



October 23, 1997

To Vote or Not to Vote, That Is the Question

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The concept of “voting power” is ubiquitous throughout the provisions of the Internal Revenue Code dealing with corporations and their shareholders. Under some provisions, a particular level of voting power -- be it 2%, 5%, 10%, 20%, 50%, or 80% -- is desirable and under some it is not, but a fundamental question always presents itself: How is “voting power” measured when a corporation has more than one class of stock outstanding? Generally, this question has been answered by reference to voting for directors. For example, shares representing 90% of a class of stock that is entitled to elect 7 out of 10 of a corporation’s directors would represent 63% of the corporation’s “voting power”.¹

One common situation in which “voting power” is relevant is in determining whether corporations are members of an “affiliated group” eligible to file consolidated tax returns. One requisite for membership in such a group is that one member hold at least 80% of the total voting power of the stock of the other.² The Tax Court recently considered the effect on affiliated group status of special voting rights and restrictions on the powers of the board of directors on certain matters. *Alumax Inc. V. Commissioner*.³ Although the issue in *Alumax* was whether a group of corporations could file a consolidated return, the case has ramifications in many areas in which voting power is a (sometimes

determining) factor in the application of the tax law.

Alumax Inc. was authorized to issue three classes of common stock. All of the class C stock was held by Amax Inc. All of the class B stock was held by one or more unrelated corporations.⁴ None of the class A stock was outstanding. Equal numbers of class B and C shares were outstanding, but their respective voting rights were quite different. As long as any class C stock was outstanding, each share of the class B stock possessed one vote and each share of class C possessed four votes. There were six voting directors on Alumax’s board, two elected by the class B shareholders and four elected by the class C shareholders. However, the class B directors had only one vote each, while the class C directors had two votes each. The Alumax directors and shareholders were entitled to vote in the aggregate, and not by class, on all matters submitted to them, except for certain specified matters, and a simple majority was required to effect an action.

Amax filed a consolidated return that included Alumax. This resulted in Alumax’s taxable income being offset by Amax’s net operating losses. The IRS asserted that Amax’s stockholdings in Alumax did not satisfy the requirements for inclusion of Alumax in Amax’s affiliated group.

Because Alumax’s class C stock held by Amax elected directors possessing eight out of ten votes on the

board, Amax contended that the “80% of the total voting power” test for affiliation was met. The IRS contended that Alumax was not affiliated with Amax because of special provisions in Alumax’s certificate of incorporation (and a shareholders agreement) that granted special rights to the class B shareholders and restricted the discretion that could be exercised by Alumax’s board of directors. The IRS argued -- and the Tax Court agreed -- that these provisions reduced the voting power of the class C shares below the 80% minimum required for affiliation.

There were three separate categories of special provisions at issue. The first category required the affirmative vote of a majority of the shareholders (in the case of shareholder votes) or directors (in the case of director votes) *voting by class*. These “restricted matters” included not only major corporate matters, such as changing the corporation’s certificate of incorporation, but also acquiring or disposing of any “material” asset (defined as an asset with a book value of at least 5% of Alumax’s net worth), making a capital appropriation or an asset disposition request of \$30 million or more,⁵ selecting or dismissing the chief executive officer, and lending money to affiliates.

The second special provision at issue related to “nonrestricted matters” -- matters not governed by the class voting requirement described above for restricted matters. Nonrestricted matters

generally could be undertaken by a majority of the class A directors (or shareholders) without regard to the class B directors (or shareholders), because voting on these matters was in the aggregate rather than by class. However, if a class B director (or the class B shareholders) did object, that “objectionable action” did not take effect for 14 days. Further, that action did not take effect at all unless a panel of arbitrators determined that it would *not* have a material and adverse impact on the value of the class B stock. If the panel sided with the class B shareholders (or failed to reach a decision), the objectionable action would not become effective and the class B shareholders would have the right to purchase between 51% and 100% of the outstanding class C shares at a price equal to 50% of the stockholder’s equity attributable to that stock. Amax could prevent this purchase from taking place by converting the class C stock into class A stock with one vote per share.

Certain other events could also trigger the class B shareholders’ right to purchase the class C stock. These included the downgrading of certain indebtedness, certain events of bankruptcy or insolvency, certain changes in the ownership of Amax or Alumax, a breach of Alumax’s certificate, bylaws, or certain other agreements in a way “materially adverse” to the class B shareholders, a change that would cause the amount of certain obligations to exceed the foreclosure value of the pledged collateral, and a change in generally accepted accounting principles that would prevent the class B shareholders from recording the net income of Alumax in their financial statements.

The third special provision was a “mandatory dividend” provision, under which dividends were required to be paid to the extent of 35% of Alumax’s net income (to the extent permitted by law). Mandatory dividends on the class C stock were to be declared and paid at one-quarter of the rate per share of dividends on the class B stock.

The question for the Tax Court was whether Alumax and its subsidiaries were members of the affiliated group of

corporations that had Amax as its common parent. The answer depended on whether the class C stock held by Amax satisfied the 80% voting requirement of Code section 1504(a). The class C shareholders elected the class C directors and the class C directors held 8 out of 10 votes -- exactly 80% -- on the board. The issue was whether the special provisions described above reduced the class C voting power for purposes of section 1504(a).

On “restricted matters,” the affirmative vote of a majority of *both classes of stock* (with respect to shareholder action) or *both classes of directors* (with respect to director action) was required to take action. Thus, the class B directors and shareholders possessed a 50/50 vote on restricted matters. Alumax argued that restricted matters were a narrow set of actions similar to the special rights frequently possessed by preferred shareholders. The Tax Court disagreed. It found significant the fact that some of the restricted matters were traditional management matters with respect to which Delaware law required director, but not shareholder, approval.

Alumax argued that the class voting requirement applied only to extraordinary or highly unusual matters and not to the vast majority of ordinary, day-to-day matters. Therefore, according to Alumax, voting by class on restricted matters did not impair the class C directors’ power to manage the business and affairs of Alumax “in any meaningful way” or significantly affect the voting power of the class C stock. The court acknowledged that most of the restricted matters were unusual and involved significant dollar amounts, but drew a different conclusion. In the court’s view, these facts only emphasized that the restricted matters were significant matters on which the Alumax board and stockholders voted by class.

With respect to the “objectionable action” provision, Alumax argued that the Class B shareholders possessed merely a contingent right to acquire additional voting power over future actions that should not be taken into ac-

count until exercised. Alumax cited authority which measured voting power based on current facts and refused to take into account the possibility that a class of stock might be entitled to vote at some time in the future. The court found that the class B shareholders’ rights were not contingent. Rather, the class B shareholders had legally enforceable rights to negate the exercise of the power of the board on any nonrestricted matter which they believed could materially and adversely affect the value of their investment in Alumax and to compel arbitrators to decide whether the Alumax board’s exercise of its power on any such matter was to become effective. As a result, the Alumax board (and thus the class C directors) did not have effective power to act on nonrestricted matters.

The mandatory dividend provision was somewhat different, because it did not grant special voting rights to the class B shareholders. Rather, it precluded the board of directors from exercising its discretion *not* to declare dividends to the extent of 35% of Alumax’s net income. Alumax argued that this restriction was similar to fixed payment provisions in debt instruments or preferential dividend provisions in preferred stock.

The court noted that a company’s directors possess the power to incur debt and, having done so, must satisfy the debt’s payment requirements as a contractual obligation. Thus, fixed payment debt instruments were not analogous. The court found preferred dividend rights also to be distinguishable. Preferential dividend rights mean that, once a board has declared a dividend, it is required to pay a certain amount to one class before paying anything to another class. By contrast, the mandatory dividend provision in the Alumax certificate restricted the power of the board to determine *whether* to declare and pay dividends to the extent of 35% of Alumax’s net income.

The Tax Court found that *each* of the special provisions at issue had an impact on the “voting power” of the class C stock. Thus, any one of them,

alone, would have been enough to “disaffiliate” Alumax, since the class C common stock possessed (without regard to the three provisions at issue) *exactly* 80% of the voting power.⁶

The facts in the case are far from sympathetic on the issue of voting control. Some of the restricted matters with respect to which voting by class was required were matters of a fairly routine, albeit significant, nature (for example, acquisition or disposition of any “mate-

rial” asset). The fact that even nonrestricted actions -- those not subject to the class voting requirement -- could be overturned by the class B shareholders, subject to arbitration, also did not help. Similarly, although a small mandatory dividend might have been seen as an acceptable encroachment on the board’s powers, a mandatory dividend of 35% of net income was large enough to represent a significant restriction on the board’s power to “grow” the business,

undertake new ventures, etc. Notwithstanding these “bad” facts, however, *Alumax* represents an important reminder that the question of voting control involves more than just tallying voting rights in the election of directors. Any special voting rights, “springing” rights, or provisions limiting director discretion on matters normally within the board’s purview may be taken into account.

¹ See, e.g., Revenue Ruling 69-126, 1969-1 C.B. 218.

² Section 1504(a)(2)(A) of the Internal Revenue Code of 1986 (the “Code”).

³ 109 T.C. No. 8 (September 30, 1997).

⁴ Most (90%) of the class B shares were held by a Japanese corporation or its U.S. affiliate.

⁵ While \$30 million is not an insignificant figure, it represented less than 5% of Alumax’s net worth.

⁶ This went further than even the IRS had argued. The IRS position was that the *cumulative* effect of these three provisions had reduced the voting power below the 80% requirement.

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