

and 305(c) to have received a distribution of preferred stock to which section 301 applies. See the examples in §§ 1.305-3(e) and 1.305-5(d) for further illustrations of the application of section 305(c).

(b) *Antidilution provisions.* (1) For purposes of applying section 305(c) in conjunction with section 305(b), a change in the conversion ratio or conversion price of convertible preferred stock (or securities), or in the exercise price of rights or warrants, made pursuant to a bona fide, reasonable, adjustment formula (including, but not limited to, either the so-called “market price” or “conversion price” type of formulas) which has the effect of preventing dilution of the interest of the holders of such stock (or securities) will not be considered to result in a deemed distribution of stock. An adjustment in the conversion ratio or price to compensate for cash or property distributions to other shareholders that are taxable under section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) will not be considered as made pursuant to a bona fide adjustment formula.

(2) The principles of this paragraph may be illustrated by the following example:

Example. (i) Corporation U has two classes of stock outstanding, class A and class B. Each class B share is convertible into class A stock. In accordance with a bonafide, reasonable, antidilution provision, the conversion price is adjusted if the corporation transfers class A stock to anyone for a consideration that is below the conversion price.

(ii) The corporation sells class A stock to the public at the current market price but below the conversion price. Pursuant to the antidilution provision, the conversion price is adjusted downward. Such a change in conversion price will not be deemed to be a distribution under section 305(c) for the purposes of section 305(b).

(c) *Recapitalizations.* (1) A recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which section 305(c) and this section apply if—

(i) It is pursuant to a plan to periodically increase a shareholder’s proportionate interest in the assets or earnings and profits of the corporation, or

(ii) A shareholder owning preferred stock with dividends in arrears exchanges his stock for other stock and,

as a result, increases his proportionate interest in the assets or earnings and profits of the corporation. An increase in a preferred shareholder’s proportionate interest occurs in any case where the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization), exceeds the issue price of the preferred stock surrendered.

(2) In a case to which subparagraph (1)(ii) of this paragraph applies, the amount of the distribution deemed under section 305(c) to result from the recapitalization is the lesser of (i) the amount by which the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or (ii) the amount of the dividends in arrears.

(3) For purposes of applying subparagraphs (1) and (2) of this paragraph with respect to stock issued before July 12, 1973, the term *issue price of the preferred stock surrendered* shall mean the greater of the issue price or the liquidation preference (not including dividends in arrears) of the stock surrendered.

(4) For an illustration of the application of this paragraph, see *Example (12)* of § 1.305-3(e) and *Examples (1), (2), (3), and (6)* of § 1.305-5(d).

(5) For rules relating to redemption premiums on preferred stock, see § 1.305-5(b).

[T.D. 7281, 38 FR 18538, July 12, 1973, as amended by T.D. 8643, 60 FR 66138, Dec. 21, 1995]

§ 1.305-8 Effective dates.

(a) *In general.* Section 421(b) of the Tax Reform Act of 1969 (83 Stat. 615) provides as follows:

(b) *Effective dates.* (1) Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply with respect to distributions (or deemed distributions) made after January 10, 1969, in taxable years ending after such date.

(2)(A) Section 305(b)(2) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall not apply to a distribution (or deemed distribution) of stock made before January 1, 1991, with respect to stock (i) outstanding on

January 10, 1969, (ii) issued pursuant to a contract binding on January 10, 1969, on the distributing corporation, (iii) which is additional stock of that class of stock which (as of January 10, 1969) had the largest fair market value of all classes of stock of the corporation (taking into account only stock outstanding on January 10, 1969, or issued pursuant to a contract binding on January 10, 1969), (iv) described in subparagraph (c)(iii), or (v) issued in a prior distribution described in clause (i), (ii), (iii), or (iv).

(B) Subparagraph (A) shall apply only if—

(i) The stock as to which there is a receipt of property was outstanding on January 10, 1969 (or was issued pursuant to a contract binding on January 10, 1969, on the distributing corporation), and

(ii) If such stock and any stock described in subparagraph (A)(i) were also outstanding on January 10, 1968, a distribution of property was made on or before January 10, 1969, with respect to such stock, and a distribution of stock was made on or before January 10, 1969, with respect to such stock described in subparagraph (A)(i).

(C) Subparagraph (A) shall cease to apply when at any time after October 9, 1969, the distributing corporation issues any of its stock (other than in a distribution of stock with respect to stock of the same class) which is not—

(i) Nonconvertible preferred stock,

(ii) Additional stock of that class of stock which meets the requirements of subparagraph (A)(iii), or

(iii) Preferred stock which is convertible into stock which meets the requirements of subparagraph (A)(iii) at a fixed conversion ratio which takes account of all stock dividends and stock splits with respect to the stock into which such convertible stock is convertible.

(D) For purposes of this paragraph, the term *stock* includes rights to acquire such stock.

(3) In cases to which Treasury Decision 6990 (promulgated January 10, 1969) would not have applied, in applying paragraphs (1) and (2) April 22, 1969, shall be substituted for January 10, 1969.

(4) Section 305(b)(4) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall not apply to any distribution (or deemed distribution) with respect to preferred stock (including any increase in the conversion ratio of convertible stock) made before January 1, 1991, pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.

(5) With respect to distributions made or considered as made after January 10, 1969, in taxable years ending after such date, to the extent that the amendment made by subsection (a) does not apply by reason of paragraph (2), (3), or (4) of this subsection, section 305 of the Internal Revenue Code of 1954

(as in effect before the amendment made by subsection (a)) shall continue to apply.

(b) *Rules of application.* (1) The rules contained in section 421(b)(2) of the Tax Reform Act of 1969 (83 Stat. 615), hereinafter called “the Act”, shall apply with respect to the application of section 305(b)(2), section 305(b)(3), and section 305(b)(5). Thus, for example, section 305(b)(5) of the Code will not apply to a distribution of convertible preferred stock made before January 1, 1991, with respect to stock outstanding on January 10, 1969 (or which was issued pursuant to a contract binding on the distributing corporation on January 10, 1969), provided the distribution is pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.

(2)(i) For purposes of section 421(b)(2)(A), (B)(i), and (C) of the Act, stock is considered as outstanding on January 10, 1969, if it could be acquired on such date or some future date by the exercise of a right or conversion privilege in existence on such date (including a right or conversion privilege with respect to stock issued pursuant to a contract binding, on January 10, 1969, on the distributing corporation). Thus, if on January 10, 1969, corporation X has outstanding 1,000 shares of class A common stock and 3,000 shares of class B common stock which are convertible on a one-to-one basis into class A stock, corporation X is considered for purposes of section 421(b)(2)(A), (B)(i), and (C) of the Act to have outstanding on January 10, 1969, 4,000 shares of class A stock (1,000 shares actually outstanding and 3,000 shares that could be acquired by the exercise of the conversion privilege contained in the class B stock) and 3,000 shares of class B stock.

(ii) For the purposes of section 421(b)(2)(A) (other than for the purpose of determining under section 421(b)(2)(A)(iii) that class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation), (B)(i), and (C) of the Act, stock will be considered as outstanding on January 10, 1969, if it is issued pursuant to a conversion privilege contained in stock issued, mediately or immediately, as a stock

dividend with respect to stock outstanding on January 10, 1969.

(3) If, after applying subparagraph (2) of this paragraph, the class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation is a class of stock which is convertible into another class of nonconvertible stock, then for purposes of section 421(b)(2)(C)(ii) of the Act stock issued upon conversion of any such convertible stock (whether or not outstanding on January 10, 1969) into stock of such other class shall be deemed to be stock which meets the requirements of section 421(b)(2)(A)(iii) of the Act.

(4) For purposes of section 421(b) of the Act, stock of a corporation held in its treasury will not be considered as outstanding and a distribution of such stock will be considered to be an issuance of such stock on the date of distribution. Stock of a parent corporation held by its subsidiary is not considered treasury stock.

(5) The following stock shall not be taken into account for purposes of applying section 421(b)(2)(B)(i) of the Act: (i) Stock issued after January 10, 1969, and before October 10, 1969 (other than stock which was issued pursuant to a contract binding on January 10, 1969, on the distributing corporation); (ii) stock described in section 421(b)(2)(C)(i), (ii), or (iii) of the Act; and (iii) stock issued, mediately or immediately, as a stock dividend with respect to stock of the same class outstanding on January 10, 1969. For example, if on June 1, 1970, corporation Y issues additional stock of that class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation, such additional stock will not be taken into account for the purpose of meeting the requirement under section 421(b)(2)(B)(i) of the Act that the stock as to which there is a receipt of property must have been outstanding on January 10, 1969, and thus subparagraph (A) of section 421(b)(2) of the Act will not, where otherwise applicable, cease to apply.

(6) Section 421(b)(2)(A) of the Act, if otherwise applicable, will not cease to apply if the distributing corporation issues after October 9, 1969, securities

which are convertible into stock that meets the requirements of section 421(b)(2)(A)(iii) of the Act at a fixed conversion ratio which takes account of all stock dividends and stock splits with respect to the stock into which the securities are convertible.

(7) Under section 421(b)(4) of the Act, section 305(b)(4) does not apply to any distribution (or deemed distribution) by a corporation with respect to preferred stock made before January 1, 1991, if such distribution is pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969. For example, if as of January 10, 1969, a corporation had followed the practice of paying stock dividends on preferred stock (or of periodically increasing the conversion ratio of convertible preferred stock) or if the preferred stock provided for a redemption price in excess of the issue price, then section 305(b)(4) would not apply to any distribution of stock made (or which would be considered made if section 305(b)(4) applied) before January 1, 1991, pursuant to such practice.

(8) If section 421(b)(2) is not applicable and, for that reason, a distribution (or deemed distribution) is treated as a distribution to which section 301 applies by virtue of the application of section 305(b)(2), (b)(3), or (b)(5), it is irrelevant that, by reason of the application of section 421(b)(4) of such Act, section 305(b)(4) is not applicable to the distribution.

[T.D. 7281, 38 FR 18539, July 12, 1973]

§ 1.306-1 General.

(a) Section 306 provides, in general, that the proceeds from the sale or redemption of certain stock (referred to as "section 306 stock") shall be treated either as ordinary income or as a distribution of property to which section 301 applies. Section 306 stock is defined in section 306(c) and is usually preferred stock received either as a non-taxable dividend or in a transaction in which no gain or loss is recognized. Section 306(b) lists certain circumstances in which the special rules of section 306(a) shall not apply.

(b)(1) If a shareholder sells or otherwise disposes of section 306 stock (other than by redemption or within the exceptions listed in section 306(b)),