

**MEMO# 1821**

April 16, 1990

## **IRS REVENUE RULING TREATING "DUTCH-AUCTION RATE" PREFERRED STOCK AS EQUITY**

- 1 - April 16, 1990 TO: CLOSED-END FUND MEMBERS NO. 15-90 TAX MEMBERS NO. 16-90  
ACCOUNTING/TREASURERS MEMBERS NO. 12-90 RE: IRS REVENUE RULING TREATING  
"DUTCH-AUCTION RATE" PREFERRED STOCK AS EQUITY

The attached IRS revenue ruling holds that certain dutch- auction rate preferred stock is treated as equity for tax purposes and that a corporation holding this preferred stock can treat dividends received with respect to such stock as qualifying for the Code section 243 dividends received deduction. The purchase of the dutch-auction rate preferred stock involved in the ruling is conditioned upon the purchaser agreeing to sell the shares only through a "dutch auction" proceeding. The dividend rate on the shares is reset by "dutch auction" every 49 days. Prior to each auction, holders of preferred stock elect to either (i) continue to hold shares at whatever rate is set for the next dividend, (ii) place a bid order to hold shares, provided the applicable rate for the next dividend period is not below the rate specified in the bid, or (iii) place an order to sell shares regardless of the applicable rate. No guarantees (either express or implied) are made that any holder of the preferred shares will be able to sell its shares in the auction. The revenue ruling states that the question of whether dutch-auction rate preferred stock is debt or equity depends on the facts and circumstances of each case. In this case, the dutch-auction rate preferred stock is treated as equity because (i) shareholders have no right to receive a sum certain either on demand or on a specified date, (ii) at liquidation or in bankruptcy, the shareholders' rights are subordinate to the claims of the corporation's creditors, (iii) the corporation may redeem the stock, but the shareholder cannot compel redemption, (iv) the corporation has not guaranteed or otherwise arranged to - 2 - ensure that the shareholders can sell their preferred stock in an auction, and (v) the shareholders' receipt of dividends is dependent upon dividends being declared by the corporation and paid out of legally available funds. The ruling further concludes that, because the preferred shareholders do not have either an option to sell shares, or rights equivalent to an option to sell shares, a corporation receiving a dividend distribution with respect to the preferred stock will not be precluded by the dutch-auction mechanism from claiming a dividends received deduction under Code section 243. Finally, the ruling provides relief with respect to any dutch-auction rate preferred stock issued before March 15, 1990, whereby the IRS will not seek to (i) recharacterize the stock as debt, or (ii) apply the holding period limitations to treat shareholders as ineligible for the dividends received deduction. However, the holding period limitations will apply if an agreement or other arrangement exists that effectively guarantees that a shareholder can sell its preferred stock. We will keep you informed of developments. Keith D. Lawson

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