SIMPSON
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OUTLINE
TRACKING STOCK

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I. BACKGROUND

A. Definition of Tracking Stock

1. Generally a class or series of common stock of the issuing corporation.

2. Designed to give a return that is determined by reference to the earnings of less than all of the issuer's assets (*i.e.*, generally a separate business or group of businesses of the issuer).

3. Payment is subject to the risk of the operations of the issuer as a whole.

B. Salient Features of Tracking Stock

1. **Voting Rights**
Holders of tracking stock typically have voting rights, which may be fixed at the time of issuance or floating (*e.g.*, fixed but subject to periodic adjustments based on relative market values).

2. **Dividend Rights**
The dividend rights of tracking stock are based on the earnings of the tracked business. The dividend policy (*i.e.*, when and how much of the tracked business' earnings are to be distributed) is subject to the discretion of the Board of Directors of the issuer.

3. **Liquidation Rights**
Holders of tracking stock do not have a special right to the tracked assets and share in all of the issuer's assets. Liquidation rights are often based on the relative values of the tracked and total assets at the time of issuance, but are sometimes fixed in proportion to relative market capitalization immediately prior to liquidation.

4. **Conversion Rights**
The issuer can generally elect to convert the tracking stock, often at a premium, into another class of stock subject to certain restrictions. In some transactions, the tracking stock automatically converts to another class of stock if the issuer

sells the tracked assets. In other instances, conversion may be one of several options.

C. Business Advantages of Tracking Stock

1. Enables the market to value more accurately the respective businesses of the issuer without complete economic separation.

2. Permits continuation of synergies arising from the operation of a larger enterprise (*e.g.*, counter-cyclical nature of distinct lines of business; sharing of administrative costs; lower borrowing rates, etc.).

3. Improves employee stock option plans and management incentive programs by more closely aligning stock with the performance of a specific business.

4. Avoids the tax costs of a separation and the disadvantages of a spinoff or deconsolidation.

5. Results in state tax savings.

6. Can be used as acquisition currency (*e.g.*, motivates managers who stay with the company; allows shareholders of target to continue to participate in equity appreciation associated with target's business).

7. Permits separate financing of business opportunities.

8. Provides for separate accounting of tracked businesses, thereby avoiding distortions created by losses of one business artificially offsetting income of another.

D. Creation of Tracking Stock

1. Often created by a recapitalization of existing common into new common ("other stock") and tracking stock or by a distribution of tracking stock on the common stock. *See*, *infra*, Part VII.B.

    a. In many instances outstanding tracking stock will represent an interest in only a portion of the tracked business with the remaining interest retained as an element of the other stock.

b. Note that other stock also becomes a tracking stock since it tracks other business (including any "retained" interest in tracked business).

2. Sale to non-shareholders in an initial public offering. *See*, *infra*, Part VII.C.

   a. Often preceded by issuance to existing shareholders to help establish a market.

   b. Tracking stock sold in IPO usually represents only a portion of the tracked business with the remaining interest retained as an element of the other stock.

3. Tracking stock can also serve as useful consideration in business combinations. *See*, *infra*, Part VII.A.

   a. Can permit selling shareholders to have continuing play in sold business.

   b. Can resolve unwanted asset problems by leaving economic interest in unwanted assets with selling shareholders.

E. Alternatives to Tracking Stock

1. **Spinoff**
   The "tracked" assets of the parent are dropped into a new subsidiary, which is then spun off to shareholders of the issuer.

2. **IPO Carve Out**
   The "tracked" assets are dropped into a subsidiary and the subsidiary engages in an initial public offering for up to 20% of its stock. The parent and the new subsidiary remain consolidated for tax purposes.

3. **Convertible Debt**
   Issuer issues debt, which is convertible into stock of the subsidiary.

F. Examples of Recently Completed Transactions

(see Appendix A for a more exhaustive list of public tracking stock transactions)

1. Sprint – Sprint PCS (1998)

2. AT&T – TCI and Liberty Media (issued 1999; Liberty Media split-off planned 2001); AT&T Wireless Group Tracking Stock (issued 2000; split-off 2001)

3. Genzyme Corp. – Genzyme Surgical Products Division (GZSP) Stock (1999)

4. Applera Corporation (formerly Perkin-Elmer Corporation) – PE Biosystems Stock and Celera Genomics Stock (1999)

5. WorldCom, Inc. – MCI group stock (2001)

6. Cablevision – Rainbow Media Group (2001)

7. Sony – Sony Communications Network (2001)

II. TAX ISSUES

A. Whose Stock Is It?

1. Important tax implications arise depending on whether tracking stock is viewed as stock of the issuing company or stock of an actual or constructive subsidiary owning the tracked business.

   a. ***Characteristics of Tracking Stock which Support Classification as Stock of the Issuer***

      (1) *State Law*: For state law purposes, tracking stock is treated as stock of the issuer.

      (2) *Voting Rights*: Holders of tracking stock vote as shareholders of the issuer, not the subsidiary.

      (3) *Dividend Rights*: Dividends are received from the issuer, declared by the issuer's Board of Directors and subject to state law limitations on dividends paid by the issuer on its capital stock.

(4) *Liquidation Rights*: Holders of tracking stock must look to net of issuer's assets in excess of liabilities and have no security interest in or special liquidation rights to receive the tracked assets.

b. ***Tax Consequences if Tracking Stock Is Characterized as Stock of the Issuer***

(1) Distribution of tracking stock to the issuer's shareholders qualifies as a nontaxable stock dividend under section 305(a).[1]

(2) Distribution of tracking stock to the issuer's shareholders is tax-free to the issuer under section 311.

(3) A public offering by the issuer of tracking stock is nontaxable to the issuer under section 1032.

(4) Conversion by the issuer of tracking stock into residual stock or into other tracking stock is tax-free under section 368(a)(1)(E).

(5) Query whether an exchange by a holder of tracking stock for the residual stock or other tracking stock might also be tax-free under section 1036. *See* Rev. Rul. 54-65 discussed *infra* Part II.A.2.a.(3).

(6) The tracked assets remain part of the issuer's consolidated tax group.

c. ***Tax Consequences if Tracking Stock Is Characterized as Stock of a Subsidiary***

(1) If the transaction does not qualify as a section 355 spinoff, distributions to the issuer's shareholders would be taxable as dividends under section 301.

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[1] All section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended (the "Code").

(2) If the distribution of the tracking stock does not qualify as a section 355 spinoff, the difference between the fair market value and basis of the stock distributed would be recognized as gain to the issuer under section 311.

(3) A public offering of the tracking stock would not qualify under section 1032 and the issuer would recognize gain.

(4) If the tracking stock constitutes more than 20% of the vote or value of the subsidiary, then deconsolidation, for federal tax purposes, would result.

d. ***Other Tax Considerations***

(1) The potential effect of tracking stock on subsequent section 355 transactions. *See* discussion, *infra*, Part II.B.

(2) Tracking stock may avoid changes in ownership under section 382 for the targeted business. As parent stock, the effect under section 382 will be determined at the parent level.

(3) A holder of tracking stock and a contingent value right (*see*, *e.g.*, GM Class E Stock) may be deemed to be holding a straddle under section 1092.

2. **Authorities**

a. ***Mutual Fund Precedents***

(1) For regulated investment companies ("RICs"), a "series fund" is an entity with separate investment funds. It issues series of stock which have dividend and liquidation rights linked to the different funds.

(2) *Union Trusteed*: The Tax Court refused to treat each fund of a RIC as a separate corporate entity, due to the absence, at the time, of any support in the statute, regulations or decisions

for separate corporate treatment. Union Trusteed Funds, Inc. v. Commissioner, 8 T.C. 1133 (1947), *acq*. 1947-2 C.B. 4.

(3) *Rev. Rul. 54-65*: The IRS held that stock of one series of a RIC exchanged for stock of a different series of the same RIC did not qualify as a nontaxable exchange of stock. Because the stock exchanged was treated as "special stock" and not as common or preferred for section 1036 purposes and each series was dependent on entirely different assets for its earnings and liquidation value, the exchange gave rise to taxable gain or deductible loss. 1954-1 C.B. 101.

(4) *Section 851(h)*: In 1986, Congress legislatively overruled *Union Trusteed* for series funds organized as corporations. Section 851(h) provides that when a RIC has more than one fund, "each fund shall be treated as a separate corporation" for federal tax purposes. The legislative history to section 851(h) indicates Congressional intent that each fund should meet RIC qualification tests separately to resolve uncertainties and inconsistencies in the treatment of series funds.

b. ***Farley Realty***: The Second Circuit held that where (in connection with a lower interest rate on a loan) a mortgagee obtained the right to receive, from a corporate debtor, 50% of the appreciation in value of certain real property, and where the right to share in the property's appreciation had no termination date, the right constituted an equity interest in the real property and the payment was not deductible as interest on the debt. Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960).

c. ***Maxwell Hardware***: Two real estate developers established a real estate division in a corporation which had historically operated as a hardware business, and which had sustained significant losses. The division was set up using funds furnished by the two developers through the purchase of nonvoting preferred stock of the corporation, for an amount equal to approximately 40% of the value of the corporation's common stock. The developers and the corporation agreed that after six years, if the division was discontinued or the preferred stockholders sold their interest, the corporation would redeem the preferred stock by a distribution in kind of 90% of the division's assets. The real estate business used the NOLs of the economically unrelated hardware business and the Ninth Circuit upheld the treatment as one company. Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir. 1965).

d. ***Section 1298(b)(4)***: This provision, added in 1986, grants the Secretary the power to issue regulations to treat "separate classes of stock (or other interests) in a corporation . . . as interests in separate corporations." The legislative history evidences a concern that a corporation might issue a separate class of stock to track passive assets while avoiding PFIC classification. Under those circumstances, it might be necessary for regulations to treat that separate class of stock as a separate corporation. *See* Joint Comm. on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* at 1032 (Comm. Print 1987).

e. ***Section 337(d)***: In 1989, it was reported that the Treasury Department had indicated that it would exercise its authority under section 337(d) to prevent the use of tracking stock to sell a business without triggering a *General Utilities* tax. *See* Matthews, "Conference Covers the Waterfront on 1989 Tax Issues," 42 Tax Notes 1540 (1989).

f. ***Section 355(d)***: The 1990 Act legislative history indicates an intention to toll the holding period for tracking stock arrangements, albeit while treating tracking stock as stock of the issuer. *See* discussion, *infra*, Part II.B.

g. ***Section 367***: Treas. Reg. § 1.367(b)-4 (adopted June 18, 1998) applies to certain exchanges of foreign corporations that are described in section 351 or described in section 354 and made pursuant to certain reorganizations. If an exchange is described in the Treasury regulation, United States shareholders are required to include in income, as a deemed dividend, the "section 1248 amount" attributable to the stock that is exchanged. One of the exchanges described occurs if a United States corporate shareholder exchanges stock in a foreign corporation and receives stock that, in the discretion of the IRS, entitles the shareholder to participate (through dividends, redemption payments or otherwise) disproportionately in the earnings generated by particular assets of the foreign acquired corporation or the foreign acquiring corporation and if certain other conditions are met.

h. ***In Re General Motors Class H Shareholders Litigation***, 734 A.2d 611 (Del. Ch. 1999): The court did not directly address tax issues. Nevertheless, the court did not consider the Class H stock (the tracking stock) to be anything other than stock of the issuer, General Motors.

i. ***Solomon v. Armstrong***, 747 A.2d 1098 (Del. Ch. 1999): The court did not directly address tax issues. Nevertheless, the court considered the tracking stock to be stock of General Motors: "[Defendant's] position [that the Class E shareholders should be considered stockholders in GM] has substantial appeal considering that; 1) the Class E stock was in fact a GM stock; and 2) EDS was held as a wholly-owned subsidiary of GM."

3. **IRS Pronouncements Involving Tracking Stock**

a. ***PLR 7740034***: In July 1977, the IRS issued a ruling that appeared to treat "special" stock with tracking stock characteristics as stock of the issuer.

b. ***PLR 8817007***: In August 1987, the IRS seemingly characterized tracking stock as stock of the issuer in the context of a reverse triangular merger of two banks. However, the ruling may have been based upon the taxpayer's representation that the tracking stock was stock of the issuer. The IRS subsequently revoked the ruling to reflect its no-ruling policy on tracking stock classification. *See* ***PLR 8844038***.

c. ***Rev. Proc. 87-59***: Two months after PLR 8817007 was issued, the IRS classified tracking stock as an "Area

Under Extensive Study" in which rulings or determination letters would not be issued until the IRS resolved the issue through a published ruling. 1987-2 C.B. 764.

d. ***PLR 9422057***: In spite of the no-ruling policy, on March 11, 1994, the IRS issued a spinoff ruling where the spinoff was to holders of the non-tracking residual stock. *See also* **PLR 9526032**, holding that the sale of the targeted subsidiary will not adversely affect the initial ruling.

e. ***PLR 9624049***: On December 27, 1995, the IRS issued a ruling regarding the spinoff of a subsidiary of a company that had tracking stock outstanding. The issues regarding the treatment or characterization of the tracking stock were not explicitly addressed in the ruling. The company, however, represented that, for tax purposes, the tracking stock was stock of the company (not of the subsidiary).

f. ***Rev. Proc. 95-3****:* In January 1995, the IRS continued its no-ruling policy on tracking stock. However the matter was moved from "Areas Under Extensive Study" to "Areas in Which Rulings or Determination Letters Will Not Be Issued." 1995-1 I.R.B. 85.

g. ***PLR 9625038***: In March 1996, the IRS issued a ruling regarding a tax-free reorganization in which tracking stock was used as part of the acquisition currency. The acquiring company represented that the tracking stock was common stock of the company for tax purposes.

h. ***PLR 9802048***: In July 1997, the IRS issued a ruling regarding the reorganization of Hughes Aircraft in which stock was recapitalized to track the earnings of a Hughes Aircraft subsidiary. Hughes Aircraft represented that, for tax purposes, the tracking stock was stock of the company. *See*, *infra*, Part VII.A.1.

i. ***PLR 9826030***: In March 1998, the IRS issued a ruling regarding the use of tracking stock in the reorganization of U.S. West's subsidiaries. The company represented that, for tax purposes, the tracking stock was stock of the company.

j. ***Rev. Proc. 2001-3***: In January 2001, the IRS continued its no-ruling policy on tracking stock. Tracking stock continues to be classified under "Areas in Which Rulings or Determination Letters Will Not Be Issued." 2001-1 I.R.B. 103.

B. The Effect of Tracking Stock on Section 355 Transactions

1. **Section 355(d) Five Year Holding Period**
Currently section 355(d) requires a distributing corporation to recognize gain on the distribution of appreciated stock or securities of a controlled corporation in a "disqualified distribution." A "disqualified distribution" is defined as one in which, immediately after the transaction, any person holds a 50% or greater interest (by vote or value) in either the distributing or controlled corporation consisting of stock purchased within the five-year period ending on the date of the distribution.

a. Section 355(d)(6) suspends the running of the five-year period for any period in which the holder's risk of loss with respect to the stock or securities, or with respect to any portion of the activities of the corporation, is substantially diminished by, among other things, a "special class of stock."

b. The Code does not define a "special class of stock," but the legislative history explicitly states that tracking stock is considered a "special class of stock" for purposes of tolling the five-year holding period.

c. Regulations interpreting section 355(d), adopted in 2000, take the position stated in the legislative history. The regulations define the term "special class of stock" to include a class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to the earnings, assets, or attributes of less than all the assets or activities of a corporation or any of its subsidiaries. The regulations state that tracking stock is an example of such a "special class of stock." *See* Treas. Reg. § 1.355-6(e)(4)(iv).

d. Prior to Treas. Reg. § 1.355-6, it was unclear whether a stock dividend of tracking stock constituted a purchase under section 355(d). Treas. Reg. § 1.355-6(d)(2) clarifies that a purchase does not include an acquisition of stock in a distribution qualifying under section 305(a) to the extent section 307 applies to determine the recipient's basis.

2. **Spinoff Rulings**
Although the IRS has adopted a no-ruling policy on tracking stock, corporations, apparently, are able to represent that the tracking stock qualifies as stock of the issuer. *See* **PLR 9422057; PLR 9624049; PLR 9625038; PLR 9637043, PLR 9802048; PLR 9826030.**

3. **Section 355(e) Change in Ownership**
Section 355(e) disallows the tax-free treatment to a distributing company if the distribution is pursuant to a plan to change ownership.

4. **Section 355(e) Establishing absence of a plan**

   a. The 1999 proposed regulations provided the exclusive means by which a taxpayer could establish that a distribution and an acquisition were not part of a plan, and required that the taxpayer must establish the absence of a plan with clear and convincing evidence. 1999 Prop. Reg. § 1.355-7(a)(2)(iii)(B). After consideration of the comments received, the IRS and the Department of the Treasury decided to withdraw the 1999 proposed regulations and issue new proposed regulations (hereinafter referred to as the 2000 proposed regulations) to provide guidance concerning the interpretation of the phrase "plan (or series of related transactions)."

   b. Operating Rule 6 of the 2000 proposed regulations tolls the running of any time period prescribed under the 2000 proposed regulations where the risk of loss is substantially diminished under the principles of section 355(d)(6)(B). The 2000 proposed regulations do not address how this tolling rule is intended to apply in the case of tracking stock.

   c. The New York State Bar Association Tax Section recommends changes to the 2000 proposed regulations defining the scope of a plan under section 355(e). The NYSBA believes that final regulations should clarify that a split-off distribution of controlled corporation stock in redemption of tracking stock does not automatically result in the acquisition of stock of the "tracked" subsidiary being considered to be part of a plan under the "facts and circumstances" test. The NYSBA asserts that it is appropriate to toll the running of safe harbor periods, but it does not believe that the issuance of tracking stock, which, by its terms, the issuer may redeem in a split-off transaction, should necessarily cause the acquisition of the tracking stock and the distribution to be treated as a "plan." The NYSBA believes that other factors, such as the length of time the tracking stock is outstanding, are more relevant to the determination of whether the issuance of the tracking stock and an ultimate distribution are truly part of a plan. *NYSBA Suggests Changes to the Proposed Anti-Morris Trust Regs.* (Released Apr. 10, 2001) 2001 Tax Notes Today 72-17 (Apr. 13, 2001).

C. Is It Section 306 Stock?

1. If section 306 stock is distributed as a stock dividend, a holder will recognize dividend income on redemption of the section 306 stock and could realize ordinary income with no basis offset if such holder sells the section 306 stock.

2. Sections 306(c)(1)(A) and (B) provide that the term "section 306 stock" includes certain stock other than common stock. While "common stock" is not defined in section 306 or the related regulations, the IRS has held that the determinative factor is whether the stock represents an unrestricted interest in the equity growth of the corporation. Rev. Rul. 79-163, 1979-1 C.B. 131; *see also* Rev. Rul. 81-91, 1981-1 C.B. 123.

   a. Tracking stock does not have limitations on the amount of dividends or liquidation proceeds that are available to the stockholders. Therefore, such stock participates in the equity growth of the corporation and should not be characterized as "section 306 stock."

   b. *But see* American Health Properties Psychiatric Group Preferred Stock, which carries a stated liquidation preference but pays a dividend based upon the performance of the Psychiatric Group.

D. **Preferred Stock Considerations**
The use of preferred stock as tracking stock:

1. May avoid a shareholder vote;

2. Raises section 306 issues if treated as preferred stock;

3. Should be treated as common stock if it has only a *de minimis* liquidation preference and no dividends priority; and

4. Should not be treated as disqualified preferred stock under section 1059(f):

   a. Not preferred as to dividends because dividends are discretionary; and

   b. Issue price does not necessarily exceed stated redemption price or liquidation rights.

E. **State Tax Considerations**

1. Tracking stock allows the corporation to continue to file combined returns.

2. There are similar implications under state tax law as under federal law if the tracking stock is not characterized as stock of the issuer.

III. COMMENTATORS ON THE CHARACTERIZATION OF TRACKING STOCK

A. **1987 New York State Bar Association Report**
Concludes that current law generally precludes a holding that tracking stock is stock of the subsidiary. Suggests that for some purposes tracking stock could be treated as if it represented an interest in a separate entity which holds the targeted property, a kind of joint venture. The interests in the joint venture could be viewed as held by both the issuer and the holders of the tracking stock. Recommends that the Treasury Department consider the applicability of specific Code provisions to tracking stock transactions, and identify objective criteria to be used in determining whether a proscribed tracking stock arrangement is present. New York State Bar Assoc. Tax Section, *Report Regarding "Tracking Stock" Arrangements*, 43 Tax L. Rev. 51 (1987).

B. **Sheppard Article (1987)**
Analyzes the different ways the GM acquisition of EDS and

creation of Class E Stock could be characterized under existing law. Suggests that section 305 should be reviewed and that it should not tolerate vertical divisions of corporate common stock interests if they change shareholders' relative interests in the corporation. Concludes that any attempt to characterize tracking stock as stock of the issuer or the subsidiary is uncertain because it is a question of the facts and circumstances of each transaction. Lee Sheppard, *GM's Class E Stock: Tax Planning in Second Gear*, 87 Tax Notes Today 132-2 (July 9, 1987).

C. **Sheffield Article**

Argues that tracking stock should be characterized as stock of the issuer if it shares both the economic benefits and burdens of the issuer as a whole. Concludes that tracking stock generally meets this test and should be viewed as stock of the issuer. Suggests the following guidelines for evaluating specific tracking stock arrangements: (i) to be viewed as stock of the issuer there should be some economic participation in all assets; (ii) if the stock tracks passive assets, it should not be viewed as stock of the issuer; and (iii) if the stock does not relate to a substantial business of the issuer, it should be characterized as "section 306 stock." Jeffrey Sheffield and Barbara St. Clair, *An Abecedarium on Alphabet Stock*, 66 Taxes 954 (Dec. 1988).

D. **Steinberg Article**

Discusses the interaction of tracking stock and section 355(d), specifically sections 355(d)(6) and 355(d)(7). Points out that tracking stock is explicitly included in the legislative history as a special class of stock that could trigger section 355(d)(6)'s special rule tolling the required five-year holding period. Lewis Steinberg, *Selected Issues in the Taxation of Section 355 Transactions*, 51 Tax Law. 7 (1997). *See* discussion, *supra*, Part II.B.

E. **American Bar Association Report**

Argues that, with the exception of unusual cases, it is unfair to characterize the issuance of tracking stock as the sale of an interest in a subsidiary since such stock is ultimately an interest in the issuer. Holders of tracking stock do not have access to the underlying assets nor do they have rights in the tracked subsidiary. In addition, the issuer of tracking stock remains subject to corporate level tax with respect to the tracked assets because it continues to own those assets and has not disposed of them. Suggests that legislation should be aimed at those instances in which tracking stock is properly treated as an equity interest in the tracked entity or assets. This would avoid taxing commonly used instruments that should not be treated as triggering gain recognition. Suggests that basis issues should be addressed immediately rather that left for future regulations in order to avoid irrational results such as double taxation on the issuance of tracking stock. Committee on Corporate Tax, American Bar Association*, Comments on Proposal to Tax Issuance of Tracking Stock* (Released June 23, 1999), 1999 Tax Notes Today 127-30 (July 2, 1999).

F. **1999 New York Bar Association Report**

In a letter to the House Ways and Means Committee, the New York Bar Association asserts that tracking stock is not presently being used in public situations primarily for tax avoidance purposes. As a result, they do not support the adoption of the FY 2000 Budget proposal (which would have required a corporation issuing tracking stock to recognize gain, *see* discussion, *infra*, Part IV.A) without a comprehensive review of the issues. A part of this comprehensive review would include an examination of the extent to which issued tracking stock has been correlated to the performance of the underlying subsidiary. The Bar Association believes that tracking stock without a "high degree of correlation in performance" does not raise significant tax policy concerns and appears to serve legitimate non-tax business objectives. Suggests that there is some concern that tracking stock allows corporations to create shareholder interests in pools of assets while retaining tax ownership and the benefits of consolidation. Argues, however, that this is consistent with current practices in financial accounting which allow a company to separate the results of a loss subsidiary from its profit- making subsidiaries. *Letter from Harold Handler to the Honorable Bill Archer, Chair, House Ways and Means Committee* (Released June 2, 1999), 1999 Tax Notes Today 110-35 (June 9, 1999).

G. **Sheppard Article (1999)**

States that recent amendments to section 355 have made it too difficult for companies to sell unwanted assets without incurring tax, hence the recent popularity of tracking stock. Asserts that tracking stock represents a horizontal, rather than a vertical, division of ownership rights and that tracking stock should be thought of as derivatives instead of the equity of any one issuer. Supports the FY 2000 Budget proposal in finding a constructive sale of the tracked asset (or subsidiary) when tracking stock is issued. Lee Sheppard, *Business Revenue Raisers: Cleaning Up and Necessary Fixes* (released Feb. 5, 1999), 1999 Tax Notes Today 25-4760 (Feb. 8, 1999).

H. **Stratton & Sheppard Article (1999)**
In ruling that several proposed reorganizations qualify as valid tax-free reorganizations (PLR 9422057, PLR 9625038, PLR 9802048, PLR 9826030), the IRS has accepted representations by taxpayers that tracking stock is stock of the issuer. But authors warn against interpreting those rulings as evidence that the IRS agrees that tracking stock is stock of the issuer. Sheryl Stratton & Lee Sheppard, *Officials Consider Cross-Border Exchangeable Stock Deals*, 1999 Tax Notes Today 19-3 (Jan. 29, 1999).

I. **Rizzi Article**
Predicts that tracking stock transactions will become more widely used in the future because tracking stock allows a corporation to replicate the principal economic effects of a spinoff distribution of the tracked business without losing ultimate control of that business. Describes past uses of tracking stock and the typical features and tax issues of tracking stock transactions. Robert Rizzi, *Tracking Stock: The Past and the Future*, Mergers and Acquisitions 3 (May 2000).

J. **Freeman Article**
Concludes that the USX transaction (in which the company issued tracking stock, *see*, *infra*, Part VII.B.1) should be upheld, based on existing law, because both classes of stock possess the fundamental characteristics of common stock. Notes the "feel" of many that tracking stock is different than direct ownership of the tracked business. Louis Freeman, *General Overview and Strategies in Representing Sellers*, 473 PLI/Tax 7 (2000).

K. **Finkelstein and Todd Article**
Summarizes the characteristics and tax issues of tracking stock. Stuart Finkelstein and Joseph Todd, *Tracking Tracking Stock*, 481 PLI/Tax 169 (2000).

L. **Dahlberg and Perry Article**
Explains the history, characteristics, and uses of tracking stock. Also discusses "virtual" instruments that, like tracking stock, allow companies to engage in mergers and acquisitions using non-traditional equity alternatives. These "virtual instruments," including exchangeable stock and equalization agreements, (see *IRS Officials Consider Cross-Border Exchangeable Stock Deals*, 1999 Tax Notes Today 19-3 (January 29, 1999) (Release Date: January 28, 1999)), raise the question of whether an instrument could represent an interest in an entity which owns the issuer, or in some fictional entity resulting from a "virtual" combination of the

issuer with a third party. James Dahlberg & Jay Perry, *Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions*, 481 PLI/Tax 241 (2000).

M. **Schler Article**
Discusses lack of tracking stock authority in regulations under section 1504 addressing options. Section 1504(a)(5)(B) authorizes regulations to provide that in determining the consolidated return 80 percent ownership tests, options can be treated as exercised. Treas. Reg. § 1.1504-4 treats options as exercised in certain circumstances. "Options" include calls, puts, and convertibles, as well as cash settlement options, phantom stock, and similar interests other than stock. The preamble to the final regulations states that despite requests for clarification, the treatment of "tracking stock" is not addressed. Michael Schler, *Selected Recent Consolidated Return Developments*, 486 PLI/Tax 503 (2000).

N. **Cummings Article**
Discusses qualified SEC opinions as they relate to tracking stock. Notes that the Wachtell, Lipton and Baker & Botts opinions for the AT&T/TCI merger are "should" opinions, which indicates some degree of uncertainty as to the status of tracking stock. The S-4 filed on January 8, 1999 explained that the uncertainty about the tracking stock issue derived from lack of authority, but that counsel believe "it is unlikely that the IRS would prevail in a court of law on this issue." Jasper Cummings, Jr., *Reorganization Tax Opinions*, 478 PLI/Tax 1181 (2000).

O. **Friedman Article**
Discusses the reasons why tracking stock is an attractive structuring option for a dotcom business. Also explains the accounting treatment of a parent corporation that issues tracking stock. Notes that companies that want to accomplish a tax-free share buyback should examine GM's offer to exchange a substantial portion of its retained interest in the Hughes business (tracked through the GM Class H shares) for GM shares. Gary Friedman, *The Old Economy Meets the New Economy: Structuring a Dotcom Subsidiary*, 477 PLI/Tax 785 (2000).

P. **Steinberg Article**
Asserts that most practitioners believe that the type of tracking stock publicly issued to date should not constitute stock of the tracked business, but rather stock of the parent. States that, to the author's knowledge, the IRS has never challenged the classification of publicly issued tracking stock as stock of the

parent. Warns, however, that, as the article by Stratton and Sheppard asserts (see above), this does not necessarily mean that the IRS agrees that tracking stock is stock of the issuer. Lewis Steinberg, *Tax Considerations in Structuring Corporate Acquisitions*, ALI-ABA CLE (March 8, 2001).

IV. CLINTON ADMINISTRATION BUDGET PROPOSALS

A. FY 2000 and FY 2001 Proposals

In both the FY 2000 (issued Jan. 1999) and FY 2001 (issued Jan. 2000) Budget proposals, the Clinton Administration proposed recognizing gain in tracking stock transactions. The FY 2000 Budget proposal would have required the issuing corporation to recognize gain. By contrast, the FY 2001 Budget proposal would have required the shareholder receiving the tracking stock to recognize gain. The FY 2001 Budget proposal also differed from the FY 2000 Budget proposal in that it would have exempted stock splits of tracking stock or similar transactions. *See* Budget of the United States Government, Fiscal Year 2000 (1999); Budget of the United States Government, Fiscal Year 2001(2000).

B. Status of Tracking Stock Unchanged

1. Strong opposition to the Clinton Administration's tracking stock budget proposals for FY 2000 and FY 2001 resulted in neither the House nor the Senate including any tracking stock proposals in their budget submissions.

2. The FY 2002 Budget proposal (issued Jan. 2001) that President Bush submitted to Congress in April did not include any tracking stock proposals.

V. STRUCTURAL CONSIDERATIONS

A. Positive Characteristics

The following characteristics are supportive of "stock of issuer" analysis:

1. **Divisional Form**
Assets are held in divisional form, not in a single entity. On the other hand, arrangements that separate tracked businesses are a negative.

2. **Voting Rights**
Holders of tracking stock generally vote as shareholders of the

issuer. It is a positive characteristic if the holders of tracking stock do not have special voting rights regarding the tracked assets or businesses. The characterization of tracking stock as stock of the issuer is made more difficult if the holders of tracking stock have the right to control directly the tracked assets such as the right to elect a separate Board of Directors.

3. **Dividend Rights**

a. Declaration of dividends should be left to the discretion of the issuer's Board of Directors, subject to corporate governance issues discussed *infra* Part V.B.

b. Participation in profits of non-tracked businesses would be helpful, but is typically not found in tracking stock transactions.

4. **Liquidation Rights**

a. Holders of tracking stock should look only to the general assets of the issuer.

b. Arrangements that determine the amount distributed to holders of tracking stock without reference to the value of the tracked assets are helpful.

5. **Liabilities**
Significant actual or contingent liabilities at the issuer level support the characterization of the tracking stock as stock of the issuer.

6. **Conversion Rights**
Issuer has the ability to convert tracking stock into residual common, often at a premium. *E.g.*, sale of Continental Baking subsidiary by Ralston Purina and conversion of CBG shares (which tracked Continental Baking) into RPG shares (residual) at a 15% premium (1995).

B. Non-Tax Considerations (Corporate Governance)

1. **Board of Directors Issues**
The issuance of tracking stock can create conflicts between groups of shareholders and the Board will need to deal with the added pressures. *See* Stephen I. Glover, *The Tracking Stock Company's Board of Directors*, The M&A Lawyer, Feb. 2001 (discussing the fiduciary duties a tracking stock company

board of directors owes to the different classes of stock and proposing tracking stock policies for companies to adopt).

a. Often the Board requires detailed operating guidelines which begin to conflict with tax considerations.

b. Allocation of various expenses and liabilities is required, including tax items under one or more tax sharing agreements.

c. Operating Committees may be useful to the Board of Directors in managing the tracked assets. However, any such committees should be controlled by the Board with the tracking shareholders having no control over such committees. A separate Board of Directors which the tracking stockholders control increases the risk that the tracking stock could be characterized as other than stock of the issuer.

2. **Extraordinary Transactions**
Tracking stock complicates fairly common restructuring situations. For example, if a corporation sells half of a tracked business, it raises the issue of what they can do with the proceeds. In this respect, the use of tracking stock has the potential to become unwieldy.

3. **Separate Audited Financial Statements**
Separate audited financial statements are required when a company has issued tracking stock. The issuer must prepare three sets of audited financial statements: one for the entire company; one for the tracked business; and one for the remaining business. A benefit of the issuance of tracking stock is that it allows an issuer to separate the financial performance of the tracked assets from the rest of the issuer's business.

4. **Shareholder Approval**
Shareholder approval is required to issue common stock as tracking stock. This may be avoided with the use of preferred stock.

5. **Separation May Be Desirable**

a. Tracking stock may prevent needed streamlining of a company (*See, e.g.,* Kmart's proposal to retain specialty stores and issue tracking stock, which was rejected by the shareholders.) *See* Stephanie Strom, *It's Called Targeted Stock; Shun It, Some Experts Say*, New York Times, July 12, 1994.

b. Tracking stock may be used instead of other alternatives that may be more favorable to shareholders solely to allow management to retain control of both businesses. *See* Comments & Analysis, *On the Wrong Track: Complex Financial Innovations Like Tracking Stocks Allow Managers to Retain Control, But Bring Few Benefits For Shareholders*, Financial Times, May 18, 1999.

c. Liabilities/potential liabilities remain with the parent. In the case of RJR, for example, the desire to insulate the food business from the tobacco business liabilities may have been a factor in the decision not to issue tracking stock.

VI. TAX DISCLOSURE CONSIDERATIONS

A. Sale of Tracking Stock to the Public

Typically has not been much tax disclosure. Recent issuances generally have included the following conclusions and discussions:

1. The tracking stock will be considered common stock of the issuer;

2. The IRS currently has a no-ruling policy on tracking stock classification; and

3. The mention of past legislative proposals regarding tracking stock including the consequences if any similar future proposals were to be enacted.

B. Distribution to Existing Shareholders

Often includes the following conclusions and discussions:

1. Both the redesignated stock and the tracking stock are common stock of the issuer;

2. Redesignation of the underlying stock and stock dividend of tracking stock will not be a taxable event to the issuer or a taxable dividend to the shareholders;

3. Distributed tracking stock will not be characterized as "section 306 stock";

4. Section 337(d) empowers the IRS to address retroactively tracking stock arrangements;

5. The IRS currently has a no-ruling policy on tracking stock classification;

6. The consequences if the tracking stock is characterized as property other than stock of the issuer are mentioned; and

7. A description of past legislative proposals regarding tracking stock and the consequences if any similar future proposals were to be enacted.

C. Acquisitions

1. Includes disclosure similar to that listed above for distributions.

2. No gain or loss is recognized by the target shareholders from the receipt of tracking stock, if the transaction otherwise complies with the reorganization provisions.

VII. POSSIBLE USES OF TRACKING STOCK

A. Acquisition Currency

1. **GM**: Issued tracking stock in its acquisition of both EDS (1984) and Hughes Aircraft Company (1985). The use of tracking stock allowed the differentiation of EDS, which was a high growth company, from GM. In 1996, GM spun-off EDS. *See* PLR 9802048, and discussion, *supra*, Part II.A.3.h).

2. **TCI/Viacom**: In 1996, Viacom issued cable subsidiary common stock to its shareholders in a spinoff of this subsidiary. Immediately following the acquisition by TCI of the cable subsidiary, these common shares were converted automatically into preferred stock that is exchangeable for TCI tracking stock five years after issuance.

3. **Atlantic Energy/Delmarva Power & Light**: Newly created holding company issued tracking stock to Atlantic Energy's shareholders in 1998 in connection with Atlantic Energy's tax-free merger with Delmarva Power & Light. The stock

represents a 30% interest in the earnings of Atlantic Energy's regulated utility business in excess of $40 million per year.

4. **Sprint**: In 1998, the existing common stock was redesignated as FON Stock and each share of FON Stock received one-half share of PCS Stock. The plan separated the Company's personal communications business from its other operations.

5. **AT&T**: In 1999, in connection with its acquisition of TCI, AT&T replaced its stock with three different tracking stocks that track its consumer business, its wholesale networking assets, and the Liberty Media Group.

B. Nominal Separation of Diverse Businesses While Maintaining Control

1. **USX**: Existing common stock was redesignated as Marathon Stock in 1991, and in a recapitalization, each share of the former common stock received 1/5th of a share of Steel Stock. The separation of USX into Marathon and Steel Stocks was done to reflect the separate performances of the oil and steel businesses.

2. **Tele-Communications ("TCI")**: Existing common stock was redesignated in 1996 as TCI Group Common Stock, and in a recapitalization, each share of TCI Group Common received 1/4th of a share of Liberty Media Group Stock. The plan separated the media businesses from other communications businesses.

3. **Circuit City**: In 1997, the existing common stock was redesignated as Circuit City Stock and each share of Circuit City Stock received one share of CarMax Stock. The plan separated the new and used car businesses from the appliance and electronics businesses.

4. **Georgia-Pacific**: In 1997, the existing common stock was redesignated as Georgia-Pacific Group Stock and each share of Georgia-Pacific Group Stock received one share of Timber Stock. The plan separated the manufacturing and timber businesses. In 2000, Georgia-Pacific proposed a spinoff of the Timber group.

5. **Applera Corporation** (formerly Perkin-Elmer Corporation): In 1998, the existing common stock was redesignated as PE

Biosystems Stock and each share of PE Biosystems Stock received one-half share of Celera Genomics Stock. The plan separated the company's genomics division from its life sciences division.

6. **Cablevision**: In 2001, Cablevision issued tracking stock for Rainbow Media Group (RMG), whose principal assets include the American Movie Classics, Bravo, Independent Film Channel, MuchMusic and WE: Women's Entertainment. Months earlier, Cablevision abandoned efforts to sell the unit outright. Cablevision shareholders received one share of RMG for every two Cablevision shares. The tracking stock move was aimed at boosting the value of Cablevision's growing content empire.

7. **WorldCom**: In 2001, WorldCom shareholders agreed to exchange each share of its common stock for one share of WorldCom group stock and also 1/25th of a share of MCI group stock. The tracking stock will reflect the company's consumer, long-distance voice, telecom-wholesale, dial-up Internet access and two-way paging services. WorldCom stock will continue to represent the company's commercial voice, data, Internet and international services.

C. Raising Capital in Connection with New Business

1. **Donaldson, Lufkin & Jenrette:** Public offering of DLJ Direct Stock to track the Company's online brokerage business.

2. **Ziff-Davis Corporation**: Public offering of ZD Net stock representing the Company's online division.

3. **AT&T:** Public offering of AT&T Wireless Group Tracking Stock to expand wireless business and to pursue acquisitions as they arise.

4. **Sony**: In Japan's first issue of tracking stock, public offering of Sony Communications Network Corp. representing the Company's Internet business. In connection with the Sony issuance, Japan's Financial Services Agency announced it will revise rules on insider trading to pave the way for Japanese companies to issue tracking stock. Under the revised rules, companies will be forced to publish important data about their subsidiaries, such as changes in their sales prospects and information on their dividend payments.

D. Companies with Both Regulated and Unregulated Businesses
The valuation of these companies could be enhanced if the market could distinguish between their regulated and unregulated businesses.

E. Defensive Measures
NL Industries: In response to a tender offer from the Simmons Group, NL anticipated undertaking a spinoff of NL Chemicals, its wholly-owned subsidiary. In contemplation of the spinoff, NL issued Series C preferred stock, which tracked Chemicals' assets, to NL shareholders. The spinoff was never completed and the shares remain outstanding.

VIII. EXIT ALTERNATIVES

There are various alternatives available to a company that wants to unwind its tracking stock structure in connection with the sale of one of the tracked businesses.

A. Sale of Tracked Assets and Payment of Net Proceeds: Will generally result in double taxation- the company will pay corporate tax on the sale of the tracked assets and the shareholders will again pay tax upon receipt of the net sales proceeds, whether such proceeds are paid as a dividend or in redemption of their stock.

B. Conversion of Tracking Stock: Tracking stock can be converted into another class of stock of the company, either in contemplation of or after the sale of the tracked business. *See*, *supra*, Part I.B.4.

C. Formation of Joint Venture: The company can, in a tax-free transaction, contribute the tracked assets to a newly established entity (typically a partnership or "joint venture") in exchange for equity securities of the joint venture. The tracking stock will then represent only an indirect interest in the tracked assets.

D. Split-off: The company can redeem its tracking stock in exchange for stock of a subsidiary that holds the tracked assets. The interested purchaser of those tracked assets can then effect a merger with that subsidiary immediately following the split-off. The split-off will qualify for tax-free treatment to the company and its shareholders provided the requirements of section 355, including section 355(e), are satisfied. *See*, *supra*, Part II.B.

IX. RELATED CONCEPTS TO TRACKING STOCK

Other structures also attempt to deal with grouping of assets in a corporate solution.

A. Reverse Tracking Stock

SmithKline Beecham: Shareholders of the U.S. company entitled to additional dividend based upon the performance of its U.K. parent.

B. Twin Holding Companies

Royal Dutch Shell: U.K. and Dutch holding companies pay dividends which correspond to separate operating groups.

C. Stapled Stock Arrangements

Thompson Group: U.K. shareholders exchanged their common shares for common and preferred shares in a new Canadian holding company and its U.K. subsidiary. The stock was stapled allowing shareholders to elect to receive their dividends, which were equalized, from either company. Generally, stapled stock gives domestic shareholders a right to receive dividends directly from the domestic subsidiary that are based on the performance of the subsidiary, yet subject to the dividend policy of the foreign issuer. *See* section 269B.

D. Equity Swaps

Stream of payments paid to swap party designed to replicate the ownership of stock without actual ownership.

E. Exchangeable Security

Debt or preferred stock exchangeable into an asset of the issuer or a subsidiary of the issuer. Exchange treated as a taxable event.

F. Partnership

Assets placed in partnership rather than corporate solution and partnership interests linked to performance of assets. Potentially avoids section 311 gain on future transfer of assets to partners.

G. Down-REIT

A structure known as a “down-REIT” consists of third parties investing in a partnership with a REIT. The investors’ return is determined by reference to the results of the REIT which has substantial assets in addition to the partnership interest.

H. Contingent Payment Securities

Payments on the securities are, in part, a function of the earnings or the value of a subsidiary or groups of assets.

Examples:

1. **Disney "Movie" Notes**. Pay fixed interest of 2% plus contingent interest based on film revenues generated by a portfolio of films (1995).

2. **Debt Exchangeable for Common Stock ("DECS")**. Payment at maturity is linked to the value of stock of a subsidiary or portfolio investment (*e.g.*, Tribune Company (The Learning Company) DECS 1998; Kerr-McGee Corporation (Devon Energy Corporation) DECS 1999; Metromedia Fiber Network, Inc. DECS 1999).

APPENDIX A: Examples of Transactions

1. Alaska Interstate VICO Special Stock (1977)

2. GM Class E Stock (issued 1984; spun-off 1996)

3. GM Class H Stock (1985)

4. NL Industries Series C Preferred Stock (1986)

5. Chemical Class B Stock (1987)

6. USX Steel Stock (issued 1991; current proposal to spin off tracked business 2001)

7. USX Delhi Stock (1992)

8. RJR Nabisco Stock (proposed 1992; abandoned 1993)

9. Pittston Minerals Stock (issued 1993; tracking stock structure eliminated 1999)

10. Ralston Purina Continental Baking Group Stock (issued 1993; redemption of tracking stock 1996)

11. Fletcher Challenge Forest Division Shares (issued 1993; unwound in connection with sale 2000)

12. Kmart Specialty Retail Stock (proposal rejected by shareholders 1994)

13. Seagull Enstar Alaska Stock (proposal approved by shareholders 1994; proposal abandoned)

14. Genzyme – Genzyme Tissue Repair (GTR) Stock (issued 1994; assets of one tracked business replaced 2000)

15. American Health Properties (REIT) Psychiatric Group Preferred Stock (1995)

16. CMS Energy Class G Common Stock (issued 1995; redeemed 2000)

17. TCI and Liberty Media (issued 1995; split-off planned 2001)

18. U.S. West – Communications Group Common Stock and Media Group Common Stock (1995)

19. Pittston Burlington Group Stock and Pittston Brinks Group Stock (1996)

20. TCI Acquisition of Spun-Off Viacom Cable Subsidiary (1996)

21. Inco Limited – Class VBN Shares (1996)

22. Circuit City – Circuit City Stock and CarMax Stock (first issued 1997; further issuance 2001)

23. Genzyme Corp./PharmaGenics, Inc. Merger – Genzyme Molecular Oncology Division Common Stock (1997)

24. USX Corporation – USX Capital Trust I - Trust Convertible Quarterly Income Preferred Securities (convertible into USX-U.S. Steel Group Common Stock) (1997)

25. Georgia-Pacific – Georgia-Pacific Group Stock and Timber Stock (issued 1997; proposed elimination of Timber group stock in connection with Plum Creek Timber Co. merger 2000)

26. TCI – TCI Ventures Stock (1997)

27. Atlantic Energy, Inc./Delmarva Power & Light Co. Merger – Class A Common Stock (1998)

28. Telephone & Data Systems (proposed 1998; proposal abandoned)

29. Sprint – Sprint PCS (1998)

30. Agouron Pharmaceuticals Inc. – Oncology Division Stock & Pharmaceutical Stock (proposal approved by shareholders 1998; proposal abandoned)

31. Disney Enterprises Inc. – Go.com stock (issued 1999; Go.com closed and tracking stock structure eliminated 2001)

32. Donaldson, Lufkin & Jenrette – DLJDirect Stock (issued 1999; converted to CSFBDirect tracking stock in connection with

acquisition of DLJ; plans to abandon CSFBDirect tracking stock structure 2001)

33. Genzyme Corp. – Genzyme Surgical Products Division (GZSP) Stock (1999)

34. Applera Corporation (formerly Perkin-Elmer Corporation) – PE Biosystems Stock and Celera Genomics Stock (1999)

35. The Quantum Corporation – DLTtape and Storage Systems (DSSG stock) and hard disk drive business (HDDG stock) (issued 1999; Maxtor Corp. purchased Quantum's disk drive operations and tracking stock eliminated 2001)

36. Snyder Communications – Snyder Communications Stock and circle.com stock (issued 1999; after acquisition of Snyder by France's Havas, tracking stock redeemed 2001)

37. Ziff-Davis Corporation – ZD Stock and ZDNet Stock (issued 1999; merger with CNET and elimination of tracking stock structure 2000)

38. Cendant Corporation—Move.com stock and CD stock (issued 2000; Move.com acquired by Homestore.com and tracking stock eliminated 2001)

39. J. C. Penney Company, Inc. – Eckerd drugstores (proposed 1999; postponed 2001)

40. Staples, Inc. – e-commerce business (Staples.com stock) and retail and delivery business (Staples RD stock) (proposed 1999; proposal abandoned 2001)

41. AT&T – AT&T Wireless Group Tracking Stock (issued 2000; split-off 2001)

42. Apollo Group Inc. – University of Phoenix Online common stock (proposed 2000)

43. BellSouth Corporation – Latin American group stock (proposed 2000)

44. Comdisco, Inc. – Comdisco Ventures (proposed 2000; proposal abandoned 2001)

45. Electronic Arts Inc. – EA.com (issued 2000; EA.com integrated back into Electronic Arts 2001)

46. Global Crossing – Telephone services and Internet services (proposed 2000; proposal abandoned 2001)

47. New York Times co. – New York Times Digital (proposed 2000; proposal abandoned 2001)

48. AT&T –Broadband business and Consumer Services business (proposed 2001)

49. WorldCom, Inc. – MCI group stock (2001)

50. Cablevision – Rainbow Media Group (2001)

51. Sony – Sony Communications Network (2001)

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