition of an "investment company." Trading of 144A DR's is done on the PORTAL system, which is the NASD's quote system for 144A securities.

Global Depositary Receipts (GDR's) allow companies to raise capital in two or more countries simultaneously. GDR's can be issued in public or private markets. Most GDR's comprise a U.S. component which can be publicly offered or privately placed under Rule 144A and an international component placed under Regulation S. Under Regulation S, securities offered to investors outside the United States are not subject to SEC registration requirements.

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places. At one level, all it means is that you have to decide whether the cash, stock or other property received in a redemption should be treated as a dividend or as a capital gain or loss. Yet as simple as this issue appears, it raises a whole raft of sub-issues, some of which have no easy answer.

This article only scratches the surface, but with any luck you will never have to plumb the depths. If nothing else, readers should remember that there are four basic tests under 302 for determining whether a redemption should be treated as a sale: (1) It must not be essentially equivalent to a dividend, (2) there must be a complete termination of interest, (3) there must be a substantially disproportionate redemption of stock or (4) it must be a partial liquidation. If any one of these criteria are met, the consideration received is taxed as a capital gain or loss. If not, it is treated as a dividend ... and that's life.

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Happy Thanksgiving!