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PREFERRED STOCK

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In taking a company from an idea to an Initial Public Offering (IPO), an entrepreneur generally needs to raise interim capital in stages. Initial capitalization often consists of the entrepreneur's savings or funds from his or her friends and family. After the company is formed, it usually needs several additional rounds of financing to grow the business. This additional financing is almost always provided by a venture capital firm, "angel," or other similar wealthy investor. These investors generally insist on receiving preferential treatment from the company in exchange for their disproportionately large contribution to the company's capital.

Preferred stock is the most common vehicle used to provide these investors with this preferential treatment. As a general rule, the special privileges associated with preferred stock are almost always augmented and expanded by a shareholders' agreement that addresses issues such as stock transfer restrictions, board composition, operational restrictions on management and registration rights. This article provides a broad discussion of preferred stock by examining the variety of preferences it offers to investors.

BLANK CHECK PREFERRED STOCK

Preferred stock may be issued in the following two ways:

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1. Shareholders can approve a particular issuance of preferred stock proposed by the board of directors; or
2. The board of directors of the company can issue preferred stock without shareholder approval if the company's articles of incorporation contain a "blank check preferred stock" provision. Such a provision allows the board of directors to unilaterally issue one or more series of preferred stock that have particular rights and preferences designated by the board at the time of issuance. Often the initial shareholders of a company will include a blank check provision in the articles of incorporation to avoid the logistical and administrative difficulties associated with obtaining shareholder consent for each of a company's many stages of capitalization.

Preferred stock, regardless of how it is created, usually embodies some combination of the following preferences.

VOTING RIGHTS

The stock may be "voting" or "nonvoting." Voting preferred stock is entitled to vote on certain company actions. This stock may be created so that it votes either along with all other classes of the company's voting stock or as a separate class (in which case the holders of such stock would have a "veto" right on certain decisions of the holders of other classes). "Nonvoting" preferred stock has no voting rights beyond a statutory right to vote on certain company actions which, if approved, could adversely affect the interests of the nonvoting preferred stock holders.

DIVIDEND RIGHTS

Holders of preferred stock may or may not be entitled to receive dividends. If they are, those dividends may take several forms. Some types of preferred stock pay dividends at a stated rate each year, *e.g.*, a 10 percent rate on a $100 stated value means a $10 annual dividend; others pay dividends only upon board approval; others pay dividends as and when dividends are paid on common stock; and others combine one or more of these options. Additionally, dividends on preferred stock can be either cumulative, in which case unpaid dividends in any year accrue and must be paid in subsequent years before any dividends can be paid on junior classes of stock; or non-cumulative, in which case the company has no liability with respect to unpaid dividends. The terms of a preferred stock may provide for dividends to be payable in cash, or in additional shares of preferred stock ("pay in kind") or in some combination thereof.

LIQUIDATION PREFERENCES

Most preferred stock contains a liquidation preference of some kind. A liquidation preference means that, upon the dissolution of the company, the holders of preferred stock will receive a stated amount of money prior to any distribution to any junior classes of stock (including common stock). Typically, the liquidation preference will equal either the purchase price paid for the stock or the purchase price plus a return.

REDEMPTION RIGHTS

In a redemption, the company repurchases the preferred stock from the shareholder in exchange for a cash payment. Such a redemption right can be structured to occur at the option of either the company or the shareholder (or both of them), or it can be structured to occur on a specific date. The redemption right will generally specify either the redemption price or a formula to calculate the price. In addition, redemption rights can require that each share of a class or series of stock receives equal treatment or that a minimum number of shares of preferred stock be redeemed before the company is obligated to repurchase those shares.

CONVERSION PROVISIONS

Conversion provisions require or allow the holders of preferred stock to convert their shares into common stock in accordance with a predetermined formula. Upon a conversion, the preferred stock is no longer outstanding, and the holders become common shareholders. Holders of convertible preferred stock can typically convert their preferred stock to common stock at any time by giving notice to the company. Conversions are typically mandatory either upon the consummation of an initial public

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offering which raises funds in excess of a minimum threshold amount (and also often requires a minimum share price) or upon the conversion of a substantial portion of the class or series.

Most convertible stock also has antidilution protection, which protects the investors from the dilution of their "value" in the shares. This protection provides that an initial conversion ratio will increase at any time the company subsequently issues any shares of its common stock at a per share price lower than that paid by the preferred shareholders. The amount of this increase is usually heavily negotiated and may range from some weighted average adjustment to a complete recalculation based on the new price. For example, if an investor paid $100 for one share of convertible preferred stock with antidilution protection and an initial one-to-one conversion ratio and the company subsequently issued shares of its common stock for $50 per share, then the conversion ratio on the convertible preferred stock held by the investor would automatically be increased to provide that the investor could convert each of its shares of preferred stock into up to two shares of common stock.

PREEMPTIVE RIGHTS

Preferred stock may also carry preemptive rights, which allow the preferred shareholders to maintain their overall percentage ownership in the company in the event that additional shares are issued. Preemptive rights are essentially "rights of first refusal" for existing shareholders to purchase their proportionate share of any stock subsequently issued by the company.

CONCLUSION

Entrepreneurs seeking to achieve the grand scale of success frequently associated with an IPO will need to attract significant capital to their companies. Generally, the requisite capital for such an undertaking will need to come from wealthy investors such as venture capitalists. Preferred stock, with the various rights and privileges it can provide investors, is one tool that entrepreneurs can use to attract the investment interest of these wealthy investors. ◆

DOING BUSINESS IN THE ATLANTA EMPOWERMENT ZONE

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The Atlanta Empowerment Zone presents companies with an opportunity to aid in the revitalization of a blighted urban area while adding to their bottom lines. In December 1994, the U.S. Department of Housing and Urban Development (HUD) approved the City of Atlanta's application for designation as an urban empowerment zone, making Atlanta one of the first cities in the country to be selected to participate in this innovative urban reinvestment program. Since 1994, the program has been expanded to include more than 20 cities, including Baltimore, Maryland; Detroit, Michigan; New York, New York; Columbia, South Carolina; Sumter, South Carolina; Norfolk/Portsmouth, Virginia and Miami, Florida.

The program provided Atlanta with a grant of $100 million and targeted tax credits of $150 million to rebuild an area known as the "Atlanta Empowerment Zone" (AEZ). The AEZ surrounds Atlanta's central business district to the east, west and south and consists of approximately nine square miles with a population of approximately 50,000. The AEZ, while suffering from a variety of socioeconomic problems, is conveniently located near rail and highway transportation, the downtown business district, Hartsfield Airport and the campuses of Georgia State University and Georgia Tech. The AEZ is also home to the Atlanta University Center; Spelman, Morehouse and Morris Brown Colleges; Clark Atlanta University and the Interdenominational Theological Center. In addition, many areas of the AEZ are benefiting from the rediscovery of downtown Atlanta as a place to live as well as to work.

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The AEZ initiative is managed by the Atlanta Empowerment Zone Corporation (AEZC). AEZC is a non-profit corporation created by the City of Atlanta to oversee the implementation of the AEZ Strategic Plan. All decisions regarding the approval and implementation of programs or projects, distribution of grant funds, amendment of the Strategic Plan, and operation of the AEZC are made by its governing Executive Board. The AEZC Executive Board is chaired by the Mayor of the City of Atlanta, who is joined by various community representatives, government officials and business leaders.

The AEZC maintains a revolving loan fund to support the development or expansion of businesses in the AEZ. All loans funded by AEZC are expected to result in tangible and quantifiable benefits to the AEZ and its residents. These benefits may include:

- job training;
- employment opportunities;
- improvement or rehabilitation of vacant or abandoned lots or buildings;
- development of community accessible facilities (*e.g.*, child care, recreation, training, etc.);
- improvement of infrastructure;
- development partnerships which provide for community participation in the ownership or management of facilities or businesses;
- funding of various civic or other community groups;
- provision of automated resources to AEZ residents; and
- improvement in the educational resources of AEZ schools.

In addition to low interest financing, a number of federal, state and local tax incentives are available to businesses located in the AEZ. In general, the tax incentives are directed at businesses that are located within the AEZ for the purpose of establishing a new enterprise or expanding an existing one. These incentives are designed to encourage businesses to: (i) create new facilities; and (ii) employ AEZ residents. Certain incentives are available to those who own or rent property, while others are available only to property owners.

The following table provides a brief overview of the incentives available for lessees and owners of qualifying property located in the AEZ.

INCENTIVES FOR *RENTERS*	INCENTIVES FOR *OWNERS*
Federal AEZ Employment Credit	Federal AEZ Employment Credit
State Job Tax Credit	State Job Tax Credit
State Child Care Tax Credit	State Child Care Tax Credit
State Retraining Tax Credit	State Retraining Tax Credit
State Investment Tax Credit (leases five years or longer)	State Investment Tax Credit (leases five years or longer)
State Sales Tax Exemption	State Sales Tax Exemption
**	Increased Federal Section 179 Deduction
**	Federal Tax Exempt Enterprise Zone Facility Bonds
**	Local Tax Benefits (if application approved)

Companies that have light manufacturing operations, call centers, data processing centers, warehouses or like facilities and that are willing to work with the AEZC to design job training and child care solutions are best positioned to take advantage of the opportunities and benefits that doing business in the AEZ offers. ◆

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CASHING IN AND OUT OF LLCs — RECENT IRS GUIDANCE

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The single-member limited liability company (LLC) provides the business person a vehicle by which to maintain sole ownership of an entity with limited liability but without the burden of corporate formalities. Due to changes in the tax law, however, the federal income tax consequences of the decision to buy into or cash out of an LLC are not clear. While recent guidance from the U.S. Internal Revenue Service (IRS) has clarified the issue, traps for the unwary and tax planning opportunities for the well-advised remain.

In February of this year, the IRS issued two public rulings that address the tax consequences of certain "non elective" entity reclassifications that result from a member (or members) selling interests in or cashing out of an LLC. This article analyzes the rulings and describes their effect on tax planning for conversions of single-member LLCs to multi-member LLCs and vice versa.

- **Rev. Rul. 99-5** provides guidance on the tax consequences of converting a single-member LLC into a multi-member LLC (treated as a partnership for federal income tax purposes).
- **Rev. Rul. 99-6** provides guidance on the tax consequences of converting a multi-member LLC into a single-member LLC.

REGULATORY BACKGROUND

The federal income tax classification of an entity determines whether its earnings will be taxed at the entity and the owner level, as is the case with a corporation (other than an "S" corporation), or will pass through and be taxed only at the owner level, as is the case with partnerships and LLCs.

The LLC is a hybrid creation of state law that combines the traditional attributes of a corporation and a partnership. The LLC in general, and the single-member LLC in particular,[1] posed unique problems for the IRS.

In December 1996, the Treasury Department introduced a new elective regime of entity classification with the promulgation of the Check-the-Box Regulations. Under this elective regime, the owners of an unincorporated entity may simply choose for the entity to be taxed as a corporation or as a partnership.[2] A business entity with one owner or a corporation with a single shareholder may elect to be treated as an entity that is disregarded (for federal tax purposes) as separate from its owner (the "Disregarded Entity").[3]

In October 1997, the IRS proposed amendments to the Check-the-Box Regulations that address the tax consequences of certain elective changes in entity classification.[4] The proposed regulations, however, do not specifically address the federal

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[1] Currently, only California, the District of Columbia, Massachusetts and Tennessee still continue to require domestic LLCs to have at least two members.

[2] Notwithstanding this freedom of choice in classification, in general, an election will be binding for a period of five years from the date it is made. See Treas. Reg. Section 301.7701-3(c)(i)(iv).

[3] The majority of states that permit the formation of single member LLCs follow the Check-the-Box regime.

[4] For example, the proposed regulations provide that if a corporation elects to be treated as a single member LLC, the change will result in a liquidation of the corporation for federal income tax purposes. Also, the proposed regulations provide that if a partnership elects to be treated as a corporation, the partnership will be treated as having contributed the assets of the partnership in exchange for all of the stock in the corporation, then distributing the stock to the partners in complete liquidation of the partnership. Prop. Treas. Reg. Section 301.7701-3(g)(1) 62 Fed. Reg. 55768 (1997).

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tax consequences of the conversion of a single-member LLC into a two-member LLC (*i.e.*, a Disregarded Entity converting to an entity recognized as a partnership for tax purposes) or the converse. The recent revenue rulings provide the IRS's view of the tax consequences of these non-elective reclassifications. Each ruling describes two fact patterns.

REV. RUL. 99-5

(A one-member LLC adds an additional member)

Situation 1

Taxpayer Andy owns an LLC that is a Disregarded Entity for tax purposes. Andy sells a 50 percent membership interest to Burt. Under Rev. Rul. 99-5, for tax purposes, Andy is deemed to have sold a 50 percent undivided interest in each of the LLC's assets to Burt, followed by a capital contribution of the assets by Andy and Burt to a newly formed LLC, with the following consequences:

- Andy must recognize gain or loss on the sale to Burt of the 50 percent undivided interest in the assets, and his tax basis in the interest in the newly formed LLC will be equal to his basis in his undivided 50 percent share of the assets.
- Burt's basis in his interest in the new LLC will be the purchase price that he paid to Andy.
- The LLC (now treated as a partnership for tax purposes) will have a basis in the assets deemed contributed by Andy and Burt that is equal to Andy's and Burt's bases immediately before the deemed contribution.
- Andy's holding period in his LLC interest will include his pre-conversion holding period in the LLC's assets.
- Burt's holding period begins the day after the purchase/conversion, and the LLC's holding period for the assets will be bifurcated between Andy's and Burt's.

Situation 2

Instead of purchasing a 50 percent interest from Andy, Burt contributes cash directly to the LLC in exchange for a 50 percent interest in the LLC. Pursuant to Rev. Rul. 99-5, neither Andy nor Burt recognizes gain on the conversion with the following consequences:

- Both Andy and Burt are each deemed to have contributed assets (in Andy's case, the assets of the existing LLC, and in Burt's case, the cash) to a partnership in exchange for an interest therein, a non-recognition event for tax purposes.
- Andy's basis in his membership interest in the LLC will be his basis in the LLC's assets. Andy's holding period in interest will include his holding period prior to Burt's buy in.
- Burt's basis in his membership interest in the LLC will be the amount of cash contributed. Burt's holding period in his interest will begin on the day after his buy in.
- The LLC will have a basis in its assets that equals the cash contributed plus Andy's pre-conversion basis, but in this case the holding period for the assets will not be bifurcated.

REV. RUL. 99-6

(Members of a multi-member LLC sell their interest to a single member)

Situation 1

Alice and Brenda are the members of a two-member LLC. Alice is ready to cash out and does so by selling her 50 percent interest to Brenda. Since the LLC no longer has two or more members, it cannot be treated as a partnership for tax purposes.[5] Under Rev. Rul. 99-6, the LLC is treated as having distributed its

[5] Internal Revenue Code (the "Code" Section 708(b)(1).

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assets to Alice and Brenda in complete liquidation. Alice is treated as having *sold her membership interest* to Brenda, and Brenda is treated as having *purchased the assets* previously deemed distributed to Alice, with the following consequences:

- Alice recognizes capital gain (or loss) on the sale of her interest in accordance with Section 741.
- Brenda recognizes gain (or loss) on the distribution in accordance with the rules governing partnership distributions. This means Brenda's income may be taxed at capital or ordinary rates, depending on the nature of the LLC's assets.
- Brenda's basis in the assets attributable to Alice's 50 percent interest is equal to the purchase price for Alice's interest.
- Brenda's basis in the assets attributable to her 50 percent interest is determined under the rules governing partnership distributions. Brenda's holding period (and, consequently, that of the new single-member LLC) for the assets attributable to Alice's interest begins on the day after the purchase.
- Brenda's holding period in the assets attributable to her interest in the LLC includes the pre-conversion holding period. The result is a bifurcated holding period in the assets of the single-member LLC.

Situation 2

Alice and Brenda are the members of a two-member LLC and each desires to cash out of the investment by selling her respective 50 percent interest in the LLC to Clare. Under Rev. Rul. 99-6, the LLC terminates for tax purposes, and is deemed to have made a liquidating distribution of its assets to Alice and Brenda immediately followed by Clare's acquisition of those assets. However, as in Situation 1, Alice and Brenda are considered to have *sold their interests* in the LLC, while Clare is considered to have *purchased the assets* with the following consequences:

- Alice and Brenda each recognize capital gain (or loss) on the sale of their interests in accordance with Code Section 741.
- Clare's basis in the assets is the purchase price for the interests.
- Clare's holding period (and that of her single-member LLC) in the assets begins on the day following the purchase.

The published rulings demonstrate the IRS's view of the tax consequences associated with the specific situations addressed. There still remain potential traps for the unwary, however, as well as opportunities for the well advised. The rulings should not be considered determinative with respect to the complex issues that will arise in more sophisticated transactions. For example, the rulings do not address the federal income tax consequences of similar reclassifications where the LLC holds so-called "hot assets," such as inventory and unrealized receivables, or where the LLC holds assets that are subject to liabilities. Because the potential for unanticipated gain recognition in these scenarios is high, a taxpayer must give careful consideration to the proper structure for a buy in or cash out.

Further, the guidance in the rulings should not be considered determinative with respect to well planned ownership changes. For example, if the buy in or cash out can be structured as an installment sale, a redemption, or an asset sale (as opposed to the sale of an interest in the LLC), then a more favorable tax scenario may be achieved. Each structure may create tax advantages depending upon an LLC's assets and its owner's ability to absorb varying degrees of tax exposure. Thus, while the rulings provide a clearer background against which the tax consequences of certain entity reclassifications may be determined, the rulings have by no means limited the planning opportunities available to taxpayers. ◆

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