TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Redemptions

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This Portfolio revises and supersedes 767-3rd T.M., *Redemptions*. Portfolio 767-3rd T.M. should be discarded.

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TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Redemptions

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Redemptions*, No. 767-4th, discusses the tax effects of a stock redemption both to the redeeming corporation and the redeemed shareholder and analyzes the categories of §302 transactions. In addition to discussing the applicable rules and tax consequences, this Portfolio emphasizes practical problems and planning techniques.

A redemption is a transfer by a shareholder of some or all of the shareholder's stock to the issuing corporation in return for cash or other property. Section 302 contains the basic tax rules governing redemptions of stock by shareholders.

Section 302 authorizes "exchange" treatment to a recipient of a redemption distribution if: (1) its effect is not essentially equivalent to a dividend; (2) the exchange is "substantially disproportionate;" (3) the shareholder's interest in the corporation is completely terminated; or (4) it is a distribution in redemption of the stock of a noncorporate shareholder in a partial liquidation. If a redemption fails to satisfy any of these tests, the distribution is treated as a §301 distribution, requiring further analysis of the proper tax treatment.

Section 311 addresses the effect on the issuing corporation of a distribution of property (other than cash or obligations of the issuing corporation), while §312 addresses the effect on the issuing corporation's earnings and profits.

In addition to analyzing the definitional elements and the effects of redemptions, this Portfolio briefly explains the application of the constructive ownership rules of §318 to redemptions.

Also relevant are 383 T.M., *Nonstatutory Stock Options*, 384 T.M., *Restricted Property — Section 83*, 554 T.M., *The Attribution Rules*, 562 T.M., *Capital Assets — Related Issues*, 564 T.M., *Related Party Transactions*, 566 T.M., *Tax Consequences of Contingent Payment Transactions*, 700 T.M., *Choice of Entity: Operational Issues*, 702 T.M., *Capitalizing a Business Entity: Debt vs Equity*, 731 T.M., *S Corporations: Corporate Tax Issues*, 740 T.M., *Taxation of Regulated Investment Companies and Their Shareholders*, 764 T.M., *Dividends — Cash and Property*, 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306*, 768 T.M., *Stock Sales Subject to Section 304*, 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects*, 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations*, 774 T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations*, 776 T.M., *Corporate Separations*, 782 T.M., *Boot Distributions and Assumption of Liabilities*, 784 T.M., *Corporate Liquidations*, and 809 T.M., *Estate*

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Planning for Owners of Closely Held Business Interests (Estates, Gifts & Trusts Series).

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DETAILED ANALYSIS

I. Introduction

A. *The Basic Statutory Scheme*

This Portfolio examines the federal income tax treatment of corporate stock redemptions, including the tax consequences to the shareholder and the redeeming corporation. In addition to presenting the basic rules, this Portfolio presents various planning techniques for achieving particular shareholder and corporate objectives, such as generating long-term capital gain or dividend income.

Generally, gain on exchange transactions is realized pursuant to §1001 and, except as otherwise provided in the Code, recognized.[1] A redemption, like an ordinary exchange transaction, involves the surrender of property in exchange for consideration, in this case stock is surrendered in exchange for cash or property. Because this exchange involves a degree of preexisting relatedness, the rules surrounding the taxation of redemption transactions create the possibility that a redemption is taxed consistent with its form, (i.e., as a §1001) or under a fictitious treatment, (i.e., as a distribution under §301). The operative code sections, §302 and §317, make this determination, depending on the extent of the interests redeemed or the nature of the transaction. Section 302 is used for related determinations under §304[2] and 356, involving stock sales between related parties and boot in reorganizations, respectively, as such transactions share similar degrees of relatedness between shareholders and the corporations that they own, and often control. In this series of related Code sections, including §305 and §306,[3] Congress established a framework for the proper characterization of distributions (and exchanges that are more appropriately taxed as distributions). Congress believed that these categories of transactions require special rules due to the shareholder/corporate relationship.[4] While §304, §305 and §306, are related Code sections, each are covered in separate Portfolios, as noted in this text.

To understand the tax considerations of a redemptive transaction, it is important to first understand the taxation of distributions with respect to stock. Distributions with respect to stock, however, represent a special category of corporate transaction that requires no exchange component. The inherent rights of stock ownership determine a particular shareholder's right to receive distributions from a corporation. Distributions can be made out of either earnings or out of invested capital. Additionally, certain circumstances permit distributions in excess of invested capital. The taxability of a distribution to a shareholder depends upon the characterization of the distribution by the corporation.

Pursuant to §301, a distribution is a "dividend" if made by a corporation out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year of distribution.[5] To the extent the amount of the distribution exceeds earnings and profits (either current or accumulated), §301(c)(2) provides that the balance of the distribution "shall be applied against and reduce the adjusted basis of the stock." Next, under §301(c)(3)(A), the portion of the distribution "which is not a dividend, and to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property." If the stock is a capital asset in the shareholder's hands and if the required holding period is satisfied, then gain under §301(c)(3)(A) is long-term capital gain.

Under §317(b), a "redemption of stock" is a corporation's acquisition of "its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." For the purposes of corporate distributions, §317(a) defines "property" to include all property other than stock (and stock rights) in the redeeming corporation.

Section 302, the topic of this Portfolio, governs a corporation's redemption of stock. Conceptually, §302(a) presents a statutory fork in the road. Down one path, §302(a) provides that a redemption satisfying any one of the four tests in §302(b) is treated as a distribution in part or full payment in exchange for the stock (i.e., as a sale transaction). If the stock redeemed was held as a capital asset (as defined in §1221) on the date of the exchange, as is generally the case, then the provisions relating to capital gains and losses apply.[6] Down the other path, if a redemption satisfies none of the §302(b) tests, the redemption is treated under §302(d) as a distribution of property governed by §301. Therefore, a redemption that does not satisfy any of the §302(b) tests is a dividend to the extent of the redeeming corporation's earnings and profits,[7] and any excess is treated first as a return of capital[8] and then, to the extent that the portion of the distribution which is not a dividend exceeds the shareholder's basis in the stock, as gain from the sale or exchange of property.[9]

The four tests for exchange treatment in §302(b) are disjunctive to permit a shareholder to qualify a stock redemption as an "exchange" under one or more, but not all of the tests. Additionally, the tests must be applied with respect to each shareholder; a redemption may qualify as a sale or exchange as to certain shareholders but not others.

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[1] All section references herein are to the Internal Revenue Code of 1986 9the "Code"), as amended, and the regulations thereunder, unless otherwise stated.

[2] For a detailed discussion of §304, see 768 T.M., *Stock Sales Subject to Section 304* and a further discussion of §304 in X.C., below.

[3] For a detailed discussion of §305 and §306, see 765 T.M., *Stock Rights and Stock Dividends: Sections 305 and 306.*

[4] For a discussion of related party transactions more generally, see 564 T.M., Related Party Transactions.

[5] §301(c)(1), §316(a).

[6] For a discussion of the rules applicable to capital gains and losses, see 561 T.M., *Capital Assets.*

[7] §301(c)(1), §316.

[8] §301(c)(2).

[9] §301(c)(3).

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Under §302(b), the following redemptions qualify for exchange treatment: (1) redemptions that are "not essentially equivalent to a dividend";[10] (2) redemptions that are "substantially disproportionate";[11] (3) redemptions that completely terminate the shareholder's equity interest in the corporation;[12] and (4) redemptions from noncorporate shareholders in a partial liquidation.[13]

Various attribution rules, fact patterns, and regulatory and judicial interpretations give these four tests a greater degree of complexity.

From the standpoint of the redeeming corporation, the rules generally are straightforward. If the redeeming corporation uses appreciated property for the redemption transaction, the corporation recognizes gain, regardless of whether the redemption satisfies §302(a) or is treated as a §301 distribution.[14]

In the case of a distribution of gain property, the distributing corporation will recognize gain either by way of §1001 or §311(b). On the other hand, if it uses depreciated property (i.e., loss property), the redeeming corporation recognizes no loss by way of the combination of §1001 and §267 or §311(b). Special problems arise in calculating the effects of a redemption that satisfies §302(a) on the earnings and profits of the redeeming corporation. See III.A.2.c., below.

B. The Tax Dilemma

The rationale underlying the statutory scheme in §317, §302, and §301 is this: Congress wished to distinguish redemption transactions that resemble sales of stock to third parties from those that occur between a corporation and its owner and that resemble the payment of dividends. The statutory scheme is designed to protect the dividend rules, while permitting sale treatment when the shareholder's interest in corporate equity has been reduced sufficiently.

There are potential tax advantages to each type of treatment. So long as the stock is a capital asset in the hands of the selling shareholder, a sales transaction generally requires a comparison of the amount realized with the shareholder's basis in the stock to determine the amount of recognizable capital gain or loss. This basis offset represents a significant advantage over a transaction form where no such basis offset is available (e.g., a dividend distribution). Unlike exchange treatment, basis in stock in a distribution is relevant only after the earnings and profits have been depleted.

Additionally, the character of the amount taxable may, depending on tax rate differentials between ordinary income and capital gains produce a significant advantage or disadvantage. Tax rates go through cycles of modification based on changes in the political and economic climates, so the impact of rate differentials may change over time. It is significant to note, however, that under §1(h)(11), "qualified dividend income" (which generally includes dividends received from domestic (and certain foreign) corporations by noncorporate shareholders) is taxed as net capital gain. Prior to 2003, dividend income was taxed as ordinary income, which created a significant tax advantage to redemptive distributions over dividend distributions for noncorporate shareholders. This significant advantage is no longer relevant as most dividend income is taxed as net capital gain to noncorporate shareholders.

Corporate shareholders are generally able to take advantage of the dividends received deduction upon receipt of a dividend distribution.

The statutory scheme does not permit all redemptions that resemble sales to be treated as sales. A sale of any amount of stock to an unrelated third party generally produces sale treatment. The rules governing redemptions, however, permit sale treatment only when the redeemed shareholder's interest in the corporation has been reduced by an amount that is "meaningful" or that satisfies certain other prescribed thresholds.[15] It is clear why Congress wished to treat redemptions that do not affect a shareholder's equity interest as distributions. The more difficult question is why redemptions that change the shareholders' relative equity interests, no matter how slightly, should be treated differently than third-party sales.[16]

> *Example:* Corporation X has three equal shareholders — B, C, and D — each of whom owns 100 shares of X stock. A redemption for cash by X of 30 shares from each shareholder has no effect upon their relative ownership interests in the corporation. From the standpoint of the tax law, the transaction is identical to a distribution of cash by X, and §317, §302, and §301 will treat it as such. The redemption of stock does not affect the shareholders' relative equity interests in the corporation, and to treat such redemptions as exchanges would undermine §301.
>
> The above example represents a relatively easily understood illustration. The situation is more complex if not all shareholders participate in the redemption, if X has more than one class of stock, or if one or more shareholders simultaneously sell other shares.

> *Example:* Assume that in the previous example X had redeemed 30 shares from each of B and C, but only 25 shares from D. Although the relative equity ownership of X has shifted in D's favor, it does not automatically follow that B and C are entitled to exchange treatment. Section 302 contains the rules addressing this situation.

C. The Stakes — Sale or Exchange vs. Distribution

The difference in tax result between sale or exchange treatment and distribution treatment can be dramatic, and the desired outcome depends on the taxpayer and situation.

1. Individuals

When the redeeming corporation has ample earnings and profits, an individual shareholder with an adjusted basis in corporate stock that is less than the stock's fair market value gen-

[10] §302(b)(1).
[11] §302(b)(2).
[12] §302(b)(3).
[13] §302(b)(4), §302(e).
[14] §311(b).

[15] §302(b); *U.S. v. Davis*, 397 U.S. 301 (1970), reh'g denied, 397 U.S. 1071 (1970).
[16] The IRS has interpreted §302(b)(1) in a way that provides sale treatment for even slight reductions in equity interest, provided the shareholder's stock ownership is below certain thresholds. See VI.F.4.b.(3), below.

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erally prefers sale or exchange treatment to distribution treatment, due to the basis offset that occurs in a §1001 transaction.[17] If the taxpayer held the shares redeemed as capital assets, any gain is capital gain. The taxpayer also is entitled to use the taxpayer's basis in the shares redeemed before recognizing any gain. Thus, sale or exchange treatment allows immediate basis recovery.

If the taxpayer has an unrealized loss in the shares, sale or exchange treatment generally permits recognition of the loss, although the loss may be subject to the limitations on the use of capital losses (§1211(b)) or other limitations under the Code (e.g., under §267 or §356).[18]

If the redemption is taxed as a distribution, however, the taxpayer realizes dividend income to the extent of the corporation's earnings and profits. Although dividends historically have been taxed as ordinary income, changes to the Code in 2003 provide that an individual's "qualified dividend income" (generally, dividends received from domestic corporations and from certain foreign corporations) is taxed as net capital gain.[19] Because of the reduced rate on qualified dividend income found in §1(h)(11), the difference in tax result between sale or exchange treatment and distribution treatment for noncorporate taxpayers is less dramatic than it once was. If the redemption is taxed as a distribution, however, then any basis in the redeemed shares goes unused currently and is added to the basis of the shareholder's remaining shares.[20] The taxpayer also does not recognize any unrealized loss in the shares.

If the redeeming corporation lacks, or has minimal, earnings and profits, however, individuals may prefer §301 treatment. Under §301(c)(2), arguably, the taxpayer is entitled to recover the basis in all the shares (not just those redeemed) before the recognition of any gain.[21]

2. Corporations

A U.S. corporation holding shares with built-in gain of a redeeming corporation with ample earnings and profits generally prefers distribution treatment to sale or exchange treatment, provided that a §243 dividends received deduction is available and that the §1059 extraordinary dividend rules do not apply.[22] For example, if a redemption by a corporation with sufficient earnings and profits is treated as a distribution, and the corporate shareholder is entitled to a 50% dividends received deduction, only 50% of the proceeds are subject to federal income tax, albeit as ordinary income. Provided that §1059 does not apply, no basis reduction occurs for the untaxed portion of the dividend.[23]

Note that the dividends received deduction varies depending on the corporate shareholder's degree of investment in the distributing corporation. For taxable years ending after December 31, 2017, a corporate shareholder owning less than 20% of the distributing corporation (by vote and value) is allowed a 50% dividends received deduction, a corporate shareholder owning more than 20% of the distributing corporation (by vote and value) is allowed a 65% deduction and a corporate shareholder receiving dividends from another member of the same affiliated group, generally is allowed to deduct 100% of the amount of the dividend received.[24] The deductions for dividends received by these types of corporate shareholders are 70%, 80%, and 100%, respectively, for taxable years beginning before December 31, 2017.

Several planning techniques have developed to ensure that redemptions from corporate shareholders are treated as distributions, including the purchase of out-of-the-money options by the redeemed shareholder to prevent any decrease under §302 (by reason of §318) in the shareholder's equity interest in the corporation. Some of these techniques will be discussed in the analysis of the §302 requirements.

Corporations lacking earnings and profits and corporations with minimal amounts of earnings and profits generally have the same preferences for §301 treatment as individuals. Again, in the case of an unrealized loss, a shareholder typically will prefer exchange treatment under §302(a).

D. Uses of Redemptions

There are many situations in which a transfer by a shareholder of some or all of the shareholder's stock back to the corporation in exchange for cash or other property is preferable to a sale of that stock to a third party. Those situations frequently arise in the context of private corporations, and less frequently in the context of public corporations.

1. Private Corporations

Most private corporations, including family-owned businesses, have no ready market for corporate equity. Retiring owners and the estates of deceased owners may need liquidity. Dissident shareholders or those who wish to pursue other ventures may wish to withdraw the value of their investment. Often the only practical means to achieve the desired result is to cause the corporation to redeem shares from the particular shareholder in question.

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[17] Foreign individuals not subject to U.S. tax may be indifferent as to whether a redemption is treated as a sale (unless the Foreign Investment in Real Property Tax Act (FIRPTA) rules of §897 and §1445 apply) or as a distribution (unless the distribution is subject to withholding tax under §871 that is not absorbed by the payor through a gross-up or reduced or eliminated by treaty).

[18] For a discussion of transactions between related parties more generally, see 564 T.M., *Related Party Transactions.*

[19] See §1(h)(11).

[20] For rules relating to basis when the taxpayer no longer owns shares in the redeeming corporation, or when the shareholder owns different blocks or classes of stock, see III.B.1.d.(2).

[21] If the shareholder has differing bases in differing blocks of shares (or holds different classes of stock), however, the recovery of basis rules become somewhat murky. At least one court has held that §301(c)(2) and §301(c)(3) must be applied separately to different blocks of stock. *See Johnson v. U.S.*, 435 F.2d 1257 (4th Cir. 1971). For a further discussion of these issues, see III., below.

[22] Foreign corporations that are not subject to U.S. tax may be indifferent as to whether the transaction is treated as a sale, although, like foreign individuals, they must take into account the FIRPTA rules and dividend withholding under §881 that is not either absorbed by the payor or reduced or eliminated by treaty.

[23] Section 1059 provides for basis reduction equal to the untaxed portion of certain "extraordinary" dividends, except when specific holding period requirements are satisfied. Other provisions also affect availability of a dividends received deduction. *See, e.g.*, §246A (reducing the amount of the dividends received deduction with regard to portfolio stock that is debt-financed). For a detailed discussion of extraordinary dividends, see 764 T.M., *Dividends — Cash and Property.*

[24] *See* §243(a)(1), *as amended by* the Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97. For a detailed discussion of the dividends received deduction, see 764 T.M., *Dividends — Cash and Property.*

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While the remaining shareholders might purchase the shares, those shareholders may have little net worth beyond their own interest in the corporation. They would need to fund any purchase by personal debt, which generally could only be repaid by taking dividends out of the corporation. For C corporation shareholders, this option results in a very inefficient tax structure, as two levels of tax must be paid to fund the purchase; the corporation first pays tax on its earnings, and the purchasing shareholders then pay tax on the dividend distributions received from the corporation. A purchase of shares by the corporation, however, funded by corporate debt, results in only a single level of future tax, as corporate earnings are used to amortize the debt rather than to pay dividends. For S corporation shareholders, however, a cross-purchase of shares by remaining shareholders, creates basis in purchased shares to, for example, increase the shareholders' future loss absorption capacity.

Redemptions also may be permitted or required by contract to enable a corporation to limit the owners of its equity to those within certain defined groups. For example, stock in a private corporation may be subject to a right of first refusal, permitting the corporation to match the offer of any potential third-party purchaser and buy back the shares. Alternatively, the stock may be subject to a buy-sell agreement that requires the holder to sell, and the corporation to redeem, the stock upon the occurrence of certain events, such as when the shareholder dies or, if the shareholder is an employee, upon termination of employment.

A buy-sell agreement can be used to guarantee a source of liquidity for the estate of a deceased shareholder. Liquidity may be especially important at that time both to permit satisfaction of bequests and to satisfy the tax liability and administrative costs of the estate. Section 303 provides special rules applicable to certain redemptions from an estate. For a detailed discussion of those rules, see 809 T.M., *Estate Planning for Owners of Closely Held Business Interests.*

2. *Public Corporations*

Redemptions to provide liquidity are unnecessary in the context of most public companies, as there already exists a ready market for corporate equity. Other reasons for public companies to redeem stock include the following:

(a) supporting the market for the corporation's equity;

(b) acquiring stock for reissue under existing stock option plans, or to satisfy the exercise of warrants and the conversion of convertible debentures;

(c) acquiring stock for reissue in an acquisition of another corporation;

(d) eliminating a dissident shareholder; and

(e) defending against unwanted takeover bids.

Redemptions for reasons (a), (b), and (c) above generally occur at a time when management believes that the corporation's stock is undervalued in the market. When stock is undervalued, issuing additional shares results in excessive dilution of the equity of the current shareholders.

Management of public companies sometimes wish to "go private"; i.e., to purchase all the company's outstanding public equity. Because these transactions often rely on a significant amount of debt financing secured by the assets of the company itself, they are known as leveraged buy-out (or LBO) transactions.

In a typical LBO transaction, management will form a new corporation (Newco) financed with some equity and a significant amount of debt. The debt financing is contingent upon closing of the deal, and will be secured (and serviced) by the assets of the existing corporation (Target). The shareholders of Target vote on the terms of the transaction and, assuming it is approved, Newco merges into Target, with the shareholders of Target receiving cash or other property for their shares. This type of transaction generally is treated as part purchase (to the extent of the equity in Newco) and part redemption (to the extent of the debt in Newco or borrowed by Target in connection with the transaction).[25]

Though the question of the taxation of redemptions is predominantly a shareholder consideration, pursuant to §4501, enacted by the Inflation Reduction Act of 2022, the redeeming company may be subject to a tax payment obligation. The amount of tax payable is equal to 1% of the value of the share repurchases. This excise tax is applicable to domestic companies that are traded on established markets.[26] See X.G.1., below.

Similarly, the use of special purpose acquisition corporations, known as SPACs, are funded with founder capital and are created for the limited purpose of identifying and closing on a transaction target within a set amount of time. To the extent that the SPAC is unable to close on a transaction target, the proceeds raised by the SPAC through its public offering, are returned to the shareholders. The question of whether such redemptions should be subject to §4501's excise tax is a matter of debate.[27]

E. Nontax Restrictions

As indicated previously, a corporation's purchase of its own stock can be equivalent in economic effect to the payment of an ordinary dividend. From a nontax viewpoint, an ordinary dividend and a dividend equivalent redemption both reduce corporate assets available to meet the claims of other shareholders and corporate creditors. Because of this fact, almost all states that empower a corporation to purchase or redeem its own stock impose financial requirements analogous to those imposed on dividend payments.[28]

1. *In General*

In general, the most common financial requirements are that:

(a) redemptions must be made only out of surplus rather than capital; and

(b) redemptions cannot be made if the corporation is, or would be rendered, insolvent.

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[25] See also 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects.*

[26] For a discussion of §4501, see Cathryn R. Benedict and Philip B. Wright, *Excise Tax on Share Repurchases: A Provision Searching for Its Purpose*, 63 Tax Mgmt. Memo. No. 19, 241 (Sept. 12, 2022).

[27] Michael Kliegman and Joshua Williams, *Should SPACs Be Spooked By The Excise Tax on Stock Buybacks?*, 63 Tax Mgmt. Memo. No. 23, 301 (Nov. 7, 2022).

[28] *See, e.g.*, N.Y. Bus. Corp. Law §513 (McKinney 2001); Del. Code Ann. tit. 8, §160 (2001); Tex. Bus. Corp. Act Ann. art. 2.38 (West 2001).

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Most states make certain exceptions to the first of these requirements. Although not all exceptions are allowed by all states, the exceptions generally allow the corporation to:

(a) redeem "callable" (redeemable) stock (usually preferred stock);

(b) eliminate fractional shares;

(c) satisfy, settle or compromise a debt owed to the corporation;

(d) pay dissenting shareholders under appraisal rights;

(e) redeem stock from employees;

(f) convert convertible stock; and

(g) conduct a business as an investment company.

In exercising its power to buy back the company's own stock, whether common or preferred, callable or not, the board of directors must comply with the statutory and common law financial restrictions imposed on redemptions. The board of directors must also satisfy the limitations arising out of the fiduciary obligations its members have to the shareholders and their obligations to the company's creditors. When a corporation violates any of these restrictions, the directors and officers are responsible, and the shareholders who received payment for their shares also may be liable to creditors and other shareholders harmed by the transaction.[29]

Restrictions designed to enforce similar fiduciary duties are also imposed by federal and state securities laws. Federal securities law restrictions govern all publicly held corporations. Under §10(b) of the Securities Exchange Act of 1934, federal securities law can be imposed upon closely held corporations if the U.S. mail is used in the redemption negotiations.

Before a corporation can consummate a redemption, it must examine the terms of any existing loans to the corporation to determine whether any creditor has restricted the use of corporate funds during the life of a loan. Creditors typically prohibit dividends and redemptions altogether or, alternatively, permit such payments only if the corporation satisfies certain financial ratios after the transaction. A corporation similarly must examine its articles and bylaws before making a redemption.

2. *Effect of Nontax Restrictions on Federal Tax Consequences*

For federal income tax purposes, the Tax Court and the Sixth Circuit have specifically held that even if a redemption violates state corporate restrictions, the transaction will still be tested under the tax rules governing redemptions. In *Wentworth v. Commissioner*,[30] an Ohio corporation paid $462,000 in redemption proceeds to the shareholder (taxpayer) at a time when its surplus was only $176,000. There is no record of creditors or other shareholders challenging the distribution. The IRS determined that the redemption qualified for exchange treatment and resulted in a taxable capital gain to the taxpayer. The taxpayer argued that he was not taxable on the distribution because the distribution violated §1701.35(b) of the Ohio Revised Code, and "therefore the purported redemption was a nullity with no taxable consequences." The Ohio statute provided as follows:

> A corporation shall not purchase its own shares except as provided in this section, nor shall a corporation purchase or redeem its own shares if immediately thereafter its assets would be less than its liabilities plus stated capital, or if the corporation is insolvent, or if there is reasonable ground to believe that by such purchase or redemption it would be rendered insolvent.

The Tax Court rejected the taxpayer's argument, stating that, "The fact that the redemption may have violated state law does not affect its federal income tax consequences. We hold that, regardless of state law, Chemical's redemption of [taxpayer's] stock in 1965 resulted in taxable gain."

On appeal, the taxpayer stressed those cases holding that state law defines the nature of legal interests for purposes of federal tax liability. The Sixth Circuit held, however, that the claim of right principle of federal tax law governs this situation and renders the transaction taxable in the year in which the redemption occurred. The court stated:

> Where a transaction with taxable consequences is carried out in one year and treated by the parties accordingly, the discovery in a subsequent year that the transaction in fact violated a state law does not alter the tax liability of the year of the event. From November 30, 1965 until sometime in April 1966, all parties to the redemption transaction took the position that taxpayer was no longer a shareholder of Chemical and that neither Chemical nor Vulcan was a creditor of taxpayer. Later discovery that the transaction by which this situation was brought about apparently violated the corporation laws of Ohio did not affect the tax consequences as they were fixed on December 31, 1965.

The court also stressed that state corporate law is not self-executing but is enforced only if there is a complaining party. Here, neither the state authorities, nor the parties themselves treated the redemption as void in the year in which it occurred. Therefore, the IRS was entitled to apply the annual accounting concept and hold the parties to the way they treated the transaction.

Observation: The appellate opinion clarified certain facts of the case. The corporate books showed a negative net worth for the year of the redemption because of a reserve for anticipated losses on uncompleted contracts. However, the fact that the negative net worth was the result of reserves rather than liquidated claims did not appear to be a factor in the court's opinion.

The IRS, however, has argued that interest payments on notes used to fund a redemption that allegedly violated state corporate law should be nondeductible. In *Mountain State Steel Foundries v. Commissioner*,[31] the IRS disallowed corporate deductions claimed for interest on promissory notes distributed

[29] *See, e.g.*, *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975); Recent Case, *Donahue v. Rodd Electrotype Co.*, 89 *Harv. L. Rev.* 423 (1975); Del. Gen. Corp. Law §141(a) *et. seq.*

[30] 510 F.2d 883 (6th Cir. 1975), aff'g T.C. Memo 1973-199.

[31] 284 F.2d 737 (4th Cir. 1960), rev'g T.C. Memo 1959-059.

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in a stock redemption. As the IRS interpreted state corporate law, the notes impaired the company's capital and were therefore unenforceable and did not represent binding obligations of the issuer. The Fourth Circuit allowed the deductions, however, after interpreting the state statute to require the corporation only to have enough surplus to back each note payment as and when made. Under this test, the corporation had enough surplus to support the note payments in issue. Whether the court would have sustained the IRS if surplus had been lacking remains an unanswered question.

In *U.S. v. General Geophysical Co.*,[32] a planned redemption of a controlling owner of a close corporation for cash and promissory notes was modified to provide additional protection to the redeemed shareholder. The corporation's counsel had cautioned that if the corporation became insolvent, the notes would be subordinate to other creditors' claims. Under a substitute plan, the corporation distributed appreciated real property in redemption of the stock and then "repurchased" the property for notes in the same amount as would have been distributed in the redemption under the original plan. The issue before the court was whether the corporation's basis in the real property should be stepped up to reflect the "purchase" from the shareholder. Because of the transitory nature of the steps involved, the court held that, in substance, the property never left corporate solution and its basis should remain unchanged.

Under current law, if the distribution of the appreciated property were treated as a separate step, the corporation would recognize gain under §311(b). The IRS might therefore take a different position on similar facts in the future. Moreover, because *General Geophysical* is an example of a court applying the step-transaction doctrine in the IRS's favor to ignore intermediate steps, taxpayers should use caution in relying on it in structuring future transactions. The possibility of §311(b) causing recognition of gain (or, with respect to depreciated property, §311(a) denying loss recognition but resulting in a step-down in basis) is substantial, and it may be difficult for the taxpayers to ignore their own form.[33]

In planning a redemption, the parties should consider possible unenforceability if, at the appropriate point in time under corporate law, the corporation lacks sufficient surplus from which to make the payment. Alternatives to consider are:

(a) have the corporation buy insurance policies on the life of any shareholder whose stock is to be redeemed at death;

(b) reduce corporate "capital" by prescribed statutory procedures;

(c) revalue assets to create revaluation surplus (if permitted by local law);

(d) accumulate earnings in anticipation of a potential redemption (considering accumulated earnings tax problems under §531 that may arise);

(e) structure an installment redemption, relying on local law (where applicable) requiring only that the corporation have surplus equal to the amount of each payment at the time each payment is due;

(f) require the other shareholders to contribute additional capital to the corporation to use as surplus to redeem the stock; and

(g) require the other shareholders to purchase the stock to the extent that the corporation is unable to redeem the stock.

F. Ruling Requests

As in many other areas of federal tax law, the IRS will issue advance rulings on the tax consequences of a redemption transaction.

1. When a Ruling Should Be Sought

Whether the parties to a redemption transaction should seek an advance ruling from the IRS that the proposed redemption qualifies as an exchange depends upon a variety of factors. Because rulings require an average of four to six months from date of filing to date of final response, parties involved in a time-sensitive transaction may not have the option of requesting an advance ruling.

In those cases where time is not critical, the factors to be considered in determining whether to seek an advance ruling include: (i) the scope and nature of the tax exposure if the transaction fails to qualify as an exchange (including whether public shareholders will be affected), (ii) the degree of comfort offered by the tax advisors to the transaction (including the availability of appropriate opinions), and (iii) the presence of issues that would place the transaction within the scope of the IRS's "no ruling" policy. Advance rulings from the IRS are not necessary (or available) in many cases. Moreover, because the IRS requires the taxpayer to make all factual representations necessary to reach the legal conclusion, the ruling is only as good as the representations behind it. On audit, agents are free to challenge the tax treatment of the transaction if they can show a discrepancy between the representations and subsequent events.

2. Procedure for Requesting a Ruling

The formal requirements of a ruling request are set forth in Reg. §601.201. The first revenue procedure of each calendar year sets forth more detailed procedural rules for the issuance of rulings and determination letters, and outlines generally the information required by the IRS in a ruling request. See 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements*

Rev. Proc. 86-18[34] contains more specific guidelines regarding representations and information that must be included with requests for rulings on redemptions. A practitioner filing a ruling request in the redemption area should review those revenue procedures, as well as any recent private letter rulings released by the IRS covering the type of transaction at issue. Although not authoritative except for the taxpayer to whom issued, recent private letter rulings give necessary insight into additional facts or representations currently required by the IRS, and illustrate those factors the IRS considers important.

[32] 296 F.2d 86 (5th Cir. 1961), cert. denied, 369 U.S. 849 (1969).

[33] Taxpayers must generally demonstrate strong proof that its chosen form was inconsistent with the economics of the transaction. *See generally Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

[34] Referenced in the first annual Rev. Proc.

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The IRS charges "user fees" for the issuance of private letter rulings.[35] For a discussion of the user fee program, including the current fee for filing a ruling request, see 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements.*

3. "No Ruling" Areas

In an annual revenue procedure, the IRS announces those areas in which ruling letters will not (or ordinarily will not) be issued.[36] Certain issues involved in redemptions come within the no-ruling areas.

Comment: Note that this annual revenue procedure is not an exhaustive list of the areas in which the IRS will not issue rulings. The IRS is extremely wary of issuing any rulings that are not within the pattern of previous rulings.

The IRS will not rule on the following questions involving redemptions:[37]

(a) Whether §302(b) applies to a redemption where the consideration includes corporate notes, the redeemed shares are held as collateral, and the shareholder may recover the shares in the event of default;

(b) Whether §302(b) applies to a redemption where corporate debt, the amount of which is contingent upon future earnings or similar contingencies, is included as consideration;

(c) Whether §302(b) applies to a redemption where the shareholder leases or licenses property to the corporation, payments for which are contingent upon the corporation's future earnings or are subordinate to the claims of general creditors. Payments for the use of property will not be considered to be dependent upon future earnings merely because they are based on a fixed percentage of receipts or sales;

(d) Whether an acquisition or disposition of stock described in §302(c)(2)(B) was for tax avoidance purposes, except within the fact patterns set forth in certain published rulings; and

(e) The amount of working capital attributable to a business that may be distributed in a partial liquidation; and

(f) Treatment of basis in a §302 or §304 redemption.

In addition, the IRS ordinarily will not rule on the following questions:

(a) The treatment of redemptions in exchange for notes that have terms in excess of 15 years; and

(b) Whether a distribution that does not contract the corporate business or assets by certain safe-harbor amounts qualifies as a partial liquidation.[38]

[35] §7528.

[36] *See* Rev. Proc. 2025-3.

[37] Rev. Proc. 2025-3, §3.01(50) – (54), §5.01(1). With respect to the treatment of basis in a §302 or §304 transaction, the IRS will not rule on this area until it resolves the issue through published guidance. Rev. Proc. 2025-3, §5.01(1). *See* 84 Fed. Reg. 11,686, 11,687 (Mar. 28, 2019) (withdrawing proposed regulations (REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009)) related to, among others, exchange transactions to which §302(a) applies and redemptions governed by §302(d), citing a need for significant modification before rules could be finalized).

[38] Rev. Proc. 2025-3, §4.01(23), (24).

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II. Definition of a Redemption

A. *In General*

In analyzing corporate redemption transactions, the threshold issue is, of course, whether a redemption has occurred, and if so, when. Section §302 applies only where a redemption has occurred. The definition of "redemption" is found in §317(b), which provides:

> For purposes of this part [§301–§318], stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

This chapter analyzes the various requirements imbedded in this statutory language, including: (1) the time of a redemption, (2) whether an exchange has occurred, (3) whether property has been given in the exchange, (4) whether stock has been acquired, and (5) whether the exchanging party is a shareholder.

1. Timing

The tests of §302 are applied at the time "the redemption" occurs. The time that a redemption occurs is not always easy to pinpoint, although this question can be important for several tax purposes, such as determining the taxable year in which income or gain is realized. In most cases, before steps purporting to constitute the actual redemption are taken, the corporation's board of directors will adopt a resolution authorizing and directing the redemption of shares. Where the mechanics of a redemption are carried out loosely, as often occurs in closely held corporations, the surrender of stock and the distribution may not occur simultaneously. Book entries may be made by the corporation in its own records before or after the shareholder actually endorses the shares in writing to the issuing company.

Unfortunately, the case law has not as yet produced consistently applied rules for determining the point at which a redemption will be considered to have taken place for tax purposes. In *Lisle v. Commissioner*,[39] the Tax Court noted:

> [T]he question as to when a redemption is consummated for tax purposes is a practical one to be decided by weighing all of the various factors. . . . The factors to be considered are not unlike those examined when deciding whether the seller or the buyer of stock is subject to tax on dividends declared on pledged stock subject to a contract of sale . . .; or whether the buyer or the seller is a shareholder for subchapter S purposes.

The Tax Court also said:

> [A] sale for tax purposes, and consequently a redemption herein, occurs upon a passing of sufficient incidents of beneficial ownership rather than technical requirements for the passage of legal title under state law.

In *Lisle*, the shares to be redeemed were delivered to a pledgeholder to hold during the period that the corporation was making deferred installment payments of the redemption price, but the shares were not endorsed by the shareholder to either the pledgeholder or the corporation.[40] Apparently, the endorsement was to be made only after the corporation completed its payments for the stock. Nevertheless, the court held that the shares had been validly redeemed at the time the shares were pledged.

In *Smith v. Commissioner*,[41] the shareholder executed a written assignment of some of his shares to the issuing company, although he retained title to the certificates until after the beginning of the following calendar year. At that time, the company's stock transfer agent cancelled the old certificates and issued new certificates representing the balance of the nonsurrendered shares. The Tax Court held that the transfer of shares to the corporation took place, for tax purposes, on the date when the written assignment was executed and delivered (along with the shareholder's existing stock certificates) to the transfer agent. According to the court, those steps gave the issuing company beneficial ownership of the shares. Moreover, the fact that new certificates were not issued at the date of assignment was immaterial because the corporate officer designated in the shareholder's assignment was under a fiduciary duty to effect the transfer on the company's books. The Tax Court held that the transfer of shares to the corporation took place, for tax purposes, on the date when the written assignment was executed and delivered (along with the shareholder's existing stock certificates) to the transfer agent. According to the court, those steps gave the issuing company beneficial ownership of the shares. Moreover, the fact that new certificates were not issued until the subsequent year was immaterial because the corporate officer designated in the shareholder's assignment was under a fiduciary duty to effect the transfer on the company's books.

Note: In *Smith*, the shares were surrendered in anticipation of a possible conversion of convertible notes held by an outside creditor. The IRS argued that the transferred shares were intended to be held in escrow by the issuing company as agent for the shareholder and to be transferred to the company only if the notes were converted into stock. The court rejected this contention, however, on the grounds that the shareholder's written assignment was unconditional on its face.

In an earlier decision, the Tax Court held that a redemption did not occur until the shares were physically endorsed and delivered to the corporation. In that case, *Moore Est. v. Commissioner*,[42] the board of directors in May 1956 adopted a resolution that it would redeem certain shares held by the estate of its former majority shareholder in compromise of a debt owed to the company by the decedent. Previously, in February 1955, the probate court had issued an order authorizing the transaction. The estate did not actually endorse and deliver the stock certificates to the company until January 14, 1957, at which time the

[39] T.C. Memo 1976-140. See II.A.3.a., below, for a discussion of this case.

[40] For a discussion of special problems relating to installment redemptions, see III.A.1.d., below.

[41] 66 T.C. 622 (1976), rev'd on other grounds sub nom., *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979).

[42] T.C. Memo 1961-257.

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company issued a new certificate for the balance of the shares owned by the estate.

The IRS determined that the redemption had occurred in 1956. The estate argued that the redemption had taken place during 1957, a year not before the court. The court upheld the estate's contention, saying as to the probate court order and the board resolution:

> Neither of these unilateral, preparatory actions by the parties to the redemption, however, constituted the redemption. Not until petitioners' 897 shares were actually tendered to the corporation and accepted by the corporation — events which the record indicates occurred on January 14, 1957 — did the redemption take place. It was on that day and not before that the corporation acquired its stock from petitioners as described in the definition of a stock redemption in section 317(b) of the 1954 Code.

In *Meyer v. Commissioner*,[43] cash distributions of $31,000 were made to a shareholder in a closely held corporation before she physically surrendered her stock later in the same calendar year in a redemption treated as a §301 distribution. At the time the payments were made, the parties intended to determine the exact redemption price later in the year by reference to either the par value or book value of the shares. The corporation began a new tax year between the date of actual payment and the date on which the shareholder surrendered her stock. In the tax year the taxpayer surrendered her stock, the corporation had no earnings and profits, although the corporation had earnings and profits in the prior year.

The IRS argued that the redemption took place at the time of the cash distribution, thereby causing the redemption proceeds to be taxed as a dividend. The court held, however, that the distribution was part of "one planned transaction" involving a redemption that took place for tax purposes in the company's tax year when the shareholder surrendered her shares. The court based its holding on the fact that the corporation and the shareholder intended the transaction to be a single redemption, with the cash distribution constituting an advance against the later surrender of shares.

In *Tabery v. Commissioner*,[44] the court held that a redemption occurred in the year both parties intended the redemption to occur and so treated it on their records. The sole shareholder did not physically surrender his shares, which remained in a vault on the company's premises. The corporation made entries on its books discharging the shareholder's debt due the corporation. Both parties' tax returns for the year in issue reported a redemption as having occurred. The court indicated that for federal tax purposes it was not bound by state corporate law governing transfers of stock.

If a shareholder surrenders part or all of the shareholder's stock in return for an agreement to receive the redemption price in future installments, the redemption "occurs" at the time the stock is surrendered to the corporation, and it is at this time that the redemption is tested under §302. Later corporate distributions that are part of the installment payments, but are unaccompanied by a surrender of stock, are treated in accordance with the previously determined tax treatment of the redemption.

In *Mathis Est. v. Commissioner*,[45] the shareholder placed his stock in escrow for surrender when he received the final payment under an installment redemption. The IRS argued that the "redemption" occurred only when the final payment was made because at that time the stock was released to the corporation. Before that time, the IRS contended that the corporation had only an "option" to purchase the stock (there being no express penalty if the corporation decided not to make the final payment) and all interim distributions were thus ordinary dividends. The court rejected this argument, however, and held that all payments were part of the redemption price governed by §302. The court stated:

> The fact that title to the preferred stock did not pass upon execution of the purchase agreement does not preclude the existence of a binding redemption contract. . . . The absence of penalty provisions would not eliminate a cause of action for breach of contract upon nonperformance by either party. The decedent's estate could not have kept the payments made under the agreement and refused to convey the stock when the final payment was tendered.

For the question of whether a redemption, once accomplished, can be reversed or rescinded during the same taxable year, see II.A.7., below. For a further discussion of problems relating to redemptions accomplished in installments, see III.A.1.d., below.

2. "Sale" vs. "Redemption"

The term "sale" is sometimes used informally to describe a redemption transaction from the shareholder's viewpoint. Section 1001(c) provides that the amount of gain or loss realized is recognized, subject to exceptions for specially designated transactions described and dealt with elsewhere in the Code. Stock based transactions are among the types of transactions that are often subject to special treatment outside of §1001(c). In certain instances the special treatment may ultimately result in gain recognition Accordingly, although a corporation can sell property to a shareholder (in exchange for some or all of the shareholder's stock) for purposes of corporate recognition of gain (but not loss),[46] and although before 1954 some courts allowed a shareholder to "sell" stock to the corporation without having to satisfy redemption criteria,[47] if a shareholder surrenders stock for property within the meaning of §317(a), the exchange must be tested as a redemption under §302 unless a different Code provision applies more specifically to the exchange, or unless the transaction is vulnerable to some different treatment on substance-over-form grounds.

If, after testing a redemption under §302, the transaction qualifies for exchange treatment, the shareholder's gain or loss is recognized under §1001(c). But a redemption cannot qualify

[43] 46 T.C. 65 (1966), aff'd and rem'd on other grounds, 383 F.2d 883 (8th Cir. 1967).

[44] 354 F.2d 422 (9th Cir. 1965), aff'g T.C. Memo 1964-189. *See also Barton Theatre Co. v. Commissioner*, T.C. Memo 1980-128 (1980), aff'd, 701 F.2d 126 (10th Cir. 1983); *Bette v. Commissioner*, T.C. Memo 1977-404.

[45] 47 T.C. 248 (1966), *acq.*, 1967-1 C.B. 2.

[46] For a discussion of §311, see III.A.2., below. See also, 564 T.M., *Related Party Transactions*, for additional restrictions on loss limits for transactions between related taxpayers.

[47] *See, e.g., Trust Co. of Georgia v. United States*, 60 F. Supp. 470 (Ct. Cl. 1945); *Smith v. Commissioner*, 38 B.T.A. 317 (1938), *acq.*, 1939-2 C.B. 34.

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for exchange treatment directly under §1001 without first running the §302 gauntlet.

The terms "purchase," "repurchase" and "buy-back" are frequently used outside the tax law to describe a transaction in which a corporation, for consideration, reacquires its own outstanding stock. For corporate law purposes, the term "purchase" includes, but is broader than, the concept of "redemption." "Redemption" is used in corporate law somewhat technically to refer to a repurchase of shares by a corporation pursuant to a "call" provision built into the terms of the stock. This situation usually arises in the case of preferred stock or distinct classes of stock issued in special circumstances.[48]

Apart from callable stock, corporate law generally uses the terms "purchase" and "repurchase" to refer to the variety of situations where the issuing company reacquires its own stock for consideration: acquisitions pursuant to a pre-existing "buy-sell" agreement among the various shareholders and the corporation under which the corporation may, or is obligated to, redeem stock on the death of an owner; purchases in the open market, in the case of a company whose stock is publicly traded; and purchases made in private face-to-face negotiation in the case of an isolated agreement where one or more shareholders desire to, or are willing to, reduce their ownership interest in the corporation.

For tax purposes, the term "redemption" covers all of the above situations regardless of corporate law, fiduciary law or securities law, provided the corporation distributes "property" in payment for its own stock. "Redemptions" of redeemable stock and "purchases" of stock are governed by §302 whether or not the acquisition occurs pursuant to a prior agreement, is voluntary or involuntary on the part of either the shareholder or the corporation, or whether or not the shares redeemed are cancelled or held as treasury stock.[49]

Observation: The term "repurchase" often refers to a publicly held company's acquisition of its own stock in the open market or by a formal exchange offer. When such transactions occur over a stock exchange, the corporation does not know the identity of the seller, nor does the seller know that stock is, in fact, being redeemed. Nevertheless, in theory, if not always in actual practice, §302 applies to such transactions. The IRS apparently adopts a rule of reason with respect to periodic, open-market repurchases, and such transactions can safely be reported as sales under §1001, in the absence of specific knowledge by the seller that shares have been sold to the corporation.

3. *Termination of Proprietary Interest of Redeemed Shares*

For a redemption to occur, the shareholder's equity interest represented by the surrendered shares, whether the shares represent all or a portion of the shareholder's stock, must be entirely terminated. The courts have generally expressed this requirement in terms of parting with "beneficial ownership" of the redeemed shares, and this concept is used throughout the tax law in determining tax ownership. The Tax Court has held:

> [A] sale for tax purposes, and consequently a redemption herein, occurs upon a passing of sufficient incidents of beneficial ownership rather than technical requirements for the passage of legal title under state law.[50]

A number of specific factors bear on this determination. Termination of interest in redeemed stock is a requirement that is basic to all redemptions, whether or not they qualify for exchange treatment under any specific category of §302(b).[51]

Observation: This "termination of interest" requirement is broader than the specific requirements of §302(b)(3), and applies to all redemptions. Section 302(b)(3) authorizes exchange treatment if all of a shareholder's stock in the corporation is redeemed. The general "termination of proprietary interest" is a threshold test that applies to each share that is redeemed. Under this requirement, a shareholder must terminate the shareholder's equity interest in the corporation to the extent such equity is represented by the shares redeemed, even though the shareholder may continue to own an equity interest through other shares that are not redeemed (and continue to be owned by the shareholder).

a. *The Lisle Case*

In *Lisle v. Commissioner*,[52] a closely held corporation in the funeral home business purported to redeem all the shares owned by its two principal shareholders, the brothers Joel and Claude Lisle, under agreements providing for down payments and deferred installments payable over 20 years. The shareholders remained as directors of the corporation, and their shares were placed in escrow to secure the corporation's obligation to make future payments. The IRS argued that neither shareholder transferred enough of his proprietary interest in the redeemed shares to qualify the transfers as redemptions and treated each corporate payment as a dividend distribution. The Tax Court held, however, that redemptions had occurred. Each payment, therefore, qualified for exchange treatment by application of §302(b)(3).

The facts in the *Lisle* case seemed at least somewhat supportive of the IRS's position. Joel Lisle's agreement was secured by the shares being redeemed, by the corporation's real estate, and by insurance policies on the lives of other principal shareholders. Joel Lisle deposited the redeemed shares with a third-party pledgeholder, but did not endorse them. Joel Lisle remained entitled to vote all of the pledged shares (and not just those for which payment had not been made) until the full installment price had been paid. If the corporation declared dividends on any of the pledged shares, the dividend amount was to be applied to the redemption price. In case of default, Joel Lisle could also vote the stock owned by two other principal shareholders. Also, in case of default, or if Joel Lisle at any time considered any of the collateral insufficient because of a decline in market value, he could "in his discretion" sell any or all of the

[48] For example, so-called "alphabet" or "tracking" stock, which is common stock that tracks the value of a separate division or subsidiary, often contains provisions authorizing or requiring a redemption of that class of stock in certain circumstances.

[49] For a discussion of whether the tax rules governing redemptions apply even where the corporate law places restrictions on redemptions, see I.E., above.

[50] *Lisle v. Commissioner*, T.C. Memo 1976-140.

[51] Where no redemption has taken place, due to a failure to terminate proprietary interest, §301 automatically would apply to the distribution.

[52] T.C. Memo 1976-140.

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collateral at public or private sale (and could himself become a purchaser).

Joel Lisle could and did remain an officer and director of the funeral home for eight years after the "redemption." In addition, the corporation paid his country club dues for five years, made living quarters available to him for when he was in town to assist in business, and on one occasion guaranteed a loan to him by a third party.

The IRS felt that none of the shares had been validly redeemed because:

(1) the corporation lacked a specific, firm and fixed plan to terminate either brother's interest in his shares;

(2) the shares were not endorsed by the shareholders;

(3) the shareholders retained the right to vote all the shares until the last installment was paid;

(4) the long installment payment period indicated no termination of interest in the equity represented by the redeemed shares;

(5) dividends during the payout period would have been paid to the brothers as record owners of the "redeemed" shares;

(6) each brother continued to participate in management as an officer and director;

(7) Joel Lisle could sell the collateral even without a default; and

(8) each brother had "continued access to corporate benefits."

The Tax Court, in a memorandum opinion, rejected each of these attacks. First, the language of the redemption agreement referred to a purchase of "all" of each shareholder's stock. The lack of endorsement was not a controlling factor. "Whether shares of stock are transferred to the purchaser and assigned to the escrow holder, endorsed in blank by the seller and transferred to the escrow holder or merely transferred to the escrow holder," the court said, "is immaterial when the purpose of the escrow, as here, is to provide security for deferred payments and the shares are in the possession of the pledgeholder."

The court observed that the right to vote as such bears less on beneficial ownership of an equity interest than does "the opportunity for effective exercise and the ability to affect decision making." The retained voting rights here served chiefly as additional security for the company's payments (although the court acknowledged that the remaining shareholders wanted Joel Lisle to retain voting rights in order to "counter" Claude's possible influence over the funeral home's management). Although both brothers remained as officers and directors for several years after the redemption, the court concluded they held these positions in name only and did not in fact "appreciably" influence corporate decisions. The court concluded that Joel Lisle's right to sell the security related chiefly to the adequacy of the security but did not detract from the substance of a sale. The length of the installment period raised the possibility of using a long-payout redemption as a way to substitute deductible interest for nondeductible dividends, but the court found no evidence that such a plan existed here (and the IRS conceded that the notes represented bona fide debt). The court added:

> The length of the payout period, of itself, in the peculiar facts of this case, does not cause the redemption to fail. That is not to say that a payout of 20 years, together with other factors not present here, might indicate that the arrangement did not constitute a complete termination of a shareholder's interest in the corporation.

The court also held that the fact that dividends would have been paid to the Lisle brothers as record owners of the redeemed shares was not controlling in deciding whether a completed sale had occurred, because dividends were to be credited against the redemption price of the stock (rather than being paid in addition to the redemption price). The court appeared to accept the principle that continued access to corporate benefits should be considered in determining whether a valid redemption has occurred. In this case, however, the court found the facts unpersuasive. The court viewed the interest-free loans to Joel Lisle, the company's guarantee of a bank loan to him, the providing of lodging, and company payment of his country club dues as items bargained for in the original redemption. The company's loan guarantee was found immaterial because the former shareholder could as easily have assigned his rights under the redemption agreement as security to the lending bank.

b. Other Cases and Rulings

In *Hoffman v. Commissioner*,[53] the Tax Court held that a shareholder, who held her redeemed stock as security until the corporation made final payment on an installment note, was a creditor and no longer a shareholder for Subchapter S purposes. Apparently, unless the corporation defaulted in its payments, the distributee could not vote the shares held in escrow. The court said that parting with beneficial ownership, rather than naked legal title, determines whether the distributee remains a shareholder.

In *Turner Constr. Co. v. United States*,[54] the court denied a shareholder's claimed capital loss on a purported redemption. The shareholder had exchanged shares in the corporation for a corporate note. The face amount of the note was based on the maximum estimated value of the shares in light of expected losses. The amount of the note would be reduced if the loss was larger than the estimate. The shareholder remained liable to pay additional money into the corporation if needed. In these circumstances, the court stressed that the shareholder had given up only his "management rights" in the business. As his investment could not be worth more than the amount of the note, while he bore the risk of additional loss, he had not terminated his "financial" stake in the business.

Note: Depending on the terms under which stock was issued, a shareholder may cease to have "shareholder rights" before the shareholder actually surrenders stock. For example, rights as a preferred shareholder may terminate at the point the stock is called for redemption, so that thereafter the holder possesses only the right to payment for the shares. Termination

[53] 47 T.C. 218 (1966), aff'd per curiam, 391 F.2d 930 (5th Cir. 1968).
[54] 364 F.2d 525 (2d Cir. 1966), aff'g 270 F. Supp. 918 (S.D.N.Y. 1964).

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of "shareholder rights" can be significant in determining that stock is no longer outstanding for other tax purposes.[55]

The question of whether a shareholder has terminated the shareholder's proprietary interest in stock arises also when a shareholder waives family attribution in connection with a complete termination of interest under §302(b)(3). Under the rules in §302(c)(2), a redeemed shareholder may not hold or retain any interest in the corporation for 10 years, except an interest as a creditor. As discussed later in more detail, the statute and regulations generally prohibit the shareholder from holding any "proprietary" interest in the redeeming corporation during this period. The IRS has litigated with taxpayers over whether, in specific circumstances, a former shareholder upon receiving an installment note from the corporation in payment for the repurchased shares has become solely a "creditor" or, by reason of specific rights, holds a proprietary interest. In *Dunn v. Commissioner*,[56] the court made a detailed inquiry into the specific rights of a former shareholder to decide whether her interest was debt or equity. The court held that the redeemed shareholder's interest in installment payments was a creditor's interest satisfying Reg. §1.302-4(d).

Cases and rulings that distinguish between debt and equity for purposes of waiving family attribution under §302(b) are also relevant generally to the issue of proprietary interest under §302(b), including attempts to qualify a redemption under §302(b)(3) where, on the particular facts, family attribution is not involved. For further discussion of the role of debt-equity distinctions, see IV.B.2., below.

4. *Repurchase of Option Stock*

Under some employee stock option plans, the company reserves a right to repurchase shares if an employee dies, retires, ceases to be employed by the company, or desires to sell shares to a third party.[57]

a. *Qualified Stock Options*

The Tax Reform Act of 1976 generally terminated the granting of qualified stock options after May 20, 1976 (by amending former §422(b)). The discussion below is pertinent, however, for any taxable year in which qualified stock options may be granted or exercised.[58]

If an employee sells stock that was acquired by exercising qualified stock options (qualified option stock) back to the issuing company before satisfying the three-year holding period, the rules governing disqualifying dispositions, which treat part of the proceeds as compensation income, apparently partly override §302.[59]

Even if the redemption is essentially equivalent to a dividend, qualified option stock would still be "disposed of" for stock option purposes.[60] Part of the distribution would therefore be ordinary compensation income regardless of the company's earnings and profits.

If an employee sells qualified option stock back to the issuing company after satisfying the three-year holding period, the usual redemption rules of §302 test the transaction. None of the proceeds is considered compensation income. The entire redemption price will receive either exchange treatment or §301 treatment via §302(d).

Note: Several courts have held that, if an employee was allowed to buy stock in his employer for notes that would be discharged out of the proceeds of a repurchase by the company if and when the employee terminated his employment, the employee "could not lose" and the entire repurchase proceeds constituted compensation income to the employee.[61] For a discussion of these cases, see X.A., below.

b. *Restricted Stock or Other Property: Section 83*

When either an employee purchases stock in his corporate employer pursuant to a nonstatutory option or the employer grants him such stock outright, and when in either situation the purchase renders §83 (relating to restricted property) applicable, the circumstances in which §302 does and does not govern a later retransfer of such stock to the employer are not completely clear. The possible application of §302 may arise, for example, if the employer requires the employee to return the stock (with or without receiving a payment therefor) upon resignation within a stated period of years; or if the employer reserves a "right of first refusal" to repurchase the stock if and when the employee desires to dispose of it. For a discussion of the overlap of §83 and §302, see 383 T.M., *Nonstatutory Stock Options*, and 384 T.M., *Restricted Property — Section 83.*

If a shareholder (usually the controlling owner) of the employer corporation transfers stock to a key employee as compensation for services to the corporation, the transaction is recast by Reg. §1.83-6(d) as if the shareholder — whether an individual or a corporation — contributed the stock to the capital of the corporation, which, in turn, transferred it to the employee. The purpose of this rule is to ensure that the employer gets a §162 deduction for the compensation payment. If the employee also pays some money to the shareholder from whom he actually received the stock, the money (or other property) "shall be considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which §302 applies."[62]

Comment: In the context of the preceding sentence, the word "applies" is ambiguous. It is unclear whether it means that the redemption will always be accorded exchange treatment, or instead that the deemed redemption must run the gauntlet of the specific tests under §302.

5. *Conversion of Convertible Preferred Stock*

In Rev. Rul. 69-265, the IRS held that "conversion" of convertible preferred stock into stock of the parent of the issu-

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[55] *See, e.g.,* Rev. Rul. 68-285, Rev. Rul. 55-440 (redemption of dissenters does not invalidate "B" reorganization, even where redemption occurs after the stock swap has occurred, because dissenter's rights as shareholders were terminated upon the transaction).

[56] 615 F.2d 578 (2d Cir. 1980), aff'g 70 T.C. 715 (1978).

[57] *See, e.g., Spitzer v. Commissioner*, 153 F.2d 967 (8th Cir. 1946); *Kuchman v. Commissioner*, 18 T.C. 154, 159 (1952), *acq.*, 1952-2 C.B. 2.

[58] For a full discussion of the rules relating to options, see 381 T.M., *Statutory Stock Options.*

[59] Rev. Rul. 71-114. *See also Brown v. United States*, 427 F.2d 57 (9th Cir. 1970); *Rank v. United States*, 345 F.2d 337 (5th Cir. 1965).

[60] Reg. §1.425-1(e)(1).

[61] *National Clothing Co. of Rochester, Inc. v. Commissioner*, 23 T.C. 944, 949 (1955), *acq.*, 1956-1 C.B. 5; *Mart's Inc. v. Commissioner*, 19 T.C.M. 669 (1960). *See also Aylesworth Est. v. Commissioner*, 24 T.C. 135 (1955).

[62] Reg. §1.83-6(d)(1).

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ing company constitutes a redemption of the convertible stock where the issuing company owns stock of the parent and distributes such stock upon conversion. So viewed, the conversion, tested under §302, is a taxable event to the shareholder. While such transactions are sometimes referred to as "conversions," they are, in fact, exchanges.

The conversion of convertible preferred stock into common stock of the issuing company is not a redemption as defined in §317(b) because the issuing company's common stock does not constitute property under §317(a). Rather, the conversion of preferred stock into common stock of the same corporation is a recapitalization under §368(a)(1)(E) and is tax free to both the shareholders and the corporation.

6. *Dealings with Shareholder in Nonshareholder Capacity*

a. *In General*

In the past, if a corporation "sold" property to a shareholder in exchange for the corporation's own stock, the shareholder would sometimes be treated as any other buyer of property, such that §302 was not applied. Likewise, if there was a corporate damage claim against a shareholder and that shareholder satisfied, or "settled," the claim by surrendering stock in the corporation, the shareholder sometimes argued that §302 should not apply. Former Reg. §1.311-1(e), which was removed as obsolete in 1993, indicated that certain distributions of property for stock were not redemptions — where the distribution was made to the shareholder outside the corporate/shareholder relationship.

Comment: Given the removal of former Reg. §1.311-1(e), the better answer appears to be that all such transactions should be treated as redemptions governed by §302, even though some of them (such as surrender of shares to settle a damage suit brought by the corporation) may not be governed by §311.

Note: A shareholder who is indebted to the corporation frequently arranges to pay the debt by having stock redeemed and the proceeds applied to discharge the debt. From the shareholder's viewpoint, this type of transaction is treated as a redemption tested under §302.[63]

b. *Cross-Redemptions*

In some situations, two corporations, each owning a stock interest in the other, seek to unwind their cross-ownership. The corporations might disentangle their ownership through a mutual exchange of the stock that each corporation owns in the other.[64] This type of transaction raises difficult conceptual questions under §302 and §311. First, each corporation could be viewed as functioning solely in its capacity as a shareholder in the other and surrendering shares for redemption. Alternatively, each corporation could be viewed as making a distribution in redemption of its own stock held by the other on which it realizes no loss via §311(a) but only gain under §311(b). A third possibility is to treat one of the corporations for all purposes as the distributing company and the other as the shareholder whose stock is redeemed.

Under the first approach, there is no distributing corporation to which §311 applies because each "distributing" corporation is itself a shareholder surrendering shares for redemption. Under the second approach, if §311(a) is to prohibit recognition of loss, and if §311(b) is to require recognition of gain by both corporations, there must be a distribution in "redemption" of the distributing corporation's own stock. Yet if each corporation is viewed as a distributing corporation, neither is a shareholder surrendering its stock in the other for redemption.

In Rev. Rul. 79-314, the IRS announced a position on cross redemptions.[65] The IRS stated that each corporation was viewed as a distributing company and was therefore tested under §311. On the particular facts considered, the IRS found that the exception to gain recognition contained in pre-TRA 1986 §311(d)(2)(A) applied so that neither corporation recognized gain or loss to the extent stock was exchanged for stock. One of the corporations also made a cash payment, which the ruling treats solely as a redemption.[66]

A similar problem arises if two corporations own stock in each other and if one corporation receives back its own stock as part of a distribution in complete liquidation of the other corporation. At least two cases have held that the recipient received its own stock in the capacity of a shareholder. Therefore, it must recognize gain or loss under the predecessor of §331 on the assets received, including its own stock.[67]

By using a "May Department Stores" type transaction, a corporation could formerly use a partnership to eliminate gain on distribution of appreciated property. A partnership (P) with a corporate partner (C) would acquire C stock from, for example, a large C shareholder, (S). C would then contribute appreciated assets to P. The partnership rules worked to allow an avoidance of §311(b) gain. Under those rules, a distribution of the appreciated property to S permitted S to receive those assets with a substituted basis. Further, C received its own shares with a substituted basis (thus, preserving the gain in the appreciated assets C contributed to P). However, under §1032, C did not recognize gain when it issued its own stock. Thus, the gain was eliminated. This was the "May Department Stores" transaction.[68]

The IRS has eliminated this end-run around §311(b). First, the IRS issued Notice 89-37, in which it stated it would use its regulatory authority under §337(d) to trigger appropriate gains. The resulting regulations generally require gain to be recognized upon a corporate partner's contribution of appreciated as-

[63] *See, e.g., Tabery v. Commissioner*, 354 F.2d 422 (9th Cir. 1965); *Bradbury v. Commissioner*, 298 F.2d 111 (1st Cir. 1962).

[64] For an example in a nontax (securities) context of a cross-redemption, see *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964) (National Airlines exchanged with Pan American World Airways all of National's stock holdings in Pan Am for part of Pan Am's stock holdings in National).

[65] *Obsoleted by* Rev. Rul. 2003-99. Rev. Rul. 79-314 was obsoleted in part by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 (TEFRA). The pre-TEFRA exception to §311(d), for complete redemptions under §302(b)(3), was repealed by §223 of TEFRA). *See also* PLR 8108097 (applying Rev. Rul. 79-314); GCM 33634 (Sept. 22, 1967).

[66] *See* Rev. Rul. 80-101 (discussing overlap between §302 and §311 in context of complete liquidation otherwise taxable to shareholder under §331), *obsoleted by* Rev. Rul. 2003-99.

[67] *Walville Lumber Co. v. Commissioner*, 35 F.2d 445 (9th Cir. 1929); *Union Trust Co. of N.J. v. Commissioner*, 12 B.T.A. 688 (1928).

[68] For a discussion of this transaction, see Canellos, *Acquisition of Issues Security by a Controlled Entity: Peter Pan Seafoods, May Department Stores, and McDermott*, 45 Tax Law. 1 (1991), *but see* Allyson Versprille, *IRS Issues Final 'May Co.' Partnership Rules; Changes May Follow*, 111 DTR 4 (June 7, 2018).

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sets to a partnership that owns or acquires stock of the corporate partner (as defined in Reg. §1.337(d)-3(c)(2)), and in certain circumstances, again upon the distribution of such stock to the corporate partner[69]

7. *Rescission Transactions*

a. *Annulling a Prior Tax-Free Reorganization*

Rescission transactions involve unwinding of a prior tax-free acquisition by returning some or all of the acquired stock or assets to its original owners in exchange for part or all of the consideration which they received in the acquisition. The question is whether unwinding the earlier steps has independent tax effects or whether the unwind should be treated as simply a nontaxable "annulment" of the earlier transaction. Among the possibilities in this connection is the applicability of §302 to the "unwinding" transaction.[70]

Comment: Unless the rescission is complete and takes place within the same tax year as the reorganization, §302 would seem to apply.[71]

Note: Rev. Proc. 2025-3[72] provides that no rulings will be issued on whether a completed transaction can be rescinded.

b. *Return of Contingent Stock Issued in a Tax-Free Reorganization*

In a "contingent stock" reorganization, a portion of the stock of the acquiring company is held in escrow until: (1) either or both companies attain a specified future earnings level for either or both companies; (2) the outcome of a warranty or guarantee by the acquired company; or (3) the existence or nonexistence of contingent liabilities. Frequently, the escrow agreement provides that all or part of the escrowed shares will be returned to the acquiring company after a specified time if profits have not reached the desired levels, or as a means of satisfying a breach of warranty claim by the acquiring company. In the interim, the shareholders of the acquired company may own beneficially the escrowed shares, voting the shares and receiving any dividends.[73] If and when a return of shares occurs, several interesting tax questions arise. Under one approach, the return of shares could produce realization of gain or loss by the shareholders of the acquired corporation. Alternatively, the return could be viewed as a nontaxable adjustment of the original exchange. If so, the basis of the returned shares must be accounted for. Finally, it must be determined whether the return has any adverse effect on the tax-free treatment of the initial reorganization.

While such transactions generally should be treated only as an adjustment to the purchase price in the original transaction, in some situations the IRS has said that a transaction of this type can also be a redemption. If treated as a redemption, the tax treatment must be tested under the usual rules of §302. Close attention must be paid to the details of the escrow arrangement because (at least as spelled out so far in rulings issued by the IRS) the specific terms of the escrow, especially with respect to whether the shareholder has received any benefit or detriment from changes in value of the escrowed shares, may determine just how the return transaction is treated for tax purposes.[74]

c. *Reversing a Redemption*

It is questionable whether a redemption of stock may be rescinded without tax effects later in the same taxable year. The Court of Claims denied a shareholder's attempt to reverse a redemption that he learned, after surrendering shares and receiving a distribution, would be considered essentially equivalent to a dividend. On July 31, the 99% shareholder surrendered part of his shares for a combination of cash and certain investment assets. Later in the same year, the shareholder's accountant decided that under the tax rules dividend treatment would result. In order "to reverse the unfavorable tax effect of what was done on July 31," the corporation on September 15 returned the redeemed shares and the shareholder issued to the company his interest-bearing note for the cash plus the fair market value of the assets he had received. The shareholder claimed that he did not return the assets in kind because the corporation's bonding company had indicated that it would not accept one of the investment assets that had been distributed to the shareholder. The Court of Claims held that the redemption stood for tax purposes, and would not be viewed as, in net effect, a sale of corporate assets to the shareholder for a note. The court relied on the fact that complete rescission had not occurred, and that the reason for the reversal was to obtain better tax treatment rather than any bona fide business objective.[75]

Comment: Though the overarching purpose for the partial rescission was to garner a tax benefit, perhaps if the taxpayer had returned the assets and regained his shares, and done nothing else until the next tax year to permit economic effect to the return of stock and assets, the court would have come to a different result.[76] By returning the assets with rescinded shares, the

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[69] Reg. §1.337(d)-3; T.D. 9833, 83 Fed. Reg. 26,580 (June 8, 2018), applicable to transactions occurring on or after June 12, 2015. Prop. Reg. §1.337(d)-3(c)(2), REG-135671-17, 84 Fed. Reg. 11,005 (Mar. 25, 2019), would modify the definition of stock of the corporate partner. Taxpayers are permitted to rely on the proposed regulations for transactions occurring on or after June 12, 2015 provided that the taxpayer consistently applies the proposed regulations to all such transactions. For further discussion of this topic, see 784 T.M., *Corporate Liquidations*.

[70] For an example of a public transaction raising these issues, see Prospectus, Rescission Offer to Certain Former Holders of Common Stock of Piper Aircraft Corporation by Bangor Punta Corporation (March 17, 1976).

[71] *Cf.*, Rev. Rul. 78-142 (rescission rights that were an inherent feature of stock issued in a tax-free reorganization do not constitute other property). *See also* PLR 200911004 (rescission of merger, due to adverse tax effects, resulted in treatment of entities as separate corporations); PLR 200908016 (because amalgamation and rescission took place in same year, foreign subsidiary will be treated as not having amalgamated into newly formed corporation; foreign subsidiary and corporation will be treated as two separate corporations at all times during taxable year).

[72] *See* Rev. Proc. 2025-3, §3.02(8).

[73] *See, e.g.,* PLR 200515012 (acquired corporation's transfer to escrow account of new acquiring shares, subsequent transfer of escrow rights to "liquidating trust," and distribution of beneficial interests in liquidating trust to acquired corporation's shareholders, did not invalidate "C" reorganization).

[74] *See* Rev. Rul. 78-376 (gain or loss recognized, because number of shares redeemed to satisfy obligation was based upon fair market value of shares on date of release); Rev. Rul. 76-334 (no gain or loss recognized where number of shares released was not measured by value on release date; basis allocated to remaining shares); Rev. Rul. 76-42 (same); Rev. Proc. 76-26.

[75] *Blanco v. United States*, 602 F.2d 324 (Ct. Cl. 1979).

[76] *See* Rev. Rul. 80-58 (complete rescission of sale of land within same tax year held effective to neutralize tax effects of the sale); PLR 201008033 (sale treated as redemption under §304(a)(1) disregarded where transfer of interests between members of consolidated return group was rescinded and then under-

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assets would have been held by a taxpayer with a different legal profile and would have been exposed to theoretical trade creditors, employees, and others who conduct business with the company. As such, the legal and underlying economic consequences would have been more substantive.

8. Reduction in Par Value of Stock

A reduction by a corporation in the par value of its outstanding stock, accompanied by a reduction in stated capital and creation of paid-in surplus, is not a redemption. Ordinarily, the total number of outstanding shares will remain unchanged. The corporation may, however, issue new stock certificates evidencing the new par value in exchange for the old certificates. The transaction by which par value is reduced is treated as a tax-free recapitalization of the corporation.[77] If the corporation makes a distribution of cash or other property, concurrently with a reduction in par value, however, the IRS apparently treats the distribution as taxable under §301 entirely apart from §302.[78]

In *Moloney v. United States*,[79] a corporation recorded a stock redemption on its books to correct an error that had been made two years earlier when the corporation was created and the stated value of the stock had been recorded as $50,000. The taxpayers, a husband and wife, had intended when they incorporated part of the business of their partnership, to have capital of only $5,000 and 100 issued shares of common stock divided equally between themselves (but held by the partnership). When the "mistake" (as the court found) was discovered, entries were made in the corporate records and in those of the partnership reflecting a "redemption" of 90 shares of stock and reducing capital from $50,000 to $5,000. In fact, no stock certificates were ever actually issued and no actual distribution was made to the partnership or to the taxpayers directly in connection with the correcting entries. The IRS claimed that the "redemption" was a taxable event for the taxpayers, as it was essentially equivalent to a dividend, and therefore resulted in $45,000 ordinary income to them. The court held, however, that in these circumstances the transaction "resulted in neither gain nor loss to anybody." No money was actually distributed either in a redemption or as an ordinary §301 distribution.

The Sixth Circuit reversed the district court, however, and held that the reduction in the stated value of the capital stock from $50,000 to $5,000 did represent a redemption distribution of $45,000 to the two equal shareholders and, as such was essentially equivalent to a dividend.[80] The appeals court determined that the corporation's opening balance sheet showed that it had begun business with inventory and capital assets whose undisputed book value exceeded $50,000. The court concluded that no mistake had been made in setting up an initial $50,000 capital account. The Sixth Circuit also determined that $45,000 was distributed by the corporation through a reduction of $45,000 of a debt owed to the corporation by a partnership through which the two shareholders conducted sales activities for the corporation. Under well-established principles, a corporation's cancellation of a debt owed to it by a shareholder involves a constructive distribution of money or other property to the shareholder.[81] When the transaction was tested as a redemption, the appeals court found that the distribution was pro rata to the two equal shareholders. It also said that the alleged subjective motive to correct a clerical error, and the embarrassment with creditors that would have occurred if the "error" had been corrected earlier, were immaterial in any event in light of the Supreme Court's rejection of business purpose in *United States v. Davis*.[82]

B. Exchange

1. In General

A redemption cannot occur in the absence of an exchange of shares for cash or other kinds of property.[83] However, not all literal exchanges of stock for property qualify for "exchange" treatment as that term is used for capital gain or loss purposes. Moreover, not all payments made in connection with a redemption are necessarily made in "exchange" for stock. The shareholder might provide other consideration as well (e.g., services).

Comment: To determine the extent of an exchange, the authors recommend that all the elements of the economic transaction be identified with a value assigned to the exchange portion, with the most supportable valuation being an independent appraisal.

An exchange does not necessarily require the consent of the shareholder. A redemption tested under §302 will occur even if the shareholder's surrender of stock is involuntary rather than voluntary, e.g., pursuant to court order or pursuant to a restriction imposed by the company on the particular stock.[84] A redemption tested under §302 occurs where stock is repurchased by the issuing company from the estate of a deceased shareholder. This may occur pursuant to the provisions of a buy-sell agreement executed by the owners of a close corporation during their lives, specifying that when one owner dies the corporation has an option (or an obligation) to redeem the decedent's stock from the estate. Likewise, a redemption tested under §302 occurs where, under state corporation law, a corpo-

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taken again following conversion of one sub from corporate form to limited liability company); PLR 200915031 (proposed actions of consolidated group parent to rescind issuance of excess shares between foreign subsidiaries and restore parties to original positions would neutralize tax effects of issuance); PLR 200752025 (rescission of issuance of preferred stock to U.S. parent in amalgamation of its foreign subsidiaries within same tax year ruled effective to neutralize tax effects of issuance).

[77] *See* GCM 8175, IX-2 C.B. 134 (1930), *obsoleted by* Rev. Rul. 68-674; *Sheehan v. Dana*, 163 F.2d 316 (8th Cir. 1947); *Avco Mfg. Corp. v. Commissioner*, 25 T.C. 975, 997 (1956); *see also* PLR 7809062.

[78] GCM 8175.

[79] 375 F. Supp. 737 (N.D. Ohio 1974), rev'd, 521 F.2d 491 (6th Cir. 1975).

[80] *Moloney v. United States*, 521 F.2d 491 (6th Cir. 1975), cert. denied, 423 U.S. 1017 (1975).

[81] *See, e.g., Shephard v. Commissioner*, 340 F.2d 27 (6th Cir. 1965), cert. denied, 382 U.S. 813 (1965); *Haber v. Commissioner*, 52 T.C. 255, 262 (1969), aff'd, 422 F.2d 198 (5th Cir. 1970).

[82] 397 U.S. 301 (1970), rev'g 408 F.2d 1139 (6th Cir. 1969). The *Davis* case is discussed at VI.C.1., below, in connection with §302(b)(1).

[83] §317(b). *See* CCA 201247010 (lowering of number of common parent class X shares into which common parent class Y shares convert to account for contingent liabilities of common parent class Y shareholders, does not constitute actual, constructive, or deemed redemption of class Y shares; common parent did not acquire class Y shares from shareholders for property as required by §317(b)).

[84] *See* Rev. Rul. 69-550, Rev. Rul. 55-717. Note that in certain partial liquidations, it is unnecessary to actually redeem shares. See VII.B.2., below.

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ration is required to purchase the stock of shareholders who dissent from a merger into another company and where the state statute provides that dissenters automatically lose their stock ownership upon filing their dissent.[85]

2. Special Cases

a. Theft of Corporate Assets

If property distributed in a purported redemption of stock constitutes a theft of corporate assets, questions arise as to whether the transaction should be viewed as a redemption for tax purposes, or instead as ordinary income that is neither distribution proceeds nor exchange proceeds. Under *James v. United States*,[86] embezzled funds must be included in income in the year the embezzlement occurs. Some cases have held that monies illegally withdrawn from a corporation by a shareholder are governed by the corporate distribution rules of the Code, such as §301.[87] However, there is no clear authority on the tax treatment where corporate assets are withdrawn without permission in the form of a redemption of stock.[88]

In *Lunsford v. Commissioner*,[89] the Tax Court examined an attempt by a shareholder, who had wrongfully appropriated corporate funds for his personal use, to repay his "debt" to the company by surrendering part of his stock, after the shareholder was ordered in a bankruptcy proceeding involving the corporation, to repay in cash the monies appropriated. The IRS argued that the shareholder realized a gain on this stock surrender. Apparently, because the shareholder had been ordered to repay the money withdrawn, the Tax Court held that he realized no gain on surrendering his stock.[90]

b. Questions of Fact

Whether a specific amount of money or an item of property distributed to a shareholder is part of the redemption price paid by the corporation in exchange for stock, and hence part of the exchange tested under §302, is a question of fact. Merely because several items of property are transferred to a shareholder simultaneously with a redemption of part or all of the shareholder's stock does not necessarily mean that all such property will be treated as part of an exchange tested under §302. The property that will be treated as distributed in part or full payment for the stock largely depends on the parties' intentions. In these situations, the court will weigh all the facts, and, based the facts, allocate the total payment made by the corporation among the different elements to which the payment relates, only one of which may be payment for the value of the stock surrendered.

Note that the shareholder and the corporation may have adverse interests in how payments are characterized. For example, if the payment is determined to be an exchange for the stock and §302(a) is satisfied, the shareholder will recover basis and generally report any excess as capital gain. The corporation, however, will not be entitled to any deduction. If, on the other hand, the payment is allocated to something else, such as the shareholder's employment relationship with the corporation, the shareholder will realize ordinary income and the corporation generally will be entitled to a deduction.

Comment: The characterization of the transaction by the parties may, therefore, depend upon which party the IRS has brought to court. In many circumstances, the IRS will bring both parties to court to ensure its interests are protected.

(1) Life Insurance Policy

In *Wilkin v. Commissioner*,[91] the question was whether the cash surrender value of a life insurance policy on the officer-shareholder's life, which the corporation assigned to him during the six-year period it was redeeming all of his stock at a specified cash price, was part of the redemption price of the stock. The court found, on the facts, that the cash surrender value was not intended to be part payment for the stock. The court did not decide whether the distribution was taxable to the shareholder as a dividend or as compensation.

(2) Covenant Not to Compete

When an outgoing shareholder agrees not to compete with the corporation, it is important to consider whether the parties intended to allocate any portion of the total distribution to the covenant. If so, any portion so allocated will be taxable as ordinary income, independently of §301 and §302, and the corporation can amortize its payment.[92] If no allocation to the covenant is intended or appropriate, the entire distribution will be tested under §302 and the corporation will not be entitled to any deduction.

In *Sigman v. Commissioner*,[93] the IRS sought to allocate part of a redemption distribution to the distributee's five-year covenant not to compete with the corporation. On the facts, the court found that the parties intended no payment to be allocated to the covenant.[94] In *Annabelle Candy Co. v. Commissioner*,[95] a corporation was not allowed to amortize any part of its redemption distribution because the parties had not allocated any amount to the shareholder's covenant. In *Halbert v. Commissioner*,[96] the court held that the redemption payment was entirely allocable to payment for the stock. The redemption agreement made no allocation to the shareholder's covenant not to compete, but the court relied primarily on analysis of the par-

[85] *See* Rev. Rul. 73-102 (acquiror's assumption and payment of target's liability to dissenters is treated as boot constructively received and distributed by target); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970) (New York State Corporation Law).

[86] 366 U.S. 213 (1961).

[87] *See, e.g., DiZenzo v. Commissioner*, 348 F.2d 122 (2d Cir. 1965).

[88] *See* Gardner, *The Tax Consequences of Shareholder Diversions in Close Corporations*, 21 Tax L. Rev. 223, 242 (1966).

[89] 11 T.C.M. 554, 1952-169, rev'd on other grounds, 212 F.2d 878 (5th Cir. 1954).

[90] *See also Alper Est. v. Commissioner*, T.C. Memo 1961-316 (redemption gain taxable under claim of right concept even though FHA questioned propriety of distribution; FHA objections later settled).

[91] T.C. Memo 1969-130.

[92] Under §197, it is unclear whether any such payment must be amortized over 15 years, rather than over the term of the covenant. *See* §197(d)(1)(E).

[93] T.C. Memo 1972-256.

[94] *See also Zipp v. Commissioner*, 28 T.C. 314 (1957), aff'd per curiam, 259 F.2d 119 (6th Cir. 1958).

[95] 314 F.2d 1 (9th Cir. 1962), aff'g T.C. Memo 1961-170. *See also Colonial Eng'g Co. v. Commissioner*, T.C. Memo 1963-287.

[96] T.C. Memo 1978-88.

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ties' intent and the economic realities of all surrounding circumstances.[97]

(3) "Death Benefit"

In *Graybar Elec. Co., Inc. v. Commissioner*,[98] a "special death benefit" paid by a corporation, in addition to the price set forth under an employee stock purchase plan, to reacquire a deceased employee's stock from his estate was held part of the redemption price, and nondeductible by the corporation, rather than separately deductible as compensation for the decedent's past services. The "special death benefit" was payable over five post-redemption years and was measured by the dividends paid on a number of shares equal to the number redeemed.

(4) Employment and Consulting Agreements

It is not unusual for corporations to redeem the stock of departing employee/shareholders. If the employee had an employment contract with the corporation, some part of the distribution to the employee may be in settlement of a contract right. Alternatively, the corporation may enter into a new employment or consulting agreement with the former shareholder, in which case the question is whether distributions are in exchange for the former shareholder's stock or instead are pursuant to the new agreement.

In *Coca-Cola Co. v. Commissioner*,[99] and *S. Blechman & Sons, Inc. v. Commissioner*,[100] the courts held that because no part of a redemption distribution was allocable to a simultaneous termination of the shareholder's employment contract, no corporate §162 deduction was permitted. In *Scull v. Commissioner*,[101] the entire amount received by the shareholder was characterized as part of the redemption distribution (and no part of the consideration was deemed received for cancellation of his employment contract).

In *Lewis and Taylor, Inc. v. Commissioner*,[102] the court permitted a corporation and the executor of a deceased employee-shareholder to amend an existing buy-sell agreement to reallocate a $17,500 post-death payment by the corporation to the redemption of the stock ($10,000 held to be fair market value) and $7,500 to additional compensation for the decedent's past services. The corporation was thus allowed to deduct $7,500 as compensation. The IRS had argued that the entire payment was attributable to the redemption of stock, which the IRS estimated had a fair market value of $17,500.

Brush-Moore Newspapers, Inc. v. Commissioner,[103] involved a transaction in which President Warren G. Harding, while in office in 1923, contracted with two newspapermen to sell them all of his stock in the Harding Publishing Company, which published the Marion Star in Marion, Ohio. The negotiated purchase price was $600 per share. The sale contract with Harding attributed $263,000 to the stock and provided for a separate employment agreement under which the corporation would pay Harding $13,300 a year for 10 years for his services as "associate editor." After the agreement was executed, Harding died. His widow claimed that the corporation had to make the annual payments to her, arguing that the amounts specified were really intended as part of the agreed purchase price for the stock. The new owners of the business insisted that the payments in dispute were intended for personal services and were discharged by the President's death. The parties settled the dispute, however, by causing the corporation to assume all of the new owners' remaining obligations under the stock purchase agreement (including the obligation to pay the $263,000 purchase price), and agreeing to cause the corporation to pay $13,300 a year for 10 years to the President's widow or to her successor in interest. The tax issue concerned the corporation's deduction of its yearly payments. The court upheld the IRS's denial of the deduction on the grounds that the payments were part of the purchase (redemption) price of Harding's stock and, as such, were not deductible.

Note: The courts noted that the purchasers had agreed to guarantee and secure payment of the $13,300 for the full 10 years, and also that the contract provided that if Harding died during that period, the payments should be continued to his widow or to his estate. The courts cited testimony that the "salary" payments had been calculated by reference to the remaining $100,000 necessary to give Harding a total of $363,000 for his stock, representing $600 for each of his 605 shares. The remaining $33,000 of total purported "salary" (above the $100,000 which was to be paid in 10 equal annual installments of $10,000) was calculated as an interest element. The corporation claimed its deduction not as "salary" to Harding, but as a business expense in settlement of threatened litigation.

In *Royal Arrow Co. v. Commissioner*,[104] the court held that an agreement by the issuing corporation to retain the distributee shareholder as a consultant for six years at $25,000 a year was separate from the redemption price for his stock, because the corporation otherwise paid fair market value for the stock. It was immaterial that the consulting contract was part of a "package deal" to "induce" the shareholder to agree to the redemption, or that he would not have so agreed without the contract. The court held the corporation could deduct its payments under the contract. Presumably, the recipient was required to report the payments as compensation income.[105]

In *Carrington v. Commissioner*,[106] the former shareholder, not the corporation, was before the court. The Tax Court held, in favor of the IRS, that the parties intended that Carrington receive $75,000 in redemption (at current value) of all his stock and, separately, $8,000 a year for six years for continuing to

[97] *See also Emmer v. Commissioner*, T.C. Memo 1978-102 (sale of stock to new investor; simultaneous employment and consulting agreement between selling shareholder and corporation; company's payment under latter agreement held ordinary income to selling shareholder, not additional consideration for his stock).

[98] 29 T.C. 818 (1958), aff'd per curiam, 267 F.2d 403 (2d Cir.), cert. denied, 361 U.S. 822 (1959).

[99] 369 F.2d 913 (8th Cir. 1966), aff'g T.C. Memo 1965-285.

[100] 229 F.2d 925 (2d Cir. 1956), aff'g per curiam T.C. Memo 1954-152.

[101] T.C. Memo 1964-224.

[102] 447 F.2d 1074 (9th Cir. 1971).

[103] 95 F.2d 900 (6th Cir. 1938), aff'g 33 B.T.A. 362 (1935).

[104] T.C. Memo 1972-58.

[105] *Cf.*, *Bagley v. Commissioner*, 85 T.C. 663 (1985) (payment received in exchange for termination of a stock option treated as compensation for consultative services rather than as capital gain), aff'd, 806 F.2d 169 (8th Cir. 1986). *But see Twin City Dodge-Chrysler, Inc. v. United States*, 97-1 USTC ¶50,483 (W.D. Mich. 1997) (payment by automobile dealership to redeeming sole shareholder and CEO for "his years of diligent and loyal service" not deductible by dealership under §162 as compensation).

[106] 7 T.C.M. 162 (1948).

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render services as "sales advisor" to the corporation. The specific issue concerned treatment of two $8,000 annual payments which Carrington received under the latter agreement. Each payment was held taxable as compensation income. Carrington claimed that the payments were not taxable on the grounds that the $48,000 total to be received under the separate agreement was part of the redemption price and was properly taken into account in the prior year of the redemption in computing an alleged capital loss realized by him on the exchange.

In *Thermoclad Co. v. Commissioner*,[107] the court had before it both the corporation and the former shareholder from whom the corporation had redeemed stock and with whom it entered into a "consulting" agreement for post-redemption services. The former shareholder, Akerly, had been one of two equal owners of the corporation. After a dispute between the two owners involving animosity and ill will, they agreed to sever their relationship completely. The initial plan was for the company to redeem all of Akerly's stock for $100,000. However, a redemption payment of that sum would have produced a deficit in the company's capital account. The plan was then revised so that the company redeemed all of Akerly's stock for $50,000 and separately entered into a two-year consulting agreement with him under which the company would pay him $30,000 in the first year and $20,000 in the second year. Seeking to protect itself, the IRS denied the deductions claimed by the company for its payments under the consulting agreement and also denied Akerly's treatment of the consulting fees as capital gain from the redemption of his stock. On the facts, the court held that the "consulting fees" were really part of the redemption price of Akerly's stock and, as such, they were not deductible by the company and were taxable as capital gain to Akerly. The court emphasized that despite the purported consulting agreement, Akerly was prohibited from entering the company's premises; the agreement did not prevent him from competing with the company; no services were ever performed under the agreement; and the tenor of the relationship between the two men was one of animosity. The court concluded that the parties recast their original agreement because of the potential deficit in the company's capital account and not because they intended any real consulting relationship to exist.[108]

In *Steffen v. Commissioner*,[109] the court also had before it both the corporation and the former shareholder, all of whose stock had been redeemed by a group practice professional corporation. The court held that a distribution of medical instruments, a cash value life insurance policy, and $40,000 cash to the former shareholder was, as to him, capital gain payment in redemption of his stock and as such as nondeductible by the corporation. The corporation argued that its payment was severance pay deductible as compensation, because the cash payment represented a discounted value of the former shareholder's 25% interest in accounts receivable. If this deduction were not allowed, the corporation would be taxable on the receivables when collected without having received an offsetting deduction for salary paid to the former shareholder. The court noted that the agreement might have clearly designated part of the payment as severance pay, provided facts existed that would support treatment of the payment as attributable to rights that the former shareholder held as an employee (rather than as a shareholder). The court pointed out that unrealized corporate income increases the value of each shareholder's stock but does not, without more, convert distributions to shareholders into compensation payments.

In *Muskogee Radiological Group, Inc. v. Commissioner*,[110] the corporation, the sole taxpayer before the court, was allowed to deduct $100,000 of $131,000 paid to a retiring shareholder. The agreement between the parties allocated $31,000 as the book value of the outgoing doctor's stock, $50,000 as compensation for past services (under a corporate plan adopted two months before the redemption agreement), and $50,000 to be paid as consulting fees for services to be rendered over five years (pursuant to a specific agreement to this effect). The court allowed the deduction even though hindsight showed that the former shareholder was never actually consulted by his former colleagues and notwithstanding the IRS's contention that $100,000 of the total payment was allocable to the goodwill of the medical practice.

In *Russo v. Commissioner*,[111] a portion of each of a series of installment payments purportedly in redemption of the shareholder's stock was held allocable to termination of the shareholder's unexpired employment contract, and was, therefore, separately taxable to him as ordinary income. The court accepted the IRS's argument that fragmenting the total payment was valid on the facts, even though the reallocated amounts were set forth in the redemption agreement as part of the "value per share" to be paid by the corporation. The court held that the form of the agreements for employment and stock redemption formerly executed by the parties were sufficiently clear and legally binding. The shareholder was not able to convince the court by "strong proof" that the agreements were intended to be only a means of temporarily reducing the per-share value of the company so that new investors could buy in at an affordable price.

(5) Settlement of Lawsuit

Redemptions are sometimes used to eliminate dissident shareholders, including those who may have filed suit against the corporation or its management. Where a redemption includes withdrawal or settlement of a lawsuit, the question arises as to whether any of the redemption proceeds are properly allocable to the litigation, rather than the stock.

In *Bird v. Commissioner*,[112] the court allowed a shareholder to report as part of his redemption proceeds the entire amount he received, rather than requiring, as the IRS argued, the shareholder to allocate to the redemption only the amount calculated under the formula in his buy-sell agreement, and to report the rest as ordinary income stemming from settlement of his lawsuit against corporate officers for diversion of profits from the corporation. The court held the fair market value of the redeemed shares was based on their formula value, which

[107] T.C. Memo 1974-289.

[108] Taxpayer should be cautious in relying on *Thermoclad*. In some circuits, taxpayers are virtually prohibited from ignoring the tax consequences of an express contractual provision. *See, e.g., Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).

[109] 69 T.C. 1049 (1978).

[110] 37 T.C.M. 1851 (1978).

[111] 39 T.C.M. 691 (1979).

[112] 27 T.C.M. 1469 (1968).

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in turn was increased by the implicit admission by corporate officials that the book value of the stock would have been higher if the diversion of corporate funds had not occurred.[113]

In *Colonial Eng'g Co. of Springfield v. Commissioner*,[114] the Tax Court allowed a corporation to deduct under §162 an amount it paid to settle a judgment against it for loss of profits and compensation. The judgment had been obtained by a former one-third shareholder, all of whose stock had been redeemed three years before. The corporation had agreed at the time of the redemption to permit the shareholder to solicit its existing customers for future business and, if he obtained their business, to release such customers from their existing contracts with the corporation. The corporation later refused to release one customer who desired to transfer his business to the former shareholder, who then sued the corporation on its agreement. The IRS argued that the company's settlement payment was part of the redemption price for the shareholder's stock. The court found, however, that the parties had not intended this particular agreement as part of the payment for the stock. In dictum, the court also said that the settlement was ordinary income to the former shareholder.[115]

In *Gidwitz Family Trust v. Commissioner*,[116] a merger plan provided that certain "excluded" assets (including valuable real estate) were to be distributed before the merger in a redemption of stock of certain insiders. Two unrelated minority shareholders objected on grounds that the excluded assets had been stated at $20 million below their true value, and that the minority shareholders should be allowed to share in the redemption at whatever value was assigned to the excluded assets. The minority shareholders threatened court action to block the merger unless this demand was met. An oral agreement was made with the insiders whereby they would receive all the excluded assets and then grant to the two minority shareholders options to purchase a portion of the assets at their stated value. The insiders never granted the options in writing, however, and the minority shareholders sued for damages. The parties settled the suit for a $225,000 payment divided equally between the plaintiffs. The court held that this cash payment was additional consideration for each minority shareholder's stock in the acquired company (and as such was taxable as capital gain), rather than, as argued by the IRS, ordinary compensation income for refraining from blocking the merger.

In *GC Services Corp. v. Commissioner*,[117] a corporation was not permitted to deduct any portion of its payment to repurchase its stock from a 25% shareholder whose employment as president had been terminated. The corporation claimed that part of its payment was allocable to a release by the shareholder of several of his claims against the corporation over the value of the stock for purposes of setting the redemption price. The stock repurchase agreement referred to the agreed payment only in connection with repurchase of the stock and provided separately for "mutual release" of claims, without expressly allocating any part of the total payment thereto (although the parties labeled their overall document a "settlement agreement"). The corporation and the IRS disagreed over whether, despite the language of the agreement, the corporation could show that the allocation did not reflect the true intention of the parties. The court denied the deduction on the factual ground that the corporation had not shown that the corporation and the shareholder had, in fact, agreed on or even discussed allocating any part of the payment to the mutual release of claims.

In *Taylor v. Commissioner*,[118] in a reversal of the normal fact pattern, the redeemed shareholder sought to allocate part of the redemption payment to the release of his claim for a share of profits from a radio business allegedly owned by the corporation. The former shareholder sought to treat a portion of the total payment made to him as ordinary income, so that he could offset this amount by an otherwise useless deduction for certain state income taxes he had paid. The court upheld the IRS in denying the allocation of a portion of the total redemption payment to the release, relying on the absence of any such allocation in the redemption agreement.

In *Rhodes v. Commissioner*,[119] as part of a settlement of a will contest and claims of mismanagement, a minority shareholder surrendered all of her 150 shares to the corporation and gave up her right to receive an additional 100 shares under her father's will, in return for a cash payment made partly by the corporation and partly by her brother, the majority shareholder. The IRS argued that part of the corporate payment was made in redemption of 250 shares from the taxpayer and part was ordinary income based on settlement of her claims against the corporation. The IRS conceded that the payment she received from her brother was nontaxable as it had been received in lieu of an inheritance. The court accepted the taxpayer's argument that only her pre-existing 150 shares had been redeemed. The remainder of the amount she received from the corporation was received as part of the compromise of her rights as an heir and, under applicable income tax law, was nontaxable. Apart from the 150 shares redeemed, the court viewed the shareholder as parting only with "her right to receive" 100 shares under the will. Her mismanagement claims against the corporation were seen as inseparable from her inheritance, because the reason she did not want the 100 shares under the will stemmed from her brother's complete control of the corporation. In this respect the court viewed the taxpayer as a dissatisfied heir rather than a disgruntled shareholder.

(6) Repayment of Debt

When the issuing company is indebted to a corporate shareholder at the time it makes a distribution to him purportedly in redemption of some or all of its stock, the parties may attempt to allocate the payment between debt repayment and redemption distribution. If so, and if there is not enough to make both payments in full, it may be possible for a corporate shareholder to determine how much ordinary loss (via a bad debt deduction) and how much capital loss (on the redemption) it will realize. In a complete liquidation the courts and the IRS gener-

[113] *See also Megargel v. Commissioner*, 3 T.C. 238 (1944), *acq.*, 1944 C.B. 19.

[114] 22 T.C.M. 1476 (1963)

[115] *But cf.*, *Arthur H. Dugrenier, Inc. v. Commissioner*, 58 T.C. 931 (1972) (settlement payments where former shareholder claimed redeemed stock was undervalued, treated as a capital expenditure and not as deductible under §162).

[116] 61 T.C. 664 (1974), *acq.*, 1974-2 C.B. 2.

[117] 73 T.C. 406 (1979).

[118] 298 F.2d 198 (4th Cir. 1962).

[119] 3 T.C.M. 963 (1944).

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ally apply the first assets distributed to repayment of any preexisting debt to the shareholder.[120] It is not completely clear that a similar rule necessarily operates where only one shareholder-creditor's stock is redeemed or where less than all of the shareholder-creditor's shares are redeemed. Arguably the parties can apply a corporate payment either to the debt or to the stock as they choose.[121]

In *W.D. Haden Co. v. Commissioner*,[122] the issuing corporation owed its preferred corporate shareholder $82,000. The issuer distributed $120,000 to the shareholder, $60,000 purportedly in part payment of the debt and $60,000 purportedly in redemption of its preferred stock ($300,000 basis). The shareholder claimed $22,000 as a bad debt deduction and $240,000 as a capital loss on the redemption. The court, following the IRS, allocated the first dollars of the distribution to debt repayment, leaving only $38,000 to be allocated to the redemption. This allocation produced a $262,000 capital loss on the redemption as the only tax result of the transaction. The appellate court noted that because the transaction was carried out as part of a complete liquidation of the corporation (which followed shortly thereafter), both the ordinary rule of liquidation and the terms of the preferred stock required creditors to be paid first upon liquidation. Hence, *W.D. Haden Co.* seems to deal more with a complete liquidation situation than with a redemption of one shareholder not connected with a complete liquidation.

If the issuing company is insolvent when it purports to redeem the stock owned by a shareholder-creditor, the precedents governing complete liquidation of an insolvent corporation may apply. Under those rules, the distribution must first be allocated to repay the debt.[123]

(7) Noncompete Covenants

Upon redeeming the stock of a departing key employee, a corporation might typically request a noncompete covenant in order to prevent the departing employee from competing against the corporation within the same geographical area. The issue arises as to whether the payments for the noncompete covenant are part of the redemption price.

In *Frontier Chevrolet Co. v. Commissioner*,[124] a case of first impression, a corporate taxpayer borrowed money to redeem all of the stock of its 75% shareholder. As part of the same transaction, the parties entered into a noncompete covenant preventing the redeemed shareholder from competing with the taxpayer within a defined geographical area for a period of five years. The issue concerned whether the noncompete covenant was amortizable over its five-year life or over the 15-year §197 period. The Tax Court agreed that the payments under the noncompete covenant were in addition to the redemption consideration and not part of the redemption price. The court allowed the taxpayer to amortize and deduct the noncompete covenant over 15 years pursuant to §197.

C. "Property"

A redemption requires that stock be exchanged for property. Section 317(a) defines "property" for §302 purposes as "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)."

In general, cases and rulings dealing with the definition of "property" distributions for purposes of the dividend and liquidation provisions of the Code, including §301, §304, and §331 (and former §333 and §346), apply equally under §302 through the general reference to "money, securities and any other property" in §317(a).

The question of whether "property" has been distributed and received by the shareholder in a redemption that must run the §302 gauntlet precedes, and is separate from, the question of whether the shareholder must recognize the entire realized gain or loss all in the year in which the redemption exchange occurs. For possibilities of deferring tax beyond the year of the exchange, for example, where debt obligations are distributed by the corporation to the shareholder, see III.A.1.d., below. Where contract, license, or damage claims against third parties are distributed in a redemption, the valuation rules developed under analogous areas of the tax law, particularly the complete liquidation provisions of §331, seem equally applicable under §302.

1. Distributing Company's Own Stock

Stock in the distributing company is excluded from the coverage of §302 in order to distinguish a transaction tested as a redemption from a transaction tested as a recapitalization under §354, §356, and §368, or as a tax-free exchange of stock under §1036. If a corporation includes any of its own stock in a distribution to a shareholder in exchange for some or all of the shareholder's stock in the same company, the transaction is treated as a recapitalization even if the corporation also distributes property of a kind described in §317(a). The latter property is then tested as "boot" under §356. For special aspects of the role of §302 in connection with "boot" distributed in a tax-free reorganization exchange (including recapitalizations), see X.B., below.

2. Debt Obligations

Distribution of a corporation's own debt obligations in exchange for its outstanding stock is treated as a redemption rather than a recapitalization. A corporation's own obligations are treated as "property" within the meaning of §317(a).[125] For rules relating to the timing of recognition of income or gain by the redeemed shareholder, see III.A.1.d., below.

The obligation, of course, must be bona fide debt. If a debt obligation distributed by the corporation in redemption of its stock can be reclassified as an equity interest under the familiar debt-equity distinction,[126] the exchange is taken entirely outside §302 and must be tested as a recapitalization under §368(a)(1)

[120] *See* Rev. Rul. 70-271; *Houston Natural Gas Corp. v. Commissioner*, 9 T.C. 570 (1947), aff'd, 173 F.2d 461 (5th Cir. 1949).

[121] *See Jorden v. Commissioner*, 11 T.C. 914, 921 (1948) (question of fact), *acq.*, 1949-2 C.B. 2.

[122] 165 F.2d 588 (5th Cir. 1948), aff'g 5 T.C.M. 250 (1946).

[123] *Cf.*, Rev. Rul. 70-271; *Jorden v. Commissioner*, 11 T.C. 914 (1948), *acq.*, 1949-2 C.B. 2; *Aldrich v. Commissioner*, 1 T.C. 602 (1943).

[124] 116 T.C. 289 (2001), aff'd, 329 F.3d 1131 (9th Cir. 2003).

[125] Rev. Rul. 65-289, Rev. Rul. 68-601; *Smith v. Commissioner*, 49 T.C. 476 (1968), *acq.*, 1968-2 C.B. 3.

[126] See II.D.2., below, for further discussion. For a discussion of §385, see 702-1st T.M., Capitalizing a Business Entity: Debt vs Equity.

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(E) or as a §1036 exchange of stock for stock of the same corporation.[127]

When a corporate debt obligation distributed in redemption of stock must itself be valued (under other tax rules) and the resulting gain or loss recognized in the year of distribution, the obligation itself is the "property" embraced by §317(a). When a corporate debt obligation need not itself be valued (under appropriate tax rules) and the resulting gain or loss recognized in the year the obligation itself is distributed, the redemption exchange is also tested under §302 in the year the obligation itself is distributed. The tax treatment so determined, however, then controls treatment of payments of the obligation. Thus, the basic tax character of the redemption is tested under §302 in the year in which the closing under the redemption agreement occurs and the corporate obligation is distributed to the shareholder.[128]

An agreement by the issuing corporation to pay a "private annuity" to a shareholder of a stated dollar amount at periodic intervals for the rest of the shareholder's life is also "property" within the coverage of §317(a).[129] For the rules concerning when the recipient is actually taxable on the annuity payments, see 805 T.M., *Private Annuities and Self-Canceling Installment Notes* (Estates, Gifts, & Trusts series).

Mere creation of a debt to the shareholder on the corporate books, not accompanied by a separate corporate note, in exchange for the shareholder's stock has also been held to be a distribution of "property" within the meaning of §317(a), bringing §302 into play.[130]

It is unclear whether a convertible debenture distributed by the issuing corporation will in every situation be treated as debt rather than stock. The debenture represents a potential equity interest. In Rev. Rul. 68-601, the IRS tested a redemption distribution of convertible debentures under §302, thereby implicitly treating the debentures in that situation as debt in their entirety.

Rev. Rul. 77-166 holds that a corporation's assignment to a trustee for shareholders of payments to be received in the future by the company on a third party note receivable held by the company is a "distribution" for purposes of former §346(a)(2) in the amount of the fair market value of the right to receive the payments. Legal title to the note remained with the corporation. It appears that a similar rule would apply for purposes of §302.

3. *Stock Rights*

Rights to acquire the distributing company's own stock (e.g., stock warrants) are excluded from the definition of "property" for §301 and §302 purposes.[131]

Comment: It appears that stock rights constitute "property" for purposes of the general sale or exchange rule of §1001. As such, the rights, when distributed in exchange for the issuing company's own stock, may be taxable and receive exchange treatment directly under §1001.[132] Alternatively, it is arguable that §317 pre-empts the field here, rendering §1001 inapplicable, thus allowing the shareholders to receive the stock rights tax free.

Note: The argument has been made that a warrant on the issuing company's own stock is nontaxable via §305.[133] While that may be true on a straight distribution of warrants, the application of §305 to a redemption-type transaction is less clear.

Rev. Rul. 68-601 involved a distribution of convertible debentures and warrants to buy the distributing company's own stock in exchange for the distributing company's own stock. The ruling holds that the convertible debentures and warrants constitute options that trigger option attribution under §318(a)(4). The ruling then proceeds to test the transaction under §302(b)(2) as a disproportionate redemption. Rev. Rul. 68-601 does not trigger option attribution for purposes of treating warrants or convertible debentures themselves as stock distributed by an issuing company in redemption of its own stock. Otherwise, the entire exchange would be taken outside §302 and would be tested as a recapitalization (possibly with boot) under §354–§356 or as a §1036 exchange (possibly with boot) of stock for stock of the same corporation.

Rights to acquire stock in a corporation other than the distributing company are property within the meaning of §317(a),[134] as is stock in a corporation other than the distributing corporation.

4. *Assumption of Liability*

"Money" as defined in §317(a) includes a corporation's assumption of a liability owed by one of its shareholders to a third person,[135] according to some courts. The Eighth Circuit has held that, for purposes of initially testing the transaction under §302, the redemption occurs when the corporation assumes the shareholder's note to the third person. The assumption is not taxable as a distribution of "property" to the shareholder, however, until the year(s) in which the corporation makes principal and interest payments on the note.[136]

The Eighth Circuit's holding in effect permits the distributee shareholder a form of tax deferral on the redemption even where the exchange is held to be dividend equivalent. These tax

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[127] *Cf.*, *Mazo v. Commissioner*, 32 T.C. Memo 546 (1973); *Rialto Realty Co. v. United States*, 366 F. Supp. 253 (E.D. Pa. 1973), aff'd, 503 F.2d 1399 (3d Cir. 1974).

[128] *See, e.g.*, *Vinnell v. Commissioner*, 52 T.C. 934 (1969).

[129] *Fehrs Financing Co. v. Commissioner*, 58 T.C. 174 (1972), aff'd, 487 F.2d 184 (8th Cir. 1973), cert. denied, 416 U.S. 938 (1974).

[130] *Wiseman v. United States*, 259 F. Supp. 90 (D. Me. 1966), aff'd per curiam, 371 F.2d 816 (1st Cir. 1967) (also stressing constructive receipt arising from the shareholder's ability to cause the corporation to pay the debt during the year and the company's financial ability to do so); *Bradbury v. Commissioner*, 298 F.2d 111 (1st Cir. 1962).

[131] §317(a). Note, however, that in Jan. 1998 the IRS changed its longstanding regulatory position for purposes of §354 through §356 by issuing regulations which provide that the term "securities" includes rights issued by a party to a §368 reorganization to acquire its stock and rights issued by the distributing corporation or the controlled corporation to acquire the stock of that corporation in a §355 transaction. However, these regulations did not affect the treatment of rights to acquire stock under §302. *See* T.D. 8752, 63 Fed. Reg. 409 (Jan. 6, 1998).

[132] *See Bateman v. Commissioner*, 40 T.C. 408 (1963), *nonacq.*, 1965-2 C.B. 7. *See also Smith Est. v. Commissioner*, 63 T.C. 722 (1975).

[133] Eustice, *Going Private: Tender Offer Redemptions for Cash or Securities*, 2 J. Corp. Tax'n 137, 165 (1975).

[134] Rev. Rul. 70-521.

[135] *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972), *nonacq.*, 1977-2 C.B. 2. The Eighth Circuit was affirming in part *Maher v. Commissioner*, 55 T.C. 441 (1970), supp. opin., 56 T.C. 763 (1971). *See also Hayes v. Commissioner*, 101 T.C. 593 (1993).

[136] *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972), *nonacq.*, 1977-2 C.B. 2.

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deferral aspects of *Maher* are discussed further in connection with installment payout redemptions at III.A.1.d., below.

The IRS has announced that it will follow the *Maher* decision concerning when a distribution resulting from assumption of a liability of a shareholder is taxable to the shareholder.[137] When a shareholder remains secondarily liable on the debt, the IRS will consider the shareholder to have received corporate distributions in the shareholder's taxable years in which the corporation makes payments to the creditor.[138]

5. No Consideration

A redemption does not occur when a shareholder surrenders stock to the issuing corporation but receives no "property" in return. Stated broadly, the courts and the IRS seem to agree that if no property is received in return for a surrender of shares to the issuing company, the contributing shareholder does not realize any gain. If all shareholders contribute the same percentage of their shares to the issuing company for no consideration, the courts and the IRS also agree that the transaction is a contribution to capital on which neither gain nor loss is realized.[139] But if fewer than all shareholders contribute shares or if shares are surrendered non-pro rata by several shareholders, the courts have sometimes allowed the shareholder an ordinary loss deduction.[140] The IRS follows the contribution to capital theory and refuses to allow any deductible loss.

Note: The surrender of shares with no consideration to a corporation that is legally insolvent, however, may produce deductible loss under §165.

A shareholder's bequest of stock back to the issuing corporation is also not a redemption tested under §302. In *Diebold v. Commissioner*,[141] the court treated such a transaction, for basis purposes, as a bequest to the other shareholders, which, under the predecessor of §1014, increased the basis of their shares in the corporation. The Third Circuit held that the other shareholders were entitled to increase the basis of their stock in the corporation by an amount equal to the fair market value of the decedent's stock multiplied by their respective percentage increases of ownership in the corporation as a result of the bequest.[142]

Note: In Rev. Rul. 74-329, the IRS stated that it will rationalize the basis increase allowed in cases such as *Diebold*, above, and *Hitchon v. Commissioner*,[143] as a gift or bequest of shares directly to other (surviving) shareholders in proportion to their respective interests in the existing stock, followed by a pro rata contribution to capital by them of the additional shares received. For a discussion of the basis consequences of redemptive distributions, see III.B.1.d.(2), below.

6. Release of Contract Claims

It is unclear whether "property" includes a release by the issuing corporation of contract or damage claims that it holds against the distributee shareholder. In *Crow v. Commissioner*,[144] in return for a surrender of all the taxpayer's preferred stock and debentures and part of his common stock, the issuing corporation "released" the taxpayer from any claims the corporation "has or might have" against him for breach of a prior contract between the two parties. The company's president also promised individually that if the company was later sold or went public, he would guarantee the taxpayer the original value of his remaining common stock. The court characterized the transaction as an "exchange" giving rise to a capital loss, but does not explain whether this result occurs via §302.

In *Arlington Metal Indus., Inc. v. Commissioner*,[145] the corporation "released" two shareholders from claims it held against them for lost profits (through mismanagement) and from all other existing or potential causes of action in return for a similar release by the shareholders (relating chiefly to accrued salaries and unpaid loans) plus all their stock. The issue concerned the corporation's taxability on receipt of its own stock. Although the corporation was held taxable, the court described the transaction as an "exchange." It is unclear whether each shareholder would be taxable on his side of the transaction or, if so, whether he would be governed by §302.

In *Montana Power Co. v. United States*,[146] a corporate shareholder surrendered all of its stock in another corporation to the issuing corporation with which the shareholder had contracted to supply crude oil, in return for a release from the contract. In addition, the shareholder paid the issuer $120,000 cash. In these circumstances the court allowed the shareholder to deduct as a current business expense its cash payment plus the current market value of the surrendered stock. The court also allowed the shareholder a capital loss in the amount of the excess of its basis in the stock over current value.

7. Reduction in Shareholder's Debt to Corporation

The issuing corporation is considered to make a constructive distribution of property to a shareholder for §302 purposes where, in part or full payment of the redemption price, it reduces or completely offsets the shareholder's pre-existing debt to the corporation.[147] Reg. §1.317-1 includes in the definition of

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[137] Rev. Rul. 77-360.

[138] *See also* Rev. Rul. 78-422 (corporation's assumption of shareholder's debt to a bank, in connection with a §304(a)(1) transaction, is tested under §302 and, on the facts, constitutes a §301 distribution). Note, however, that by declaring Rev. Rul. 78-422 obsolete in Rev. Rul. 95-71, the IRS implicitly acknowledged that its position in the 1978 ruling is covered by §302(b)(3).

[139] *See* Rev. Rul. 70-291.

[140] *Smith v. Commissioner*, 66 T.C. 622 (1976), rev'd sub nom., *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979); *Budd Int'l Corp. v. Commissioner*, 45 B.T.A. 737 (1941), nonacq., 1977-2 C.B. 2, rev'd, 143 F.2d 784 (3d Cir. 1944), cert. denied, 323 U.S. 802 (1945). *See Foster v. Commissioner*, 9 T.C. 930 (1947), *acq.* 1948-1 C.B. 2 (loss reduced by increase in value of taxpayer's remaining shares); *see also Crow v. Commissioner*, 29 T.C.M. 1321 (1970); *Downer v. Commissioner*, 48 T.C. 86 (1967); *Commissioner v. Wright*, 47 F.2d 871 (7th Cir. 1931), modifying 18 B.T.A. 471 (1929) (strong dissent). *But see Commissioner v. Fink*, 483 U.S. 89 (1987) (no loss recognized by controlling shareholder on voluntary contribution of shares to corporation for no consideration) and *Yei v. Commissioner*, T.C. Memo 1997-57 (no capital loss allowed where taxpayer surrendered corporate stock so that a like amount could be sold to ease the corporation's cash flow problems; record did not indicate that taxpayer and members of family did not retain control of the stock).

[141] 194 F.2d 266 (3d Cir. 1952).

[142] *See also Mathieu v. Commissioner*, T.C. Memo 1952-226.

[143] 45 T.C. 96 (1965), *acq.*, 1966-2 C.B 5.

[144] T.C. Memo 1970-283.

[145] 57 T.C. 302 (1971). *See also Commissioner v. S.A. Woods Mach. Co.*, 57 F.2d 635 (1st Cir. 1932).

[146] 171 F. Supp. 943 (Ct. Cl. 1959).

[147] *See also* PLR 200928004–PLR 200928011 (shareholders' surrender of common stock to corporation in cancellation of notes owed by shareholders to corporation will be tested as §302 redemption and treated as substantially disproportionate redemption; amounts distributed to each shareholder will be

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property "indebtedness to the corporation." Usually, the shareholder's debt arises from a prior loan to him from the corporation.[148]

The constructive distribution is not automatically ordinary income to the shareholder. If the redemption qualifies under §302 and if the debt reduction is intended as part of the redemption price, the distribution will receive exchange treatment.[149] If the redemption is dividend equivalent, the debt reduction will be treated as a §301 distribution.[150] If the debt reduction is not treated as part of the redemption price, but is treated as a separate transaction, it will be a cancellation of debt treated as a §301 distribution to the shareholder.[151]

Observation: Treating the debt reduction as property is appropriate only if the existing debt is true debt, and not in fact equity as the result of a dividend from an earlier year.[152]

In *Brown Est. v. Commissioner*,[153] Brown owed $50,000 on a bank loan. After Brown died, the loan was repaid out of the proceeds of a life insurance policy on Brown's life, which policy was owned by Brown's controlled corporation. The corporation was also sole beneficiary under the policy. The IRS charged Brown's estate with a dividend in the amount of the corporate funds used to pay Brown's personal debt. The estate argued that the corporation had merely lent $50,000 to the estate. Four years after the alleged debt arose, the estate allegedly repaid it by having part of its stock in the corporation redeemed in exchange for cancellation of the debt. The Tax Court treated the issue as entirely factual, and upheld the estate's characterization of the initial transaction as a nontaxable loan to the estate rather than a dividend.

Observation: If the IRS had prevailed, it is unclear how the subsequent redemption would have been treated. If the initial event was a (constructive) dividend, no debt arose that needed to be repaid via the subsequent surrender of shares by the estate. Perhaps the later "redemption" would not be treated as a redemption at all, because the shareholder would have received no "property."

The shareholder's debt may have arisen from a prior sale of property to him by the corporation. In *Levin v. Commissioner*,[154] a corporation sold a summer cottage to a shareholder in 1962 for $15,000, to be paid for by credits against her subsequent redemption proceeds (under an installment payout) in the amounts of $7,000 in 1962 and $8,000 in 1963. The redemption was held essentially equivalent to a dividend. The court also found that the fair market value of the cottage was $19,000. The court held that she was taxable on $7,000 dividend income in 1962 and on $12,000 dividend income in 1963 ($8,000 from the redemption plus the $4,000 bargain element).

Whether or not a shareholder's debt to a corporation is cancelled (in whole or in part) in connection with a redemption is a factual question, which is to be resolved based on the particular circumstances.[155]

In *Taylor v. Commissioner*,[156] a mutual release of claims executed by shareholder and corporation as part of the redemption agreement triggered additional consideration to the shareholder for his stock, because the release included cancellation of a $12,000 receivable due the corporation by the shareholder.

8. *Other Cases*

a. *Life Insurance Policy*

If an insurance policy owned by the corporation on the life of a shareholder-employee is distributed to him in part or full payment of the redemption price, the policy is "property" within the meaning of §317 whether the transaction is treated as an exchange or as essentially equivalent to a dividend.

b. *Other Agreements*

Not every agreement by a corporation to perform an act in the future, expressly stated to be part of the consideration for the shareholder's stock, is "property" which affects the amount of gain or loss realized by the shareholder. In *Colonial Eng'g Co. of Springfield v. Commissioner*,[157] in addition to paying cash to the outgoing shareholder and transferring certain office equipment to him, the company also agreed to repay an existing debt it owed to him and to allow him to hire away any of its employees. Although not specifically at issue in the case, the latter two items would seem not to be the type of "property" or property rights which are to be valued, or that are capable of being valued, in calculating the shareholder's gain or loss.

c. *Fractional Interest*

"Property" includes a fractional interest (including an undivided interest) in an item of tangible or intangible property. Thus, for example, in part payment for stock a corporation could distribute to the shareholder an undivided fractional interest in a parcel of land and/or a building. In a subsequent year the corporation could distribute other property in payment of the rest of the redemption price, or it could distribute its remaining interest in the same property. The amount of "property" distributed in each such year equals the fair market value of the fractional interest distributed in that year.

D. *"Stock"*

1. *In General*

Section 317 and §302(a) apply to a redemption of outstanding "stock" in the corporation that issued the stock. The Code does not define stock for purposes of §317 or §302. In general, the concept of a stock interest is determined by corpo-

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treated as distribution in part or full payment in exchange for common stock surrendered as provided under §302).

[148] *See, e.g., Benjamin v. Commissioner*, 66 T.C. 1084 (1976), aff'd, 592 F.2d 1259 (5th Cir. 1979).; *Tabery v. Commissioner*, 354 F.2d 422 (9th Cir. 1965), aff'g 23 T.C.M. 1108 (1964); *Bradbury v. Commissioner*, 298 F.2d 111 (1st Cir. 1962); *McGinty v. Commissioner*, 325 F.2d 820 (2d Cir. 1963); *Heman v. Commissioner*, 283 F.2d 227 (8th Cir. 1960); PLR 200750001.

[149] *See Waldheim v. Commissioner*, 25 T.C. 839, 850 (1956), aff'd, 244 F.2d 1 (7th Cir. 1957), *acq.*, 1956-2 C.B. 9.

[150] Reg. §1.301-1(k).

[151] Reg. §1.301-1(k).

[152] *See Shephard v. Commissioner*, 340 F.2d 27 (6th Cir. 1965) (cancellation of shareholder's debt to corporation treated as distribution of property where stock purchased by shareholder bought with notes on which corporation was joint obligor).

[153] 33 T.C.M. 873 (1974).

[154] 47 T.C. 258 (1966), aff'd, 385 F.2d 521 (2d Cir. 1967).

[155] For a factual inquiry in the analogous setting of a §331 liquidation, see *Alexander v. Commissioner*, 61 T.C. 278 (1973).

[156] 298 F.2d 198 (4th Cir. 1962).

[157] 22 T.C.M. 1476 (1963).

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rate law. A stock interest represents an interest in the corporation's "equity" (i.e., its earnings and/or underlying assets). The existence of voting or dividend rights is not essential to the existence of a stock interest. Such factors are properly taken into account in comparing different kinds of stock interests in the corporation. Section 302 applies both to common and preferred stock.

Determining whether an interest in a corporation is an equity interest is not always easy. Certain types of preferred stock, for example, resemble a fixed debt.[158] Many interests in a corporation are undeniably "hybrid," combining some features of a creditor's interest and some features of an equity interest. Determining which elements of an interest in an unincorporated association taxable as a corporation are properly viewed as "equity" can also be difficult.

a. Association Taxable as Corporation

In the case of an association taxable as a corporation,[159] the surrendered interest often will not be labeled "stock." The interest may nevertheless be treated as stock for §302 purposes. A careful study must thus be made to determine what attributes of the member's interest represent an equity interest.[160]

b. Interest in Stock Purchase Agreement

In *Maher v. Commissioner*,[161] the taxpayer had contracted to buy all the stock of four corporations from a third party for cash and promissory notes. The stock certificates were placed in escrow until the purchase price was fully paid. Eight months later the taxpayer assigned to one of the corporations all his right, title and interest in the contract to purchase the stock of one of the other corporations in return for assumption by the assignee of all his obligations under the contract. The taxpayer, however, remained secondarily liable on the assumed obligations; i.e., he would be personally liable on the promissory notes if the assignee failed to pay the notes in full.

The IRS determined that the assignment constituted a constructive redemption, within the meaning of §304(a)(1), by the assignee corporation of its own stock. The taxpayer argued that the constructive redemption rule of §304(a)(1) did not apply because the assignee corporation did not acquire "stock," but rather "a right to a contract to purchase stock." The taxpayer pointed out that title to the assigned stock did not pass to him under this purchase contract until the purchase price was fully paid. The Tax Court held, however, that the taxpayer had become the beneficial owner of the assigned stock at the time of the assignment for the following reasons: the placing of title in escrow was only a security arrangement; the taxpayer could vote the stock unless he defaulted on the purchase contract; the purchase price was definitely fixed; the taxpayer was personally liable if default occurred (although secondarily following his assignment); and the parties intended ownership to pass to the taxpayer when the agreement of purchase was signed. Consequently, the Tax Court (with the Eighth Circuit agreeing) held that the taxpayer's assignment was equivalent to a transfer of "stock" by him for purposes of §304 and §302.[162]

The IRS has stated that it will dispose of cases under §301, that are substantially identical on their facts to *Maher*, in accordance with that decision.[163]

For a different outcome on different facts, see *Citizens Bank & Trust Co., Ex'r v. United States*,[164] where a corporation's purchase of stock in a "sister" corporation from a third person was held not a purchase from the taxpayer shareholder, even though the buying company assumed the shareholder's existing contract obligation to buy the stock. The taxpayer did not "own" the stock at the time the purchase price was paid. Further, the buying company, and not the taxpayer-shareholder, actually received the purchased stock.

Cases such as *Maher* and *Citizens Bank & Trust Co.* turn on traditional questions of tax ownership. At some point the benefits and burdens of property are sufficiently vested in a party, such that the party is considered the tax owner, even though formal title may not have passed under state law.[165]

c. Warrants and Convertible Debentures

As discussed in II.C.3., when rights to acquire a distributing company's own stock are distributed in a redemption, the Code does not treat such rights as "property" within the scope of §317(a). Section 318 does treat such rights as stock, however, for purposes of determining whether the tests of §302(b) are satisfied.

The option attribution rule of §318(a)(4) does not treat a surrender (for consideration) to the corporation of an outstanding stock warrant as a surrender of the underlying stock for

[158] The issue of whether purported stock should, for federal tax purposes, properly be characterized as debt has been addressed by only a few courts, and the general trend to the case law in the area suggests that one need seldom worry about a court treating stock as debt. *See, e.g., Zilkha & Sons v. Commissioner*, 52 T.C. 607 (1969), *acq.*, 1970-2 C.B. xxi (IRS argued that stock was debt; court held it was equity); *Segel v. Commissioner*, 89 T.C. 816 (1987) (same). *See also* CCA 201236025 (temporarily or partially restricted voting convertible preferred entitled to receive non-cumulative dividends and premium equal to purchase price of shares and thereafter an equal share of liquidation proceeds was treated as common stock for purposes of §302(b)). *See* CCA 201236025 (temporarily or partially restricted voting convertible preferred stock entitled to receive non-cumulative dividends and premium equal to purchase price of shares and thereafter an equal share of liquidation proceeds was treated as common stock for purposes of §302(b)). For further discussion, see Willens, *CCA Concludes Stock Either Preferred or Common*, 192 Daily Tax Rep J-1 (Oct. 4, 2012). *See also* CCA 201247010 (lowering of number of common parent class X shares into which common parent class Y shares convert to account for contingent liabilities of common parent class Y shareholders, does not constitute actual, constructive or deemed redemption of class Y shares; common parent did not acquire class Y shares from shareholders for property).

[159] *See* Reg. §301.7701-3.

[160] *Cornwall v. Commissioner*, 48 T.C. 736 (1967), *acq.*, 1968-2 C.B. 2 (voting rights, interest in investment income and underwriting income compared); Rev. Rul. 70-298, Rev. Rul. 69-6, Rev. Rul. 69-3, Rev. Rul. 68-22. *See* CCA 201511020 (citing Rev. Rul. 70-298, qualified written notices of allocations — written documents that meet certain requirements and by which cooperative allocates earnings to patron — are equity for purposes of §368); PLR 200307080 (membership interests in life insurance company treated as stock for purposes of §331 and §346, and distributions to eligible members treated as distributions in complete liquidation and as payments in exchange for their membership interests).

[161] 469 F.2d 225 (8th Cir. 1972), aff'g and rev'g in part 55 T.C. 441 (1970), supp. opin., 56 T.C. 763 (1971).

[162] For a detailed discussion of §304, see 768 T.M., *Stock Sales Subject to Section 304.*

[163] *See* Rev. Rul. 77-360.

[164] 580 F.2d 442 (Ct. Cl. 1978).

[165] *See, e.g.,* FSA 200111011 (applying *Maher* to determine when the benefits and burdens had sufficiently passed in sole or exchange of stock through flow-through entities).

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which the option can be exercised and, hence, as a redemption tested under §302.

Comment: Section 1234 contains special rules relating to sale or exchange of an option to buy or sell property. This latter provision appears to govern a sale to the issuing company of an outstanding stock warrant or similar right to purchase stock of the issuing company.

Several miscellaneous points regarding options and convertible instruments should also be noted. First, gain realized by the holder of a compensatory stock option upon a sale of the option back to the issuing company is generally ordinary compensation income.[166] Second, convertible preferred stock will be tested by §302 criteria applicable to preferred stock rather than common stock.[167] Third, convertible debentures will not be treated as stock, and hence governed by §302, solely by reason of their convertibility into stock.[168] However, where the shareholders hold such instruments in proportion to their stock interests, the IRS may deem such instruments to be stock as well.[169] Furthermore, even where the instruments are not proportionately held, if the equity features predominate, the instruments may be considered stock.

2. Debt-Equity Distinction

The debt-equity distinction may not only cause obligations distributed by a corporation to be reclassified as stock, but may also affect the interest surrendered to the corporation. If a surrendered "stock" interest can be treated as debt for tax purposes, §302 is inapplicable and the transaction can be treated as a repayment of debt.[170] The determination of whether an instrument should appropriately be classified as debt or equity has been an area frequently considered by the courts and the relevant case law in this area provides substantial guidelines to make this determination.[171]

Note: Amounts received by the holder "on retirement of" a corporate debt obligation in written form, i.e., a bond, debenture, note, or other evidence of indebtedness, are treated as amounts received in exchange for the obligation.[172] This means that principal repayments are tax-free to the extent of the holder's basis in the obligation. Amounts received in excess of the holder's basis in the obligation constitute capital gain. Amounts received by the holder of a debt obligation as principal payments short of the final payment are considered received "on retirement of" the obligation.[173]

If a corporate debt obligation is merely a contract promise not evidenced by a separate promissory note, bond, or debenture, amounts received in excess of the creditor's basis in the obligation are taxable as ordinary income.[174]

There are relatively few situations where a surrendered "stock" interest has been reclassified as debt for tax purposes. In most such cases, a holder of preferred stock that was originally issued for funds intended to represent temporary loans to the corporation, or was issued to capitalize a prior indebtedness owed by the corporation to a shareholder, argues that the corporation's "redemption" of the preferred stock should be analogized to debt repayment and governed by the same rules for tax purposes.[175]

More often encountered is the situation where a corporation purports to pay interest on, or to repay part or all the principal of, an outstanding "debt" obligation. If the obligation is vulnerable to being treated as an equity interest in the corporation, and hence as equivalent to stock for tax purposes, each "repayment" of the principal will be treated as a distribution in redemption of "stock," tested as such under §302.[176] A risk of §301 treatment of the full amount of the purported principal repayment is thereby incurred.[177]

However, the holder can still argue for exchange treatment by trying to qualify the "redemption" under one of the categories of §302(b). Each payment of "interest" on a purported debt treated as stock will be treated as a nondeductible dividend on the stock. This same result occurs even if the redemption (purported principal repayment) qualifies for exchange treatment under §302(b). The dividend element does not run the §302 gauntlet; as an ordinary dividend, it is separately subject to the rules of §301.[178]

The debt-equity status of a special class of "guaranteed stock" which had been redeemed at a sizable premium above par value was at issue in *Richmond, Fredericksburg, and Po-*

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[166] *Bagley v. Commissioner*, 85 T.C. 663 (1985) (resale to employer of stock option treated as ordinary income), aff'd, 806 F.2d 169 (8th Cir. 1986); *Rank v. United States*, 345 F.2d 337 (5th Cir. 1965) (resale to employer of pre-1964 restricted stock option); Rev. Rul. 73-146, 1973-1 C.B. 61 (unexercised qualified stock option); Rev. Rul. 67-366, 1967-2 C.B. 165 (cancellation of nonstatutory stock option). *See also LeVant v. Commissioner*, 45 T.C. 185 (1965), aff'd, 376 F.2d 434 (7th Cir. 1967).

[167] *See* Rev. Rul. 71-83. *But see* CCA 201236025 (temporarily or partially restricted voting convertible preferred stock entitled to receive non-cumulative dividends and premium equal to purchase price of shares and thereafter an equal share of liquidation proceeds was treated as common stock for purposes of §302(b)).

[168] *See* Rev. Rul. 69-91, Rev. Rul. 67-269. Note, however, that by declaring Rev. Rul. 67-269 obsolete in Rev. Rul. 95-71, the IRS implicitly acknowledged that its position in the 1967 ruling (namely, that an S corporation did not jeopardize its status as a "small business corporation" by issuing instruments that did not carry voting rights or claims to dividends) was restated in Reg. §1.1361-1(l)(4). *See also Roberts & Porter, Inc. v. Commissioner*, 307 F.2d 745 (7th Cir. 1962), *acq.*, 1969-2 C.B. 5.

[169] The withdrawn §385 regulations had provided that a hybrid instrument, if proportionately held, was stock. Former Reg. §1.385-6(c).

[170] As noted previously, however, there is scant authority that would permit a taxpayer to treat stock as debt.

[171] See IV.B.2., below, for further discussion. See also 702 T.M., *Capitalizing a Business Entity: Debt vs Equity*, for a detailed analysis of characterizing debt versus equity.

[172] §1271(a)(1).

[173] *Jamison v. United States*, 297 F. Supp. 221 (N.D. Cal. 1968), aff'd, 455 F.2d 1397 (9th Cir. 1971); *Wilson v. Commissioner*, 51 T.C. 723 (1969), *acq.*, 1976-2 C.B. 3; *Timkin v. Commissioner*, 6 T.C. 483 (1946); *acq.*, 1946-2 C.B. 5.

[174] *See* Rev. Rul. 58-402.

[175] *See Miele v. Commissioner*, 56 T.C. 556 (1971) (taxpayer argument that preferred stock should be viewed as debt not accepted by court), aff'd, 474 F.2d 1338 (3d Cir. 1973), cert. denied, 414 U.S. 982 (1973).

[176] *See* Rev. Rul. 73-122 (debentures upheld as valid debt; principal repayments not treated as redemptions of stock).

[177] Dividend treatment: *Sansberry v. United States*, 70-1 USTC ¶9216 (S.D. Ind. 1970); *Burr Oaks Corp. v. Commissioner*, 43 T.C. 635, 651–52 (1965), aff'd, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967); *Moughon v. Commissioner*, 329 F.2d 399 (6th Cir. 1964); *Gooding Amusement Co. v. Commissioner*, 23 T.C. 408, 421–22 (1954), aff'd, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957). Debt status upheld: *Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969).

[178] *See, e.g., W.B. Killhour and Sons, Inc. v. Commissioner*, 32 T.C.M. 855 (1973); *Zilkha & Sons, Inc. v. Commissioner*, 52 T.C. 607 (1969), *acq.*, 1970-2 C.B. xxi; *Moughon v. Commissioner*, 329 F.2d 399 (6th Cir. 1964), aff'g 22 T.C.M. 94 (1963).

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tomac R.R. Co. v. Commissioner,[179] where the Fourth Circuit held on the facts that the stock was more like true equity, so that the premium element was not deductible as interest (as the corporation claimed).

The debt-equity distinction can affect determinations under the safe haven categories of §302(b)(2) and §302(b)(3). As explained in III.A.1., below, a shareholder can qualify for capital gain treatment if a redemption completely terminates the shareholder's interest in the corporation. If a redeemed shareholder continues to hold pre-existing corporate debt obligations, and if such obligations are vulnerable to attack as equity, the redemption loses the protection of §302(b)(3) ab initio. The substantially disproportionate tests of §302(b)(2) can also be failed by reclassifying "debt" which the distributee holds before and after the redemption of actual stock.

The specific criteria that are applied in the tax law to distinguish debt from equity are beyond the scope of this Portfolio. For a detailed discussion of §385 and the regulations thereunder, see 702 T.M., *Capitalizing a Business Entity: Debt vs. Equity*.

For additional discussion of debt vs. equity as applied in the context of a complete termination of a shareholder's interest, see IV.B.2., below.

3. *Determining Outstanding Stock*

The question of what constitutes a "stock" interest in the distributing company arises not only with regard to the interest surrendered or received, but also in determining the total amount of stock outstanding for purposes of measuring the "before" and "after" effect of a redemption.

The debt-equity distinction can operate on interests other than those redeemed and thereby disqualify a redemption under §302. If, for example, another related shareholder holds purported corporate "debt" at the time of the redemption, the IRS might seek to reclassify such debt as equity for purposes of attributing the reclassified "stock" to the distributee under the constructive ownership rules of §318, thereby foreclosing exchange treatment for failure to satisfy the requirements of §302(b)(1), §302(b)(2), or §302(b)(3).

In addition, the rules of constructive ownership in §318(a)(2)(C) provide that a shareholder is deemed to own a proportionate share of the stock owned by a corporation if the shareholder owns 50% or more of the stock of that corporation. A shareholder could conceivably contend that some of the corporation's outstanding debt was really stock, in order to increase the total amount of "stock" outstanding, and thereby reduce the shareholder's ownership interest below 50%, eliminating attribution under §318(a)(2)(C).

The IRS has ruled that treasury stock or unissued stock that a redeemed shareholder (or a person with whom the shareholder has an attribution relationship under §318) has an option to buy under stock warrants or convertible debentures enter into the numerator and denominator of the shareholder's ownership interest before and after the redemption. However, similar options held by other persons are ignored.

A question exists as to whether rights to "contingent stock" granted by the corporation granted in a prior reorganization should be treated as outstanding stock. In Rev. Rul. 68-601, the IRS required option attribution under §318(a)(4) with respect to options that were not subject to any contingencies on their exercise. The IRS has also ruled that options whose only contingency is the passage of time are to be treated as stock under §318(a)(4).[180] Under these criteria, an acquired shareholder's right to additional stock in an acquiring company depending on future events, such as future earnings of either company, should arguably not be considered outstanding stock in determining the effect of a redemption of stock in the acquiring company.

Observation: If an acquiring company in a tax-free reorganization distributes some of its stock to an escrow agent to be held until contingencies are resolved and, while the escrow still exists, the acquiring company redeems some of its actual outstanding stock, it is unclear whether the escrowed stock is to be included in total outstanding stock in measuring the effect of the redemption under §302. For some purposes, contingent beneficiaries of an escrow account are considered equitable owners of the stock; for other purposes their status is less clear.[181]

In FSA 200212030, the Chief Counsel's Office advised that the exercise of a call option by a subsidiary of the corporation attempting to redeem its own stock does not qualify as a redemption under §317(b). The Chief Counsel's Office stated that §317(b) requires that the corporation acquire its own stock in order to be treated as having redeemed the stock.

4. *Investment Units of Interest in Mutual Fund*

In Rev. Rul. 74-463, an open-end regulated investment company (as defined in §851) sold 10-year transferable contracts called "participating agreements" which were subdivided and expressed in terms of "investment units." The IRS held that the investment units were "stock" for §302 purposes, because the investment units dictated the number of votes that the investor had, his share of the profits (income and capital gains) of the fund, and his share of fund assets on liquidation or complete redemption of his interest in the fund. Consequently, each partial cash withdrawal from the fund that an investor may make periodically by surrendering one or more of his "units" is treated as a redemption, which must run the §302 gauntlet in order to receive exchange treatment.

E. "Shareholder"

The requirements of §302 apply to an acquisition of stock "from a shareholder."[182] Ordinarily, no difficulty arises in determining who is the shareholder in a redemption transaction. The shareholder is the person who beneficially owns the stock redeemed and is the person from whom the corporation acquires the stock. In certain situations, however, it is less clear to whom the §302 requirements apply.

1. *Constructive Ownership Rules*

The rules of constructive ownership in §318 (see X., below) operate under §302 to determine the stock ownership of a

[179] 528 F.2d 917 (4th Cir. 1975), aff'g 62 T.C. 174 (1974).

[180] Rev. Rul. 89-64.

[181] *See, e.g.,* Rev. Rul. 72-256.

[182] §317(b).

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person who in fact transferred stock to the issuing corporation. Section 318 does not operate to attribute stock owned by the person from whom stock was actually redeemed "away" from him to a different person, or to treat the other person as a shareholder subject to §302.[183] In *Hanna Est. v. Commissioner*,[184] the Sixth Circuit rejected an argument by the IRS that, for loss disallowance purposes under §267(a)(1), stock redeemed from an estate was attributable to its beneficiaries and, so viewed, each beneficiary owned more than the requisite 50% ownership needed under §267.

2. Voting Trust

When the stock redeemed is held in a voting trust, it may be difficult to identify the shareholders. In Rev. Rul. 71-262, the IRS ruled that the requirements of §302 apply to the beneficiary, not the trust. The ruling involved a situation in which a father and son each owned 50% of the corporate stock. Each transferred all of his stock to a voting trust with an unrelated voting trustee, taking back certificates of interest in the trust. The trustee held legal title to the stock and held exclusive voting rights for the duration of the trust. Dividends were to be distributed currently to the certificate holders. The corporation redeemed all the stock held in the trust on behalf of the father, who otherwise severed all interest in the corporation. If the trust were treated as owner of the stock, the redemption would fail §302(b)(3) because the trust would continue in fact to own the son's stock. The IRS ruled that each trust beneficiary will be considered, for §§302 purposes, as the shareholder to whom the §302(c)(2) requirements apply.

Note: Rev. Rul. 71-262, in effect, also treats other beneficiaries as owning the stock held in trust for their benefit, for purposes of attributing such stock under §318 to the redeeming shareholder.[185] The position taken in Rev. Rul. 71-262 is not based on §318 attribution of the trust's stock to its beneficiaries. The ruling cites *Federal Grain Corp. v. Commissioner*,[186] which treats trust beneficiaries as the equitable, though not legal, owners of stock held in a voting trust.

3. Community Property

When stock is held as community property in accord with local law, e.g., a spouse holds stock as community property, the IRS has ruled that each spouse is considered a distributee as to half the redemption price of the stock.[187] This rule has important consequences in qualifying a redemption for exchange treatment under §302(b)(3) where the rules of family attribution would otherwise prevent such qualification.

When a spouse that holds stock as community property dies, the redemption proceeds on the stock from the estate are ordinarily taxable one-half to the estate and one-half to the surviving spouse. The Ninth Circuit addressed a variation of this in *Coates Trust v. Commissioner*.[188] The husband and wife had executed mutual wills. In her will, the wife agreed that if the husband predeceased her, she would transfer her share of the community property (including stock) into trust for herself and the couple's children. Under state law (Washington), such an agreement was specifically enforceable by the named beneficiaries. The court found that on the husband's death, the wife held her share of the community property in constructive trust for the beneficiaries of her agreement. The trust (which she subsequently created) was the beneficial owner of the stock when the redemption occurred from the estate. Therefore, the trust, rather than the wife personally, was the party taxable on the wife's community share of the redemption proceeds.

4. Publicly Held Corporations

Corporations whose stock is publicly held and traded on a securities exchange (whether national or regional) often go "into the market" to repurchase their own stock. In such situations the company does not negotiate directly with individual shareholders; it simply instructs its broker to purchase stated quantities of the outstanding stock. In accordance with standard procedures, the company does not know the identity of the person selling the shares; nor does the seller know the identity of the purchaser of the stock.

Comment: Whether §302 governs transactions when neither party knows the other's identity, is an unresolved tax question. The definition of redemption in §317(b) does not specifically require that the shareholder know that the issuing company is the buyer of the stock. As a practical matter, this issue is routinely ignored, and it is unlikely to be raised on audit since it would be difficult, if not impossible, to find who purchased the stock.[189]

5. Grantor Trust

When stock held by a "grantor" trust governed by §671–§678 is redeemed, the person to whom the trust's income is taxable is also treated as the shareholder to whom the requirements of §302 apply. In Rev. Rul. 72-471, a corporation had two shareholders — a son and a grantor trust whose sole beneficiary was the son's mother. The corporation redeemed all the stock held by the trust. The IRS ruled that because the mother was considered the redeemed shareholder for §302 purposes, the redemption could qualify for exchange treatment under §302(b)(3) if the mother filed the agreement required by §302(c)(2) for waiving attribution under §318 of her son's stock to herself.

If, in the basic fact pattern involved in Rev. Rul. 72-471, the trust's corpus was to go to the son at his mother's death, and if the corporation redeemed all the son's stock instead of all the trust's stock, it is unclear whether the trust's stock would be attributed to the son on the ground that the son has an actuarial interest as remainderman. If so, §302(c)(2) would not enable the son to avoid attribution of the trust's stock to himself. But if the mother, not the trust, is considered to own the stock for attribution purposes, the son could, via §302(c)(2), waive attribution from his mother. One commentator believes that, as ap-

[183] *Friend v. United States*, 345 F.2d 761 (1st Cir. 1965).
[184] 320 F.2d 54 (6th Cir. 1963), rev'g 37 T.C. 63 (1961).
[185] *See also* Rev. Rul. 71-426.
[186] 18 B.T.A. 242 (1929).
[187] Rev. Rul. 71-138.
[188] 480 F.2d 468 (9th Cir. 1973), aff'g 55 T.C. 501 (1970).

[189] Several commentators have argued that the §302 rules should not be applied to public companies. *See, e.g.*, Tierney, *Proposed Reg. Under 305(c) May Create Unexpected Taxable Stock Dividends*, 35 J. Tax'n 184 (1971).

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plied to this situation, the IRS would treat the trust as owning the stock for purposes of attribution to the son.[190]

Practice Point: The IRS ordinarily will not issue a ruling or determination letter on the question of whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under §671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.[191]

6. Testamentary Trust

In *Coates Trust v. Commissioner*,[192] a family corporation redeemed stock owned by the estate of one of its major shareholders, agreeing to pay the redemption price in annual installments over a 10-year period. Before the first payment was due, the estate distributed an undivided one-third interest in its rights under the redemption agreement to the trustee of the testamentary trust created by the decedent's will. The IRS found the redemption to be essentially equivalent to a dividend. In light of the estate's distribution to the trust, the IRS imposed the resulting tax on the testamentary trust to the extent of its interest in the redemption proceeds. The trust argued that the estate was the proper party to whom the deficiency letter should have been issued because the trust was not even in existence when the stock was redeemed by the corporation. However, the courts held that the "conduit" income taxation rules of §661 and §662 require the estate's distributee (the trust) to include the redemption proceeds in its income. The Tax Court stated:

> Although the Estate of Sydney N. Coates sold the shares to produce the income, such income, when distributed, was deductible by the estate and taxable to the beneficiary. See §§661 and 662. The Trust Under Will of Sydney N. Coates recognized the pass-through character of the income distribution from the Estate of Sydney Coates and reported such income as capital gain on the installment basis on its tax return for 1965.[193]

7. Other Cases

In *Wren v. Commisioner*,[194] the court permitted parol evidence to show that a written property settlement agreement dividing the spouses' community property had been orally modified, so that instead of the husband keeping 133 shares of stock in a family corporation and paying his wife $18,000 (as provided in the written agreement), the wife would receive 40 shares of the stock. The corporation also informally agreed to redeem the 40 shares from the wife for $18,000, which represented fair market value. The IRS sought to hold the parties to the written agreement and to tax the redemption gain to the husband rather than to the wife. The court, however, held that the agreement had been modified in an effective manner so that the wife owned the 40 shares when they were redeemed and was the party to whom the gain was taxable.

[190] Note, *Stock Redemptions: Termination of Interest and Grantor Trust*, 4 Tax Adviser 290 (1973).
[191] Rev. Proc. 2023-3, §4.01(42).
[192] 480 F.2d 468 (9th Cir. 1973), aff'g 55 T.C. 501 (1970).
[193] 55 T.C. at 512.
[194] T.C. Memo 1965-52.

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III. Tax Consequences of a Redemption

A. *Consequences of Redemption Treated as an Exchange*

1. *Shareholder-Level Tax Consequences*

a. *Computing Gain or Loss*

Where a redemption qualifies via §302(a) for exchange treatment, the amount of gain or loss which the shareholder realizes on the exchange is computed pursuant to §1001(a) and (b) and ordinarily must be recognized in full pursuant to §1001(c). In computing realized and recognized gain, the shareholder offsets adjusted basis in the redeemed shares against the sum of cash plus the fair market value of property other than cash which the shareholder receives as part of the redemption transaction. The shareholder's basis in the redeemed stock is determined under §§1011–1012. In the case of stock acquired from a decedent, the basis becomes the fair market value at the date of death, unless an election for an alternate valuation is made under §2032.

In determining the year in which a redeemed shareholder is properly taxable on the redemption, general tax principles — including constructive receipt, ability or inability to value the property received, and restrictions on the shareholder's use of the amount received — apply.[195]

If the stock surrendered was a capital asset in the shareholder's hands,[196] as will usually be the case, the shareholder's gain or loss will be capital. The gain or loss will be long-term or short-term depending on the shareholder's holding period.[197]

Note: In order for a capital gain or loss to qualify as long-term, the shareholder must have held the redeemed shares for more than one year.[198]

A net short-term capital gain which exceeds net long-term capital loss is includible in full with the shareholder's other ordinary income for the year.

If the shareholder incurs a capital loss on the redemption, a shareholder who is an individual (including an estate or trust) can offset a net long-term or short-term capital loss against up to $3,000 of ordinary income for the year in which the redemption occurred.[199] Excess losses may be carried over to future years indefinitely.[200] In general, a shareholder that is a corporation cannot deduct a net capital loss against its ordinary income but can carry the loss back for three years and forward for five years.[201]

A shareholder holding more than one block of shares can choose the basis and holding period of the stock redeemed by making an "adequate identification" of the redeemed shares under Reg. §1.1012-1(c). Absent such an identification, the shares earliest acquired by the shareholder among the shareholder's total ownership will be those considered redeemed for purposes of determining basis and holding period.[202]

(1) *Receipt of More than Fair Market Value of Stock*

In negotiating the redemption price, the parties will ordinarily seek to have the corporation distribute property the current fair market value of which equals the current fair market value of the stock redeemed. Capital gain or loss treatment applies only to the extent the property received does not exceed the fair market value of the stock redeemed.[203]

If the value of the property received in the exchange exceeds the fair market value of the stock surrendered, the IRS reserves authority to treat the excess as a dividend subject to §301, as compensation from the corporation, or as a gift to the distributee from other shareholders.[204]

A dividend or other "excess" payment issue may also rise on other facts. For example, in *Rickey v. United States*,[205] the articles of a closely held corporation required a shareholder who desired to sell his stock, to offer it to the company at book value, and then to other shareholders at book value. Under this provision the company redeemed part of the interest of its majority shareholder at a negotiated price of $700 per share, although the per-share book value at the time was $500. The IRS treated the $200 excess of purchase price over book value as an ordinary §301 distribution entirely apart from §302. The court rejected this treatment, because the facts showed that the company had sound business reasons for waiving its option to repurchase the shares at book value and that the price paid reflected current fair market value. Therefore, the entire distribution was regarded as paid for the stock, subject to the rules of §302.

Note: The court found that the redemption was not intended as an exercise of the company's rights under the articles, since the taxpayer never intended to sell his shares to a third party. Instead, both he and the company regarded his health as a danger to the company's stability and recognized that if the company waited until his death to buy back his shares, the company would need to carry adequate (and costly) insurance on his life.

"Since the corporation was receiving a benefit by not having to purchase additional insurance," the court said, "the directors were willing to forego their right to purchase at book value and offer a fairer price which exceeded book value. We do not feel that Article VI prohibits such a transaction. Each side re-

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195 *See, e.g., Bette v. Commissioner*, T.C. Memo 1977-404 (redemption proceeds received in cash in 1965 not taxable in that year because agreement required immediate endorsement of check to escrow agent pending outcome of contingent corporate liabilities; actual distributions made to shareholder out of escrow in 1966 and 1970). *But see Barton Theatre Co. v. Commissioner*, T.C. Memo 1980-128, aff'd, 701 F.2d 126 (10th Cir. 1983) (where agreement providing for redemption is negotiated and dated in one year but not formally executed until the following year, the time of exchange is when redemption occurred, not the date of formal execution).

196 *See* §1221.

197 *See* §§1222, 1223.

198 §1222(3), §1222(4).

199 §1211(b).

200 §1212(b).

201 §1212(a). For tax years beginning before December 23, 2010, a regulated investment company could carry forward a capital loss for eight years. Pre-2010 §1212(a)(1)(C). For later years, there is no limit on carry forward years. §1212(a)(1)(C).

202 Reg. §1.1012-1(c)(1). *See also* Rev. Rul. 72-415.

203 Rev. Rul. 57-295.

204 For example, see Reg. §1.301-1(h); Rev. Rul. 59-97, Rev. Rul. 58-614. *See also* Rev. Rul. 77-20 (excess value of stock spun off to a shareholder in a §355 "splitoff" over value of stock surrendered separately taxable to shareholder, on the facts, as rental income); Rev. Rul. 79-10.

205 427 F. Supp. 484 (W.D. La. 1976), aff'd on other grounds, 592 F.2d 1251 (5th Cir. 1979).

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ceived some benefit and each gave up some interest in a compromise beneficial to both."[206]

(2) *Receipt of Less than Fair Market Value of Stock*

If the corporation pays the shareholder less than current fair market value, and if the redemption otherwise qualifies for exchange treatment under §302(b), it is not clear how the amount of gain or loss is computed and what other tax effects might also be involved.

> *Example:* T, an individual, owns 10 of 100 outstanding shares of X corporation. Each share is currently worth $10. T's basis in each of T's shares is $1. T surrenders all T's stock to X for a distribution of $30. In Rev. Rul. 58-614, the IRS states that "if a shareholder surrenders stock to a corporation for less than its fair market value, such surrender may be a gift or compensation to the shareholders who remain interested in the corporation."[207]
>
> In the above example, T might realize a gain of $20 ($30 amount realized less $10 basis) along with making a $70 gift, or paying $70 compensation, to other shareholders. Another possibility, suggested by Rev. Rul. 56-513,[208] is to treat a shareholder as always surrendering stock at its fair market value. Under that approach, T would be treated as surrendering to the corporation for $30 consideration only three shares and as realizing a $27 gain on the redemption ($30 amount realized less $3 basis in three redeemed shares). T might also be treated as having transferred the remaining seven shares ($70 value) to the corporation without consideration.

If the particular facts of a redemption indicate an intent by the shareholder to cause other shareholders to receive compensation rather than a gift, the shareholder is nevertheless precluded from taking a §162 deduction equal to the amount of the compensation. The transaction is recast as a contribution to the capital of the corporation, which becomes entitled to a §162 deduction as the stock is constructively retransferred from the corporation to the remaining shareholders.[209]

In a pro rata distribution in partial liquidation governed by §302(b)(4), the number of shares surrendered is immaterial to the shareholder, since the percentage interest represented by his remaining shares remains the same regardless of how many shares are surrendered by all shareholders. The abuse potential, however, is that shareholders could increase the absolute number of shares surrendered in order to apply a larger basis against the amount realized and thereby minimize their capital gain or generate a capital loss. In Rev. Rul. 56-513, the IRS ruled that, for purposes of determining gain or loss, the shareholder will be deemed to have surrendered only a portion of the total outstanding stock proportionate to the portion of the total net assets (by fair market value) received in the distribution. The ruling says, in relevant part:

> In determining the amount of the gain or loss, regardless of the actual number of shares surrendered for redemption by the stockholders, the total number of shares deemed to have been surrendered is that number which bears the same ratio to the total number of shares outstanding as the [amount] distributed bears to the total fair market value of the net assets of the corporation immediately prior to the distribution.[210]

> *Example:* The fair market value of a corporation is $600,000 represented by 1200 shares of stock, owned equally by unrelated individuals A, B, and C (400 shares each). Each shareholder's cost basis per share is $200. The company sells one of its active businesses and distributes under §302(b)(4) a total of $150,000 ($50,000 to each shareholder) in pro rata redemption of part of the stock of each shareholder. Each shareholder surrenders 200 shares, and reports a capital gain of $10,000 ($50,000 amount received less $40,000 total basis in 200 shares exchanged). Under Rev. Rul. 56-513, however, each shareholder would be deemed to have surrendered only 100 shares, so that each shareholder's capital gain would be $30,000 ($50,000 amount received; less $20,000 basis in 100 shares).

In substance, this rule provides that the exchange is deemed to occur at fair market value; that is, the distribution is deemed made in exchange for a number of shares equal in total fair market value to the total fair market value of the amount distributed to the particular shareholder.

Outside of the partial liquidation context, this issue cannot arise because a pro rata redemption that leaves a particular shareholder's percentage interest unchanged will always be equivalent to a dividend. Therefore, it is not necessary to refer to the shareholder's basis in the surrendered shares. Since *United States v. Davis*,[211] a bona fide business purpose can no longer salvage exchange treatment for a pro rata redemption.

b. *Basis in Redeemed Stock*

Where a redemption receives exchange treatment, the shareholder's cost basis in the redeemed shares is applied against the amount realized to determine the amount of gain or loss realized on the exchange. There is no "disappearing basis problem" such as can arise when a redemption is found to be essentially equivalent to a dividend. See III.B.1.d.(2), below.

In a "constructive" redemption governed by §304(a)(1), however, a transfer-of-basis question can arise even where the redemption qualifies for exchange treatment. For a discussion of §304, see 768 T.M., Stock Sales Subject to Section 304.

[206] 427 F. Supp. 484 (W.D. La. 1976), aff'd on other grounds, 592 F.2d 1251 (5th Cir. 1979).

[207] *See also* Rev. Rul. 79-10. *Cf.* PLR 200117016 (no constructive dividend to remaining shareholders (husband and wife) from redemption of stock held by other family members; stock valued by qualified appraiser on purchase date with significant majority of assets being publicly traded securities).

[208] Amount of gain or loss in a pro rata liquidation distribution determined by reference to number of shares deemed redeemed in proportion to net assets of corporation (by fair market value). *Cf.* Rev. Rul. 55-592.

[209] Reg. §1.83-6(d) (corporation gets deduction under contribution to capital theory); Rev. Rul. 80-76(corporation may take §162 deduction by virtue of §83(h)), *amplified by* Rev. Rul. 81-45; *Plumley v. Commissioner*, 29 T.C.M. 98 (1970) (no shareholder deduction).

[210] Rev. Rul. 56-513. *See also* Rev. Rul. 77-245 (publicly traded stock) *amplifying* Rev. Rul. 56-513; PLR 9619050 (to the extent the fair market value of the distribution exceeds the fair market value of the stock deemed surrendered in exchange therefor, the additional shares considered redeemed pursuant to Rev. Rul. 77-245 will be determined in accordance with Rev. Rul. 68-348 and Rev. Rul. 85-48).

[211] 397 U.S. 301 (1970).

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c. Basis in Distributed Property

If a redemption is treated as essentially equivalent to a dividend under §301(a), the basis of property received is fair market value.[212] If the redemption is treated as an exchange under §302(a), the distributed property has a cost basis (the fair market value of the redeemed stock) under §1012. If the fair market value of the stock redeemed is not equal to the fair market value of the property received, the basis of the property received depends on the characterization of the transaction, as discussed above.

If the property distributed is the corporation's own debt obligation and, under the tax rules, the obligation itself must be valued and taken into account as part of the shareholder's recognized gain or loss, the shareholder takes a basis in the obligation equal to its fair market value. This value may not equal the full principal amount of the obligation. If the obligation is not required to be taken into account when distributed, the obligation does not receive a separate basis in the shareholder's hands. If the redemption qualifies for exchange treatment, the shareholder's stock basis is applied directly against later corporate payments on the obligation. See III.A.1.d., below.

If the shareholder elects installment reporting under §453 with respect to the gain realized on the redemption exchange, the shareholder's basis in the debt obligation received from the corporation is not the current fair market value of the obligation; instead, the shareholder's basis in the obligation is determined under §453.[213]

d. Installment Payouts

When a corporation distributes the corporation's own debt obligation to a shareholder in part or full payment of the redemption price of some or all of the shareholder's stock, the corporation is treated as having agreed to pay all or part of the redemption price in one or more future payments.

Regardless of whether the corporation merely promises to pay the redemption price in future installments under the redemption agreement or executes a separate written promissory note, debenture, or other similar debt instrument, the obligation is considered "property" for purposes of testing the tax treatment of the redemption under §302. See II.C.2., above.

Once the basic tax treatment of the redemption is determined (i.e., exchange or §301 distribution), the question becomes when the redemption is taxable. Under the general rule of §1001(b), if the redemption qualifies for exchange treatment, a corporate note, bond, or debenture itself ordinarily must be valued and taken into account at its fair market value, rather than at its principal (face) amount, in computing the gain or loss realized by the shareholder on the exchange. This general rule applies to both corporate and noncorporate shareholders. A different measurement of amount realized applies, according to the IRS, to shareholders (individual or corporate) using the accrual method of accounting. Accrual method taxpayers that sell property and receive a debt obligation of the buyer in part or full payment must take the obligation into account at its face or principal amount (rather than at its fair market value).[214] This rule also applies to the determination of an accrual method shareholder's gain or loss on a redemption of stock when the redemption qualifies for exchange treatment.

If the corporation issues its own note or debenture, it has the opportunity to defer payment of tax on the gain and to pay the tax out of the company's payments as and when received.[215] The courts and the IRS have also developed specific factors for determining whether a shareholder can defer tax on the gain when either a separate written debt obligation or a "mere" contract promise is distributed to the shareholder. Among the factors are the shareholder's accounting method, the degree of "contingency" of the company's obligation, the transferability of the obligation, and the financial condition of the corporation.[216]

Practice Point: Note that installment sale reporting is not permitted if the corporation's stock is publicly traded.[217] The installment sale method is also unavailable in a redemption that is treated as a distribution subject to §301 (instead of as an exchange subject to §302(a)).[218]

If the corporation distributes its own debt obligation in a redemption (whether or not evidenced by a mere contract promise or by a separate written promissory note or debenture), and if the obligation itself is required to be valued for gain or loss recognition purposes, the excess of the face (principal) amount of the obligation over the fair market value of the redeemed stock (or its equivalent, the fair market value of the obligation itself) ordinarily is not subject to dividend, compensation, or gift treatment.

e. Special Situations

(1) Accrued Dividends on Preferred Stock

If the redemption price of preferred stock includes accrued, previously unpaid dividend arrearages, the entire distribution may be eligible for capital gain or loss via §302 under certain conditions. For example, the entire amount paid in redemption of preferred stock, including a dividend accruing on the date set for redemption and amounts offered for earlier redemption and designated as interest was considered payment for the stock surrendered.[219] Under other conditions, part or all of the distribution representing accrued dividends may be treated as dividend income. For example, an amount representing a dividend declared before the redemption of preferred stock, and included in the total redemption payment, was treated as a dividend distribution under §301.[220] For a discussion of these issues, see 764-4th T.M., *Dividends — Cash and Property.*

[212] §301(d).

[213] *See* Rev. Rul. 79-371.

[214] Rev. Rul. 89-122, Rev. Rul. 79-292.

[215] *See* §453.

[216] *Cf. Burnet v. Logan*, 283 U.S. 404 (1931) (value of property received in liquidation not readily determinable; therefore, court held that gain could not be ascertained until future payments were more than indeterminate sums). If a corporation issues debt to a stockholder in connection with a redemption of stock from the stockholder and the parties later agree to reduce the amount of the debt, the reduction is treated as an adjustment to the purchase price of the stock under §108(e)(5), provided that the reduction did not occur in a Title 11 case or when the corporation was insolvent. *See* TAM 9338049.

[217] §453(k)(2)(A).

[218] *See* TAM 8134027.

[219] Rev. Rul. 69-131.

[220] Rev. Rul. 69-130.

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(2) Section 306 Stock

If "§306 stock" is redeemed, the entire amount of the redemption proceeds may be a §301 distribution entirely apart from the §302 tests.[221] However, several exceptions in the §306 rules provide an escape from this flat §301 treatment. The effect of falling within any of these exceptions is not automatically to achieve exchange treatment, but rather to reinstate the tests of §302. See 765-4th T.M., *Stock Rights and Stock Dividends: Sections 305 and 306.*

(3) Collapsible Corporations — Prior Law

The collapsible corporation provisions under former §341 were permanently repealed by the American Taxpayer Relief Act of 2012.[222] If a corporation was classified as a collapsible corporation for years during which the collapsible corporation provisions were in effect, it was unclear whether a redemption by the corporation was subject to former §341(a), which stated that gain with respect to the stock was ordinary gain. Former §341(a)(1) applied the collapsible corporation rules to a "sale or exchange of stock of a collapsible corporation," and former §341(a)(2) referred to a distribution in partial or complete liquidation, but not to a redemption tested under §302. The regulations, which the IRS removed in 2019, stated that former §341 applied to an '"actual" sale or exchange of stock and to a distribution in complete or partial liquidation "treated as" payment in exchange for stock.[223]

Comment: The omission of redemptions tested under §302 was probably a legislative oversight rather than a policy decision. The conservative conclusion was that former §341 would apply to a former §341 redemption (which was also treated as an exchange).[224]

A collapsible corporation that filed a consent in accordance with former §341(f) had to recognize gain on its "subsection (f) assets" if it later distributed those assets in a redemption of its own stock. As to each subsection (f) asset, former §341(f)(2) stated that the corporation had to recognize as gain the excess of the fair market value of the asset at distribution over its adjusted basis to the corporation.

Under the general gain recognition rule of former §341(f)(2), gain was recognized notwithstanding any other income tax provision of the Code, but only to the extent gain was not recognized under any other such provision. Because §311(b)(1) generally requires recognition of gain, §311(b)(1) appears to take precedence over former §341(f)(2). Under §311(b)(1), the amount and nature of gain recognized to the corporation generally is determined as if the property were sold for its fair market value on the date of distribution. Because "subsection (f) assets" by definition were not capital assets, the gain recognized via §311(b)(1) was in many cases ordinary gain. This is the same tax result as former §341(f)(2) typically produced.

(4) Controlled Foreign Corporation

Section 1248 supersedes §302 in the redemption by a controlled foreign corporation from a U.S. shareholder. If §1248 is satisfied, part of a shareholder's gain on a redemption, which otherwise qualifies for exchange treatment under §302(a), is treated as a dividend to the extent of corporate earnings and profits accumulated after 1962 and during the period for which the shareholder held the stock.[225]

(5) Tax-Exempt Entities

If the shareholder is a §501(a) tax-exempt organization, the entire amount of the redemption proceeds it receives is free of income tax. Included in tax-exempt organizations are charities and educational institutions described in §501(c)(3) and trusts under qualified employee pension or profit-sharing plans.[226]

If stock is redeemed from a "private foundation" (basically, a §501(c)(3) organization that is not publicly supported to a prescribed degree), an excise tax may be imposed on the corporation if the redemption price is paid in future installments and constitutes "self-dealing."[227]

A redemption of stock owned by trust under tax-exempt employee benefit plans may bring into play the §4975 excise tax on prohibited transactions. This tax may be imposed on a "disqualified person" in (among other transactions) a sale or exchange of property or a lending of money or other extension of credit between an employee trust and a disqualified person.[228]

(6) Noninvestment Purposes

In *Corn Products Refining Co. v. Commissioner*,[229] the Supreme Court held that capital gain (or loss) is not available for transactions in property that produce gain or loss from the everyday conduct of a taxpayer's business. This concept has been applied to a taxpayer's purchase of stock in an unrelated corporation with which the taxpayer does business for the purpose of assuring or maintaining a source of supply or other business relationship. The courts have considered whether a loss sustained by the taxpayer on a later sale of the stock is treated as capital loss or an ordinary loss. Courts finding that the taxpayer was not interested in holding the stock as an investment generally have allowed the taxpayer an ordinary loss.

The *Corn Products* doctrine was substantially narrowed in *Arkansas Best Corp. v. Commissioner*,[230] in which the Supreme Court held that virtually all investment losses are considered capital unless they are the functional equivalent of inventory.

Comment: Few cases in this area have involved a sale by the taxpayer back to the issuing corporation. However, it seems plain that both the courts and the IRS would permit ordinary loss treatment on a sale of the stock back to the issuer where the *Corn Products* doctrine, as modified by *Arkansas Best*, is oth-

[221] §306(a)(2).

[222] The 2003 Jobs and Growth Tax Relief Reconciliation Act repealed the collapsible corporations provisions (former §341) for tax years beginning after 2002.

[223] Reg. §1.341-1, removed by T.D. 9849, 84 Fed. Reg. 9231 (Mar. 14, 2019).

[224] *See Spangler v. Commissioner*, 278 F.2d 665 (4th Cir. 1960). *Cf.* Holden, "The Collapsible Corporation . . .," 34th *N.Y.U. Ann. Inst. on Fed. Tax* 11, 19 (1976).

[225] §1248(a).

[226] *See* §401(a).

[227] *See* §4941(d)(1)(B).

[228] §4975(c)(1)(A), (B).

[229] 350 U.S. 46 (1955).

[230] 485 U.S. 212 (1988).

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erwise satisfied.[231] Indeed, the IRS has advised that redemption proceeds were ordinary income when received by the redeeming corporation's former creditor who had accepted part payment in stock because of the company's financial difficulty but who also had the right to redeem the stock for cash. The IRS ruled that the holding of the stock was business-related and that the proceeds also substituted for collection of debt obligations acquired by the creditor in the ordinary course of his business.[232]

f. Recognition of Loss

If the shareholder's stock basis exceeds the amount received, the shareholder will realize a loss only if the redemption qualifies for exchange treatment pursuant to §302, and generally will be treated as a capital loss. If the redemption is equivalent to a dividend, the amount of the distribution will be subject to §301 without regard to the shareholder's basis in the redeemed stock.

Where a shareholder realizes a capital loss on a redemption that is treated as an exchange under §302, the rules of §267 and a variety of nonstatutory principles may cause the loss to be nondeductible.

(1) Section 267

The principal statutory limitation on recognizing a redemption loss is §267(a), which disallows any deduction in respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified within any one of the paragraphs of §267(a). A redemption that qualifies for exchange treatment under §302 is subject to §267(a).[233] Among the related parties between whom a loss is disallowed is "[a]n individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual."[234] Section 267 also applies to a trust shareholder if either the trust or its grantor owns, directly or indirectly, more than 50% in value of the outstanding stock.[235] Section 267 incorporates its own set of broad attribution rules.[236] For a more detailed discussion concerning the rules of §267, see 564 T.M., *Related Party Transactions.*

Note: An estate can also realize a loss on a redemption, but the courts have held that an estate is not subject to the limitation in §267(a)(1).[237] When an individual shareholder dies, the shareholder's estate generally takes a basis in the stock acquired from the decedent equal to its fair market value at death (under §1014). In some cases the stock basis will be stepped down and thus automatically wipe out any unrealized loss existing before death. Nevertheless, depending on when a redemption occurs after death, an estate may still realize a loss.

Observation: Ordinarily, the buyer of loss property takes a cost basis in the property, so that where §267 applies, the portion of the seller's basis in excess of the sale price is effectively "lost" for most purposes. The only exception arises if the buyer later resells the property at a gain. In such a case §267(d) provides that the gain is recognized only to the extent it exceeds the previously disallowed loss. However, where the redeeming corporation is reselling its own stock, §1032 requires nonrecognition of any gain, so that part of the redeemed shareholder's basis in the shares is permanently lost.[238]

(2) Section 461(l)

For tax years beginning in 2021 through 2028, §461(l), enacted as part of the Tax Cuts and Jobs Act of 2017, limits the deductibility of excess business losses of noncorporate taxpayers. Specifically, a noncorporate taxpayer is able to deduct business losses to the extent of business income plus $250,000 ($500,000 in the case of a joint return). The statutory amounts for disallowance are adjusted for inflation.[239] Additionally, any disallowed loss from one year is carried forward as a net operating loss to the following tax year.[240] An excess business loss carryover may be subject to the 80% of taxable income limitation in the carryover year.[241]

(3) Nonstatutory Principles

Sections 267 and 461 are not exclusive. Even if a loss between related parties survives §267, it can still be disallowed even if the terms of §267 are not satisfied where the evidence shows that the loss is not bona fide or otherwise lacks economic substance.[242]

(4) Corporate Note Received: When Loss Realized

The IRS and the courts apply the same loss rules for redemptions as are applied in situations where a corporation completely liquidates. No loss is considered realized until the total amount that the shareholder can expect to receive for the shareholder's stock in the corporation is reasonably ascertainable. The shareholder cannot select the year to claim his loss, in part or in whole, by estimating a maximum amount the shareholder expects to receive over the course of the liquidation and deducting a loss based on that estimate.[243]

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[231] *See* Rev. Rul. 70-64 (loss incurred by member of an agricultural cooperative on redemption of qualified written notice of allocation held ordinary loss on *Corn Products* principles); Rev. Rul. 58-40, *suspended by* Notice 87-68. *See also Agway, Inc. v. United States*, 524 F.2d 1194 (Ct. Cl. 1975) (gain on a redemption of preferred stock held by the taxpayer-patron in an agricultural cooperative (before enactment of §1381–§1388) qualified for capital gain treatment; a dissenting opinion argued that since there was not investment intent in the holding of the stock, the taxpayer's gain should be ordinary income).

[232] PLR 7903024.

[233] *McCarthy v. Conley*, 341 F.2d 948 (2d Cir. 1965); *Reubin v. Commissioner*, 5 T.C.M. 216 (1946); Rev. Rul. 57-387, *as modified by* Rev. Rul. 77-293.

[234] §267(b)(2).

[235] §267(b)(8).

[236] §267(c).

[237] *Hanna Est. v. Commissioner*, 320 F.2d 54 (6th Cir. 1963), rev'g 37 T.C. 63 (1961). *See also Ingalls Est. v. Commissioner*, 45 B.T.A. 787 (1941), aff'd, 132 F.2d 862 (6th Cir. 1943).

[238] *See McCarthy v. Conley*, 341 F.2d 948, 953, n.14 (2d Cir. 1965).

[239] §461(l)(3)(B).

[240] §461(l)(2).

[241] For losses arising in tax years beginning after December 31, 2020, the net operating loss deduction is limited to 80% of a taxpayer's taxable income, computed without regard to the net operating loss deduction, or deductions under §199A and §250.

[242] Reg. §1.267(a)-1(c). For additional information on §267, see 564 T.M., *Related Party Transactions.*

[243] *See Turner Constr. Co. v. United States*, 364 F.2d 525 (2d Cir. 1966). *See also Schmidt v. Commissioner*, 55 T.C. 335 (1970); Rev. Rul. 68-348, *amplified by* Rev. Rul. 85-48.

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In a redemption, this situation may arise where a shareholder receives a corporate promise to pay in the future, or to make one of a series of promised payments, in exchange for the redeemed shares.

2. Corporate-Level Tax Consequences

a. Recognition of Gain

(1) In General

Section 311(a) provides the general rule that no gain or loss is recognized by a corporation on the distribution of property "with respect to its stock." However, §311(b)(1) provides that if:

> (A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a distribution to which subpart A[244] applies, and
>
> (B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

Non-liquidating distributions, therefore, are subject to tax on gain, but nonrecognition of loss.[245] In both cases, however, shareholders take a fair market value basis in the distributed property.[246] This "step-down" in basis where loss property is distributed is permanent (unlike where §267(a) applies, and §267(d) may provide some future benefit).

Section 311(b)(2) provides that rules similar to the rules of §336(b) apply for purposes of §311(b). Section 336(b) generally provides that in determining fair market value of assets subject to a liability (or where the distributee assumes a liability in connection with the distribution), the value of the property distributed is deemed to be not less than the liability.

Observation: When a corporation desires to use loss property to redeem its stock, it may be advisable to sell that property to a third party and use the cash proceeds for the redemption. This will generally permit the corporation to recognize the loss. Sales to related parties, however, may be caught by the loss disallowance/deferral rules of §267.

Observation: When both gain and loss property are to be distributed, no netting of losses against gains is permitted. Contributing both gain and loss assets to a new corporation before distribution, however, does produce netting, as the basis and value of the distributed stock, which reflects the aggregate bases and values of the contributed assets, will be the measure for any §311 gain. This netting, however, comes at the cost of leaving the assets in corporate solution. Use of a partnership or trust to arrive at the same result, however, is proscribed by §311(b)(3) (under yet-to-be-written regulations). In some cases, use of an S corporation may provide some relief.

Observation: When a distribution of corporate assets in kind is to be made to public shareholders, the form of that distribution is generally a distribution of the stock of a subsidiary. If §311(b) gain is recognized on the subsidiary's stock, the corporation pays tax but provides no future tax benefit to the shareholders because the basis of the assets of the subsidiary are not "stepped-up" to reflect the gain recognized by the corporation on the distribution of the subsidiary's stock. If the distributing corporation wishes instead to recognize §311(b) gain on the assets of the distributed subsidiary, and thereby give the subsidiary a "step-up" in the basis of its assets, proper planning can accomplish the desired result. Note that section 336(e) provides that a corporation that owns enough stock in a subsidiary corporation to satisfy the §1504(a)(2) 80% vote and value test may elect to treat a sale, exchange or distribution of all such stock as a sale, exchange or distribution by the subsidiary of all of its assets.[247] The regulations allow a domestic corporation or S corporation shareholder(s) that make a "qualified stock disposition" (QSD) of another domestic corporation to elect to treat the disposition as a deemed asset sale. A QSD is a transaction or series of transactions in which stock meeting the requirements of §1504(a)(2)(80% by vote and value) of a domestic corporation is either sold, exchanged or distributed (or any combination thereof) by a another domestic corporation or by the S corporation shareholders in a disposition during the 12-month disposition period.[248]

Section 311 applies both to redemptions that receive exchange treatment under §302(a) and those that receive distribution treatment under §302(d).

The character of the corporation's gain under §311(b)(1) as ordinary or capital, long-term, or short-term, depends on the usual rules governing the type of property distributed and its holding period in the hands of the corporation, applied as if the corporation sold the property for its fair market value at the distribution date. If the property distributed were depreciable, the depreciation recapture rules in §1245 and §1250 may require recognition of gain realized on the property.[249] Furthermore, when the recapture rules overlap §311(b)(1), they characterize part or all of the gain recognized under §311(b)(1) as ordinary income. These rules apply to the distributing corporation regardless of the tax treatment of the redemption at the shareholder level.[250] The recapture rules of §1252 (regarding farm recapture property) similarly overlap §311(b)(1) and characterize part or all of a recognized gain.

If a corporation distributes depreciable property to a 50% or greater shareholder in redemption of part or all of the shareholder's stock, the provisions of §1239 may operate to treat the corporation's recognized §311(b)(1) gain as ordinary income.[251]

244 Here, "Subpart A" refers to §301–§307.

245 Different rules apply for purposes of complete liquidations under §336.

246 §301(d). Reg §1.301-1(g), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(d) in 1988.

247 *See* Reg. §1.336-2(a).

248 Reg. §1.336-1(b)(6)(i). For any "qualified stock disposition" (QSD) for which the disposition date is prior to May 15, 2013, the corporation could not avail itself of §336(e), because the proposed regulations had not been finalized; with respect to QSDs for which the disposition date is on or after May 15, 2013, the final §336(e) regulations apply. Note that in CCA 201009013, the Chief Counsel's Office advised that a taxpayer was not permitted to make an election under §336(e) until the proposed regulations were finalized.

249 *See* Reg. §1.1245-1(a)(1); §1.1245-1(c)(2) *Ex.* 1.

250 Rev. Rul. 76-339 (defining "disposition"). §1245(a)(1), §1245(d), §1250(a)(1), §1250(a)(2), §1250(a)(3).

251 Rev. Rul. 75-514. *See also Pope & Talbot, Inc. v. Commissioner*, 162 F. 3d 1236 (9th Cir. 1999) (interpreting Rev. Rul. 75-514).

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Section 1239 applies to gain recognized on a "sale or exchange" of depreciable property between certain related persons including a corporation and a shareholder who owns (actually and constructively) more than 50% or more in value of the outstanding stock.[252] Thus, if a corporation enters into a sale or exchange with one or more of its shareholders by distributing depreciable property in exchange for shares of its own stock, and the general rule of §311(b)(1) requires the company to recognize gain on the property. Part or all of the gain may produce ordinary income by virtue of §1239. This result will occur, however, only with respect to a shareholder who owns more than 50% in value of the outstanding stock. If a greater than 50% shareholder and one or more minority shareholders have some or all of their shares redeemed at the same time, §1239 would convert to ordinary income only the part of the corporation's recognized gain attributable to the distribution to the 50% shareholder. The rest of the corporation's recognized gain would not be affected by §1239.

Note that the hypothetical sale language of §311(b)(1) is not limited to a sale to an unrelated outsider. Moreover, it is immaterial that the redemption reduces a greater than 50% shareholder's percentage ownership to 50% or less as a result of the redemption. Rev. Rul. 75-states that in applying §311(b)(1), the IRS is not confined to hypothesizing a corporate sale to an unrelated person but must, instead, hypothesize a sale to the person who actually received the distribution. Under this view, §1239 becomes relevant. The ruling also interprets §1239 as making no exception for a situation where as a result of the redemption, the shareholder's percentage ownership drops below 50%.[253]

Under §10201 of the Inflation Reduction Act, signed into law on August 16, 2022, certain public corporations that enter into stock buybacks are subject to a 1% excise tax measured on the amount of consideration used to buy stock back on the open market.[254] For a detailed discussion of the stock buyback excise tax, see X.G., below.

(2) Exceptions

(a) Debt Obligations of Distributing Corporation

Section 311(b)(1) (requiring gain recognition on the distribution of appreciated property) overrides §317(a) (broadly defining "property") in one important respect: obligations of the distributing company are specifically excepted from the definition of "property" for purposes of §311(b)(1). The general rule of §311(b)(1) refers to a distribution of property by a corporation "other than an obligation of such corporation." The effect of this exception is to permit an installment payout redemption free of tax to the corporation.

Practice Point: Promissory notes issued by a corporation generally constitute property within the meaning of §317(a). Such notes may have a zero basis to their issuer,[255] so that, but for the exclusion, the corporation might recognize gain to the full extent of the notes' fair market value.

If a corporation redeems some or all of a shareholder's stock for its own note or debenture and, at the time of the redemption, there is a plan or intent to satisfy the note with appreciated property, the tax results are unpredictable. The IRS may apply general step-transaction principles and deny the benefit of the exception under §311(b)(1) for the distributing company's own obligations. Instead, the IRS may treat the corporation as having distributed appreciated property in the year in which the redemption occurred.[256]

If the corporation issues its debt obligation for the redemption price and, assuming no prearranged plan, later distributes appreciated property in payment of one or more installments due under the obligation, the corporation must recognize gain on the later distribution, not via §311(b)(1), but via the broader general rule requiring recognition of gain when appreciated property is used to pay a debt.[257] The IRS reached the same conclusion in Rev. Rul. 77-256,[258] where a corporation that had redeemed all of a shareholder's stock for a note two years earlier made a note payment to him in the form of appreciated property. The IRS ruled that, at the later date, the former shareholder received the payment solely in his capacity as a creditor, not as a shareholder. Because appreciated property was used to pay a debt, the corporation was required to recognize gain in the year in which the appreciated property was transferred, in the amount of the difference between the fair market value of the property on the date of transfer and its adjusted basis to the company on that date.

(b) Section 355 Transactions

The §311 rules cover only distributions of appreciated property to which §301–§307 apply.[259] Consequently, §311(b)(1) does not apply to transactions that qualify as tax-free divisions under §355. In a §355 transaction, a corporation distributes to its shareholders the stock or securities of a corporation that it controls, sometimes in exchange for all or part of the receiving shareholders' stock or securities in the distributing corporation.[260] The distribution need not be pro rata.[261] In a §355 transaction, the receiving shareholders are not taxed on the distribution and, so long as the transaction qualifies under §355, the distributing corporation is protected against §311(b)(1). If, however, the corporation distributes appreciated property other than stock or securities of the controlled corporation, rules sim-

[252] §1239(a); Reg. §1.1239-1.

[253] The ruling cited *Drake, Inc. v. Commissioner*, 145 F.2d 365 (10th Cir. 1944), as support for this interpretation. Technically, Rev. Rul. 75-514 did not interpret §1239 as providing no exception where a shareholder's percentage ownership drops below 50%. Rather, it interpreted §1239 as providing no exception where the percentage of ownership drops below 80%. The 80% threshold was relevant because, before its amendment in the 1986 TRA, §1239 applied only when a corporation distributed property to a shareholder who owned 80% (rather than 50%) or more of that corporation. Presumably, however, the reasoning of Rev. Rul. 75-514 remains valid despite the 1986 TRA's change in the percentage of pre-redemption ownership required to apply §1239. *See also Moore v. Commissioner*, 202 F.2d 45, at 47 (5th Cir. 1953).

[254] §4501.

[255] *See* Rev. Rul. 68-629; *Alderman v. Commissioner*, 55 T.C. 662 (1971). *But see Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989) and *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir., 1998).

[256] *See* Rev. Rul. 77-256, *obsoleted by* Rev. Rul. 2003-99.

[257] *See, e.g., United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960).

[258] *Obsoleted by* Rev. Rul. 2003-99.

[259] §311(b)(1)(A).

[260] *See* §355(a)(1).

[261] §355(a)(2)(A).

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ilar to §311(b) apply.[262] For a more detailed discussion of §355, see 776 T.M., Corporate Separations.

(c) Reorganizations

Because the §311 rules cover only distributions of appreciated property to which §301–§307 apply, §311 does not apply to exchanges covered by the reorganization provisions. However, as in §355 transactions, distributions of appreciated property other than stock or securities of the distributing corporation or of another party to the reorganization result in recognition of gain under rules similar to §311.[263]

In some cases, a particular shareholder in an acquired corporation may receive no stock in the acquiring company, but instead solely "boot" or solely securities of the acquiring company. Such an exchange is not governed by §354 and §356, but instead is governed by the redemption rules of §302.[264] Accordingly, if such a shareholder receives appreciated property, the corporation may not be protected from §311 gain as to that property.

For a more detailed discussion of the reorganization provisions, see 771 T.M., Corporate Acquisitions — (A), (B), and (C) Reorganizations, 772 T.M., Corporate Acquisitions — D Reorganizations, and 774 T.M., Single Entity Reorganizations: Recapitalizations and F Reorganizations.

b. Basis in Stock Redeemed

If a corporation redeems its own stock and holds the shares in its treasury rather than canceling them, the question may arise whether the corporation has any basis in that stock if and when such stock is later reissued.

The IRS historically took the position that a corporation took a zero basis in its own stock, including when the corporation reacquired its own shares from a shareholder in return for cash or other property or when it repurchased some of its own stock in the open market for cash. The IRS suggested that the fact that the corporation paid cash to reacquire its own shares did not give it tax basis. The treatment of the redemption at the shareholder level (whether treated as an exchange or as a §301 distribution) was immaterial, and it was not material whether or not the company held the reacquired shares in its treasury for possible later reissue. However, as discussed directly below, this position is under review.[265]

In Rev. Rul. 74-503, a corporation (X) repurchased some of its stock from its shareholders for $2,000. Several years later, when the same shares had a fair market value of $3,000, X transferred these treasury shares as property in a §351 transaction to corporation Y and received $3,000 worth of Y's newly issued shares. The ruling holds that each corporation takes a carryover basis from the other, pursuant to §362(a), in the stock that each received from the other. Consequently, X's basis in the Y stock it received was zero, and Y's basis in the X stock it received was also zero. In Rev. Rul. 2006-2, the IRS said that the conclusion in Rev. Rul. 74-503 that X's basis in the Y stock received in the exchange is determined under §362(a) is incorrect. It also said that the other conclusions, including that X's basis in the Y stock received in the exchange and Y's basis in the X stock received in the exchange are zero, are under study.

c. Effect on Earnings and Profits

The effects of a redemption on the earnings and profits of the redeeming corporation differ, depending upon whether the redemption is taxable as an exchange or as a distribution. In many situations, however, it may be difficult, if not impossible, for the corporation to determine the effects of a redemption on a particular shareholder.[266] For public companies, non-pro rata redemptions have been treated as exchanges for the purpose of determining their effect on earnings and profits, in the absence of evidence to the contrary.[267]

(1) Use of Cash or Notes

If a corporation uses cash or its own notes to effect a redemption that qualifies under §302, corporate earnings and profits generally are reduced by an amount equal to the cash, or in the use of a note, its principal amount (or the adjusted issue price, if the original issue discount rules apply).[268] That reduction is limited, however, to an amount not in excess of the ratable share of the earnings and profits allocable to the stock redeemed.[269]

If a corporation issues debt to a stockholder in connection with a redemption of stock from the stockholder and the parties later agree to reduce the amount of the debt, the reduction is treated as an adjustment to the purchase price of the stock under §108(e)(5) if the reduction did not occur in a title 11 case or when the corporation was insolvent. If this occurs, the corporation must increase its earnings and profits by the excess of the amount of the purchase price adjustment over the amount of the redemption which did not result in a decrease in earnings and profits at the time of the redemption.[270]

The addition of §312(n)(7) in 1984 overruled cases such as *Helvering v. Jarvis*,[271] and the rulings that had followed it.[272] Before the enactment of §312(n)(7), it was possible to take the position that a redemption qualifying for exchange treatment reduced earnings and profits to the full extent of the distribution.

[262] *See* §355(c)(2). Note that under §355(c) and §355(d), even a distribution of stock in the controlled corporation can result in gain to the distributing corporation in the case of certain "disqualified" distributions.

[263] §361(c)(2).

[264] *See* Reg. §1.354-1(d) *Ex.* 3; Rev. Rul. 77-415, *obsoleted on another issue by* T.D. 9182, 70 Fed. Reg. 9219 (Feb. 25, 2005).

[265] Rev. Rul. 2006-2, *revoking* Rev. Rul. 74-503; *see also* Reg. §1.358-6, §1.1032-2 (special basis and nonrecognition rules for use of controlling corporation's stock by controlled subsidiary in certain "triangular reorganizations").

[266] This can arise, for example, by application of the attribution rules or by simultaneous purchases or sales by shareholders.

[267] *See, e.g.,* Reg. §1.355-2(d)(3)(iii) ("The fact that the distributing corporation is publicly traded and has no shareholder who is directly or indirectly the beneficial owner of more than five percent of any class of stock is evidence of nondevice."), §1.355-2(d)(5)(iv) ("A distribution is ordinarily considered not to have been used principally as a device, if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied."). *But see* REG-134016-15, 81 Fed. Reg. 46,004 (July 15, 2016) (proposed regulations that would clarify the device rules); Notice 2015-59 (stating certain characteristics of a transaction may overcome both the nondevice factor of public trading and the non-pro rata structure of a distribution).

[268] §312(a).

[269] §312(n)(7).

[270] *See* TAM 9338049.

[271] 123 F.2d 742 (4th Cir. 1941).

[272] *See, e.g.,* Rev. Rul. 79-376, *obsoleted by* Rev. Rul. 95-71.

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In many cases, this would completely deplete the corporation's earnings and profits, permitting §301(c)(2) and §301(c)(3) distributions to the remaining shareholders.

The operation of §312(n)(7) can be illustrated as follows:

> *Example:* B and C, two unrelated individuals, are the sole shareholders of corporation X, and each owns 500 shares of X common stock. X has accumulated earnings and profits of $25,000. X redeems the shares of B for $40,000 in cash. Under §312(n)(7), the earnings and profits of X are reduced by $12,500, an amount equal to B's pro-rata share of X's earnings and profits.

Observation: The statute refers only to earnings and profits "accumulated after February 28, 1913,"[273] leaving open the question as to whether current earnings and profits should be given different treatment. By the language of the statute, redemptions qualifying under §302(a) can never reduce current earnings and profits before their reduction for regular dividends or redemptions treated as §301 distributions.[274]

The legislative history[275] provides that, if a corporation has more than one class of stock, earnings and profits generally should be allocated among them. An exception to this rule applies to "plain vanilla" preferred stock, i.e., preferred stock that is nonconvertible and does not participate in corporate growth to any significant extent.[276] In redemptions of such "plain vanilla" preferred, earnings and profits should be reduced only to the extent the redemption distribution includes dividend arrearages.[277]

Differences in legal rights between classes of stock also may produce differences in calculation of their ratable shares of earnings and profits. For example, if a corporation has two classes of common stock, A and B, and the A class has a preference as to dividends and liquidating distributions in a 2:1 ratio to the B class, the A class and B class share in earnings and profits in the same proportion (i.e., 2:1).[278]

(2) Use of Property

If a corporation uses property other than its own notes or cash to effect a §302(a) redemption, the effects on its earnings and profits are essentially the same. However, if appreciated property is used, §311(b) will cause corporate gain recognition, and a corresponding increase in earnings and profits.[279] Where depreciated property is used to effect the redemption, earnings and profits are reduced by the adjusted basis of the distributed property, although no loss is recognized.[280] The legislative history to §312(n)(7), in rather loose language, states that the reduction to earnings and profits should not exceed the "amount" of the redemption.[281] At least one commentator believes that this statement conflicts with §312.[282]

d. Deductibility of Corporate Payments and Expenses

Section 162(k)(1) provides that no deduction is allowed for any amount paid or incurred by a corporation "in connection" with the redemption of its stock.

Section 162(k) applies to all amounts paid "in connection" with a redemption. The legislative history states:

> While the phrase "in connection with [a] redemption" was intended to be construed broadly, Congress did not intend the provision to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances. For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision.[283]

Note: Section 162(k) also provides that §162(k) applies to any acquisition of its stock by a corporation or by a party that has a relationship to the corporation described in §465(b)(3)(C).[284] Thus, for example, the denial of a deduction applies to any reacquisition, regardless of whether the transaction is treated as a redemption, as a sale of the stock or as a dividend, and as a reorganization or other transaction.

There are three specific statutory exceptions to this general rule, including (1) deductions allowable under §163 (i.e., interest); (2) deductions for amounts which are properly allocable to indebtedness and amortized over the term of such indebtedness; and (3) deductions for dividends paid (within the meaning of §561).[285]

Comment: Reg. §1.263(a)-5 requires taxpayers to capitalize amounts paid or incurred to facilitate the acquisition of a trade or business, a change in the capital structure of a business entity, and other enumerated transactions. Reg. §1.263(a)-5(a)

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[273] §312(n)(7).

[274] *Cf.*, §316, which refers separately to accumulated earnings and profits (§316(a)(1)) and earnings and profits for the current year (§316(a)(2)).

[275] *See* General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (1984 Bluebook) at 181 (1984).

[276] Section 1504(a)(4) contains a separate definition of plain vanilla preferred stock, which includes the foregoing attributes plus lack of voting rights and lack of an unreasonable redemption or liquidation premium.

[277] 1984 Bluebook at 181.

[278] 1984 Bluebook at 181.

[279] §312(b).

[280] §312(a)(3), §311(a).

[281] 1984 Bluebook at 181.

[282] Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶9.24 (Thomson Reuters/WG&L, 7th ed. 2006 & Supp. Oct. 2010).

[283] 1986 Bluebook at 278–9. *See, e.g.*, *Chief Indus. Inc. v. Commissioner*, T.C. Memo 2004-45 (company entitled to deduct as ordinary and necessary expenses under §162(a) settlement paid to founder; §162(k) not applicable because payment of settlement, made near time founder's stock redeemed, did not have "sufficient nexus to the redemption to be limited by §162(k)"); TAM 9645003 (fees and expenses incurred near time of stock redemption were not §162(k) redemption costs).

[284] Pub. L. No. 104-188, §1704(p).

[285] §162(k)(2)(A). The second exception was added to §162(k) by the Small Business Job Protection Act of 1996. Prior to this amendment, the Tax Court, in *Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994), had held that loan fees incurred in connection with the redemption of a corporation's stock were nondeductible. In a supplemental opinion, the Tax Court reversed its holding in *Fort Howard Corp.*, based on the amendments made by the Small Business Job Protection Act of 1996. The Tax Court held that §162(k), as amended, does not preclude the deduction of costs and fees paid or incurred in redemption of stock, other than interest, that are properly allocable to indebtedness and amortized over the term of the indebtedness. 107 T.C. 187 (1996). *See also United States v. Kroy (Europe) Limited*, 92-2 USTC ¶50,611 (D. Ariz. 1992), rev'g 92-1 USTC ¶50,146 (Bankr. D. Ariz. 1992), rev'd, 27 F.3d 367 (9th Cir. 1994), (decided before the amendment of §162(k) in 1996).

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(3) excludes amounts paid or incurred to facilitate a redemption from the scope of Reg. §1.263(a)-5, and the preamble to the 2002 proposed regulations stated that the costs incurred in a redemption are governed exclusively by §162(k).[286] Reg. §1.263(a)-4(c)(1)(i), however, provides that taxpayers must capitalize amounts paid to another party to acquire "in a purchase or similar transaction" an ownership interest in a corporation. If Reg. §1.263(a)-4(c)(1)(i) applies to redemption expenses, it in no way conflicts with §162(k). The regulation simply makes more explicit the treatment of such capitalized costs. Reg. §1.263(a)-4(g)(1) provides that amounts capitalized under Reg. §1.263(a)-4 are added to the basis of the intangible created. Under the regulation, presumably, redemption costs are added to the basis of the acquired ownership interest, a result that would follow from §162(k) in any event.

In *Kitchen Kaboodle II v. United States*,[287] a district court denied a government motion for summary judgment because the taxpayer had presented sufficient evidence to raise an issue of fact as to whether the taxpayer's true intent in paying a royalty to a former shareholder was to compensate him for past services (thus making the payments deductible) or to redeem his stock (thus making the payments nondeductible under §162(k)). While the stock purchase agreement contained no reference to compensating the shareholder, the court found persuasive the fact that the shares were redeemed for much more than their actual worth.

In *UNUM Corp. v. United States*,[288] the court held that a corporation could not take a deduction for cash distributed during a demutualization transaction by an insurance company. The court stated that the demutualization was a capital transaction subject to the general provisions of Subchapter C, which, the court stated, clearly prohibit a company from deducting cash or the value of stock distributed to its policyholders in redemption of their equity interests.

B. Consequences of Redemption Treated as Distribution

1. Shareholder-Level Tax Consequences

a. Rules of §301

A §301 distribution is a "dividend" if made by a corporation "out of" earnings and profits (E&P) accumulated after February 28, 1913, or "out of" E&P of the taxable year.[289] These two "funds" are determined separately, and the latter is computed (i) as of the close of the taxable year, without diminution by reason of any distributions during that year, and (ii) without regard to the amount of E&P at the time the distribution was made. A redemption, therefore, may be a distribution other than a dividend when it is made (because the corporation lacks sufficient E&P) but subsequently become a dividend if the corporation has earnings later in the taxable year. Section 301 distributions are presumed to be "out of" E&P to the extent thereof and to be from the most recently accumulated E&P.[290]

Section 301 also applies to a distribution by a corporation that results in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or E&P of the corporation.[291] Thus, in Rev. Rul. 78-60, the IRS ruled that a redemption of stock that increases the proportionate ownership of some shareholders causes a deemed §301 distribution of property to these shareholders.[292]

Whether a redemption should receive exchange treatment or §301 treatment is determined without regard to the amount of the corporation's current or accumulated E&P. If §301 governs the distribution, the next question is what portion of the amount distributed is the true "dividend" portion in light of the recipient's ratable share of corporate E&P.

To the extent the amount of the distribution exceeds E&P, §301(c)(2) provides that the balance of the distribution "shall be applied against and reduce the adjusted basis of the stock." Next, under §301(c)(3)(A), the portion of the distribution "which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property." In most situations, if the stock is a capital asset in the shareholder's hands and if the required holding period is satisfied, gain under §301(c)(3)(A) is long-term capital gain.

The language of §301(c) does not clarify whether, before reporting capital gain, the shareholder can recover tax-free the aggregate basis in all the stock the shareholder owns in the corporation, or whether the shareholder must apply the basis recovery rule share-by-share or block-by-block in situations in which the shareholder acquired the shares at different cost bases. The weight of authority appears to require the recipient of a §301 distribution first to apply it against the recipient's ratable share of E&P (determined by reference to the shareholder's total percentage interest in the corporation), then to apply the balance as a nontaxable recovery of cost basis in the stock (allocating the distribution among different blocks acquired at different bases), and finally to report any unabsorbed balance as gain from the sale or exchange of property.[293]

Note: In a transaction that qualifies under §302(a), however, a shareholder may specifically identify the shares they wish to redeem.[294] In doing so, the shareholder applies all the basis in the redeemed shares in order to determine the extent of capital gain under §1001 by virtue of Reg. §1.1012-1(c). If, however, the redemption does not qualify for exchange treatment under §302(a) and instead is treated as a distribution of property pursuant to §302(d), then the manner in which the shareholder recovers basis in different blocks of stock is likely on a pro rata or block-by-block basis. The IRS has taken the position that this is the correct approach (as opposed to allowing the recovery of aggregated basis).[295]

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[286] *See* REG-125638-01 (preamble), 67 Fed. Reg. 77,701 (Dec. 19, 2002). The preamble to the final regulations contains no such language.

[287] 97-1 USTC ¶50,455 (D. Or. 1997).

[288] 130 F.3d 501 (1st Cir. 1997).

[289] §301(c)(1), §316(a).

[290] §316(a).

[291] *See* §305(b)(2).

[292] *Cf.* Rev. Rul. 78-115 (periodic, mandatory series of preferred stock redemptions is not considered deemed distribution under §305(b)(2) and (c)).

[293] *See Johnson v. U.S.*, 435 F.2d 1257 (4th Cir. 1971). See also *Anderson v. Commissioner*, 92 T.C. 138 (1989); PLR 8928066.

[294] Reg. §1.1012-1(c).

[295] *See Johnson v. U.S.*, 435 F.2d 1257 (4th Cir. 1971). Proposed regulations issued in January 2009 would have followed the Johnson approach, but were withdrawn in 2019. Former Prop. Reg. §1.301-2(a), REG-143686-07, 74 Fed. Reg. 3509 (Jan. 16, 2009), *withdrawn*, 84 Fed. Reg. 11,686 (Mar. 28,

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Example: T owns two equal blocks of stock in corporation X, which has no current or accumulated E&P. T's basis in block 1 is $1,000, and T's basis in block 2 is $2,000. X distributes $2,500 to T. Under the IRS approach, the block-by-block rule results in $250 current taxable capital gain to the shareholder on block 1 by reason of the distribution ($1,250 allocable to each of block 1 and block 2, applied against $1,000 basis in block 1 and $2,000 basis in block 2).

In the case of a dividend equivalent redemption, it is unclear if the block-by-block rule applies. If not, the redeemed shareholder may recover under §301(c)(2) the basis in all the stock the shareholder owns, including shares not redeemed, before reporting capital gain. A shareholder typically prefers the aggregation rule, while the IRS ordinarily prefers the share-by-share rule. This issue arises when all of the shareholder's stock consists of a single block acquired at the same time and at the same cost per share, as well as when the redeemed shareholder owns different blocks acquired at different cost bases per block.

Example: T owns 100 of 1,000 outstanding shares of corporation X. T's basis is $20 per share. The fair market value per share is $50. X redeems 200 of its outstanding shares from all shareholders, including 20 shares from T. The total amount distributed by X is $10,000, including $1,000 distributed to T. The corporation lacks current or accumulated E&P. Assume all the redemptions are dividend equivalent as to each shareholder. T's basis in the 20 shares redeemed from T is $400. T may treat the $1,000 received as $400 tax-free recovery of basis in the 20 shares redeemed plus $600 capital gain, or T may treat the distribution as nontaxable because the $1,000 received is less than the $2,000 aggregate basis of all 100 shares T owned.

Comment: When a §301 distribution arises from a dividend equivalent redemption via §302(d), the portion of the total distribution to the shareholder that exceeds the shareholder's ratable share of E&P should reduce the shareholder's total basis in all stock within the same block as the shares redeemed, and the shareholder should report capital gain only if any unabsorbed balance of the distribution remains. The shareholder should not be required to report capital gain after recovering basis only in the shares actually redeemed.[296] If the shareholder owns different blocks of stock acquired at different cost bases, the balance of the distribution, after offset against any E&P, apparently must be allocated among the different blocks, and the basis recovery and capital gain results under §301(c)(2) and (3), respectively, must be determined block-by-block. This method of computation follows from *Johnson*, although there is no case or ruling on point involving a dividend equivalent redemption.

Note 1: The "disappearing basis" problem, discussed at III.B.1.d.(2), below, involves a dividend equivalent redemption. Under Reg. §1.302-2(c), the shareholder's basis in redeemed shares is transferred to the shareholder's remaining shares in the corporation. Although Reg. §1.302-2(c) does not expressly say so, this basis transfer seems to occur only to the extent the company has sufficient E&P to result in dividend treatment of all or part of the distribution. If all the shares held by the shareholder comprise a single block with the same cost basis per share, the shareholder's basis in the redeemed shares is transferred to the unredeemed shares and the combined basis of the remaining shares is then reduced in determining the nontaxable basis recovery portion of the distribution.[297]

Note 2: The true dividend portion of a §302(d) distribution itself may be taxed as net capital gain. Section 301(f)(4) refers to §1(h)(11) for "taxation of dividends received by individuals at capital gain rates." Section 1(h)(11) taxes a noncorporate shareholder's "qualified dividend income" as net capital gain rather than ordinary income for taxable years beginning after 2002. "Qualified dividend income" refers to dividends received from domestic corporations and dividends from certain foreign corporations. Under §301(f)(4), therefore, a redemption of a noncorporate shareholder's stock that is treated as a dividend under §302(d) nevertheless may be taxed to the shareholder at capital gain rates rather than ordinary income rates.[298] The difference in result between §302(a) exchange treatment and §302(d) dividend treatment, however, has not been eliminated entirely; the shareholder's basis is taken into account in determining the shareholder's gain (or loss) in an exchange but not in determining dividend income.

b. *Effect of No E&P*

The term "dividend" as defined in §316(a) presupposes distributions supported by sufficient E&P. If a corporation lacks E&P at the time it makes a distribution in redemption of some of its stock, either the IRS or the shareholder may contend that the exchange is not essentially equivalent to a "dividend."

If a redemption distribution exceeds the shareholder's basis in the shares redeemed (but not the shareholder's aggregate basis in all shares of that block), the corporation lacks E&P, but the exchange otherwise is essentially equivalent to a dividend, the IRS may contend that the redemption must receive exchange treatment under §302(a) because it cannot be "essentially equivalent to a dividend." The shareholder, in that case, must recognize a current capital gain. The shareholder, on the other hand, ordinarily prefers that §301 govern the redemption, via §302(d), because — without E&P — the shareholder has no current income at all (and applies the distribution against the basis of all of the shareholder's stock, not just the redeemed shares).

If the amount of a redemption distribution is *less* than the shareholder's basis in the stock surrendered, the corporation has no E&P, and the redemption cannot qualify within any category of §302(b), the shareholder may argue that the redemption cannot have the effect of a "dividend" and, accordingly, it

2019). The notice of withdrawal noted that the IRS will continue to apply the outcome of *Johnson* in determining the basis.

[296] Reg. §1.302-2(c).

[297] For an additional discussion of disappearing/shifting basis, see Alfred H. Bae, *A Tangential Difficulty: Unutilized Stock Basis in Dividend-Equivalent Redemptions*, Tax Management Memorandum (BNA), April 3, 2017.

[298] Under §1, qualified dividends are taxed at 0%, 15% or 20% depending on taxpayer's income level and tax filings status, with such rates having historically changed based on economic and political climates. A concurrent understanding of applicable tax rates is recommended whenever analyzing a course of action with respect to distributions and redemptions.

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is entitled to a capital loss. On the other hand, if §302 tests the redemption and — after the effect of the redemption is found to be equivalent to a dividend — §301 applies via §302(d), the shareholder must reduce the basis of all of the shareholder's stock in the corporation and is not allowed a current capital loss.

The regulations provide, however, that the determination of whether a redemption is essentially equivalent to a dividend is made without regard to the E&P of the corporation at the time of the distribution.[299] A redemption distribution, therefore, must be tested under §302 even if there is no E&P. If the distribution is otherwise essentially equivalent to a dividend, the rules of §301 govern the distribution. A shareholder with sufficient basis in the shares does not realize a current capital gain but makes the basis reduction required by §301(c)(2). The purpose of this rule is to test all redemptions under §302, regardless of whether the shareholder or the IRS benefits.

c. Amount of Distribution

(1) In General

The amount of a §301 distribution equals the money received plus the fair market value of the other property received, determined as of the date of the distribution.[300] This amount is reduced (but not below zero) by the amount of any corporate liability assumed by the shareholder and by any liability to which the property received is subject immediately before, and immediately after, the distribution.[301]

Note: Reg. §1.301-1(c) provides that property distributed in kind must be included in income when received by, or unqualifiedly made subject to the demand of, the shareholder. Reg. §1.301-1(b) provides that the amount of the distribution is the property's fair market value on the distribution date (which, in some situations, may be earlier than the date of receipt).

(2) Corporate Obligation

If a corporation distributes to a shareholder in a redemption (i) solely its own contract promise to pay the redemption price in one or more future installments or (ii) its promise to pay plus its separate debt instrument (such as a bond, debenture, or promissory note), the obligation is "property" within the meaning of §317(a) for purposes of determining the basic tax treatment of the redemption as an exchange or as a §301 distribution.

Once the basic tax classification is decided, the time at which the property is taxable to the shareholder must be determined. If the redemption is dividend equivalent and the recipient is a cash basis taxpayer, a corporate promissory note, debenture, or other form of bond ordinarily must be taken into account at fair market value (rather than at face amount). Accrual basis taxpayers must take such instruments into income at face.[302]

There is authority, when the distributing corporation has merely promised to pay the redemption price in future installments but has executed no separate written debt instrument, for a cash basis shareholder's taking a "mere" contract promise itself into account as part of the distribution, even if the redemption is dividend equivalent. There is also authority for not requiring a shareholder on either the cash or accrual basis to take either a mere contract promise or a separate written note or debenture into account in the year received in light of certain types of "contingencies" affecting the amount or certainty of payments to be received.[303] There is no cost recovery in either situation; the shareholder must report the full amount of each payment under §301 in the year received.

Another question is whether the tax character of the §301 distribution is determined by the status of corporate E&P in the year in which the closing occurs under the redemption agreement or by reference to E&P during each year in which payments are received. Because the "dividend" is not effective until payment is made, it is the measure of the corporation's E&P in the year of payment that is relevant.[304]

When either a separate written debt obligation or a mere contract promise is valued in the year distributed, but at an amount less than face amount (reflecting the interest rate, the financial condition of the corporation, and other factors requiring a discount from face), payments (exclusive of any original issue discount or unstated interest) that the shareholder later receives in excess of the valuation figure at which the obligation was taken into account when first distributed generally result in capital gain.[305] These rules operate when the basic tax character of the redemption is dividend equivalent as well as when the redemption qualifies for exchange treatment. For a discussion of these rules, see 181 T.M., *Time Value of Money — Holders of Debt Instruments*, 182 T.M., *Time Value of Money — Issuers of Debt Instruments*

Note: If a corporate obligation distributed in a dividend equivalent redemption is required to be valued in the year distributed, and if its value exceeds the fair market value of the redeemed stock, the portion of the obligation equal to the value of the redeemed stock is distributed in the redemption exchange and (because the exchange is dividend equivalent) this portion is subject to §301 via §302(d). The portion of the obligation exceeding the value of the redeemed stock is also governed by §301, but pursuant to the rule that the excess of the value of property transferred to a shareholder over the amount (value) paid by the shareholder is a §301 distribution.

[299] Reg. §1.302-2(a).

[300] §301(b)(1), §301(b)(3). Reg. §1.301-1(b) as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021) to update Reg. §1.301-1 to reflect statutory amendments made to §301(b)(1) in 1988.

[301] §301(b)(2). No reduction is made for the amount of any liability unless the liability is "assumed" within the meaning of §357(d). Reg. §1.301-1(f)(1).

[302] Section 301, unlike §312, does not expressly incorporate the concepts of the original issue discount rules contained in §1271 through §1275.

[303] *See, e.g., Fehrs Fin. Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1973); *Stephens v. Commissioner*, 60 T.C. 1004 (1973), aff'd, 506 F.2d 1400 (6th Cir. 1974). *See also Illinois Power Co. v. Commissioner*, 87 T.C. 1417 (1986), *acq.*, 1990-2 C.B. 1 (1990).

[304] *McWhorter Est. v. Commissioner*, 69 T.C. 650 (1978), aff'd by unpub. opin., 590 F.2d 340 (8th Cir. 1978) (dividend declared on last day of year 1, paid in year 2, held made out of E&P of year 2).

[305] §1271(a)(1).

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d. Basis Rules

(1) The Property Received

A shareholder's basis in property received in a dividend equivalent redemption is its fair market value.[306] The holding period for the property begins with the date of the distribution.

If the property distributed is the corporation's own debt obligation and if the obligation itself must be valued and taken into account as part of the §301 distribution, the shareholder takes a basis in the obligation equal to the value at which the obligation is taken into account.[307] If the obligation itself is not required to be valued as part of the §301 distribution, the obligation itself does not receive a basis in the shareholder's hands; the corporation's later payments on the obligation are treated as direct §301 distributions to the recipient.

(2) Disappearing Basis Problem

Because the dividend income that is deemed received in a dividend equivalent redemption bears no relation to the shareholder's basis in the stock surrendered, the Code leaves an unanswered question concerning that basis. Legislative proposals that would have addressed the disappearing basis problem were not adopted.[308] Current regulations address the possibility of disappearing basis by adding the basis of the shares surrendered to the basis of remaining shares outstanding, so-called "basis shifting."[309] Proposed regulations issued by the IRS in 2009, however, would have eliminated this basis shifting approach and either: (1) created a deemed recapitalization fiction where a shareholder retains a portion of stock of the redeeming corporation; or (2) suspended basis until such time as a loss becomes appropriately recognized.[310] This proposed change was an attempt to unify the manner in which stock basis is maintained for purposes of §301, §302, and §358. In 2019, the IRS withdrew the 2009 proposed regulations, noting that they could not be finalized without "significant modifications," and stated the IRS position that with respect to redemptions governed by §302(d), unrecovered basis in the redeemed stock may be shifted to other stock only if such adjustment is proper under Reg. §1.302-2(c).[311]

> *Example:* T has a $100,000 basis in T's X stock. X redeems half of T's shares in a redemption that is essentially equivalent to a dividend. Reg. §1.302-2(c) provides that in this situation "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Under the regulations, T's $50,000 basis in the redeemed stock is added to T's $50,000 basis in T's remaining stock; T's remaining stock thereafter has a $100,000 basis.[312]

The situation is more complicated if all of the shareholder's stock is redeemed but the redemption is considered dividend equivalent because of the attribution rules of §318. Example (2) of Reg. §1.302-2(c) indicates that the basis of the surrendered stock is allocated to the person whose stock was attributed to the distributee, at least when the distributee gave the stock to the related person before the redemption. *Levin v. Commissioner*,[313] reached this result; all of the taxpayer's stock in *Levin* was redeemed but, because of attribution from her son, the taxpayer was treated as having received a dividend. The court said that "her basis does not disappear, it simply is transferred to her son," the remaining sole shareholder.[314] This rule will presumably be employed in all cases where §302(d) applies despite a complete termination of actual ownership, although the results might be unrealistic in situations where there is no community of interest between the distributee and the related person.

Note: Losses arising from certain basis shifting tax shelters have been disallowed on economic substance grounds.[315] In *Blum* and *Reddam*, the taxpayers argued Reg. §1.302-2(c) *Ex. 2*, taking the position that the stock basis of a redeemed shareholder, a foreign corporation, should be transferred to the taxpayers' stock basis when the foreign corporation was redeemed in a transaction that failed to qualify for sale or exchange treat-

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[306] §301(d). Reg. §1.301-1(g), as amended by T.D. 9954, 86 Fed. Reg. 52,612 (Sept. 22, 2021), to update Reg. §1.301-1 to reflect statutory amendments made to §301(d) in 1988.

[307] The example in Reg. §1.301-1(j) implies that the distribution of a corporation's own obligations is a distribution to which §301 applies. Before the §301 regulations were amended by T.D. 9954 to reflect statutory changes made to §301 in 1988, former Reg. §1.301-1(d)(1)(ii) provided that the amount of distribution to be taken into account with respect to a corporate shareholder included an amount equal to the fair market value of any property distributed, which consisted of, among other things, any obligations of the distributing corporation. The amendments to the regulations eliminated the distinction between distributions to corporate and noncorporate shareholders and, therefore, former Reg. §1.301-1(d) was deleted as obsolete. However, the regulations retained former Reg. §1.301-1(l) (including the example implying that §301 applies to a distribution of a corporation's own obligations) and redesignated it as Reg. §1.301-1(j).

[308] *See, e.g.*, ABA Tax Section Recommendation No. 1976-6, 29 *Tax Law.* 1156 (1976), *amended*, 30 *Tax Law.* 498 (1977) (proposing that basis of stock redeemed in dividend equivalent redemption be added to basis of other stock in issuing company actually owned by redeemed shareholder; shareholder owning no such other stock would deduct basis of redeemed shares at loss — typically capital — from sale or exchange of stock; proposed treatment would have applied to any distribution governed by §301, regardless of whether it received §301 treatment because of §318 attribution); Advisory Group Revised Report on Corporate Distributions and Adjustments 7–8 (1958) (recommending statutory amendment allowing distributee to elect to add basis of redeemed stock to distributee's other shares or to basis of shares owned by persons within distributee's §318 attribution group; distributee owning no remaining shares could elect to transfer basis to attribution group or take loss deduction in amount of distributee's basis).

[309] Reg. §1.302-2(c).

[310] Withdrawn Prop. Reg. §1.302-5, REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009), *withdrawn by* 84 Fed. Reg. 11,686 (Mar. 28, 2019). For a discussion of the proposed regulations (REG-143686-07), see NYSBA *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities*, reprinted in 26 Daily Tax Rep. G-5 (Feb. 9, 2015).

[311] 84 Fed. Reg. at 11,687.

[312] Reg. §1.302-2(c) *Ex. (1). See Edmister v. Commissioner*, 46 T.C. 651 (1966), aff'd, 391 F.2d 584 (6th Cir. 1968); Rev. Rul. 66-37.

[313] 385 F.2d 521 (2d Cir. 1967). The IRS has listed as a listed tax shelter a basis shifting scheme that uses Reg. §1.302-2(c). Under the scheme, a corporation redeems the stock of a shareholder that is not subject to U.S. tax. Under §318, the redeemed shareholder may not step up its basis in the stock. Therefore, the other shareholders receive a step-up in basis. In such a case, the IRS does not treat the redemption as a dividend, so the "proper adjustment" under Reg. §1.302-2(c) is unnecessary. Notice 2001-45. *See also* Announcement 2002-97 (settlement initiative for such transactions). See X.I.1., below.

[314] 385 F.2d at 528, n. 29.

[315] *See, e.g.*, *Blum v. Commissioner*, T.C. Memo 2012-16 and *Reddam v. Commissioner*, T.C. Memo 2012-106. For a complete discussion of the contours of those rules, see 508 T.M., *The Economic Substance Doctrine.*

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ment under §302(b) by operation of the attribution rules under §318(a)(4) and §318(a)(3)(C) on corresponding options which the foreign corporation held on stock owned by the taxpayers. The Tax Court ruled against the taxpayer in both cases, however, in *Reddam*, the court indicated that, under different circumstances, it might be willing to explore the IRS argument that the party from whom the taxpayer claimed the shifted basis may never have received the benefits and burdens of stock ownership — that its ownership was "illusory." While not arriving at a definitive conclusion with respect to this argument, the Tax Court expressly noted its merit, apparently due to the fact that the redemption of the foreign entity's stock on which the taxpayer held an option was part of an orchestrated plan to generate a large capital loss.[316]

A statute of limitations problem may arise if a redeemed shareholder's stock basis is to be transferred to a person whose stock was attributed to the shareholder via §318.

> *Example:* In year 1, all of H's shares in X corporation are redeemed in what H believed was a redemption qualifying under §302(a). In year 3, H is audited for year 1 and H signs waivers that extend the three-year statute of limitations period. In year 6, H agrees to §301 treatment of the transaction (or H litigates the dividend equivalence issue and loses in court). In year 2, H's "tax relative" (via §318), S, sold all of S's stock in the corporation and year 2 is now closed under the statute of limitations. No transfer of basis appears to be available in this situation, because the statute of limitations has closed for year 2. H's basis has disappeared.

In *United States v. Coyle*,[317] involving a §304(a)(1) constructive redemption, the redeemed shareholder actually owned no stock in the "brother" corporation that purchased some of his stock in a "sister" corporation. His ownership of the buying corporation was entirely constructive from his sons. The redemption was held to be dividend equivalent. The court said that two reasonable solutions were to increase the sons' stock basis pro rata in the brother corporation or to increase the distributee's basis in his remaining sister corporation stock. In Rev. Rul. 71-563, involving a fact situation similar to *Coyle*, the IRS adopted the second of these solutions and allowed the shareholder to add the basis of the "redeemed" stock to the basis of his remaining stock in the corporation whose stock was sold.

However, in Rev. Rul. 70-496,[318] the shareholder sold all of his sister corporation stock to a brother corporation in which he actually owned no stock but which he was deemed to control by attribution. The IRS ruled that the shareholder's basis in the stock of the "sister" corporation simply disappears. The shareholder could not increase the basis of any of his other assets. The IRS refused to allow the party whose stock in the buying company was attributed to the selling shareholder to increase his stock basis by the selling shareholder's basis in the stock sold.

Note: If the selling shareholder had actually owned any stock in the buying corporation, perhaps even only one share, the shareholder's basis for the stock sold would not disappear, but would be added to the basis of that one share.[319]

If less than all of a shareholder's stock is redeemed in a dividend equivalent distribution, and if the shareholder owns other shares of the same class along with shares of a different class, there is no clear rule as to whether the basis of the redeemed shares is added solely to the shareholder's basis in the remaining shares of the same class (and whether such addition is to be made equally to each such share), or whether the shareholder's basis in shares of a different class is also to be increased.

If a shareholder owns both common and preferred stock and all of the shareholder's shares in one class are redeemed, and if the redemption is treated as a dividend, Reg. §1.302-2(c) apparently intends that the basis of the redeemed shares be added to the shareholder's basis in the shareholder's remaining stock even though it is a different class. In *United States v. Davis*, the Supreme Court said that the taxpayer's basis in his redeemed preferred stock was applied to his remaining common stock.[320] Apparently, this rule is mandatory, so that if stock owned by other shareholders was attributed to the taxpayer via §318 (as in *Davis*), the taxpayer cannot elect between increasing the basis of stock that the taxpayer continues to own or allowing the taxpayer's "tax relatives" to increase the basis of their stock.

Comment: If all of a shareholder's stock of one class is redeemed and if the distributee continues to own more than one other class of stock, one approach would be to allocate the basis of the surrendered shares to each such other class in proportion to the relative fair market values of the shareholder's holdings in each such class.

Where a distributee actually owns no stock after a dividend equivalent redemption, and the distributee's basis is transferred to "tax relatives" within the attribution categories of §318, numerous other complexities arise. How is the taxpayer's basis to be divided among two or more tax relatives? Should any distinction be made between family members and non-family members? What if a tax relative owns more than one class of the company's stock? If the taxpayer constructively owns stock via a chain of attribution in accord with §318, should all persons in the chain share equally in the taxpayer's basis?

Comment: If the taxpayer's "tax relatives" are non-family members, but stem from business associations through partnerships or corporations that also own stock in the issuing company, transferring the taxpayer's basis to such persons may amount, in reality, to a disappearing basis as to the taxpayer and the taxpayer's personal family circle. Other possibilities are to allow the taxpayer a loss deduction (capital or ordinary de-

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[316] *Reddam*, 15 at fn. 12 (citing *Anschutz Co. v. Commissioner*, 135 T.C. 78, 99 (2010) (citing 11 factors evaluated in determining whether transaction validly transfers stock ownership), aff'd, 664 F.3d 313 (10th Cir. 2011); *Calloway v. Commissioner*, 691 F.3d 1315 (11th Cir. 2012) aff'g 135 T.C. 26, 33–34 (2010) (citing eight factors); *Merrill Lynch & Co. v. Commissioner*, 120 T.C. 12, 51–52 (2003) (integrating redemption with one or more other transactions to decide whether requirements of §302(b) are met if redemption was part of "firm and fixed plan" as evidenced by taxpayer's intent), *aff'd in part and rem'd in part*, 386 F.3d 464 (2d Cir. 2004)).

[317] 415 F.2d 488 (4th Cir. 1968).

[318] *Obsoleted by* Rev. Rul. 2003-99. *See also* Rev. Rul. 74-605.

[319] *See* Reg. §1.304-2(a). *See also* Rev. Rul. 71-527. For more discussion of the disappearing basis issue in the §304 context, see 768 T.M., *Stock Sales Subject to Section 304.*

[320] *United States v. Davis*, 397 U.S. 301, 307–08, n.9 (1970).

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pending on the surrounding facts) or to allow the taxpayer to increase basis in other capital assets which the taxpayer owns. However, there is no authority for adopting any of these alternatives.

Comment: If a distributee utilizes §302(c)(2) to waive family attribution and thereby qualify under §302(b)(3), but, within the following 10 years, reacquires stock that reinstates family attribution and causes the redemption to be dividend equivalent, probably the most reasonable rule would be to increase the distributee's basis in the reacquired stock by the amount of the distributee's original basis in the stock redeemed. If the distributee becomes an officer, director or employee, original basis could be transferred to the "tax relatives" from whom family attribution was originally waived via §302(c)(2). No authority exists on these issues.

e. Corporate Shareholders

Special problems arise when the redeemed shareholder is itself a corporation.

When a corporate shareholder has a gain in its shares and the redeeming corporation has earnings and profits, the shareholder would prefer a redemption distribution to be treated as a §301 distribution. The dividends-received deduction under §243 would then shelter a substantial portion of the distribution. If a corporate shareholder could have some of its shares redeemed in a dividend equivalent redemption, and if it could then increase its basis in its remaining shares in the issuing company by the amount of its basis in the redeemed shares, an overall net tax benefit could be produced. The redemption proceeds would be taxable as ordinary income, but the taxable amount would be only the amount left after deducting the §243 dividends-received deduction. The distributee could then sell its remaining shares in the issuing company. The transfer of additional basis to the latter group of shares could help produce a capital loss (rather than a capital gain) on a market sale. This loss could in turn offset (and shelter) other capital gains that the distributee may have in the year in which the market sale occurred.

Section 1059 addresses this potential abuse by requiring a corporate shareholder to reduce its basis in stock by an amount equal to the untaxed portion of certain dividends. Those dividends that are affected are extraordinary dividends. Extraordinary dividends include dividends that exceed certain threshold amounts (except where specified holding period requirements are met), and dividends that arise through non-pro rata redemptions. For additional discussion of §1059, see 764 T.M., *Dividends — Cash and Property*.

2. To the Corporation

The rules of §311, discussed at III.A.2., above, apply at the corporate level on a redemption distribution of property (other than obligations of the distributing corporation) regardless of whether the shareholders receive exchange treatment under §302(a) or distribution treatment under §301. Under §311(b)(1) and (2), when a corporation makes a distribution of property to a shareholder with respect to its stock, it recognizes gain if the property is either appreciated or subject to a liability that exceeds the basis of the property. The corporation may not, however, recognize loss upon the distribution of property to a shareholder with respect to its stock.[321]

Practice Point: If a property distribution is made to a shareholder, but not in the shareholder's capacity as a shareholder (e.g., as a creditor of the corporation), then the corporation may be able to recognize loss, subject to the restrictions of §267.[322]

Under §10201 of the Inflation Reduction Act, signed into law on August 16, 2022, certain public corporations that enter into stock buybacks are subject to a 1% excise tax measured on the amount of consideration used to buy stock back on the open market.[323] For a detailed discussion of the stock buyback excise tax, see X.G.1., below. For a further discussion of the tax effects of dividends in kind at the corporate level, see 764 T.M., *Dividends — Cash and Property*.

As indicated at III.A.2.b., above, the IRS takes the position that a corporation always takes a zero basis in its own stock, even where it repurchases the stock for cash from an existing shareholder and holds the shares in its treasury for possible later reissue. This zero basis rule applies regardless of the tax treatment of a repurchase transaction to the selling shareholder.

3. Effect on Earnings and Profits

a. In General

The general rule of §312(a) applies to redemption distributions that are treated as distributions under §301 while redemptions that qualify for exchange treatment to the shareholder are governed by §312(n)(7).[324] Thus, redemptions treated as §301 distributions are treated for earnings and profits (E&P) purposes as any ordinary dividend distribution.

Under §312(a), E&P are reduced by the amount of money distributed, the principal amount of obligations of the corporation that have been distributed, and the adjusted basis (to the corporation) of other property distributed. On the other hand, E&P may be increased when certain other property distributions are made. These increases will arise from gains on the distribution, which are recognized under §311(b).[325]

b. Ordinary Dividends, Redemptions Treated as §301 Distributions, and Redemptions Qualifying Under §302(a) During the Same Year

With respect to current E&P, ordinary dividends and redemptions treated as §301 distributions take priority over redemptions qualifying under §302(a), even if the §302(a) redemption occurs earlier in the year than the distributions.[326] Accumulated E&P, however, are allocated chronologically among ordinary dividends and redemptions, regardless of whether the redemptions qualify under §302(a), subject to the limitations of §312(n)(7).[327]

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[321] §311(a).

[322] For a discussion of §267, see 564 T.M., *Related Party Transactions*.

[323] §4501.

[324] See III.A.2.c., above, for a discussion of §312(n)(7).

[325] For discussion of these issues, see III.A.2.c., above.

[326] *Baker v. U.S.*, 308 F. Supp. 1129 (D. Neb. 1970), aff'd, 460 F.2d 827 (8th Cir. 1972); *Anderson v. Commissioner*, 67 T.C. 522 (1976), aff'd, 583 F.2d 953 (7th Cir. 1978); Rev. Rul. 74-338; Rev. Rul. 74-339.

[327] Reg. §1.316-2(b); Rev. Rul. 74-338.

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IV. Section 302(b)(3) — Complete Termination of Shareholder's Interest

A. In General

Section 302(b)(3) provides that a redemption will be treated as an exchange "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."

Under this safe haven category, all the stock in the corporation that the shareholder owns — including nonvoting preferred stock, either actually, or constructively through the operation of §318 — must be redeemed.

Although §302(b)(3) is titled "Termination of Shareholder's Interest," except for certain situations where the family attribution rules of §318 cause a problem in qualifying under §302(b)(3), a shareholder need only terminate its stock interest in the corporation. The shareholder can continue to hold, or can later acquire, an "interest" in the corporation as a director, officer, employee, creditor, supplier, lessor, etc.

Although a former shareholder is generally not prohibited from reacquiring a stock interest in the company, it would be dangerous for the shareholder to reacquire stock under circumstances where the IRS could apply the step transaction doctrine to "step" the reacquisition together with the prior redemption. In such circumstances, the termination of stock interest would not be considered as bona fide.

In some situations, the stepping together of the separate steps of a large transaction can help the taxpayer qualify under §302(b)(3). For example, it may be possible to qualify under §302(b)(3) a series of annual redemptions of portions of a shareholder's stock where, pursuant to a plan, the series in the aggregate results in redemption of all of the shareholder's stock.

Apart from the specific statutory permission to disregard family attribution in qualifying under §302(b)(3), discussed below, other §318 categories producing constructive ownership of stock always operate in testing a redemption under §302(b)(3). Therefore, if a shareholder owns some stock constructively under one of the nonfamily categories of §318, a redemption will fail to result in a complete termination of stock ownership. Whether or not the shareholder may have also retained an interest in the corporation as an officer, director, employee, etc., is immaterial, except in the case of the special statutory permission to disregard family attribution.

B. Installment Payout Redemptions

1. In General

Although §302(b)(3) uses the phrase "complete redemption," a redemption can qualify under §302(b)(3) even though the corporation pays for redeemed stock in installments over one or more years after the year in which the stock is actually surrendered by the shareholder.[328] When a redemption involves this type of installment payout, the corporate obligation to make such payments may take the form of a bond, debenture, promissory note or a mere contractual promise. Where the corporation and the shareholder want all payments within the series of payments to be tested under the §302(b)(3) test, then each such payment should be explicitly documented as part of an overarching plan in order to invoke the binding commitment test of the step transaction doctrine.[329] Under §302(b)(3), the distributee can continue to hold, after the redemption, a debt obligation of the issuing corporation, provided the obligation stands up as debt under the tax criteria distinguishing debt from equity.[330]

2. Debt vs. Equity

Under general tax principles, the determination of whether an instrument is more appropriately characterized as debt or equity is governed by §385. Under §385(a), Treasury is authorized to prescribe regulations to determine whether an "interest" in a corporation is to be treated as stock or indebtedness (or as in part stock and in part indebtedness). In 2016, the IRS issued final and temporary regulations that establish threshold documentation requirements that must be satisfied in order for certain related-party interests issued by a domestic corporation to be treated as indebtedness for federal tax purposes, and treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes.[331] Even where the documentation rules would have applied to a specific instrument, general federal tax principles apply to determine whether an instrument is equity or debt.[332] The documentation rules proved controversial and after first proposing to delay implementation,[333] the IRS removed the rules altogether.[334] The IRS continues to study the documentation issue and may issue simplified and streamlined documentation regulations in the future.[335]

Under general federal tax principles, the determination of whether the instrument is debt or equity has long been a ques-

[328] *See* PLR 201405005, PLR 200052024, PLR 9837022.

[329] *See Commissioner v. Gordon*, 391 U.S. 83 (1968); *Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981); *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (Ct. Cl. 1969); *Security Industrial Ins. Co. v. U.S.*, 702 F.2d 1234 (5th Cir. 1983); *Merrill Lynch & Co. v. Commissioner*, 120 T.C. 12 (2003), aff'd in part and remanded in part on other issue, 386 F.3d 464 (2d Cir. 2004); *Andantech L.L.C. v. Commissioner*, T.C. Memo 2002-97, aff'd, 331 F.3d 972 (D.C. Cir. 2003); *Associated Wholesale Grocers, Inc. v. U.S.*, 720 F. Supp. 887 (D. Kan. 1989), aff'd, 927 F.2d 1517 (10th Cir. 1991).

[330] The debt equity issue also arises when trying to qualify an installment payment redemption under §302(b)(1) and (b)(2).

[331] T.D. 9790, 81 Fed. Reg. 72,858 (Oct. 21, 2016), corrected by 82 Fed. Reg. 8165 and 82 Fed. Reg. 8169 (Jan. 24, 2017). The temporary regulations (Reg. §1.385-3T and Reg. §1.385-4T) also serve as the text of proposed regulations issued on the same date. REG-130314-16, 81 Fed. Reg. 72,751 (Oct. 21, 2016). Reg. §1.385-3T and Reg. §1.385-4T expired on October 13, 2019, however, the IRS has indicated that taxpayers may rely on the proposed regulations until further notice, provided that taxpayers consistently apply the rules in the proposed regulations. REG-123112-19, 84 Fed. Reg. 59,318, 59,320 (Nov. 4, 2019). In 2020, the IRS finalized the proposed regulations in REG-130314-16 without any substantive change. *See* T.D. 9897, 85 Fed. Reg. 28,867 (May 14, 2020). For a detailed discussion of §385 and the §385 regulations, see 702 T.M., *Capitalizing a Business Entity: Debt vs Equity*.

[332] Former Reg. §1.385-2(a)(2).

[333] Notice 2017-36 (announcing intent to delay the applicability of the documentation rules until January 1, 2019).

[334] T.D. 9880, 84 Fed. Reg. 59,297 (Nov. 4, 2019) (finalizing REG-130244-17, 83 Fed. Reg. 48,265 (Sept. 24, 2018) (proposing removal of Reg. §1.385-2 and conforming modifications)).

[335] Preamble to T.D. 9880, 84 Fed. Reg. at 59,299.

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tion of facts and circumstances.[336] Section 385(b) sets forth some of the factors that any such regulations must take into account in determining whether a debtor-creditor relationship exists. These factors include (i) whether there is a written unconditional promise to pay, on demand or on a specified date, a fixed amount of money in return for an adequate consideration and to pay a fixed rate of interest; (ii) whether there is subordination to or preference over any indebtedness of the corporation; (iii) the ratio of debt to equity of the corporation; (iv) whether there is convertibility into the stock of the corporation; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

However, the courts have articulated varying lists of factors to be considered in making this determination with the only consensus that not one factor is determinative, but rather the consideration of all the facts and circumstances in each case is appropriate. One example of the list of factors a court may consider is provided in *Estate of Mixon v. U.S.*,[337] where the court articulated thirteen factors: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement. The determination of the most appropriate classification of an instrument is made based on the specific facts of each case.

It is unclear, for purposes of §302(b)(3), what the criteria are for determining whether a corporate instrument is debt or equity §385(c) provides that the characterization by the issuer at the time of issuance as to whether an interest in a corporation is stock or debt is binding on the issuer and on all holders of the interest.[338] However, under §385(c)(2), this characterization rule does not apply if the holder of the interest discloses on its tax return that it is treating such interest in a manner inconsistent with the characterization by the issuer.

The regulations under §302 provide guidance for distinguishing a debt interest from an equity interest but, apparently, these regulations apply only for purposes of determining under §302(c)(2) whether a distributee shareholder becomes a "creditor" of the corporation under an installment payout arrangement. Section 302(c)(2) relates specifically to the situation where the shareholder is seeking to waive the family attribution rules and, as a condition of such waiver, is prohibited from retaining an interest in the corporation other than as a creditor. Reg. §1.302-4(d) begins by stating "[f]or the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if…" It is not clear whether the IRS will apply the tests set forth in the regulation to classify a purported debt obligation for §302(b)(1), (2), or (3) *generally*, and not just under the special rule of §302(c)(2).

Comment: For planning purposes, it should probably be assumed that the IRS will apply Reg. §1.302-4(d) generally under §302.[339]

If a corporation issues a note to a shareholder in exchange for the shareholder's stock, but the note is treated as an equity interest, then this exchange is not a redemption, as defined in §317. Section 317(b) provides that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock for a shareholder in exchange for property"

Section 317(a) provides that the term "property" does not include stock in the corporation making the distribution. Thus, if the note received by the shareholder in exchange for the shareholder's stock is treated as equity, this equity interest is not property under §317(a) and a redemption has not occurred under §317(b). Rather, this exchange of stock for a note that is recast as an equity instrument is arguably a recapitalization that is tested for tax-free treatment under §368(a)(1)(E).[340] Any property distributed in addition to the obligation would then be governed by §354 and §356. Each later principal payment on the "obligation" would not be a tax-free repayment of debt, but would be tested as a redemption of stock under §302. Under §358, the recipient will take a basis in the "obligation" (stock) equal to the recipient's basis in the actual stock surrendered therefor. It is not clear, however, whether each later "principal" payment should be viewed as one of a series of redemptions of a proportionate part of the total "stock" interest, to which basis is allocated pro rata, or whether the transaction should be treated as an "open" transaction in which the shareholder fully recovers basis before recognizing capital gain. Each later "principal" payment by the corporation will also be exposed to full dividend treatment under §302(d).

3. *Private Ruling Policy*

The IRS does not ordinarily issue rulings on the classification of any instrument as debt or equity, because the question is primarily one of fact.[341] In its annual "no ruling" revenue procedure, the IRS lists three specific areas in the installment payout redemption context where it will not privately rule, discussed in the sections below.[342]

[336] *Estate of Mixon v. United States*, 464 F.2d 394 (1972); *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980), *acq.*, 1982-2 C.B. 1 (1982); *Segel v. Commissioner*, 89 T.C. 816; *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790 (1975); *Laidlaw Transp., v. Commissioner*, T.C. Memo 1998-232 (1998); *Hardman v. United States*, 827 F.2d 1409 (1987); *A. R. Lantz Co. v. United States*, 424 F.2d 1330 (9th Cir. 1970).

[337] 464 F.2d 394 (1972).

[338] §385(c), added by Pub. L. No. 102-486, §1936(a) and applicable to instruments issued after Oct. 24, 1992.

[339] See IV.C.3.b., below, for a discussion of Reg. §1.302-4(d).

[340] This exchange may also qualify as a tax-free §1036 exchange of stock for stock of the same class in the same corporation if the recast debt instrument is treated as stock of the same class that the shareholder exchanged.

[341] Rev. Proc. 2025-3, §4.02(1). If the taxpayer believes that the facts strongly support the classification and can demonstrate a unique and compelling reason to justify the issuance of the letter ruling, the IRS may issue an advanced ruling. Rev. Proc. 2025-3, §4.02(1). At the beginning of each year, the IRS issues a revenue procedure stating areas where it will not issue advance rulings. There are two types of no-rule positions — "will not rule" and "ordinarily will not rule." A taxpayer considering seeking an advance ruling under §302 should consult Rev. Proc. 86-18, for the information and representations required to be submitted in the private letter ruling request.

[342] Rev. Proc. 2025-3, §3.01(50), (51), (52).

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Comment: It is important to note that where the IRS has a no-rule position, it does not necessarily mean that the IRS will prevail in court on the no-rule issue. In fact, as discussed below, the courts have generally been pro-taxpayer with regard to installment payment redemption issues on which the IRS will not rule. However, the fact that there are several no-rule positions regarding installment redemptions shows the IRS's sensitivity to this issue.

a. Reacquisition of Stock

Rev. Proc. 2025-3 provides that the IRS will not issue private rulings on whether §302(b) applies to redemptions where the corporation distributes its notes in part or full payment of the redemption price and the stock is held in escrow or as security for payment of the notes, and it is possible that the stock may or will be returned to the shareholder upon occurrence of specified defaults by the corporation.[343]

Under this provision, the IRS will not rule even if a reacquisition of stock is merely possible, e.g., only if the corporation defaults in its payments, rather than being probable or prearranged. This policy of refusing to rule extends to all types of redemptions under §302(b).

Comment: Apparently the IRS's concern is not that the corporate debt obligation is equity, but rather that the distributee has never fully surrendered control of the stock.

Although the IRS will not issue private rulings where the redeemed stock is held in escrow as security for the company's payments, taxpayers should not conclude that the redeemed shares cannot, as a matter of law, be held in escrow as security or that, on audit, the IRS will necessarily challenge exchange treatment of the redemption because of such an arrangement.[344] Indeed, apart from waiver of family attribution under §302(b)(3) and (c)(2), there is no prohibition in the statute, regulations, cases or published rulings against a distributee reacquiring stock in the issuing company, such as by purchase, so long as the reacquisition was not prearranged. If the distributee retains voting rights or other rights indicating beneficial ownership of the escrowed stock, however, the IRS may argue that a redemption never occurred. If no such rights are retained, the mere possibility of reacquiring the stock on default does not ipso facto disqualify the redemption under §302(a).

b. Contingent Redemption Price

Rev. Proc. 2025-3 provides that the IRS will not issue private rulings on whether §302(b) applies when the consideration given in redemption by a corporation in exchange for a shareholder's stock consists entirely or partly of the corporation's promise to pay an amount based on, or contingent on, future earnings of the corporation, when the promise to pay is contingent on working capital being maintained at a certain level, or any other similar contingency.[345]

Comment: Here the IRS has a legitimate concern that the corporation's "promise to pay" is a disguised equity interest because, like the return on certain equity investments, it is dependent on the fortunes of the corporation.

The courts, and the IRS in a published ruling, have allowed taxpayers some leeway in making the redemption price contingent on the corporation's future performance. In *Erickson v. Commissioner*,[346] the Tax Court held that a redemption price need not be paid in a lump sum or in a fixed amount in order to qualify for capital gain treatment, but may be based on a percentage of the corporation's future profits.

c. Redemption Followed by Use of Shareholder's Property

Rev. Proc. 2025-3 provides that the IRS will not issue advance rulings when following a redemption the corporation uses the distributee-shareholder's property and pays for such use an amount that is based on corporate earnings or that is subordinate to general creditors. The IRS's concern is that if the payment for the use of the property is contingent on future earnings or subordinate to the claim of general creditors, the payment is actually a disguised equity interest.[347]

In Rev. Rul. 77-467, the taxpayer had all of his stock in a family corporation redeemed, but continued to receive payments from the corporation for the use of a building owned by the taxpayer. The issue considered by the IRS was whether the leasing agreement was a prohibited interest in the corporation within the meaning of §302(c)(2)(A). Because the payments were not dependent on the corporation's future earnings or subordinate to the corporation's general creditors, the IRS ruled that the fixed rent lease was not a proprietary interest.

d. Fifteen Year Limit on Payments

Rev. Proc. 2025-3 provides that the IRS will "ordinarily" not issue private rulings on the tax effect of a redemption of stock for notes where payments on the notes are to be made over a period in excess of 15 years from the date of issuance of the notes.[348] Generally, a long-term maturity is evidence supporting a finding that the instrument is equity. The IRS's concern is that a prolonged payout period, with interest, can become a means of paying a shareholder a fixed and steady income with deductions for the corporation (for interest) as a substitute for nondeductible dividends. The former shareholder would still have received fair market value in exchange for the stock in terms of the principal amount of the corporate obligation, but if the interest payments are spread over a long period of years, the redemption begins to look like a substitute for div-

[343] Rev. Proc. 2025-3, §3.01(50).

[344] *See Lisle v. Commissioner*, 35 T.C.M. 627 (1976) (stock escrowed to secure payment); *Lynch v. Commissioner*, 83 T.C. 597 (1984), rev'd on other grounds, 801 F.2d 1176 (9th Cir. 1986) (note secured by pledge of remaining shareholder's stock); *Mathis Est. v. Commissioner*, 47 T.C. 248 (1966) *acq.*, 1967-2 C.B. 3 (stock held in escrow); *Hoffman v. Commissioner*, 47 T.C. 218 (1966), aff'd per curiam, 391 F.2d 930 (5th Cir. 1968) (pledge of stock as security).

[345] Rev. Proc. 2025-3, §3.01(51).

[346] 56 T.C. 1112 (1971), *acq.*, 1978-2 C.B. 2. *See also* Rev. Rul. 75-433 (following *Erickson*); *Harlan v. U.S.*, 409 F.2d 904 (5th Cir. 1969) (notes payable only to extent corporate surplus exceeds stated amount held valid debt); *Jones v. U.S.*, 659 F.2d 618 (5th Cir. 1981) (surplus capital notes payable only to extent surplus exceeded a given amount held valid debt); *Duerr v. Commissioner*, 30 T.C. 944 (1958) (debt payable out of earnings treated as preferred stock). *See generally* Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369, 414–417, 442–447 (1971); *see also Monon R.R. v. Commissioner*, 55 T.C. 345 (1970) *acq.*, 1973-2 C.B. 3 (debentures on which interest payable out of "available net income" upheld as debt).

[347] Rev. Proc. 2025-3, §3.01(52).

[348] Rev. Proc. 2025-3, §4.01(23). *Cf. Monon R.R. v. Commissioner*, 55 T.C. 345 (1970), *acq.*, 1973-2 C.B. 3.

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idends rather than a bona fide effort to terminate or reduce the shareholder's equity interest.

In *Lisle v. Commissioner*,[349] the Tax Court upheld under §302(b)(3) a 20-year redemption payout period, although cautioning that this approval was based on the particular facts and circumstances and that in other situations "a payout of 20 years, together with other factors, might indicate that the arrangement did not constitute a complete termination of the shareholder's interest in the corporation."

In *Lisle*, the IRS used the length of the deferred payment period to make a variation of the usual debt versus equity argument; instead of arguing that the notes received represented some form of equity interest, it argued that the 20-year payment period was one factor indicating that the redeemed shareholder had not transferred sufficient beneficial interest in the shares to qualify the exchange as a bona fide termination of interest in the corporation.[350]

C. Waiving Family Attribution

1. Introduction

If the redemption of stock from a shareholder would qualify for exchange treatment under §302(b)(3), but for the fact that, under §318(a)(1), the shareholder is considered to own stock owned by the shareholder's spouse, children, grandchildren, or parents, the statute permits these family attribution rules[351] to be "waived" (i.e., not applied) under certain circumstances, so that the redemption can otherwise qualify under §302(b)(3). It should be noted that this relief from the attribution rules is available only with regard to family attribution under §318(a)(1). Attribution based on other provisions of §318 cannot be waived.

Section 302(c)(2) contains the rules for obtaining a waiver of family attribution. The conditions under which family attribution can be waived are as follows:

(a) immediately after the distribution the distributee must have no interest in the corporation, including an interest as an officer, director, or employee, other than an interest as a creditor;[352]

(b) the distributee must not acquire any such interest in the corporation (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution;[353] and

(c) the distributee must agree to notify the IRS of any acquisition of such interest and to retain records of the transaction.[354]

The 10-year restriction against reacquiring an interest in the issuing company can be onerous and need not be imposed if a particular redemption can qualify under §302(b)(1) or (2) (where no 10-year restrictions are required).

Observation: The quantity of stock that the distributee might reacquire during the 10-year future period is immaterial. If he reacquires even one share, the tax effect will be to reinstate all applicable family attribution as of the redemption date. This will necessarily disqualify the exchange from the safe haven of §302(b)(3), but even with the distributee's constructive stock ownership, the shareholder's stock interest might be reduced enough to qualify for "exchange" treatment under §302(b)(1) or (2).

If the corporation simultaneously redeems all of the stock owned by a shareholder and by members of the shareholder's family, so that after these redemptions neither he nor any member of the shareholder's family actually owns any stock in the corporation, there is no need for any of these shareholders to waive family attribution.[355] Therefore, any of these redeemed shareholders may, subsequent to the redemption, remain or become an officer, director or employee of the corporation, or reacquire stock in the company without losing exchange treatment under §302(b)(3) (subject, of course, to step transaction principles under which a planned reacquisition of stock could void the bona fides of the termination of interest). In Rev. Rul. 76-524, the IRS stated explicitly:

> [W]here there is no stock outstanding after the redemption the ownership of which would be attributed to the redeeming shareholder, the waiver rule of section 302(c)(2) of the Code, and the conditions under which waiver can occur, are not applicable. Section 302(b)(3), by itself, places no restriction on the retention of interests in the corporation after the redemption, as long as the entire stock interest is terminated. Thus, if a shareholder's direct stock interest is completely terminated in a redemption, and that shareholder has no indirect ownership of stock after the redemption through application of the constructive ownership rules of section 318(a)(1), the redemption qualifies under section 302(b)(3) regardless of whether the shareholder retains positions as officer and director.

In Rev. Rul. 76-524, a closely held corporation with 100 outstanding shares redeemed for cash 30 shares owned by shareholder H. The company also redeemed the 30 shares owned by H's spouse W, and the 30 shares owned by their son S. None of the remaining shareholders, all of whom were individuals, were "related" to H, W, or S under §318. After these redemptions H, W, and S owned no stock in the company. Before the redemptions H had been president and board chairman. Afterward he remained as president and as a director. Because none of H's family members owned any stock after the redemp-

[349] T.C. Memo 1976-140.

[350] *See also Mountain State Steel Foundries v. Commissioner*, 284 F.2d 737 (4th Cir. 1960), rev'g 18 T.C.M. 306 (1959) (27-year and 44-year 4% redemption notes upheld as debt even though, with $450,000 principal, total interest paid over term of notes would be $351,000).

[351] *See, e.g.*, PLR 200025035 and PLR 200022020 (corporation's redemption of all of mother's stock is a "complete termination"; as long as she meets requirements of §302(c)(2)(A)(i), (ii) and (iii), the family attribution rules of §318(a)(1) will not apply). For a discussion of the family attribution rules, see VIII., below.

[352] §302(c)(2)(A)(i).

[353] §302(c)(2)(A)(ii). *See also* PLR 199914017 (appointment of trustee succession committee members results in the acquisition of an interest in the redeeming corporation under §302(c)(2)(A), so that proceeds received on the redemption of stock would be taxed as dividend income under §301(a)).

[354] §302(c)(2)(A)(iii). *See also* PLR 9613009.

[355] Rev. Rul. 76-524.

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tion, H did not have to waive family attribution and thus could continue as an officer and director.

a. Waiver of Family Attribution by Entities

Family attribution may operate to prevent an entity (such as an estate, trust, corporation, or partnership) from qualifying a redemption under §302(b)(3).

> *Example:* Assume that corporation C is owned equally by partnership P and individual F. F's son S, is a partner in P. Even if P's entire interest in C is redeemed, P will still be considered a 50% shareholder in C, because under §318(a)(1)(A)(ii), F's 50% ownership in the corporation will be attributed to his son S, and under §318(a)(3)(A), S's 50% deemed ownership will in turn be attributed to P.

Section 302(c)(2)(C), allows an entity[356] to waive the family attribution rules, provided: (i) the distributee entity and each related person meet the requirements of §302(c)(2)(A) (have no interest in the redeeming corporation, other than as a creditor, immediately after the distribution; acquire no such interest for a period of 10 years after the distribution, and file an agreement to notify the Secretary if such interest is acquired within the prohibited period); and (ii) each related person agrees to be jointly and severally liable for any deficiency resulting from an acquisition of interest in the redeeming corporation within the prohibited 10-year period.[357]

Note that §302(c)(2)(C) allows the entity to waive the family attribution rules only when the entity member (partner, beneficiary, or shareholder) owns the stock constructively by virtue of §318(a)(1). If the member directly owns stock in the redeeming corporation, §302(c)(2)(C) is inapplicable, and attribution to the entity cannot be waived. Thus, if in the above example S is a 10% direct shareholder in C, a waiver under §302(c)(2)(C) will apply only to the constructive ownership by S of F's 50% stockholding (which is then attributed to P). A complete termination of P's interest in C within the meaning of §302(b)(3) is not possible, since S's 10% ownership in C will be attributed to P under §318(a)(3)(A), and cannot be waived by P.[358]

In PLR 9547027, the IRS ruled that the §302(c)(2)(A) entity waiver rule did not apply to a redemption of preferred stock from an estate because the common stock in the corporation was owned directly by the estate's beneficiaries and was attributed under §318(a)(3), not §318(a)(1).

b. Family Attribution Waived for Purposes of §302(b)(3) Only

Waiver of family attribution for purposes of §302(b)(3) does not eliminate family attribution that arises under other Code provisions where attribution also operates.[359] This fact should be kept in mind in planning all tax aspects of a proposed redemption. For example, constructive ownership rules apply under and can cause a family member to be considered an over-50% shareholder of a corporation, with the result that an interest payment by the corporation to that family member could become subject to deductibility restrictions under §267 and the accrual of such interest payment may become nondeductible by the corporation until paid in cash.

> *Example:* All the stock of a family business is owned as follows: Husband, 50 shares; Wife, 25 shares; their children, 25 shares. The company redeems all of Wife's shares in return for an interest-bearing installment note. The redemption can qualify under §302(b)(3) if Wife agrees to comply with §302(c)(2). However, the waiver of family attribution under that provision is not effective to waive family attribution under §267. This means that under §267(c)(2), Wife will still constructively owns all the company's stock and, in turn, if the company uses accrual accounting and does not make its interest payments to her within 2 1/2 months after the close of its taxable year, its interest deduction will be denied until paid.[360]

c. Continued Interest Not Prohibited if Family Attribution Is Not Involved

The various prohibitions against continuing or reacquiring an interest in the issuer corporation as an officer, director, or employee, contained in §302(c)(2), apply only if family attribution under §318(a)(1) would otherwise prevent the redemption from qualifying for exchange treatment under §302(b)(3). The prohibitions do not apply in qualifying a redemption under §302(b)(1) or (2), or in situations where family attribution would not come into operation following a termination of interest redemption under §302(b)(3). Also, as noted earlier, a redeemed shareholder can continue to be, or can become, an officer, director, or employee of the issuer company if a family member's stock is redeemed simultaneously with the taxpayer's stock, so that no family member owns stock in the company after the redemption of the taxpayer's shares.

2. Community Property

Stock held as community property is treated as owned half by the husband and half by the wife. Thus, for purposes of §302, if one spouse has stock redeemed, the other is treated as receiving half the total redemption price. If a member of H's and W's family also owns stock in the corporation, a redemption of all the community stock will not qualify under §302(b)(3) unless family attribution to both spouses is waived under §302(c)(2). Therefore, each spouse must file a 10-year agreement and otherwise satisfy §302(c)(2).[361]

In Rev. Rul. 71-138, a husband (H) and his wife (W) lived in a community property state. H and his son, S, each owned 50% of the stock of X corporation. X redeemed all of H's

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[356] Defined in §302(c)(2)(C)(ii)(I) as a partnership, estate, trust, or corporation.

[357] *See* PLR 200102017; PLR 200052024.

[358] *See* PLR 9547027.

[359] See Rev. Rul. 88-55 (family attribution rules waived for §302, but continue to apply fo§267r §304 purposes).

[360] §267(a)(2). *See also Metzger Trust v. Commissioner*, 76 T.C. 42 (1981), aff'd, 693 F.2d 459 (5th Cir. 1982). *See Ronald Morgan Cadillac v. U.S.*, 2002-2 USTC ¶50,709 (C.D. Cal. 2002), 385 F.3d 1230 (9th Cir. 2004) (accrual method corporation permitted to deduct accrued interest on loan from cash method shareholder for year in which shareholder sold loan to unrelated party, but not permitted to deduct interest accrued prior to that year until actually paid). Note that taxpayer's name is "Ronald Moran Cadillac"; subsequent order from court is given under that proper name. For a detailed discussion of §267, see 564 T.M., *Related Party Transactions*.

[361] Rev. Rul. 71-138.

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shares. Clearly, for the redemption to qualify under §302(b)(3), H needed to file a waiver of the family attribution rules to prevent the stock owned by S from being attributed to him. However, because, under state law, W was treated as receiving one-half of the total redemption proceeds, the IRS ruled that W also had to file a waiver to qualify her respective share of the redemption proceeds.

Observation: If H and W had no children, and if no other family member owned stock that would be attributed to H and W under §318(a)(1), a redemption of all the stock held by H as community property would qualify under §302(b)(3) without any need for either H or W to file a waiver.

3. "Interest"

a. In General

The IRS generally takes a broad view of what constitutes an "interest" in the corporation. A continuing stock interest is clearly prohibited. Section 302(c)(2)(A)(i) specifically provides that continuing as an officer, director, or employee is not permitted.[362] However, the IRS interprets the statute as forbidding many other types of interests that allow the former shareholder to benefit from the activities of the corporation.[363] For example, the distributee cannot perform services for the corporation as an unpaid consultant.[364] In addition, the IRS has also ruled that the appointment of a trustee succession committee results in the acquisition of an interest in the redeeming corporation under §302(c)(2)(A), so that the proceeds received on the redemption of stock would be taxed as dividend income under §302(a)(i).[365]

Comment: Arguably, a former shareholder should be permitted to become a paid employee for a short period in order to train rank-and-file employees in a particular skill necessary in the business.[366] This technically would be a financial interest, but it would not involve significant corporate decision making.[367]

In Rev. Rul. 59-119, a distributee's right to have his lawyer serve as a paid director of the corporation in order to protect his continuing creditor interest was not permitted, even though the lawyer's real power as a director was limited because he would be a minority member of the board. The lawyer could, however, attend directors' meetings.

(1) Employee, Officer or Director

Despite the specific statutory language prohibiting an interest in the corporation as an employee, director or officer the Tax Court in several cases has refused to hold that §302(c)(2)(A)(i) prohibits the retention of an employment interest per se. Rather, the Tax Court has looked to whether, by retaining an interest as an employee, director or officer, the former shareholder has either retained a financial stake in the corporation or continued to control the corporation and benefit by its operation. (but see IV.C.3.a.(2), below, regarding the Ninth Circuit's rejection of this approach.)

The "control or financial stake" standard finds its genesis in Judge Simpson's concurring opinion to *Lewis v. Comr.*, where he stated:

> As I read section 302(c)(2)(A)(i), it does not provide that every officer or director shall be treated as having retained an interest in a corporation. It provides merely that a retained interest *may* include an interest as an officer or director, but it does not require us to find that every officer or director has retained an interest… Immediately after the enactment of the 1954 Code, it was recognized that section 302(c)(2)(A)(i) did not prohibit office holding per se, but was concerned with a retained financial stake in the corporation, such as a profit-sharing plan, or in the creation of an ostensible sale that really changed nothing so far as corporate management was concerned.[368]

In *Lewis*, a shareholder of a closely held corporation had all of his shares redeemed over a period of years; his son owned the remaining shares of the corporation. After he terminated his stock interest, he remained as an officer and director of the corporation, but he received no compensation from the corporation, performed no service for it, and exercised no influence over its affairs. The IRS argued that even the nominal retention of a position as an officer or director is not permitted. The court did not have to address the issue because it decided the redemption was not essentially equivalent to a dividend under §302(b)(1). Judge Simpson concurred in this result, but disagreed with the reasoning of the majority. He concluded that the former shareholder was entitled to capital gain treatment because there was a waiver of the attribution rules under §302(c)(2) and a complete termination of the former shareholder's interest under §302(b)(3). Judge Simpson stated that "Congress did not intend us to hold that an officer or director who performs no duties, receives no compensation, and exercises no influence has retained an interest in the corporation."[369]

The "financial stake or control" standard was adopted by the Tax Court in both *Seda v. Commissioner*,[370] and *Cerone v. Commissioner*.[371] In *Seda*, a shareholder had all his shares in a corporation redeemed but continued working for the corporation for two years after the redemption. He received a salary of $1,000 per month. The Tax Court refused to hold that §302(c)(2)(A)(i) prohibits the retention of employment relations per se, despite the unequivocal language in the statute. Instead, the

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[362] See the discussion at IV.C.3.a.(1), below, regarding the Tax Court's analysis of this statutory language.

[363] *See Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967), aff'g 47 T.C. 258 (1966); Rev. Rul. 56-556 (no interest allowed in assets or business, nor can services be rendered to corporation with or without compensation). *See also Seda v. Commissioner*, 82 T.C. 484 (1984) (gain on redemption treated as ordinary income, where redeemed shareholder was employed by corporation after redemption, but terminated employment upon learning of the possible adverse tax consequences).

[364] Rev. Rul. 75-2, Rev. Rul. 70-104, Rev. Rul. 56-556.

[365] PLR 199914017.

[366] *See* Rev. Rul. 54-408.

[367] *But see* PLR 8944076.

[368] *Lewis v. Commissioner*, 47 T.C. 129, 137 (1966).

[369] *Lewis v. Commissioner*, 47 T.C. 129, 137 (1966). Judge Simpson implied, however, that participation in medical insurance coverage by the corporation might be enough of an interest to disqualify a former shareholder's §302(c)(2) waiver. The IRS has subsequently held that participation in medical coverage by the corporation does not constitute a prohibited interest so long as the redeemed shareholder pays the costs associated with such participation. *See* PLR 199923011, PLR 9502027, PLR 9408018.

[370] 82 T.C. 484 (1984).

[371] 87 T.C. 1 (1986).

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court applied the facts and circumstances approach to determine whether the former shareholder retained a financial stake or continued to control the corporation. The Tax Court found that the monthly payments of $1,000 constituted a financial stake in the corporation. The court also found in *Seda* no evidence that the former shareholder had ceased to manage the corporation. Eight of the 17 Tax Court judges who reviewed *Seda* concurred in the result but would have classified all officer, director, or employee relationships as prohibited interests under §302(c)(2)(A)(i).

In *Cerone*, a father and son owned all the shares of a corporation formed to operate their restaurant. The corporation agreed to redeem all of the father's shares in order to resolve certain disagreements between the father and son concerning the management of the business. However, the father remained an employee of the corporation for at least five years after the redemption, drawing a salary of $14,400 for the first three years and less thereafter. The father claimed that he was entitled to capital gain treatment on the redemption because he had terminated his interest in the corporation within the meaning of §302(b)(3).

The Tax Court refused to find that the father held a prohibited employment interest per se. Rather, the court concluded that because the father received a salary, the father retained a prohibited interest in the company. Although the father did not continue to control the corporation after the redemption, that fact did not affect the court's decision because the court indicated that the test is whether the shareholder continues to control the corporation or retains a financial stake in the corporation.[372] In *Hurst v. Commissioner*,[373] a taxpayer sold all of his stock in a wholly-owned family business, principally to the company itself, although small portions of stock were purchased by three key employees. The taxpayer's wife signed an employment contract with the company under which she received salary and fringe benefits, including medical insurance. The court held that the employment contract did not constitute a prohibited interest because the wife's compensation and benefits were fixed and were not subordinated to the claims of general creditors, she continued to perform the activities she had performed before the sale of the company, and there was no evidence that she used the employment to retain any control of the company. Of note, the wife had not owned any of the stock of the corporation, thus she was not a distribute prohibited from having any interest in the corporation (including an interest as an officer, director or employee). Instead, the issue was whether her employment was a "prohibited interest" for the taxpayer. The IRS argued that the taxpayer was using the wife's employment to continue to have an ongoing influence over the corporation's activities. However, the court found no evidence of a continuing proprietary stake or control of corporate management.

(2) Independent Contractor

(a) In General

It is not unusual in the closely held context for the redeemed shareholder to continue to provide services to the corporation as an independent contractor. The issue arises whether this interest is a prohibited interest under §302(c)(2)(A)(i).

Section 302(c)(2)(A)(i) provides that the distributee may not have any interest in the corporation, other than an interest as a creditor. Arguably, this provision prohibits any noncreditor interest. The Tax Court, however, has used the "financial stake and control" standard to determine whether noncreditor interests in the corporation are prohibited interests under §302(c)(2)(A)(i).

The Ninth Circuit, on the other hand, in *Lynch v. Commissioner*[374] criticized and specifically overruled the Tax Court's use of the "financial stake or control" standard to analyze whether an interest as an independent contractor is prohibited under §302(c)(2)(A)(i). The Ninth Circuit went even further and held that those who provide post-redemption services, whether as an independent contractor or an employee, hold an interest prohibited under §302(c)(2)(A)(i) because they are more than merely creditors. The following is a summary of the Tax Court's and Ninth Circuit's opinions involving independent contractors.

(b) Tax Court Decisions

In *Lennard Est. v. Commissioner*,[375] a family corporation redeemed all of a father's one-third ownership of common stock and 37.5% ownership of preferred stock in a company that had been founded by a son, who owned the same percentage as his father in the common and preferred stock. The son alone managed the business. Two unrelated individuals owned the remaining stock but, like the father, did not participate in making policy. The father served as secretary-treasurer and was also a director. The father was also a certified public accountant who had long engaged in that business separately through his own firm. Since its formation the company had continuously retained the father and his firm to perform accounting services. These services consisted basically of reconciling bank statements, preparing monthly trial balances and financial statements, verifying inventories and preparing tax returns. The father was paid $250 per month for these services until May 1965, when he formed an accounting partnership with two other unrelated persons. The partnership continued without interruption as the corporation's accountants. In the redemption, the company paid the father $125,000 down and distributed its promissory note for $150,000, payable in full the next year. The father resigned as an officer and director and timely filed the 10-year agreement pursuant to §302(c)(2)(A)(iii), so as to waive attribution of his son's stock to himself.

Thereafter, the father continued to perform the same accounting services for the company as a partner in his accounting firm. During the following year, the father advised his son concerning an acquisition of another company, but the court found as a fact that the son alone made the final decision. The son also installed a pension plan for the company. The father became trustee and served as such until he died five years later. He was never a beneficiary under the plan. The father also supplied information on behalf of the corporation to a revenue agent who was auditing the company.

[372] 87 T.C. at 33.
[373] 124 T.C. 16 (2005).
[374] 801 F.2d 1176 (9th Cir. 1986), rev'g 83 T.C. 597 (1984).
[375] 61 T.C. 554 (1974), *acq. in result only*, 1974-2 C.B. 3, *nonacq.*, 1978-2 C.B. 3.

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In *Lennard*, Judge Goffe wrote:

> Congress was primarily concerned with the situation where a transferor retained a financial stake in the corporation or continued to control the corporation and benefit by its operations after making only a nominal transfer of stock. It is apparent that by the use of the word "interest," Congress had in mind a corporate involvement greater than that attributable to a third party providing goods or services to the corporation. In fact, the statute specifically excluded creditor interests from those prohibited by the attribution waiver rules contained in section 302(c).

The court rejected the IRS's contention that the father's services "greatly influenced" the corporation. The court said that the son had founded and run the business himself and its success was not directly attributable to the father's accounting services. An earlier increase in the accounting firm's fee was found, on the facts, to be reasonable in light of the company's increased growth and its increased accounting needs. Also, the accounting fee was not keyed to profits. The father's status as trustee of the pension plan was held to indicate, if anything, his independent relationship with the corporation. The father's dealings with the revenue agent were viewed as done in his capacity as an independent accountant. In summary, the court observed:

> [W]e do not have here a father who is attempting to transfer his business to his son and continue to retain control of its operation. Rather, we have a situation where a son has established a successful business with the financial cooperation of his father, and the father is in a position to provide services to the corporation in an independent capacity after his stock ownership and interest therein had been severed.

The court indicated that the prohibition in §302(c)(2)(A)(i) against having any "interest in the corporation" is not violated if the former shareholder becomes a bona fide independent contractor, and in that capacity supplies goods or services to the corporation and receives reasonable compensation for doing so. In so holding, Judge Goffe noted that the IRS's ruling treating consulting services as a prohibited interest[376] was not controlling and, in any event, was distinguishable on the particular facts before the court.

In *Chertkof v. Commissioner*,[377] the Tax Court held that a management agreement between the redeemed shareholder, Chertkof, and the issuer corporation was, on the particular facts, a prohibited interest for purposes of §302(c)(2). The corporation, which was a real estate company, distributed to Chertkof in the redemption an undivided one-third interest in the company's commercial real estate, including several shopping center properties, which had previously been managed for the corporation by the father and son (after the redemption the sole shareholder was Chertkof's father). The corporation and Chertkof agreed that for 10 years the corporation would manage the real estate interests distributed to Chertkof for a management fee payable by Chertkof to the corporation. However, six months after the redemption and due to the declining health of Chertkof's father, Chertkof (through a corporation 100% owned by him and his father) entered into a separate management contract with the corporation under which Chertkof's separate company (Chertkof Co.) would manage all the real estate company's assets for a cost not to exceed 5% of annual rentals.

The court held that this management contract gave the former shareholder a prohibited interest in the issuer real estate company. Judge Wiles based his conclusion on the fact that the management contract with Chertkof's wholly owned company gave "much broader" powers than were customary for similar management contracts, at least in the same geographical area. For instance, the contract gave Chertkof Co. exclusive authority to make all of the real estate company's major policy decisions and the real estate company could not discharge Chertkof Co. except on the annual renewal date after the initial two-year term of the contract. The Tax Court concluded Chertkof had reacquired a financial stake in the real estate company through his management responsibilities concerning leases, rentals, and lease renewals, which enabled him to increase the income of both the properties in which he owned a one-third interest as well as the two-thirds interest retained by the issuer company. The court noted further that Chertkof Co. had not managed property for any client other than the issuer company either before or after the redemption. In all these factual respects, the court distinguished the Tax Court decision in *Lennard Est. v. Commissioner*

In *Lynch v. Commissioner*,[378] a father and his son owned all the shares of a corporation. The corporation redeemed all of the father's shares. The son, wishing to retain the father's expertise, had the corporation enter into a consulting agreement with the father (the agreement was entered into the same day the father was redeemed). The consulting agreement provided the father with payments of $500 per month for five years, plus reimbursement for business related travel, entertainment, and automobile expenses. The corporation also leased or purchased a pick-up truck for the father's use; the truck was available for use by other employees. The father's consulting fee was reduced, a little over a year into the agreement, to $250. The corporation never withheld payroll taxes from payments made to the father.

Initially, the father shared an office with his son, but eventually he received a private office. The father continued to be covered by the corporation's group medical insurance policy for a period of time.

After citing the "control or financial stake" standard, the Tax Court engaged in a two-step analysis. First, the court concluded that the taxpayer was an independent contractor rather than an employee because the corporation had no right under the consulting agreement to control his actions. Second, the court undertook a "facts and circumstances" analysis to determine whether the taxpayer had a financial stake in the corporation or managerial control after the redemption. Because the consulting agreement was not linked to the future profitability of the corporation, the court found that the taxpayer had no financial stake. The court also found no evidence that the taxpayer exerted control over the corporation. Thus, the Tax

[376] Rev. Rul. 70-104, 1970-1 C.B. 66.

[377] 72 T.C. 1113 (1979), aff'd, 649 F.2d 264 (4th Cir. 1981).

[378] 83 T.C. 597 (1984), rev'd, 801 F.2d 1176 (9th Cir. 1986).

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Court determined that the taxpayer held no interest prohibited by §302(c)(2)(A)(i).

Both the analysis and the conclusion of the Tax Court were rejected by the Ninth Circuit when it reviewed the case on appeal.

(c) Ninth Circuit's Rejection of the Financial Stake or Control Standard

As the decisions discussed above reveal, the Tax Court believes that an interest other than that of a creditor is not necessarily a prohibited interest. The Tax Court's rule is that the test is whether the redeemed shareholder retained a financial stake or continued to control the corporation.[379] The Ninth Circuit, however, rejected the Tax Court's position in the strongest possible language. The Ninth Circuit held that whenever a taxpayer provides post-redemption services, either as an employee or an independent contractor, he holds a prohibited interest in the corporation because he is more than a mere creditor.[380] In other words, according to the Ninth Circuit, any interest other than that of a creditor is a prohibited interest.

One of the rationales the appellate court gave for rejecting the Tax Court's approach is that it involves a "facts and circumstances" analysis, which spawns uncertainty and "undermines the definite contours of the safe harbor Congress intended to create with §302(b)(3) and (c)(2)(A)(i)."[381] A second rationale for the Ninth Circuit's rule involves its construction of the parenthetical phrase in §302(c)(2)(A)(i) that describes which interests are prohibited. That phrase reads: "including an interest as an officer, director, or employee." According to the Ninth Circuit, this phrase "merely provides a subset of prohibited interest from the universe of such interests, and in no way limits us from finding that an independent contractor retains a prohibited interest."[382]

Like the Ninth Circuit, the IRS apparently believes that the parenthetical phrase in §302(c)(2)(A)(i) merely illustrates, and does not limit, the types of interests that are prohibited.[383]

(3) Voting Trustee

In Rev. Rul. 71-426, the IRS ruled that a right as a voting trustee to vote stock beneficially owned by others constitutes a prohibited interest for purposes of §302(c)(2)(A)(i).[384] On the facts considered in the ruling, the redeemed shareholder, who remained as a voting trustee, was deemed to own, via family attribution, the stock held in the trust for the benefit of her children. It was apparently immaterial in Rev. Rul. 71-426 whether the mother was sole trustee or only one of several trustees. The IRS has also ruled that the appointment trustee succession committee members results in the acquisition of a prohibited interest in the redeeming corporation under §302(c)(2)(A).[385]

In Rev. Rul. 71-262, the IRS ruled that when stock held in a voting trust is redeemed, the trust's beneficiary is the shareholder to whom the §302 tests apply.

Comment: In light of Rev. Rul. 71-262, if stock held in a voting trust by a father (F) as trustee for his son (S) is redeemed, and if F separately owns stock in the corporation, S must file a 10-year agreement pursuant to §302(c)(2)(A)(iii) in order to waive attribution of F's stock to S. However, F's status as voting trustee is a prohibited interest only in a situation where F's stock is redeemed, and F seeks to eliminate attribution of S's stock to F. F's position as voting trustee will not constitute a prohibited interest by S.

(4) Other Relationships

The IRS has ruled that no prohibited interest exists merely where a distributee's other corporation may at some point in the future participate in a joint venture with the distributing corporation.[386]

A landlord-tenant relationship between the redeemed shareholder and the corporation with respect to the property distributed is permitted. In Rev. Rul. 77-467, the IRS approved a continuation of lease payments from the corporation to the redeemed shareholder following the redemption, where the corporate lessee's payments were in a fixed amount not dependent on the company's earnings, were determined in an arm's-length exchange and were not subordinate to general creditors. "This relationship will not provide [the redeemed shareholder] with an interest in [the issuer company] greater than that of a creditor." Accordingly, the former shareholder did not hold a prohibited interest for purposes of §302(c)(2)(A)(i).[389][387]

In Rev. Rul. 84-135, the IRS ruled that the redeemed shareholder's right to receive payments under an unfunded pension agreement does not constitute the retention of a prohibited interest in the corporation under §302(c)(2)(A)(i). Although the pension agreement was unfunded, payments under the agreement were not dependent upon the future earnings of the corporation and the former shareholder's claim to such payments were not subordinate to the claims of the corporation's general creditors. The only rights retained in the corporation by the former shareholder were contract rights available to enforce the corporation's duties under the pension agreement.

The IRS cited Rev. Rul. 84-135 in PLR 8646021, where it was ruled that the redemption of stock from a trust and a beneficiary qualified under §302(b)(3), despite the beneficiary's continued receipt of deferred compensation, because deferred compensation is not a prohibited interest within the meaning of §302(c)(2)(A)(i).

In Rev. Rul. 81-233, the IRS found that a former shareholder who had filed a §302(c)(2)(A)(iii) agreement held a prohibited interest when the shareholder became a custodian of stock of the distributing corporation under the Uniform Gifts to Minors Act when the shareholder's minor child had stock gifted to him. The IRS reasoned that under the Uniform Gifts to Minors Act, a person having custody of stock held pursuant to the act was entitled to vote, thus showing an interest in the cor-

[379] *E.g., Cerone v. Commissioner*, 87 T.C. 1 (1986).

[380] *Lynch v. Commissioner*, 801 F.2d 1176 (9th Cir. 1986), rev'g 83 T.C. 597 (1984).

[381] *Lynch v. Commissioner*, 801 F.2d 1176 (9th Cir. 1986), rev'g 83 T.C. 597 (1984).

[382] *Lynch v. Commissioner*, 801 F.2d 1176 (9th Cir. 1986), rev'g 83 T.C. 597 (1984).

[383] *See, e.g.*, PLR 8944076 (if a redeemed shareholder became an independent contractor (a management consultant), he would hold a prohibited interest).

[384] *See also* PLR 199914017.

[385] *See* PLR 199914017.

[386] PLR 8313125.

[387] *See also* Rev. Rul. 70-639; PLR 9837022; PLR 9811051.

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poration.[388] However, the IRS ruled that a redeemed shareholder's remainder interest in a trust that holds stock of the corporation and is taxed to the shareholder's father under the grantor trust provisions does not constitute a prohibited interest.[389]

In PLR 8234061, a shareholder who had all his stock redeemed in exchange for a note was found not to have held a prohibited interest when payment of the note was secured by an escrow of the remaining shares in the company. The IRS based this determination on the fact that if the company did default on the note, the escrowed stock would be sold and the proceeds would be distributed to the former shareholder.

Comment: It is reasonable to believe that if the agreement was for the stock itself to be distributed to the former shareholder upon default, the IRS would have found that to be a prohibited interest.

If a redeemed shareholder receives a private annuity payable over the shareholder's remaining life, the shareholder's eligibility under §302(b)(3) appears to be unhampered. The IRS has ruled that an unsecured private annuity that is not subordinated to the rights of general creditors and upon default will not revert company stock to the redeeming shareholder is not a retained "interest" in the company. This is true despite the fact that the annuity probably will be paid out of future corporate earnings.[390]

Where a corporation agrees to redeem all of a shareholder's stock for installment payments over future years, the parties sometimes write into the redemption agreement specific prohibitions against certain corporate actions until the redemption price has been paid in full. The corporation, for example, may be barred from declaring dividends without the prior written consent of the redeemed shareholder, increasing salaries of other officers or paying salaries in excess of a stated amount, or selling its assets except in the ordinary course of business. In such situations, if the redeemed shareholder's rights with respect to the corporation are not broader or greater in scope than necessary for the enforcement of the shareholder's claim, Reg. §1.302-4(d) provides that the distributee's continuing influence over corporate policies in the ways described will not constitute a prohibited "interest in the corporation" for waiver of family attribution purposes.

In *Niedermeyer v. Commissioner*,[391] all of the shareholder's common stock had been redeemed, but he retained preferred stock in the corporation. In trying to qualify for waiver of family attribution in connection with §302(b)(3), the shareholder argued that even if his preferred stock were treated as equity rather than debt, his interest was not prohibited because the stock carried no right to participate in management of the company. The court rejected the argument, believing apparently that the statute prohibits any retained interest (when waiver of family attribution is sought), regardless of whether management rights are also retained. The Tax Court also rejected the shareholder's argument that §302(c)(2)(A)(i) permits retention of a "de minimis" stock interest. The taxpayer had retained 6.3% of the preferred stock.

Practice Point: Note, however, that in *Niedermeyer* the redeemed shareholder owned directly, and not through attribution, a preferred stock interest. Thus, even without application of the family attribution rules the shareholder did not completely terminate his interest under §302(b)(3).

Questions of particular difficulty may arise in a community property state. Consider the following two situations:

(a) H and W live in a community property state. Eighty shares of their family corporation are registered in W's name; the remaining 20 shares are divided among their four children. The corporation redeems all 80 shares from W. H continues as an officer of the company. W files a 10-year agreement. W was never an officer, director, or employee and does not become such during the 10-year period. Does W receive capital gain treatment under §302(b)(3)? Did she retain (by law) a community property interest in H's salary received by him from the corporation? In PLR 199942018, the entire ownership interest of H, along with the interest of other family members, was redeemed. W, an employee of the company, did not own any shares of the company. H and W lived in a community property state. Following H's redemption, W continued her employment with the company. In order to prevent W's salary as a company employee from being considered an "interest" of H, H and W entered into a "property agreement" that provided that all consideration paid to W in her capacity as a company employee will constitute her sole and separate property in such amounts. The IRS ruled that a complete redemption occurred subject to the validity of the property agreement that all earnings will be the sole and separate property of W. (See IV.C.2., above, for a discussion of whether H must file a waiver to qualify his share of W's redemption proceeds.)

(b) Assume that H and W, in a community property state, own all 80 of the outstanding shares. Forty shares are registered to H and 40 shares to W. The corporation redeems 40 shares from W, who files a 10-year agreement in order to avoid attribution to her of the 40 shares registered to H. Is §302(c)(2) satisfied? W holds by law a community interest in the 40 remaining shares registered in H's name. Is this ownership interest an actual continuing stock interest through W's community interest in the remaining 40 shares? W probably will be considered to hold a prohibited stock interest when the shares are considered community property. Rev. Rul. 82-129 considered a redemption of one spouse's interest to be a complete termination under §302(b)(3) and (c), but only when, before the redemption, the shares owned as community property were partitioned under state law so that each spouse held a separate interest. Consequently, it can be assumed that absent partition of shares or some other clearly definable separation of interest, a redemption of only part of the total shares among

[388] *See* GCM 38663 (discussing Rev. Rul. 81-233). *But see* PLR 7931043 (opposite holding to Rev. Rul. 81-233 on identical facts; no revocation of PLR).

[389] PLR 8217136.

[390] PLR 7727018.

[391] 62 T.C. 280 (1974), aff'd per curiam, 535 F.2d 500 (9th Cir. 1976), cert. denied, 429 U.S. 1000 (1976).

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parties holding community property will be considered a prohibited interest within the meaning of §302(c).[392]

If the issuer corporation is a general partner in a limited partnership that conducts an active business (such as owning and operating a hotel) it is unclear whether a redeemed shareholder who filed a 10-year agreement may enter into a management contract with the partnership to manage the hotel. One would argue that this is not a prohibited interest in the issuer corporation, because the agreement is made with the partnership, which is the legal owner of the business assets. On the other hand, the corporation is the general partner in the partnership. If the issuer corporation is only a limited partner, the argument that the former shareholder does not hold a prohibited interest is even stronger.

b. Creditor Status

Section 302(c)(2)(A)(i) permits a redeemed shareholder to continue as a creditor in the corporation without triggering family attribution for §302(b)(3) purposes. Reg. §1.302-4(d) contains the following guidelines for determining creditor status —

> [A] person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

There are at least two possible tax effects of failing to satisfy this regulation. The most obvious conclusion might be that because the regulation has been violated, the former shareholder has retained more than a creditor's interest. Hence, family attribution will operate and cause the redemption to fail the requirements of §302(b)(3) (the redemption, however, may still qualify under §302(b)(1) or (2)). This general approach to the tax effects of violating Reg. §1.302-4(d) was taken by the IRS in *Dunn v. Commissioner*,[393] discussed below. However, if the redeemed shareholder's interest can fairly by viewed as "proprietary," the initial redemption may be more properly treated as a tax-free recapitalization under §368(a)(1)(E). See IV.B.2., above, for a discussion of this approach.

In *Niedermeyer v. Commissioner*,[394] the Tax Court refused to treat as debt (and therefore as evidencing solely a creditor's interest) preferred stock retained by a shareholder after a redemption of all of his common stock. The court applied standard debt-equity criteria to treat preferred stock as equity, and, hence, as a prohibited interest for purposes of §302(c)(2)(A)(i).

In *Lennard Est. v. Commissioner*,[395] the court upheld the creditor status of a former shareholder who received a subordinated promissory note as part payment of the redemption price. A close corporation distributed in redemption of all the shareholder's stock $125,000 cash plus a 4% promissory note payable three months later during the following calendar year. The shareholder needed to waive family attribution and relied on §302(c)(2). The note was subordinated to all other corporate debts then existing or later incurred. Subordination was not a condition for obtaining financing for the corporation but was employed so that the corporation would not be compelled to disclose the debt to its bankers. At all times the corporation had enough funds to pay the note in full, and it did do so on the due date before paying its other indebtedness. The court read the reference to subordination in Reg. §1.302-4(d) as part of the requirement that the creditor's claim not be proprietary. Because, under the case law, a purported debt can still qualify as debt despite subordination, and because the note qualified as bona fide debt by reason of all other facts and circumstances, the court interpreted the regulation to permit creditor status, even where there was subordination.[396]

In *Hurst v. Commissioner*,[397] the Tax Court again upheld the creditor status of a former shareholder, disagreeing with the IRS's argument that the redeemed shareholder's right, under a promissory note issued in the redemption, to seize stock of the redeeming corporation gave the redeemed shareholder an interest greater than that of a creditor.

The taxpayer was the sole shareholder of the corporation. The corporation redeemed 90% of the taxpayer's stock with an installment note, and the taxpayer sold 51% of his remaining stock to his son and the other 49% to unrelated individuals. The corporation entered into a lease of the business premises from the taxpayer and entered into an employment agreement with the taxpayer's wife. The stock that the corporation redeemed was pledged to the taxpayer as security for the installment note, and a stock pledge agreement provided that the taxpayer could foreclose on the pledged stock in the event of default on the

[392] *See also* Rev. Rul. 71-138 (in order for husband in community property state to have all stock redeemed and avoid family attribution rules, wife must also file §302(c)(2)(A)(iii) agreement because stock jointly owned by her).

[393] 615 F.2d 578 (2d Cir. 1980). As discussed below, the IRS concluded in FSA 200203021 that a redeemed shareholder was more than a creditor and, thus, had a prohibited interest by virtue of the attribution rules because, among other reasons, (i) an installment agreement used to redeem shares provided for acceleration if the corporation fired the redeemed shareholder's spouse or broke a lease with the shareholder and (ii) the shareholder continued to influence the corporation's decision. In *Hurst v. Commissioner*, 124 T.C. 16 (2005), however, the Tax Court disagreed with the IRS's conclusion in FSA 200203021, holding that the redeemed shareholder's interest after the redemption was not greater than that of a creditor.

[394] 62 T.C. 280 (1974), aff'd per curiam, 535 F.2d 500 (9th Cir. 1976), cert. denied, 429 U.S. 1000 (1976).

[395] 61 T.C. 554 (1974), *acq. in result only*, 1974-2 C.B. 3, *nonacq.*, 1978-2 C.B. 3.

[396] For additional discussion of the debt vs. equity question, see IV.B.2., above. *See also Duerr v. Commissioner*, 30 T.C. 944 (1958); *Turner Constr. Co. v. U.S.*, 364 F.2d 525 (2d Cir. 1966) (amount of corporate note issued in redemption depended on future corporate earnings); *Erickson v. Commissioner*, 56 T.C. 1112 (1971), *acq.*, 1978-2 C.B. 2 (note subject to later increase or decrease depending on outcome of pending construction project; decided under §302(b)(1)); PLR 9734058 (stock redemptions by family members qualify as §302(b)(3) termination, assuming that notes received in exchange for stock not later determined to be equity instead of debt).

[397] 124 T.C. 16 (2005).

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note. The installment note itself provided that if the corporation breached either the employment agreement or the lease, the remaining principal on the note would become immediately due and payable, and that the corporation's failure to pay the full amount due could trigger the default provisions of the stock pledge agreement.

The redemption of the taxpayer's stock in *Hurst* would be a complete termination under §302(b)(3) only if the taxpayer could waive application of the family attribution rules; the taxpayer's son, otherwise, would own 51% of the outstanding stock after the transaction and §318(a)(1) would attribute that stock to the taxpayer. The IRS, in FSA 200203021, concluded that the taxpayer's interest after the transaction was not a creditor interest for §302(c)(2) purposes and, thus, was a prohibited interest. The IRS based its conclusion on the fact that the installment note's default provision (in the event of breach by the corporation of the employment agreement or lease agreement) went beyond protections that would be necessary for a creditor and gave the taxpayer continuing influence and a continuing financial stake in the corporation.

The Tax Court disagreed with the IRS, holding instead that none of the collateralization provisions and default provisions gave the taxpayer a post-transaction interest greater than that of a creditor. The court noted that the installment note called for periodic payments of principal and interest on a fixed schedule and that neither the amount nor the timing of the payments was tied to the corporation's financial performance. The court also noted that, although the note was subordinate to the corporation's obligation to its bank, the note was not subordinate to general creditors. The court found, moreover, that the default provisions giving the taxpayer the option to retrieve his shares in the event that the company failed to meet any financial obligation to him merely protected the value of his security interest and, thus, were consistent with a creditor's interest. The court also determined that, "despite the Commissioner's qualms," the taxpayer had not participated in any post-redemption corporate activity that would indicate a continuing proprietary stake or control of corporate management.

Creditor status includes a distributee who held outstanding corporate debt obligations before the redemption and continues to hold the obligations thereafter. The statute also allows a distributee to receive a corporate debt obligation in the redemption itself. As to whether, for waiver of family attribution purposes, the statute allows a distributee to become a creditor after the redemption date, see IV.C.4.b., below.

Reg. §1.302-4(d) received a thorough review in *Dunn v. Commissioner*[398] The taxpayer owned 249 of 500 outstanding shares of a Chevrolet dealership, in which her son and two daughters owned the remaining shares. Her son was president of the company. The franchisor, General Motors (GM), wanted the son to be the majority owner. The taxpayer was elderly and wanted to retire to Florida. On June 1, 1970, the corporation redeemed all of the taxpayer's stock for $335,000 payable $100,000 down and the balance at 5% interest over 10 years. In order to qualify for capital gain under §302(b)(3), the taxpayers filed the 10-year agreement to waive family attribution. The 1970 and 1971 installments were before the court. The IRS contended that the terms of the redemption agreement caused the transaction to violate several parts of Reg. §1.302-4(d) and that, accordingly, the redemption failed to qualify for capital gain treatment and was taxable to the shareholder as an ordinary §301 distribution.

The redemption agreement contained several restrictions, insisted on by GM, on the company's payments under the agreement, including a provision that the dealership would have to "postpone" its annual redemption payments if the payments would reduce its net working capital below a specified level or if the company would not be left with at least 50% of the year's net after tax profits. In fact, the company failed to meet the minimum working capital or earnings levels specified in the redemption agreement, and the installment payments due during 1971 through 1975 were each postponed a year or more. Even when the installments were paid, they violated the restrictions in the redemption agreement, but GM made no objection to the payments.

The Second Circuit upheld the redeemed shareholder's status as a creditor, and rejected the IRS's claim that the redemption payments had been subordinated to general creditors in violation of the regulation. The court disagreed with the IRS that the former shareholder's claim had been subordinated. If the company had liquidated, the court pointed out, no general creditor could have validly argued that his claims should be paid before the taxpayer. According to the court,

> [i]t is certainly true that Bresee [the dealership] could not stay in business unless it paid its operating expenses as they came due, and that, in that sense, an ordinary trade creditor, with a right to insist on payment of his bill when due, stood in a different position than the taxpayer. But that is just the difference between any trade creditor selling on current account and a long-term creditor, secured or unsecured. Nothing in the Agreement gave trade creditors any standing whatever to insist upon Bresee's observance of GM's owned net working capital requirement. Indeed, in practical reality Bresee's general creditors were just as subject as the taxpayer to the invocation of the only sanction which GM had for enforcing the owned net working capital requirement, that is, termination of Bresee's Chevrolet franchise: the owned net working capital requirement could as easily be breached by incurring operating expenses as by paying the taxpayer.

The Second Circuit also rejected the IRS's argument that the "amount" or "certainty" of the redemption payments depended on earnings. "Only the time when the payments were made might be influenced by Bresee's owned net working capital position or rate of net profits after taxes, but neither the amount of the payments to be made nor the duty to make the payments was dependent on the existence of earnings." The court thus distinguished between deferral of payment and contingency of the underlying obligation:

> [T]he obligation here, to the extent that it differs from the classic debt of fixed amount and inexorable due date, does not differ in the direction of being a proprietary or equity type of interest, but differs simply in being unmistakably debt, but of a seemingly

[398] 615 F.2d 578 (2d Cir. 1980), aff'g 70 T.C. 715 (1978).

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somewhat inferior quality because of the postponement clause.

Because the taxpayer held no other shareholder rights, such as an officer position, voting rights or rights to reacquire stock on default, the court held that, following the redemption, she was solely a creditor.

c. Warrants or Convertible Debentures Received in the Distribution

If a corporation distributes an option instrument as part of the redemption price, e.g., a warrant to buy stock in the issuing company itself or a debenture convertible into stock of the issuing company, the instrument may trigger the option attribution rule of §318(a)(4).[399] This rule provides that if a person has an option to acquire stock, such stock will be considered as owned by such person. The effect of this rule is not to treat the option instrument itself as stock. Rather, the rule is used to determine the amount of stock in the issuing company that the distributee is deemed to own after the exchange for purposes of testing the exchange under the different categories of §302(b). Therefore, if an option instrument is received in the exchange and if option attribution is triggered, the exchange obviously cannot qualify under §302(b)(3) because through option attribution the distributee will still hold shares in the corporation. Unlike the family attribution rules, the option attribution rules cannot be waived. Even with the constructive ownership triggered by the option rule, however, the exchange may still qualify under §302(b)(1) or (2).

Note: As discussed earlier, a stock warrant, whether comprising part or all of the redemption price, is not itself governed by §302, by reason of the definition of "property" in §317(a).

Observation: If the option attribution rules do not apply to an option instrument (e.g., a convertible debenture subject to contingencies) received by the distributee as part of the redemption price, then an issue may arise under §302(c)(2)(A)(i) whether the distributee has a prohibited "interest" in the corporation as a potential shareholder. This issue is present only in a situation where other family members own stock in the corporation and the distributee who receives a convertible debenture is trying to qualify under §302(b)(3) and to have family attribution of other stock to himself waived. Family attribution will not be waived in this situation if the holding of the convertible debenture is viewed as the retention by the distributee of a noncreditor interest in the corporation.

4. Ban on Acquiring Interest for 10 Years

a. Other Corporations

Section 302(c)(2)(A) prohibits the distributee from having an interest in "the corporation" immediately after the distribution and from acquiring an interest in the 10 years following the redemption. Reg. §1.302-4(c) extends this ban to an acquisition of an interest (through stock or as an officer, director, or employee) in a parent or subsidiary of the distributing corporation. This regulation also prohibits interests in a "successor" to the distributing corporation.

The percentage ownership that makes another corporation a parent or subsidiary, and the scope of the "successor" concept, remain unclear. The IRS has ruled that "[w]hether a corporation is a 'successor corporation' depends upon the facts of the particular case."[400]

Reg. §1.302-4(c) provides that if a shareholder in a parent corporation sells its entire stock interest in the parent to a subsidiary, and if §304 applies to the sale, the 10-year ban extends to an interest in both the parent and the subsidiary.

Presumably some minimum stock ownership is required in order to be a "parent" or "subsidiary" of the distributing company. Where such minimum ownership is not present, a distributee could remain or become an officer, director, or employee of a corporation in which the distributing company owns stock or hold a similar position in a corporate shareholder (or tax-exempt organization) that owns stock in the distributing company. In 1958, the Advisory Group on Subchapter C proposed that, for purposes of Reg. §1.302-4(c), the parent-subsidiary relation be defined as 50% or greater ownership of, or by, the distributing company. A "successor" would be a successor within the meaning of §381(a).[401]

As PLR 8944076 illustrates, the "successor corporation" issue arises in the context of brother-sister corporations as well as in the context of parent-subsidiary corporations. That ruling involved two corporations, X and Z. Before 1984, C (the taxpayer) and his father, B, owned all the stock of X. In 1984, X redeemed all of C's shares, making B the sole shareholder of X. In 1987, B formed corporation Z and became its sole shareholder. Thus, in 1987 B owned all the shares of both X and Z. At a later date, Z proposed to engage C's services as a management consultant. C requested a ruling as to whether Z was a successor to X. The IRS ruled that Z was not a successor corporation, but gave no explicit reasons for so ruling. The IRS provided implicit reasons for its holding, however, in the representations that it had required the taxpayer, C, to make as a condition to issuing its favorable ruling. The required representations implied that, when considering this issue, the IRS looked to the dealings between the two corporations involved and the relation between each shareholder of both corporations to each corporation. The IRS required C to represent, for example, that: (1) B did not use any of the distributions he received from X to acquire shares in, or make loans to, Z; (2) none of corporation X's operating assets had been sold or otherwise transferred to Z; (3) Z had never engaged in X's business and would not so engage until 1994; (4) no corporation for which Z provided services was engaged in X's business, and Z would not provide any services to such a corporation before 1994; and (5) Z provided no products or services to X, and X provided none to Z, except to the extent of accounting services provided to Z at an arm's-length price.

In Rev. Rul. 76-496, the IRS ruled that a successor, for purposes of Reg. §1.302-4(c), does not include a separate corporation that, within the 10-year period, purchases for fair mar-

[399] *See* Rev. Rul. 68-601(warrant treated as option for §318(a)(4) purposes, if holder has right to obtain stock at his election and there exists no contingencies with respect to such election). See VIII.B.4., below, for a discussion of the option attribution rule.

[400] Rev. Rul. 76-496.

[401] Advisory Group on Subchapter C, *Revised Report on Corporate Distributions and Adjustments*, 6–7 (1958).

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ket value (and in a taxable transaction) some of the distributing company's assets. In this ruling, X redeemed all of its stock owned directly by a 26% shareholder, T. The other shareholders were T's son and B, an unrelated individual. In order not to be treated as constructively owning his son's shares, T filed a 10-year agreement. Two years later, T and unrelated persons formed a new corporation, Z, which purchased from X assets of one of its divisions that had been advertised for sale and which constituted approximately 15% of the fair market value of X's total assets. The IRS ruled that Z was not a "successor" to X, so that T's participation in the asset purchase from X did not adversely affect his prior redemption. The ruling stressed the small size of the division sold, the valid business reasons for X's sale, the fact that none of X's shareholders after the redemption became shareholders of Z, and the fact that none of X's tax attributes under §381 carried over to benefit T indirectly through Z.

Rev. Rul. 76-496 leaves certain questions unanswered. Consider, for example, the case of a corporation that sells services rather than goods. In this case, the value of the corporation's tangible assets may be nominal when compared to the corporation's intangible assets or its total value. In such a case, how is the "15% of the assets" test of Rev. Rul. 76-496 to be applied? In PLR 9018028, the IRS suggested that, where the value of tangible assets acquired may not be a good measure of whether the purchasing corporation is a successor corporation, the IRS will apply some alternative method of measuring what the purchasing corporation acquired to determine whether the purchasing corporation is a successor. In that ruling, the redeeming corporation, X, had three shareholders: a father (F), his son (S), and an unrelated minority shareholder. In 1984, X redeemed all of S's shares. X, operated a nationwide consulting business. X's business was divided into regions representing geographical areas of the United States and separate income and expense records were kept for each of its operations in these areas. Before the proposed transaction, X's western region had been operating at a loss for several years. F determined that the western region had to be sold or discontinued. S believe that he could make the western region profitable. S proposed to form a new corporation, Newco, of which he would be the sole shareholder, and to cause Newco to purchase, at arm's-length, the assets and operations of X relating to the western region operations. These assets were primarily intangible assets, e.g., client lists and records of contacts.

Most of X's six employees associated with its western region were to be offered employment with Newco. X's fixed assets were of nominal value, but its western region generated about 10% of X's annual gross revenues, and its six employees represented about 8% of X's total work force.

On these facts, the IRS ruled that Newco would not be a successor corporation to X, but gave no reason for its ruling, and did not cite Rev. Rul. 76-496. PLR 9018028 provides guidance nevertheless, for it suggests that where the value of tangible assets acquired is not a good measure of whether the purchasing corporation is a successor, the IRS looks to, for example, the percentage of gross revenues and employees "acquired."

b. Later-Acquired Interests

It is generally immaterial how or from whom the redeemed shareholder reacquires stock in the company.[402] If, for example, the corporation redeems part of a shareholder's stock while simultaneously the shareholder resells the rest of its shares to a third person on the installment basis, retaining a security interest in the stock sold, reacquiring the stock as a result of the third person defaulting will violate §302(c)(2)(A) and reinstate family attribution with respect to the redemption.

If the distributee becomes a creditor of the redeeming corporation and later enforces its creditor's right to acquire assets of the corporation, this acquisition will not violate the no-interest rule.[403] However, the creditor may not reacquire stock of the redeeming corporation in enforcing its creditor's rights, as might occur if the corporation had pledged the stock as security for its payments or placed the stock in escrow as security for its payments and then defaulted.[404] The same rule would apply if the corporation pledged or escrowed stock of its parent or subsidiary and the shareholder later reacquired such stock.

Note: It has been suggested that a way to escape the no-interest rule where the creditor later reacquires stock on default is to provide in the redemption agreement that the former shareholder may sell the pledged stock in a private or public sale in order to satisfy the obligation owed to the former shareholder, but the former shareholder cannot purchase the stock at such a sale.[405]

As previously indicated, unless the distributee needs to waive family attribution in order to qualify the redemption under §302(b)(3), as distinct from §302(b)(1) or (2), the distributee can retain a security interest in the redeemed stock itself and is not limited to a security interest in corporate assets.

Can a shareholder whose stock interest is completely terminated later loan money to the corporation and take back its note? Or can the former shareholder purchase an outstanding corporate debt obligation for reasons unrelated to payment for its stock? The statute is ambiguous on this point. Section 302(c)(2)(A)(i) provides that immediately after the distribution the distributee may have no interest in the corporation other than as a creditor §302(c)(2)(A)(ii) then states that during the next 10 years the distributee may "not acquire any such interest (other than stock acquired by bequest or inheritance)…"

Comment: For private ruling purposes, the IRS will allow a redeemed shareholder to become a creditor of the corporation during the 10-year period for reasons unrelated to the redemption. However, if the debt instrument can be treated as equity for tax purposes, the distributee will have reacquired a stock interest in violation of §302(c)(2)(A)(ii).

The statute does not provide an exception for short-term interests.

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[402] See IV.C.4.c., below, for when exceptions regarding bequest or inheritance.

[403] If the taxpayer has transferred its creditor's interest to another corporation, and that corporation acquires assets from the redeeming corporation in a default, the IRS might argue that the second corporation is a successor, thereby violating §302(c)(2)(A)(i).

[404] Reg. §1.302-4(e).

[405] *See* Rev. Rul. 59-119.

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Example: A shareholder wishing to terminate its interest in a family business has the corporation redeem all of its stock and files the required agreement in order to waive family attribution. However, eight years later, the manager of one of the company's branch operations suddenly quits and the shareholder is asked to fill the position until a replacement can be hired. A replacement is found one month later, and the shareholder returns to retirement. The statute seems to be unforgiving in this situation. Apparently, the shareholder has acquired a prohibited interest in violation of the statute.[406]

Similarly, a waiver of family attribution under §302(b)(3) may be lost if a redeemed shareholder forgets about the 10-year agreement and purchases some stock in the redeeming company but, when reminded by a tax advisor, promptly sells the stock the next day.[407] The better result would be that a rule of reason should prevail, and if the facts and circumstances indicate no attempt to abuse the policy of the statute, a court may not disqualify the entire redemption.[408]

c. Acquiring Stock Through Bequest or Inheritance; Becoming an Executor or Co-Trustee

Section 302(c)(2) permits acquisition of an interest through bequest or inheritance.[409] The statute is silent as to whether a shareholder who relied on §302(c)(2) is permitted to become an executor of an estate of another shareholder who died after the redemption. Acquiring status as an executor or co-trustee is arguably analogous to acquiring an interest by bequest or inheritance. In Rev. Rul. 72-380, the IRS ruled that becoming executor of an estate of a deceased shareholder within 10 years after a redemption of all the stock owned by the distributee does not constitute a forbidden interest in the corporation within the meaning of §302(c)(2)(A)(ii). This ruling implies that it is immaterial whether the distributee is a beneficiary of the decedent's estate, so that even if the distributee is not a beneficiary of the estate, the distributee can still vote stock in the estate without jeopardizing the distributee's own prior redemption.

In Rev. Rul. 75-2, the IRS amplified Rev. Rul. 72-380 by ruling that although an executor (whose own shares were previously redeemed under protection of a waiver of family attribution) does not hold a forbidden interest merely by being able to vote stock contained among the estate's assets, the executor will acquire a forbidden interest if he becomes an officer of the company during the administration of the estate within the 10-year period set forth in §302(c)(2)(A)(ii). The ruling adds that a forbidden interest will also be acquired (a) if the former shareholder first becomes an officer after the estate is settled (and within the 10-year period), or (b) if the executor becomes an officer during the administration of the estate but ceases being an officer after the estate is settled.

Observation: In this ruling the executor/former shareholder became president of the company during the administration of the estate. In terms of what constitutes a forbidden interest, however, all officer positions in the company are prohibited. The ban thus extends to becoming president, vice president, secretary or treasurer.

Query: If a shareholder who is relying on §302(c)(2) for waiving family attribution reacquires stock in the company by bequest or inheritance during the 10-year period, can the shareholder use the voting power of such stock to become an officer, director, or employee of the company? The statute is not clear on this point. Perhaps the shareholder cannot become an officer, director, or employee personally, but can place others under the shareholder's control as officers, directors, or employees. But if the statute permits the shareholder to exercise shadow control, it would seem that it should be interpreted to permit direct control.

The IRS has extended the rationale of Rev. Rul. 72-380 to allow a redeemed shareholder who filed a 10-year agreement to become a successor co-trustee of an inter vivos trust previously established by her parents for the benefit of her brother's child. The trust held voting stock of the issuer corporation and in the capacity as trustee, the redeemed shareholder acquired a right to vote the stock held in the trust.[410]

d. Effect of Attribution Rules on Reacquisitions of Interest

(1) Family Attribution

If the distributee satisfies the requirements of §302(c)(2)(A) in order to waive attribution of stock owned by a family member at the date of the redemption, attribution is also waived with regard to stock that a family member acquires after the redemption and within the future 10-year period. In Rev. Rul. 71-562, the IRS ruled:

> [A]ny interest in the corporation arising during the ten-year period following the redemption of A's [the distributee] stock which would be attributed to A solely by reason of the application of the family attribution rules of section 318(a)(1) of the Code is to be disregarded for purposes of section 302(c)(2)(A)(ii) of the Code.

It should follow from Rev. Rul. 71-562 that family attribution will not operate in determining whether the distributee has satisfied §302(c)(2)(A) by not retaining or acquiring a non-stock interest in the corporation as officer, director, or employee. Thus, a redeemed shareholder's wife or son should be able to remain as a shareholder, or become an officer or director of the distributing company (or its parent or subsidiary), within the future 10-year period without adversely affecting the distributee's §302(b)(3) treatment.

If the above interpretation is sound, Rev. Rul. 71-562 demonstrates the IRS's acceptance of the so-called "bedroom redemption" situation. The issue involved in the bedroom redemption situation is whether, in view of the usual close rela-

[406] Perhaps the Tax Court would permit this interest, applying the "control or financial stake standard." See IV.C.3.a.(2)(b), above.

[407] Perhaps the taxpayer could enter into a rescission transaction. *Cf.* Rev. Rul. 80-58 (reconveyance in year of sale of land between parties because of buyer's inability to acquire zoning permits considered a rescission that put taxpayers in their original tax position).

[408] *But see* Rev. Rul. 75-2, discussed below.

[409] *See* PLR 200025035.

[410] Rev. Rul. 79-334.

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tionship between husband and wife, the ban in §302(c)(2)(A) against a distributee having an interest in the company for 10 years is realistically satisfied if his or her spouse continues as a shareholder, officer, director, or employee, or otherwise holds an interest in the corporation. The IRS has ruled that the requirements of §302(c)(2)(A) are satisfied where the spouse of the distributee continues as an employee of the corporation,[411] and where the distributee's son[412] or daughter[413] returns as an employee. Suppose that all of a father's stock in a closely held company is redeemed, no other family members own stock in the company, but the father's son is president of the company (but owns no actual stock). The father does not need to waive family attribution at the threshold, so there is no problem in the son's continuing as an officer, director, or employee — or indeed in the father's continuing in any such capacity.[414] Suppose that the father's spouse, W, owns stock in the company and continues as a shareholder after the father's redemption, and son is the president (but W has no position with the company). In that case, father needs waiver of attribution of W's stock to himself. The fact that son is an officer does not seem to trigger any adverse result. Even if W's stock is owned constructively by son via §318(a)(1) that stock would not be reattributed to father,[415] so it appears that son could continue as an officer without any adverse effect on father's redemption.

In Rev. Rul. 88-55, the IRS ruled that a former shareholder of a redeeming corporation did not acquire a prohibited interest under §302(c)(2)(A)(ii) by virtue of selling stock of a related corporation to the redeeming corporation even though the sale was treated as a distribution in redemption of stock in the redeeming corporation under §304. In that ruling, the stock of two corporations (X and Y) was owned by a father (F) and son (S). In 1985, X redeemed F's stock for cash and F filed a waiver of family attribution. Two years later, F sold his Y stock to X for cash. Under the family attribution rules of §304(c)(3), F was considered to control both X and Y and, therefore, §304(a)(1) treated F's sale to X of the Y stock as a distribution by X to F in redemption of X stock for purposes of §302.

The IRS ruled that the application of §304(a)(1) to the second transaction does not result in the acquisition of a prohibited interest in X for purposes of §302(c)(2)(A)(ii) because F was not treated as if he had owned stock in X immediately before the redemption for purposes of §302(c). Accordingly, the IRS concluded that F is not required to notify the Secretary of the 1987 sale under the agreement filed under §302(c)(2)(A)(iii) with respect to the 1985 redemption.

(2) Nonfamily Attribution

It is unclear whether the acquisition of an interest by an entity whose ownership would be imputed to the distributee through nonfamily attribution rules violates the restriction in §302(c)(2)(A)(ii) against reacquiring an interest in the corporation, but that reading seems consistent with the statute.[416]

Example: All of a shareholder's stock is redeemed by X corporation. The only other family member who continues to own stock in the company is the shareholder's spouse. The redeeming shareholder, therefore, utilizes §302(c)(2). During the 10-year period, however, a corporation (in which the redeeming shareholder owns 55% of the stock) acquires X stock. Under §318(a)(2), such stock is deemed owned by the redeeming shareholder. Is this constructive ownership considered a reacquisition of a prohibited interest in X? If it is, the family attribution originally waived (the stock held by the redeeming shareholder's spouse) would be reactivated and the redemption would not qualify under §302(b)(3).

Observation: If stock is constructively owned by the redeemed shareholder at the time of the redemption by reason of nonfamily attribution, e.g., partnership to partner attribution, the redemption cannot qualify as a complete termination of interest at the threshold. Section 302(c)(2) is not available to waive the attribution because that provision waives only family attribution.

Comment: If the redeemed shareholder does not own any stock constructively after the redemption by reason of family or nonfamily attribution, but later becomes a partner in a partnership that owns stock in the corporation, no issue arises under §302(c)(2). Apparently, unless the constructive ownership is acquired as the result of a prearranged plan or scheme, no adverse impact on the redemption occurs and it can still remain qualified under §302(b)(3).

5. Transfers of Stock During Prior 10 Years

a. Two Different Situations

Section 302(c)(2)(B) is designed to prevent abuse of family attribution waiver where an artificial situation has been prearranged between or among family members before the redemption (within the prior 10 years) to take advantage of the waiver rule and thereby qualify a redemption under §302(b)(3). There are two basic situations where such an abuse can occur, and §302(c)(2)(B) deals with both:

(1) A family member has transferred stock to another family member so that the corporation can later redeem all such stock from the transferee; or

(2) A family member has transferred stock to another family member in order to qualify a redemption of the remainder of the transferor's stock as a complete termination of interest.

Any kind of transfer is covered by the rules for these two situations. Typically, the transfer will be by gift from one family member to another.[417] But other forms of transfer are also

[411] PLR 9023047, PLR 8743013.
[412] PLR 9214024.
[413] PLR 9144017.
[414] *See* Rev. Rul. 76-524.
[415] §318(a)(5)(B).
[416] *See* Willens, *Recent Decisions Open the Way for Trusts and Estates to Waive Stock Attribution*, 51 J. Tax'n 208, 209 (1979). *See also Johnson Trust v. Commissioner*, 71 T.C. 941, 952 (1979); PLR 7931033 (no opinion expressed whether future acquisition of stock by an employee trust of which redeemed shareholder was a trustee will be considered a prohibited acquisition by the redeemed shareholder).
[417] For additional rulings involving transfers, see PLR 201228012 (in closely-held context, parent, wishing to terminate his interest in family corporation, may transfer majority stock control to child and qualify redemption of balance of his stock under §302(b)(3) through waiver of family attribution rules; gifts

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covered, including a sale for consideration.[418] A distribution of stock as an asset of a testamentary estate to a beneficiary of the estate is also a transfer for purposes of §302(c)(2)(B).[419] However, in Rev. Rul. 82-129, the IRS ruled that the partition of community property stock into separate property of a husband and wife is not a transfer described in §302(c)(2)(B).

Observation: The rules in §302(c)(2)(B) are designed chiefly for intra-family transfers of stock. Section 302(c)(2)(B) is not expressly limited to transfers of stock to or from family members, as the rules in §302(c)(2)(B) refer to stock attributable to the distributee from another person at the date of the distribution. If stock is attributable to the distributee from another person or entity via a relationship other than a family relation, the redemption will not qualify as a complete termination of interest in any event, because of nonfamily attribution to the distributee.

In Rev. Rul. 77-293, the IRS explained the purpose of these prior transfer limitations as follows:

> The structure and legislative history of section 302 of the Code make it clear that the purpose of section 302(c)(2)(B) is not to prevent the reduction of capital gains through gifts of appreciated stock prior to the redemption of the remaining stock of the transferor, but to prevent the withdrawal of earnings at capital gains rates by a shareholder of a family controlled corporation who seeks continued control and/or economic interest in the corporation through the stock given to a related person or the stock he retains. Application of this provision thus prevents a taxpayer from bailing out earnings by transferring part of the taxpayer's stock to such a related persons and then qualifying the redemption of either the taxpayer's stock or the transferee's stock as a complete termination of interest by virtue of the division of ownership thus created and the availability of the attribution waiver provisions.

In the same ruling the IRS illustrates the problem situations addressed by the statute with these examples:

> Tax avoidance within the meaning of §302(c)(2)(B) of the Code would occur, for example, if a taxpayer transfers stock of a corporation to a spouse in contemplation of the redemption of the remaining stock of the corporation and terminates all direct interest in the corporation in compliance with §302(c)(2)(A), but with the intention of retaining effective control of the corporation indirectly through the stock held by the spouse. Another example, which would generally constitute tax avoidance within the meaning of this provision, is the transfer by a taxpayer of part of the stock of a corporation to a spouse in contemplation of the subsequent redemption of the transferred stock from the spouse.

b. Transfer to Distributee

Section 302(c)(2)(B)(i) does not allow the family attribution rules to be waived if:

> any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section §318(a)…

If the transferor (to the distributee) is deceased at the date of the redemption, this rule will not be applicable, because the language requires that attribution operate from the transferor to the transferee at the date of the distribution.

If the distributee received "tainted" stock during the prior 10 years, but the corporation redeems other stock that was not acquired from a "tax-relative" under §318, the 10-year "look-back" will also have no adverse effect. Of course, in this latter situation, in order to qualify the redemption under §302(b)(3), the distributee must dispose of the tainted stock to an unrelated person before the redemption in question. Otherwise, the distributee's actual stock interest will not be completely terminated. If the distributee disposes of the tainted stock to an unrelated person, attribution of stock owned by family members at the time of the redemption can still be waived under §302(c)(2).

The reference to "directly or indirectly" in §302(c)(2)(B)(i) reaches a situation where the distributee acquired stock from a person who previously acquired the stock from a "tax relative" whose remaining stock would be attributed to the distributee at the redemption date. It appears to be immaterial whether the intermediate owner was a member of the distributee's family or was otherwise "related" to the distributee under §318. It also appears to be immaterial by what method the intermediate owner acquired the stock from the original transferor or by what method he transferred it to the distributee.

c. Transfer by Distributee

Section 302(c)(2)(B)(ii) does not allow the family attribution rules to be waived if:

> any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

Under this rule, if the transferee no longer owns, at the date of the redemption, *any* shares of the corporation, including the shares he acquired from the distributee during the preceding 10 years, the distributee can still use §302(c)(2) to eliminate family attribution from other family members to himself.

If, at the redemption date, the transferee has disposed of part of the very same shares he acquired from the distributee during the preceding 10 years, but still owns *some* of such shares, §302(c)(2)(B)(ii) will be triggered (unless the simultaneous redemption exception is used). The effect of triggering §302(c)(2)(B)(ii) appears to be to require attribution to the dis-

do not have as one of their principal purposes avoidance of federal income tax under §302(c)(2)(B)), PLR 200939011, PLR 200022020, PLR 200011016.

[418] *See* Rev. Rul. 77-455. *See also* S. Rep. No. 83-1622, at 237 (1954).

[419] Rev. Rul. 79-67.

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tributee of all stock that all family members, not just the transferee, own in the corporation at the redemption date.

Note: The amount of stock the transferee originally acquired from the redeemed shareholder is irrelevant. Family attribution will be triggered as to the stock the transferee owns at the date of the redemption and as to stock that other family members may also own at that date.

If, at the redemption date, the transferee has disposed of all the stock acquired from the distributee during the preceding 10 years but the transferee still owns other stock in the corporation which the transferee acquired from an independent source, §302(c)(2) may not be available to prevent attribution of such independently acquired stock (as well as stock owned at the redemption date by other family members) to the redeemed shareholder. The reason for this result is that §302(c)(2)(B)(ii) is literally triggered so long as the transferee owns, at the redemption date, any stock that is attributable to the redeemed shareholder under §318 — and not necessarily the very same shares that the transferee acquired from the redeemed shareholder during the prior 10 years. On the other hand, from a policy viewpoint, Congress appears to have assumed that the transferee would still own, at the redemption date, some or all of the stock he acquired from the distributee during the preceding 10 years.[420] If that situation does not exist at the redemption date, the policy underlying §302(c)(2)(B)(ii) does not seem violated by permitting the distributee to waive attribution to themself of the transferee's independently acquired stock.

d. Simultaneous Redemption from Transferee

(1) Limited Scope of the Rule

Section 302(c)(2)(B)(ii) does not apply if the stock transferred by the distributee to the transferee is redeemed in the same transaction in which the distributee's stock is redeemed. When a simultaneous redemption of this type occurs, the distributee will be permitted to waive the family attribution rules.[421]

The simultaneous redemption rule does not protect the tax treatment of a simultaneous redemption of the stock held by the transferee. From the transferee's perspective, the redemption is one in which the shareholder being redeemed received stock from a related person during the preceding 10 years. This type of situation is literally covered by §302(c)(2)(B)(i). As such, the redemption from the transferee ordinarily cannot qualify for waiver for family attribution, except under the no-tax-avoidance escape hatch discussed in IV.C.5.e., below. The fact that the transferor's stock is being redeemed simultaneously will not help the transferee; the simultaneous redemption rule does not apply to the transferee.

(2) Transferred Stock Must Be Redeemed

The exception in §302(c)(2)(B)(ii) for a simultaneous redemption of "such stock so acquired from the distributee" relates only to the very same shares that the transferee acquired (directly or indirectly) from the distributee, and not to stock which the transferee acquired from other sources. This limitation means that waiver of family attribution is not available if the corporation simultaneously redeems from the transferee only stock that the transferee acquired from sources other than the distributee and does not redeem other stock which the transferee owns at that time which he acquired from the distributee, directly or indirectly, during the preceding 10 years.

The following example illustrates the simultaneous redemption exception.

> *Example:* Assume that spouses, A and B, each own some of the outstanding stock of X corporation. During the preceding 10 years, A acquired some X stock from B and acquired some X stock from a person unrelated to either A or B. If the corporation redeems all of B's stock and simultaneously redeems from A only the shares A acquired from B, B can qualify under §302(c)(2)(A) for waiver of attribution to B of A's remaining shares.
>
> If the corporation redeems simultaneously from A only the shares A acquired from an unrelated person, A's remaining shares which A acquired from B will be attributed to B. The simultaneous redemption exception of §302(c)(2)(B)(ii) will not be satisfied, because the identical shares that A acquired from B were not redeemed. Additionally, family attribution will also not be eliminated as to stock owned at the redemption date by members of B's family other than A.
>
> If the corporation redeems simultaneously from A all of A's stock, no stock will be attributed from A to B because, entirely apart from §302(c)(2), A after the redemption will own no stock that could be attributed to B. The simultaneous redemption of the very stock that A acquired from B will, however, permit B to comply with §302(c)(2)(A) in order to waive attribution of stock owned by members of B's family (other than A).
>
> If, at the redemption date, A has disposed of all the shares acquired from B during the preceding 10 years, but still owns the shares acquired from the unrelated person, A owns no stock on which the simultaneous redemption exception can operate. As indicated above, §302(c)(2)(B)(ii) is then literally triggered and attribution to B of A's remaining shares would be required (along with shares owned by other family members that are attributable to B), because A had received stock from B during the prior 10 years and A owned, at the distribution date, stock (acquired from an unrelated person) whose ownership is attributable to B under §318(a).

e. Escape Hatch if No Tax Avoidance Purpose

(1) Generally

Section 302(c)(2)(B) (flush language) provides that if the acquisition in §302(c)(2)(B)(i) (or the disposition in the case of §302(c)(2)(B)(ii)) "did not have as one of its principal purposes the avoidance of Federal income tax," family attribution can still be waived despite stock transfers during the preceding 10 years.

Reg. §1.302-4(g) states that a transfer within the 10-year period will not be deemed to have the prohibited purpose mere-

[420] S. Rep. No. 83-1622, at 236–37 (1954).
[421] *See* PLR 9839009.

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ly because the transferee is in a lower tax bracket than the transferor.

Comment: The IRS has interpreted the tax avoidance escape hatch of §302(c)(2)(B) in both public and private rulings in a pro-taxpayer fashion.[422]

As a result, transfers of stock followed by a §302(b)(3) redemption (qualifying through a waiver of family attribution) can be a useful planning tool. For example, in the closely held context, a parent, wishing to fully terminate an interest in a family corporation, may be able to transfer majority stock control to a child and qualify the redemption of the balance of the stock under §302(b)(3) through a waiver of the family attribution rules.[423]

Although the IRS has interpreted the "tax avoidance" test of §302(c)(2)(B) in a manner favorable to taxpayers in published rulings, the IRS has restricted the situations in which it will give a private ruling under §302(c)(2)(B). Rev. Proc. 2025-3[424] provides that the IRS will not issue a private letter ruling on whether the acquisition or disposition of stock described in §302(c)(2)(B) has, or does not have, as one of its principal purposes the avoidance of federal income taxes within the meaning of that section, unless the facts and circumstances are materially identical to those set forth in certain revenue rulings.[425]

Comment: It is not completely clear from the language of the §302(c)(2)(B) escape hatch whose purpose is tested for tax-avoidance — the transferor of stock, the transferee, or both. Also, it is not completely clear from the rulings issued to date whether the facts and circumstances only of the transfer or of the later redemption are relevant, or whether the tax avoidance test looks to both the transfer and the later redemption. Nor is it clear whether the IRS relies on the shareholder's representations of subjective intent or whether the IRS looks for objective facts from which it will decide whether a prohibited purpose motivated the transfer. Application of the test in all these areas seems to be flexible; both the IRS and taxpayers are probably free to stress one or more party's purposes and to look only to the purpose of the transfer or to the purpose of both the transfer and the redemption, depending on the overall circumstances.[426]

If the distributee violates §302(c)(2)(A) during the future 10 years, of course, stock held by family members at the redemption date will be attributed to the distributee despite the earlier lack of tax avoidance intent.

[422] For rulings involving transfers that were held to not have principal purpose the avoidance of federal income tax, see PLR 200011016; PLR 200022020; PLR 200025035.

[423] *See* Rev. Rul. 77-293; PLR 9837022 (same). *Cf.* PLRs 9843021–23 (following release of parent's interest to facilitate redemption, trust terminates and distributes stock to children, after which those not active in business are completely redeemed; no waiver needed because only sibling owners after trust terminated).

[424] Rev. Proc. 2025-3, §3.01(53).

[425] *See* Rev. Rul. 85-19; Rev. Rul. 79-67; Rev. Rul. 77-293; Rev. Rul. 57-387; Rev. Rul. 56-584; and Rev. Rul. 56-556. *See also* PLR 9502027 (preredemption gifts of stock were not made with the principal purpose of tax avoidance within the meaning of §302(c)(2)(B)); PLR 199942018; PLR 9743007; PLR 9728018; and PLR 9644071.

[426] *Compare* Rev. Rul. 77-293, 1977-2 C.B. 91 (stresses transferor's purpose) *with* Rev. Rul. 79-67 (considers both transferor's and transferee's purposes).

(2) Rulings

(a) In General

Most of the revenue rulings and private rulings applying §302(c)(2)(B) have involved a family business operated through a closely held corporation where one or both parents eventually decide to retire or otherwise withdraw from active participation as owners and managers, and to transfer stock control (along with management) to one or more of their children. To this end, the parents, before the redemption of all their stock, have typically transferred (ordinarily by gift, but sometimes by sale) a portion of their stock to their son or daughter during the 10 years preceding the parents' redemption.

(b) Early Revenue Rulings

In Rev. Rul. 56-556, H and W owned 255 shares in an automobile dealership. The parents had given the remaining 80 shares to their son S in 1947. In 1955 H tried to find outside buyers to take over the dealership but was unsuccessful. As an alternative, he decided to turn over control to S. Under a plan, S bought 50 shares from H and the corporation redeemed the remaining 205 shares held by H and W. When H and W gave 80 shares to S in 1947, H had not intended to retire from the business or to have S acquire the dealership. The later transactions were undertaken to enable H and W to retire from the business. The IRS ruled that tax avoidance did not motivate the 1947 stock gift from H to S. The ruling ignores the additional question whether the 1955 sale to the son also passed the no-tax-avoidance test.

In Rev. Rul. 56-584, F gave his son, S, a 7% stock interest to encourage his interest in the business. S was at that time an adult and an employee in the business. Five years later S left the corporation for lack of opportunity and had his stock redeemed. The IRS found that the stock gift was made for bona fide business reasons and there was, at the time of the gift, no plan to have the stock redeemed from S. Therefore, attribution from F to S could be waived, provided S otherwise complied with §302(c)(2).

In Rev. Rul. 57-387, H, his adult sons, and W's estate owned all the stock of a corporation. The sons had acquired their stock through gifts by H and W from 1923 to 1951. In 1957 three of the sons wished to dispose of their stock. First, they received preferred stock from W's estate in satisfaction of their inheritance. Second, each sold some stock to H. Third, the corporation redeemed their remaining shares. The IRS ruled that the stock received from their father within the prior 10 years qualified under the escape hatch because the prior gifts were not made in contemplation of the later redemption. The sale of part of the sons' stock to their father also was ruled not to involve tax avoidance because the sons could just as well have sold that stock to the corporation and would also have achieved capital gain (assuming §302(c)(2) were otherwise satisfied).[427]

[427] *See* PLR 9314054, in which the IRS, citing Rev. Rul. 57-387, ruled that because the preredemption gifts of stock were not made with a principal purpose of tax avoidance under §302(c)(2)(B), the redemptions will qualify as a complete termination of the shareholders' interests under §302(b)(3). *See also* PLR 9222006; PLR 8637090.

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(c) 1977–1979 Revenue Rulings

In the late 1970s, the IRS issued several rulings interpreting the §302(c)(2)(B) tax avoidance test. In Rev. Rul. 77-293, the IRS ruled that tax avoidance is not present merely because, by disposing of some of his shares before a company redeems his remaining shares, the distributee pays less capital gains tax than he would have paid if he had retained all of his shares and if the company had redeemed all the shares from him (rather than the smaller number of shares that it actually redeemed from him).

Rev. Rul. 77-293 considers a situation where a father who owned all the stock of a family corporation gave 60 of his 120 shares to his son as part of the father's plan to retire from the business and pass sole ownership of the company to his son. The son had for many years been employed by the company as vice president and had been trained in all phases of the business. Shortly after the gift, the father resigned as president and was succeeded by the son. The company then redeemed the father's remaining 60 shares for property and the father ceased to be an officer, director, or employee or to have any other interest in the company. In order to receive exchange treatment, the father needed to waive the family attribution rules to qualify under §302(b)(3). Although the father had given part of his stock to his son during the preceding 10 years, the IRS ruled that the father's purpose was not avoidance of federal income tax but was instead "intended solely" to enable him to retire and pass complete ownership and control to his son who had been groomed to take over the business. Accordingly, the prior transfer limitation on waiving family attribution was not invoked and the redemption was held to qualify for exchange treatment under §302(b)(3), subject to the father's not acquiring any interest in the company for the following 10 years.

Comment: The rationale for reaching a pro-taxpayer result in this ruling stresses the father's intent not to retain effective control indirectly through his son. The gift to the son was clearly in contemplation of the redemption. In this respect, the IRS seems to be indicating a more liberal approach than the approach taken in the 1950s rulings. The rationale of Rev. Rul. 77-293 is muddied, however, by the statements in the ruling that the son was active in and knowledgeable about the business and would control it after the redemption. It is unclear whether objective facts of this kind must exist along with (or perhaps as evidence of) the transferor's lack of tax-avoidance intention. Presumably, if the son were not active in the business, the test of the ruling, that the father not continue to control the company or keep an economic interest in it through the shares transferred to his son, would be more convincingly satisfied. Perhaps the IRS will rule favorably based on the transferor's subjective intent and a bona fide business purpose for the transfer and redemption. The business purpose aspect might be satisfied without necessarily showing that the transferee was an employee of the company or would end up with controlling stock ownership.

In *Fehrs v. U.S.*,[428] the IRS invoked the tax avoidance provision of §302(c)(2)(B) in an attempt to deny waiver of family attribution in a situation where a father made gifts of 241 of 1,380 shares of his stock in a family business among his wife, two daughters, his son-in-law and his grandchildren. Three months later the father and his wife sold all of their remaining stock to a newly formed family corporation that had been created by the father's two daughters. This latter sale was a §304(a)(1) transaction treated as a redemption tested under §302 by reference to the stock of the company whose stock had been sold to the newly formed company. From the redeemed shareholder's viewpoint, the purpose of the transaction was to permit the father to retire with a satisfactory income while keeping ownership of the company in the family. (The father and mother received a private annuity as payment for their stock.) At a motion for summary judgment in the Court of Claims, the IRS first argued tax avoidance under §302(c)(2)(B) arising from the preredemption gifts to family members. The Court of Claims did not grant summary judgment on this issue, but gave the taxpayer an opportunity to argue the issue at trial. The court noted that the burden of proof would be on the taxpayer to show lack of a tax-avoidance motive.

Rev. Rul. 77-455 approves under §302(b)(3) a redemption preceded by a sale of some of the shareholder's stock to his son and a sale of some of his stock to a key employee. The son was active in the business and both he and several key employees already owned minority interests in the outstanding stock. The father wanted to retire and to arrange the stock ownership so that his son held voting control; however, the employees owned over half of the future growth through the common stock. Under an integrated plan, the father sold some of his stock to his son and another portion to one of the key employees, and then had the company redeem the balance of his shares. In this ruling, the corporation had outstanding 115 shares of common stock and 300 shares of preferred stock. Each share of both classes carried one vote per share. The father, F, owned 69 common shares and all of the preferred. F's son, S, owned 22 common shares. Ten key employees owned the remaining 24 common shares. Under the plan, F sold 10 common shares and 18 preferred shares to S and 25 common shares to an unrelated key employee. The corporation then redeemed F's remaining 34 common shares and 282 preferred shares. As a result, S owned 50.5% (50/99) of the total voting power but the key employees owned 60.5% (49/81) of the common stock. Because of these business objectives, the IRS ruled that the father's prior sales to his son did not have as their principal purpose the avoidance of federal income tax.

In Rev. Rul. 79-67, a testamentary estate owning stock in a family corporation (most of which had been owned by the decedent) distributed the stock to the decedent's widow, who was sole beneficiary of the estate. The estate continued in existence thereafter and the widow remained a beneficiary of the estate. The company redeemed the stock from the widow. Because her son owned the balance of the stock, her redemption needed waiver of family attribution in order to qualify under §302(b)(3). The ruling allows the redemption to qualify, pursuant to the no-tax-avoidance escape hatch. Technically, the mother violated §302(c)(2)(B)(i) because she had acquired (within the prior 10 years) stock from a related person (the estate) under §318. Nevertheless, the ruling finds that the mother would not retain any interest in the company after the redemption either actually or constructively through her status as beneficiary of the estate (her transferor). The ruling also acknowledges that the for-

[428] 556 F.2d 1019 (Ct. Cl. 1977).

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mat used in this situation sidesteps the §301 treatment which (in the IRS's view) would have resulted if the stock had been redeemed from the estate. The IRS ruled that "[t]he distribution of the … stock by the estate to the mother and the subsequent redemption of such stock … from the mother was intended to enable the son to obtain complete control of [the corporation]. Therefore, the avoidance of federal income tax will not be deemed to have been one of the principal purposes of the distribution of stock from the estate to the mother, notwithstanding the difference in tax treatment had the estate directly redeemed the stock."

Comment: Rev. Rul. 79-67 does not discuss whether the mother would continue to "control" the corporation through her influence over her son. In discussing the purpose of the no tax avoidance test, Rev. Rul. 77-293 describes the abuse situation as one where a shareholder seeks continued control and/or economic interest "through the stock given to a related person or the stock he retains."' In Rev. Rul. 79-67 the widow had apparently not given her son the stock he owned. Would it be relevant, in light of the language of Rev. Rul. 77-293, whether the mother could influence her son enough to continue to control the company (assuming the stock redeemed from her was a controlling block)?

(d) Rev. Rul. 85-19

The IRS's most recent published ruling involving the §302(c)(2)(B) tax avoidance provision is Rev. Rul. 85-19. That ruling involved a parent, P, and P's child, C, who together owned all of the stock of a corporation. C's stock interest was acquired in part by inheritance from C's deceased grandparents (constituting 14% of the corporation's outstanding stock) and in part by gifts from P two years before (constituting 3% of the corporation's outstanding stock). Because C was never involved in the business affairs of the corporation, C wished to terminate his interest in the corporation. This objective was accomplished by C selling the shares acquired from P back to P and the corporation redeeming the remaining shares held by C.

The issue considered by the IRS was whether P's acquisition of the corporation's shares had as one of its principal purposes the avoidance of federal income tax under §302(c)(2)(B) (thus prohibiting waiver of family attribution under §302(c)(2)(B)(ii)).[429]

The IRS discussed the meaning of tax avoidance under §302(c)(2)(B). It stated that tax avoidance: necessarily requires both the presence of a certain state of mind on the part of the taxpayer in connection with the acquisition or the disposition of stock, coupled with the accomplishment of the tax avoidance design via a redemption of stock. Tax avoidance, therefore, cannot be present, for example, merely because there has been a transfer of stock by one §318(a)(1) relative to another, when such transfer was not in contemplation of redemption of the balance of the transferor's stock nor of the stock transferred to the transferee… Similarly, tax avoidance cannot be present merely because a shareholder has transferred stock to a related person within the meaning of §318(a)(1) even though such transfer may have been in contemplation of redemption of the balance of the transferor's stock or of the stock transferred to the transferee, if in fact no redemption of either the transferor's stock or the stock transferred to the transferee actually occurs.

The IRS also noted that the purpose of §302(c)(2)(B) is to prevent the withdrawal of earnings at capital gains rates by a shareholder of a family-controlled corporation who seeks continued control and/or economic interest in the corporation through the stock given to a related person or the stock retained. Application of this provision thus prevents a taxpayer from bailing out earnings by transferring part of the taxpayer's stock to such related person and then qualifying the redemption of either the taxpayer's stock or the transferee's stock as a complete termination of interest by virtue of the division of ownership thus created and the availability of the attribution waiver provisions.

In the present case, because C had been a relatively minor shareholder who was never involved in corporate affairs, C had never been in a position to control the corporation. Thus, the sale to P was not part of a plan to withdraw earnings at capital gains rates while retaining control. Further, the IRS noted that the sale of the stock by C to P seems merely to have been an attempt to return to the status quo ante and avoid any possible problem under §302(c)(2)(B)(i). Therefore, the IRS concluded that P's reacquisition from C of the gifted stock is not deemed to have had as one of its principal purposes the avoidance of federal income tax.

6. Written Agreement; Statute of Limitations; Record Keeping

a. In General

As indicated earlier, the statute expressly requires that in order for family attribution to be waived in qualifying under §302(b)(3), not only must the former shareholder have no prohibited interest immediately after the distribution or during the next 10 years, but he must also file with the IRS an agreement to notify the IRS of any acquisition by him of a prohibited interest during the 10-year period. The former shareholder must also retain records on the facts and circumstances concerning the redemption. The statute delegates authority to the IRS to provide rules for the time and manner in which the 10-year agreement must be filed.[430]

Pursuant to this legislative delegation, Reg. §1.302-4(a) requires the distributee to file with its tax return timely filed for the year in which the distribution occurred: (1) a written statement titled "Statement Pursuant to Section 302(c)(2)(A)(iii) by [Taxpayer name and TIN], a Distributee (or Related Person) of [Distributing Corporation Name and EIN]" that the former shareholder has not acquired (other than by bequest or inheritance) any prohibited interest in the corporation since the distribution; and (2) an agreement to notify the IRS within 30 days following any acquisition (other than by bequest or inheritance) of a prohibited interest in the corporation during the 10-year period after the distribution date. If the Distributee is a controlled foreign corporation (as defined under §957), each U.S. shareholder (within the meaning of §951(b)) with respect to the con-

[429] Note, there is no §302(c)(2)(B)(i) problem because C's shares acquired from P are sold back to P. The transaction that solves the §302(c)(2)(B)(i) problem creates the §302(c)(2)(B)(ii) issue.

[430] §302(c)(2)(A)(iii). *See* Family Attribution Agreement Waiver (§302(c)(2)(A)) in the Elections & Compliance Statements library.

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trolled foreign corporation must include such a statement on or with its return.

The distributee must also retain copies of income tax returns and any other records indicating the amount of tax that would have been payable had the redemption been treated as a §301 distribution.[431]

If the distributee acquires a prohibited interest within the future 10-year period, the statute of limitations period on the redemption remains open until the later of (i) one year after the date on which the distributee notifies the IRS that he has acquired a prohibited interest, or (ii) the date the statute was otherwise scheduled to expire.[432] Therefore, if the distributee fails to notify the IRS of the reacquired interest, the limitations period on the redemption remains open indefinitely.

Note: The triggering event that gives the IRS an additional year to audit the redemption is not the date on which the 10-year agreement is filed (whether filed timely or late), or the date on which the former shareholder acquires a prohibited interest in the corporation. The triggering event is the date on which notice is given to the IRS that such an interest has been reacquired.

In this situation the statute of limitations might be conceived as closing on the redemption after the normal three-year period following the year in which the distribution occurred, but as being reopened if the former shareholder reacquires a prohibited interest during the 10-year period. In the latter case, the statute of limitations will be reopened for one year, beginning with the date on which the former shareholder notifies the IRS that he has acquired an interest.

b. Distributee Dies

Suppose a shareholder has all of its stock redeemed dies before filing a tax return for the taxable year in which the redemption occurred. May the executor file the 10-year agreement on behalf of the decedent? Because an executor files a decedent's income tax return for the year of death,[433] and an executor or other fiduciary has the powers, rights, and duties of the decedent or other beneficiary,[434] the IRS allows an executor or administrator to file a waiver agreement on behalf of a decedent-former shareholder.[435] In this situation, the agreement need only state that the decedent had not acquired any interest in the corporation after the distribution and up to the date of the agreement. The decedent obviously cannot acquire any interest in the future, and an acquisition of an interest during the 10-year period by a member of the decedent's family will have no adverse effect on the redemption.

c. Agreement Not Timely Filed

Current regulations make no provision for agreements not timely filed.[436] In the preamble to the current regulations, the IRS and Treasury clarified that the omission of rules for late filing was intentional as the required statement is a regulatory election and as such is governed under the late filing provisions under Reg. §301.9100-1. The IRS and Treasury reasoned that the inclusion of any additional rules on late filing of the waiver statement was not necessary and could cause undue confusion.

d. Section 302(b)(6)

Section 302(b)(6) provides, in part:

> If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

The meaning of this provision is not entirely clear. It is clear that a shareholder whose redemption, even after applying family attribution, would qualify under §302(b)(1) or (2) can retain or acquire an interest in the corporation as a director, officer, employee, etc. Perhaps that is all that the above provision is intended to say.

Section 302(b)(6) may be intended to indicate that if a redemption would qualify under §302(b)(1) or (2) even after triggering family attribution, but the shareholder sought the assurance of complying with §302(b)(3) through a waiver of family attribution under §302(c)(2), the portion of §302(c)(2) extending the statute of limitations will be inapplicable. If the redemption would have qualified for exchange treatment under §302(b)(1) or (2), no need exists to extend the statute of limitations because, even if the distributee reacquires an interest in the corporation, he will already have reported the transaction as it should have been reported.

> *Example:* Taxpayer A (child of P) owns 40 of 100 outstanding shares. A's parent, P, owns 20 shares. The remaining 40 shares are owned by unrelated persons. The corporation redeems all of A's stock. Even in light of family attribution, A's percentage interest decreases from 60% to 33 1/3% (20/60). Such a reduction qualifies under §302(b)(2). If A filed a §302(c)(2)(A)(iii) agreement nevertheless, and later reacquired stock in the company, A can still show that the redemptions qualified under §302(b)(2) and that the reacquisition produces no adverse tax effect.

e. Section 304(a)(1) Redemption

Section 304(a)(1) provides that, to the extent a §304 transaction is treated as a distribution under §301, the transferor and the acquiring corporation are treated as if (1) the transferor had

[431] Reg. §1.302-4(b).

[432] §302(c)(2)(A). *See also* PLR 9613009.

[433] §6012(b).

[434] §6903.

[435] Rev. Rul. 77-93.

[436] Reg. §1.302-4(a), T.D. 9329, 72 Fed. Reg. 32,794 (June 6, 2007). For waivers before May 29, 2006, former regulations allowed late filing under certain conditions. Former Reg. §1.302-4(a)(2), *removed by* T.D. 9264, 71 Fed. Reg. 30,591 (May 30, 2006). Under former Reg. §1.302-4(a)(2), if the distributee failed to file the agreement specified in §302(c)(2)(A)(iii) at the time provided in §302(c)(2)(A)(i), then the district director could grant a reasonable extension of time for filing such agreement, provided (1) it was established to the satisfaction of the district director that there was reasonable cause for failure to file the agreement within the prescribed time, and (2) a request for such extension was filed within such time as the district director considered reasonable under the circumstances. Former Reg. §1.302-2(a)(2) still did not resolve clearly all questions concerning late-filed agreements, including questions that arose in several litigated cases. In particular, the former regulations did not indicate whether there was any date after which the IRS would have considered it too late to file the agreement. There was relevant case law on this point. *See, e.g., Fehrs v. United States*, 556 F.2d 1019 (Ct. Cl. 1977).

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transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which §351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. See discussion in VI.F.3.d., below. For a comprehensive discussion of §304, see 768 T.M., *Stock Sales Subject to Section 304.*

In a §304(a)(1) "constructive" redemption, the shareholder may qualify the redemption under §302(b)(3) by complying with §302(c)(2) to waive family attribution. Under this approach, is the 10-year agreement to be filed with respect to the acquiring company or the company whose stock was transferred to the acquiring company, or both companies? This question will arise where the shareholder's stock interest in the acquiring company is solely constructive through family attribution. The Code deems that the acquiring company has redeemed its own stock, but also provides that, in testing the redemption, §302 is to be applied by reference to the company whose stock was transferred to the acquiring company. If the same family member owns stock in both companies, it is arguable that family attribution in both corporations should be waived if the distributee files a 10-year agreement with respect to any future interest in the issuing company. However, to be on the safe side, the agreement should be filed with respect to both companies.

> *Example:* Taxpayer owns 100% of the stock of corporation X. Taxpayer and spouse, S, own 75% and 25%, respectively, of the stock of corporation Y. S sells all of S's Y stock to X. Even though S is not an actual shareholder in X, S is still deemed to own all of Taxpayer's stock in X via family attribution.[437] Therefore, §304(a)(1) governs S's sale. Testing this constructive redemption by reference to S's before and after interest in Y, S owns after the transaction, by attribution under §318(a)(1), Taxpayer's actual 75% interest in Y. Also, the Y stock which X acquired is deemed owned by Taxpayer via §318(a)(2)(C), and, through taxpayer, by S via family attribution. S can clearly waive attribution of Taxpayer's actual interest in Y by filing the §302(c)(2)(A)(iii) agreement. The same agreement should also waive attribution to S of Taxpayer's constructive interest in Y through corporation X. S can make certain of the latter waiver by filing a similar agreement with respect to S's future interest in X.

[437] *See U.S. v. Coyle*, 415 F.2d 488 (4th Cir. 1968).

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V. Section 302(b)(2) — Substantially Disproportionate Redemptions

A. In General

Under §302(b)(2), a redemption will receive exchange treatment (as a substantially disproportionate redemption) if three conditions are satisfied —

(1) the shareholder's percentage ownership of the outstanding voting stock (including all classes that carry voting rights) is reduced immediately after the redemption to less than 80% of the shareholder's percentage interest in such stock immediately before the redemption;[438]

(2) the shareholder's percentage ownership of the outstanding common stock (both voting and nonvoting) immediately after the redemption is reduced to less than 80% of such percentage ownership immediately before the redemption;[439] and

(3) the shareholder owns, immediately after the redemption, less than 50% of the total combined voting power of all classes of stock entitled to vote.[440]

The requirements of §302(b)(2) are mechanical. If the specific percentage reduction is achieved by a particular shareholder, that shareholder will receive exchange treatment under §302(a), regardless of the tax treatment accorded any other shareholder.[441]

The attribution rules of §318 apply when measuring the distributee's interest in the corporation.[442] The §318 attribution rules cannot be waived in connection with §302(b)(2).

Because waiver of family attribution is not a factor in qualifying under §302(b)(2), a shareholder does not have to satisfy the restrictions against retaining an interest in the corporation as a shareholder, officer, director or employee, etc. These restrictions only apply where the shareholder seeks to qualify under §302(b)(3) by eliminating family attribution of stock ownership.

B. Reduction in Percentage Interest in Voting Stock

1. The Basic Test

Section 302(b)(2)(C) requires a reduction in the shareholder's percentage interest in the voting stock of the corporation. This percentage interest is computed as a percentage of outstanding stock "before" and "after" the redemption.

The voting stock[443] to which the statutory test applies includes all classes of voting stock and both voting preferred and voting common if both exist in the same corporation.[444]

Reg. §1.302-3(a) provides that only stock which is issued and outstanding is to be considered in making calculations under §302(b)(2). However, the IRS takes the position that the option attribution rules can operate to increase the amount of shares outstanding with respect to the distributee and related parties under §318. Under §318(a)(4), if any person has an option to acquire stock, such stock is considered as owned by such person.

In Rev. Rul. 68-601, the IRS ruled that stock which a shareholder has a right to purchase under a stock warrant, or by converting a convertible debenture, is in certain circumstances deemed outstanding stock for purposes of §302(b)(2). However, under Rev. Rul. 68-601, this stock is only deemed outstanding for purposes of measuring the distributee's interest (and related parties under §318).[445] Thus, the amount of stock outstanding for purposes of §302(b)(2) may differ between shareholders who are having shares redeemed at the same time.

Rev. Rul. 89-64 extends the reasoning in Rev. Rul. 68-601. Under Rev. Rul. 89-64, an option received in a redemption that could not be exercised until a fixed period of time had passed after the redemption was still ruled to be outstanding stock for purpose of §318(a)(4). The IRS reasoned that the delayed option violated Congress's intent in enacting §302(b)(2) because the option offers no "assurance that the redeemed shareholder will sustain the required contraction of equity with a degree of permanence."

Stock that has not yet been issued to particular shareholders, but that the shareholders have a contingent right to acquire under an earlier reorganization involving "contingent stock," is probably not counted as part of a corporation's outstanding stock for §302 purposes, at least so long as issuance or nonissuance of the stock is not within the shareholder's contract or contingent merely upon the passage of time.

Outstanding stock probably includes stock that has been placed in escrow during the "earnout" period with the potential recipients having current voting rights, but is subject to return to the acquiring company if the contingencies do not occur.[446]

The required reduction in percentage interest must be based on the reduced number of shares outstanding after the exchange, including stock redeemed from the shareholder under consideration and from other shareholders in the same transaction. The Senate Finance Committee Report (the "Report") on the 1954 Code itself makes the error, in two examples illustrating §302(b)(2), of failing to take into account the reduction of outstanding shares that results from the redemption. The example in the Report involves a corporation with 100 shares outstanding that redeems 11 of the 50 shares held by individual A. The Report concludes that apart from any constructive ownership this redemption would qualify under §302(b)(2).[447] The Report erroneously concluded that A's percentage interest is reduced from 50% to 39%, i.e., to less than 80% of A's prior 50% interest. The Report assumed that 100 shares remained outstanding after the exchange. However, total outstanding stock was reduced from 100 to 89 shares. This reduction affects the denominator of the shareholder's ownership fraction after the exchange. A's percentage interest after the exchange would actually be 43% (39/89), which would not quali-

[438] §302(b)(2)(C).
[439] §302(b)(2)(C).
[440] §302(b)(2)(B).
[441] *See generally* PLR 199946002 and PLR 9514020.
[442] §302(c); Reg. §1.302-3(a).
[443] See V.G., below, for a discussion on what characteristics stock must have to be considered voting stock.
[444] *See* PLR 7904011 (reduction of combined voting power of voting common and voting preferred from 25.5% to 14.7% qualified under §302(b)(2)).
[445] Rev. Rul. 68-601 is discussed further in V.C.1., below.
[446] *See* Rev. Rul. 76-334.
[447] S. Rep. No. 83-1622, at 252–253 (1954).

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fy under §302(b)(2). If A were the only shareholder redeemed, it would be necessary to redeem at least 17 shares from A in order to satisfy §302(b)(2). A's percentage interest after the exchange would then be 33/83, or 39.76%. A similar error was made in another example in the Report.[448]

It is important to note that the statutory rule does not focus on the *number* of shares owned by the distributee before and after the redemption; it focuses, instead, on the overall decrease in percentage ownership.

> *Example:* Shareholder S owns 35 of 100 outstanding shares constituting a 35% interest in the sole class of voting common stock. Section 302(b)(2)(c) requires that the number of shares which S continues to own after the redemption constitute a less than 28% interest in the remaining outstanding stock, i.e., S's percentage interest must be reduced to less than 80% of S's pre-redemption 35% interest (80% of 35% = 28%). Assuming that S is the only shareholder redeemed, S must surrender at least 10 shares. Such an exchange will reduce S's percentage interest to 27.8% (25/90), which is less than 28% and satisfies §302(b)(2)(C). If S had merely surrendered 1 more than 20% of S's shares, i.e., 8 (20% of 35 = 7 shares), S's percentage interest would drop to 29.3% (27/92), which would not satisfy the statute. On the other hand, if the requirement was that S's percentage interest must drop by more than 20 percentage points, i.e., in this example, to less than 15% of the remaining outstanding stock, more shares would be redeemed from S than would be necessary to satisfy §302(b)(2).

2. *Minority Interests*

The required reduction in percentage interest applies even where a shareholder has a small minority interest in the corporation before the exchange. In Rev. Rul. 56-183, for example, a reduction in a trust's interest from 11 to 9% qualified under §302(b)(1) but did not satisfy §302(b)(2), because the trust's interest would have to be reduced to less than 8.8% (80% of 11% = 8.8%) of the total outstanding stock after the exchange.

In Rev. Rul. 76-385, the IRS ruled that a redemption in percentage interest from .0001118% to .0001081% did not satisfy §302(b)(2). It would have been necessary to reduce the shareholder's interest to less than .0000894% to satisfy §302(b)(2). A reduction in a shareholder's interest from 30 to 24.3% also failed to satisfy §302(b)(2) because it would have been necessary to reduce the shareholder's interest to less than 24%.[449]

3. *Test Applied on Shareholder-by-Shareholder Basis*

The computations required by §302(b)(2) are applied on a shareholder-by-shareholder basis.[450] Therefore, simultaneous redemptions from several shareholders may satisfy §302(b)(2) as to some shareholders but not as to others. However, if several shareholders exchange shares simultaneously or otherwise pursuant to the same plan, §302(b)(2) is applied by reference to the total shares left outstanding after all exchanges under the plan. As participation by several shareholders further reduces total outstanding stock after the exchange, it may be necessary to redeem more shares from a given shareholder than if he alone were redeemed.

> *Example:* Corporation M has 400 shares of common stock outstanding of which A, B, C, and D each own 100 shares, or 25%. No stock is constructively owned by A, B, C, or D under §318. M redeems 55 shares from A, 25 shares from B and 20 shares from C. For the redemption to be disproportionate as to any shareholder, that shareholder must own after the redemption less than 20% (80% of 25%) of the 300 shares then outstanding. After all redemptions are completed, A owns 15% (45/300), B owns 25% (75/300) and C owns 26 2/3% (80/300). The distribution is substantially disproportionate only with respect to A.[451]

The absolute number of percentage points by which a shareholder's pre-redemption ownership interest must be reduced in order to satisfy the 80% tests of §302(b)(2) will vary depending on that shareholder's pre-redemption percentage ownership interest. For example, a 60% shareholder's percentage interest would have to be reduced to less than 48%, a reduction of over 12 absolute percentage points. A 50% shareholder's percentage interest would have to be reduced to less than 40%, a reduction of over 10 absolute percentage points. A 20% shareholder's percentage interest would have to be reduced to less than 16%, a reduction of over 4 absolute percentage points.

4. *Mathematical Formulas*

The minimum number of shares that must be redeemed in order to satisfy §302(b)(2) can be computed for a particular situation under various mathematical formulas. Where the shareholder to be redeemed owns 62.5% or less of the voting power before the redemption, the formulas are relatively simple. One simple formula, where it is prearranged that stock is to be redeemed from only one shareholder, is to round to the next highest whole number the number determined as follows:

$$X = \frac{N - DT}{1 - D}$$

N is the number of shares owned by the shareholder before the exchange. D is the decimal percentage representing 80% of the shareholder's pre-redemption percentage interest. T is the total number of shares outstanding before the redemption. X is the number of shares that need to be redeemed to exactly reduce the shareholder's percentage interest to 80% of the shareholder's prior percentage interest.

Thus, for a shareholder who owns 60 of 100 total outstanding shares, the calculation is:

[448] S. Rep. No. 83-1622, at 234–235 (1954).
[449] Rev. Rul. 75-512.
[450] Reg. §1.302-3(a).
[451] Reg. §1.302-3(b). *See* TAM 8137023 (two redemptions treated as part of a single plan and, therefore, the taxpayer failed to meet the substantially disproportionate test).

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$$X = \frac{60 - .48\,(100)}{1 - .48}$$

$$X = 23.08$$

Rounding upward, 24 shares must be redeemed from this shareholder in order to reduce the shareholder's interest to less than 50% and to less than 80% of the shareholder's original 60% ownership.[452]

Where a shareholder owns more than 62.5% of the voting stock before a redemption, and where several shareholders are redeemed simultaneously, the formulas are more complex.[453]

5. Public Company Redemption Offers: Conditional Tenders

In several situations where publicly held companies have made exchange offers to their own shareholders, the end results of which are not prearranged, the company has calculated a minimum percentage of each shareholder's stock which, if exchanged with the company, will qualify under §302(b)(2). Depending on the maximum number of shares the company will accept from all shareholders on a first-come first-served basis, a minimum tender can be calculated for each under-50% shareholder, which, if conditioned on redemption of the stated maximum number of shares, assures that §302(b)(2) will be satisfied. The procedure is to calculate for a hypothetical shareholder owning an assumed percentage of the total voting stock the minimum number of shares the shareholder must exchange in order to reduce the shareholder's percentage interest by more than 20%, based on total outstanding stock if the maximum number of shares under the offer are redeemed. The minimum number of shares that must be redeemed from the shareholder can then be expressed as a percentage of the shareholder's pre-redemption holdings. This percentage will then "work" for every shareholder owning less than 50% of the voting power of all classes of stock entitled to vote.

> *Example:* A publicly held company has one million outstanding shares of voting common stock. The company offers to redeem up to 100,000 shares. Institutional investor M owns 50,000 shares (5%). In order to qualify under §302(b)(2), M must reduce its percentage interest to less than 4%. If the exchange offer is fully successful, M must own less than 36,000 shares (4% of 900,000). Therefore, M must exchange more than 14,000 of its shares. To use round figures, A will qualify if it exchanges 14,500 shares, a quantity that represents 29% of its pre-redemption holdings. Therefore, 29% represents the minimum percentage of each shareholder's holdings, based on the figures in this transaction, which will satisfy §302(b)(2).[454]

C. Reduction in Percentage Interest in Common Stock

In addition to the prescribed percentage decrease in voting stock, §302(b)(2) also requires that a shareholder's percentage ownership of common stock — whether voting or nonvoting — be reduced, as a result of the redemption, to less than 80% of the shareholder's pre-redemption percentage interest in such stock.[455] The required reduction applies to the quantity of voting and nonvoting common stock combined.[456]

If there is more than one class of common stock, determinations are to be made by reference to fair market value.[457] In Rev. Rul. 87-88, the IRS determined that if a corporation has both voting and nonvoting common stock, the two categories should be aggregated for the reduction requirement of §302(b)(2)(C). The IRS based its ruling on the wording of §302(b)(2)(C), which specifies that, if there is more than one class of common stock, the fair market value of all of the common stock, voting and nonvoting, will be used to determine whether there has been the requisite reduction in ownership.

1. Shareholder Owns Only Voting Preferred

If a shareholder owns only voting preferred stock and no common stock, technically, a redemption of the shareholder's preferred stock will not reduce the shareholder's common stock interest, since the shareholder's interest in the common stock is zero before and after the redemption.

In Rev. Rul. 81-41, A owned the 4,900 outstanding shares of voting preferred stock of a corporation, but held none of the common stock. Upon A's request, the corporation redeemed 2,000 of A's voting preferred shares for cash. The revenue ruling addresses the issue whether the redemption qualifies under §302(b)(2), even though A cannot satisfy the 80% reduction of common stock test because A owned no common stock either directly or constructively.

The IRS analyzed the legislative history of §302(b)(2), and concluded that the purpose of the reduction in common stock requirement was to prevent a shareholder from receiving exchange treatment where the shareholder's voting interest in the corporation was reduced but the shareholder either retained or improved the shareholder's "participatory" interest (represented by the common stock) in the corporation as a result of the redemption. However, if the shareholder holds only voting preferred stock, the shareholder does not have a participatory interest in the corporation either before or after the redemption. Thus, the abuse prevented by the reduction in common stock requirement is not present where the shareholder holds only voting preferred stock. Therefore, the IRS ruled that a redemption of voting preferred stock can qualify as a substantially disproportionate redemption under §302(b)(2) even though the redeeming shareholder does not experience a reduction in common stock ownership, if the shareholder owns no common stock either directly or constructively.

A problem may arise if a shareholder owning only voting preferred stock surrenders some of those shares and receives warrants to purchase common stock of the distributing corpora-

[452] If 24 shares are redeemed, the shareholder's ownership will be 47.4% (36/76), which is less than 50% and less than 48% (80% of 60%).

[453] For formulas to use in such situations, see the Worksheets, below.

[454] *See* Notes, "Conditioned Offer Assures Disproportionate Redemption," 33 *J. Tax'n* 320 (1970).

[455] §302(b)(2)(C) (flush language).

[456] §302(b)(2)(C) (flush language).

[457] §302(b)(2)(C) (flush language).

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tion. Under Rev. Rul. 68-601, if no contingencies limit the exercise of the warrants, option attribution causes the shareholder to be considered as owning the common stock for which the warrants can be exercised. As a result, the shareholder's interest in the common stock will increase from zero to some degree of percentage interest in the company's common stock. In this situation, §302(b)(2)(C) would not be satisfied.

2. Planning

Care must be taken when planning the initial capitalization of a new corporation if §302(b)(2) will be relied upon to cash out an investor's equity interest. In the typical case, the various incorporators will invest varying amounts of cash, property, and services in return for stock of the corporation. Those investors that contribute primarily cash to the corporation may wish to cash out on a portion of their investment once the business is up and running. On the other hand, those investors that contribute minimal cash, but manage the business on a daily basis, will often desire a common stock interest equal to that of the majority cash investor. In such a situation, the investors that contribute a majority of the cash typically receive common stock and nonvoting preferred stock of the corporation while the service providers take only common. If this is the course chosen by the parties, §302(b)(2) may not be available to qualify the redemption of the nonvoting preferred stock under §302(b)(2) when the cash investor seeks to cash out a portion of the investment through a redemption of the nonvoting preferred. On the other hand, if the parties choose to have the corporation issue only common stock, it will be difficult to maintain the desired percentage sharing of ownership while still returning to the investors their original funds through a §302(b)(2) redemption. One alternative is to have the corporation issue a combination of debt and equity. The following example illustrates the advance planning problems associated with §302(b)(2).

Example: Three individuals, A, B, and C, form a new company and each wants an equal one-third interest. A, however, has only $5,000 to invest. B and C can each invest $35,000 but want $30,000 returned once the business gets off the ground. Each party could take a one-third voting interest by putting $5,000 into common stock. B and C could each invest $30,000 in nonvoting, nonparticipating preferred stock that can later be redeemed. However, §302(b)(2) will not be available for such a redemption solely of nonvoting preferred. If A, B, and C put all their investment into common stock, the potential increase in value of such stock will make it difficult to redeem $30,000 worth of such stock from B and C while still preserving equal one-third ownership interests.

The parties could consider taking common and preferred stock as follows:

	A	B	C
Common:			
Capital	$5,000	$12,600	$12,600
Shares	50	126	126
%	16.56%	41.72%	41.72%
Nonvoting Preferred:		$22,400	$22,400

If the company later redeems 76 common shares each from B and C, along with all of its preferred stock, each 33 1/3% interest of B and C in the common stock after the redemption qualifies under §302(b)(2) as less than 80% of 41.72%. The preferred stock redemption will automatically qualify under Regs. §1.302-3(a) (discussed at VI.E. below). The difficulty with this plan, however, is that the more successful the business, the higher the value of the common stock becomes, and B and C cannot each recoup $30,000 while reducing their common stock interests to 33 1/3% and also eliminating all preferred stock.

In this particular situation, it is difficult to plan for the use of §302(b)(2) to return $30,000 each to B and C while preserving equal one-third ownership interests among A, B, and C. Because of such difficulties, the three owners should perhaps each invest $5,000 in common stock, while B and C each take back debt obligations for their $30,000. Later, the corporation can repay B and C tax-free, if the debt is upheld as valid debt for tax purposes, while the three owners continue to hold equal equity interests.[458]

D. Less Than 50% Voting Power

In addition to the voting stock and common stock requirements discussed above, in order for a redemption to be considered substantially disproportionate under §302(b)(2), immediately after the redemption, the shareholder must own less than 50% of the total combined voting power of all classes of stock entitled to vote.[459] Therefore, a redemption is able to meet the substantially disproportionate requirements only if the redeeming shareholder owned over 50% of total voting power before the redemption and gave up such control in the redemption, or the redeeming shareholder owned less than 50% of total voting power before and after the redemption. The apparent purpose of this rule is to allow exchange treatment under §302(b)(2) only where the taxpayer is not a controlling shareholder after the redemption, either directly or constructively.

A difficult question that arises in connection with the less-than-50%-rule is whether this rule can be circumvented by special charter or bylaws provisions which give the shareholder "effective" control even though, quantitatively, the shareholder owns less than 50% of total voting power. For example, after the redemption of a portion of shareholder T's shares, share-

[458] *See* Bravenc, "A Corporate Financial Structure Facilitating Later Withdrawal of Invested Capital," *Prentice-Hall Tax Ideas* ¶ 25,025 (1977).

[459] §302(b)(2)(B).

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holder T owns 26% of total voting power. However, the corporate bylaws provide that certain corporate decisions require a vote of at least 76% of the common stock and the other two shareholders own 26 and 48%, respectively, of the remaining stock. In this case, no two shareholders can collaborate to effect positive corporate action, so that any one shareholder can, in effect, veto any proposed transaction. In substance, a unanimous vote is required for affirmative action. It is unclear whether this kind of veto power, or "negative control," will be considered equivalent to at least 50% of total voting power.[460]

E. Simultaneous Redemption of Nonvoting Preferred Stock

Under §302(b)(2), a shareholder's exchange must involve at least some voting stock, either common or preferred. If the shareholder owns voting preferred stock and nonvoting common stock, the redemption must include both the preferred and common stock in order to satisfy §302(b)(2).

Section 302(b)(2) does not apply to a redemption solely of nonvoting common stock or solely of nonvoting preferred stock. However, the regulations provide in effect that if at least some voting common stock is redeemed from a shareholder, nonvoting preferred stock which is not §306 stock may be redeemed simultaneously from that shareholder along with the qualifying stock, and will also receive exchange treatment. Reg. §1.302-3(a) states, in part:

> Section 302(b)(2) only applies to a redemption of voting stock or to a redemption of both voting stock and other stock. Section 302(b)(2) does not apply to the redemption solely of nonvoting stock (common or preferred). However, if a redemption is treated as an exchange to a particular shareholder under the terms of section 302(b)(2), such section will apply to the simultaneous redemption of nonvoting preferred stock (which is not section 306 stock) owned by such shareholder and such redemption will also be treated as an exchange.

Note: This regulation does not require any minimum reduction in the shareholder's percentage interest in nonvoting preferred stock redeemed simultaneously with the qualifying stock under §302(b)(2).

A shareholder holding only nonvoting preferred stock may be able to qualify a redemption of the nonvoting preferred stock under §302(b)(2), if voting common stock constructively held by the shareholder under §318 is simultaneously redeemed.[461]

Practice Point: This free ride, or piggyback, rule for nonvoting preferred stock is useful in planning the affairs of closely held companies where the senior shareholders desire to transfer part of the common stock interest to younger members of management. A frequent solution is to recapitalize the company and have the senior shareholders exchange part of their common stock for nonvoting preferred stock. At a later date, the corporation can redeem from the senior members part of their voting common stock and their nonvoting preferred stock under the protection of §302(b)(2). If preferred stock is received in a recapitalization, however, and the recipients retain common stock in the corporation (or constructively own common stock under the attribution rules of §318, the preferred stock might be vulnerable to being classified as §306 stock.[462] A later redemption of part or all of the preferred stock would then suffer dividend treatment under §306(a)(2) unless the shareholder surrenders all of the shareholder's preferred and common stock.[463]

F. Attribution Rules

1. Generally

Section 318 provides an elaborate set of "attribution rules" that operate in the redemption context to treat the distributee as constructively owning stock that is owned by certain related parties (see IX, below, for a discussion of the §318 attribution rules).

The constructive ownership rules of §318 apply in making calculations under §302(b)(2) for stock ownership before and after the redemption.[464] There is no leeway to disregard attribution for any reason. However, an unresolved issue under §302(b)(1) is whether actual hostility between persons as to whom §318 constructive ownership would literally apply can justify not applying attribution.[465] This issue theoretically could arise under §302(b)(2) as well. No cases to date, however, have permitted nonapplication of the §318 rules in testing a redemption under §302(b)(2).

2. Use of Attribution Rules to Qualify a Redemption Under §302(b)(2)

If stock is simultaneously redeemed from the distributee's tax "relative," in certain circumstances, this redemption is in effect treated as also occurring from the distributee. In such cases, the attribution rules could be used to help qualify a redemption under §302(b)(2).

The authority for treating a redemption as being from someone other than the actual owner of the stock is found in Rev. Rul. 77-237. This revenue ruling involved unrelated individuals A and B who each owned 50 of 100 shares of voting common stock, and A's father, C, who owned all 100 outstanding shares of nonvoting preferred stock. The company redeemed all of C's nonvoting preferred shares and 20 common shares from A. The redemption of the 20 common shares from A qualified under §302(b)(2). Because under §318, C was treated as owning all of the common shares held by A, the IRS treated the redemption of the common stock as being from A for purposes of A's tax treatment, and also from C, for purposes of determining C's tax treatment. Therefore, because the constructive redemption of common shares from C qualified under §302(b)(2), under the rule of Reg. §1.302-3(a), the simultaneous redemption of C's nonvoting preferred stock qualified under §302(b)(2).

[460] *See Fireoved v. U.S.*, 462 F.2d 1281 (3d Cir. 1972) (in cited fact pattern, T held to be in control of corporation for purposes of §306(b)(4)(B)). See VI.F.4.c., below, for a more detailed discussion of *Fireoved.* For an argument that under-50% veto power should be held not to satisfy §302(b)(2), see Note, 51 *Texas L. Rev.* 782 (1973). *But see* "Redemptions From Minority Shareholders and §302(b)(1)," 77-1 *Tax Mgmt. Memo.* 7, n.50 (Jan. 3, 1977).

[461] *See* Rev. Rul. 77-237, discussed at V.F.2., below.

[462] *See* §306(c).

[463] *See* §306(b)(1)(B).

[464] Reg. §1.302-3(a).

[465] See VI.I., below.

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Rev. Rul. 77-237 applies the constructive ownership rules of §318, not only for determining the distributee's interest in the corporation before and after a redemption, but also for treating redemptions of common stock as having occurred from a person other than the person from whom that redemption actually occurred. This interpretation represents a somewhat unusual application of the constructive ownership rules, but one that, in this kind of situation, helps taxpayers.

Note: In Rev. Rul. 77-237, the father could have qualified his redemption under §302(b)(3), but would then have to satisfy §302(c)(2) in order to waive attribution of his son's stock to himself.

Another situation where the IRS's position in Rev. Rul. 77-237 can benefit taxpayers is where a shareholder, A, owns voting stock of a corporation and a trust for the benefit of A's children actually owns nonvoting preferred stock (not §306 stock). It may be possible to qualify under §302(b)(2) the simultaneous redemption of part of A's common stock and all of the trust's nonvoting preferred stock. The trust is the constructive owner of the common stock (the father's shares are attributed to his children and then reattributed to the trust). Under Rev. Rul. 77-237, the redemption of the nonvoting preferred stock from the trust could apparently qualify for exchange treatment under §302(b)(2) provided that the redemption of the voting common stock from A qualifies under §302(b)(2).

Other variations of the use of Rev. Rul. 77-237 are illustrated by the following example:

> *Example:* A Taxpayer owns some of the outstanding voting common stock, and spouse (S) owns some of the voting preferred stock, of the same corporation. If all of S's preferred stock is redeemed, S could qualify for exchange treatment under §302(b)(3) by filing a 10-year agreement to waive attribution of Taxpayer's common stock to S. But if only part of S's preferred stock is redeemed, attribution of Taxpayer's common stock to S (assuming it is not simultaneously redeemed from taxpayer) cannot be waived, and may prevent S from qualifying under §302(b)(2) if the IRS takes the view that S has not satisfied the percentage reduction requirement in §302(b)(2)(C) as to common stock. If S's stock is nonvoting, S would clearly be ineligible to qualify under §302(b)(2). From a planning viewpoint, however, if Taxpayer arranges to have enough of Taxpayer's common stock redeemed simultaneously so as to satisfy §302(b)(2) as to Taxpayer's common stock, it appears that because the redemption of Taxpayer's stock would in effect be attributed to S, S's constructive qualification under §302(b)(2) would also result in exchange treatment for the actual redemption from S of voting preferred stock.

G. *What Is Voting Stock and Related Matters*

Section 302(b)(2) refers to several different characteristics of stock that affect the mathematical calculations under this provision. Care must be taken to differentiate "stock entitled to vote," "voting stock," "total combined voting power," and "common stock."

1. *Voting Stock*

To be considered voting stock, the stock generally must have the current right to vote in the election of corporate directors.[466] Whether the stock is common stock or preferred stock is irrelevant; the only issue is whether the stock is, in fact, properly classified as voting stock.[467] Thus, voting rights with respect to major corporate events, such as mergers, sales of substantial portions of assets, etc., are not by themselves sufficient voting rights to satisfy the voting stock requirement.[468]

Although voting stock must possess the current right to vote in the election of directors, no authority exists regarding the extent of the voting rights required. An issue arises where a class of stock has voting rights that, on a vote-to-value basis, are less than those of other classes of issuer's voting stock. Suppose, for example, that a corporation has 10 shares of voting preferred stock, which carry one vote per share, and has a value equal to one million of the corporation voting common shares, which also carry one vote per share. In this case, the IRS presumably could make a compelling argument that the voting preferred stock is, in fact, not voting stock, because its voting rights in relation to its value are insignificant when compared to the voting rights of other classes of the corporation's voting stock.

Comment: Deciding whether stock labeled as voting stock should qualify as such really comes down to a matter of instinct and common sense. Provided that the purported voting stock carries voting rights that are not wildly disproportionate to the value of the stock (when compared to the relationship of voting rights to value of other voting stock of the issuer), such stock should be considered voting stock.

It is not completely settled whether, to be treated as voting stock, the vote must be available for all, or for possibly the most significant management decisions. In *Cornwall v. Commissioner*,[469] a reduction in voting rights as to a member's money withdrawals from an insurance underwriting association (taxable as a corporation) was held insufficient to satisfy the voting rights rules of §302(b)(2) because the shareholder had not shown that his voting or management rights were reduced on other subjects; apparently, the association followed a one-man-one-vote policy on all management issues except money withdrawals.

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[466] Rev. Rul. 71-83 (voting power for §1504(a) purposes is determined without regard to convertibility of nonvoting stock into voting stock). For an interesting (and perhaps unique) departure from this general rule, see *Forrest Hotel Corp. v. Fly*, 112 F. Supp. 782 (S.D. Miss. 1953) (common stock could not vote currently, due to dividend arrearage on preferred; common nonetheless held to be voting stock). *See also* Rev. Rul. 73-28 (Parent issued its voting stock to its 1st-tier subsidiary in exchange for stock of 2nd-tier subsidiary in "B" Reorganization; Parent stock constituted "voting" stock even though, under state law, it could not be voted in the hands of the 1st-tier subsidiary).

[467] *See, e.g.,* Rev. Rul. 63-234; Rev. Rul. 69-126 (for purposes of §1504(a), preferred stock having the right to select three of eight directors is voting stock). *But see* TAM 9452002 (80% voting power requirement under §1504(a) does not require that affiliation be determined mechanically based solely on election of directors where substantial restrictions are placed on authority of those directors).

[468] Many of the authorities in the voting stock area arise in the context of determining whether one corporation is affiliated with another. Affiliation requires, inter alia, ownership of 80% of the voting power of the affiliated corporation. §1504(a).

[469] 48 T.C. 736 (1967).

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A redemption of stock held in a voting trust and voted by an unrelated trustee is tested under §302 by reference to the beneficial owner of the stock.[470] Apparently, the stock is still considered voting stock for §302 purposes even though the beneficial owner does not exercise the voting power. It is unclear whether an agreement among shareholders giving one shareholder rights to vote stock owned by another shareholder would be treated the same way.

2. *Stock Entitled to Vote*

Stock that can elect directors is both "voting stock" and "stock entitled to vote." Stock that cannot elect directors may not qualify as "voting stock" under the authorities discussed above, but may qualify as "stock entitled to vote" in applying the 50% limitation of §302(b)(2)(B).

If stock has a right to vote on any corporate subject, whether routine or extraordinary (such as a merger or sale of assets), such stock might qualify as "stock entitled to vote." There are opinions to the contrary.[471] Literally, a right to vote on any subject, even contingently, gives stock at least some voting power. But if such rights do not justify treating stock initially as stock entitled to vote, presumably the fact that such stock has some voting power will be disregarded under §302(b)(2)(B).

3. *Total Combined Voting Power*

Because the 50% limitation of §302(b)(2)(B) refers to the total combined voting power of all classes of "stock entitled to vote," it is necessary to compute the total combined voting power by reference to such stock rather than by reference to "voting stock." Where the right to elect directors is the sole criterion of voting stock, voting power has been determined by the relative percentages of the total board membership that each class of stock can elect and the shareholder's percentage ownership of each class.[472] Where rights in addition to, or other than, electing directors must be weighed, there are no clear guidelines.

4. *Common Stock*

As indicated above, the reduction in common stock requirement includes both voting and nonvoting common stock. For authority in other areas as to when stock is or is not treated as common stock, see Rev. Rul. 79-163 (voting common having either a limited right to dividends or to assets on liquidation held not common stock for §306 purposes); Rev. Rul. 76-386 (voting common held still common stock despite corporation's right of first refusal); Rev. Rul. 76-387 (nonvoting common still common for §306 purposes even though one class could receive dividends without equal dividends being paid on the other); Rev. Rul. 75-236 (special class of voting common having limited preferred right to dividends and to assets on liquidation held not common stock for §306 purposes); Rev. Rul. 57-132 (nonvoting common redeemable at discretion of corporation not common stock for §306 purposes).

H. *Related Transactions Under a Plan*

Occasionally, a redemption is combined with another transaction under a single overall plan for rearranging shareholders' ownership interests. For example, a corporation may redeem some (but less than all) of the shares owned by one or more shareholders at the same time that the same or another shareholder sells some of that shareholder's remaining shares to an outsider,[473] or the corporation sells newly issued stock to new investors (for example, in a public offering of its stock). In addition, existing shareholders may want to rearrange their holdings by combining a redemption with direct stock sales between or among themselves. In any of these situations, the question arises as to the proper "before" and "after" measuring points for testing the redemption under §302(b)(2).

Section 302(b)(2)(D) expressly adopts step transaction principles to determine when the distributee's interest in the corporation should be measured. Generally, for purposes of determining the tax consequences of a transaction, the step transaction doctrine will integrate a series of formally separate interdependent steps and view the transaction as a whole.[474] Section 302(b)(2)(D) provides that §302(b)(2) will not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution that (in the aggregate) is not substantially disproportionate with respect to the shareholder.[475] Reg. §1.302-3(a) provides that whether or not such a plan exists will be determined from all the facts and circumstances.

The scope of §302(b)(2)(D) was analyzed by the IRS in Rev. Rul. 85-14. In this revenue ruling a corporation, X, had a single class of stock outstanding that was held by four unrelated shareholders, A (the president of X), B (the vice-president of X), C, and D. A held 1,466 shares, B held 210 shares, C held 200 shares, and D owned 155 shares of X stock. X had a repurchase agreement with shareholders B, C, and D. This agreement provided that if any shareholder ceased to be actively connected with the business operations of X, that shareholder must tender to X its then-held X shares. X had a reciprocal obligation to purchase such shares within six months of such sharehold-

[470] *See* Rev. Rul. 71-262.

[471] *See* Rev. Rul. 72-72; Rev. Rul. 63-226, *revoked by* Rev. Rul. 73-611. Note, however, that by declaring Rev. Rul. 73-611 obsolete in Rev. Rul. 95-71, the IRS implicitly acknowledged that its position in the 1973 ruling regarding whether an S corporation violated the §1361(b)(1)(D) "1 class of stock" requirement by issuing stock that carried varied voting rights was superseded by the enactment, under the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, §2, of §1361(c)(4) (which provides that differences in voting rights will not necessarily cause an S corporation's common stock to be segregated into classes).

[472] Rev. Rul. 69-126; Rev. Rul. 63-234.

[473] *See, e.g., Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954) (sale of stock by distributee, followed by corporation redeeming the balance of distributee's shares qualified under §302(b)(3) as a complete termination). See IX., below, for a discussion of redemptions that are part of a larger plan. Also, as in PLR 200125010 and PLR 199946002, a corporation may institute several integrated transactions, such as joining a redemption and a recapitalization with the issuance of stock to key employees. The IRS ruled that this series of integrated transactions resulted in substantially disproportionate redemptions for the redeeming shareholders.

[474] See X.A., below, for a discussion of the step transaction doctrine; PLR 200441007 (company had no plan for a series of related redemptions where only the board of directors could authorize redemptions and shareholders had no knowledge of other shareholders' requests for redemptions).

[475] *See* PLR 9223030 (granting to certain shareholders of right to require company to redeem their stock ("put right") under certain circumstances (reaching the age of 65, etc.) not considered to be a plan that would prevent redeemed shareholder from qualifying under §302(b)(2)).

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er's ceasing to be actively connected with X's business operations.

On January 1, 1983, B notified A that B was going to resign as vice-president as of March 22, 1983. Based on this information, A caused X to redeem 902 shares of A's X stock, on March 15, 1983. This redemption, standing alone, qualified for exchange treatment under §302(b)(2) (pre-redemption interest in X equaled 72.18%, post-redemption interest in X equaled 49.96%, which is less than 57.74% (80% of 72.18%).

On March 22, 1983, B resigned from X and, in accordance with the repurchase agreement, X redeemed all of B's shares within the next six months. After the redemption of B's shares, A's interest in X increased to 61.37%. Thus, if A's redemption were considered to be part of a §302(b)(2)(D) series of redemptions, it would not qualify under §302(b)(2) because A's ownership of X's voting stock immediately after the series of redemption's exceeded 50% of the total combined voting power of all the X stock and A's ownership of X's stock after the redemption was reduced from 72.18% to 61.37%, which would not meet the 80% requirement of §302(b)(2)(C).

The IRS concluded that:

> "[A]lthough A and B had no joint plan, arrangement, or agreement for a series of redemptions, the redemption of A's shares was causally related to the redemption of B's shares in that A saw an apparent opportunity to secure exchange treatment under §302(b)(2) of the Code by temporarily yielding majority control over the affairs of X.
>
> Nothing in section 302(b)(2)(D) of the Code or in the legislative history of this section (S. Rep. 1622, 83d Cong., 2d Sess. 234–235 (1954)) indicates that the existence of a plan depends upon an agreement between two or more shareholders. Thus, a "plan" for purposes of §302(b)(2)(D) need be nothing more than a design by a single redeemed shareholder to arrange a redemption as part of a sequence of events that ultimately restores to such shareholder the control that was apparently reduced in the redemption."

Therefore, the proper time to measure A's interest is after the redemption of B's shares. At this point in time, A's interest in X fails to meet the standards of §302(b)(2).

The Tax Court analyzed §302(b)(2)(D) in *Glacier State Elec. Supply Co. v. Commissioner*,[476] which involved a buy-sell agreement entered into between a corporation, GSB, and its shareholders X, Y, Z, and P. The buy-sell agreement provided that one-half of the GSB shares held by P would be redeemed upon the death of X or Y and that all of Z's shares would be redeemed upon Z's death. X died in 1976 and pursuant to the buy-sell agreements, one-half of P's GSB shares were redeemed. This redemption reduced P's interest in GSB from 60.22% to 42.91%. Further, after the redemption, P owned less than 50% of the GSB stock that was entitled to vote. Therefore, the redemption of P's shares qualified for exchange treatment under §302(b)(2).

However, P preferred dividend treatment because it was a corporation and entitled to a dividend received deduction under §243(a). P argued that the redemption of its GSB shares, when coupled with the eventual redemption of Z's shares upon Z's death, constituted a series of redemptions under §302(b)(2)(D). If P's interest were measured when Z's shares were redeemed, P would not qualify for exchange treatment under §302(b)(2) (assuming GSB had the same capital structure at the time of Z's death).

The court held that although the redemption of P's shares may be part of a series of redemptions and pursuant to a plan, the buy-sell agreements were entered into for legitimate business reasons and the "purpose or effect" of the agreement was not to result in a substantially proportionate distribution to P. The court also pointed out that even if P's interest in GSB were measured after the eventual redemption of Z's shares, the redemption still might be substantially disproportionate, because GSB's capital structure may change before Z dies. Therefore, the court held that §302(b)(2)(D) did not apply and the redemption of the GSB shares held by P qualified for exchange treatment under §302(b)(2).

Observation: The court in *Glacier State* rejected the use of general common law step transaction principles used in *Roebling v. Commissioner*[477] and *Johnston v. Commissioner*[478] to find a plan under §302(b)(1) and §302(b)(3) because "the express language of sec. 302(b)(2)(D) states that it applies only for purposes of sec. 302(b)(2)."[479] Apparently, this quoted language means that the §302(b)(2)(D) standard is the IRS's only recourse for integrating a series of redemptions under §302(b)(2). However, the finding of a series of redemptions is not the IRS's only means for policing §302(b)(2). For example, the IRS could use general step transaction doctrine principles to disqualify a redemption under §302(b)(2) where the distributee, pursuant to a plan and after the redemption of the distributee's shares, purchases from other shareholders an amount of shares to return the distributee back to its pre-redemption interest in the corporation.

[476] 80 T.C. 1047 (1983).

[477] 77 T.C. 30 (1981).

[478] 77 T.C. 679 (1981).

[479] 80 T.C. 1047, 1060, n.23.

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VI. Section 302(b)(1) — Not Essentially Equivalent to a Dividend

A. Introduction

Section 302(b)(1) provides that a redemption will receive exchange treatment "if the redemption is not essentially equivalent to a dividend." When the requirements of §302(b)(2), (3) and (4) cannot be satisfied, this section provides the taxpayers a chance to receive exchange treatment.[480]

Unlike the requirements of §302(b)(2) (substantially disproportionate redemptions) and §302(b)(3) (redemptions that terminate a shareholder's interest), there is no mathematical safe haven with respect to redemptions that are not essentially equivalent to a dividend. Instead, the language of §302(b)(1) is general in nature and requires an analysis of the facts and circumstances of each particular case.[481] A proper "feel" for the way in which this criterion is likely to be applied in a particular case requires an understanding of the tax rules governing redemptions and partial liquidations at least as far back as the 1954 Code.

From a planning point of view, §302(b)(1) presents great difficulties. Without an advance private ruling from the IRS, there are few situations where a taxpayer can rely with complete certainty on §302(b)(1) for exchange treatment of a redemption. Nevertheless, a number of safe havens have been established by the courts and the IRS upon which taxpayers continually rely.

The major Supreme Court case in the area of §302(b)(1) redemptions is *U.S. v. Davis*.[482] In *Davis*, the Supreme Court held that business purpose is not pertinent to determinations under §302(b)(1).[483] The Court also held that a redemption from a sole shareholder (i.e., a shareholder who owns 100% of the corporation) is always essentially equivalent to a dividend and that the attribution rules of §318 are to be applied.[484]

The Court stated that the basic test under §302(b)(1) is whether the redemption results in "a meaningful reduction of the shareholder's proportionate interest in the corporation."[485] No guidelines were furnished, however, as to when a reduction in interest is "meaningful."

While the application of §302(b)(1) — both before and after *Davis* — depends on the facts and circumstances of each case, the IRS will issue advance private rulings under §302(b)(1).[486]

A redemption is tested under §302(b)(1) solely by reference to the shareholder's stock ownership, and the attributes of such ownership, before and after the exchange. Unlike the special rules for disregarding ("waiving") family attribution in qualifying a redemption under §302(b)(3), a shareholder may, in connection with §302(b)(1), retain an interest in the corporation. The only requirement under §302(b)(1) is that enough of a reduction in the shareholder's stock ownership occur so that the shareholder's rights and influence as a shareholder are reduced sufficiently to persuade the IRS or the courts that there has been a "meaningful" reduction in the shareholder's stock ownership interest.

B. Legislative History

1. The Sale Analogy

The legislative history of §302 rests on the comparison between a redemption of stock and a sale of the same stock to a third person. If the stock is held as a capital asset, its sale to a third person produces capital gain or loss under the general rules of §1001 and §1201[487] – §1223. Because a sale of stock to a third person reduces the seller's percentage interest in the corporation, i.e., the same total number of shares remain outstanding but the seller owns fewer shares, Congress has reasoned that a redemption which also reduces the shareholder's interest in the corporation deserves "sale" treatment for tax purposes.

Despite this rationale in the legislative history, however, the so-called "sale" analogy is not a simple guide for determining when a redemption will qualify under §302(b)(1). Unlike a sale of stock to a third person, a redemption involves an actual distribution of corporate earnings, an event that, under the rules of §§301 and 316, is ordinarily taxable in full as dividend income. In a sale, the amount of corporate earnings is usually reflected in the selling price of the stock, but the reflection is indirect. Actual corporate earnings stay intact, presumably to be taxed later to the buyer when he withdraws them. In a redemption, corporate earnings leave corporate solution permanently and, if not taxed at divided rates then, they never will be so taxed. The redemption rules thus reflect a basic tension between a literal sale analogy and the need to protect the dividend rules of the tax code.

Another difference between a sale to a new investor and a redemption is that after a redemption the shareholder's remaining stock recoups, in effect, part of the equity interest represented by the redeemed shares, while a sale of the same number of shares to a third person costs the seller the full equity interest represented by those shares. The significance of this difference between a redemption and a sale to third persons is discussed below.

Even without the problems of comparing redemptions with sales to third persons, the courts and the Treasury have generally required that the reduction in interest as a result of the redemption be "significant," "substantial," or, as the Supreme

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[480] Of course, in the case of a corporate taxpayer desiring a dividends received deduction, this section may provide the last clear chance for the IRS to find §302(a) treatment. Note that according to §302(b)(5), except to the extent provided in regulations, the redemption of stock of a publicly offered RIC is treated as an exchange if the redemption is upon the demand of the shareholder and the company issues only stock which is redeemable upon the demand of the shareholder.

[481] Reg. §1.302-2(b)(1).

[482] 397 U.S. 301, reh'g denied, 397 U.S. 1071 (1970).

[483] Under the predecessor of §302, the courts had struggled with the question of whether business purpose was a factor in finding dividend equivalence. See VI.B., below.

[484] *See also* Reg. §1.302-2(b)(1).

[485] 397 U.S. at 313.

[486] *See, e.g.* PLR 201918009. *But see* Rev. Proc. 2025-3, §3.01(50), (51) (rulings or determination letters may not be issued where the redemption of stock under §302 involves the exchange of certain forms of consideration such as when a corporation's promise to pay is based on future earnings or when the corporation's promise to pay consists entirely of notes payable secured by the shareholder's stock).

[487] Section 1201 was repealed by the TCJA, Pub. L. No. 115-97, §13001(b)(2)(A).

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Court said in *Davis*, "meaningful." In addition, the courts and the Treasury have generally superimposed a "control" test in deciding whether to allow exchange treatment under §302(b)(1). The details of this test are discussed below. The effect of requiring a "meaningful" reduction in interest, and of inquiring into whether the redeemed shareholder retained control over corporate affairs after the redemption, is that not every redemption in which a reduction of interest occurs will qualify under §302(b)(1).

Recognizing these technical defects in a formal "sale" analogy, some commentators believe that Congress intended §302 and its predecessors to operate less conceptually and instead to carry out a specific policy objective: to provide favorable tax treatment to the owners of closely held businesses who, if the company were not able to buy their shares on favorable tax terms (exchange treatment under §302), would be frozen into the business more completely than a partner in a comparable unincorporated enterprise.[488]

2. *1954 Code*

In 1954, the House of Representatives proposed a mechanical approach to the taxation of stock redemptions. The House would have created separate categories for "partial liquidations" and "redemptions." The former would have been confined to termination of part of a corporation's business. The redemption rules would have allowed exchange treatment within only six specific categories; all redemptions outside the safe havens would have received dividend treatment. The House bill would have allowed exchange treatment for distributions that terminate the shareholder's interest in both common and preferred stock, distributions where the shareholder's percentage interest in common stock is reduced by more than 20%, and distributions made to a shareholder holding less than 1% of the common stock.[489]

The Senate rejected this approach as overly mechanical, preferring that the tax rules remain flexible in order to deal with the "myriad" varieties of business transactions.[490] The Senate accepted a separation of partial liquidations and redemptions into distinct categories and also accepted the substantially disproportionate and complete-termination-of-interest rules, adding refinements. The Senate also reinstated the "dividend equivalence" standard of prior law, but turned it around so that it affirmatively authorized exchange treatment for redemptions which were not essentially equivalent to a dividend.

The pertinent parts of the Senate report follow:

> [General Explanation]
>
> Under present law it is not clear when a stock redemption results in capital gain or ordinary income. Some courts have held that a distribution disproportionate to the shareholder's ownership of common stock in the corporation results in capital-gains treatment, but no definite test has developed. While the House bill sets forth definite conditions under which stock may be redeemed at capital gain rates, these rules appeared unnecessarily restrictive, particularly in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. This general rule is supplemented by your committee by the rule of the House bill that a redemption which is substantially disproportionate shall also qualify so as not to be taxable as a dividend. (pp. 44–45)
>
> (d) Partial liquidation — Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.
>
> Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in Part I of this subchapter. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation. (p. 49)
>
> [Technical Explanation]
>
> Section 302 corresponds in function to section 302 of the House bill and relates to section 115(c), (g) and (i) of the 1939 Code… Unlike the House bill, however, section 302 does not provide specific statutory guides governing the tax consequences of every stock redemption. In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry… In general, under this subsection [§302(b)] your committee intends to incorporate into the bill existing law as to whether or not a redemption is essentially equivalent to a dividend under section 115(g)(1) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances. (p. 233)

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[488] *See, e.g.*, Herwitz, "Stock Redemptions and the Accumulated Earnings Tax," 74 *Harv. L. Rev.* 866, 897–98 (1961). *See also* Chirelstein, "Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares," 78 *Yale L. J.* 739, 749–50 (1969).

[489] H.R. Rep. No. 8300, §302(a) (1954).

[490] S. Rep. No. 83-1622, at 12 (1954).

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> The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation.

C. Meaningful Reduction Test

1. U.S. v. Davis

a. In General

In 1945, Maclin Davis (the taxpayer) and E.B. Bradley formed the Tennessee Foundry and Machine Company to manufacture steel castings. Davis negotiated with a local bank and with the Reconstruction Finance Corporation (RFC) for a $95,000 loan to the corporation to enable it to begin business. The lenders agreed to make the loan if, among other conditions, the incorporators supplied $25,000 additional working capital to the corporation in the form of additional common stock, preferred stock or a subordinated note. Bradley was unable or unwilling to invest any more funds, but still insisted on retaining 50% of the voting power. Davis supplied the $25,000, taking back 1,000 shares of 6%, $25 par value preferred stock. Davis felt that a long-term debt liability would be less attractive on the corporation's balance sheet. After this transaction, the outstanding stock was owned as follows:

	Common	Preferred
Davis	250	1,000
Davis' wife	250	
Bradley	500	

Davis, Bradley, and the corporation agreed that the preferred stock would be redeemed when the RFC loan was fully repaid.

In 1952, Davis purchased Bradley's 500 shares of common stock and in 1959 transferred 250 shares to his son and 250 shares to his daughter. In 1960, the corporation obtained the lender's consent to pay dividends on the preferred stock and began paying $750 semiannual dividends. In 1963, the final payment of the loan was made and the Board of Directors accepted Davis' offer to redeem all his preferred stock for $25,000. Eighteen years after the preferred stock was issued, Davis received back the $25,000 he had advanced to the corporation.

On his 1963 income tax return, Davis treated the transaction as a return of capital giving rise to no realized gain or loss, since the amount realized and his basis were both $25,000. The IRS determined that the redemption proceeds were essentially equivalent to a dividend to Davis. The IRS viewed Davis both before and after the redemption as sole owner of all the outstanding stock by reason of the family attribution rules of §318. Both the District Court[491] and the Sixth Circuit[492] decided in Davis' favor, holding that the redemption was "not essentially equivalent to a dividend" within the meaning of §302(b)(1).

The Supreme Court[493] reversed the Sixth Circuit in a 5-3 decision, holding that the redemption was essentially equivalent to a dividend. The Court first dealt with Davis' contention that the attribution rules apply only to paragraphs (2) and (3) of §302(b). The Court stated that the attribution rules necessarily apply to §302(b)(1) because Davis' argument would allow any redemption that fails the mathematical tests of §302(b)(2) or (3) because of the attribution rules to qualify under §302(b)(1) thereby eliminating the need to qualify under §302(b)(2) or (3). Davis, the Court said, "must" be considered the owner of all the common and preferred stock in testing the exchange under §302(b)(1).

The Court then held that the redemption of preferred stock in these circumstances was equivalent to a dividend because, after applying the attribution rules, the facts simply involved a sole shareholder who caused part of his stock to be redeemed. "We conclude," the Court said, "that such a redemption is always 'essentially equivalent to a dividend' within the meaning of that phrase in Section 302(b)(1)…"

The Court next agreed with the IRS that a bona fide business purpose for a redemption was not intended to be relevant after 1954. The majority interpreted the 1954 legislative history as clearly indicating an intent by Congress to eliminate tax avoidance purpose as a factor that can cause denial of exchange treatment under §302(b)(1) or, by the absence of tax avoidance, support exchange treatment. Although admitting that its reading of Congress' intent was not free of doubt, the Court concluded that by calling for an inquiry "solely" into the question whether a redemption "by its nature" can properly be treated as a sale, Congress was ruling out tax avoidance purpose and, with it, business purpose as a potential rebuttal to an avoidance purpose. The Court also pointed to examples in the 1954 Senate Committee Report indicating that a pro rata distribution should always be treated as a dividend or §301 distribution and, the opinion says, "nothing suggests that there should be a different result if there were a 'business purpose' for the redemption."

The taxpayer argued that exchange treatment would have been available to him if he had not purchased Bradley's stock or if he had originally supplied the needed funds as a loan rather than in the form of preferred stock. To trigger a dividend on a redemption in such circumstances, the taxpayer maintained, elevates form over substance. The Court replied:

> The difference between form and substance in the tax law is largely problematical, and taxpayer's complaints have little to do with whether a business purpose is relevant under section 302(b)(1). It was clearly proper for Congress to treat distributions generally as taxable dividends when made out of earnings and profits and then to prevent avoidance of that result without regard to motivation where the distribution is in exchange for redeemed stock.

[491] 274 F. Supp. 466 (M.D. Tenn. 1967).

[492] 408 F.2d 1139 (6th Cir. 1969).

[493] 397 U.S. 301 (1970), reh'g denied, 397 U.S. 1071 (1970). *See also* PLR 9810020 (redemption by S corporation treated as distribution under §301 because shareholder continued to own, actually or constructively, all of corporation's stock).

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The Court then said:

> If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the stockholders. Where a redemption has the same effect, it cannot be said to have satisfied the 'not essentially equivalent to a dividend' requirement of section 302(b)(1). Rather, to qualify for preferred treatment under that section, a redemption must result in a *meaningful reduction* of the shareholder's proportionate interest in the corporation. (Emphasis added.)

In a dissenting opinion, Justice Douglas (joined by Justices Burger and Brennan) disagreed with elimination of business purpose as a factor in determining dividend equivalence. The dissenters reasoned that "the bona fide business purpose of the redemption belies the payment of a dividend." The dissenters also interpreted the majority opinion as holding that a redemption of stock in a one-man or closely held corporation is always equivalent to a dividend. This result, they believed, "effectively cancels section 302(b)(1) from the Code," a responsibility they indicated lies with Congress not the courts.

b. Further Dissenting Views of the Supreme Court

The cases of *Miele v. Commissioner*,[494] and a companion decision, *La Fera Contracting Co. v. Commissioner*,[495] led in 1973 to important dissenting comments on *Davis* by three Justices of the U.S. Supreme Court. The Tax Court in *Miele* had held simultaneous redemptions of all of a corporation's outstanding preferred stock dividend equivalent, where seven individuals and a corporation owned by two of them each owned the preferred stock in substantially the same proportion as they owned the common stock. The stock ownership was as follows:

	Common		Preferred	
	Stock	%	Stock	%
Joseph Miele	21	16	50	16.7
Anthony Miele	21	16	50	16.7
– Richard (son)	2	1.5	—	—
Luke Spiniello	22	16.7	50	16.7
James Spiniello	22	16.7	50	16.7
Joseph La Fera, Sr.	1	0.7	—	—
– Joseph (son)	1	0.7	—	—
– La Fera Co.	42	31.7	100	33.3
Total	132	100	300	100

The corporation ("A & S") operated a business of moving sludge out to sea by means of a barge. It needed to replace its barge but needed outside financing. To this end, A & S began negotiating with the U.S. Maritime Commission, which was empowered to guarantee a private loan to the company to purchase a new barge. The government agency advised the company that before it could help, A & S would need additional capital of at least $150,000, which could be supplied either by a subordinated loan to the company or by its issuing nonvoting, non-dividend-paying preferred stock. The principal shareholders preferred putting in the additional funds by loan, but their counsel advised that, as summarized by the Tax Court, issuing preferred stock "would accomplish their entire purpose in the shortest time."[496] (This rationale was not further explained.) Preferred stock was then issued for $150,000 and pursuant to its terms the stock was non-dividend-paying and required to be redeemed within 10 years but not before the barge loan had been fully repaid. Six years later A & S repaid the barge loan and then "at the insistence of the shareholders" redeemed half of its preferred stock pro rata in each of two consecutive years.

The Tax Court held that the preferred stock should be treated as equity rather than (as the shareholders argued) as debt; that the fact that the redemption had a business purpose (the funds supplied for the stock were no longer needed) was immaterial after *Davis*; and that each redemption "did not change the relative economic interests, control, or rights of the stockholders (the petitioners here-in)…"

In *La Fera Contracting Co.*, the Tax Court had before it the corporate shareholder in A & S and reached the same conclusion of dividend equivalence as to that shareholder. The Third Circuit affirmed both *Miele* and *La Fera Contracting Co.* without written opinion.[497]

The executors of the estate of Joseph Miele, who died after the Tax Court decision, petitioned the U.S. Supreme Court for certiorari. A majority of the Court denied the petition.[498] However, Justice Powell, joined by Justices Douglas and Blackmun, dissented with a written opinion. (Neither Powell nor Blackmun was on the Court when it decided *Davis* in 1970.) The dissent begins with the proposition that, realistically, the redemption provided the shareholders with no more than a return of capital which they had been "compelled" to put into the business to obtain the needed financing. They had realized no element of gain; yet the entire amount of the redemption proceeds had been held taxable at ordinary income rates. It is "unjust," the dissenters felt, to leave shareholders in a position where they are either locked in without income on their investment or compelled, as the price of terminating it, to pay tax at ordinary income rates on a nonexistent gain. Such a dilemma, they said, is justified neither by the statutory language nor by the legislative history of §302(b)(1). Justice Powell saw a desire for ease of administration underlying the *Davis* concept that a redemption is always dividend equivalent where no change occurs in the relative economic interests or rights of a shareholder. But, he said, ease of administration is "too high a price" in a situation such as *Miele*. If Congress had intended a flat rule such as results from *Davis*, it could easily have written such a rule into the Code "in the simplest language." Instead, Congress retained a specific category for redemptions that were "not essentially equivalent to a dividend," and the underlying committee

[494] 56 T.C. 556 (1971), acq., 1972-1 C.B. 2, aff'd per curiam, 474 F.2d 1338 (3d Cir. 1973), cert. denied sub nom., *Albers v. Commissioner*, 414 U.S. 982 (1973), reh'g denied, 414 U.S. 1104 (1973).

[495] 30 T.C.M. 691 (1971); *aff'd in unpub. opin.* (5th Cir. 4/11/73).

[496] 56 T.C. at 559.

[497] 474 F.2d 1338 (3d Cir. 1973).

[498] *Albers v. Commissioner*, 414 U.S. 982 (1973).

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reports indicate an intent to have a factual inquiry made in applying that test to specific situations.

Note: In this regard, Justice Powell cited the statement in the 1954 Senate report indicating that exchange treatment is appropriate, under the §302(b)(1) criterion, where preferred stock is called from a shareholder who lacks control over the occurrence of the redemption.

Justice Powell did not comment specifically on the fact that the shareholders originally chose stock over debt. However, he impliedly addresses this point by observing that the *Davis* rule is "often a trap for unwary investors in small businesses…"

Comment: Justice Powell's disagreement with *Davis* focused on not necessarily accepting the form of a transaction that a taxpayer himself has chosen to use. In stressing the propriety of taking "business purpose" into account under §302(b)(1), Justice Powell would, in effect, analogize the preferred stock, in the circumstances involved in *Miele*, to debt obligations with tax-free repayments to the creditor.

Observation: A corporation that needs to raise funds for corporate purposes can still receive such funds in the form of loans from shareholders. If the debt character of such loans is bona fide repayment of the loans will not confront the shareholders with the adverse tax results involved in *Miele*. For a case where an effort to infuse the additional capital via debt was unsuccessful because the "debt" was treated as equity, see *Colorado Life Co. v. Commissioner*.[499] It has been suggested that even after *Davis* a court may still be permitted to allow exchange treatment on a pro rata redemption of preferred stock where the stock was originally issued for some "business necessity" — presumably such as if the Maritime Commission had required that the additional capital come in for stock rather than debt.[500] The analogy would be to the so-called "source of supply" cases typified by *Commissioner v. Bagley & Sewall Co*.[501] Arguably, a subsequent return of the stock by the shareholders should not be treated as a capital transaction at all. Yet it is still not clear that the analogy carries to the point of treating the corporate distribution as a tax-free repayment of debt, or that the corporate distribution rules of §301 can be ignored.

2. *"Meaningful Reduction in Proportionate Interest"*

a. *Proportionate Interest*

The concept of "proportionate interest" includes the entire package of rights and restrictions that flow from owning the stock in question. A detailed factual inquiry has become more important than ever, requiring careful weighing of the rights of the shares redeemed and a study of which effects of the redemption on particular rights are truly significant.

Different classes of stock may carry disproportionate votes per share, voting limited to certain matters, different voting rights contingent on future events, and different rights to earnings and assets. The power of control may also be an important attribute of a given block of stock. Section 302(b)(1) now requires careful evaluation of all the various rights attaching to stock in the particular case, giving more weight to one or another characteristic where appropriate in the particular circumstances.

In *Himmel v. Commissioner*,[502] the leading authority for the identification of the specific rights which arise from owning stock in a corporation that are relevant in testing a redemption for dividend equivalence, the Second Circuit stated:

> Ownership of stock can involve three important rights: (1) to vote and thereby exercise control, (2) to participate in current earnings and accumulated surplus, and (3) to share in net assets on liquidation.

The court pointed out that common stock generally carries all three of these rights. Preferred stock generally carries only the last two and only to a limited extent. For a redemption to be treated as not essentially equivalent to a dividend, there must be some change in a shareholder's proportionate interest in one or more of these areas.

The court pointed out that difficult questions arise when a corporation has more than one class of stock outstanding, when some of the stock (including common stock) has voting rights and some does not, and when different shareholders own different amounts of preferred stock or different amounts of both preferred and common.

In published rulings since *Davis*, the IRS has cited the factors listed in *Himmel* and indicated that it will consider the effect of a redemption on these various rights in testing a transaction under §302(b)(1).[503]

In Rev. Rul. 85-106, however, the IRS expressly rejected the *Himmel* holding and treated the lack of change in a shareholder's voting interest as a "key factor" in determining the applicability of §302(b)(1). Despite a factual finding that the redemption at issue resulted in a reduction in the shareholder's percentage interest in current earnings, accumulated surplus, net assets upon liquidation, and in a reduction in the fair market value of the shareholder's ownership in the corporation, the IRS found no reduction in the shareholder's voting power, thus denying the applicability of §302(b)(1).[504]

However, the *Himmel* factors should not be the only factors that affect the §302(b)(1) analysis. There are other facts and circumstances which will be relevant if they exist. For example, special provisions in a company's charter or bylaws

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[499] 29 B.T.A. 950 (1934).

[500] *See* P-H Tax Ideas Rept. Bull. No. 1, ¶ 1.2 (1974).

[501] 221 F.2d 944 (2d Cir. 1955).

[502] 338 F.2d 815 (2d Cir. 1964).

[503] *See* Rev. Rul. 81-289; Rev. Rul. 75-512; Rev. Rul. 75-502. *See also* GCM 38357 (Apr. 4, 1980), which discusses the ruling result proposed under Rev. Rul. 81-289 and notes that a determination of whether a redemption is essentially equivalent to a dividend must be made on a shareholder-by-shareholder analysis. *See also* PLR 9709043, where the factors in Rev. Rul. 75-502 and the attribution rules of §318 were applied to deny the taxpayer sale or exchange treatment because there had been no meaningful reduction in his interest.

[504] Rev. Rul. 85-106. *See also* CCA 200409001 (Chief Counsel's Office advised that right of control is key right in determining if redemption substantially reduced shareholder's interest in corporation); PLR 7933006 (National Office considered reduction in voting rights of control over corporate officers to be most significant factor in testing redemption under §302(b)(1)). For similar treatment by the courts, see *Johnston v. Commissioner*, 77 T.C. 679 (1981) (decreases in voting control considered "the most significant indicator of a 'meaningful' reduction"); *Paparo v. Commissioner*, 71 T.C. 692 (1979) (reality of control factor stressed); *Benjamin v. Commissioner*, 66 T.C. 1084, 1111 (1976) (retention of "absolute voting control" outweighs other *Himmel* factors), aff'd, 592 F.2d 1259 (5th Cir. 1979). *See also* Karlin, "Rev. Rul. 85-106: An Unsupported Attack on Section 302(b)(1) Redemption," 64 *TAXES* 529 (1986).

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may be given great significance if an over-50% owner of common stock has enough stock redeemed to reduce his percentage ownership to 30% but, under the bylaws, corporate decisions require unanimity among all shareholders who own at least 25% of the stock.

In *Davis*, as indicated earlier, the Supreme Court prefaced its statement of the "meaningful reduction in proportionate interest" test by contrasting it to a typical dividend distribution where property is transferred to shareholders "without a change in the relative economic interests or rights of the shareholders."[505] The Court was, therefore, calling attention to the "economic" aspects of a shareholder's stock ownership, as well as to the "rights" conferred by stock ownership. Thus, despite the treatment of voting power by courts and the IRS as an important factor, voting rights alone do not exhaust the "proportionate interest" in the corporation represented by stock ownership.[506]

For a good example after *Davis* of a detailed inquiry by the court into the reality of control exercised by a class of preferred stock (which the shareholder argued was laden with restrictions), and a comparison with the "real" rights of the common stock, see *Benjamin v. Commissioner*,[507] discussed below at VI.G.2. In this case, the court looked at "the totality of the facts and circumstances," including the effects of a written side agreement among the various shareholders. "We are not swayed by labels," the court said, "and will look at substance over form in considering the character of the redeemed stock."

b. Interest of Officer, Employee, Etc.

As noted earlier, a shareholder can qualify under §302(b)(1) without giving up an "interest" in the corporation of the kind barred under the special rule for waiving family attribution under §302(b)(3). The nondividend equivalence category does not require complete termination of a shareholder's stock ownership in the corporation; nor does he have to cease being an officer, director, or employee of the corporation, or to cease having any other type of "interest" that would be forbidden if he were trying to waive family attribution under §302(c)(2) and qualify under §302(b)(3).

A shareholder may remain as an officer, director, employee, etc., but the broader question under §302(b)(1) will be: considering all facts and circumstances as a whole, has a meaningful reduction occurred in the shareholder's stock ownership in the corporation and in the incidents of such stock ownership? That inquiry may take into account the effects and influence which the shareholder's remaining stock will enable him to have in corporate affairs. In that context, holding a position as a director or officer may be an incident of owning stock and will be one fact to be weighed along with all others in the particular situation. But at least a shareholder is not disqualified automatically under §302(b)(1) by reason of remaining as an officer or director, or as an employee, or by having any other "interest" in the corporation after the exchange.

c. "Reduction"

Davis requires a reduction in the redeeming shareholder's proportionate interest in the corporation. In cases where several classes of stock are involved, with different rights as between the classes, a redemption may change some of a shareholder's rights but not others, or may change different rights in different degrees. It will be necessary to analyze the facts of the particular case to determine whether the rights reduced are significant, or whether the fact that other characteristics of the shareholder's interest are not reduced is more significant.

Although an exchange necessarily reduces the actual number of shares a shareholder owns, that shareholder's percentage ownership of the total remaining outstanding stock may remain unchanged — or may even increase — by reason of the constructive ownership rules of §318.

> *Example:* Mother, Son and Key Employee own 40, 25, and 35 shares, respectively, of 100 outstanding shares. Corporation redeems all the stock owned by Mother and Key Employee. Before these exchanges Mother owned 65% of the company (actually and constructively); afterward she owns 100% (by attribution from her Son who has become sole owner).[508]

Pre-*Davis* cases that denied §302(b)(1) exchange treatment where, by attribution, a redeeming shareholder's interest increased rather than decreased, will continue to be relevant authorities.[509] Section 301 treatment also seems called for where a redeeming shareholder's interest increases by reason of simultaneous redemptions from other shareholders.[510]

> *Example:* A, B, C, and D own 400, 300, 200, and 100 shares, respectively, of 1,000 outstanding shares. The corporation redeems 100 shares from A, 100 shares from B, and 86 shares from C. Even though the shareholders are unrelated and A surrendered 100 shares, A's resulting percentage interest increases from 40% to 42% (300/714).

d. Meaningful

A redemption from a given shareholder can reduce the shareholder's percentage interest (both actual and constructive), but still fail to qualify under §302(b)(1) because the reduction is not considered "meaningful" enough.

In its reference to a meaningful reduction in interest, the Supreme Court may have intended merely to paraphrase several references in the IRS's brief to language used by the First Circuit in *Bradbury v. Commissioner*[511] The IRS in its brief before the Supreme Court in *Davis* quoted a statement from the appellate court's opinion in *Bradbury* that the basic inquiry un-

[505] 397 U.S. at 313. *See also* PLR 200307001 (redemption of shareholder's (S's) stock not essentially equivalent to dividend where stock not attributable to S is also redeemed as long as no other stock attributable to S by family attribution is redeemed).

[506] *See Brown v. U.S.*, 345 F. Supp. 241, 244 (S.D. Ohio 1972) (referring to "the 'net economic effect' test" enunciated in *Davis*), aff'd per curiam, 477 F.2d 599 (6th Cir. 1973).

[507] 66 T.C. 1084 (1976), aff'd on other grounds, 592 F.2d 1259 (5th Cir. 1979).

[508] *See Hirsch v. Commissioner*, 123 F.2d 24 (9th Cir. 1941). *See also* CCA 200409001.

[509] *See Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967). *See also Metzger Trust v. Commissioner*, 76 T.C. 42 (1981), aff'd, 693 F.2d 459 (5th Cir. 1982) (§301 applies where trust remained 100% shareholder by application of §318, even though trust's entire direct stock interest was redeemed).

[510] *See, e.g., Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967).

[511] 298 F.2d 111 (1st Cir. 1962).

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der §302(b)(1) is whether the surrender of shares is "an economically meaningful gesture or a sterile exercise in formalism."[512] The court in *Bradbury* also stated that the first step in making determinations under §302(b)(1) is "whether the redemption of stock has caused a meaningful change in the position of the shareholder with relation to his corporation and the other shareholders." The government's brief in *Davis* contains this specific passage:

> Our principal contention in this brief is that a redemption is "not essentially equivalent to a dividend" only if the result of the redemption is to effect a meaningful reduction in the proportionate interest in the corporation of the shareholder whose stock is redeemed. Where, on the other hand, a shareholder receives cash, separated from the corporation, and in return relinquishes stock certificates without in any way reducing the shareholder's proportionate interest in the enterprise, we view the redemption as being "essentially equivalent to a dividend" because, like a dividend, it gives him cash separated from the corporation, but the redemption has no effect on the proportionate stock interest of the recipient shareholder (Brief for the U.S., p. 7).

The famous meaningful-reduction test of *Davis* may spring from this passage in the government's brief, with no clearer or more precise concept motivating the Supreme Court's reference to a "meaningful" reduction.

The concept of a "meaningful" reduction in interest superimposes policy factors on the mere quantity of reduction in a shareholder's percentage interest in the corporation.[513] Unfortunately, the Supreme Court defined none of the factors which should be applied to a given set of facts. "Meaningfulness" should be understood to involve: (1) determining which attributes of a stock interest are to be given the greatest weight in a specific case; (2) determining not only how much of a quantitative reduction in the shareholder's ownership of that attribute has occurred, but also what kind of change in the relationships among all the remaining shareholders has occurred; and (3) taking into account any other transactions that are considered related or relevant to determining the effect of the redemption on the total bundle of rights held by the shareholder.

e. Business Purpose

Davis has eliminated the "business purpose" for a redemption or for the original issuance of stock as a pertinent factor in determining dividend equivalence. The Supreme Court's analysis of business purpose arose in the context of a single-owner corporation and a pro rata redemption. The broad sweep of the opinion also indicates that business purpose is irrelevant for non-pro rata distributions among two or more shareholders. The rejection of business purpose also seems to rule out both "shareholder" and "corporate-level" purposes.

Apparently, the Supreme Court also intended to rule out business purpose in considering whether a redemption of preferred stock can, at the threshold, be analogized to debt repayment. The taxpayer in *Davis* argued that his redemption should be analogized to debt repayment.[514] The Court, however, ignored this argument.

Business purpose considerations may still be pertinent after *Davis*, however, for purposes of ascertaining the point in time at which the "meaningfulness" of a redemption is tested under §302(b)(1).

After *Davis*, a variety of miscellaneous considerations which courts sometimes mentioned in applying §302(b)(1) have been swept out of the picture: whether the corporation had any plan to contract its activities; whether the corporation or the shareholder "initiated" the redemption; the company's past dividend record; and the extent of accumulated earnings at the time of the redemption. One commentator has concluded:

> The solution of the meaningful reduction issue in any one case turns, it would seem, more on the nature of the corporate capital structure than on the details of the redemption itself.[515]

In one area, however — distributions of cash in lieu of fractional shares — the IRS seems to grant business purpose an important role. Rev. Proc. 77-41,[516] states that the IRS will issue private rulings under §302 that cash distributed to shareholders in lieu of fractional shares will receive exchange treatment if the cash is distributed "solely for the purpose" of saving the corporation the expense and inconvenience of issuing fractional shares. "The purpose of the transaction … [is] among the factors that will be considered in determining whether a ruling is to be issued."

3. Classes of Stock Covered by §302(b)(1)

Although the 1954 Senate Committee Report expresses an intention only to benefit redemptions of preferred stock, neither the courts nor the IRS have limited §302(b)(1) to preferred stock (voting or nonvoting). In *Commissioner v. Antrim*,[517] the Fourth Circuit specifically rejected an apparent "test" contention by the IRS that §302(b)(1) is limited to redemptions of part of the preferred stock owned by a person who owns no common stock. The court said if that were the case, Congress would have created a specific category for preferred stock rather than reverting to the general language of the pre-1954 statute. The court also indicated that (a) the concept of "dividend" equivalence cannot disregard common stock, and (b) it would be unfair to allow capital gain treatment to a redemption of preferred stock where the shareholder owns no common stock, but to deny such treatment where the shareholder owns only one share of common stock.

Comment: The example in Reg. §1.302-2(a) illustrates only that a preferred stock redemption which fails to qualify under §302(b)(2) or (3) can qualify under (b)(1). It seems mistaken to construe this example as limiting the scope of (b)(1) itself. Al-

[512] 298 F.2d at 114; Brief for U.S., p. 15.

[513] In PLR 8103029, the IRS indicated that in some instances it will be possible for a taxpayer to meet the "meaningful reduction" requirement without reducing the taxpayer's percentage ownership below 50% (for example, where the taxpayer directly owns none of the corporation's stock, but is deemed to own 50% of the corporation's stock under the attribution rules of §318).

[514] *U.S. v. Davis*, 397 U.S. 301 (1970). Reply Brief for Taxpayer at p. 5.

[515] Swennes, *'Not Essentially Equivalent to a Dividend' Exception Still Viable Despite Davis*, 41 *J. Tax'n* 78 (1974).

[516] *See, e.g.*, PLR 200741015, PLR 199901024.

[517] 395 F.2d 430 (4th Cir. 1968).

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though *Davis* involved preferred stock, the Supreme Court prescribed a test of apparent general application under §302(b)(1).

D. Redemption that Fails § 302(b)(2) or §302(b)(3)

Section 302(b)(6) states, in part:

> In determining whether a redemption meets the requirements of [Section 302(b)(1)], the fact that such redemption fails to meet the requirements of [Section 302(b)(2), (3), or (4)] shall not be taken into account.

It is not clear whether an exchange which narrowly misses qualifying under §302(b)(2) can still qualify under §302(b)(1), or whether, as some commentators suggest, the "integrity" of the safe haven rule would be undermined by such a result.[518] Thus, for example, it might be argued that if a reduction in a sole shareholder's ownership to less than 66 2/3% but more than 50% can qualify under §302(b)(1) based on the theory of the *Wright* case, discussed below, this dilutes the significance of §302(b)(2)(B) which requires a reduction to less than 50% of all voting stock. On the other hand, the (b)(2) tests offer certainty while (b)(1) is uncertain, at least without an advance private ruling. This is a two-sided interpretative issue not easy to resolve. There are two statutory safe havens alongside a generalized test.

One might reason that narrowly missing §302(b)(2) should produce dividend equivalence because that is the only way to give the safe havens any significance. Under this approach, §302(b)(1) could be satisfied only where the transaction misses qualifying by a wide mark but there are other special circumstances which seem to distinguish it from a true dividend situation. The other point of view is that the IRS and the courts should be more willing to find nondividend equivalence where the reduction barely misses the percentages specified in §302(b)(2), because the latter is a legislative benchmark of a reduction which is not equivalent to a dividend.

In *Davis*, the Supreme Court did not express any opinion on this question, except that in discussing the role of §318 constructive ownership, the majority specifically rejected the contention that a redemption can automatically qualify under §302(b)(1) if it fails to satisfy (b)(2) or (3) solely because of the attribution rules. The Court said that this would "nullify" (b)(2) and (3). *Davis* thus seems at least to leave the door open to qualifying a transaction under (b)(1) even though it barely misses satisfying the 80 or 50% tests of (b)(2). On this point, *Davis* seems only to have said that if the reason that the exchange failed (b)(2) or (3) is attribution, the exchange must still run the (b)(1) gauntlet; it cannot automatically qualify under (b)(1) but it also does not automatically fail (b)(1). Whether or not the attribution rules themselves must always be applied under (b)(1) is a separate issue discussed at VI.I., below.

Note: The Government's brief in *Davis* contains this statement:

> We do not mean to suggest that dividend equivalence results only when there is no reduction whatever in the shareholder's proportionate interest. Such equivalence may exist when there is a reduction that is not of sufficient magnitude to be substantially disproportionate under §302(b)(2). See *Berenbaum v. Commissioner*, 369 F.2d 337, 341 (C.A. 10th Cir. 1966).[519]

The regulations contain only one illustration of the above portion of §302(b)(6). If a shareholder owns only nonvoting stock that is not §306 stock and is limited and preferred as to dividends and in liquidation, and half such stock is redeemed, the distribution will "ordinarily" satisfy §302(b)(1) even though it will not satisfy §302(b)(2) or (3).[520]

In rulings since *Davis*, the IRS has plainly taken the position that a narrow miss under (b)(2) or a failure to terminate a stock interest completely, even if caused solely by the attribution rules, will be neutral vis-à-vis testing the redemption under §302(b)(1). The IRS has not cited failure to satisfy (b)(2) as a reason for finding dividend equivalence and has not given a narrow miss under (b)(2) as a reason for allowing exchange treatment under (b)(1).[521]

It would be hazardous to conclude that a narrow miss under §302(b)(2) will, or should, guarantee exchange treatment under (b)(1), because the court decisions do not support such a view.[522]

It is clear that a shareholder who relies on waiver of family attribution in order to qualify under §302(b)(3), but who subsequently reacquires a prohibited interest in the company so as to violate §302(c)(2), can still argue for exchange treatment under §302(b)(1).[523]

Observation: If a transaction would likely fail to qualify under §302(b)(1), but literally satisfies §302(b)(2), the IRS might try to argue that (b)(2) has not been satisfied in light of the "reality" of control over company policy. For an argument that veto power over corporate decisions by a less than 50% shareholder should be deemed equivalent to at least 50% of voting power for purposes of §302(b)(2), see V.D., above.

E. Applying §302(b)(1) Shareholder-by-Shareholder

1. In General

Although the Supreme Court in *Davis* did not pass on a series of simultaneous redemptions from many shareholders, it seems a fair inference that each shareholder's exchange must now be separately tested under §302(b)(1), and that taxpayers cannot rely on the fact that the distributions are overall non-pro

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[518] *See, e.g., Note, Relevance of 'Business Purpose' in Establishing Dividend Equivalence Under Section 302(b)(1)*, 84 *Harv. L. Rev.* 234, 241 (1970).

[519] *U.S. v. Davis*, 397 U.S. 301 (1970). Brief for the U.S. at p. 7, n.7.

[520] Reg. §1.302-2(a).

[521] *See* Rev. Rul. 77-218 (reduction from 60% to 55%; held dividend equivalent); Rev. Rul. 76-385 (reduction from .0001118% to .0001081% fails 80% test of §302(b)(2) but still meets (b)(1)); Rev. Rul. 76-364 (reduction from 27 to 22.27% narrowly misses (b)(2) but meets (b)(1)); Rev. Rul. 75-512 (reduction from 30 to 24.3% doesn't qualify under (b)(2) but qualifies under (b)(1); Rev. Rul. 75-502 (reduction from 57 to 50% fails 50% test of §302(b)(2) but still satisfies (b)(1)). PLR 9709043 (reduction from 83.6% to 76.1% in nonvoting preferred stock; held dividend equivalent). Before *Davis*, see Rev. Rul. 56-183 (reduction from 11 to 9% fails (b)(2) but meets (b)(1)).

[522] *See, e.g., Bloch v. U.S.*, 261 F. Supp. 597 (S.D. Tex. 1966), aff'd per curiam, 386 F.2d 839 (5th Cir. 1967) (reduction from 58.75% to 47.5% narrowly misses §302(b)(2) yet held dividend equivalent). *See* "Redemptions from Minority Shareholders and Section 302(b)(1)," 77-1 *Tax Mgmt. Memo.* 7 (Jan. 3, 1977).

[523] *See Lewis v. Commissioner*, 47 T.C. 129 (1966).

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rata as among all shareholders.[524] Even though the term "dividend" implies equal treatment of all shareholders, it appears to be settled that where a corporation redeems stock from several shareholders at the same time, each exchange is tested under §302(b)(1) on a shareholder-by-shareholder basis and a redemption can be dividend equivalent as to some shareholders while other shareholders receive exchange treatment.

Before *Davis*, some authorities held that the fact that a redemption distribution was "non-pro rata" as among all shareholders of the company supported a conclusion that each participant's exchange was not essentially equivalent to a dividend.[525] On the other hand, the fact that only one shareholder was redeemed so that the distribution was literally "non-pro rata" as among all shareholders has not prevented the courts or the IRS from treating the exchange as equivalent to a dividend.[526] Reg. §1.302-2(b)(1) states that "[a]ll distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding."

2. *The Pro Rata Concept*

The question arises as to just what is meant by a "pro rata" or "non-pro rata" distribution. In common usage in connection with redemptions, it is sometimes not clear whether these terms are used with reference to the overall nature of the company's distribution as among all shareholders or whether they are used to refer simply to the change or lack of change in a particular shareholder's percentage ownership before and after the transaction.

The simplest (and probably preferable) usage is to use "pro rata" to refer to a redemption of the same percentage of each and every shareholder's stock. Thus, if A, B, C, and D own 40, 30, 20, and 10 shares, respectively of 100 outstanding shares and if the company redeems 10% of each owner's shares, it will repurchase four shares from A, three from B, two from C, and one from D. Afterward the ownership percentages of the remaining shares will remain the same as they were before the transaction. This is a true "pro rata" distribution. If the company had bought different percentages of each owner's shares, the distribution would have been "non-pro rata" as among all the owners.

Certainly under *Davis* (and under case law before that decision) each exchange in a completely pro rata distribution would be taxable under §301.[527] Under this narrow definition of pro rata, it is then necessary to add that the mere fact that a redemption is non-pro rata as among all shareholders does not guarantee exchange treatment under §302(b)(1) for all those from whom shares were redeemed.

In actual tax usage, the terms "pro rata" and "non-pro rata" have also been used to refer to the presence or absence of change in a given shareholder's percentage ownership before and after a redemption, regardless of whether shares have also been redeemed from any other owner and *regardless* of whether the percentage interests of other shareholders from whom shares have been redeemed have gone up or down. If the company redeems stock from several shareholders at the same time, fewer than all other shareholders may also surrender stock. Also, all or less than all other shareholders may surrender differing percentages of their respective holdings. Yet a given shareholder's percentage interest may remain unchanged without regard to §318, by reason of the aggregate reduction in total outstanding stock. It is common to say that "as to" that shareholder, the distribution is pro rata.

> *Example:* Shareholders A, B, C, and D own, respectively, 100, 200, 300, and 400 shares of the total outstanding 1,000 shares of a corporation. If the corporation simultaneously redeems 25, 50, and 175 shares from A, B, and D, respectively, and none from C, B will own a 20% interest before (200/1,000) and after (150/750) all the redemptions. "As to" B, the distribution is pro rata. As to A, it is pro rata because A's interest remains 10%. As to D, it is non-pro rata because D's interest decreases from 40 to 30%.

It would probably help tax vocabulary if *Davis* had the effect of eliminating use of the terms "pro rata" and "non-pro rata" to refer to the presence or absence of reduction in a shareholder's percentage interest after a redemption. One might better refer simply to the presence or absence of a meaningful reduction in the particular shareholder's proportionate interest.

Note: A good example of the confusion, and strange results, which can sometimes result from the use of "pro rata" and "non-pro rata," appeared in *U.S. v. Carey*.[528] Individuals A and B each owned 300 shares of the sole class of stock, i.e., 50% each. B wanted to withdraw completely and sell B's interest to key employee, C. A wanted to keep majority control. C could not afford to pay for the full block of B's shares. To acommodate all these factors, the company first redeemed 145 shares each from A and B. B then sold two of B's remaining 155 shares to A and 153 to C at a price that reflected the prior reduction in per-share value. A became the 51% owner and C a 49% owner. The court held that B's redemption qualified under §302(b)(3) as a termination of interest but also that A's redemption was not essentially equivalent to a dividend. "If

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[524] For examples of pre-*Davis* cases that did examine distributions among all shareholders, see *U.S. v. Carey*, 289 F.2d 531 (8th Cir. 1961) (determining that the whole transaction among multiple shareholders resulted in exchange treatment under §302(b)(1)); *Bains v. U.S.*, 289 F.2d 644 (Ct. Cl. 1961) (determining that a redemption, viewed as a whole, among multiple shareholders was not a reduction essentially equivalent to a dividend). *But see Ballenger v. U.S.*, 301 F.2d 192, 197, n.10 (4th Cir. 1962) (*Carey* and *Bains* "broader plan" analysis criticized).

[525] Rev. Rul. 68-547; Rev. Rul. 56-485. All of these revenue rulings were declared obsolete by Rev. Rul. 80-367.

[526] *See* Rev. Rul. 57-353 ("A tax advantage to the shareholders need not be pro rata to common shareholders, particularly in closely held corporations, for it to characterize a distribution of earnings by means of stock retirement as essentially equivalent to a dividend for tax purposes."); Rev. Rul. 56-182.

[527] The IRS ruled that a partial redemption of a minority shareholder's interest in a publicly traded corporation, pursuant to a tender offer, does not qualify as an exchange under §302(a) and (b)(1) when the pro rata interest of the particular shareholder is not reduced. According to the IRS, the circumstances presented failed to satisfy the meaningful reduction standard enunciated in *Davis* because the redemption did not result in a reduction of the shareholder's right to vote, participate in current earnings and accumulated surplus, or share in the corporation's net earnings upon liquidation. Rev. Rul. 81-289. *See also* GCM 38357 (Apr. 4, 1980) (discusses ruling result originally proposed under Rev. Rul. 81-289, which was opposite of conclusion eventually reached in ruling).

[528] 289 F.2d 531 (8th Cir. 1961).

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there was no pro rata distribution to Brown [B]," the court said, "there could be no pro rata distribution as to Carey [A]." The Eighth Circuit pointed out that the relation of the shareholders to the corporation was materially changed since B was eliminated and a new co-owner had come in, and A had become the majority owner. These results were unlike the result of an ordinary dividend.

Today, the proper analysis of this situation would be that A would receive dividend treatment because there was no meaningful reduction in A's interest in the company. In fact, there was an increase in A's proportionate interest.

A company may redeem a uniform percentage of the stock owned by fewer than all shareholders, but the net result may still be to reduce the percentage interest of some or all of those shareholders. As to such shareholders, their redemption is non-pro rata. For example, when a publicly held company makes a formal redemption offer to its own shareholders it often reserves discretion to accept or reject shares tendered in excess of the total number for which the offer is made. Sometimes the company says that if it decides to accept more shares than the total tendered, it will accept all tendered shares on a "pro rata" basis. This means that the company will redeem from each tendering shareholder a number of tendered shares in proportion to the ratio between the total number to be accepted and the total number of shares tendered.

Example: A corporation has 100,000 shares outstanding. It offers to redeem a total of 10,000 shares, but if more than that number are tendered, it may accept the excess or any part, and will do so "pro rata." Shareholders A, B, C, and D, who represent less than all the shareholders and who own 12,000, 8,000, 7,000, and 5,000 shares, respectively, tender a total of 15,000 shares as follows: A, 6,000 shares; B, 4,000 shares; C, 3,500 shares; and D, 1,500 shares.

If the corporation elects to accept 13,000 shares in total, it will accept 13/15 of each tender as follows:

From	Shares Accepted
A	5,200
B	3,467
C	3,033
D	1,300
	13,000 total

Each shareholder has 86.7% of its tender redeemed. Although each shareholder has the same percentage of its tendered shares redeemed, each shareholder still may not end up with an unchanged percentage interest because fewer than all the shareholders had stock redeemed, and not all who tendered did so in the same proportions.

Example: In the preceding example, where the company elects to redeem 13,000 shares, 87,000 shares remain outstanding. The participating shareholders' percentage interests are reduced as follows:

	Percentage Interest:	
	Before	After
A	12%	7.8%
B	8%	5.2%
C	7%	4.6%
D	5%	4.0%

Regardless of whether all shareholders have a uniform percentage of their holdings repurchased or whether shares are redeemed from some, but less than all shareholders, the best way to avoid confusion is to test each redeeming shareholder separately under §302(b)(1) and to inquire whether there has been a meaningful reduction in that shareholder's proportionate interest in the company.

If each participating shareholder is tested separately, it should be clear that the distribution by the company may be dividend equivalent as to some shareholders but not as to others, or may be governed by §302(b)(1) as to some shareholders but by §302(b)(2) or (3) as to other shareholders.[529]

Note: See, however, Rev. Rul. 74-515, in which the IRS ruled that a reorganization distribution of "boot" qualified for exchange treatment under §356 in light of "principles" of §302. Cash received in a merger for preferred stock of the acquired company was held not to have the effect of a dividend as to persons who had owned both common and preferred stock of the acquired company, because this group of shareholders had owned less than 10% of each class of stock, the cash distribution was disproportionate, and it bore no relation to the common stockholdings of all shareholders of the acquired company. The ruling makes no attempt to discuss the possible effect of constructive ownership rules on the tax treatment of any of the shareholders.

It is not clear that the approach reflected in this ruling can be taken as showing a general willingness by the IRS to depart from a shareholder-by-shareholder test under §302(b)(1) directly.

In summary, after *Davis*, the courts, the IRS and some commentators seem to agree that the fact that a redemption distribution is non-pro rata as among all shareholders will not necessarily mean that, for that reason, a particular redemption is entitled to exchange treatment. On the other hand, the fact that exchanges are pro rata "as to" other shareholders, i.e., leaving some of their percentage interest unchanged, does not mean that another shareholder whose interest is reduced cannot receive capital gain treatment.

It should be noted that:

[529] For pre-*Davis* cases on this point, see *U.S. v. Carey*, 289 F.2d 531 (8th Cir. 1961); *Phelps v. Commissioner*, 247 F.2d 156 (9th Cir. 1957).

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(1) An individual redemption can be dividend equivalent even if other shareholders receive exchange treatment under §302(b).[530]

(2) A given redemption exchange can still be found to be dividend equivalent, in light of the application of attribution rules or in light of the degree of reduction in the particular shareholder's interest in the corporation, even if stock is not simultaneously redeemed from all other shareholders or if unequal percentages of the shareholders' respective holdings are redeemed.

(3) Where several shareholders are redeemed simultaneously, the effect of each separate redemption will be determined in light of all other exchanges under the same plan.

F. Single Class of Voting Common Outstanding

1. Overview

a. Factual Inquiry

After *Davis*, the characteristics of the redeemed stock must be carefully examined and compared with the rights of other classes in determining how "meaningful" a reduction occurs in the shareholder's "proportionate interest."

Common stock represents the residual interest in earnings and assets of a corporation. Where only a single class of common stock is outstanding, the principal attributes of stock ownership — the right to vote, the right to share in current and future earnings, and the right to share in corporate assets on liquidation — are combined. Reducing the quantity of common stock outstanding automatically reduces each of these attributes in equal measure. Where a corporation has only one class of stock outstanding — voting common — the IRS and the courts have regarded a reduction in the quantity of shares owned as an accurate gauge of the reduction in the shareholder's total "interest" in the business.

However, there are innumerable ways in which common stock can create problems in applying the *Davis* criterion. Different classes of common stock may be created, carrying voting and other rights disproportionate to dividend rights. Common stock may coexist with "participating" preferred stock. One class of common stock may be nonvoting while another class has voting rights. In one case,[531] all the voting power resided in the preferred stock; all of the outstanding common was nonvoting. The courts and the IRS have thus felt required to make a detailed factual inquiry into the rights and attributes of common stock in relation to the rights of other stock, and in relation to the corporate rights retained by other shareholders, in applying the *Davis* criterion.[532]

[530] *Coates Trust v. Commissioner*, 480 F.2d 468 (9th Cir. 1973), aff'g 55 T.C. 501 (1970), cert. denied, 414 U.S. 1045; *U.S. v. Carey*, 289 F.2d 531 (8th Cir. 1961); *Phelps v. Commissioner*, 247 F.2d 156 (9th Cir. 1957); *Boyle v. Commissioner*, 187 F.2d 557 (3d Cir. 1951), cert. denied, 342 U.S. 817 (1951); *Tiffany v. Commissioner*, 16 T.C. 1443 (1951), *acq.*, 1957-2 C.B. 5; Rev. Rul. 57-353; Rev. Rul. 56-521; PLR 9607003.

[531] *Benjamin v. Commissioner*, 66 T.C. 1084 (1976), aff'd, 592 F.2d 1259 (5th Cir. 1979).

[532] *See, e.g., Cornwall v. Commissioner*, 48 T. C. 736 (1967), *acq.*, 1968-2 C.B. 2; Rev. Rul. 70-199.

b. What Is Meaningful?

Saying that a detailed factual inquiry must be made leaves questions as to (1) what specific criteria determine whether a reduction in interest is "meaningful," and (2) how much of a reduction will be "meaningful?" In the cases and rulings since *Davis*, one finds discussion of two basic concepts: the "before" and "after" voting power held by the redeemed shareholder and that shareholder's before and after "economic" interest in earnings (through dividends) or assets (upon liquidation). These two criteria, however, are different aspects of one basic focal point: the interest in corporate equity represented by the stock redeemed.

If a shareholder owns 100% of the sole class of stock of a corporation and surrenders 20% of its shares for cash, the effect is completely equivalent to an ordinary dividend, because the shareholder continues to own 100% of the company's remaining equity. This is the same effect that occurs when an ordinary dividend is paid without any surrender of shares. What matters is not the number of shares surrendered, but instead, the effect of the exchange on the shareholder's continuing interest in the equity represented by the shares redeemed.[533]

(1) Resemblance to Sale to Outsider

The following example illustrates the differing effects a sale of shares to a third party and a redemption have on a shareholder's continuing interest in a corporation.

Example: A closely held corporation has two owners and 100 shares outstanding. A owns 80 shares and B owns 20 shares. The company will redeem 10% of its total equity for cash.

Case 1. The company redeems 10 shares from B. As a result, B's percentage interest declines from 20% to 11.1% (10/90). Although B surrendered a claim on 10% of the company's equity, B's percentage interest in the company has been reduced by only 8.9 percentage points. This means that B's remaining shares include a claim on 1.1 percentage points of the 10 points of equity surrendered. B's remaining shares, in effect, recoup part of the equity redeemed — 11%, to be exact (1.1/10). In the transaction, B has lost 89% (8.92/10) of the claim on the 10% of the company's equity represented by the shares redeemed.

If, instead of exchanging the 10 shares with the issuing company, B had sold the same shares to an unrelated new investor, B's percentage interest would have been reduced to 10% (10/100). Because, via the redemption, B's percentage interest was reduced to 11.1%, a comparison of the effects of the redemption with the effects of a sale to a third party shows that 1.1 of the 10 points of equity redeemed is equivalent to an ordinary dividend. The remaining 8.9 percentage points or the equity redeemed resembles the effects of a sale to outsiders and, arguably, is a meaningful reduction in B's interest in the company.

[533] *See* CCA 201052012 (shareholders who, despite redemption, preserved their investments and arguably gained additional interest, by acquiring control of new LLC, did not experience meaningful reduction).

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Under this approach, 11% of the total distribution would be taxable under §301 and 89% would be entitled to capital gain treatment.

Case 2. The same company redeems 10 shares from A. A's percentage interest will decline from 80 to 77.8% (70/90). Although A (like B) will have surrendered a right to 10% of the company's equity, A's percentage interest is reduced by only 2.2 percentage points. A's remaining shares therefore "recoup" 7.8 percentage points of the 10 points of equity redeemed. If A had sold 10 of his shares to an outsider, A's ownership percentage would become 70% (70/100). As the redemption route leaves A with 77.8%, 7.8 points of the 10-point equity redeemed is equivalent to an ordinary dividend and 2.2 points resembles a sale and should get capital gain treatment. (Thus, 78% of the distribution would be governed by §301 and 22% by §302(a)).

The cases and rulings have not, of course, adopted the fragmentation approach suggested by the above example. However, this example may help rationalize why the courts and the IRS attach significance under §302(b)(1) to voting power, control over corporate policy, and interest in earnings and assets. As indicated in the detailed discussion below, the authorities generally focus on whether an over-50% shareholder's percentage ownership stays above 50% after the redemption or drops below 50%. Fifty percent stock ownership also seems to be a generally accepted dividing line for distinguishing a controlling shareholder from a noncontrolling shareholder. The cases and rulings have generally held that a shareholder who controls the corporation before and after a redemption cannot satisfy §302(b)(1), while a controlling shareholder who loses control in the redemption, or a noncontrolling shareholder, can qualify under §302(b)(1) on the basis of a much lesser reduction in percentage interest. It seems fairly safe to conclude that, under *Davis*, the courts and the IRS would treat the redemption in Case 1 above as a meaningful reduction, largely because B owned less than 50% of the stock to begin with. Case 2 would be treated as a §301 distribution because A "controlled" the company beforehand and continued to control it by a wide margin afterward.

Depending on whether the redeemed shareholder owns more or less than 50% of the remaining stock after the redemption, he will in most cases give up less than 50% or more than 50%, respectively, of the equity represented by the shares redeemed. Note that, in Case 1, B gave up 89% of the equity represented by the redeemed shares. In Case 2, A lost only 22% of the equity claimed by the shares redeemed from him.

Note: In the above example, if the company had redeemed 61 shares from A, A's percentage interest would have been reduced to 49% (19/39). The likelihood is that all courts and the IRS would view this reduction as qualifying under §302(b)(1). (This reduction would separately qualify, of course, under §302(b)(2)).

If the transaction is analyzed under the fragmentation approach, the same result seems justified because the shareholder will have permanently lost over half the equity on which the surrendered shares had a claim. Although A surrendered a claim on 61% of the equity, A's percentage interest would drop by only 31 points. This indicates that A's remaining shares recoup, in effect, 30 percentage points of the equity that previously flowed to the redeemed shares (61-31). The 31 points of equity lost is 50.8% of the 61 points of equity redeemed.

Observation: It may be that by using a 50% dividing line under §302(b)(1), the courts and the IRS are, in effect, adopting an all-or-nothing approach to the amount of equity the shareholder gives up when the shareholder surrenders shares. That is, if the shareholder gives up more than 50% of that equity, the redemption qualifies in toto under §302(b)(1); if the shareholder gives up less than 50%, §302 will apply to the whole amount received.

(2) Voting Power

Why do the authorities stress the effect on voting power as a factor under §302(b)(1)? In *Davis*, the Supreme Court described an ordinary dividend as not changing in any way "the relative economic interests or rights of the stockholders," and if a redemption has the same effect, it is equivalent to a dividend. However, voting power may be unaffected by either a straight sale or an ordinary dividend. This is less true with common stock but, in the case of preferred stock, the cases to date indicate that if a shareholder who owns nonvoting preferred stock and over 50% of the voting common has some of its preferred redeemed, the exchange will not qualify for exchange treatment (see discussion of preferred stock, below). If the same shareholder received a dividend on the preferred stock, the shareholder's voting power would be unchanged. Yet if the same shareholder had sold the same preferred to an outsider, the shareholder would receive capital gain treatment (entirely outside §302) and the shareholder's voting power would also be unchanged. Thus, voting power may not be a factor in comparing a dividend with a sale, or in determining whether a redemption of preferred stock is more like a sale or an ordinary dividend. But in the case of both common and preferred stocks, voting power may serve another function. It may bear on the economic effect of the transaction.

In most closely held companies, voting power bears directly on the ability to declare current dividends or to obtain accumulated earnings on liquidation. If an individual (or family) controls the company after a redemption, the individual can recover through salaries or special transactions between the individual and the company the economic loss given up in a redemption. Therefore, even though a redemption reduces a controlling shareholder's interest by 10, 20, 30 or more percentage points, if the individual still "controls" company policy afterward (whether control is defined as over 50% or by some other figure), the equity redeemed may not have been given up permanently. This relation to ultimate economic effect may be the reason that retention of voting control has been a significant factor in testing an exchange for its resemblance to an ordinary dividend.

2. 100% Shareholder

a. Authorities Since Davis: Summary

The authorities since *Davis* dealing with shareholders owning (or considered to own) all the sole class of stock before and after the redemption can be summarized as follows:

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One Class of Voting Common Stock Outstanding Common Stock Redeemed	Reduction in Percentage Ownership (Actual and Constructive)
Equivalent to a Dividend	
Rev. Rul. 75-174, *obsoleted by* Rev. Rul. 2003-99 (ruling based on former §963)	100% before and after
Rev. Rul. 72-569	100% to 85%
Rev. Rul. 72-57, *modified by* Rev. Rul. 78-351	100% before and after
Rev. Rul. 71-563	100% before and after
Rev. Rul. 71-261	100% before and after
Rev. Rul. 70-496, *obsoleted by* Rev. Rul. 2003-99 (ruling based on pre-1997 Act §304)	100% before and after
Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972), aff'g and rev'g in part 55 T.C. 441 (1970), supp. opin., 56 T.C. 763 (1971)	100% before and after
Runnels Est. v. Commissioner, 54 T.C. 762 (1970)	100% before and after
Johnson v. U.S., 434 F.2d 340 (8th Cir. 1970)	100% before and after
Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir. 1973), aff'g 55 T.C. 501 (1970)	100% before and after
Metzger Trust v. Commissioner, 76 T.C. 42 (1981), aff'd, 693 F.2d 459 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983)	100% before and after
Cerone v. Commissioner, 87 T.C. 1 (1986)	100% before and after
Combrink v. Commissioner, 116 T.C. 296 (2001), withdrawn and reinstated, 117 T.C. 82 (2001)	100% before and after
Exchange Treatment	
NONE.	

b. Discussion

Davis has been generally interpreted as requiring any redemption to be treated as equivalent to a dividend where a single shareholder owns all the stock of a corporation (actually and constructively) both before and after a redemption. The business reasons for such a transaction, no matter how sound or required by circumstances or free of a subjective tax avoidance motive, cannot be considered in measuring the economic effect on the shareholder.

Cases and rulings since *Davis* have accepted this proposition. In such situations, the shareholder cannot qualify under §302(b)(3), of course, because a surrender of all of the stock would constitute a liquidation of the company. The disproportionate redemption test of §302(b)(2) also cannot be satisfied because a sole shareholder will necessarily own 100% of the voting power after the transaction.

Even though a shareholder does not in fact own all the shares of the sole class of stock, the shareholder will be treated as the sole shareholder if the other owner's shares are attributed to the shareholder before and after the redemption pursuant to §318. For a discussion of the possibility of escaping such attribution, at least in the case of "bad blood" among family members, see VI.I., below.

Rev. Rul. 72-57[534] applies the sole shareholder rule to a parent corporation that, as part of a recapitalization of a subsidiary designed to squeeze out minority shareholders of the subsidiary, surrendered its old common stock for new common plus cash to round out fractional shares. The ruling treats the receipt of cash for the fractional share interests as a redemption to be tested under §302. Because the parent owned all of the subsidiary's stock after the transaction, the cash it received was held to be a §301 distribution. (Note that under §243 the parent is entitled to a 100% dividend received deduction for receipt of a §301 distribution.)

In Rev. Rul. 71-261, the IRS treated a decedent's estate as a sole shareholder where all of the estate's stock (received from the decedent) was redeemed and, by attribution from the widow and children who were beneficiaries of the estate, the estate constructively owned all the stock before and after the transaction. A dividend result in this type of situation has been criticized,[535] but dissatisfaction with the result seems traceable more to constructive ownership in this kind of case than to redemption criteria as such.

Note that a shareholder who in fact owns all the sole class of stock before a redemption may not in all cases be treated as the sole owner, actually or constructively, after the redemption. The special situation where this may occur is a §304(a)(1) transaction. Under that provision, if the same shareholder controls two "brother-sister" corporations (actually or constructively), and if the shareholder sells some or all of the shareholder's stock in one company to the other, the transaction will be treated as a redemption tested by the shareholder's before and after interest in the company whose stock was sold. Relevant authorities under this provision are discussed in 768 T.M., *Stock Sales Subject to Section 304.*

Illustrating that an actual sole owner may experience a percentage interest reduction in a §304(a)(1) transaction, Rev. Rul. 73-2[536] considered a situation where individual A owned

[534] Rev. Rul. 72-57 is *modified by* Rev. Rul. 78-351.

[535] Swennes, *'Not Essentially Equivalent to a Dividend' Exception Still Viable Despite Davis*, 41 *J. Tax'n* 78, 79 (1974).

[536] Note, however, that by declaring Rev. Rul. 73-2 obsolete in Rev. Rul. 95-71, the IRS implicitly acknowledged the changes wrought by the enactment, under the 1982 TEFRA, Pub. L. No. 97-248, §226(a)(1)(A), of §304(b)(3), which provides that §304, and not §351, governs transactions that qualify under both sections.

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all the stock of corporation Y and 30 of 50 outstanding shares of corporation X. The other owners of X were unrelated to A. A sold all of A's stock in Y to X for additional stock in X plus cash. The additional stock increased A's ownership of X to 81%. The ruling held that the cash received was governed by §304(a)(1) and had to be tested as though X had redeemed some of its own stock from A. However, under §304, the effect of this "deemed" redemption is measured by the shareholder's before and after percentage ownership in the selling company (Y).

After the sale, X actually owned all the stock of Y and, by attribution,[537] A owned 81% of X's ownership of Y. Therefore, A's ownership of the company whose stock was sold decreased from 100% to 81% (even though in fact A actually owned no stock in Y after the transaction). Although a reduction occurred, the IRS ruled that the amount of the reduction was not meaningful within the *Davis* test, so that the cash received by A was taxable under §301.

In another §304(a)(1) ruling, Rev. Rul. 72-569, a shareholder who owned all the stock of one company (sister) and 85% of the sole class of stock of another company (brother) sold all of the sister stock to brother for cash. The other owners of the buying company were unrelated to the selling shareholder. The shareholder's ownership of sister company changed from 100% (actual) before to 85% (constructive), via §318(a)(2)(C) after. The IRS held that no meaningful reduction in interest occurred, citing Rev. Rul. 56-182, in which a majority shareholder's reduction from 81 to 66 2/3% was held dividend equivalent on the ground that the shareholder still owned more than a majority of the stock so that no appreciable change occurred in the relative status of the majority and minority owners.

3. Majority Shareholder

a. Authorities Since Davis: Summary

Only One Class of Voting Common Stock Outstanding-Common Stock Redeemed	Reduction in Percentage Ownership (Actual and Constructive)
Equivalent to a Dividend	
Rev. Rul. 78-401	90% to 60%
Paparo v. Commissioner, 71 T.C. 692 (1979) (two shareholders)	78% to 81%
	78% to 74%
Rev. Rul. 77-218	60% to 55%
Rev. Rul. 75-502	57% to over 50%
Niedermeyer v. Commissioner, 62 T.C. 280 (1974), aff'd per curiam, 535 F.2d 500 (9th Cir.), cert. denied, 429 U.S. 1000 (1976)	(dictum) 90% to 83%
Fehrs Finance Co. v. Commissioner, 487 F.2d 184 (8th Cir. 1973), aff'g 58 T.C. 174 (1972)	98.2% to 88.69%
Title Ins. & Trust Co. v. U.S., 484 F.2d 462 (9th Cir. 1973)	70% to 100%
Sawelson v. Commissioner, 61 T.C. 109 (1973)	65.5% to 74.1%
Jones v. U.S., 72-1 USTC ¶9349 (D. N.J. 1972)	98.5% to 96.1%
Leleux v. Commissioner, 54 T.C. 408 (1970)	86% to 84.8%, then 75%, then 53.5%
Vahlsing Christina Corp. v. Commissioner, T.C. Memo 1985-273	93.33% to 89.19%
Exchange Treatment	
Rev. Rul. 75-502	57% to 50%
Rickey v. U.S., 427 F. Supp. 484 (W.D. La. 1976), aff'd on other grounds, 592 F.2d 1251 (5th Cir. 1979)	72% to 58%
Shimberg v. U.S., 415 F. Supp. 832 (D. Fla. 1976)	66% to under 1%
Wright v. U.S., 482 F.2d 600 (8th Cir. 1973)	85% to 61.7%
Patterson Trust v. U.S., 729 F.2d 1089 (6th Cir. 1984)	80% to 62.8%
Voting Common and Nonvoting Common Outstanding:	
Equivalent to a Dividend	
Furr v. Commissioner, 34 T.C.M. 426 (1975) (part of nonvoting common redeemed)	41.2% to 39.5% nonvoting common, unchanged ownership of 72% of voting common
Furr v. Commissioner, 34 T.C.M. 433 (1975) (part of nonvoting common redeemed)	24.19% to 23.5% of nonvoting common, unchanged ownership of 72% of voting common and 49.5% of preferred stock
Exchange Treatment	
NONE.	

b. Retention or Loss of Control

Cases and rulings since *Davis* have continued to emphasize the retention or loss of "control" as the key factor in testing a repurchase of shares from an over 50% owner of the sole class of voting common stock. This control test was a key factor before *Davis* and has continued to be central, with the courts and the IRS now saying that continued ability to control corporate

[537] §318(a)(2)(C).

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activities by a previously "dominant" shareholder does not indicate any meaningful reduction in interest.[538]

Control has generally been defined by reference to more or less than 50% ownership of stock (indicating more or less than 50% of the voting power and right to earnings and assets). In Rev. Rul. 77-218,[539] a testamentary trust sold (for cash) all of its stock in a family corporation to another corporation controlled by the same family. Under §304(a)(1), the transaction was tested as a redemption by the selling company of its own stock. Taking into account actual and constructive stock ownership before and after the transaction, the trust's ownership of the sole class of common stock of the selling company decreased from 60% to 55%. The IRS ruled that this change was not a meaningful reduction in the trust's proportionate interest in the selling company. The redemption was, therefore, essentially equivalent to a dividend. Although the trust owned no actual stock in the selling company after the transaction, the stock attributed to the trust under §318 represented an indirect ownership interest "in excess of 50 percent." The ruling also notes that the stock attributed to the trust after the transaction included stock actually owned by S, the son of the trust's settlor, and by the settlor's widow (who was income beneficiary of the trust). S "manages and controls the affairs" of both companies, the ruling observes, and also served as a co-trustee of the trust.

(1) Pre-Davis Authorities

Before *Davis*, the following common stock cases and rulings found dividend equivalence where the shareholder continued to hold majority control of the corporation:

	Percent of Voting Common Stock Owned Actually and Constructively:	
	Before Redemption	After Redemption
Friend v. U.S., 345 F.2d 761 (1st Cir. 1965)	73%	66%
Phelon v. Commissioner, 25 T.C.M. 1024 (1966)	83%	72%
Humphrey v. Commissioner, 39 T.C. 199 (1962)	67%	55%
Jaffe v. Commissioner, 26 T.C.M. 1110 (1967)	75%	67%
Rev. Rul. 56-182, 1956-1 C.B. 157	81%	66 2/3%
Rev. Rul. 56-103, 1956-1 C.B. 159	75%	66%
Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967)	62.7%	100%
Meyer v. Commissioner, 46 T.C. 65 (1966), aff'd, 383 F.2d 883 (8th Cir. 1967)	85%	81%
Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962)	91.3%	89.7%
Neff v. U.S., 305 F.2d 455 (Ct. Cl. 1962)	90%	56%
Salvatori v. U.S., 66-2 USTC ¶9670 (S.D. Cal. 1966)	74.2%	54.6%
Haserot v. Commissioner, 46 T.C. 864 (1966), aff'd, 399 F.2d 828 (6th Cir. 1968)	96%	91%

Before *Davis*, the following cases allowed exchange treatment where a common shareholder lost 50% or over 50% control in the redemption:

	Percentage of Voting Common Stock Stock Considered Owned:	
	Before Redemption	After Redemption
Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964)	50%	44% & 38%
Squier Est. v. Commissioner, 35 T.C. 950 (1961), *acq.,* 1961-1 C.B. 5	50.09%	41.27%
Parker v. Commissioner, 20 T.C.M. 893 (1961)	50.3%	29%
McDonald v. Commissioner, 52 T.C. 82 (1969)	91%	Small minority interest

(2) Reduction to Exactly 50%

A 50% stock interest may hold "veto power" over corporate action by its ability to block a majority vote of the director-shareholders. Nevertheless, is a reduction from over 50 to exactly 50% meaningful enough? In *Fireoved v. U.S.*,[540] the Third Circuit suggested that a 25.3% common stock interest, representing veto power over corporate action on particular facts, constituted enough control to warrant dividend treatment of a preferred stock redemption. In Rev. Rul. 75-502, the IRS indicated that, in at least some circumstances, it will treat a reduction to exactly 50% of a controlling shareholder's ownership of voting common stock as a "meaningful" reduction which qualifies for exchange treatment under §302(b)(1). Before the re-

[538] *Fehrs Fin. Co. v. Commissioner*, 58 T.C. 174, 185 (1972), aff'd, 487 F.2d 184 (8th Cir. 1973), cert. denied, 416 U.S. 938 (1974). *See also Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), aff'd per curiam, 535 F.2d 500 (9th Cir.), cert. denied, 429 U.S. 1000 (1976).

[539] *See also* TAM 199934001 (taxpayer reduced his voting interest from above 50% to below 50% and the IRS applied the redemption rules by analogy and ruled that the transaction was taxable under §1001).

[540] 462 F.2d 1281 (3d Cir. 1972).

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demption, a close corporation's sole class of stock was owned as follows:

	Voting Common
Estate	250 shares
Individual A (sole beneficiary of Estate)	750 shares
Individual B (unrelated to A within meaning of §318(a)(1))	750 shares
Total	1,750 shares

The corporation redeemed all of the estate's stock for cash. Before this transaction, the estate owned constructively all of A's shares,[541] so that its total ownership interest was 57% (1,000/1,750). Afterward, the estate continued to own A's shares constructively, so that the estate remained constructively a 50% shareholder in the company (750/1500 shares). The ruling notes that stock gives a shareholder the right to vote ("and thereby exercise control"); the right to participate in current earnings and accumulated surplus; and the right to share in net assets on liquidation of the company. The ruling also notes that the redemption reduced from 57 to 50% the estate's interest in the latter two of these rights and also produced a situation where a single unrelated shareholder (B) owned the other 50% of the voting rights. If the estate's stock interest had been reduced by less than 7 percentage points, the ruling adds, the redemption would not qualify under §302(b)(1) because "the estate would continue to have dominant voting rights" in the company.

The IRS was evidently impressed by the veto power inherent in the other remaining shareholder's interest after the redemption. Note that the estate also held a veto power over management decisions after the redemption. The IRS apparently does not consider a change from dominant voting rights to veto power (as a 50% shareholder) as preventing exchange treatment.

It may be significant that the other 50% of the outstanding stock not owned by the estate in Rev. Rul. 75-502 was held by a single shareholder. If ownership of the other 50% had been spread among several unrelated shareholders, it is possible the IRS might view the redeemed shareholder as continuing to hold "dominant" voting rights by reason of the concentration of voting rights in the redeemed shareholder vis-a-vis voting rights diffused among multiple holders of the other 50% block.

(3) Loss of Control While Retaining Over 50% of Stock

The special emphasis placed by *Davis* on a "meaningful" reduction in interest has led to some movement away from a rigid focus on 50% as the dividing line between control and lack of control. The fact that this development has occurred, however, may cut both ways. In *Wright v. U.S.*,[542] the Eighth Circuit held that a reduction in ownership of the sole class of stock from 85% to 61.7% was a meaningful reduction because, although the shareholder could still control routine company decisions, he could no longer act alone to amend the articles of incorporation, sell all the assets, or merge or liquidate the company. Under state corporate law, a two-thirds vote was required for these major actions, and, after the redemption, the shareholder had to obtain consent from at least some of the other shareholders in order to do any of these things. The *Wright* decision has led at least some commentators to see a possible breakthrough to a concept that if there are certain "significant corporate acts" that the redeemed shareholder can no longer direct alone, such as merging, liquidating, or amending the articles, a "meaningful" reduction has occurred even though the shareholder continues to own a majority of the outstanding stock.[543]

The IRS has refused to accept the *Wright*-type analysis, however, and has focused the test instead on who controls the "day to day affairs" of the company.[544]

On the other hand, if there is a possible opening for this kind of detailed analysis, the courts and the IRS can be expected to look closely at the "reality" of control exercised by an under 50% shareholder. This could mean that the mere fact that a redemption reduces a shareholder's percentage ownership from above 50% to below 50% will not in all cases assure exchange treatment under §302(b)(1).

(4) The Wright Case

The redemption issue arose in *Wright*[545] in the setting of a reorganization with boot tested under §354 and §356. This was the first court decision after *Davis* that, without regard to business purpose, allowed capital gain on a redemption that left the shareholder owning over 50% of the remaining outstanding common stock. Wright, his family, and his business colleagues owned stock in two corporations as follows:

	F&G Corp.		World Wide Corp.	
	Shares	%	Shares	%
Wright	238	99.2	603	56
His wife	1	0.4	—	—
His mother	—	—	150	14
His attorney (unrelated)	1	0.4	1	.0009
Dunn (unrelated)	—	—	323	30
Total	240	100.0	1077	100.0

F&G and World Wide were consolidated into a new corporation, Omni, in which Wright received stock plus a

[541] §318(a)(3)(A).

[542] 482 F.2d 600 (8th Cir. 1973).

[543] Jacobson, *Corporate Distributions: Not Essentially Equivalent to a Dividend; Assignment of Income and Other Problems*, 33 *N.Y.U. Tax Inst.* 1007, 1016 (1975). *But see* Zinn & Silverman, *Redemptions of Stock Under Section 302(b)(1)*, 32 *Tax Law.* 91, 97 (1978).

[544] Rev. Rul. 78-401.

[545] *Wright v. U.S.*, 482 F.2d 600 (8th Cir. 1973). See also *Patterson Trust v U.S.*, 729 F.2nd 1089 (6th Cir. 1984) and *Conopco, Inc. v. U.S.*, 2007-2 USTC Para. 50,582, 42 EBC 1187 (D.N.J. 2007).

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$102,002 promissory note payable in 10 years with 5% interest. Omni issued its common stock as follows:

	Class "A"	Class "B"	Total Shares	Percentage of Total
Wright	223	1999	2222	61.7
His wife	2	19	21	.6
His mother	33	301	334	9.3
His attorney	2	21	23	.6
Dunn	100	900	1000	27.8
Total	360	3240	3600	100.0

The general issue was whether, under §356, the promissory note also issued to Wright had the effect of a dividend to him.

If Omni had issued solely stock in the consolidation, Wright would have received an 85% interest in Omni. Wright took a note for part of his interest in the combining companies because he and Dunn desired that they end up owning Omni in approximately the same proportions as they owned the stock of a third corporation (Danco) not involved in the consolidation. Wright owned 71.5% of Danco, Dunn 27.9% and Wright's attorney 0.6%.

The Eighth Circuit viewed the transaction as though Wright received all stock in Omni and then surrendered some of that stock for Omni's note in a redemption tested under §302. So viewed, the court found that, apart from family attribution (which the court did not apply since the IRS had not asked the court to do so), Wright's ownership of Omni decreased from 85% to 61.7%. Because under state law a two-thirds vote was required to merge, consolidate, or liquidate the company, or to amend the articles of incorporation, the court indicated that the redemption "created a meaningful change in the voting power of the taxpayer under Arkansas law." Wright's right to dividends and to assets on liquidation also decreased by 23.3 percentage points. The court also stressed the change in Wright's interest in each of the combining companies. His interest in F&G's assets declined from 99.2% to 61.7% and his interest in World Wide's assets increased from 56% to 61.7%, but that increase still did not give Wright sole power to make corporate changes under state law. On these grounds, the Eighth Circuit held that the note distribution was not dividend equivalent under §302(b)(1) and was also not dividend equivalent under §356(a)(2).

Note: The dissent argued that even though the IRS had not argued for attribution, the court should still have tested the transaction in light of family attribution. The dissent also pointed out the majority should have applied family attribution because of Wright and Dunn's admitted objective of having Wright emerge with approximately the same percentage interest as he owned in Danco, i.e., 72%. Wright did receive such an interest in Omni, shared among himself, his wife, and his mother. So viewed, Wright's interest, including his wife and his mother's Omni stock, declined from 85% to 72% (2,577/3,600), "a relatively insignificant change." At the same time, the note received by Wright represented virtually the entire earned surplus of F&G just before the consolidation.

The *Wright* approach persuaded a district court to make a similar analysis as one of the alternative grounds of decision in *Rickey v. U.S.*[546] A redemption there reduced a majority shareholder from 72% to 58%. Although the court principally held that the redemption satisfied §302(b)(2) in light of the overall plan for later redemptions from the same owner, the court also found that the reduction in his interest immediately after the redemption satisfied §302(b)(1). At that point, Rickey owned 58% of the sole class of stock, and, after calling attention to *Wright*, the court noted that Rickey had lost the two-thirds vote needed under Louisiana law to sell assets, merge, liquidate or amend the charter. "Thus, under the principles set out in *Davis* and *Wright*… the redemption resulted in a meaningful reduction of Mr. Rickey's ownership interest and significantly altered his economic interests and rights relative to the other shareholders."

Suppose that a redemption reduces a shareholder's ownership from 81% to exactly 66 2/3% and that, under state law, a two-thirds vote is required for major corporate actions. This amount of reduction occurred in Rev. Rul. 56-182, where the IRS found dividend equivalence by reference to a majority-minority dividing line for control. Although *Wright* moves the dividing line higher in at least some situations, even *Wright* may not protect a case where the redeemed owner still has enough voting power alone to cause major corporate actions.

Note: In developing criteria under §302(b)(1) based on changes in corporate control, the reality of control can be expected to govern.[547] Although not yet tested, it might be argued that a reduction in voting power not amounting to a loss of two-thirds control over the board might still be "meaningful" where the shareholder's right to future earnings is reduced and he must thereafter deal with a large and independent or hostile minority and owes fiduciary duties to the minority.[548]

Where the minority is passive, under the dominating influence of the majority owner, or otherwise unable to act, any reduction in the majority owner's interest, even loss of majority ownership, may be insufficient.[549] On the other hand, if a controlling block of stock passes to an heir who lacks any interest in participating in corporate affairs, and instead allows other shareholders to make all corporate decisions, the heir's "power" of control might be accorded less weight.[550]

Where voting rights are different as between electing the board and all other management matters, the question will arise whether one or another set of rights is more important.

[546] 569 427 F. Supp. 484 (W.D. La. 1976), aff'd on other issues, 592 F.2d 1251 (5th Cir. 1979).

[547] *Haserot v. Commissioner*, 46 T.C. 864, 867 (1966), aff'd, 399 F.2d 828 (6th Cir. 1968).

[548] *Compare Grabowski Trust v. Commissioner*, 58 T.C. 650 (1972) (constructive 80.2% ownership of common stock after redemption supported dividend equivalence despite "not insubstantial" minority interest).

[549] *See Boyle v. Commissioner*, 187 F.2d 557 (3d Cir. 1951), cert. denied, 342 U.S. 817 (1951).

[550] *But see Lammerts Est. v. Commissioner*, 54 T.C. 420, 444 (1970) (redemption of preferred stock from widow who constructively continued to own all the common through her son held dividend equivalent, despite her actual inactive status), aff'd, 456 F.2d 681 (2d Cir. 1972).

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In *Davis*, the Supreme Court said that a redemption which does not "change … the relative economic interests or rights of the stockholders" cannot qualify under §302(b)(1).[551] This disjunctive reference to economic interests "or" rights may indicate that where a corporation has several classes of common stock outstanding with differing voting and dividend rights, control might not necessarily have to be given up if a large enough reduction occurs in the other attributes of the redeemed stock, such as its right to earnings and assets.

(5) Rev. Rul. 78-401

Rev. Rul. 78-401 takes the position, contrary to *Wright*, that in a two-person one class of stock corporation, a reduction in one shareholder's ownership from 90 to 60% is essentially equivalent to a dividend, notwithstanding that the redeemed shareholder, by dropping below two-thirds ownership, lost sole power to liquidate, merge or sell all the assets of the company. On the facts, the ruling notes that no major event such as a liquidation or sale was contemplated. "Although A [the redeemed shareholder] has surrendered the ability to individually control those corporate decisions requiring a 66.67% vote, A has retained control of the day-to-day affairs of X. Since A is in control of the day-to-day affairs of X and because there is no indication that the type of corporate action requiring a 66.67% shareholder vote is imminent, the retention by A of 60% of the voting rights in X becomes a predominant factor in determining whether the redemption results in a meaningful reduction of A's interest in X."

Comment: The IRS's position in this ruling is tenuous at best. It seems that a reduction of the type discussed in Rev. Rul. 78-401 is more "meaningful" than a slight reduction in a minority shareholder's interest, yet the IRS routinely grants §302(b)(1) treatment for the latter.

(6) Other Developments

Where an issuer corporation "goes public" at the same time it redeems some of its stock, a question arises whether the change from closely held to public ownership status, and resulting SEC supervision, will affect the "meaningfulness" of the change in a redeemed shareholder's relationship to the corporation. The Tax Court minimized the significance of this particular factor, however, in *Paparo v. Commissioner*[552] "While admittedly Nashville and Jasper, as wholly owned subsidiaries of a public corporation, are subject to a variety of SEC rules and regulations, this fact alone will not convert the transaction in the instant case from a distribution of property to a distribution in exchange for petitioners' stock."

c. Nonvoting Common Stock

A shareholder who owns both voting and nonvoting common stock, and whose voting stock (either actually or constructively owned, or both) amounts to a majority of the voting stock, will find it extremely difficult to obtain capital gain treatment under §302(b)(1) for a redemption of any of the shareholder's nonvoting common.

In *Don Furr v. Commissioner*,[553] the Tax Court held dividend equivalent a redemption of 16 of 31 nonvoting common shares actually owned by the taxpayer, where (actually and constructively) he owned 72.34% of the voting common stock before and after the redemption, 41.2% of the nonvoting common (actually and constructively) before the redemption, and 39.5% of the nonvoting common (actually and constructively) afterward. The redemption occurred in the setting of §304(a)(1). The Tax Court applied both a voting control test and an economic interest test. The court found that the taxpayer's voting control over the company was unchanged and that the small percentage decrease in his proportionate ownership of nonvoting common also failed to alter his economic interest in the company in a meaningful way.

In *Roy Furr v. Commissioner*,[554] a redemption of 673 of 10,024 nonvoting common shares owned by the taxpayer was held dividend equivalent where the taxpayer's voting control was unchanged, his dividend and liquidation rights in the outstanding preferred stock were unchanged, and his dividend and liquidation rights in the nonvoting common were reduced only to a "small" extent. In this case, the taxpayer owned the following percentage interests in the stock before and after the redemption:

		Before Redemption (Percentage)	
	Directly	Constructively	Total
Preferred	13.4	36.1	49.5
Voting common	2.1	69.8	71.9
Nonvoting common	6.3	17.89	24.19
		After Redemption (Percentage)	
	Directly	Constructively	Total
Preferred	13.4	36.1	49.5
Voting common	2.1	69.8	71.9
Nonvoting common	5.89	17.97	23.86

The court emphasized that the reduction in the net worth of the taxpayer's interest was minimal, i.e., only 0.33% in his ownership of nonvoting common.

d. Special Problems Under §304(a)(1)

To the extent that a §304[555] transaction is treated as a distribution under §301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which §351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued.[556] Thus,

[551] 397 U.S. at 313.
[552] 71 T.C. 692 (1979).

[553] 34 T.C.M. 426 (1975).
[554] 34 T.C.M. 433 (1975).
[555] For a more detailed discussion of §304, see 768 T.M., *Stock Sales Subject to Section 304*.
[556] §304(a)(1).

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the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, if the §304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under §1059.[557]

Comment: Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a withdrawal of earnings from corporate solution. Such concerns are most relevant where the shareholder is an individual. Corporations have different concerns due in part to the presence of the dividends received deduction. A corporation often may prefer a transaction to be characterized as a dividend, as opposed to a sale or exchange. The provisions in §304 are aimed at preventing a corporation from intentionally seeking to apply §304 to a transaction which is in substance a sale or exchange. Corporations that are related for purposes of §304 need not be 80% controlled by a common parent. The separate rules for corporations filing a consolidated return, that would generally reduce basis for untaxed dividends received, do not apply. Furthermore, in some situations where the selling corporation does not in fact own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that inappropriate results would be obtained.

For example, in certain related-party sales the selling corporation may take the position that its basis in any shares of stock it may have retained (or possibly in any shares of the acquiring corporation that it may own) need not be reduced by the amount of its dividends received deduction. This could result in an inappropriate shifting of basis. The result can be artificial reduction of gain or creation of loss on disposition of any such retained shares.

In a §304(a)(1) transaction, it is unclear whether, in testing the redemption under §302, the shareholder's post-"redemption" constructive stock interest under §318(a)(2)(C) in the corporation whose stock was transferred is the only relevant factor, or whether the "reality" of the shareholder's interest in that corporation, as filtered indirectly through the shareholder's stock in the acquiring company, can also be considered.

In applying §302 to a §304(a)(1) transaction, for example, if the issuing corporation has outstanding only a single class of common stock, but the acquiring corporation has a complex multiclass capital structure with voting rights among the classes disproportionate to dividend rights and liquidation rights, the shareholder's interest in the issuing corporation may undergo complex constructive changes.

Example: Individual X owns 100% of the sole outstanding class of capital stock of corporation S. Corporation B has outstanding two classes of common stock, 150 class "A" shares and 100 class "B" shares. Both classes have equal dividend and liquidation rights per share. Class "A" carries one vote per share; class "B" carries two votes per share. The value of each "B" share is determined to be 1 1/2 times greater than each "A" share. X owns all 100 class "B" shares. Unrelated persons own the class "A" shares. X thus owns 40% (100/250) of the equity interest, i.e., dividend and liquidation rights, in corporation B; 57% (200/350) of the total voting power of both classes of stock; and 50% of the total value of both classes of stock.

X sells all of X's S stock to corporation B for cash.

Under §304(a)(1) this transaction is treated as a redemption tested under §302 by reference to X's pre-sale and post-sale interest in S, the company whose stock was sold. After the sale, §318 treats X as constructively owning S stock actually owned by B (under §318(a)(2)(C)). X constructively owns a percentage of the S stock that B owns equal to X's percentage ownership of the total "value" of all the stock of B. It is unclear whether "value" for this purpose means fair market value. It probably does.[558]

If so, the different voting rights, dividend rights, and liquidation rights of B stock must be carefully weighted in arriving at an overall fair market value of the various classes of B stock. If fair market value is the test, X constructively owns 50% of S's outstanding stock after sale. Section 304(b)(1) suspends the 50% minimum value ownership rule that generally must exist before §318(a)(2)(C) is triggered. However, can the reality of X's indirect interest in S as filtered through B be considered — 57% voting control and a 40% equity interest — or are the attributes of X's interest in B relevant only in applying §318(a)(2)(C) to determine the value of X's stock in B and not thereafter in testing X's post-sale interest in S under §302? Under the latter interpretation, because S has only one class of stock outstanding, the S stock constructively owned by X after the redemption would be regarded as representing 50% of the voting power and equity of the S stock. Reg. §1.304-2(a), seventh sentence, seems to support this approach. On the other hand, Congress directed that a "factual inquiry" be made in testing a redemption under §302(b)(1), and one of the relevant circumstances, arguably, is X's actual degree of control or equity in S, even indirectly through B. Query, however, whether this latter approach in effect completely disregards the use of attribution rules to determine X's post-redemption interest in S.

Of course, even if X's actual indirect interest in S can be considered under §302(b)(1), X can still argue that, on the particular facts, the reduction in X's equity interest in S is more significant than the reduction in X's voting interest. On this question, a "facts and circumstances" test probably must still be used. Reducing a shareholder's equity interest to below 50%, for example, along with introducing an independent minority interest in S, might be "meaningful" in some situations, while if the corporation has rarely paid dividends and the shareholders withdraw earnings chiefly through salaries, reducing a shareholder's "equity" interest might not seem very meaningful in those circumstances.

[557] §1059.

[558] *Cf.* Rev. Rul. 69-399 (application of §1239 "more than 80 percent in value" ownership test is not determined solely by the number of shares outstanding).

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4. *Minority Shareholder*

a. *Authorities Since Davis: Summary*

Only One Class of Common Stock Outstanding	Reduction in Percentage Ownership (Actual and Constructive)
Equivalent to a Dividend	
Rodgers P. Johnson Trust v. Commissioner, 71 T.C. 941 (1979)	43.6% to 40.8%
Rev. Rul. 78-60	Eight shareholders redeemed; largest owned 10.8% before redemptions; reductions in each case less than 1 percentage point
Haft Trust v. Commissioner, 61 T.C. 398 (1973), rem'd, 510 F.2d 43 (1st Cir. 1975), supp. opin., 62 T.C. 145 (1974)	31.6% to 33.33%
Exchange Treatment	
Rev. Rul. 76-385	0.0001118% to 0.0001081%
Rev. Rul. 76-364	27% to 22.27%
Rev. Rul. 75-512	30% to 24.3%

b. *Relation to Control*

A partial redemption of voting common stock owned by a shareholder who owns (actually and constructively) less than 50% of the stock is generally more likely to receive capital gain treatment than if he owned more than 50%. The apparent rationale for this result is that the distributee did not dominate the decision-making process of the company and had no power alone to cause the redemption. Influenced by this notion, cases and rulings have generally allowed a smaller reduction in absolute percentage points to qualify under §302(b)(1) where the shareholder owned (at the outset) less than 50% of the sole voting stock. In Rev. Rul. 76-385, the IRS decided the fact situation before it partly by referring to the apparent intent of Congress in enacting §302(b)(1). The ruling says, in part:

> One purpose for the enactment of section 302(b)(1) of the Code was to provide capital gain treatment for redemptions of stock held by certain minority shareholders, especially minority holders of preferred stock who exercise no control over corporate affairs. *See* S. Rep. No. 83-1622, 83rd Cong., (1954).
>
> The redemption in the instant case falls within the category of redemptions Congress intended to exclude from dividend treatment through the enactment of section 302(b)(1) of the Code since the redemption involves a minority shareholder whose relative stock interest in Z is minimal and who exercises no control over the affairs of Z.

Although the IRS's rulings since *Davis* indicate the general trend where minority shareholders are redeemed, there are no specific guidelines as to how much of a reduction is required for the change to be "meaningful." In *Johnson Trust v. Commissioner*,[559] a shareholder's reduction in interest from 43.6% to 40.8% was considered essentially equivalent to a dividend. The mere fact that a minority shareholder's interest in the basic three attributes of stock — voting power, rights to current earnings and rights to assets on liquidation — is reduced does not necessarily satisfy *Davis*. In almost all the rulings since *Davis*, some additional ground for the decision is given, usually relating to the effect on corporate control or the absence of control at the outset. Although the IRS has issued a number of rulings dealing with minority shareholders, it may still be difficult to distill clear principles on which one can rely. Several rulings note that the minority shareholder lacked control beforehand and reduced his economic (dividend and asset) rights. In these cases, exchange treatment is allowed, but it is not clear whether the reduction in economic rights is most important, whether the lack of control is the main factor, or whether any guidelines are being used to decide just how much of a reduction in economic rights make the reduction meaningful. If control is absent at the outset, does any reduction in economic rights suffice? Even if one concludes conservatively that the reduction in economic rights should be sizable in absolute terms (a quantitatively large reduction), the fact that the shareholder is a minority holder might be offset by a contention that he is still part of a group of owners who, working together, control the company. In addition, there might be special provisions in the charter or bylaws which give the shareholder disproportionately large voting or other rights. Also, the "reality" of the situation might be that the other shareholders are passive or simply defer to their largest minority colleague. In cases of this kind, the shareholder might be found to hold a position equivalent to control and this factor alone might offset a sizable reduction in his economic rights.[560]

"Effective" or "working" control may exist in a minority stock position in a large or publicly held corporation by reason of the scattered nature of the other holdings and the power of a unified minority block to elect several directors.[561] As yet, there are no cases or rulings under §302(b)(1) dealing with a minority shareholder who holds effective control.

As discussed earlier, the "reality" of control arrangements will likely govern in testing share repurchases under §302(b)(1). This means at least two things. First, mere numerical ownership of less than 50% of the voting common stock will not guarantee exchange treatment if bylaw provisions or other arrangements give the minority block some form of operating control. Second, even if there are no formal bylaw provisions or written agreements, the fact that other shareholders are in reality passive, complacent, or acquiescent to the taxpayer's wishes

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[559] 71 T.C. 941 (1979), *acq.*, 1984-2 C.B. 1.

[560] Swennes, *'Not Essentially Equivalent to a Dividend' Exception Still Viable Despite Davis*, 41 *J. Tax'n* 78, 79 (1974).

[561] *See Golconda Mining Corp. v. Commissioner*, 58 T.C. 139 (1972), rev'd, 507 F.2d 594 (9th Cir. 1974) (accumulated earnings tax issues).

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(despite their formal "rights") may well be seen as vesting effective control in the taxpayer.[562]

In *Johnson Trust v. Commissioner*,[563] the Tax Court held that a reduction in a shareholder's actual and constructive ownership of Crescent Oil Company from 43.6% to 40.8% of the sole class of stock did not qualify under §302(b)(1):

> In the case now before us there was no significant change in the control of Crescent Oil after the redemptions… [W]e find that the result of this small reduction in ownership interest was not meaningful and that petitioner has not met the requirements of §302(b)(1).

The court refers to Rev. Rul. 76-364, but it is not clear whether the court viewed the redeemed shareholder (a testamentary trust) as actively engaged in controlling company affairs and as not having its power changed significantly by the redemption, or whether the court focused on the significance of the reduction in percentage interest on an assumption that the trust was a passive shareholder before the redemption.

(1) Pre-Davis Authorities

The following cases and rulings allowed exchange treatment where a common shareholder lacked control before and after the redemption:

	Percentage of Voting Common Stock Considered Owned:	
	Before Redemption	After Redemption
Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964)	50%	44% and 38%
Cornwall v. Commissioner, 48 T.C. 736 (1967), *acq.,* 1968-1 C.B. 2	21%	16%
Rev. Rul. 56-183	11%	9%

Observation: Cornwall v. Commissioner, above, illustrates the type of factual inquiry which is especially difficult. The taxpayer in that case was a member of an insurance underwriting business operating as an association taxable as a corporation. His interest in the business consisted, before the redemption, of an 18.25% interest in the capital and investment income of the business and a 21% interest in its income or loss from underwriting. The taxpayer had an equal vote with other members on all management matters except with regard to members' withdrawals, which required approval by a majority in interest. The association distributed $200,000 to Cornwall in reduction of part of his "interest" in the business. His interest in underwriting income was reduced from 21% to 16%. His capital account and share of investment income were reduced from 18.25% to 17.44%. His voting rights were not changed except as to voting on withdrawals. The court held that the distribution was not essentially equivalent to a dividend. Because his voting interest was not reduced on management matters, with one exception, the redemption failed to qualify under §302(b)(2). However, there was still a "substantial change in his participating rights."[564]

The following cases and rulings imposed dividend treatment on a less than 50% owner before the transaction:

	Percentage of Voting Common Stock Considered Owned:	
	Before Redemption	After Redemption
Blount v. Commissioner, 425 F.2d 921 (2d Cir. 1969)	40.1	39
Bloch v. U.S., 261 F. Supp. 597 (S.D. Tex. 1966), aff'd per curiam 386 F.2d 839 (5th Cir. 1967)	45	43
Rev. Rul. 57-353,	40	33 1/3

(2) Control Group

The courts and the IRS have developed concepts of "collective control" by two or more minority shareholders, so that a redemption of part of the stock owned by such a shareholder has in the past failed to qualify under §302(b)(1). After the redemption, the members of the control group can still collaborate to control corporate policy.

On the basis of collective control, the following authorities found dividend equivalence: *Haserot v. Commissioner*,[565] *Blount v. Commissioner*, above; *Bloch v. U.S.*, above; Rev. Rul. 57-353, above. The *Bloch* decision is somewhat peculiar because the court said:

> Prior to the redemption in this case, the taxpayer was a minority stockholder and could only exercise control by aligning himself with one or more of the other stockholders. After the redemption, he was still a minority stockholder who could only exercise control by aligning himself with other stockholders.[566]

It might be that *Bloch* is a warning that a substantial minority shareholder (45% before and 30% afterward) is more likely to be treated as part of a control group than one who held a smaller interest to begin with.

Note: For a post-*Davis* case in point, holding dividend equivalent a reduction from 43.6 to 40.8%, see *Johnson Trust v. Commissioner*[567]

In Rev. Rul. 57-353, shares were owned as follows: B, 100 shares; C, 100 shares; D, 50 shares. The company redeemed 50 shares from each of B and C. The IRS ruled that each exchange

[562] *See Kraus v. Commissioner*, 490 F.2d 898 (2d Cir. 1974), aff'g 56 T.C. 681 (1973).

[563] 71 T.C. 941 (1979), *acq.,* 1984-2 C.B. 1.

[564] 48 T.C. at 749.

[565] 46 T.C. 864 (1966), aff'd, 399 F.2d 828 (6th Cir. 1968). *Cf. Pacific Vegetable Oil Corp. v. Commissioner*, 251 F.2d 682 (9th Cir. 1957) (dividend equivalence without invoking collective control; shareholder's interest increased from 40.4% to 50%).

[566] 261 F. Supp. at 612–13.

[567] 71 T.C. 941 (1979), *acq.,* 1984-2 C.B. 1.

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was equivalent to a dividend. Beforehand, B and C each owned 40% (total 80%). Afterward, B, C and D each held a one-third interest. Nevertheless, the ruling says that the distribution was "proportionate as to those persons owning 80% of the stock of the corporation and did not substantially change their relative control of the corporation." Although the owners held equal one-third interests after the redemption, B and C had previously united against a former shareholder from whom B and C had each bought half of their respective stock holdings. The ruling thus seems to group B and C together as a single unit that held two-thirds control afterward as against D.[568]

In Rev. Rul. 76-364,[569] a redemption from the largest minority holder in a four-person company was held entitled to capital gain where the shareholder's ownership fell from 27% to 22.27%. The company had 200,000 common shares outstanding with one vote each, owned as follows:

	Shares	Percent
A	54,000	27
B	48,667	24.3
C	48,667	24.3
D	48,667	24.3

A retired and took no part in management. A surrendered 12,160 shares for cash, leaving A with 41,840 of 187,840 shares. Control was thus reshuffled by reducing A to 22.27% and increasing B, C, and D to 25.91% each. The ruling points out that previously A could control the company if A acted in concert with only one other shareholder. But after the exchange, A lost this power. This, the IRS said, was a meaningful reduction in A's interest. This ruling implies that even if A may have been part of a closely knit group of owners, a meaningful change still occurred because previously, if A could persuade only one colleague, A had a 51% vote. After the redemption, A needed to persuade more than one colleague in order to get the same control.

As A's economic rights were reduced (to earnings and assets) and A owned less than 50% of the stock at the outset, why did the IRS test A as a possible control person? Certainly, one could say that A could have been outvoted before the transaction by the combined votes of B, C and D (just as C could have been outvoted in Rev. Rul. 57-353, above, by a coalition of the partners).

The point might be that the facts and circumstances will determine whether the person being redeemed will be regarded as part of the control group at the outset and, if so, the person's relationship with co-owners will be examined after the transaction from a control point of view. Perhaps the most obvious factor is a relatively small group of owners and minority holders who own 20% or more of the stock or some other substantial minority interest. The status of the shareholder as the founder of the company, as a key employee, or as an inactive heir who inherited shares from one active in the business, or the like, will also "color" the entire transaction.

In Rev. Rul. 75-512,[570] the IRS ruled that a reduction in a redeemed trust's stock ownership from 30 to 24.3% was "meaningful" where another shareholder controlled and managed the company's affairs and the trust was a minority shareholder who took no part in management before or after the redemption.

(3) *Publicly Held Companies*

It is not completely clear how redemptions by publicly held companies are to be tested under §302(b)(1). Will the same criteria used for closely held companies be equally applied where widely held companies buy in some of their own shares?

The first guidance on this subject came in Rev. Rul. 76-385.[571] A publicly held company with 28 million shares made a tender offer to its own shareholders as part of settlement of an antitrust suit in which the company agreed to divest itself of certain property. Among the tendering shareholders was a corporate shareholder that owned 0.0001118% of the stock. All of that shareholder's stock was redeemed. However, because the corporate parent of the shareholder continued to own some of the stock in its own right (and did not tender any of its shares), the corporate shareholder continued to own 0.0001081% of the public company's stock constructively. The ruling notes that the tendering shareholder reduced its voting rights and its right to earnings and assets, but the key rationale (as suggested earlier) lay in the IRS's view of the intent of Congress in enacting §302(b)(1). In these circumstances, the IRS evidently saw no reason to test the redeemed shareholder by reference to a possible collective control position.[572]

In Rev. Rul. 78-60, the IRS ruled that simultaneous redemptions from eight shareholders of a widely, although not publicly, held corporation were dividend equivalent. The corporation had 24 shareholders who were descendants of the company's founder. The redemptions occurred pursuant to a plan permitting each shareholder to elect annually to have redeemed 2/3 of 1% of his stock. The plan limited to 40 the total number of shares that could be redeemed each year under the

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[568] *But see Seabrook v. U.S.*, 253 F. Supp. 652 (W.D. Okla. 1966) (allowing exchange treatment despite collective control).

[569] Corrected by Announcement 76-127.

[570] *See also* PLR 201002022 (closely held corporation's periodic redemption of nonvoting shares held by retirement plan, so as to provide plan liquidity, qualified for §302(b)(1) treatment, whereas unrelated redemption of nonvoting shares held by family group controlling corporation constituted single and isolated transaction and did not result in deemed distribution under §305 with respect to any shareholder).

[571] *See also* PLR 200912006, in which a foreign public corporation, desiring to privatize itself, redeemed its outstanding Class A common stock and a percentage of its Class B common stock, the latter of which was all held by a single corporate shareholder. Under the scheme, the corporation also simultaneously issued new Class B shares to an investor group and thereby equalized the voting power possessed by the shareholder and the new investors. The IRS ruled that the corporation's redemption of the Class B shares would qualify for §302(b)(1) treatment. *See also* PLR 9829008 (exchange treatment allowed for partial redemption, via participation in corporation's continuing stock-reduction program, of common stock owned by shareholder desiring diversification whose interest in corporation went from 5.91% of value to 5.10% and 1.72% of voting power to 1.56%; management group and another shareholder each owned a multiple of what this shareholder owned).

[572] If the shareholder had desired §301 treatment, perhaps it could have purchased additional shares of the public company's stock or options to purchase stock, thereby ensuring no reduction in interest.

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plan. To the extent fewer than 40 shares are tendered for redemption in any year, a shareholder may have more than the normal percentage (2/3 of 1%) of his shares redeemed during that year. Actually and constructively, the changes in ownership of the redeemed shareholders as a result of the redemptions occurring under the plan for a single year were as follows:

	Before	After
B	8.0333%	8.0034%
C	8.0333%	8.0034%
D	11.4167%	11.3591%
G	3.2500%	3.1711%
J	9.5333%	9.4631%
V	3.2833%	3.2383%
W	5.0000%	4.9329%
X	10.8167%	10.8389%

Although seven of these shareholders reduced their percentage interests, the IRS introduced factors other than the effect on corporate control and ruled that none of the redemptions produced a meaningful reduction "because the reductions were small and each shareholder has the power to recover the lost interest by electing not to participate in the redemption plan in later years."

In Rev. Rul. 81-289, the IRS required a redemption received by a minority shareholder in a public company to be treated as dividend equivalent where the company had an isolated tender offer for the redemption of shares. This shareholder redeemed 40 shares, which turned out to be pro rata in relation to the total number of shares redeemed by the corporation. As a result, the shareholder's percentage interest remained the same both before (2,000/1,000,000 = .2%) and after (1,960/980,000 = .2%). The IRS treated this as a pro rata redemption and accordingly denied exchange treatment.

c. Negative Control

Suppose a shareholder holds "negative control," i.e., the power to *prevent* corporate action on certain matters even if the shareholder cannot compel affirmative action by the shareholder's own vote. Is a redemption not dividend equivalent if a person who holds negative control beforehand loses that power? Is the answer different if an under-50% shareholder who has negative control retains such control after the transaction? What if an over-50% owner reduces their interest to exactly 50%, which thereafter gives them an effective veto over company policies?

The answers to these questions are not always clear. In *Sorem v. Commissioner*,[573] a redemption that reduced the ownership of voting common by each of two 50% owners to 44 and 38%, respectively, was held entitled to capital gain treatment. "Prior to the sale," the court said, "although neither *Boogaart* nor *Sorem* had positive control over the Retail Corporations, each had negative control, that is, the power to prevent any action requiring the approval of a majority of the shareholders. Subsequent to the sale, neither of them had such negative control, and either, by inducing the other stockholders to join with him, could exercise corporate control." In this situation, the redeemed parties gave up negative control.

In Rev. Rul. 75-502, a reduction in an estate's ownership of a closely held company from 57 to exactly 50% of the sole class of stock was ruled not to be dividend equivalent. The ruling emphasizes that the other 50% of the voting rights was held by a single unrelated individual. Even though the estate also could deadlock the company, exchange treatment was allowed.

A case that is frequently discussed in connection with §302(b)(1) but did not actually involve that provision is *Fireoved v. U.S.*[574] In *Fireoved*, a company redeemed part of the preferred stock held by Fireoved who, at that time, owned 25 1/3% of the voting common stock. The preferred had been issued four years earlier when Fireoved had then owned one-third of the common. In the interim he had sold some of his common to one of his co-owners. Because of this earlier reduction in his underlying common, one issue was whether the statutory exception in §306(b)(4)(B) could protect the redemption from ordinary income treatment under §306. The Third Circuit rejected this argument, on the grounds that the exception was not intended to be available where the shareholder disposes of some of the underlying common but still retains all the control he had previously. The court concluded that Fireoved had retained such control in light of the fact that there were special provisions in the bylaws that required the unanimous consent of all directors for decision making and required a 76% vote to amend the bylaws. Because the rest of the common stock was owned 25 1/3% by C and 49 1/3% by E (unrelated persons), no two parties could vote more than 74 2/3% of the common. Unanimity was thus required in order to act. Originally, the three men had equal one-third interests so that unanimity had been required then, too. Therefore, no change had occurred in Fireoved's negative control over company policy. Although Fireoved appeared to hold only a numerical minority interest, the court said that he still had a form of control over the company.

d. Summary

A distinction exists between a minority shareholder and a noncontrolling shareholder. The facts and circumstances of each case seem to be crucial to determining what factors will be considered relevant to determining whether a reduction in interest has been meaningful. Just as an over-50% owner after a redemption of some of his voting common has an improved chance, after Wright, to qualify under §302(b)(1) in light of state law, caution should be shown where shares are repurchased from one who owns less than 50%, but, because of special provisions in the charter, bylaws, side agreements, voting trust arrangements, and the like, can exercise disproportionate voting rights or claim a disproportionate share of earnings or assets.

A noncontrolling minority shareholder should not be denied exchange treatment under §302(b)(1) solely by reason of

[573] 334 F.2d 275 (10th Cir. 1964).

[574] 462 F.2d 1281 (3d Cir. 1972).

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having a minority status both before and after the transaction.[575] On the other hand, *Davis* may not pose a barrier to grouping minority shareholders together, without regard to §318, as members of a control group for purposes of applying §302(b)(1).

Thus, special care should be taken where a less than 50% shareholder (before and after) can, by reason of special provisions or circumstances:

(1) exercise a majority vote;

(2) join with friendly co-owners as part of a group that can cast a majority vote;

(3) block positive action by the board or shareholders; or

(4) exercise "effective" control as the largest minority holder or because of the dispersion of ownership of the other shares.

G. Redemption of Preferred Stock

1. In General

Until *Davis*, the courts and the IRS applied at least four different criteria to test redemptions of preferred stock. These were: (1) business purpose; (2) the "comparative dividend" test; (3) the proportionate or disproportionate holdings of common and preferred stock as among all shareholders; and (4) the degree of reduction in absolute ownership of preferred stock by the redeeming shareholder.[576] After *Davis* it would seem that all these criteria must be disregarded and that §302(b)(1) must be applied solely by reference to the changes in *each* redeeming shareholder's own overall interest in the corporation. It is evidently no longer significant how many persons own both common and preferred, or only shares of one class; what percentage of the preferred is held by all holders of common as a group; or that all the outstanding preferred stock is redeemed pro rata.[577] In a pre-*Davis* ruling, a preferred shareholder who owned more than 50% of the voting common was allowed exchange treatment when the company redeemed all of its preferred, for the reason that the preferred was not held proportionate to the ownership of common stock.[578]

When a company has different classes of stock, particularly common and preferred, it is especially difficult to decide which of the ownership criteria — voting power, dividend rights, or asset rights — are most relevant and how much reduction in any of these rights makes the reduction meaningful. These kinds of difficulties exist whether preferred shares are redeemed from persons who hold both common and preferred or whether common stock is redeemed from such persons. Even where preferred shares are redeemed from persons who own only preferred, the numerous possible rights that may attach to preferred stock may mean that a meaningful reduction in interest has not occurred — particularly if there are several classes of preferred, each with different voting, dividend and asset rights. Preferred stock can carry voting rights, which may or may not equal those of the common, and may vary as to the matters on which a vote exists. Preferred may also participate in earnings with the common, subject to stated priorities, or it may be "fully participating."

a. The "Hypothetical Dividend" Concept

Before *Davis* some courts hypothesized a dividend of the total redemption proceeds pro rata among all holders of the common stock and then compared what each preferred shareholder actually received and what he would have received under a "comparative" or "hypothetical" dividend. Sometimes absolute dollar amounts were compared; sometimes percentage interests as between each alternative distribution were compared; sometimes percentage point differences between the percentage interests in each respective distribution were compared. The basic notion was that if this comparison showed that the taxpayer received a different dollar amount on the redemption — usually taken to mean a larger dollar amount — than he would have received if the company's total distribution had been an ordinary dividend on the common stock, the exchange reduced the shareholder's right to earnings. Thus, the exchange was not essentially equivalent to a dividend.

The leading case using the hypothetical-dividend-on-common approach is *Himmel v. Commissioner*,[579] in which the Second Circuit allowed exchange treatment after finding that on a hypothetical dividend on common the taxpayer would have received 50% of the amount he received on the actual redemption.

In *Grabowski Trust v. Commissioner*,[580] the court made a comparative dividend analysis of a preferred stock redemption, finding dividend equivalence partly because the shareholder received less than he would have received if an ordinary dividend had been declared. The court said that this form of the comparative dividend test is "a minimum condition established by *Davis*," although alone it does not necessarily show a meaningful reduction in interest.

In *Brown v. U.S.*,[581] the court appeared to believe that the comparative dividend analysis is not permissible after *Davis*. The court held a preferred stock redemption essentially equivalent to a dividend by referring to changes in the taxpayer's percentage interest in the preferred stock. The court said it reached this result "not without difficulty" because, in its view, the hypothetical dividend test would have justified exchange treatment.

b. Equity Recoupment Theory

Where a distributee owns both common and preferred stock and some or all of his preferred stock is redeemed, the approach used by the Tax Court in a post-*Davis* case, *Hays v. Commissioner*,[582] may signal the direction the courts will take. In *Hays*, the taxpayer owned 100% of the 6% nonvoting $10 par value preferred stock of a closely held corporation and 80% of its common stock. An unrelated business associate owned

[575] *But see Bloch v. U.S.*, 261 F. Supp. 597 (S.D. Tex. 1966), aff'd per curiam, 386 F.2d 839 (5th Cir. 1967).

[576] As to the last criterion, see *Berenbaum v. Commissioner*, 24 T.C.M. 758 (1965), rev'd, 369 F.2d 337 (10th Cir. 1966).

[577] *See* Rev. Rul. 68-547; Rev. Rul. 56-540; Rev. Rul. 56-485. All three revenue rulings were declared obsolete by Rev. Rul. 80-367.

[578] Rev. Rul. 68-547. Rev. Rul. 68-547 was declared obsolete by Rev. Rul. 80-367.

[579] 338 F.2d 815 (2d Cir. 1964).

[580] 58 T.C. 650 (1972).

[581] 345 F. Supp. 241 (S.D. Ohio 1972), aff'd per curiam, 477 F.2d 599 (6th Cir. 1973).

[582] 30 T.C.M. 378 (1971).

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the remaining 20% common stock interest. The corporation redeemed at par 300 of its 3,000 outstanding preferred shares. The court held that the redemption did not produce a meaningful reduction in Hays' proportionate interest in the corporation because, although his interest in earnings and profits was reduced by $180 ($.60 yearly dividend × 300 redeemed shares), he would, economically, recoup 80% of that "loss" by virtue of his continuing 80% ownership of the common stock. The court said:

> Hays remained owner of 80 percent of the common stock in Associates. Thus while his rights to earnings and profits via the preferred stock was reduced by the amount of $180, he continued to have access to 80 percent of that amount via his common stock. Since Hays owned the overwhelming majority of the common, the only voting stock, his ability to declare dividends was assured.

The "offset" approach to evaluating the effect of a preferred stock redemption on the recipient's interest seems to be a logical outgrowth of the *Davis* decision. *Davis* holds that where a shareholder owns 100% of both common and preferred stock, neither his "economic interest" nor his "rights" are changed by a redemption of all of his preferred stock. The Tax Court in *Hays* apparently interpreted this idea to mean that whatever dollar amounts the preferred shareholder loses in the redemption he recoups by reason of owning the residual stock interest in the business, i.e., the common stock, because amounts no longer paid as dividends on the preferred stock will be paid to holders of the residual interest.

This equity recoupment concept resembles the rationale suggested earlier for the courts' treatment of redemptions where only one class of stock is outstanding. *Hays* differed from *Davis* in that in the former case, the sole owner of the preferred stock owned less than all of the outstanding common stock. However, because Hays continued to control the corporation through his 80% ownership of the common stock, the court apparently concluded that the redemption did not produce a "meaningful" reduction in his interest in the corporation. In view of this emphasis on the shareholder's continued "control" of the corporation, it may be that if a shareholder, some or all of whose preferred stock is redeemed, continues to own 50% or more of the total outstanding common stock, his redemption will receive §301 treatment, while if he owns less than 50% of the common stock, redemption of his preferred stock will receive exchange treatment under §302(b)(1).

This approach is suggested by Rev. Rul. 66-37, in which a redemption of all the outstanding preferred stock from a shareholder who owned 80% of the outstanding common stock was ruled dividend equivalent on the ground that the shareholder continued to own a majority of the common stock.

Rev. Rul. 77-426, allowed exchange treatment for the redemption of 5% of the preferred stock from a shareholder who owned all of the outstanding preferred stock but no common stock, rationalizing the result on an equity recoupment theory (or here the lack thereof) of the kind used in *Hays*.

Tested by such a 50% criterion, a redemption of all the preferred stock owned by a shareholder who owns 100% of the preferred stock and 65% of the total outstanding common stock would be dividend equivalent. Such treatment would change the result in *Dorsey v. U.S.*,[583] which, before the decision in *Davis*, allowed exchange treatment under §302(b)(1) because of a sufficient business purpose.

In *Berenbaum v. Commissioner*,[584] the taxpayer owned 80% of the outstanding common stock and 90.5% of the nonvoting preferred stock. The corporation redeemed all of the taxpayer's preferred stock. The court found dividend equivalence, stressing the taxpayer's unchanged voting control of the corporation. *Hays* would also impose dividend treatment because the taxpayer continued to own at least half the total outstanding common stock.

In *Antrim v. Commissioner*,[585] where all preferred stock was redeemed, one redeemed shareholder owned two-thirds of the outstanding common stock and 15% of the nonvoting preferred stock. The court allowed exchange treatment, largely under a comparative dividend approach. Under *Hays*, such a factual situation seems highly vulnerable to dividend treatment.

After *Hays*, dividend treatment of preferred stock redemptions would probably also remain unchanged in *Archbold v. U.S.*[586] (entire holding of 9% of nonvoting preferred redeemed from taxpayer who continued to own constructively 98% of the common); Rev. Rul. 56-265 (redemption of all outstanding preferred from sole owner of common held dividend equivalent); and Rev. Rul. 56-521 (redemption of preferred stock owned by owner of 100% of common stock, along with redemption of remaining preferred stock from other persons, held dividend equivalent).

Comment: There have not been many preferred stock redemption cases since the *Davis* decision. The cases that have arisen have generally involved a redemption from a person who also owned a majority of the voting common, and the holdings of the courts have been that these redemptions were equivalent to a dividend. The equity recoupment theory expressed in *Hays* — with a 50% dividing line — perhaps rationalizes the results so far and suggests a guideline for future planning. An important caveat is that in applying the 50% test, the courts and the IRS might be expected to look to voting power as well as to dividend and asset (i.e., economic) rights of the shareholder before and after the transaction.

Observation: A 50% dividing line for a *Hays*-type equity recoupment might be less persuasive if one believes that a common stockholder who also owns nonvoting preferred stock carrying a fixed right to earnings and assets does not actually recoup, through his common stock, the absolute dollar amounts previously paid as dividends on his preferred stock. Assuming that the corporate assets as a whole generate a given percentage return annually, the effect of redeeming preferred stock is to remove assets from corporate solution and to reduce the corporation's total income-producing power. The assets that previously generated the earnings paid out as dividends on the preferred stock have left corporate solution. Accordingly, in the year following the redemption there will not be the same absolute dollar amount of "earnings" previously available for dividends on both common and preferred stock. The conclusion

583 311 F. Supp. 625 (S.D. Fla. 1969).

584 369 F.2d 337 (10th Cir. 1966).

585 395 F.2d 430 (4th Cir. 1968).

586 201 F. Supp. 329 (D.N.J. 1962), aff'd per curiam, 311 F.2d 228 (3d Cir. 1963).

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might be drawn that all redemptions of preferred stock should receive exchange treatment regardless of whether the recipient owns more or less than 50% of the underlying common. The *Hays* approach, by contrast, assumes that despite the redemption of preferred, a fund of the same total size will be available for distribution in the following year or years.

2. *Redemption of Some or All of the Preferred from Shareholder Who Owns No Common*

It seems fairly clear that, in general, a redemption of some or all of conventional nonvoting, nonparticipating preferred stock from a holder who owns (actually or constructively) no common stock, or other class of preferred stock, will qualify for exchange treatment. The fact that the redeemed shareholder owned the entire class of such preferred stock or most of it, or that more or less than half of the preferred was redeemed, would seem to be immaterial. If only some of the holder's preferred is redeemed, the exchange should normally qualify under §302(b)(1). If all of the holder's preferred stock is redeemed, his exchange should normally qualify under §302(b)(3).

Reg. §1.302-2(a) contains this example:

> For example, if a shareholder owns only nonvoting stock of a corporation which is not §306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section.

In Rev. Rul. 74-515, the IRS ruled, applying §302 principles to cash boot received in a statutory merger, that the exchange by shareholders of the acquired company who owned only preferred stock of that company for cash of the acquiring company did not have the effect of a dividend. The ruling notes that all the outstanding preferred represented less than 10% of the combined value of the common and preferred of the acquired company and that no person who owned both common and preferred owned more than 1% of either class.

It is not clear whether the fact that one-half of the shareholder's preferred was redeemed in the Example in Reg. §1.302-2(a), or that the total value of the preferred was less than half the total value of the company in Rev. Rul. 74-515, was a critical factor, the absence of which would have changed the result.

In Rev. Rul. 77-426, the IRS ruled that a redemption of 5% of the preferred stock held by an individual who owns no common stock qualifies for exchange treatment under §302(b)(1). The preferred in this ruling was nonvoting, nonconvertible, nonparticipating, and was not "section 306 stock."

Under these circumstances, the IRS said, "the rights represented by the redeemed shares were yielded to the common shareholders of the corporation and could not be recovered through the taxpayer's continued stock ownership." The ruling expressly allows redemption of any amount of the preferred stock in these circumstances to receive exchange treatment.[587]

As indicated earlier, however, preferred stock can come with many variations. If a class of preferred carries full participation rights (with or without a possible extra priority claim on earnings), or if it has voting rights (either fully equal to the common's rights or equal only on certain matters, or perhaps superior to the common on certain issues), a redemption of such stock might be treated just as though it were common stock. A situation of this kind might also arise if a class of preferred stock has acquired voting rights, under the terms by which it was issued originally, because the company has missed a stated number of dividend payments.

One should always be alert to the "real" role that preferred stock plays in the control structure of the company. A recent, though perhaps extreme, illustration of the possible problems along this line arose in *Benjamin v. Commissioner*[588] In this case, the Tax Court held dividend equivalent a redemption of part of a class of voting preferred stock from a shareholder who in fact owned no common stock. Blanche Benjamin was considered to own all the common by attribution from her children and grandchildren (who were the actual owners of the common). But the significant feature of the situation is that only the preferred stock held by Blanche Benjamin had voting power. The court made a detailed inquiry into the unusual capital structure of the company and into the real power structure, and said that even if family attribution under §318 were not applied in the situation, Blanche Benjamin still would not have meaningfully reduced her interest in the company. In substance, the court treated the preferred stock on these facts as if it were the real common stock instead of the nominal common held by the children. Before the redemption Blanche Benjamin owned all of the company's voting power, which resided in the class A and class B preferred shares. Her children and grandchildren owned all of the common stock, which was nonvoting. Blanche Benjamin, her children and her grandchildren also owned 96.6% of the class C nonvoting preferred stock. The rest of the class C stock was owned by two of Blanche Benjamin's daughters-in-law. The stock ownership was, therefore, as follows:

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[587] *See also* PLR 200123053 (redemption by corporation with three classes of stock of its preferred stock from a group of shareholders qualifies under §302(b)(1)); PLR 8001044 (redemption of some preferred from shareholder who owns no common stock qualifies under §302(b)(1); PLR 8002086 (redemption of all preferred from owner of no common qualifies under §302(b)(3)).

[588] 66 T.C. 1084 (1976), aff'd, 592 F.2d 1259 (5th Cir. 1979).

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Shareholder	Relationship to Blanche	A	No. of Preferred Shares by Class B	C	No. of Common Shares
Blanche S. Benjamin		4,732	7,255	968	—
Edward Benjamin, Jr.	son			730	313 1/3
Edward Benjamin, Jr.'s wife	daughter-in-law			60	—
W. Mente Benjamin	son			550	46 1/3
Jonathan Benjamin	son			550	333 1/3
Jonathan Benjamin's wife	daughter-in-law			60	—
Grandchildren	grandchildren			600	307
		4,732	7,255	3,518	1,000

In 1964, the corporation redeemed 2,000 class A preferred shares from Blanche Benjamin by reducing a debt that she owed to the company. After the redemption, the stock ownership was unchanged except that she then owned 2,732 (rather than 4,732) shares of class A preferred. Four years later the company redeemed all of Blanche Benjamin's remaining (preferred) stock. Only the 1964 redemption was before the court.

Each preferred share had a call price and liquidation preference of $100 a share but no participation beyond that amount. The shares also had an annual $3 noncumulative dividend preference over the common stock and an equal participation with the common stock in dividends above that level. Sole voting rights vested in the class A and B preferred so long as some or all of these shares were outstanding. Fifteen years before the redemption, Blanche Benjamin had entered into a written agreement with her sons growing out of her desire to revoke trusts that she had earlier created (and which held stock in the company for her as income beneficiary and for her sons as remaindermen). The agreement provided that the sons would agree to revocation of the trusts if (among other things) Blanche Benjamin made gifts of all the outstanding common stock to her sons and also agreed that after she realized, during her lifetime, $100 per share on each class A and B preferred share she owned (whether by distribution of capital or income), she would then give all of her preferred shares to her sons.

The Tax Court minimized the tax significance of these various restrictions, however, emphasizing that the special preferred gave Blanche Benjamin complete management control. After the redemption she still owned other preferred stock and was not obligated to give that stock to her sons (the company had not paid any dividends up to the redemption). Blanche Benjamin's remaining stock also constituted the sole voting stock. In that light, the court said:

> The A and B preferred possessed dividend and liquidation preferences normally associated with senior securities and additionally, the voting characteristic of most common stock… Her retention of the A and B preferred entitled Blanche to complete management control as she, exercising her best business judgment, deemed appropriate. The common shareholders had no current interest in the corporation (Starmount had never declared a dividend) nor were they privy to Starmount business affair.
>
> * * *
>
> Controlling the activities of a family corporation through voting superiority, or supremacy, is the most significant attribute a shareholder possesses.
>
> * * *
>
> Whatever changes in net worth and participation in earnings Blanche experienced as a result of the distribution, factors considered by the Second Circuit in *Himmel v. Commissioner*, … in our opinion the retention of absolute voting control in the present case outweighs any other consideration.

The Fifth Circuit affirmed the Tax Court as to the failure to qualify under §302(b)(1), adding in dictum:

> The factor which we find most persuasive is the element of corporate control. Both before and after the 1964 redemption, Blanche Benjamin owned all of the voting stock of Starmount. While her equity interest was diminished after the redemption due to the 1950 agreement, she still had the formidable power of controlling the business enterprises of the corporation, determining directions of corporate expansion and growth, as well as controlling the timing of the redemption of her own shares of stock. Although the Benjamins contend that they were under a fiduciary duty to retire the stock as soon as possible, they concede, as they must, that they are vested, as corporate directors, with wide discretion in determining when the redemption was possible. We note that several years prior to the 1964 redemption of her stock, Starmount undertook the development of a shopping center, requiring a cash outlay by Starmount of at least $1.4 million. Rather than using that money to redeem her stock, the Board of Directors (comprised of Mr. and Mrs. Benjamin and a North Carolina attorney) decided to proceed with development of the shopping center. It is precisely this type of control which leads us to reject petitioner's argument that there has been a "meaningful reduction" in Mrs. Benjamin's interest in Starmount.[589]

[589] 592 F.2d at 1261, n.3.

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3. *Redemption of Preferred from Owner of All the Common*

The *Davis* case is, of course, the prime example of a case in this category. The result was dividend equivalence, as indicated by the authorities even before *Davis* (some of which are cited in the discussion of the equity recoupment theory of the *Hays* case, above).

Dividend equivalence will apparently result regardless of whether all or some of the particular shareholder's preferred is redeemed from other holders, or whether the taxpayer's continuing ownership of common is actual or constructive. The *Benjamin* case, above, illustrates (among other things) a situation where part of the preferred shares were redeemed from a person who actually owned no common stock before or after the transaction but constructively owned 100% of the common by attribution from her children. The court found dividend equivalence in that case.

In *Gray v. Commissioner*,[590] the Tax Court recast a complex factual situation as, in part, a redemption of all outstanding preferred stock from the owners of the common stock of a family corporation. So tested, each redemption was held dividend equivalent. Gray and his family owned 90% of the stock of Brother Corp. (B) and 100% of Sister Corp. (S). S owned all of B's preferred stock. Gray decided to terminate his family's ownership of S, whose book value was $1,760,000, but he wanted to do it at capital gain rates. A complete liquidation of S was hazardous because of the then-impending enactment of §1248. Instead, Gray found a third party who purchased S's stock for $1,680,000. Simultaneously, S surrendered its B preferred stock to B for redemption and received $1.5 million cash. In light of all the circumstances, the court disregarded the stock buyer as a mere accommodation party who really had just bought cash at a bargain and netted $80,000 compensation for his services. The court treated S as having liquidated completely and as having distributed its assets (including B's preferred stock) to Gray and his family from whom the stock was then redeemed. Without even invoking §318 attribution, the court held that the redemptions were virtually proportionate to the family's ownership of common stock. "Exact parity is not required," the court said. The court also stressed that Gray prearranged and controlled the entire transaction.

On appeal the Ninth Circuit viewed the substance of the overall transaction differently from the Tax Court. The Ninth Circuit said that the steps should be treated for tax purposes as a redemption of the preferred stock followed by a sale of S's stock to the outside buyer. Even tested this way, however, the redemption was held to be dividend equivalent. (Gray's 90% ownership of the common stock of the issuer company (B) was attributed to S under §318(a)(3)(C), so that the redemption was tested as a redemption of all outstanding preferred from a shareholder who also owned 90% of the common stock.)

In *Probst v. Commissioner*,[591] the taxpayer and his brother each owned 50% of the common stock of the family wholesale business and 40% and 60%, respectively, of its preferred stock. The brothers had entered into a buy-sell agreement giving each the option to buy all the stock of the other in case of death. After the brother died, Probst exercised his option and paid the estate with funds borrowed from a local bank. The loan terms required a substantial repayment three months later. In order to meet this obligation, Probst caused the corporation to redeem part of his preferred stock for cash. The court viewed him as sole owner of the common and preferred stock immediately before and after the redemption, rejecting his argument that he was only an agent for the corporation. The redemption, therefore, was held equivalent to a dividend.

4. *Redemption of Preferred from Owner of Over 50% of Common*

As indicated earlier, a redemption of preferred stock from a shareholder who also owns over 50% of the common stock is likely to be considered to have dividend equivalence regardless of whether some or all of the holder's preferred is redeemed, and regardless of what percentage of the preferred class the shareholder owns before and after the transaction. Since *Davis* the cases involving fact situations of this kind are as follows:

Preferred Stock Redeemed Reduction in Percentage Ownership (Actual and Constructive) Equivalent to a Dividend	
Brown v. U.S., 345 F. Supp. 241 (S.D. Ohio 1972), aff'd per curiam, 477 F.2d 599 (6th Cir. 1973)	34% to 29.2% of preferred; unchanged ownership of 99.3% of common
Grabowski Trust v. Commissioner, 58 T.C. 650 (1972)	33 1/3% to no preferred; unchanged ownership of 86.2% of common. 100% to 90% ownership of preferred; unchanged ownership of 80% of common
Hays v. Commissioner, 30 T.C.M. 378 (1971)	
PLR 7933006	Complete redemption of 100% nonvoting preferred from shareholder who continued to own 80% of voting common stock
Exchange Treatment	
None.	

Note: Commissioner v. Antrim,[592] and *Hinrichsen Est. v. Commissioner*,[593] two pre-*Davis* cases, in which the court allowed exchange treatment, might now come out differently.

[590] 56 T.C. 1032 (1971), rev'd, 561 F.2d 753 (9th Cir. 1977), on remand, 71 T.C. 719 (1979).

[591] 29 T.C.M. 1501 (1970).

[592] 395 F.2d 430 (4th Cir. 1968) (exchange treatment allowed, under hypothetical dividend approach, on redemption of all outstanding preferred, including 15% preferred interest held by continuing owner of two-thirds of the common).

[593] 25 T.C.M. 1383 (1966) (exchange treatment allowed on retirement of all preferred, including 77% interest held by continuing owner of 90% of common).

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5. *Redemption of Preferred from Owner of Preferred and a Minority of Common*

a. *In General*

In this category taxpayers have been able to find specific comfort in the Senate Finance Committee report on the 1954 Code, where the House bill was called "unnecessarily restrictive, particularly in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place."[594]

In a pre-*Davis* case, a group of 28 dentists had formed a dental supply business to which they had contributed all the risk capital in return for all the preferred stock and 64% of the common stock. The rest of the common was issued to three individuals in return for services. After the company had gotten off the ground, the preferred began to be retired and, in the first installment, 20% of the preferred class was redeemed by lot from 11 of the doctors. Taxpayer had owned 5/350, or 1.4%, of each class and had all of his preferred shares retired in the first group of redemptions. The court allowed exchange treatment of this redemption under §302(b)(1).[595]

In *Roebling v. Commissioner*,[596] the Tax Court found that the reduction of the voting rights of petitioner, an owner of both common and preferred, from a cumulative total (common and preferred) of 50.54% to 43.28% (petitioner owned less than 50% of the common), pursuant to a plan to redeem all of the corporation's voting preferred stock over a protracted period, qualified under §302(b)(1) as not essentially equivalent to a dividend with respect to petitioner's preferred stock.

In *Agway, Inc. v. U.S.*,[597] a redemption of preferred stock in an agricultural cooperative was given exchange treatment under §302(b)(1) where the taxpayer's ownership of the preferred class was reduced from 18% to 16% and its 6% common stock interest remained unchanged. The court did not make a full analysis of concepts derived from *Davis*, but seems to have relied chiefly on the fact that the redemption was non-pro rata as to the preferred stock class, largely because under the cooperative's by-laws the capital contributions (represented by the preferred stock) had to be retired in the order in which the members supply capital.

Two potential problem areas when preferred is redeemed from a holder of less than 50% of the common stock are discussed, below.

(1) *Control Realities*

First, the same caveats about the "realities" of control held by a minority owner of common stock, discussed earlier under redemptions of common, apply here as well.[598] In *Fireoved v. U.S.*,[599] Fireoved owned 67% of the total outstanding nonvoting preferred stock and 25 1/3% of the common. The company redeemed part of his preferred shares so that Fireoved became an equal one-third owner of the preferred with his co-owners. Although the issue in the case concerned §306 and not §302, the court examined the special provisions of the corporate bylaws which in effect gave the nominal minority common stock interest an effective veto over corporate decision making. As such, the court viewed Fireoved as really one of the controlling shareholders and, on the special facts, as realistically holding a form of control before and after the redemption of his preferred. Thus, the mere fact that a shareholder owns a numerical minority of the common will not insulate him from scrutiny if either common or preferred shares are redeemed from him.

(2) *Preferred Held in Proportion to Ownership of Common*

The second problem arises where there are several shareholders, even assuming they are unrelated under §318, who hold preferred stock in substantially the same proportions as they hold the common stock. If all the preferred stock is retired, should each redemption obtain exchange treatment on the ground that each shareholder owns less than 50% of the common stock? Would the approach used in the *Hays* case, above, support such a conclusion?

In this type of case, even if each shareholder owns a minority common interest before and after the transaction, and even if the various shareholders are unrelated under §318 or cannot be shown to collaborate so closely that they are part of a control group, each redemption will probably receive dividend treatment. This result can be justified under a *Hays*-type approach, because, by reason of the redemption of preferred from all shareholders, each shareholder recoups, in effect, through his unchanged ownership of common stock, 100% of the equity represented by the preferred shares which he surrendered.

This analysis is consistent with the results reached in similar factual situations before and after *Davis*. In *Miele v. Commissioner*,[600] the Tax Court held dividend equivalent simultaneous redemptions of all of a closely held company's preferred stock where members of three families — apparently unrelated under §318 — owned the preferred in substantially the same proportions as they owned the common stock. The company redeemed the preferred in two equal installments over two successive years. The Tax Court based its holding on the fact that the transactions "did not change the relative economic interests, control, or rights of the stockholders…"[601]

b. *Other Pre-Davis Authorities*

In Rev. Rul. 59-258, three brothers and their families owned all the common and preferred stock of a corporation as follows:

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[594] S. Rep. No. 83-1622, 44 (1954).

[595] *Colvin v. U.S.*, 175 F. Supp. 877 (S.D. Cal. 1959).

[596] 77 T.C. 30 (1981).

[597] 524 F.2d 1194 (Ct. Cl. 1975).

[598] See VI.F.4.c., above.

[599] 462 F.2d 1281 (3d Cir. 1972), aff'g 318 F. Supp. 133 (D. Pa. 1971).

[600] 56 T.C. 556 (1971), *acq.*, 1972-1 C.B. 2. See VI.C.1.b., above, for additional discussion of this case.

[601] 56 T.C. 556 (1971) at 567.

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	Family A	Family B	Family C	Others
Common	41%	25%	25%	9%
1st Preferred (nonvoting)	55%	18%	27%	—
2nd Preferred (nonvoting)	80%	8%	12%	—

The corporation redeemed all shares of both preferred classes. The IRS ruled that each redemption was essentially equivalent to a dividend because "the proportionate interests of each of the three family groups were not changed substantially by the redemptions." Assuming that the preferred shares were nonparticipating, the ruling still imposed dividend treatment even though each family owned less than 50% of the common stock. No attribution under §318 applies between brothers. It is not clear that all courts would, after *Davis*, reach the same result unless all three families worked so closely together that they all are regarded as one control group.

The preferred stock in Rev. Rul. 59-258 was not held in proportion to the shareholders' ownership of common stock, so that the problem discussed above where preferred is held in proportion to the ownership of common would not arise on the facts of this ruling.

In Rev. Rul. 56-485, a redemption of 20% of a company's voting preferred stock was given exchange treatment under §302(b)(1) where, among the 70 shareholders, 16 owned only common stock, four owned only preferred and 50 owned both classes. However, the preferred was not held in proportion to the distribution of common and, although the preferred had acquired voting power because of dividend arrearages, no one shareholder or family group held more than 25% of the total voting power of all classes. Today, a more detailed analysis of this kind of fact situation would probably be made to see whether, as to each shareholder, he exercised any form of control either alone or in collaboration with other owners.

In Rev. Rul. 56-540, the IRS allowed exchange treatment where a company having 570 shareholders redeemed all of its preferred. Only 66 persons owned both classes of stock and 313 shareholders owned only preferred. Seventy-five percent of the preferred shares were purchased from persons who owned no common. The rationale relies on the lack of proportional ownership of common and preferred.

Comment: Today, however, this type of redemption might be difficult for an owner of preferred who also owned over half of the common stock or a minority amount that might be regarded as vesting him with some form of control over management decisions.[602]

In *Comess v. U.S.*,[603] the taxpayer was a 25% owner of common stock of a closely held corporation. At a time when the company needed funds, the four principal owners (including the taxpayer) advanced funds in proportion to their common stock interests. This debt account was later converted into preferred stock interests, which, 13 years later, were completely redeemed. The redemption of all the taxpayer's preferred was held equivalent to a dividend.

In *Seabrook v. U.S.*,[604] the corporation redeemed all of its outstanding preferred stock from two brothers, each of whom owned 50% of the preferred stock. The brothers also owned 41% and 24%, respectively, of the outstanding common stock. The preferred stock voted equally with the common. The first brother's total voting power declined from 46% to 41%. The second brother's total voting power declined from 38% to 24%. The court held both redemptions qualified under §302(b)(1) on the ground that each brother's interest in the corporation was "significantly reduced." The court actually viewed both brothers together as part of a control group, and, from this viewpoint, the redemptions reduced their combined voting power from 76% to 47.5% without taking attribution from a son into account, or from 84% to 64.5% if such attribution were applied. The court thought that either way of measuring showed a reduction large enough to satisfy §302(b)(1).

Comment: Today, even viewing the brothers together, the reduction with attribution applied might not qualify, unless a *Wright*-type approach is accepted. See the earlier discussion of control in connection with common stock redemptions at VI.F.3.b.(4), above.

6. *Redemption of Preferred from Owner of 50% of Common*

The IRS has allowed exchange treatment on a redemption of 93.7% of a close corporation's preferred stock from a shareholder who owned exactly 50% of the common stock. In this case, two unrelated individuals each owned 50% of the common but 15 shares and one share, respectively, of the outstanding preferred stock. Both had planned to have equal investments and to have the shareholder holding only one share of preferred purchase 14 additional shares. For personal financial reasons, however, the matching purchase could not be made. In order to equalize the two investments, the company redeemed 14 of the disproportionate owner's preferred shares. The IRS allowed exchange treatment under §302(b)(1) on the ground that the distribution was non-pro rata as among both owners.[605]

Under a *Hays*-type approach, the outcome of a situation like this one would depend on whether the dividing line is more than 50% ownership of common or less than 50% ownership. See the discussion at VI.F.4.c., above, of negative control in connection with redemptions of common stock under §302(b)(1). The existence of voting or special participation rights in the preferred would also be significant.

Note: Himmel v. Commissioner,[606] involved a taxpayer who owned 50% of the outstanding common stock and 100% of the preferred stock of a corporation. There were two classes of preferred stock, one with voting rights and one without voting rights. The corporation redeemed a small quantity of the nonvoting preferred stock. The Second Circuit allowed exchange treatment under §302(b)(1), largely on the ground that if the proceeds had been distributed as an ordinary dividend on common, the taxpayer would have received only half of what he

[602] Rev. Rul. 56-485 and Rev. Rul. 56-540 were declared obsolete by Rev. Rul. 80-367.

[603] 309 F. Supp. 1215 (E.D. Va. 1969).

[604] 253 F. Supp. 652 (W.D. Okla. 1966).

[605] Rev. Rul. 55-462.

[606] 338 F.2d 815 (2d Cir. 1964).

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actually received. Under *Hays*, the taxpayer in *Himmel* might be regarded as retaining voting control of the corporation. This factor might now lead a court to find the redemption essentially equivalent to a dividend.

Comment: If a shareholder owns a bona fide noncontrolling amount of common stock and also some preferred, it might be worth considering having enough of his common stock redeemed to qualify under §302(b)(2). A benefit is the opportunity to obtain exchange treatment on a simultaneous redemption of nonvoting preferred stock held by the same shareholder.[607]

In *Morris v. U.S.*,[608] the court allowed exchange treatment on a redemption of all the nonvoting preferred stock owned by a shareholder who owned 50% of the voting common stock before and after the transaction. At the same time, the corporation redeemed the rest of its outstanding preferred stock owned by other shareholders. The court acknowledged that the taxpayer shareholder lost no voting control over corporate affairs in the sense that he retained at least a negative veto before and after the redemption. However, the court relied on the change in the right to share in corporate earnings, because the preferred stock carried a yearly 5% dividend, whereas, once the preferred was eliminated, the taxpayer had to rely on annual dividend declarations for which he needed the agreement of the other shareholders.

H. Redemption of Common from Owner of Common and Preferred

1. Redemption of Common from Owner of Preferred and a Majority of Common

If a continuing owner of over-50% of voting common stock from whom preferred shares are redeemed has great difficulty in obtaining exchange treatment (see cases and rulings discussed above), a redemption of common from such an owner that leaves the owner still owning over half of the common may *a fortiori* be dividend equivalent. In essence, the transaction would be treated as a redemption of common and the shareholder's holding of preferred stock would be ignored.

Rev. Rul. 70-199 dealt with a §306 issue but reflects an application of §302 principles to a hypothetical redemption of all the common stock owned by a shareholder who held both common and preferred. A, an individual, owned over half the common stock of a corporation and all of its nonvoting cumulative preferred stock ("first preferred"). In a recapitalization, A exchanged all his common for a new class of noncumulative voting ("second") preferred stock whose vote was equal to that of the common stock. Because of dividend arrearages A's old preferred had previously become entitled by its terms to elect a majority of the board of directors and to do so until all arrearages had been paid in full. While accumulated dividends on the old preferred were unpaid, the corporation was prohibited from paying dividends on its common or on its new preferred. The annual increase in the corporation's net worth approximately equaled the annual dividend due on the old preferred. The voting rights of the new preferred did not affect A's right under his old preferred to continue to elect a majority of the board. The specific issue was whether the second preferred was §306 stock.

The IRS hypothesized that, under Reg. §1.306-3(d), a redemption in which A received cash (rather than the second preferred) for all of his common stock was essentially equivalent to a dividend. The IRS ruled that such a hypothetical redemption would be essentially equivalent to a dividend because, "as a practical matter," A would not have any meaningful loss of control or equity interest. His control over the company would be as complete through holding the first preferred alone as it was through his prior holding of the first preferred and common. As indicated, the company could not pay any dividends on common while the preferred arrearages were unpaid, the yearly increase in the company's net worth was equal to the annual increase in preferred dividend arrearages; and A's power to elect a majority of directors was equivalent to voting control.

In *Roy Furr v. Commissioner*,[609] discussed at VI.F.3.c., above, in connection with redemptions of nonvoting common stock, redemption of a small amount of class A nonvoting common reduced the taxpayer's ownership of that class from 24.19% to 23.86% but left unchanged his ownership of 71.9% of class B voting common and his ownership of 49.5% of preferred stock (the redemption canceled an account receivable owned by Furr to the company). In holding the redemption dividend equivalent, the court pointed out that Furr suffered no reduction in his voting position, in his dividend and liquidation rights or rights in his preferred stock. His equity reduction through the nonvoting common was too "small" to be meaningful.

2. Redemption of Common from Owner of Preferred and a Minority of Common

There are no cases since *Davis* involving redemption of common stock from an owner of preferred and a minority of common, but the likelihood is that this case would be treated under the tests that have developed for persons who own only a minority of common stock, i.e., whether the minority interest represents any form of control over company affairs. The fact that the shareholder happens also to own preferred stock will apparently be significant only if the preferred is other than a garden variety nonvoting, nonparticipating interest and vests some type of continuing control in the shareholder.

I. Disregarding Attribution Rules in Hostility Situations

1. Basic Problem

Section 302(c)(1) provides that "[e]xcept as provided in paragraph (2) of this subsection [relating to waiver of family ownership under Section 302(b)(3)], section 318(a) shall apply in determining the ownership of stock for purposes of this section." At first glance this language might seem clear enough: the §318 rules apply to any redemption being tested under any category of §302(b) — except where the special waiver rules of §302(c)(2) are satisfied — and these rules cannot be disregarded because of special or unique circumstances of a specific case.

[607] *See* Reg. §1.302-3(a). For a discussion of §302(b)(2), see V., above.

[608] 77-2 USTC ¶9740 (N.D. Tex. 1977).

[609] 34 T.C.M. 433 (1975).

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In fact, the statutory language has proven to be ambiguous, and considerable litigation has occurred both before and after *Davis* concerning what role the constructive ownership rules have in testing a redemption for dividend equivalence. Surprisingly, perhaps, taxpayers have not argued that attribution rules can be disregarded or offset by other factors under §302(b)(2) or (3). Probably the major reason that litigation has focused solely on (b)(1) is that the legislative history seems clear that in subsections (b)(2) and (3), Congress intended to adopt tests which turn solely on the ownership of stock.

Under §302(b)(1), however, the legislative history indicates at least an intent to be more flexible than under the (b)(2) and (3) tests. Based on this intent, taxpayers have argued that the family attribution rules of §318 should not apply where attributing stock between such persons produces an unrealistic community of interest. Such an unrealistic community of interest exists where there is hostility between the distributee and the person whose stock is being attributed to the distributee. For example, if spouses are in the process of obtaining a divorce, and one spouse has a portion of shares in the family corporation redeemed, does it make sense to attribute shares owned by one spouse to the other?

The hostility issue is accentuated where the redeemed shareholder is a family trust and bad blood exists between one of the trust beneficiaries and a parent or child who separately owns stock of the company. Under the §318 rules, the stock owned before and after the redemption by the separate shareholder will be treated as owned by the trust beneficiary, and such ownership will in turn be reattributed from the beneficiary to the trust. Trustees have argued in cases like these that bad blood at the beneficiary level should prevent family attribution from occurring at the threshold, so that no reattribution of stock ownership will be made to the trust after the redemption.

Several cases before *Davis* had held that family attribution could be disregarded or offset by other factors under §302(b)(1).[610]

The effect of *Davis* on this issue has not been clear and has given rise to litigation since 1970 on just what the Supreme Court held on the point. The basic difficulty is that although the statute provides that the §318 rules "shall apply" in determining the "ownership" of stock, the word "apply" is ambiguous and *Davis* appears to permit factors in addition to quantitative stock ownership to affect the result under §302(b)(1). The 1954 Code Senate Committee report is also ambiguous because the report combines several different ideas. The word "apply" might be read as compelling stock owned by one person before or after the redemption to be treated as owned by the redeemed shareholder before or after the redemption. On the other hand, the term might mean merely that attribution rules are relevant but can be disregarded in light of other factors, or that attribution must be triggered but their significance can be outweighed by other facts and circumstances.

In *Davis*, the Supreme Court spoke of a "meaningful" reduction in a shareholder's proportionate interest and distinguished a dividend as a distribution that does not change "the relative economic interests or rights of the stockholders." Those who read the Supreme Court opinion in a somewhat flexible fashion believe that even though the Supreme Court read business purpose out of §302(b)(1), it did not necessarily do the same for a "bad blood" exception to the §318 rules. Under this view, constructive ownership of stock must be considered in every fact situation under §302(b)(1) and cannot simply be totally ignored. But, on the other hand, it is argued, §318 can be disregarded after *Davis* if applying those rules would produce an unrealistic result (because of, for example, bad blood), or, even if the §318 rules were applied, they affect only the quantity of stock owned but not necessarily also all attributes of the stock, such as control over corporate affairs. Under this approach, the "factual inquiry" that Congress directed under §302(b)(1) permits §318 to be disregarded in some circumstances, particularly where doing so seems appropriate in determining that a reduction in interest is "meaningful."[611]

The regulations (predating *Davis*) have their own ambiguities. Reg. §1.302-1(a) states that "[s]ection 318(a) … applies to all redemptions under section 302…" However, another part of the regulations states:

> The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. *One of the facts* to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation *generally* will be treated as distributions under §301 if the corporation has only one class of stock outstanding. (Emphasis added.)[612]

The Fifth Circuit in *Metzger Trust v. Commissioner*[613] agreed that former Reg. §1.302-2(b) (now redesignated as Reg. §1.302-2(b)(1)) is "ambiguous." The Tax Court, however, in *Metzger* implied that this regulation is unambiguous. It declared that this regulation has been "misinterpreted as meaning [that] constructively owned stock could be disregarded under certain circumstances, such as family discord, in determining whether a meaningful reduction in the stockholder's proportionate interest in the corporation has resulted from the redemption."[614]

Ten years after the Supreme Court decision in *Davis*, the IRS, in Rev. Rul. 80-26, took a firm position that §318 attribution, including (but not limited to intrafamily constructive ownership), always applies in testing a redemption under any category of §302, that is §302(b)(1), (2), or (3). This revenue ruling is discussed further below.

2. *Qualifying Under §302(b)(1) Even with Attribution*

Triggering §318 does not necessarily mean that the redemption will leave the shareholder's stock ownership unchanged. Even if a redeemed shareholder has another share-

[610] *Lewis v. Commissioner*, 47 T.C. 129 (1966); *Squier Est. v. Commissioner*, 35 T.C. 950 (1961), *acq.*, 1961-2 C.B. 5, *nonacq. substituted*, 1978-2 C.B. 4; *Parker v. Commissioner*, 20 T.C.M. 893 (1961).

[611] For a case before *Davis* where the Tax Court majority tested a redemption under §302(b)(1) by ignoring the family attribution rules (and was criticized by Judge Simpson in dissent for doing so), see *Lewis v. Commissioner*, 47 T.C. 129 (1966).

[612] Reg. §1.302-2(b)(1).

[613] 693 F.2d 459 (5th Cir. 1982).

[614] *Metzger Trust v. Commissioner*, 76 T.C. 42, 61 (1981).

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holder's stock attributed to him under §318, there may still be enough of a quantitative reduction in the redeemed shareholder's proportionate interest (actual and constructive) to qualify under §302(b)(1).

> *Example:* Father (F) and son (S) own 50 and 10 shares, respectively, of 100 outstanding shares. The corporation redeems 21 of F's shares. Before the transaction, F's interest (actual and constructive) was 60%. After the redemption, F's interest (actual and constructive) is 49% (39/79). The loss of control produced by this change arguably qualifies as not essentially equivalent to a dividend.

For two revenue rulings (discussed in more detail below) showing that even in light of constructive ownership after a redemption, the reduction in the shareholder's interest qualifies under §302(b)(1), see Rev. Rul. 75-512 and Rev. Rul. 75-502.

3. *The Davis Decision and Its Progeny*

The Supreme Court in *Davis* made the following statement regarding the role of attribution under §302(b)(1):

> Taxpayer, however, argues that the attribution rules do not apply in considering whether a distribution is essentially equivalent to a dividend under section 302(b)(1). According to taxpayer, he should thus be considered to own only 25 percent of the corporation's common stock, and the distribution would then qualify under section 302(b)(1) since it was not pro rata or proportionate to his stock interest, the fundamental test of dividend equivalency. See Treas. Reg. §1.302-2(b) [before redesignation by T.D. 9264, 71 Fed. Reg. 30591 (May 30, 2006)]. In subsection (c) of section 302, the attribution rules are made specifically applicable "in determining the ownership of stock for purposes of this section." Applying this language, both courts below held that section 318(a) applies to all of section 302, including section 302(b)(1) — a view in accord with the decisions of the other courts of appeals, a longstanding treasury regulation, and the opinion of the leading commentators. [citations omitted]
>
> Against this weight of authority, taxpayer argues that the result under paragraph (1) should be different because there is no explicit reference to stock ownership as there is in paragraphs (2) and (3). Neither that fact, however, nor the purpose and history of section 302(b)(1) support taxpayer's argument. The attribution rules — designed to provide a clear answer to what would otherwise be a difficult tax question — formed part of the tax bill that was subsequently enacted as the 1954 Code. As is discussed further, below, the bill as passed by the House of Representatives contained no provision comparable to section 302(b)(1). When that provision was added in the Senate, no purpose was evidenced to restrict the applicability of section 318(a). Rather, the attribution rules continued to be made specifically applicable to the entire section, and we believe that Congress intended that they be taken into account wherever ownership of stock was relevant.
>
> Indeed, it was necessary that the attribution rules apply to section 302(b)(1) unless they were to be effectively eliminated from consideration with regard to sections 302(b)(2) and (3) also. For if a transaction failed to qualify under one of those sections solely because of the attribution rules, it would according to taxpayer's argument nonetheless qualify under section 302(b)(1). We cannot agree that Congress intended so to nullify its explicit directive. We conclude, therefore, that the attribution rules of section 318(a) do apply; and, for the purposes of deciding whether a distribution is "not essentially equivalent to a dividend" under section 302(b)(1), taxpayer must be deemed the owner of all 1,000 shares of the company's common stock.

Plainly, the Court treated Davis as the sole owner before and after the redemption. However, commentators have argued that the Supreme Court should be regarded only as having rejected Mr. Davis's contention that the constructive ownership rules are not to be considered at all in testing a transaction under §302(b)(1). Under this narrow reading, factors in addition to constructive ownership of stock can be considered and, in specific cases, may cause the effects of constructive ownership to be outweighed and point toward exchange treatment.[615]

To date, two strong but divergent authorities have developed on the question whether §318 must always be applied in testing a redemption under §302(b)(1), (2), or (3). The First Circuit has held that §318 can be disregarded in some factual situations,[616] while the IRS has taken the position that §318 must always be applied in testing any redemption under §302.[617]

a. *Before the Haft Trust Decision*

Post-*Davis* revenue rulings foreshadowed Rev. Rul. 80-26, above, and applied the attribution rules quite flatly in testing a redemption under §302(b)(1).[618]

At least until 1975, the Tax Court and the Federal courts generally interpreted *Davis* in a similar manner, that is, as mandating that a redemption be tested in light of constructive ownership (and the attributes represented by the constructively owned shares).[619]

In *Title Ins. and Trust Co. v. U.S.*,[620] the Ninth Circuit tested a redemption from three family trusts in light of family attribution from the parents to the child-beneficiary of each trust,

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[615] Note, *Family Hostility as Mitigating the Constructive Ownership Rules of Section 318 When Applied to the Dividend Equivalency Provision of Section 302(b)(1)*, 55 *B.U.L. Rev.* 667 (1975).

[616] *Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975).

[617] Rev. Rul. 80-26.

[618] *See, e.g.,* Rev. Rul. 77-218; Rev. Rul. 75-512; Rev. Rul. 75-502; Rev. Rul. 71-563; Rev. Rul. 71-261.

[619] *See Fehrs Fin. Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1973); *Jones v. U.S.*, 72-1 USTC ¶9349 (D. N.J. 1972); *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), aff'd on other grounds, 535 F.2d 500 (9th Cir.), cert. denied, 429 U.S. 1000 (1976); *Sawelson v. Commissioner*, 61 T.C. 109 (1973); *Grabowski Trust v. Commissioner*, 58 T.C. 650 (1972). For an indication that the Court of Claims shares this view, see *Fehrs v. U.S.*, 556 F.2d 1019 (Ct. Cl. 1977).

[620] 484 F.2d 462 (9th Cir. 1973). *See also* PLR 9709043 (no meaningful reduction existed where taxpayer experienced a 100% reduction in direct stock interest but retained a 100% indirect interest in the voting preferred stock and an indirect interest in excess of 75% of the nonvoting common).

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and then in light of reattribution from the beneficiary to the trust. The court quoted to the Supreme Court's reference in *Davis* to "the plain language of the statute." Nevertheless, the Ninth Circuit left this faint glimmer of hope:

> Such assumptions [of family harmony under §318(a)(1)] may, indeed, prove awkward or unfair in cases where families do not behave as the rules assume they will, and intrafamily disputes exist as to who should control and how. However, we do not have such a problem here.[621]

In *Wright v. U.S.*,[622] the question was raised whether a court should test a redemption in light of §318 even if the IRS has not invoked such attribution. A majority of the court tested the redemption under §302(b)(1) without applying family attribution because the IRS had not argued for such attribution before the court. The Eighth Circuit held that, without applying family attribution, the redemption qualified for exchange treatment. A dissenting judge interpreted Davis to mandate application of §318, even if the IRS has not done so, and, in light of §318, would have found the reduction in the taxpayer's interest not "meaningful" and hence dividend equivalent.

b. The Haft Trust Decision

In 1975, the First Circuit held in *Haft Trust v. Commissioner*[623] that as a matter of law the family attribution rules of §318(a)(1) can be disregarded or minimized under §302(b)(1), depending on the facts of the particular situation. In *Haft Trust*, the First Circuit interpreted the Supreme Court's opinion in *Davis* as requiring only that attribution rules must be considered in testing a redemption but are not themselves "determinative." The appeals court emphasized the portion of the Supreme Court opinion which says that exchange treatment is permitted under §302(b)(1) if the reduction in the shareholder's interest is "meaningful" and if the redemption changes the relative economic interests or rights of the shareholder. The First Circuit stated that:

> This language certainly seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules.

The First Circuit also interpreted the legislative history of §302(b)(1) as indicating that Congress intended that provision to have some flexibility. The court pointed out that in 1954 the Senate added a dividend equivalence test to the strictly objective tests contained in the House bill because the Senate felt that eliminating the dividend equivalence test of prior law would be "unnecessarily restrictive." The court also interpreted *Davis* as rejecting only the narrow contention that the attribution rules are to be entirely disregarded under §302(b)(1) because that paragraph does not actually mention the "ownership" of stock. The First Circuit agreed that the Supreme Court eliminated business purpose as a test of dividend equivalence, but this action "does not imply a rejection of all mitigating factors in the application of Section 302(b)(1)."

The IRS argued that a hostility exception would lead the courts (and presumably also the IRS) into "uncertain shifting quagmires of family relationships." The First Circuit minimized the IRS's concern in this respect, however, saying that the courts remain free to view taxpayers' claims of hostility with "jaundiced eyes." More important, the court said, by retaining a dividend equivalence test in the law, Congress showed itself willing "to tolerate some administrative inconvenience for the sake of taxpayer equity."

The First Circuit did not apply its conclusions of law, however, to the actual facts of the *Haft Trust* case. Instead, it remanded the case to the Tax Court for the purpose of considering the possible "existence of family discord tending to negate the presumption that taxpayers would exert continuing control over the corporation despite the redemption."

Haft Trust involved simultaneous redemptions from four minority shareholders where, by virtue of taking constructive stock ownership into account, each shareholder's percentage interest increased from 31.67% to 33.33%. Each redeemed shareholder was a family trust which, before the redemptions, actually owned 25,000 of 500,000 outstanding shares of a family corporation. The sole beneficiary of each trust was a different child of Burt Haft (two were children of his wife's first marriage and had been adopted by him). Burt owned 100,000 shares in his own right and was one of three beneficiaries of another trust, created by his father, which actually owned 100,000 shares. Burt was also an officer of the family corporation. The remaining 200,000 outstanding shares of stock were divided equally among Burt's brother and his brother-in-law. Before the redemptions each child's trust owned, actually and constructively:

Shares	
25,000	actually
100,000	via Burt's shares attributed to his child then reattributed to trust
33,333.33	via Burt's one-third interest in other trust reattributed to his child, then reattributed to trust
158,333.33	constitutes 31.67% of 500,000 outstanding shares

Each trust for the children had been created and funded in 1962 by Burt's father-in-law. In late 1966, divorce proceedings began between Burt and his wife. The negotiations were unfriendly and acrimonious. At the time the proceedings began, Burt moved out of the house and did not see his children for six to seven months thereafter. The divorce was granted on June 26, 1967. Pursuant to the negotiations, it had been agreed that each trust's stock interest in the corporation would be completely terminated. The redemptions occurred on June 17, 1967, just before the divorce decree. Thereafter, each trust owned no shares actually but continued to own constructively the same 133,333.33 shares which each owned constructively before the redemption. Such constructive ownership represented a 33.33%

[621] 484 F.2d 462 (9th Cir. 1973) at 462, n.4.
[622] 482 F.2d 600 (8th Cir. 1973), aff'g 72-2 USTC ¶9495 (E.D. Ark. 1972).
[623] 510 F.2d 43 (1st Cir. 1975), vac'g 61 T.C. 398 (1973), supp. opin., 62 T.C. 145 (1974).

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interest (133,333.33/400,000) of the shares actually outstanding after the redemptions.

The Tax Court held each redemption to be dividend equivalent because no reduction in each trust's percentage ownership (actual and constructive) had occurred. The court held that the family attribution rules of §318(a)(1) cannot be disregarded in "family fight" situations in testing a redemption under §302(b)(1).

Each trust argued that because an intrafamily dispute (a divorce) led to the redemptions, the facts and circumstances justified measuring each trust's before and after stock ownership solely by reference to the shares it actually owned. Judge Simpson first questioned whether the relevant relationship, for purposes of considering whether a "family fight" justifies disregarding family attribution, was between the father and his children — who were the trust beneficiaries and between whom the chain of attribution would, in part, operate — or whether the relevant relationship was between Burt and the trustees of each trust. Each trust had the same three trustees: Burt Haft's father-in-law and mother-in-law and a third individual apparently unrelated to either family. In the unfriendly divorce proceedings, Burt Haft's in-laws apparently aligned themselves with their daughter (Burt's wife), although this is not completely clear from the facts. Judge Simpson indicated an absence of evidence of actual hostility between Burt and his children. However, the court went on to consider the "family fight" issue because, broadly speaking, the redemption occurred as part of the arrangements for the divorce and property settlement.

Judge Simpson then interpreted *Davis* as indicating that the Supreme Court believed that Congress intended in 1954 to eliminate pre-1954 "uncertainties" concerning whether constructive ownership rules would be applied in particular situations, and to provide "definite rules" after 1954. Judge Simpson said:

> If the applicability of the attribution rules depended upon the feelings or attitudes among the members of a family, it would then be necessary to inquire into whether there was hostility or animosity among them, whether such discord was serious, and whether it would actually or likely impair the ability of one member of the family to influence the conduct of other members. By the terms of the statute, the attribution rules are applicable irrespective of the personal relationships which exist among the members of a family, and an interpretation of the statute which made their applicability depend upon whether there was discord among the members of the family — or the extent of any such discord — would frustrate the legislative objective and would be clearly inconsistent with the language and the rationale of *Davis*. For these reasons, we believe that in view of the Supreme Court's opinion in *Davis*, the petitioner's reliance upon *Squier* and *Bradbury* is misplaced, and we hold that the applicability of the attribution rules is not affected by the circumstances which led to the redemption.[624]

As indicated earlier, the First Circuit remanded the case to the Tax Court to consider the effect of family discord in this particular situation. There was no further Tax Court opinion on this issue, however, since the case was subsequently settled.

Note: The Tax Court's supplemental opinion in *Haft Trust*[625] dealt with an unrelated question whether family attribution could be waived under the 10-year agreement rules of §302(c)(2)(A). For the §302(b)(3) issues raised in *Haft Trust*, see the discussion of §302(b)(3), at IV.C., above.

c. Rev. Rul. 80-26

The IRS has expressly refused to follow the First Circuit's decision in *Haft Trust* and has taken a firm position that §318 attribution must always be applied mechanically in testing a redemption under §302 generally — that is, under subsection (b)(1), (2), or (3). As to the *Haft Trust* decision, Rev. Rul. 80-26 states:

> In *Robin Haft Trust*, … on facts similar to those set forth above, the court viewed the attribution rules as a presumption of continuing influence over corporate affairs and, therefore, because of the family hostility disregarded the attribution rules in testing the redemption of the taxpayers' stock for dividend equivalency. Such an interpretation is, however, inconsistent with both the legislative history of section 318 of the Code and the language and rationale of *Davis*. The purpose of the attribution rules under section 318 was to replace the confusion of prior law with clear and objective standards for attribution of stock ownership among related shareholders. The facts and circumstances of a particular case cannot contradict the mechanical determination under section 318 of how much stock a shareholder owns. Consequently, the IRS will not follow the decision of … the First Circuit in *Haft Trust*. Also, the acquiescence in the decision in *Estate of Squier v. Commissioner*, 35 T.C. 950 (1961), *acq.*, 1961-2 C.B. 5, upon which the decision of *Haft* relies, has been withdrawn and nonacquiescence substituted therefor. *See* 1978-2 C.B. 4.

The IRS's position is that §318 cannot be disregarded in a specific fact situation because of the particular circumstances such as hostility, animosity, bad feelings, or any other sentiment that exists and negates, in reality, a community of interest between or among the persons as to whom constructive ownership is triggered by §318. Rev. Rul. 80-26 notes that the 1954 Code House Report referred to the absence, under the 1939 Code, of "specific statutory guidance" for stock ownership in the area of corporate distributions and expressed an intent to adopt (in §318) "precise standards whereby under specific circumstances a shareholder may be considered as owning stock held by members of his family (… or trusts which he controls)."[626] Rev. Rul. 80-26 interprets this legislative history (as well as the Supreme Court's decision in *Davis*) as mandating a "mechanical" application of §318 in every §302 case in determining how much stock a shareholder owns. "The rules of attribution under section 318 of the Code," the IRS says flatly, "are

[624] 61 T.C. at 403.

[625] 62 T.C. 145 (1974).

[626] H.R. Rep. No. 83-1337, A96 and 36 (1954) (quoted in Rev. Rul. 80-26).

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applicable in determining whether a distribution in redemption of stock qualifies under section 302(a)."

Observation: Although Rev. Rul. 80-26 does not say so expressly, the IRS's position in the ruling does not in any way apply to the narrow statutory disregard of family attribution in testing a redemption under §302(b)(3) if the requirements of §302(c)(2) are satisfied.

The fact situation set forth in Rev. Rul. 80-26 tracks the facts of *Haft Trust* and alleged family hostility in connection with §302(b)(1). However, the ruling is not limited to hostility of the kind that the taxpayers in *Haft Trust* alleged existed there. Nor is Rev. Rul. 80-26 limited to intrafamily hostility in general. The IRS's position applies to any reason or justification a taxpayer might advance for not triggering constructive ownership under §318 in testing a particular redemption under §302.

The fact situation set forth in Rev. Rul. 80-26 involved X corporation, having one class of voting common stock outstanding, owned by the following persons:

A, an individual;

B, brother of A;

C, brother-in-law of A;

TA, trust for the benefit of A (one-third interest), B and D (sister of A);

T1, trust for the benefit of A's children;

T2, trust for the benefit of A's children;

T3, trust for the benefit of A's children;

T4, trust for the benefit of A's children.

Each trust was created by a parent of A's spouse. A and his spouse went through a divorce and an "acrimonious" property settlement. Incident thereto, the corporation redeemed all the stock owned by the four trusts for the children. Each trust's percentage ownership of stock, by reason of parent-to-child and beneficiary-to-trust attribution, changed from 31% to 33% (an increase in percentage ownership). Even though the facts stipulate that, because of the family hostility, the four trusts did not in fact exercise control over the stock attributed to them before or after the redemption, the ruling attaches no legal significance to that fact and holds that, in light of the increased percentage ownership of stock (which was wholly constructive) following each trust's redemption, each redemption failed to qualify for exchange treatment under §302(b)(1), (2), or (3) and was thus a §301 distribution.

The IRS has not wavered since the publication of Rev. Rul. 80-26 in its insistence on a mechanical approach, as evidenced by CCA 200409001. In the facts of the CCA, family-owned corporation X had two classes of outstanding stock (voting Class A common and nonvoting Class B common). X's shareholders were the taxpayers, relatives of the taxpayers, management employees and X's board members, and three trusts for the taxpayers' children. The taxpayers made gifts of their Class A voting stock to the children's trusts, which then transferred the stock to a voting trust. X redeemed a number of shares of the taxpayers' voting Class A stock to pay the gift tax on the transfers and later redeemed additional shares so that the taxpayers could pay the income tax on the first redemption. The taxpayers took the position that their transfers through the children's trusts to the voting trust reduced their voting control of X, arguing that there can be exceptions to the application of §318 to §302. The Chief Counsel's Office, reiterating that the IRS would not recognize any exceptions to the application of §318 to §302, advised that the taxpayers still owned 100% of the voting rights in X after all the transfers to the children's trusts and the transfers to the voting trust.

Comment: The analysis set forth in Rev. Rul. 80-26 and, e.g., *Metzger*[627] will probably not prevent commentators from continuing to argue for a flexible role for attribution under §302(b)(1). Under one theory, promulgated before Rev. Rul. 80-26,[628] the 1954 Code specified for the first time which relationships are relevant for constructive ownership purposes (e.g., attribution between spouses but not between brother and sister) and also the *transactions* in which attribution rules are to be considered. However, according to this theory, §302(b)(1) does not command or prevent consideration of other factors in addition to constructive ownership. *Davis* held only that factors irrelevant to the actual economic impact of a redemption cannot be considered. But, in focusing solely on the effect rather than purpose of a redemption, the statute still requires an investigation into the specific facts in order to determine what the economic effects of the transaction were. For this purpose, courts are required to "consider" both the actual distribution of control and equity before and after a redemption and also the shareholder's relationship with his tax relatives (as defined in §318). But if his actual relationship with these relative is hostile, then, according to this theory, the shareholder need not be treated as owning his relative's stock in that case. Or, alternatively, if he is considered to own that stock, he does not necessarily also have to be considered as owning all of the control or equity rights that accompany such stock. However, in *Metzger*,[629] the Tax Court expressly rejected this theory.

d. Other Developments

In 1978, the IRS withdrew its long-standing acquiescence in *Squier Est. v. Commissioner*, and substituted a full nonacquiescence in the decision.[630]

In *Metzger Trust v. Commissioner*,[631] the Tax Court mechanically applied the attribution rules to a redemption that, according to the taxpayer, qualified under §302(b)(1) due to family hostility. The taxpayer-trust in *Metzger* redeemed all of the stock it actually owned but, due to the attribution rules, was still deemed to own 100% of such stock. In finding that the redemption was the equivalent of a dividend, the court applied the attribution rules to the purported redemption notwithstanding the allegation of family hostility. Relying upon *Davis*, the Tax Court stated that family hostility plays a "limited" role in a two-step analysis of purported §302(b)(1) redemptions. The court held that in determining whether a redemption qualifies under §302(b)(1):

> First, the attribution rules are plainly and straightforwardly applied [without regard to whether family hostility exists]. Second, one looks to see if there

[627] 76 T.C. 42 (1981) (discussed at VI.I.3.d., below).
[628] *See* Note, 29 *Tax Law.* 386 (1976).
[629] 76 T.C. 42, 62 (1981).
[630] *See* 1978-2 C.B. 4.
[631] 76 T.C. 42, 61 (1981), aff'd, 82-2 USTC ¶9718 (5th Cir. 1982).

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> has been a reduction in the stockholder's proportionate interest in the corporation. If not … then a Court need not proceed any further because there being no change in stockholder's interest, dividend equivalency must follow. If there has been a reduction, then a Court should proceed to examine all the facts and circumstances to see if the reduction was meaningful for the purposes of section 302. At this point [and not before], family hostility becomes an appropriate factor for consideration. (emphasis in original).[632]

In affirming the Tax Court's decision in *Metzger*, the Fifth Circuit explicitly adopted the lower court's two-step analysis, strongly implying that the holding in *Davis* requires such an analysis. The Fifth Circuit also criticized the First Circuit's interpretation of *Davis* in its *Haft Trust* decision.[633]

In *Benjamin v. Commissioner*,[634] discussed further below, the Tax Court noted the *Haft Trust* decision but felt that it could distinguish the facts before it on the ground that the redemption would be dividend equivalent whether or not the attribution rules were applied. If §318 were applied, the taxpayer would be the sole shareholder before and after the redemption, and if §318 were not applied, the taxpayer would still have retained full control over corporate affairs. The Tax Court then proceeded to resolve the case on the assumption that the attribution rules did not apply in the case.

In *Johnson Trust v. Commissioner*,[635] and *Chertkof v. Commissioner*,[636] the Tax Court rejected taxpayer's claims that intrafamily hostility existed in the particular fact situation, so as to justify not applying family attribution under §302(b)(1).

4. Other Aspects of the "Hostility" Concept

As the above discussion indicates, there is a split in authority as to whether the attribution rules must be applied mechanically without regard to family discord. While the Fifth Circuit, the Tax Court, and the IRS believe that factors such as familial discord are taken into account only after the attribution rules have been applied, the First Circuit takes the position that familial discord is among the facts and circumstances that should be considered in determining whether the attribution rules should be applied at all. Consequently, arguments in favor of a somewhat flexible application of §302(b)(1) remain worthwhile to consider. In addition, it may continue to be worthwhile to discuss the actual scope of the "hostility" or "discord" concept, and to consider questions such as:

(1) Is the discord concept limited to intrafamily antagonism or would the logic also apply to antagonism between or among persons otherwise considered related by §318?

(2) What degree of hostility must exist?

(3) Could reasons other than hostility which negate a community of interest between persons formally covered by §318 justify disregarding §318 in certain situations?

a. Nonfamily Discord

There are few cases suggesting that antagonism, arm's-length dealing, or any other factor can justify disregarding attribution under the *nonfamily* categories of §318. For example, can attribution of stock owned by a partnership to a partner be disregarded if the latter can show that he does not get along with his fellow partners? Can a trust beneficiary's personally owned stock not be attributed to the trust if the beneficiary and the trustee have ill will toward each other? Or if the beneficiary of the grantor dislike each other? Or the grantor of an unrelated trustee? Rev. Rul. 80-26 indicates, of course, that the IRS will answer all of these questions firmly in the negative.

The leading case on point is *Squier v. Commissioner*,[637] in which the Tax Court tested a redemption without applying beneficiary-to-estate attribution in view of a dispute between the beneficiaries and the executor of the estate over appointment of a new company president.

b. Must Discord Affect Redeemed Shareholder Directly?

Rev. Rul. 80-26 involved two steps in the construction ownership chain: family attribution and beneficiary-to-trust attribution. However, the actual hostility and the parties thereto are not clearly set forth in the facts. The only apparent hostility was between A and his spouse. Nothing indicates that A and his children did not get along well. No facts indicate who was the trustee of the trusts. Although each trust was created by a parent of A's spouse (Burt Haft's father-in-law in the *Haft Trust* case), Rev. Rul. 80-26 does not indicate whether antagonism existed between A and his in-law or between the father-in-law and his grandchildren. Although the ruling points out that each trust was prevented from exercising the rights of its stock holdings before the redemption "due to family hostility," no facts spell out who controlled the company or specifically what hostility existed.

c. Factors Other than Hostility

Is "hostility" the only circumstance where attribution could be waived? What about honest but strong policy differences on how a corporation should be run? Suppose a father has simply been out of touch with his son for several years so that there is no known community of interest between them; might attribution of the father's stock to his son be waived depending on how accentuated the facts are in the particular case? Is generalized family discord enough to permit disregard of family attribution, or must specific hostility between the redeemed shareholder and other shareholders be shown?

[632] 76 T.C. at 61.
[633] 82-2 USTC ¶9718 (5th Cir. 1982).
[634] 592 F.2d 1259 (5th Cir. 1979), aff'g 66 T.C. 1084 (1976).
[635] 71 T.C. 941 (1979), *acq.*, 1984-2 C.B. 1.
[636] 72 T.C. 1113 (1979), aff'd, 649 F.2d 264 (4th Cir. 1981).
[637] 35 T.C. 950 (1961), *nonacq.*, 1978-2 C.B. 4.

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d. Burden of Proof

In 1958, the Advisory Group on Subchapter C proposed a general rule that attribution not operate under §302(b)(1) as a matter of law, but the relationships described in §318 could be "taken into account along with all other facts and circumstances." This rule would appear to place the burden on the IRS to show why attribution should apply in testing a redemption for dividend equivalence. By contrast, the First Circuit may be placing the burden on the shareholder to show why, in his particular case, attribution should not occur.

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VII. Partial Liquidation: §302(b)(4) and §302(e)

A. *In General*

The final category under §302(b) requiring exchange treatment for a distribution in redemption of shares is §302(b)(4), which provides that a distribution that is in redemption of stock held by a shareholder who is not a corporation and in partial liquidation of the distributing corporation will be given exchange treatment under §302(a). The term "partial liquidation" is defined in §302(e), which provides that a distribution will be treated as in partial liquidation of a corporation if the distribution is not essentially equivalent to a dividend and the distribution is pursuant to a plan and occurs within the taxable year in which the plan was adopted or within the succeeding taxable year.[638]

B. *The Requirements*

1. *Introduction*

The major difference between §302(b)(4) and the other §302(b) categories is that, in the determination of whether a distribution qualifies as a partial liquidation, the effect of the distribution on the *corporation* is analyzed. Under the other §302(b) categories, the effect of the distribution on the shareholder's stock ownership is analyzed. Because the focus is at the corporate level, a distribution in partial liquidation can be pro rata with respect to all of the shareholders of the corporation,[639] a trait that is nearly always fatal to exchange treatment under the other §302(b) categories. Further, this shift in emphasis to the effect of the distribution at the corporate level renders the §318 attribution rules meaningless. Under §302(b)(4), the relevant factor at the shareholder level is that the distributee cannot be a corporation.[640]

2. *Redemption of Stock*

Section 302(b)(4) provides that a distribution in partial liquidation of a corporation must be in redemption of stock held by a shareholder who is not a corporation. The issue arises whether a shareholder must actually surrender shares to the corporation for redemption, or whether this requirement will be deemed satisfied where the tendering of shares to the corporation by the distributee would be a meaningless gesture[641] (such as where the distribution is pro rata). In a pro rata distribution among all the shareholders of the distributing corporation, an actual redemption of shares will have no effect on the proportionate ownership interests of the shareholders after the redemption. Both before and after the redemption each shareholder will have the same interest in the distributing corporation. However, if the distribution is non-pro rata, a redemption of shares reduces the distributee's interest in the corporation and increases the other nonredeeming shareholder's interests.

In Rev. Rul. 81-3, declared obsolete in Rev. Rul. 90-13, the IRS addressed the redemption requirement in the context of the pre-TEFRA statutory framework. In that ruling, Corporation X had two operating divisions. X sold one of the divisions to an unrelated third party for cash and the assumption of liabilities that had arisen in connection with the operation of that division. X then adopted a plan of partial liquidation and distributed the net proceeds of the sale pro rata to its shareholders within the taxable year in which the plan was adopted. The shareholders of X did not surrender any of their stock in exchange for the cash X distributed.

The IRS ruled that because the distribution was pro rata the actual redemption of stock would have been a meaningless gesture.[642] The IRS cited *Fowler Hosiery Co. v. Commissioner*,[643] which involved a distribution from a wholly owned subsidiary to its parent corporation consisting of a major portion of the sale proceeds from the sale of its subsidiary's assets. In *Fowler*, there was neither an actual redemption of stock nor a plan of partial liquidation. On the redemption issue, the court stated:

> Since there was only one stockholder, petitioner, it was immaterial how many shares of stock represented that interest. The interest was the same whether or not any part of the stock was retired.[644]

Rev. Rul. 90-13, which has substantially the same facts as Rev. Rul. 81-3, confirms the rationale of Rev. Rul. 81-3 for the post-TEFRA statutory scheme. The ruling does mention that there were no outstanding rights, such as warrants, options, convertible securities, shareholder agreements, or rights of first refusal, affecting the stock of the distributing corporation,[645] thus ensuring that the distribution was pro rata as to all persons with any type of an equity interest in the distributing corporation. The revenue ruling cites the following excerpt from the TEFRA conference report:

> Under present law, a distribution in partial liquidation may take place without an actual surrender of stock by the shareholders (*Fowler Hosiery Co. v. Commissioner*…). A constructive redemption of stock is deemed to occur in such transactions (Rev. Rul. 81-3…). The conferees intend that the treatment

[638] *See* Reg. §1.346-1(a)(2). *See, e.g.,* PLR 200445009 and PLR 200342004.

[639] §302(e)(4). *See* PLR 200703021, PLR 200626016, PLR 200445009, PLR 200342004, PLR 200230002, and PLR 200229005.

[640] Section 302(e)(5) provides that "[f]or purposes of determining under subsection (b)(4) whether any stock is held by a shareholder who is not a corporation, any stock held by a partnership, estate, or trust shall be treated as if it were actually held proportionately by its partners or beneficiaries." In PLR 200317020, the IRS ruled that distributions to shareholding trusts may qualify as a §302(b)(4) partial liquidation if the beneficiaries of the trusts are not corporations, because the stock held by the trusts is treated as if it were actually held by their beneficiaries. In addition, the IRS ruled that qualification as a §302(b)(4) partial liquidation would not be jeopardized simply because the cash came from the sale of businesses owned by the distributor's subsidiaries, as long as there were intervening §332 liquidations of those subsidiaries.

[641] *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981) (requirement that transferee corporation exchange stock considered "meaningless gesture" in "D" reorganization where same shareholders own all the stock of both corporations); Rev. Rul. 70-240 (no actual distribution of shares necessary to shareholder who controlled both corporations in "D" reorganization); Reg. §1.368-2(l) (transaction otherwise described in §368(a)(1)(D) is treated as satisfying requirements of §368(a)(1)(D) and §354(b)(1)(B) even if no stock or securities of transferee corporation are issued, provided same person or persons directly or indirectly own all of stock of transferor and transferee corporations in identical proportions). See also TAM 2001419013.

[642] *See also* Rev. Rul. 79-257, *declared obsolete* by Rev. Rul. 90-13.

[643] 36 T.C. 201 (1961), aff'd, 301 F.2d 394 (7th Cir. 1962).

[644] 36 T.C. 221.

[645] See VII.C., below, for the IRS's private ruling position in this area.

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> of partial liquidations under present law section 346(a)(2) and (b) is to continue for such transactions under new section 302(e).[646]

In PLR 9619050, the IRS ruled that if no shares are actually surrendered, the number of shares that will be considered to have been redeemed for purposes of determining gain or loss is determined in accordance with the principles set forth in Rev. Rul. 77-245, (i.e., computed based upon the fair market value of the stock of the distributing corporation before and after the distribution).

The meaningless gesture rationale for waiving the redemption requirement does not apply to non-pro rata distributions. A redemption of stock in this transaction would affect the relative ownership interests of the shareholders after the redemption. Therefore, a redemption of stock cannot be deemed to occur under §302(b)(4)(A) and the distribution will fail to qualify as a partial liquidation.[647]

3. Plan of Liquidation

Section 302(e)(1)(B) provides, in part, that a distribution will be treated as a distribution in partial liquidation of a corporation if the distribution is pursuant to a plan. However, neither the Code nor the regulations define "plan." It is not entirely clear whether an informal plan is sufficient, but there is some authority for this proposition.[648]

4. Distribution Occurs Within the Year the Plan Is Adopted or Within the Succeeding Tax Year

Section 302(e)(1)(B) requires that the distribution in partial liquidation occur within the taxable year in which the plan is adopted or within the succeeding taxable year. This rule applies whether the distribution is in-kind or of the net sale proceeds from the sale of the business assets.

When a distributing corporation sells a business, but delays adopting a plan of partial liquidation and distributing the sale proceeds, the issue arises whether the distributed funds can still be considered the proceeds from the sale of assets that resulted in a contraction of the corporation's operations. That is, the length of time between the sale and the use of funds during this time may break the nexus between the distribution of the proceeds pursuant to the plan and the corporation contracting sale. The concern here is that, because money is fungible, the sale proceeds can be transformed into investment assets or reserves for expansion.[649]

In Rev. Rul. 71-250,[650] a corporation, in July 1970, sold one of its businesses and transferred the net sale proceeds to a special account at a bank acting as a custodian, as a temporary measure until the fund's use could be decided. The bank invested the funds in stock and Treasury bills. The bank eventually sold the stocks and T-bills at a gain and this gain was included in the gross income of the corporation. The corporation considered using the sale proceeds to expand through acquisitions but it was unable to consummate a transaction. Therefore, in December 1970, the corporation adopted a plan of partial liquidation pursuant to which it distributed, in February 1971, all the funds from the investment account (including the appreciation from its investments) pro rata to its shareholders in redemption of a part of the corporation's outstanding stock.

The IRS ruled that Reg. §1.346-1(a)(2) (prohibiting the distribution of funds attributable to an abandoned reserve for expansion to qualify for partial liquidation treatment) does not apply to the temporary investment of net sale proceeds. The IRS also ruled that preserving the proceeds through investment does not constitute a dedication of the funds to the remaining business enterprise or an expansion of an existing business.[651]

While the distribution of the principal amount of the sale proceeds that were invested with the bank qualified as a partial liquidation, the amount distributed that was attributable to the appreciation of the sale proceeds did not qualify as a distribution in partial liquidation.[652] This amount was a distribution of property under §301.

5. Not Essentially Equivalent to a Dividend

A redemption will be considered a partial liquidation under §302(b)(4) only if the redemption is not essentially equivalent to a dividend — determined at the corporate level, not the shareholder level.[653] There are essentially two ways to meet this requirement. The first is for the redemption to meet the safe harbor found in §302(e)(2)(termination of a business). The second is for the redemption to meet the requirements of a "corporate contraction."

a. Safe Harbor — Termination of a Qualified Trade or Business

Under §302(e)(2), a redemption is not essentially equivalent to a dividend (for purposes of §302(b)(4)) if the distribution is attributable to the distributing corporation ceasing to conduct, or consists of the assets of, a qualified trade or business and immediately after the distribution, the distributing corporation is actively engaged in the conduct of a qualified trade or business. Section 302(e)(3) defines a qualified trade or business as a trade or business that was actually conducted throughout the five-year period ending on the date of the redemption and was not acquired by the corporation within such period in a transaction in which gain or loss is recognized.

Note that to qualify under these sections, the distributing corporation must have two qualified businesses. This safe harbor is based on the principles of the corporate contraction doc-

[646] *Citing* H.R. Conf. Rep. No. 97-760, 530 (1982), 1982-2 C.B. 600, 628–29.

[647] *See Baan v. Commissioner*, 45 T.C. 71 (1965), aff'd, *Commissioner v. Baan*, 382 F.2d 485 (9th Cir. 1967), aff'd sub nom., *Commissioner v. Gordon*, 391 U.S. 83 (1968).

[648] *Fowler Hosiery Co. v. Commissioner*, 301 F.2d 394 (7th Cir. 1962); *see also* Rev. Rul. 65-80. *But see Blaschka v. United States*, 393 F.2d 983 (Ct. Cl. 1968) (corporation failed to adopt a formal or informal plan).

[649] The regulations provide that "the distribution of funds attributable to a reserve for an expansion program which has been abandoned does not qualify as a partial liquidation within the meaning of §346(a)." Reg. §1.346-1(a).

[650] *See also* PLR 199902001.

[651] The IRS distinguished Rev. Rul. 58-565 (partial liquidation requirements not met where sale proceeds used to pay existing indebtedness of the remaining business), and Rev. Rul. 67-299 (partial liquidation requirements not met where sale proceeds used to remodel property in order to expand the remaining business). *Cf.* Rev. Rul. 79-275 (distribution by a corporation to its shareholders of appreciated securities, in substitution for a note received upon the sale by the corporation of the assets of its terminated separate business, does not qualify as a partial liquidation).

[652] *See* Rev. Rul. 71-250.

[653] §302(e)(1)(A).

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trine. The underlying theory of the safe harbor provision is that if a company had two active businesses, and it distributed the assets of, or the sale proceeds attributable to, one of them, a genuine corporate contraction would occur.

The reference to a five-year active trade or business is meant to have the same meaning as in the §355 context.[654] The regulations contain guidelines for determining what assets will be considered part of a qualified trade or business.[655]

To qualify under this safe harbor, all of the assets or all of the sale proceeds attributable to the qualified trade or business must be distributed.[656] Apparently, in the case of an in-kind distribution, every asset of the business must be distributed. As for the relative size of the business being distributed, the IRS ruled in Rev. Rul. 77-376 that the size of the discontinued trade or business is immaterial.

b. Corporate Contraction

If a taxpayer cannot qualify under the safe harbor of §302(e)(2), the taxpayer must prove that the distribution is not essentially equivalent to a dividend by establishing that there has been a corporate contraction of the business, based on all of the facts and circumstances.

The regulations under §346 provide that an example of a distribution which will qualify as a partial liquidation . . . is a distribution resulting from a genuine contraction of the corporate business such as the distribution of unused insurance proceeds recovered as a result of a fire which destroyed part of the business causing a cessation of a part of its activities.[657]

The example in Reg. §1.346-1(a) of the distribution of insurance proceeds is similar to the facts in *Imler v. Commissioner*[658] In *Imler*, a corporation was engaged in retinning and soldering metals and in the rental of excess space in the five buildings owned by the company. It was renting the top two floors of the main building when they were destroyed by fire.

After collecting the insurance proceeds, the corporation considered rebuilding the upper two floors, but found this option to be too costly. The corporation decided on the less costly alternative of removing the two top floors and replacing them with a roof. The cost of these repairs was less than the total amount of insurance proceeds received. The corporation distributed the balance of the insurance proceeds to its shareholders. The court held this distribution resulted in a corporate contraction and qualified as a partial liquidation. The court stated that the following factors are important when considering whether there has been a corporate contraction — the presence or absence of a real business purpose, the motives of the corporation at the time of the distribution, the size of the corporate surplus, the past dividend policy, and the presence of any special circumstance relating to the distribution.[659]

Because of the extremely factual nature of the inquiry into whether a corporate contraction has occurred, the IRS has offered guidance through a series of revenue rulings.[660]

In Rev. Rul. 76-526, a corporation owned two parcels of land as passive real estate investments. The corporation leased the parcels. The lessee was required to pay all real estate taxes and was responsible for all maintenance related to the land. The corporation also had a management contract whereby another party provided renting, leasing, operating and managing services. The lessor-corporation performed no substantial activities with respect to the land.

The corporation distributed one of the parcels pro rata to its shareholders. The IRS ruled that a distribution in partial liquidation must result in a substantial reduction of activities performed by the corporation making the distribution. In the present case, there was no substantial reduction in activities because the distributing corporation had no substantial activities to perform under the lease and management contract.[661]

The IRS found a genuine corporate contraction in Rev. Rul. 74-296, where a corporation operating a full-line department store significantly downsized its operation in response to the adverse effect competing stores were having on its sales. The corporation distributed to its shareholders the proceeds from the sale of some of its assets from the departments it eliminated. The IRS ruled that because the corporation discontinued most of its activities and operation of its business, and then changed the nature of its remaining business, there was a corporate contraction and distribution in partial liquidation.[662]

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[654] Reg. §1.346-1(c) references former §1.355-1(c) (the regulations under §355 were substantially changed in 1989). *See* 776 T.M., *Corporate Separations*. *See also* PLR 9809051 (cash distributions to shareholders before §355 split-off treated as distributions in partial liquidation; five-year requirement of §355(b)(2)(B) met).

[655] *See* Reg. §1.346-1(b)(2)(i).

[656] *See Kenton & Meadows Co. v. Commissioner*, T.C. Memo 1984-379, aff'd, 766 F.2d 142 (4th Cir. 1985).

[657] Reg. §1.346-1(a).

[658] 11 T.C. 836 (1948). Other pre-1954 cases that helped create the corporate contraction doctrine were *Commissioner v. Champion*, 78 F.2d 513 (6th Cir. 1935) (distribution of unneeded reserve for expansion in redemption of stock constituted partial liquidation) (note that the holding in *Champion* was specifically rejected by the 1954 Senate report (S. Rep. No. 83-1622, 49, 262 (1954)), the regulations under §346 of the 1954 Code, and Rev. Rul. 78-55); *Upham v. Commissioner*, 4 T.C. 1120 (1945) (same); *see O'Brion*, 10 T.C.M. 1122 (1951) (redemption and subsequent distribution considered as partial liquidation where business operations were curtailed); *Commissioner v. Cordingley*, 78 F.2d 118 (1st Cir. 1935) (same); *Commissioner v. Quackenbos*, 78 F.2d 156 (2d Cir. 1935) (same); *Elton v. Commissioner*, 47 B.T.A. 111 (1942) (same); *Commissioner v. Sullivan*, 210 F.2d 607 (5th Cir. 1954) (redemption to protect corporate assets from creditors considered partial liquidation); *Lockhart v. Commissioner*, 8 T.C. 436 (1947) (redemption considered partial liquidation where done to separate two parts of a business); *Commissioner v. Babson*, 70 F.2d 304 (7th Cir.) (redemption attributable to liquidation of unprofitable division treated as partial liquidation), cert. denied, 293 U.S. 571 (1934); *Scowcroft Inv. Co. v. Commissioner*, 4 T.C.M. 755 (1945) (same). *Cf. McGuire v. Commissioner*, 84 F.2d 431 (7th Cir.) (distribution from redemption due to accumulations of sums for expansion that were ultimately not needed considered a dividend), cert. denied, 299 U.S. 591 (1936). *But see Dunton v. Clauson*, 67 F. Supp. 839 (D. Me. 1946) (distribution in redemption of stock not considered a partial liquidation despite redemption being made for a "sound business purpose"); *Chandler v. Commissioner*, 22 T.C. 1158 (1954) (redemption in order to downsize business considered essentially equivalent to a dividend), aff'd per curiam, 228 F.2d 909 (6th Cir. 1955).

[659] 11 T.C. 836, 840.

[660] In addition to the revenue rulings discussed above, see also Rev. Rul. 76-289 (working capital can be distributed in a partial liquidation), and Rev. Rul. 76-279 (amounts distributed in partial liquidation do not include earnings derived from a corporation investing the proceeds of a sale of a division, asset, or department in an investment account pending distribution to shareholders).

[661] *See also* Rev. Rul. 56-512.

[662] *But see* Rev. Rul. 60-322 (corporate contraction not found where a corporation, due to a steady decline in demand for its products, distributed cash to its shareholders, in redemption for part of their stock, that was realized from the sale of portfolio bonds and excess inventories which it had decided to gradually sell because of a decline in the demand for the inventory); Rev. Rul. 78-55 (corporate contraction not found where business-line cash reserve distributed

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In Rev. Rul. 67-16, despite a corporation having over half of its assets in a mining venture condemned by state authorities, the IRS found no current corporate contraction. The IRS reasoned that because the condemnation did not result in any current decrease in the corporation's business (27 years of limestone reserves were left for mining) the distribution of the proceeds to the shareholders was a dividend under §301.

The IRS has also issued revenue rulings distinguishing between a sale of the stock of a subsidiary by a parent corporation followed by a distribution of the sale proceeds and the sale of the assets of a subsidiary, followed by a §332 liquidation of the subsidiary and distribution of the sale proceeds by the parent to its shareholders. In the former situations, the IRS ruled that the parent's distribution of the proceeds from the sale of the subsidiary stock, while reducing the amount of the parent's assets, did not result in a contraction of the business operation of the parent. In Rev. Rul. 79-184,[663] the IRS stated that: "the overall transaction has the economic significance of the sale of an investment and distribution of the proceeds." This ruling is based on the IRS's conclusion that the subsidiary is a separate legal entity whose business cannot be attributed to the parent. The IRS has also ruled that a distribution of the stock of the subsidiary by a parent to its shareholders is not a partial liquidation, but a corporate separation.[664]

However, when the subsidiary sells its assets and liquidates into parent,[665] or the subsidiary liquidates and parent sells its assets,[666] and parent then distributes the sale proceeds, the IRS has ruled that the distribution may result in a contraction of the parent.[667] The rationale for this ruling is that the carryover of the subsidiary's attributes to the parent as a result of the complete liquidation[668] integrates the business of the subsidiary with the business of the parent. Thus, a distribution in these circumstances can result in a contraction of the parent's business.

The IRS has allowed a parent to distribute the proceeds from the sale of a subsidiary's stock in partial liquidation, where the selling parent has joined in a §338(h)(10) election with the purchaser.[669] In a §338(h)(10) election, the subsidiary is treated as selling all of its assets and liquidating into the parent under §332. Thus, the §381 "business integration" theory could be used to justify this approach.

C. Private Rulings

Taxpayers wishing to receive a private letter ruling on partial liquidation issues should consult Rev. Proc. 81-42[670] for guidelines on the information and representations required to be included in the ruling request. Taxpayers should also consult the "-3" revenue procedure for the year the ruling is requested to determine on which issues regarding partial liquidations the IRS will not rule.[671]

Rev. Proc. 2025-3, for instance, states that:

> (i) the IRS will not issue rulings on the amount of working capital attributable to a business or a portion of a business terminated that may be distributed in partial liquidation;[672] and
>
> (ii) the IRS will not ordinarily issue rulings on whether a distribution will qualify as a distribution in partial liquidation under §302(b)(4) and §302(e)(1)(A), unless it results in a 20% or greater reduction in (i) gross revenue, (ii) net fair market value of assets, and (iii) employees.[673]

In addition, it is believed that the IRS will not ordinarily issue rulings on whether a deemed surrender of stock as described in Rev. Rul. 90-13 satisfies the requirements for a redemption, when:

> (a) the corporation has outstanding more than one class of stock and there are priorities as to dividend or liquidating distributions or any other differences in stock rights, or
>
> (b) either under the terms of the stock or as established contractually, there are outstanding any rights affecting the corporation's stock, such as, but not limited to, warrants, options, convertible securities, shareholder agreements, or rights of first refusal.[674]

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to shareholders because business-line continued to operate under other financing arrangements).

[663] Rev. Rul. 79-184.

[664] Rev. Rul. 75-223. Corporate separations are subject to the stringent requirements of §355.

[665] Rev. Rul. 75-223. *See* PLR 200445009 (sale by subsidiary of assets to third party followed by liquidation into parent may qualify as partial liquidation of parent).

[666] Rev. Rul. 77-376.

[667] Rev. Rul. 75-223. *But see* Rev. Rul. 77-375 (amount distributed to shareholders in partial liquidation of a subsidiary does not include indebtedness of subsidiary to the parent cancelled in the liquidation).

[668] §332 and §381.

[669] PLR 200301029, PLR 9007036, PLR 9836027 (exchange treatment allowed where deemed asset sale election and distribution of proceeds of one of two active businesses, both conducted more than five years by group). *See also* PLR 200004029.

[670] *See* PLR 200004029, PLR 199917034, PLR 9809051, PLR 9748026 and PLR 9619050 for examples of rulings involving partial liquidations.

[671] Rev. Proc. 2025-3 is the current version.

[672] Rev. Proc. 2025-3, §3.01(54).

[673] Rev. Proc. 2025-3, §4.01(24).

[674] This no ruling area was explicitly stated under Rev. Proc. 95-3, §5.10. Under the current annual revenue procedure outlining no ruling areas, these situations are no longer specifically discussed, but presumably fall within the general rule that the IRS will not ordinarily offer rulings on factual issues. Rev. Proc. 2025-3, 4.02(1).

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VIII. Constructive Stock Ownership: §318

A. Application to §302

For purposes of testing a redemption under §302, the stock attribution rules of §318(a) apply when making computations of stock ownership before and after the redemption.[675] Under §318, in addition to stock which a shareholder actually owns, the shareholder is also considered to own constructively stock owned by certain other persons. The attribution rules operate to attribute stock to a distributee, not away from the distributee to other shareholders.[676] Further, a person can be considered to own stock by attribution from other persons under §318 even if the person actually owns no stock in the corporation.[677]

There are two possible exceptions to the application of §318 in the context of §302. The first is statutory, and permits a "waiver" (non-application) of family attribution in order to help qualify a redemption under §302(b)(3) (termination of a shareholder's interest).[678] The second is neither statutory nor an IRS-approved exception, but rather a holding by some courts that the constructive ownership rules might not apply in some situations in testing a redemption for dividend equivalence under §302(b)(1).[679] Both of these subjects have been discussed in detail earlier in this Portfolio in connection with §302(b)(1) (see VI.I., above) and §301(b)(3) (see IV.C., above).

Comment: The statutory exception under §302(c)(2) applies only to a termination of interest under §302(b)(3) and not to a redemption of fewer than all of a shareholder's shares. Also, this exception does not permit waiver of constructive ownership by reason of other nonfamily relationships. The limited case law which eliminates attribution under §302(b)(1) has so far involved situations of intrafamily hostility. But if a court is willing to accept the possibility of looking at actual relationships in testing redemptions under the (b)(1) category, the logic advanced by taxpayers on this point would seem to extend to nonfamily categories of §318 as well.

For purposes of §302, the existence of relationships that may or may not give rise to constructive ownership under §318 are to be determined at the date on which the redemption occurs (as distinct from, for example, the date on which an executory agreement to redeem stock is entered into with a specified "closing date" on which the actual exchange will occur).[680]

The details of the rules of constructive stock ownership are beyond the scope of this Portfolio. For additional information concerning this, see 554 T.M., *The Attribution Rules*, and 809 T.M., *Estate Planning for Owners of Closely Held Business Interests* (Estates, Gifts & Trusts series).

[675] §302(c).

[676] *Friend v. U.S.*, 345 F.2d 761 (1st Cir. 1965).

[677] *See, e.g.*, Rev. Rul. 77-218.

[678] §302(c)(2).

[679] *See, e.g.*, *Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975).

[680] *See* Rev. Rul. 58-111. For a discussion of difficulties in identifying the precise date on which a redemption has occurred, see II.A.1., above.

B. Relationships Through Which Attribution May Apply

1. Family Attribution

An individual is deemed to own stock owned by a spouse, children, grandchildren, and/or parents.[681] There is no attribution between brothers and/or sisters, or from grandparents to their grandchildren. There is also no attribution between spouses who are legally separated under a decree of divorce or separate maintenance.[682] Similarly, §318(a)(5)(B) provides that stock constructively owned by an individual by reason of the family attribution rules of §318(a)(1) will not be considered as owned by the individual for purposes of again applying the family attribution rules to make another the constructive owner of such stock.

2. Partnerships, Estates, and Trusts

Stock owned by a partnership or estate is considered owned proportionately by its partners or beneficiaries.[683] Stock owned by a trust (other than an employee trust under §401(a)) is considered owned by the trust beneficiaries in proportion to their actuarial interests in the trust (even if remote or contingent).[684] In the case of grantor trusts (§671–§678), stock owned by the trust is considered owned by the grantor or other person treated as owner and taxable on the income of the trust.

Note: Section 318 cannot apply to treat a participant in an employee stock ownership plan (ESOP) as constructively owning stock (held by the ESOP) of the corporation that established the ESOP because an ESOP is an employee's trust described in §401(a). However, establishing constructive ownership of stock under §318 is not necessary if direct, beneficial ownership of the stock exists. In TAM 9612001, the National Office advised that the participants in an ESOP possessed almost all of the indicia of ownership with respect to the stock and, there-

[681] §318(a)(1).

[682] An interlocutory judgment of divorce may not be enough to cut off attribution between separated spouses. *See Deyoe v. Commissioner*, 66 T.C. 904 (1976); *Johnson v. Commissioner*, 50 T.C. 723 (1968). *See also* Boffa and Greene, *Stock Redemption in Connection with the Dissolution of California Marriages*, 1 *Tax Section News* (Tax Section, California State Bar), No. 4, p. 3 (Winter 1975–76); PLR 7819038 (divorced shareholders in a community property state).

[683] §318(a)(2)(A). The term "beneficiary" includes "any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution." Reg. §1.318-3(a). *See also* Rev. Rul. 67-24 (residuary testamentary trust is beneficiary of estate, stock owned by beneficiary of trust attributed to trust and reattributed to estate); Rev. Rul. 71-211 (stock attributed under §318(a)(2)(B)(i) from an inter vivos trust to a contingent beneficiary of the trust in proportion to his actuarial interest in the trust).

[684] §318(a)(2)(B)(i). *See also* Rev. Rul. 76-213 (beneficiary's interest was held both remote, because it was less than 5% of the value of the trust property, and contingent, because (under state law) it would terminate if the beneficiary did not survive the life tenant); PLR 200546008 (no attribution because each related party was "contingent" beneficiary under Rev. Rul. 76-213 and actuarial interest of each such contingent beneficiary was "remote" under Rev. Rul. 76-213). Note that a 5% de minimis exception exists in the case of attribution to a trust but not in the case of attribution from a trust. Under Reg. §1.318-3(a), a person ceases to be a beneficiary of an estate when he has received all the property to which he is entitled, he no longer has a claim against the estate arising out of his having been a beneficiary, and when there is only a remote possibility that the estate will find it necessary to seek the return of property, or contribution or other payment by him, to satisfy administration expenses or claims against the estate.

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fore, were the beneficial owners of the stock for purposes of §302.

Stock owned by partners or beneficiaries of an estate is deemed owned by the partnership or estate.[685] All the stock of the partner or beneficiary is attributed to the entity regardless of the actual owner's proportionate interest in the entity.

Stock owned by the beneficiary of a trust (other than a §401(a) employee trust) is attributed to the trust unless such beneficiary has only a remote contingent interest in the trust.[686] Stock owned by a grantor or other person taxable on the income of a trust by virtue of §671–§678 is considered owned by the trust.[687]

3. *Corporations*

Stock owned by a corporation[688] is considered owned by its 50% or more (by value) shareholders to the extent of a proportion equal to the shareholder's percentage interest (by value) in the corporation.[689] Stock owned by a 50% or more shareholder (by value) is attributed to the corporation.[690] All stock owned by the shareholder is attributed, not just the portion equal to the shareholder's percentage interest.

4. *Option Attribution*

If a person has an "option to acquire stock," the stock is treated as owned by the option holder.[691] An option to acquire such an option, and each one of a series of such options, is considered an option to acquire such stock.[692]

Practice Point: Note that if the option, when issued, is "deep in the money" (within the meaning of §1092(c)(4)(C)), the option might be considered stock under general tax principles. In such cases, the attribution rules are superfluous.[693]

5. *Sideways Attribution*

"Sideways" attribution is curtailed by §318(a)(5)(C). Under this provision, stock attributed to a partnership, estate, trust, or corporation from a partner, beneficiary or shareholder pursuant to §318(a)(3) is not reattributed from the entity to another partner, beneficiary or shareholder pursuant to §318(a)(2). This rule does not eliminate all sideways attribution, however. The limits on the rule are described in 554 T.M., *The Attribution Rules.*

C. *Option Attribution*

The option rule of §318(a)(4) applies to options to acquire stock from another shareholder, or from the corporation itself, and also to such instruments as stock warrants and convertible debentures.[694]

Section 318(a)(4) makes no distinction depending on when the option is exercisable, whether any cash outlay is required in order to exercise the option, or whether any contingencies limit the current exercise of the option. However, Rev. Rul. 68-601, in analyzing warrants to purchase common stock directly from the issuing company and debentures convertible into common stock, both of which were distributed in a redemption, states:

> In order for a warrant to acquire stock to qualify as an option, the holder must have the right to obtain the stock at his election. When this right to acquire stock exists, warrants or convertible debentures are not realistically different from options as referred to in section 318(a)(4) of the Code. In each instance, stock may be acquired at the election of the shareholder and there exist no contingencies with respect to such election.

Rev. Rul. 68-601 does not appear to require that attribution is triggered under §318(a)(4) only if the holder's right to exercise the option is not subject to any contingencies.

Under Rev. Rul. 68-601, the concept of "contingency" with respect to exercise of an option is undefined. Apparently, the mere fact that the shareholder must pay money in order to exercise his warrant or other option is not considered a "contingency" that prevents the shares under option from being deemed owned by the option holder. Perhaps, however, as discussed further below, "contingency" includes a situation where the warrant's exercise price exceeds the current market price or value of the underlying stock, so that the warrant currently has speculative value only and, economically, will or may be exercised only if the stock's current value rises above the warrant exercise price.

In Rev. Rul. 89-64, the IRS ruled that an option received by a taxpayer in a stock redemption is an option for purposes of §318(a)(4) even if it is exercisable only after a period of time has lapsed. This ruling clarifies Rev. Rul. 68-601, as that ruling did not address whether an option may escape the application of §318(a)(4) if the right to exercise the option is delayed.

The Chief Counsel's Office also advised in FSA 199915007 that a purchaser did not have an "option" for purposes of §318 where serious conditions precedent existed that could result in substantial risk of forfeiture of the purchaser's right to exercise the option.

1. *Computing Ownership in Light of Options*

In Rev. Rul. 68-601, individuals A and B (unrelated) each owned 100 of 1,000 total outstanding shares. In redemption of 50 shares each from A and B, the corporation distributed to each a $1,000 convertible debenture and one warrant to purchase 20 shares of the corporation's stock. Each debenture was convertible into 40 shares of stock. No other shareholders had stock redeemed.

By applying §318(a)(4) to these facts, A and B each owned 10% of the outstanding stock before the redemption and 11.46% afterward (110/960). Consequently, the IRS ruled that each redemption did not qualify under §302(b)(2).

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[685] §318(a)(3)(A).

[686] §318(a)(3)(B)(i). A beneficiary's interest is considered remote if the actuarial value of the beneficiary's interest is 5% or less of the trust property.

[687] §318(a)(3)(B)(ii).

[688] The mere existence of a corporation or partnership is all that is required to trigger attribution. It does not matter that the entity is not actively conducting a business. *Sorem v. Commissioner*, 40 T.C. 206 (1963), rev'd on other grounds, 334 F.2d 275 (10th Cir. 1964).

[689] §318(a)(2)(C).

[690] §318(a)(3)(C).

[691] §318(c)(4).

[692] §318(a)(4).

[693] *See, e.g.*, Rev. Rul. 82-150. For further discussion of "deep in the money" options, see 188 T.M., *Taxation of Equity Derivatives*, at I.F.5.

[694] Rev. Rul. 68-601. *See also* Rev. Rul. 77-201; Rev. Rul. 75-114.

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Note: In this instance, the total outstanding stock of the corporation after the transaction for purposes of the computation under §302(b)(2), as applied to each shareholder separately, was 960 shares consisting of the 900 actual outstanding shares and the 60 shares that such shareholder could acquire by exercising the warrant and converting the debenture.

Presumably, the same principles and calculation methods set forth in Rev. Rul. 68-601 will be followed in testing redemptions under §302(b)(1) and (3).

In Rev. Rul. 68-601, the IRS also ruled that in computing a redeemed shareholder's percentage interest after (and presumably before) the redemption, the numerator of the redeemed shareholder's ownership fraction includes shares actually owned and shares deemed owned by the shareholder via §318, including shares that the shareholder has an option to acquire (either from another shareholder or from the corporation) and also shares that would be reattributed (under the §318 rules) to him from another shareholder's option. The denominator of his ownership fraction includes all shares actually outstanding plus shares that the shareholder or persons related to him under §318 have an option to acquire from the corporation. The IRS does not allow the denominator to be enlarged by including all unissued shares under option to shareholders whose stock ownership is not attributed (via §318) to the redeemed shareholder. Indeed, on this latter point, the IRS refuses to follow the Tenth Circuit's contrary decision in *Sorem v. Commissioner*[695]

After the IRS made its position on *Sorem* clear, the Sixth Circuit, in *Patterson Trust v. U.S.*,[696] followed the Tenth Circuit's lead in what appears to be the only appellate court opinion analyzing this issue.[697] The Sixth Circuit noted that, while there is a policy favoring the upholding of interpretations of ambiguous statutory language that are consistently applied by the IRS, the language of §318(a)(4) is "plain and unambiguous," rendering that policy inapplicable.

Observation: A redeemed shareholder that desires exchange treatment wants the denominator of the redeemed shareholder's ownership fraction after the redemption to be as large as possible, because the larger the denominator the smaller the post-redemption percentage interest, and hence the greater the reduction in percentage interest as a result of the redemption, which improves the grounds for exchange treatment.

Example: Father (F) and Son (S) own 3,000 and 500 shares, respectively, of 100,000 outstanding shares of a corporation. F also holds an unexercised qualified stock option to buy 1,000 shares from the corporation; S holds such an option for 200 shares. F wants to have enough of his shares redeemed to qualify for exchange treatment under §302(b)(2).

F is deemed to own 4,700 of 101,200 total outstanding shares before the redemption (4.64%). This figure includes 100,000 actual outstanding shares plus (solely) the shares under option to F and S. In order to satisfy §302(b)(2), F's percentage interest must be reduced to below 3.71% (which is 80% of F's pre-redemption interest). If 982 actual shares are redeemed from F, his ownership interest thereafter will be 3.71%, represented by the fraction 3,718/100,218. This fraction is F's deemed ownership fraction before the transaction reduced by 982 shares from both the numerator and denominator.

2. *Cross-Purchase Agreements*

If one shareholder holds an option to buy stock from another shareholder during the latter's life, and if the purchase price equals the fair market value of the stock at the purchase date, it is difficult to see a potential bailout of corporate earnings through the capital gain treatment of a redemption.

Example: The fair market value of a closely held corporation's stock is $200 per share. Shareholder A holds an option to buy one share from unrelated shareholder B at market value at the date the option is exercised. A has one share, which A already owns ($50 basis) redeemed for $200 cash, realizing a $150 long-term capital gain. A then exercises an option on B's stock. Here, A re-establishes A's pre-redemption stock interest but has achieved no bailout.

However, if the option arises out of a buy-sell agreement taking effect at the death of shareholder B, and if the purchase price was fixed at a figure that is below fair market value at the time of B's death, a bailout can occur. If A can buy B's stock from B's estate for any amount less than A's after tax proceeds from the stock that was redeemed, A will restore his stock interest while effectively having bailed cash out of the corporation. In this situation, the option attribution rule of §318(a)(4) seems operative and seems intended to treat A, for purposes of testing A's redemption under §302, as owning the stock which A has an option to buy from B's estate.

3. *"Entity" Buyout Agreements*

Option attribution is important in connection with buy-out arrangements in closely held corporations. Under an "entity" buy-out agreement, the corporation may be given an option to buy the stock held by the estate of a deceased shareholder. If such an option is affected by §318(a)(4), and the estate holds a 50% or greater stock interest, the corporate option on the survivor's stock would trigger attribution of such stock to the corporation and reattribution of the same stock to the estate, thereby preventing a redemption of the estate's stock from qualifying under §302(b)(3). However, in Rev. Rul. 69-562, the IRS ruled that §318(a)(4) does not extend to treating a corporation as owning its own stock which it has an option to buy from a shareholder.

A buy-sell agreement may provide that if the corporation fails to exercise its right of first refusal to buy the shares of a retiring shareholder, the remaining shareholders have a right to buy the shares before they can be sold to an outsider. If a particular shareholder has a portion of its stock redeemed by the issuer company, will that shareholder's secondary right of

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[695] 334 F.2d 275 (10th Cir. 1964). In Rev. Rul. 68-601, the IRS stated that it would not follow *Sorem* on this point. *See also Northwestern Steel & Supply Co. v. Commissioner*, 60 T.C. 356 (1973); TAM 9211006 (citing Rev. Rul. 68-601).

[696] 729 F.2d 1089 (6th Cir. 1984).

[697] Dicta in *Friend v. U.S.*, 345 F.2d 761 (1st Cir. 1965) supports the IRS's view.

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refusal pursuant to the buy-sell agreement among the shareholders constitute an "option" under §318(a)(4) to acquire other outstanding stock? If so, such option stock must be taken into account in determining the reduction, if any, in the redeemed shareholder's ownership interest (actual and constructive) in the corporation. As noted above, it is not clear what effect the contingent nature of the option, the fact that a purchase price must be paid in order to exercise the option, or the method of determining the purchase price, will or should have in connection with invoking §318(a)(4).

4. Stock Warrants

a. Bailout Potential?

Although Rev. Rul. 68-601, above, subjects warrants and convertible debentures to §318(a)(4), the bailout potential in using these instruments is somewhat less than clear. It might be thought that a shareholder could receive, in a redemption distribution, readily marketable property plus a warrant or warrants to buy the same number of shares in the issuing company as the number redeemed. The shareholder could then sell off the marketable property, use part of the proceeds to exercise the warrant and thereby reestablish its preredemption equity interest while netting cash in pocket, effectively as though that cash had been bailed out of the corporation. It is difficult, however, to find a fact situation where such a bailout could occur, if it assumes that a warrant will have a fair market value at least equal to its "intrinsic" value, i.e., such intrinsic value being any excess of the stock's current value over the warrant's exercise price.

> *Example:* Each share of close corporation X has a current fair market value of $100. A shareholder surrenders 10 shares ($10 basis each) for redemption, receiving marketable property worth $900 and one warrant to buy 10 shares at $90 each. Assuming an exchange of equal values, the warrant must have a value equal at least to the bargain element, or $10 per share × 10 shares, which equals $100. The shareholder realizes a $900 gain on which the shareholder pays a $225 tax (assuming a 25% tax rate). The shareholder then sells the marketable property for its current value and realizes no gain, since the shareholder's basis equaled the property's value at the time received in the redemption. The shareholder then must use the entire $900 to exercise the warrants. Net, the shareholder is out of pocket the tax it paid on the redemption. Assume, in the above example, that the warrant's exercise price was $110, or more than the current fair market value per share, so that the warrant has speculative value only. In such a case, the market value of the warrant would consist entirely of premium reflecting its leverage potential. But even if the warrant's market value were zero, thereby requiring a distribution of marketable property worth $1,000, the gain on the redemption and the tax would equal the amount in the previous example. The proceeds of the sale of the property ($1,000) would not provide even the amount needed to exercise the warrant ($1,100).

As suggested earlier, the statute does not distinguish among "options" whose exercise price is less than, equal to, or more than the current fair market value of the underlying stock, nor among the resulting incentives to exercise the option. Nor is it clear what the IRS means by "contingencies" in Rev. Rul. 68-601.

b. Use by Publicly Held Companies

Stock warrants and convertible debentures are particularly useful to publicly held corporations because of their business advantages to the company and their value as speculative investments to the holder. When issued in a recapitalization or redemption by a public company, options reduce the number of shares outstanding; substitute a nondividend and non-interest-paying instrument for outstanding stock or debt; reduce the number of shareholders (sometimes advantageous in takeover situations); and provide shareholders with leverage opportunities in relation to the existing price of the underlying stock.

Practice Point: Warrants often are used to provide sellers and/or lenders with an instrument that permits them to share in the future success of the corporation. Note that because a warrant will be exercised only if its exercise price is favorable, the additional capital coming into the corporation will be economically dilutive of the interests of other equity holders.

Entirely apart from their effect in possibly triggering option attribution for purposes of determining how much, if any, stock the distributee owns actually or constructively after the exchange, warrants themselves are taxable as property apart from §301 and §302, unless they can be received tax-free under §305.

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IX. Bootstrap Acquisitions and Related Topics

A. Introduction

A redemption may be a helpful tax planning tool where the present owners want to sell out or want to permit others to acquire a stock interest in the company, but the prospective buyer lacks the necessary funds. If the corporation has liquid assets not needed in its business or a strong earning capacity, the buyer might seek to finance part of the purchase price through a distribution by the corporation to the seller before the sale. Where the seller is an individual that desires sale or exchange treatment, the distribution will take the form of a redemption of shares. Where the seller is a corporation eligible for the dividends received deduction, a dividend distribution may be preferable.

These transactions have some affinity with intrafamily situations where either parent who has built a family business desires to retire and to shift current or future majority ownership to one or more of their children. To this end, the parent may have sold or made gifts of stock in the family corporation to one or more children during earlier years and the parents now desire to have all of their (the parents') shares redeemed by the corporation. In order for the redemption to be treated as a sale or exchange, under §302(b)(3), the parents need to qualify for waiver of family stock attribution under §302(c). If the redeemed shareholder had transferred stock to a family member during the preceding 10 years, however, family attribution cannot be waived unless tax avoidance was not a principal purpose for the transfer to the family member. (See IV.C.5., above.)

The transactions discussed below, however, involve a sale of stock to an unrelated person not a member of the family of the outgoing owner. Thus, eliminating the application of constructive ownership of stock from other family members is not typically an issue in these transactions.

B. Seller Redeems in Connection with Disposition of Shares

1. Straight Sale

A redemption from the seller in connection with the sale of the balance of the seller's stock is a useful planning tool where the buyer wants the target to partially finance the acquisition and the seller is an individual that desires exchange treatment.

> *Example:* Individual T is the sole shareholder of corporation X. T desires to sell their entire interest to outsider B. B cannot obtain sufficient financing for the purchase price of T's X stock. However, X has a large cash reserve. The parties structure the transaction as a sale of some of T's stock to B followed by X redeeming, pursuant to a prearranged plan, the balance of the X shares held by T. Thus, T receives exchange treatment on both the sale of the X shares to B, and the redemption of X shares under §302(b)(3).

Arranging both a sale and a redemption together is known as a "*Zenz*" transaction, after the leading case upholding a sole shareholder's claim to capital gain treatment.[698]

This type of transaction was once considered uncertain because if the redemption occurred first, the sole shareholder's status as sole owner was unchanged immediately after the redemption. As such, the redemption was essentially equivalent to a dividend. However, the IRS has generally not sought to treat the redemption as dividend equivalent where both the sale and redemption occur simultaneously.[699] If the redemption occurs first in time, the IRS will allow the redemption to qualify under §302(b)(3) if the evidence shows that both steps occurred under a prearranged plan.[700]

The courts have held, however, that in order for the *Zenz* rationale to be applied, the redemption and the sale (or gift or other mode of disposition to someone other than the issuer corporation) must be part of a single, integrated and definite plan.[701]

In Rev. Rul. 77-226, the IRS applied *Zenz* to defeat a corporate shareholder's attempt to realize dividend income (and utilize the dividends received deduction of §243) on a redemption of some of its stock in the issuer, a publicly held company, followed by an open market sale of the balance of the shareholder's stock in the issuer. The overall aim of the corporate shareholder was to realize a net tax saving from the §243 deduction and a short-term capital loss on the market sale, and to use the loss to offset short-term capital gains from other sources.[702] Rev. Rul. 77-226 states:

> In this case, the redemption and the sale were undertaken pursuant to an integrated plan. Therefore, even assuming the redemption distribution, standing by itself, would have been essentially equivalent to a dividend, the redemption and sale combined completely terminated Y's interest in X within the meaning of §302(b)(3) of the Code. That the redemption occurred before the sale is irrelevant.

2. "B" Reorganization

In *McDonald v. Commissioner*,[703] a shareholder who owned a controlling interest in both common and preferred stock caused all of his preferred to be redeemed and, seven

[698] *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). *See also* Rev. Rul. 55-745; Rev. Rul. 54-458.

[699] Rev. Rul. 75-447. *See also* PLR 200125010 (no dividend treatment on *Zenz*-type transaction in which some nonvoting common was redeemed; the remainder was exchanged for voting, and then all voting was sold).

[700] *See U.S. v. Carey*, 289 F.2d 531 (8th Cir. 1961).

[701] *See Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), aff'd per curiam, 535 F.2d 500 (9th Cir. 1976), cert. denied, 429 U.S. 1000 (1977); *Rickey v. U.S.*, 592 F.2d 1251 (5th Cir. 1979), aff'g 427 F. Supp. 484 (W.D. La. 1976); *Jones v. U.S.*, 72-1 USTC ¶9349 (D.N.J. 1972); *Merrill Lynch & Co. v. Commissioner*, 120 T.C. 12 (2003), aff'd, 386 F.3d 464 (2d Cir. 2004) (rejecting taxpayer's assertions that if third party is involved, third party must have committed to plan on or before redemption date for "firm and fixed" plan requirement to be met, and that uncertainty regarding sale terms prevents integration of transactions). Note that in *Merrill Lynch*, the taxpayer, not the IRS, argued against the finding of a "firm and fixed" plan because dividend treatment would have provided favorable tax consequences under the consolidated return regulations. The taxpayer in *Merrill Lynch* advanced a new argument on appeal: that the parent, under §318, continued to own (constructively) 100% of the stock of the second-tier subsidiaries and, thus, the complete termination never occurred. The Second Circuit remanded for consideration of the new argument. The Tax Court rejected the argument on remand, stating that §304(a)(1) recharacterization only applies to a person actually transferring stock for property (without regard to §318). *See* 131 T.C. 293 (2008).

[702] Section 1059 now provides additional protection against this type of tax avoidance transaction.

[703] 52 T.C. 82 (1969).

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days later, exchanged all of his common for stock in a widely held corporation in a tax-free reorganization under §368(a)(1)(B). His interest in the acquiring company was a small minority interest. The shareholder argued that under *Zenz* the redemption and the reorganization together completely terminated his stock interest. The IRS distinguished *Zenz* on the ground that because the common stock was exchanged in a tax-free reorganization, the taxpayer retained a continuity of interest (although indirect) in his former corporation and therefore did not terminate his interest. The Tax Court held that the *Zenz* rationale applies in testing a redemption under §302(b)(1). The court also indicated that the taxpayer's investment was "changed radically" as a result of the redemption and the reorganization, viewed together, even if the reorganization was tax-free. Hence, the redemption was held to qualify under §302(b)(1).

Comment: In *McDonald*, the acquiring company supplied the cash used to pay the redemption price of the taxpayer's preferred stock. The IRS attacked only the redemption and, for purposes of arguing that its effect was equivalent to a dividend, treated the reorganization as separate from the redemption. Therefore, no "boot" problem arose in the reorganization. The court accepted the IRS's treatment of the two exchanges as separate events for tax purposes. Yet, in testing the redemption under §302(b)(1), the court viewed the exchanges as related for tax purposes. As the government presented its case, however, a *Zenz* situation would not arise because the redemption and reorganization would be treated as separate events for tax purposes. If the two transactions were treated as parts of the same plan, the "B" reorganization would be vulnerable to attack for violation of the solely-for-voting stock rule because the cash for the redemption of the preferred came from the acquiring company.

In Rev. Rul. 75-360, the IRS in effect conceded that it "incorrectly" treated the redemption and the common-for-common exchange in *McDonald* as separate transactions. The IRS said it should have argued that both steps were part of a single integrated transaction which, on the particular facts, failed to qualify as a nontaxable "B" reorganization.

Note: In Rev. Rul. 99-58, redemptions of stock as part of a corporation's open market stock purchase program did not violate the continuity of interest requirement and the prohibition against boot in a "B" reorganization, provided that the open market purchase program was factually and economically independent of the reorganization.

3. Reverse Cash Merger

The IRS applied a *Zenz* rationale after recasting a complex corporate acquisition transaction on substance over form grounds in Rev. Rul. 79-273. In Rev. Rul. 79-273, a corporation desired to acquire all the stock of an unrelated corporation for cash, but did not want to acquire a subsidiary that the target company owned. The parties structured the transaction as a "reverse cash merger," with the target shareholders receiving all of the subsidiary's stock in addition to cash. The IRS recast the transaction as a sale of 85% of the target's stock by the target's shareholders directly to the buyer for cash and a simultaneous §302(b)(3) redemption of the remaining 15% of the target's stock in exchange for the stock of the unwanted subsidiary. The IRS ruled that the (deemed) redemption from the target's shareholders qualified for exchange treatment under §302(b)(3) in accord with the rationale of *Zenz*.

4. Recapitalization

Another technique for transferring ownership of a closely held corporation to others while extracting part of the value of the transferred interest from the company itself involves a recapitalization of some outstanding common stock for new preferred stock followed by a gift (or sale) of the remaining common stock to the incoming new owner or owners. New preferred held by the retiring shareholder provides a continuing income interest in the company (through dividends on the preferred stock) rather than an immediate cash payment through a redemption. However, §302 may play a role in determining whether the new preferred received in exchange for outstanding common stock is §306 stock.

Rev. Rul. 81-186, which addresses this issue, involved a sole shareholder who wanted to retire from active management of the business and give the growth potential to three officers of the company. The existing owner, however, wanted a continuing income interest in the business. To achieve this, he surrendered 97 of 100 outstanding common shares for newly issued 9%, nonvoting, nonconvertible preferred stock and then, pursuant to an overall plan, gave the remaining three common shares (representing future growth) to the three officers who were unrelated to him under §318. The status of the new preferred shares as §306 stock depended on whether cash received in lieu of the stock would have been treated as a §301 distribution under §302(d). If such a hypothetical §301 distribution would have occurred, the new preferred shares would be §306 stock.[704] In Rev. Rul. 81-186, the IRS ruled that *Zenz* applies in testing stock under the cash-in-lieu test of the §306 regulations, and that in the instant case a hypothetical redemption of 97 shares for cash, together with a gift of the remaining three shares, would result in a complete termination of the shareholder's interest qualifying under §302(b)(3). Accordingly, the shareholder's receipt of new preferred stock in the recapitalization was held not to be §306 stock.

5. Retention of Interest by Distributee

Frequently, a shareholder wants to sell only part of its stock interest to another shareholder or to an outsider. In conjunction with the sale, the seller has the corporation redeem some of the seller's stock to allow the buyer to acquire a predetermined interest in the corporation. The issue arises whether a partial redemption can qualify under §302(b)(2) where, under the same plan, the shareholder also sells part of its stock to a third person.

In Rev. Rul. 75-447, the IRS ruled that a redemption followed by a sale of some of the shareholders' remaining shares to a third person, or by an issue of new shares by the company to outsiders, will be tested under §302(b)(2) in light of all the steps that are part of a single plan.

Example: Individual F owns 100 of 400 outstanding shares, i.e., a 25% interest. Under a plan, F sells seven shares to outsider X and the corporation then redeems 20

[704] Reg. §1.306-3(d).

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shares from F. If the redemption is tested only after the sale to X, F's percentage interest would decrease from 23.25% (93/400) to 19.21% (73/380). This reduction fails to satisfy the required reduction in F's percentage interest under §302(b)(2) to below 18.6% (less than 80% of 23.25%). If the statute is applied by reference to F's interest before the sale, F's percentage interest declined from 25% (100/400) to 19.21%, a reduction that satisfies §302(b)(2). In this case, the sale to X helps F satisfy the redemption rules. If the redemption preceded the sale, §302(b)(2) would not be satisfied immediately after the redemption but would be satisfied after the subsequent sale. That is, the redemption alone would reduce F's interest from 25% to 21.05% (80/380) while the subsequent sale would further reduce F's interest to 19.21% (73/380).

A similar tax issue arises where a corporation plans to issue stock to new investors (as in a public offering) or issues stock to key employees (either for cash or as compensation) and to redeem some of its stock owned by preexisting shareholders. For example, individuals B and C each own 50 shares representing a 50% interest in a corporation. The corporation plans to sell 25 newly issued shares to D, an unrelated new investor, and to redeem 25 shares each from B and C, thereby equalizing all the shareholders' interests at one-third each. If the redemptions occur first, §302(b)(2) would not be satisfied immediately after the redemption because B's and C's interest would remain at 50%. However, §302(b)(2) would be satisfied if the change in interest is tested after the subsequent issuance of 25 new shares to C, since B's and C's interest would have been reduced from 50% to 33 1/3%.

If the sale to C occurs first, and if the change in B's and C's interest is measured from before the sale, each redemption will qualify under §302(b)(2) because each shareholder's interest will decline from 50% to 33 1/3%. However, if each redemption is tested from after the sale, the resulting reduction in interest from 40% (50/125) to 33 1/3% will not satisfy §302(b)(2).

Under Rev. Rul. 75-447, regardless of the sequence in which the above (or similar) transactions occur, a redemption will qualify under §302(b)(2) if it occurs as part of a single overall plan.

In *Ted Bates & Co., Inc. v. Commissioner*,[705] a shareholder (Bates) who (with his wife) owned 72.1% (185,000/256,550) of the total combined voting power of two classes of common stock sold 112,500 of his shares to three key employees and simultaneously surrendered 20,000 shares for redemption. As a result of both steps, Bates' interest declined to 22.2% (52,500/236,550). It is not clear from the facts in which order each of the steps occurred. If the redemption occurred first, Bates' interest would have been reduced from 72.1% to 69.75% (165,000/236,550) immediately afterward, a reduction which fails to satisfy §302(b)(2). Tested after the subsequent sale, however, Bates' interest would have declined to 22.2%, a reduction which satisfies §302(b)(2). If the sale occurred first, Bates' interest would have satisfied §302(b)(2) even if his interest after the sale, i.e., 28.26% (72,500/256,550), is compared with his interest after the subsequent redemption (22.2%).

Note: Eighty percent of 28.26% is 22.6%. Bates' post-redemption interest was lower than this figure.

C. Dividend Strip by Seller

When the seller is a corporation, the capital gain treatment of a *Zenz* type transaction might not be desirable. A corporate seller would usually rather receive a dividend distribution. A pre-sale dividend by a target-subsidiary to its seller-parent is an effective planning tool where the parties want the transaction partly financed by the target or where the target has unwanted assets. The benefits to the seller are two-fold — utilization of the dividends received deduction of §243 and a reduced amount realized on the sale of the target's stock.[706]

A potential hazard for the seller is a *Zenz*-type argument that a "dividend" distribution followed by sale of all the shareholder's stock to a third party is, in substance, equivalent to a simultaneous redemption and sale to a third party in which the redemption receives sale or exchange treatment under §302(b)(3).[707]

In *Waterman Steamship Corp. v. Commissioner*,[708] the Fifth Circuit reversed the Tax Court's holding respecting as a dividend a distribution of a note by a target subsidiary to its parent, immediately before the subsidiary was sold to an unrelated third party. The note was paid off with funds provided by the purchaser. The Court held that the declared dividend was actually part of the purchase price of the subsidiary received by the parent, explaining that the dividend was declared after the stock sale agreement for the subsidiary had been reached and the so-called dividend and sale were actually one transaction.

In a fact pattern similar to *Waterman Steamship*, the Tax Court held in *Litton Indus. Inc. v. Commissioner*[709] that a dividend declared by a wholly owned subsidiary before it was sold by its parent was a true dividend and not part of the selling price. In *Litton*, the dividend occurred over six months before the sale of target stock and at a time when there was only a general intent to sell the shares. At that time no specific buyer had been identified. In addition, there were some business motivations (albeit somewhat feeble) apart from the obvious objective to minimize taxes. The court distinguished *Waterman Steamship* and stated that the subsidiary declared the dividend, issued a promissory note and definitely committed itself to the dividend before making it public that it was for sale. The court stated that it would follow the Fifth Circuit's opinion in *Waterman Steamship* only in cases where the facts are virtually identical.

Note: The IRS acquiesced in the Tax Court's decision in *Litton*, agreeing that its facts are distinguishable from those in

[705] 24 T.C.M. 1346 (1965) (apparently redemption occurred first, then sale to key employees).

[706] Note that dividend stripping sales must run the gauntlet of §1059. Additionally, these transactions are not available where the parent and subsidiary file a consolidated tax return. Reg. §1.1502-32.

[707] *Cf. Casner v. Commissioner*, 450 F.2d 379 (5th Cir. 1971) (noncorporate seller; presale distribution to seller also held part of stock sale proceeds); Rev. Rul. 75-493, 1975-2 C.B. 108 (IRS will not follow *Casner*); TAM 8118004.

[708] 430 F.2d 1185 (5th Cir. 1970), rev'g 50 T.C. 650 (1968).

[709] 89 T.C. 1086 (1987).

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Waterman Steamship. However, the IRS limited its acquiescence to the result of *Litton* and stated that it will litigate any case with facts more closely resembling the facts in *Waterman Steamship*.[710]

Comment: The Commissioner benefits from the *Waterman Steamship* result where the seller is a corporation but not where the seller is an individual.[711]

D. Buyer Redeems or Strips Dividend After Sale

Another alternative structure that allows the target to provide funds for its acquisition is a post-sale dividend to the buyer. However, if the distribution is an extraordinary dividend, under §1059, or if the buyer and the target file a consolidated tax return, the buyer will be required to reduce its basis in the target's stock, thereby eliminating any benefit.

Practice Point: If the buyer is an individual, the distribution will result in dividend income to the individual to the extent of the target's earnings and profits. The buyer can attempt to have shares redeemed, but if the buyer is the sole shareholder, the distribution will fail the tests for exchange treatment under §302(b)(1), (2) and (3). Thus, the buyer's only hope for exchange treatment in this situation would be the partial liquidation provision of §302(b)(4) Since qualified dividend income (which includes most dividend income from domestic corporations and certain foreign corporations) is taxed as net capital gain, the characterization as a dividend is not as costly to the individual taxpayer as it once was.

E. Transactions Treated as Redemptions

1. LBO Structures

In certain cases, transactions which are not redemptions in form may be recharacterized as redemption transactions. For example, assume that target does not have large cash reserves, but does have the capacity to borrow. Purchaser and target agree to effect a reverse triangular merger. In order to finance all or a portion of the acquisition, S, the transitory subsidiary of purchaser, incurs debt just before, or simultaneously with, the merger; by operation of law, this debt becomes debt of target upon consummation of the merger. Provided S's existence is disregarded as transitory,[712] the debt should be treated as having been incurred by target initially, since the obligation arises simultaneously with the merger and is never truly an obligation of S.

Practice Point: It is highly unlikely that a lender would extend credit to a corporation with no assets or operations. As a practical matter, the lender in such a situation is relying on the target's assets and operations to support the debt.

As a less extreme example, consider the case where the purchaser borrows the acquisition funds, but the borrowing is actually supported by the anticipated earnings of target. Within a short time, and pursuant to a previously arranged plan, the target assumes the debt.

Practice Point: A lender that provides funds to an acquiror based upon the target's own credit is likely to require, as a contractual matter, that the debt be assumed by the target either simultaneously with the advance of funds or within a short period of time thereafter.

In this case, the IRS might apply the "step-transaction" doctrine to treat the transaction as though target had borrowed initially and used the proceeds to redeem its stock.[713] In certain cases, target might be viewed as the borrower for tax purposes even where it does not legally assume the debt, if the lender relied primarily on target's credit. This is particularly likely to be the case if target is a guarantor of the debt or grants a lien on its assets to secure the debt.[714]

Practice Point: If this transaction is not viewed as a redemption, the form of the transaction might be respected, in which case either the assumption of purchaser's debt by target or target's making payments with respect to such debt after it had been assumed would be treated as a dividend by target to purchaser.[715] Depending on whether or not target and purchaser are members of an affiliated group filing a consolidated return, this dividend may or may not be taxable.

The common feature in each of the above examples is that the debt incurred to finance the acquisition of target is supported largely or entirely[716] by the anticipated cash flows and earning capacity of the target corporation. It is this feature which is the distinguishing character of a "leveraged buyout."

2. Reverse Stock Split

In Rev. Rul. 72-57,[717] the IRS allowed the device of paying cash in lieu of fractional shares to be used as a means of forcing out minority shareholders. Corporation X had outstanding $5

[710] *See* 1988-2 C.B. 1.

[711] For additional discussion of this issue, *see TSN Liquidating Corp., Inc. v. U.S.*, 624 F.2d 1328 (5th Cir. 1980).

[712] *See Casco Prods. Corp. v. Commissioner*, 49 T.C. 32 (1967); Rev. Rul. 78-250; Rev. Rul. 73-427. Note that Rev. Rul. 73-427 involved the creation of transitory S to effect one pre-existing corporation's acquisition of another by means of S's merger into the target, while Rev. Rul. 78-250 involved only one pre-existing corporation (X). In Rev. Rul. 78-250, X's 65% shareholder—wishing to eliminate the minority stock interests—formed transitory Y and received all of the Y stock for the shareholder's X stock. Y then merged with and into X. In the merger, each share of Y stock was converted into a share of X stock, and X's minority shareholders received cash in exchange for their X stock. The IRS disregarded the creation of Y and the merger, and treated the minority shareholders' receipt of cash as distributions in redemption of their X stock subject to §302. *See also* PLR 201007051 (following Rev. Rul. 78-250, IRS ruled that corporation's major shareholders' creation of Newco and merger of Newco into corporation would be disregarded, and cash received by corporation's minority shareholders would be treated as distribution in redemption of stock subject to §302), PLR 201007052 (same).

[713] *See* Rev. Rul. 78-250 (reverse cash merger with transitory subsidiary treated as §302 redemption when target supplied the cash). *See also* TAM 9338049 (newly formed corporation purchased stock of target for debt and cash, some of which had been borrowed from target, which, in turn, had borrowed it from a bank; corporation then merged into target and became liable on the debt; three years later, target and the stockholder who sold the stock agreed to reduce the amount of the debt owed to the stockholder for the stock sale; newly formed corporation's existence ignored and target corporation treated as if redeemed its stock directly from stockholder with result that §108(e)(5) applies and reduction is treated as a purchase price adjustment).

[714] *See, e.g., Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972).

[715] *See, e.g., Enoch v. Commissioner*, 57 T.C. 781 (1972).

[716] This is clearly the case where the acquiring corporation has been formed solely as a holding company to acquire the target, and has no other assets.

[717] *See also* PLR 9809027 (cash paid to minority shareholder treated as distribution in redemption of stock under §302; creation of new corporation by majority shareholders and then its merger into existing corporation disregarded).

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par value common stock of which its parent corporation, Y owned 99%. None of the minority shareholders of X owned as many as 10 shares. In order to eliminate its minority shareholders, X recapitalized by reclassifying each 10 shares of its common stock as one share of new $50 par value common stock. X paid cash in lieu of issuing fractional shares of new common stock under this exchange ratio. As a result, all the minority shareholders were eliminated by a cash payment in exchange for their common stock. The IRS ruled that the usual rules governing cash paid in lieu of fractional shares apply and, because the cash paid to the minority shareholders represented merely a mechanical rounding off of fractions in the exchange, their tax treatment was governed by §302. So tested, the cash paid to the minority shareholders qualified for capital gain treatment under §302(b)(3).

The IRS modified its rationale for Rev. Rul. 72-57, however, in Rev. Rul. 78-351. The IRS ruled that the route for getting to the §302 tests for the cash paid to both the majority and minority shareholders (in Rev. Rul. 72-57) should not be through the cash-in-lieu-of-fractional-shares rules, because the sole business purpose for the recapitalization was not mere mechanical rounding off of fractions but was instead to eliminate one group of shareholders. Consequently, the usual recapitalization rules would govern the exchange. As such, Rev. Rul. 78-351 says that the boot rules of §356 govern the majority shareholder (and, so applied, the majority shareholder's cash was found to be divided equivalent), and the §302 rules directly govern the minority shareholders (and, so applied, they qualify for exchange treatment via §302(b)(3)).

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X. Other Special Issues

A. *Substance vs. Form*

1. In General

As discussed in numerous other contexts in this Portfolio, there are a variety of circumstances in which transactions that purport to be redemptions are not, and vice versa.[718] Additionally, special problems arise in connection with bootstrap acquisitions, including acquisitions effected by means of reverse merger. Those problems are discussed at IX., above.

This section addresses other specific problems related to application of substance-versus-form principles and/or step transaction principles to redemption transactions.

Practice Point: The codification of economic substance rules,[719] with the associated penalties, places greater importance on articulating justifications, whether legal or economic, for a particular transaction. Such planning should be accompanied with documentation of intended tax outcomes with corresponding justifications for each step.

2. Redemption or Joint Venture

In certain circumstances a taxpayer will make an "investment" in the equity of a corporation in exchange for an interest in specific assets or a specific corporate undertaking. Where the facts indicate that the "investor" is entering into a joint venture with the corporation for a limited purpose, the courts have denied redemption treatment upon a later repurchase of the taxpayer's investment in the corporation.[720]

The question of whether a taxpayer has made an equity investment in a corporation, or instead has entered into a joint venture with the corporation becomes especially important in the context of "alphabet" stock (or, "tracking" stock). Alphabet stock is designed to be common stock of the corporation that reflects the performance of a separate business or subsidiary. The IRS will not issue advance rulings with regard to the characterization of alphabet stock.[721]

3. Sale vs. Redemption

A transaction that purports to be a sale of stock may, in fact, be a redemption. *Schneider Est. v. Commissioner*[722] illustrates this principle. There, an individual, T, controlled corporation X. T had X establish a stock bonus plan under which employees of X could elect to use some or all of their cash bonuses to "purchase" from T shares of a certain non-voting class of stock. For each employee who elected to receive such stock, corporation Y, a wholly owned subsidiary of X, issued two checks. One check represented the cash portion of the bonus, net of withholding taxes; the other check represented the book value of the shares that the employee elected to purchase from T. This latter check was issued with a restrictive endorsement to T, requiring the employee to sign over the check to T to receive the stock portion of the bonus. The stock certificates that were issued to the employees by X included a legend that the shares were subject to the conditions and restrictions of transferability under the stock bonus plan established by X. No such restrictions appeared on the stock certificates held by T. Applying the step transaction doctrine to these facts, the Tax Court held that T's purported sale of the shares to the employees of T's corporation was in fact a redemption of T's shares.

4. May Department Stores Transaction — Deemed Redemption Rule (§337(d))

Under the authority of §337(d), the IRS has provided that the *General Utilities* repeal cannot be circumvented by the use of partnerships. In Notice 89-37, the IRS stated that it would publish regulations requiring a corporate partner to recognize gain when it relinquishes an interest in appreciated property in exchange for an interest in its own stock. These transactions, called "May Department Store transactions" after one widely reported transaction in 1989, otherwise would avoid the *General Utilities* repeal.

In the prototype transaction, May Department Stores wanted to dispose of its real estate subsidiary. May and the prospective purchasers formed a 50-50 partnership, to which May contributed the stock of the real estate subsidiary and to which the prospective purchasers contributed $550 million in cash, the fair market value of the real estate subsidiary. The partnership then used the cash to purchase $550 million of May common stock directly from May. After a period of time designed to avoid both the step transaction and the disguised sale rules, the partnership was to be terminated, May was to receive back its common stock, and the purchaser was to receive the stock of the real estate subsidiary. If the various steps of the transaction were respected, May would avoid gain normally recognized under §311(b) or §1001 on the appreciated property, and the purchaser would take a cost basis in the stock of the real estate subsidiary under §732(b).

Under Reg. §1.337(d)-3, this transaction is labeled a "§337(d) transaction,"[723] and is treated as a deemed redemption.[724] Under the deemed redemption rule, a corporate partner in a partnership that engages in a §337(d) transaction recognizes gain at the time and to the extent that the corporate partner's interest in appreciated property (other than stock of the corporate partner) is reduced in exchange for an increased interest in stock of the corporate partner.[725] A corporate partner is

[718] For example, payments designated as made in redemption may, in fact, be compensation payments, or payments in settlement of a lawsuit. See II.B.2.b., above. Additionally, where it is determined that debt is actually stock, a "repayment" of that debt will be characterized as a redemption. See II.C.3., above.

[719] §7701(o).

[720] *See S. & M. Plumbing Co., Inc. v. Commissioner*, 55 T.C. 702 (1971), *acq.*, 1971-2 C.B. 3. *But cf., Erickson v. Commissioner*, 56 T.C. 1112 (1971), *acq.*, 1978-2 C.B. 2 (no joint venture where redemption price was partly contingent on profit from a specific construction job); *Kaplan v. Commissioner*, 66 F.2d 401 (1st Cir. 1933), aff'g on this point 26 B.T.A. 379 (1932) (no joint venture; taxpayer had claimed ordinary loss on redemption).

[721] *See* Rev. Proc. 2025-3, §3.01(143).

[722] 88 T.C. 906 (1987), aff'd, 885 F.2d 435 (7th Cir. 1988). *See also* PLR 9525035. *But see Turner Broad. Sys., Inc. & Subsidiaries v. Commissioner*, 111 T.C. 315 (1998) (§311(a) nonrecognition of loss rule does not apply to transaction; taxpayer's form (redemption) respected where taxpayer adopted form of transaction before they had knowledge of loss).

[723] A §337(d) transaction is defined as "a transaction (or series of transactions) that has the effect of an exchange by a Corporate Partner of its interests in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by a partnership." Reg. §1.337(d)-3(c)(3).

[724] Reg. §1.337(d)-3(e).

[725] Reg. §1.337(d)-3(d).

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a person that is classified as a corporation and holds or acquires an interest in a partnership.[726]

For a detailed discussion of §337(d) transactions, see 784 T.M., *Corporate Liquidations.*

5. General Step Transaction Principles

The IRS will seek to apply general step transaction principles in appropriate fact patterns, especially where the taxpayers have structured a clear charade in an attempt to avoid or shift the incidence of tax.

In Rev. Rul. 68-388,[727] for example, an estate which wanted to have all of its stock holdings redeemed at capital gain rates sold all of the stock to its beneficiary, from whom the corporation redeemed the stock for cash. The beneficiary promptly paid the cash over to the estate. On these facts, the beneficiary's ownership of the stock was disregarded as transitory and the stock was treated as redeemed from the estate.

B. Redemptions in Connection with Reorganizations

1. In General

Certain acquisitions of the stock or the assets of one corporation by another corporation qualify as tax-free reorganizations under §368. A common requirement of all reorganizations under §368 is that some portion of the consideration paid by the acquiring corporation must consist of the acquiring corporation's stock or stock of a corporation that controls it. Any other property (i.e., "boot") that is used as consideration will be taxable to the recipient under §356.[728]

Section 356(a)(2) provides that if the receipt of boot, in exchange for stock or securities, "has the effect of the distribution of a dividend," then the gain recognized will be treated as a dividend to the extent of the recipient's ratable share of undistributed earnings and profits, and the remainder of the recognized gain will be treated as gain from the exchange of property. The statute and the regulations give no guidance in determining whether an exchange does in fact have the effect of a distribution of a dividend.

For years the courts and the IRS have analogized to the principles of §302 in making a dividend equivalency determination under §356(a)(2).[729] The more controversial issue, however, was whether the redemption standards of §302 should be applied in an acquisitive reorganization by treating the Target shareholders as having received the boot in a hypothetical redemption by Target immediately before the reorganization (the "pre-reorganization redemption" test) or in a hypothetical redemption by Acquiror of that portion of the Acquiror stock which the Target shareholders would have received if they had not received boot (the "post-reorganization redemption" test). The post-reorganization redemption test was first applied in 1973 in *Wright v. U.S.*,[730] but the validity of this test was not established until the 1989 Supreme Court decision in *Commissioner v. Clark*.[731]

In *Clark*, taxpayer's wholly owned corporation was merged into a large public corporation in a forward triangular merger. In exchange for all of his stock, taxpayer received stock in Parent representing a .92% interest and substantial cash boot. The Tax Court had found that the receipt of cash boot reduced taxpayer's "potential" holdings in Parent from 1.3% to .92%. Both the Tax Court and the Fourth Circuit followed *Wright* and held that taxpayer's receipt of boot qualified for capital gain treatment because the hypothetical post-reorganization redemption reduced taxpayer's interest from 1.3% to .92%, a reduction that met the "substantially disproportionate" test of §302(b)(2).

In a 7-2 decision, the Supreme Court agreed with the Tax Court and the Fourth Circuit and adopted the post-reorganization redemption test. The Court based its holding on the language and legislative history of §356 and on the need to view the reorganization as an integrated transaction. The Court reasoned that the IRS's approach would sever the payment of boot from the context of the reorganization. According to the Court, such a limited view of the transaction is inconsistent with the intent of §356 (i.e., to look at the effect of the entire exchange).

The application of §356 and the *Clark* test can be better understood through the following examples.

> *Example:* Assume that corporation Y has total assets worth \$150 and that Y's shareholders' basis in Y shares equals \$50. Y merges into X corporation. As part of the merger consideration, X issues its stock worth \$120 plus cash of \$30 (\$150 total consideration).
>
> Because cash consideration is issued in an otherwise nontaxable reorganization, §356 requires recognition of income to selling shareholders to the extent of the lesser of the cash consideration or the inherent gain in the stock relinquished. In addition, the transaction must be tested for dividend equivalence under §356(a)(2). The analysis under *Clark* is as follows (see illustrations below).

[726] Reg. §1.337(d)-3(c)(1). The IRS has issued proposed regulations that would amend the definition of a corporate partner. *See* REG-135671-17, 84 Fed. Reg. 11,005 (Mar. 25, 2019).

[727] Rev. Rul. 68-388, *obsoleted by* Rev. Rul. 2003-99.

[728] For a further discussion of this topic, see 782 T.M., *Boot Distributions and Assumption of Liabilities.*

[729] *See, e.g., Ross v. U.S.*, 173 F. Supp. 793 (Ct. Cl. 1959), cert. denied, 361 U.S. 875 (1959); Rev. Rul. 74-515; Rev. Rul. 74-516.

[730] 482 F.2d 600 (8th Cir. 1973).

[731] 489 U.S. 726 (1989), aff'g 828 F.2d 221 (4th Cir. 1987), aff'g 86 T.C. 138 (1986). In Rev. Rul. 93-61, the IRS adopted the post-reorganization redemption test and revoked Rev. Rul. 75-83, which applied the pre-reorganization redemption test. However, the pre-reorganization redemption test arguably still applies for divisive §368(a)(1)(D) reorganizations. *See* Rev. Rul. 93-62.

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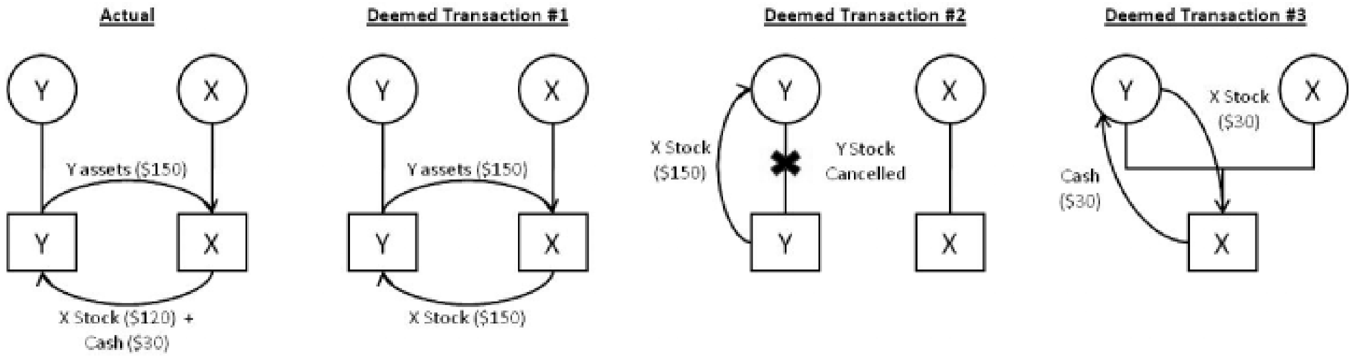
Example #1 Illustrations



First (Step One), X corporation is deemed to purchase Y's assets for stock worth $150.

Second (Step Two), Y corporation is deemed to distribute the X stock acquired in step one in complete liquidation.

Third (Step Three), X is deemed to redeem $30 of its stock from the historic Y shareholders.

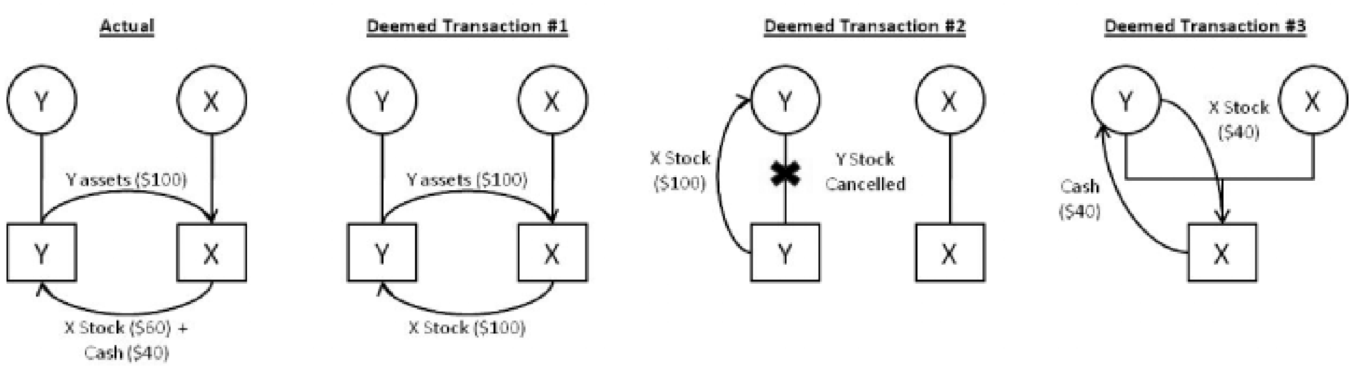
After Step Two, former Y shareholders become X shareholders holding $150 worth of X stock. Therefore, Y shareholders' relative ownership percentage is 60% ($150 worth of X shares divided by the total X shares worth $250, the assumed combined value of X and Y corporations). Under *Clark*, the deemed redemption in Step Three causes Y shareholders' relative ownership percentage to decrease to 54.54% ($120 worth of X shares divided by the total X shares worth $220).

Because Y shareholders' ownership percentage is greater than 50%, the test of §302(b)(2) is not met and the transaction does not result in a substantially disproportionate reduction in the ownership of X. Likewise, the requirements under §302(b)(1), (3), and (4) are also likely not met and as a result, the deemed redemption likely has the effect of a distribution of a dividend. Any gain upon the exchange is treated under §356(a)(2) as a dividend to the extent of the shareholders' "ratable share of undistributed earnings and profits of the corporation."[732] Any gain is limited under §356(a)(1) to the lesser of (1) the actual gain on the deemed exchange or (2) the cash received, in this example, $30.

Example: Assume that corporation Y has total assets worth $100 and that Y's shareholders' basis in Y shares equals $50. Y merges into X in exchange for X stock worth $60 plus cash of $40 ($100 total). Assume also that X has a value of $100.

Because cash consideration is issued in an otherwise nontaxable reorganization, §356 requires recognition of income to selling shareholders to the extent of the lesser of the cash consideration or the inherent gain in the stock relinquished. In addition, the transaction must be tested for dividend equivalence under §356(a)(2). The analysis under *Clark* is as follows (see illustrations below).

Example #2 Illustrations



[732] The issue of whether the earnings and profits of both the acquiring corporation as well as the transferor corporation should be considered for purposes of determining the extent of dividend treatment of any gain under §356(b)(2) has been a subject of debate over the years with no clear conclusion. However, including the earnings and profits of both corporations would seem to reflect the economic realities of the transaction and be consistent with the post-reorganization redemption analysis of *Clark* and with the result that one would obtain in an analogous provision, §304(a)(1). For a further discussion of this topic, see 782 T.M., *Boot Distributions and Assumption of Liabilities*.

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First (Step One), X corporation is deemed to purchase Y's assets for stock worth $100.

Second (Step Two), Y corporation is deemed to distribute the X stock acquired in step one in complete liquidation.

Third (Step Three), X is deemed to redeem $40 of its stock from the historic Y shareholders.

After Step Two, former Y shareholders become X shareholders holding $100 worth of X stock. Y shareholders' relative ownership percentage is 50% ($100 worth of X shares divided by the total X shares worth $200). After Step Three, Y shareholders' relative ownership percentage equals 37.50% ($60 worth of X shares divided by the total X shares worth $160). In this case, Y shareholders' ownership percentage is reduced to less than 50% following the deemed redemption. Also, the ratio of Y's shareholders' ownership immediately prior to the deemed redemption (50%) compared to their ownership immediately after the deemed redemption (37.50%) is 75% (37.50% divided by 50%), which is less than the 80% limitation required under §302(b)(2)(C). Therefore, the transaction results in a substantially disproportionate reduction in their ownership position in X and the transaction qualifies for exchange treatment. Gain upon the exchange is limited under §356(a)(1) to the lesser of (1) the actual gain on the deemed exchange or (2) the cash received, in this example, $40. In this example, the gain should be characterized as capital gain.

2. *Earnings and Profits*

In *Clark*,[733] the Court concluded that if a taxpayer satisfied the "substantially disproportionate" standards of §302(b)(2) in connection with the deemed post-reorganization redemption, the taxpayer is entitled to capital gain treatment with respect to any boot received. In cases where the post-reorganization redemption test does not result in exchange treatment under the safe harbors of §302(b)(1) through (4), the redemption will be treated as a distribution of property to which §301 applies (i.e., the distribution will be treated as a dividend to the extent of earnings and profits). The next question that naturally arises is which entity's earnings and profits should be evaluated to determine the extent of dividend treatment.

The *Clark* case should have no bearing on which corporation's earnings and profits provide the limitation under §356(a)(2) as it only provides a method for determining whether or not shareholders have sufficiently "cashed in" on their investment to merit capital gains treatment. It is only after this determination has been made that one reaches the separate question of which corporation's earnings and profits should be considered available to a shareholder who has received dividend equivalent boot.[734]

[733] 489 U.S. 726 (1989), aff'g 828 F.2d 221 (4th Cir. 1987), aff'g 86 T.C. 138 (1986).

[734] See 782 T.M., *Boot Distributions and Assumption of Liabilities* for a further discussion.

Historically, there has been significant uncertainty and lack of consistent guidance on this topic. In the case of an acquisitive type "D" reorganization, the Fifth Circuit ruled in *Davant*[735] that "[w]here there is a complete identity of stockholders, the use of the earnings and profits of both corporations is the only logical way to test which distributions have the effect of a dividend." The IRS reinforced this position in Rev. Rul. 70-240. However, the *Davant* ruling has been contradicted in the courts under *American Manufacturing*[736] and *Atlas Tool Co.*[737] leading to further uncertainty in this area (notably, both of these situations involved a complete identity of acquiring and target shareholders and theoretically would limit their applicability to these specific situations).

In CCA 201032035, the IRS concluded that in all reorganizations except for triangular reorganizations (as in *Clark*), the issuing corporation succeeds to the earnings and profits of the target corporation and thus, the earnings and profits of both issuing and target should be considered in the determination of the amount subject to dividend treatment under §356.[738]

Note that the attribution rules of §318 apply to test the hypothetical post-reorganization redemption for dividend equivalency, just as if the redemption were taking place under §302.[739]

Often in reorganizations, the acquiring corporation will pay cash in lieu of issuing fractional shares. If the cash is distributed solely for the purpose of saving the corporation the expense and inconvenience of issuing fractional shares, then the shareholders receive exchange treatment under §302(b)(1).[740]

For a more complete discussion of §356 and related topics, see 782 T.M., *Boot Distributions and Assumption of Liabilities.*

C. Section 304

Section 304 prevents the use of related corporations to receive capital gain treatment on corporate distributions that more properly should be given dividend treatment. Section 304 provides that if one or more persons are in control of each of two corporations, and, in return for property, one of the corporations acquires stock in the other corporation from the person so in control, then the property is treated as a distribution in redemption of the stock of the corporation acquiring such stock. "Control" for purposes of §304 means ownership of stock possessing at least 50% of the vote or value of the corporation.[741] The attribution rules of §318 apply, with modifications, for determining control.[742]

[735] 43 T.C. 540 (1965), aff'd in part, rev'd in part, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

[736] *American Manufacturing Co. Inc. v. Commissioner*, 55 T.C. 204 (1970).

[737] *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980), aff'g 70 T.C. 86 (1978). For a further discussion of "D" reorganizations, see 772 T.M., *Corporate Acquisitions — D Reorganizations.*

[738] *See American Manufacturing Co. Inc. v. Commissioner*, 55 T.C. 204 (1970); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980), aff'g 70 T.C. 86 (1978).

[739] §356(a)(2). Before TEFRA's amendment to §356(a)(2), the IRS had ruled that §318 did not apply for this purpose. Rev. Proc. 74-515.

[740] *See* Rev. Proc. 77-41. *See also* PLR 200741015, PLR 200016015 (cash payments in lieu of fractional shares of acquiring corporation were treated as though fractional shares were distributed and then redeemed pursuant to §302(a)).

[741] §304(c).

[742] §304(c)(3).

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Section 304 accomplishes dividend equivalence in one of two ways. First, where two corporations are commonly controlled by one or more shareholders, the purchase of stock by one commonly controlled corporation for cash of another commonly controlled corporation represents a possible cash distribution disguised as an exchange transaction.

> *Example:* Assume that shareholder S owns all of the stock of each of corporations, X and Y. Assume also that both X and Y have accumulated earnings and profits as of December 31, Year 1. On June 30 of Year 2, X purchases part of the stock of Y from S for cash. This transaction results in a potential dividend equivalent transaction that is structured in form as an exchange. Specifically, this transaction, although structured as an exchange, results in no diminished amount of control for S of either X or Y.
>
> To prevent a reduction in the dividend payment capacity through the use of an exchange transaction, §304 creates a deemed transaction in this example. First, S is deemed to contribute Y stock to X in a statutorily mandated §351 conveyance in exchange for deemed issued X stock. Second, X redeems its deemed issued stock from S with the amount of cash consideration.
>
> The deemed distribution in redemption of X's stock is tested under §302 to determine whether the transaction should be treated as an exchange, in which case the seller receives capital gain treatment, or as a §301 distribution, in which case the seller realizes ordinary income or qualified dividend income in the amount of the distribution (to the extent of the combined earnings and profits of both corporations). Although §304 deems a redemption of the acquiring corporation's stock, the §302(b) tests are applied to the seller's ownership interest in the issuing corporation (i.e., to the corporation's stock that was sold) before and after the transaction.[743]
>
> The second way that §304 creates dividend equivalence occurs on a subsidiary's purchase of parent stock. In such an instance, §304 establishes a surrogate redemption whereby the parent corporation is deemed to redeem its own shares through its controlled subsidiary corporation. In this case, dividend equivalence is measured by comparing the amount of shares owned by each shareholder immediately prior to the subsidiary's stock purchase with the amount of shares owned by the shareholder immediately after the subsidiary's stock purchase. For a more complete discussion of §304 and related topics, see 768 T.M., *Stock Sales Subject to Section 304.*

D. Section 305

Since *Eisner v. Macomber*[744] was decided by the Supreme Court in 1920, stock dividends generally have not been considered income to a shareholder because the distribution takes nothing from the property of the corporation and adds nothing to the property of a shareholder. Section 305(a) is the current codification of that landmark case, with a number of exceptions added to the Code in §305(b) and (c) to prevent some perceived abuses.

The distribution of stock rights is also tax-free under §305 unless the distribution changes, or has the potential to change, the shareholders' proportionate interest in the distributing corporation. The exceptions to the general rule of §305(a), spelled out in §305(b), cover both stock dividends and distributions of stock rights.

When a distribution of stock or stock rights is nontaxable, there is no effect on the distributing corporation. The distributing corporation recognizes no gain or loss on the distribution,[745] and the corporation has no reduction in its earnings and profits.[746] The shareholder generally allocates basis based upon relative fair market values.[747]

Transactions (including certain redemptions) that are part of a periodic plan to shift equity interests among the shareholders may trigger a deemed distribution under §305(c) that is considered a taxable distribution despite inaction, in some cases, on the part of a shareholder.[748] While all redemptions, other than proportionate redemptions, have the effect of increasing the nonredeeming shareholder's proportionate interest in the corporation, not all redemptions are considered deemed distributions to the nonredeeming shareholders. A redemption that is not a part of a periodic redemption plan is not considered a deemed distribution to the nonredeeming shareholders.[749] While the actual language of §305(c) is broad enough to include any redemption, the regulations exclude isolated redemptions.

For a complete analysis of §305, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

E. Section 303

Section 303 provides automatic exchange treatment for certain redemptions of stock if the stock is included in a decedent's gross estate. This provision was enacted to assist the closely held business owner's estate with the liquidity problems that can arise when trying to meet death-tax obligations. In many cases, ready markets are not available to dispose of shares in close corporations. As a consequence, if financing is not found to pay death taxes, the executors of the estate could be forced to sell the family business.[750]

To combat this problem, §303 was enacted to allow the generally tax-free withdrawal of funds from a corporation, by allowing a basis offset against the redemption proceeds. Because basis is stepped up at the date of death,[751] the only gain taxed is the appreciation after the date of death. For a detailed

[743] §304(b)(1).

[744] 252 U.S. 189 (1920).

[745] §311(a). *See, e.g.,* PLR 199901024.

[746] §312(d). *See, e.g.,* PLR 199901024.

[747] §307(a).

[748] *See* Reg. §1.305-3(e) *Ex. 8.*

[749] *See* Reg. §1.305-3(e) *Ex. 10. See also* PLR 201002022 (closely held corporation's redemption of nonvoting shares held by controlling family group constituted single and isolated transaction and would not result in §305 deemed distribution; redemption was unrelated to corporation's plan to periodically redeem nonvoting shares held by retirement plan); PLR 200532005 (redemption of stock pursuant to tender offer intended to increase stock price was single and isolated transaction that was not part of periodic redemption plan), PLR 200025047 (same), PLR 200025046 (same).

[750] To avoid this dire result, the company could redeem some of the decedent's shares, but, absent §303, the estate would have to secure passage through §302(b)(1)–(4) to avoid dividend treatment.

[751] §1014(a).

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explanation and analysis of §303, see 809 T.M., *Estate Planning for Owners of Closely Held Business Interests* (Estates, Gifts, & Trusts series).

F. Section 306

Section 306 was enacted to prevent shareholders from receiving corporate earnings as long-term capital gain without changing their equity position in the corporation. Section 306(a)(2), in particular, focuses on redemptions by issuing corporations. When §306(a)(2) is triggered, the amount realized in the redemption by the shareholder is treated as a distribution to which the §301 dividend distribution rules apply.

Section 306(c) describes §306 stock as:

(1) stock (other than common stock issued with respect to common stock) that is received in a nontaxable stock dividend;

(2) stock (that is not common stock) received in a tax-free reorganization or corporate division if the effect of the transaction was substantially the same as the receipt of a stock dividend, or if the stock was received in exchange for §306 stock;

(3) stock the adjusted basis of which is determined by reference to the adjusted basis of §306 stock (carryover or substituted basis stock); and

(4) stock (that is not common stock) acquired in an exchange to which §351 applies if receipt of money (in lieu of stock) would have been treated as a dividend.

Section 306(c)(2) provides that if a corporation distributes stock but has no earnings and profits in the year of distribution, the stock distributed cannot be §306 stock.

As mentioned above, when a corporation redeems §306 stock, the total amount realized by the shareholder receives dividend treatment to the extent of the redeeming corporation's earnings and profits. For taxable years beginning after 2002, the dividend a shareholder is deemed to receive may be qualified dividend income, which is taxed as net capital gain rather than ordinary income.[752] Nevertheless, the consequences of §306 can be negative even to a shareholder receiving qualified dividend income; the shareholder cannot offset basis against the amount realized as in a sale or exchange. For extensive analysis of the §306 provisions, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

G. Excise Taxes

1. Excise Tax on Repurchase of Corporate Stock

a. Introduction

For net stock repurchases occurring after December 31, 2022, a nondeductible excise tax is imposed on each "covered corporation" equal to 1% of the corporation's stock repurchase excise tax base for the taxable year.[753] A covered corporation is any publicly traded, domestic corporation.[754] In determining the corporation's stock repurchase excise tax base, a covered corporation must subtract, pursuant to a netting rule, the fair market value (FMV) of any stock issued during the taxable year, including any stock issued or provided to employees of the covered corporation or a specified affiliate (defined in X.G.1.f., below). Thus, only repurchases that exceed the value of all stock issued are subject to tax.[755]

In December 2022, Treasury and the IRS released Notice 2023-2, providing interim guidance on the stock repurchase excise tax, including examples illustrating the operating rules set forth in section 3 of the notice. Treasury and the IRS advised taxpayers that they could rely on the operating rules set forth in the notice until proposed regulations were issued.[756] In April 2024, Treasury and the IRS published proposed regulations incorporating the operating rules set forth in the notice, proposing additional guidance regarding the acquisition of stock of a foreign corporation, and responding to feedback received with respect to the notice.[757] On the same day, Treasury and the IRS also published proposed regulations providing procedural guidance on how to report and pay the excise tax.[758]

The regulations addressing operating rules are proposed to apply generally to repurchases of a covered corporation's stock occurring after December 31, 2022, during taxable years ending after that date, and to issuances and provisions of a covered corporation's stock occurring during taxable years ending after December 31, 2022. Certain rules that were not described in Notice 2023-2 would apply to repurchases, issuances, or provisions of stock of a covered corporation occurring after April 12, 2024, and during taxable years ending after that date.[759]

Provided they follow the rules consistently, covered corporations may rely on Prop. Reg. §58.4501-1 through §58.4501-5 for stock repurchases occurring after December 31, 2022, and on or before the date the final regulations are published in the Federal Register, and for stock issuances and provisions occurring during taxable years ending after December 31, 2022, and on or before the date the final regulations are published in the Federal Register. Likewise, provided they follow the rules consistently, covered corporations may rely on the provisions of Notice 2023-2 corresponding to the rules in Prop. Reg. §58.4501-1 through §58.4501-5 for stock repurchases occurring after December 31, 2022, and on or before April 12, 2024, and for stock issuances and provisions occurring during taxable years ending after December 31, 2022, and on or before

[752] §306(a)(1)(D).

[753] §4501(a), §275(a)(6), added and amended by the Inflation Reduction Act, Pub. L. No. 117-169, §10201; Prop. Reg. §58.4501-2(b), REG-115710-22, 89 Fed. Reg. 25,980 (Apr. 12, 2024). *See also Federal Excise Tax Navigator*, at 3.5.

[754] §4501(b); Prop. Reg. §58.4501-1(b)(6).

[755] §4501(c)(3). If a covered corporation's taxable year began before January 1, 2023, and ended after December 31, 2022, and the corporation engaged in a taxable repurchase of its stock during the taxable year (but after December 31, 2022), the corporation could subtract the FMV of any stock issued at any time during the taxable year in determining the taxable amount of the stock repurchase. Notice 2023-2, §2.07(2) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[756] Notice 2023-2, §1 (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[757] REG-115710-22, 89 Fed. Reg. 25,980 (Apr. 12, 2024). Examples illustrating the proposed rules under §4501 are provided in Prop. Reg. §58.4501-5.

[758] REG-118499-23, 89 Fed. Reg. 25,829 (Apr. 12, 2024).

[759] Prop. Reg. §58.4501-6. *See also* Prop. Reg. §58.4501-7(r)(1) (general applicability date for rules on acquisitions or repurchases of certain foreign corporation stock).

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April 12, 2024.[760] Notice 2023-2 is obsoleted for repurchases, issuances, and provisions of covered corporation stock occurring after April 12, 2024.[761]

In additional guidance, the IRS confirmed that no taxpayer is required to report excise tax liability under §4501(a) on any returns filed with the IRS, or to make any payments of the excise tax, before the time specified in proposed regulations.[762] The proposed regulations generally would require the stock repurchase excise tax return to be filed by the due date of the Form 720, *Quarterly Federal Excise Tax Return*, for the first calendar quarter after the covered corporation's taxable year ends, but no earlier than the due date for the first calendar quarter after the date final regulations are published in the Federal Register.[763] For further discussion of the requirement to report and pay the stock repurchase excise tax, see X.G.1.i., below.

b. Covered Corporation

A covered corporation is any domestic corporation the stock of which is traded on an established securities market.[764] A covered corporation's status as a covered corporation starts at the beginning of the corporation's "initiation date," which is the date on which the corporation's stock begins to be traded on an established securities market.[765] A corporation generally ceases to be a covered corporation at the end of the corporation's cessation date, which is the date on which all stock of a covered corporation ceases to be traded on an established securities market.[766] However, if a corporation ceases to be a covered corporation pursuant to a plan that includes a repurchase, and if the cessation date precedes the date on which any repurchase undertaken pursuant to the plan occurs, the corporation continues to be a covered corporation with regard to each planned repurchase until the date on which the last planned repurchase occurs.[767]

Clarifying rules are proposed for determining if a corporation is a domestic corporation in the context of inbound and outbound F reorganizations. If a foreign corporation transfers its assets (or is treated as transferring its assets) to a domestic corporation in an F reorganization, the corporation is not treated as a domestic corporation until the day after the reorganization. Similarly, if a domestic corporation transfers its assets (or is treated as transferring its assets) to a foreign corporation in an F reorganization, the corporation is not treated as a foreign corporation until the day after the reorganization.[768]

c. Stock Repurchase Excise Tax Base

(1) Introduction and Formula

Calculation of a covered corporation's stock repurchase excise tax base is a multi-step process. First, the covered corporation must determine the aggregate FMV of its stock that the covered corporation repurchased and that a specified affiliate of the covered corporation acquired during the covered corporation's taxable year. The covered corporation then must subtract from that amount the FMV of its stock that was repurchased or acquired by a specified affiliate during the taxable year to the extent any statutory exception applies. Finally, the covered corporation must subtract the aggregate FMV of its stock that the covered corporation issued or that a specified affiliate provided during the covered corporation's taxable year, in accordance with the "netting rule" (see X.G.1.d., below).[769]

A covered corporation is not subject to the stock repurchase excise tax with regard to a taxable year if, during that taxable year, the aggregate FMV of the stock repurchased by the covered corporation does not exceed $1 million (de minimis exception).[770] The de minimis exception applies before any adjustment of the taxable amount under the netting rule and any other statutory exception.[771] Repurchases before January 1, 2023, are not taken into account for purposes of applying the de minimis exception.[772]

(2) Fair Market Value

The FMV of a covered corporation's stock repurchased by the covered corporation or acquired by a specified affiliate is the market price of the stock on the date the stock is repurchased or acquired (the "repurchase date"). If the stock is traded on an established securities market, the covered corporation must determine the market price by using one of the following acceptable methods: (1) the daily volume-weighted average price; (2) the closing price; (3) the average of the high and low prices; or (4) the trading price.[773] The method used must be applied consistently to all repurchases or acquisitions during a taxable year and to determine the FMV of stock issued or provided under the netting rule, other than stock issued or provided in connection with the performance of services.[774]

A covered corporation the stock of which is traded on multiple established securities markets must determine the market price by reference to trading on the established securities market in the country in which the covered corporation is organized, including a regional established securities market that trades in that country. If the stock is traded on multiple established markets in the country of organization, the corporation

[760] Preamble to REG-115710-22, 89 Fed. Reg. 25,980, 26,020 (Apr. 12, 2024).

[761] Preamble to REG-115710-22, 89 Fed. Reg. 25,980, 26,030–31 (Apr. 12, 2024).

[762] Announcement 2023-18.

[763] Prop. Reg. §58.6071-1(a), Prop. Reg. §58.6071-1(c), REG-118499-23, 89 Fed. Reg. 25,829 (Apr. 12, 2024).

[764] §4501(b); Prop. Reg. §58.4501-1(b)(6). *See also* Prop. Reg. §58.4501-1(b)(13) (defining "established securities market" by reference to Reg. §1.7704-1(b)).

[765] Prop. Reg. §58.4501-2(d)(1), Prop. Reg. §58.4501-1(b)(16).

[766] Prop. Reg. §58.4501-2(d)(2)(i), Prop. Reg. §58.4501-1(b)(3).

[767] Prop. Reg. §58.4501-2(d)(2)(ii).

[768] Prop. Reg. §58.4501-2(d)(3). *See* Reg. §1.367(b)-2(f) and Reg. §1.367(a)-1(e) regarding deemed asset transfers in the context of inbound and outbound F reorganizations, respectively.

[769] Prop. Reg. §58.4501-2(c)(1).

[770] §4501(e)(3); Prop. Reg. §58.4501-2(b)(2).

[771] Prop. Reg. §58.4501-2(b)(2)(ii); Notice 2023-2, §3.03(2)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[772] Prop. Reg. §58.4501-2(c)(3)(ii).

[773] Prop. Reg. §58.4501-2(h)(1)–§58.4501-2(h)(2); Notice 2023-2, §3.06(2)(a) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). If the repurchase date is not a trading day, market price is determined on the immediately preceding trading day. Prop. Reg. §58.4501-2(h)(2)(iii).

[774] Prop. Reg. §58.4501-2(h)(2)(iv); Notice 2023-2, §3.06(2)(a)(iii), §3.08(5) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

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must determine the market price by reference to trading on the market in that country with the highest trading volume in that stock in the prior taxable year. If the stock is not traded on an established market in the country of organization, the covered corporation must determine market value in a manner that is reasonable under the facts and circumstances.[775]

If repurchased or acquired stock is not traded on an established securities market, the market price of the stock is determined as of the date of repurchase or acquisition under the principles of Reg. §1.409A-1(b)(5)(iv)(B)(*1*).[776]

Each covered corporation must separately determine the aggregate FMV of its stock repurchased or acquired during each taxable year. If the reductions for applicable statutory exceptions and stock issued by the covered corporation or provided by a specified affiliate would exceed the aggregate FMV of stock repurchased or acquired, the excess amount is not carried forward or back to a succeeding or preceding taxable year of the covered corporation for purposes of determining the stock repurchase excise tax base in those preceding or subsequent years.[777]

Stock of a covered corporation repurchased by the covered corporation or acquired by a specified affiliate before January 1, 2023, is neither included in the covered corporation's stock repurchase excise tax base nor taken into account in determining the applicability of the de minimis exception (see X.G.1.c.(3), below).[778] In response to Notice 2023-2, commentators requested transition relief that also would have exempted from the excise tax certain repurchases that occurred after January 1, 2023, in a variety of transactions, including, for example, a repurchase pursuant to a binding commitment entered into before August 16, 2022, the date of enactment of §4501. The IRS, however, expressed the view that transition relief would not be appropriate considering the plain language of Pub. L. No. 117-169, §10201(d), providing that the excise tax applies to stock repurchases after December 31, 2022.[779]

(3) Statutory Exceptions Reducing FMV

The stock repurchase excise tax base is reduced by the FMV of stock repurchased or acquired in the following circumstances:

- to the extent the repurchase is part of a reorganization (within the meaning of §368(a)) and no gain or loss is recognized on the repurchase by the shareholder;
- if the repurchased stock (or an amount of stock of equal value) is contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan;
- if the repurchase is by a dealer in securities in the ordinary course of business (as prescribed in regulations);
- repurchases by a regulated investment company (RIC) or real estate investment trust (REIT); or
- to the extent the repurchase is treated as a dividend.[780]

(a) Reorganization Exception

If the repurchase is for property permitted to be received under §354 or §355 without recognition of gain or loss, the excise tax base is reduced by the FMV of stock repurchased in the following transactions:

- a repurchase by a target corporation as part of an acquisitive reorganization;
- a repurchase by a recapitalizing corporation as part of an E reorganization;
- a repurchase by a transferor corporation as part of an F reorganization; and
- a repurchase by a distributing corporation as part of a split-off (whether or not part of a D reorganization).[781]

(b) Contributions to Employer-Sponsored Retirement Plans

If a covered corporation repurchases, or a specified affiliate acquires, covered corporation stock and contributes to an employer-sponsored retirement plan that stock, or an amount of stock equal to the FMV of the stock repurchased or acquired, the corporation's stock repurchase excise tax base is reduced by the aggregate FMV of the stock repurchased or acquired during the taxable year.[782]

If the stock contributed to the retirement plan is of the same class as the repurchased or acquired stock, the amount of the reduction is the lesser of:

- the aggregate FMV of the stock of the same class that was repurchased or acquired during the covered corporation's taxable year; or
- the amount obtained by:
  - o determining the aggregate FMV of all stock of that class repurchased or acquired during the taxable year, reduced by the FMV of shares of that class that may be subtracted from the excise tax base pursuant to an exception other than a contribution to an employer-sponsored retirement plan;
  - o dividing that amount by the number of shares of that class repurchased or acquired during the taxable year, reduced by the number of shares subtracted from the excise tax base in the previous step; and

[775] Prop. Reg. §58.4501-2(h)(2)(v).

[776] Prop. Reg. §58.4501-2(h)(3); Notice 2023-2, §3.06(2)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). For discussion of Reg. §1.409A-1(b)(5)(iv)(B)(*1*), see 385 T.M., *Deferred Compensation Arrangements*, at IV.D.

[777] Prop. Reg. §58.4501-2(c)(2).

[778] Prop. Reg. §58.4501-2(c)(3).

[779] *See* Preamble, REG-115710-22, 89 Fed. Reg. 25,980, 25,983 (Apr. 12, 2024).

[780] §4501(e); Prop. Reg. §58.4501-3(b).

[781] Prop. Reg. §58.4501-3(c); Notice 2023-2, §3.07(2) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024); *see also* §4501(e)(1). An "acquisitive reorganization" is defined as an A reorganization (including a forward triangular merger or reverse triangular merger), a C reorganization, a D reorganization, or a G reorganization. Prop. Reg. §58.4501-1(b)(1).

[782] Prop. Reg. §58.4501-3(d)(1); Notice 2023-2, §3.07(3)(a) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024); *see also* §4501(e)(2).

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o multiplying the result by the number of share of that class contributed to an employer-sponsored retirement plan for the taxable year.[783]

If the covered corporation contributed stock of a different class to the retirement plan from what was repurchased or acquired, the amount of the reduction is the FMV of the contributed stock at the time of the contribution. The reduction cannot be more than the aggregate FMV of the stock that was repurchased or acquired during the taxable year, reduced by the FMV of any stock that may be subtracted from the excise tax base pursuant to an exception other than a contribution to an employer-sponsored retirement plan.[784]

For purposes of determining the reduction to the excise tax base, a covered corporation may treat stock contributions to an employer-sponsored retirement plan as having occurred in the prior taxable year if the stock is contributed by the filing deadline for Form 720, *Quarterly Federal Excise Tax Return*, for the first full calendar quarter after the close of the corporation's taxable year, and the retirement plan treats the stock in the same manner as the plan would treat a contribution received on the last day of that taxable year. Stock contributions treated as occurring in the taxable year to which the Form 720 applies cannot be treated as occurring in any other taxable year.[785]

(c) Dealer in Securities in the Ordinary Course of Business

A "dealer in securities" is a taxpayer who either (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[786]

A corporation's stock repurchase excise tax base is reduced by the FMV of stock repurchased by a covered corporation or acquired by a specified affiliate that is a dealer in securities, to the extent the stock is acquired in the ordinary course of the dealer's business of dealing in securities. The exception applies only if:

- the dealer accounts for the stock as securities held primarily for sale to customers in the dealer's ordinary course of business;
- the dealer disposes of the stock within a period of time that is consistent with the holding of the stock for sale in the ordinary course and prevailing market practices; and
- the dealer (if it is a covered corporation) does not sell or otherwise transfer the stock to a specified affiliate of the covered corporation, or the dealer (if it is a specified affiliate) does not sell or otherwise transfer the stock to the covered corporation or another specified affiliate, other than in a sale or transfer to a dealer that satisfies the requirements of the exception.[787]

(d) Repurchase by a RIC or REIT

A corporation's stock repurchase excise tax base is reduced by the FMV of stock repurchased by the covered corporation or acquired by a specified affiliate if the covered corporation is a RIC or a REIT.[788]

(e) Repurchase Treated as a Dividend

A corporation's stock repurchase excise tax base is reduced by the FMV of repurchased stock to the extent that the repurchase is treated as a distribution of a dividend under §301(c)(1) or §356(a)(2).[789] A repurchase to which §302 or §356(a) applies is presumed not to be equivalent to a dividend and, therefore, ineligible for the exception that applies to a repurchase treated as a dividend. A covered corporation may rebut the presumption with regard to a specific shareholder solely by establishing with sufficient evidence that the shareholder treats the repurchase as a dividend on the shareholder's federal income tax return.[790]

To provide sufficient evidence, a covered corporation must:

- obtain certification from the shareholder that the repurchase constitutes a redemption treated as a §301 distribution under §302(d) or has the effect of the distribution of a dividend under §356(a)(2), including evidence that any required withholding occurred;
- treat the repurchase consistent with the shareholder certification;
- have no knowledge of facts indicating the certification is incorrect; and
- demonstrate the covered corporation has sufficient earnings and profits to treat as a dividend either the redemption under §302, or the receipt of money or other property under §356.[791]

The proposed regulation provides a list of information that must be included in the shareholder certification, including a penalty of perjury statement and the shareholder's signature.[792] After receiving the shareholder certification, the covered corporation must include on the certification a statement signed by the covered corporation under penalty of perjury that the corporation agrees to treat the repurchase consistent with the shareholder certification and has no knowledge of facts that would

[783] Prop. Reg. §58.4501-3(d)(3); Notice 2023-2, §3.07(3)(c)(i) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[784] Prop. Reg. §58.4501-3(d)(4); Notice 2023-2, §3.07(3)(c)(ii) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[785] Prop. Reg. §58.4501-3(d)(5); Notice 2023-2, §3.07(3)(d) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[786] Prop. Reg. §58.4501-3(e)(1) (reference to §475(c)(1)).

[787] Prop. Reg. §58.4501-3(e)(2); Notice 2023-2, §3.07(4)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024); *see also* §4501(e)(4).

[788] Prop. Reg. §58.4501-3(f); *see also* §4501(e)(5).

[789] Prop. Reg. §58.4501-3(g)(1); Notice 2023-2, §3.07(6)(a) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024); *see also* §4501(e)(6).

[790] Prop. Reg. §58.4501-3(g)(2)(i)–§58.4501-3(g)(2)(ii); Notice 2023-2, §3.07(6)(b)(i)–(ii) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[791] Prop. Reg. §58.4501-3(g)(2)(iii); Notice 2023-2, §3.07(6)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). The requirement in Notice 2023-2 to provide an information report to the redeemed shareholder that the repurchase constitutes a dividend was not included in the proposed regulation. *See* Notice 2023-2, §3.07(6)(b)(iii)(A) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024); preamble to REG-115710-22, 89 Fed. Reg. 25,980, 26,006–07 (Apr. 12, 2024).

[792] Prop. Reg. §58.4501-3(g)(3).

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indicate the certification is incorrect.[793] The covered corporation must retain and make available for inspection by the IRS any evidence that establishes the shareholder treats a repurchase as a dividend and records of all information necessary to document and substantiate all content of the shareholder certification.[794]

d. Netting Rule

(1) General Rule

Under the netting rule, a covered corporation's stock repurchase excise tax base for a taxable year is reduced by the aggregate FMV of the covered corporation's stock issued by the covered corporation or provided by a specified affiliate in the following circumstances:

- issued by the covered corporation during its taxable year in connection with the performance of services for the covered corporation by an employee or other service provider of the covered corporation;
- provided by a specified affiliate in connection with the performance of services for the specified affiliate by an employee of the specified affiliate during the corporation's taxable year; or
- issued by the covered corporation during its taxable year but not in connection with the performance of services.[795]

(2) In Connection with the Performance of Services

For purposes of the netting rule, stock is issued or provided to an employee of a covered corporation or a specified affiliate in connection with the performance of services only if the transfer is described in §83, including pursuant to a nonqualified stock option under Reg. §1.83-7 or a stock option described in §421.[796]

If a third party advances to a service provider an amount equal to the exercise price of a stock option or pays the exercise price on behalf of the service provider, any stock transferred by the covered corporation to the service provider, by a specified affiliate to the specified affiliate's employee, or by the covered corporation or specified affiliate to the third party upon exercise of the option is treated as stock issued or provided in connection with the performance of services. Similarly, if a third party advances an amount equal to the service provider's withholding obligation, stock transferred by the covered corporation to the service provider, by a specified affiliate to the apecified affiliate's employee, or by the covered corporation or specified affiliate to the third party is treated as issued or provided in connection with the performance of services.[797]

(3) Disregarded Issuances

Issuance of stock in the following circumstances, and only those circumstances, is disregarded for purposes of the netting rule:

- distribution of covered corporation stock by the covered corporation to its shareholders with respect to its stock;
- issuance of stock by a covered corporation to a specified affiliate, or stock issued by the covered corporation in connection with the performance of services by an employee or other service provider for a specified affiliate, with certain exceptions;
- issuance of stock as part of a transaction qualifying as a reorganization under §368(a) or a distribution under §355, if:
    - o the stock constitutes property permitted to be received under §354 or §355 without gain recognition;
    - o the stock is used by another covered corporation to repurchase its stock in the context of an acquisitive reorganization, an E reorganization, an F reorganization, or a split-off; and
    - o the repurchase by the other covered corporation is a qualifying property repurchase not included in that covered corporation's stock repurchase excise tax base;
- deemed issuance of stock by the acquiring corporation in a transaction to which §304(a)(1) applies;
- deemed issuance of a fractional share;
- issuance of stock by a covered corporation that is a dealer in securities to the extent the stock is issued, or otherwise used to satisfy obligations to customers arising, in the ordinary course of the dealer's business of dealing in securities;
- issuance by a target corporation of its stock to the merged corporation in a reverse triangular merger;
- issuance of stock by a covered corporation in exchange for stock of the covered corporation in a transaction that qualifies under §1036(a);
- issuance of stock by a controlled corporation in a distribution qualifying under §355 (or so much of §356 as relates to §355) that is not a split-off;
- any covered corporation stock contributed, or treated as contributed, to an employer-sponsored retirement plan, or sold to a leveraged or non-leveraged ESOP;
- covered corporation stock withheld by the covered corporation or specified affiliate to satisfy the exercise price of a stock option issued in connection with the performance of services, or to pay any withholding obligation;

[793] Prop. Reg. §58.4501-3(g)(4).

[794] Prop. Reg. §58.4501-3(g)(5).

[795] Prop. Reg. §58.4501-4(b)(1); Notice 2023-2, §3.08(1) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). *See also* Prop. Reg. §58.4501-4(d) (rules regarding the date of issuance), §58.4501-4(e) (rules regarding the FMV of issued or provided stock).

[796] Prop. Reg. §58.4501-4(c)(1); Notice 2023-2, §3.08(3)(a)(i) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). The timing of when stock is issued or provided to an employee in connection with the performance of services is determined by when the employee is treated as the beneficial owner of the stock for federal income tax purposes. *See* Prop. Reg. §58.4501-4(d)(2)(i); Notice 2023-2, §3.08(3)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[797] Prop. Reg. §58.4501-4(c)(2); Notice 2023-2, §3.08(3)(a)(iv) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

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• settlement of an option contract with respect to stock of a covered corporation using any consideration other than stock of the covered corporation (including cash); and

• issuance by a covered corporation or provision by a specified affiliate of an instrument that is not in the legal form of covered corporation stock, but is treated as stock for federal income tax purposes, with certain exceptions.[798]

e. Redemptions and Economically Similar Transactions

(1) Economically Similar Transactions

A stock repurchase subject to the excise tax is a redemption, as defined in §317(b), of the covered corporation's stock and any other transaction that Treasury determines is economically similar.[799]

The following is an exclusive list of transactions that are economically similar transactions and, thus, repurchases for purposes of §4501:

• the exchange by shareholders of a target corporation that is a covered corporation of their target corporation stock in an acquisitive reorganization is a repurchase by the target corporation;

• the exchange by the shareholders of a recapitalizing corporation that is a covered corporation of their stock as part of an E reorganization is a repurchase by the recapitalizing corporation;

• the exchange by the shareholders of a transferor corporation that is a covered corporation of their stock as part of an F reorganization is a repurchase by the transferor corporation;

• in the case of a split-off by a distributing corporation that is a covered corporation, the exchange by the distributing corporation shareholders of their stock is a repurchase by the distributing corporation; and

• in the case of a complete liquidation of a covered corporation to which §331 and §332(a) apply to component distributions, each distribution to which §331 applies is a repurchase by the covered corporation, but the distribution to which §332(a) applies is not a repurchase by the covered corporation.[800]

A forfeiture or clawback of stock of a covered corporation pursuant to a legal or contractual obligation is a repurchase by the covered corporation or acquisition by a specified affiliate on the date of forfeiture or clawback if the stock was treated as issued or provided for purposes of the netting rule and one of the following requirements is satisfied:

• the stock was issued pursuant to an acquisition of a target entity or its business, and the forfeiture was in accordance with the terms of the documents governing the transaction;

• the stock was subject to a substantial risk of forfeiture on the date the stock was issued or provided, the service provider made a valid §83(b) election with regard to the stock, and the forfeiture resulted from the service provider's failing to meet the vesting condition; or

• on the date the stock was issued or provided, the stock was subject to a clawback agreement, and a clawback of the stock resulted from the occurrence of an event specified in the clawback agreement.[801]

(2) Redemptions That Are Not Repurchases

The proposed regulations provide an exclusive list of transactions that are §317(b) redemptions but are not repurchases for purposes of §4501.

If §304(a)(1) applies to an acquisition of stock by an acquiring corporation (within the meaning of §304(a)(1), the acquiring corporation's deemed distribution in redemption of its stock (resulting from the application of §304(a)(1)) is not a repurchase for purposes of §4501, regardless of whether §302(a) or §302(d) applies to the acquiring corporation's deemed distribution in redemption of its stock.[802]

In addition, a payment by a covered corporation of cash in lieu of a fractional share is not a repurchase if:

• the payment is part of a transaction that qualifies as a reorganization under §368(a) or a distribution to which §355 applies, or pursuant to the settlement of an option or similar financial instrument (e.g., a convertible bond or convertible preferred share);

• the cash received by the shareholder entitled to the fractional share is not separately bargained-for consideration (i.e., the cash represents a mere rounding off of the shares issued in the exchange or settlement);

• the payment is carried out solely for administrative convenience (i.e., solely for nontax reasons); and

• the amount of cash paid to the shareholder does not exceed the FMV of one full share of the covered corporation's stock.[803]

(3) Transactions Not Economically Similar

Treasury and the IRS also provided a nonexclusive list of specific transactions that are not economically similar to a repurchase.[804]

Unless a distribution in complete liquidation is considered to be a transaction economically similar to a repurchase under Prop. Reg. §58.4501-2(e)(4)(v)(A) (described above), the following do not constitute a repurchase by a covered corporation:

[798] Prop. Reg. §58.4501-4(f); Notice 2023-2, §3.08(4) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). *See also* Prop. Reg. §58.4501-4(f)(2)(ii)–§58.4501-4(f)(2)(iv) (special rules for subsequent transfers by specified affiliates), §58.4501-4(f)(13)(ii) (special rules for certain non-stock instruments).

[799] §4501(c)(1); Prop. Reg. §58.4501-2(e)(2). A "redemption" occurs when a corporation acquires its stock from a shareholder in exchange for property, whether or not the acquired stock is cancelled, retired, or held as treasury stock. §317(b).

[800] Prop. Reg. §58.4501-2(e)(4); Notice 2023-2, §3.04(4)(a) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[801] Prop. Reg. 58.4501-2(e)(4)(vi).

[802] Prop. Reg. §58.4501-2(e)(3)(i); Notice 2023-2, §3.04(3)(a) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[803] Prop. Reg. §58.4501-2(e)(3)(ii); Notice 2023-2, §3.04(3)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[804] Prop. Reg. §58.4501-2(e)(5); Notice 2023-2, §3.04(4)(b) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

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- a distribution in complete liquidation of the covered corporation to which §331 or §332(a) applies;
- a distribution pursuant to the resolution or plan of dissolution of the covered corporation that is reported on the original (but not a supplemented or amended) Form 966, *Corporate Dissolution or Liquidation* (or any successor form); and
- a distribution pursuant to a deemed dissolution of the covered corporation (e.g., pursuant to a deemed liquidation under Reg. §301.7701-3).[805]

Unless a distribution in complete liquidation is considered to be a transaction economically similar to a repurchase under Prop. Reg. §58.4501-2(e)(4)(v), no distribution by a covered corporation during a taxable year is a repurchase if, during the taxable year, the covered corporation:

- completely liquidates under §331;
- dissolves pursuant to the resolution or plan of dissolution as reported on the original (but not a supplemented or amended) Form 966, *Corporate Dissolution or Liquidation* (or any successor form); or
- is deemed to dissolve (e.g., pursuant to a deemed liquidation under Reg. §301.7701-3).[806]

A distribution by a covered corporation of stock of a controlled corporation qualifying under §355 that is not a split-off is not a repurchase by the distributing corporation. However, a distribution by a covered corporation of other property or money in exchange for its own stock is a repurchase by the distributing corporation if it occurs as part of a transaction qualifying under §355 in which the distribution of controlled corporation stock is with respect to the distributing corporation's stock.[807]

A distribution to which §301 applies by a covered corporation is not a repurchase if:

- the distribution is subject to §301(c)(2) or §301(c)(3) (i.e., return of basis and amounts in excess of basis); and
- the distribution does not exchange stock of the covered corporation (and is not treated as exchanging such stock for federal income tax purposes).[808]

The net cash settlement of an option contract or other derivative financial instrument with respect to stock of a covered corporation is not a repurchase by the covered corporation. The net cash settlement of an instrument in the legal form of an option contract or other derivative financial instrument that is treated as stock for federal tax purposes at the time of issuance is treated as a repurchase of the instrument, and therefore, a repurchase by the covered corporation.[809]

f. Acquisition by a Specified Affiliate

A taxable repurchase also includes the acquisition of a covered corporation's stock by a "specified affiliate" from a person that is neither the covered corporation nor a specified affiliate.[810]

With respect to any corporation, a specified affiliate is:

- any corporation more than 50% of the stock of which is owned (by vote or value), directly or indirectly, by such corporation; and
- any partnership more than 50% of the capital or profits interests of which is held, directly or indirectly, by such corporation.[811]

A covered corporation must determine if another corporation or a partnership is a specified affiliate if the determination is relevant for purposes of computing the covered corporation's stock repurchase excise tax liability. The covered corporation is treated as indirectly owning stock or a capital or profits interest in a corporation or partnership, respectively, equal to the corporation's proportionate percentage of stock owned, or capital or profits interest held, through other entities.[812]

Except as discussed below, shares of stock of a covered corporation are treated as repurchased by the covered corporation if:

- a corporation or partnership becomes a specified affiliate of the covered corporation;
- at the time the corporation or partnership becomes a specified affiliate, the corporation or partnership owns those shares, and those shares represent more than one percent of the FMV of the assets of the corporation or partnership; and
- the corporation or partnership acquired the shares after December 31, 2022.[813]

Shares of a covered corporation's stock already held by the corporation or partnership at the time it becomes a specified affiliate are not treated as repurchased if the covered corporation identifies those shares as previously having been treated as repurchased. If the corporation or partnership is unable to specifically identify which shares of covered corporation stock the corporation or partnership is treated as holding at the time it becomes a specified affiliate, the covered corporation must treat the corporation or partnership as holding the most recently acquired shares.[814]

g. Acquisition of Stock of Foreign Corporations

Special rules apply to the acquisition of stock of certain foreign corporations, including applicable foreign corporations and covered surrogate foreign corporations, as described below. The stock repurchase excise tax is imposed on the acquisition of an applicable foreign corporation's stock by an applica-

[805] Prop. Reg. §58.4501-2(e)(5)(i); Notice 2023-2, §3.04(4)(b)(i) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[806] Prop. Reg. §58.4501-2(e)(5)(ii); Notice 2023-2, §3.04(4)(b)(i) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[807] Prop. Reg. §58.4501-2(e)(5)(iii); Notice 2023-2, §3.04(4)(b)(ii) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[808] Prop. Reg. §58.4501-2(e)(5)(iv).

[809] Prop. Reg. §58.4501-2(e)(5)(v).

[810] §4501(c)(2)(A); Prop. Reg. §58.4501-2(f)(1); Notice 2023-2, §3.05(1) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[811] §4501(c)(2)(B); Prop. Reg. §58.4501-1(b)(25).

[812] Prop. Reg. §58.4501-2(f)(2).

[813] Prop. Reg. §58.4501-2(f)(3)(i).

[814] Prop. Reg. §58.4501-2(f)(3)(ii)–§58.4501-2(f)(3)(iii).

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ble specified affiliate, on the repurchase of stock by a covered surrogate foreign corporation, and on the acquisition of a covered surrogate foreign corporation's stock by a specified affiliate.[815] The amount of the tax for a taxable year is equal to one percent of the §4501(d) covered corporation's "§4501(d) excise tax base."[816]

The §4501(d) excise tax base is equal to:

- the aggregate FMV of, as applicable, all §4501(d)(1) or §4501(d)(2) repurchases (discussed below) during the §4501(d) covered corporation's taxable year;
- reduced by the FMV of all stock repurchased or acquired during the taxable year to which a §4501(d) exception applies; and
- reduced by the aggregate FMV of stock to which the §4501(d) netting rule applies.[817]

However, a §4501(d) covered corporation is not subject to the §4501(d) excise tax for a taxable year if, during that taxable year, the aggregate FMV of all §4501(d)(1) repurchases or all §4501(d)(2) repurchases, as applicable, does not exceed $1 million. This determination is made before applying any §4501(d) statutory exceptions or the netting rule.[818]

Each §4501(d) covered corporation must separately determine the aggregate FMV of its stock repurchased or acquired during each taxable year. If the reductions for applicable statutory exceptions and the netting rule would exceed the aggregate FMV of stock repurchased or acquired, the excess amount is not carried forward or back to a succeeding or preceding taxable year of the §4501(d) covered corporation for purposes of determining the stock repurchase excise tax base in those preceding or subsequent years.[819]

The FMV of stock of an applicable foreign corporation or a covered surrogate foreign corporation, as applicable, that is subject to a §4501(d)(1) repurchase or §4501(d)(2) repurchase is the market price of the stock on the date of the repurchase (discussed in X.G.1.h., below).[820] The market price is determined in the same manner as in Prop. Reg. §58.4501-2(h) (discussed in X.G.1.c.(2), above), applicable to stock of a covered corporation traded on an established securities market, or under the principles of Reg. §1.409A-1(b)(5)(iv)(B)(*1*), for stock not so traded.[821] The market price of any stock of an applicable foreign corporation or covered surrogate foreign corporation that is denominated in a currency other than the U.S. dollar is converted into U.S. dollars at the spot rate on the date the stock is subject to a §4501(d)(1) repurchase or §4501(d)(2) repurchase.[822]

Section 4501(d)(1) and §4501(d)(2) repurchases occurring before January 1, 2023, are neither included in the §4501(d) excise tax base of a §4501(d) covered corporation nor taken into account in determining the applicability of the §4501(d) de minimis exception.[823]

(1) Applicable Foreign Corporations

(a) Section 4501(d)(1) Repurchase

An "applicable specified affiliate" (i.e., a specified affiliate of an applicable foreign corporation, other than a foreign corporation or foreign partnership (unless the partnership has a domestic entity as a direct or indirect partner)[824] that acquires stock of an applicable foreign corporation from a person that is not the applicable foreign corporation or another specified affiliate is treated as a §4501(d) covered corporation for the acquisition.[825] The acquisition, in turn, is treated as a repurchase of stock of a covered corporation by the covered corporation (a "§4501(d)(1) repurchase"),[826] and the §4501(d) netting rule adjustment is determined only with respect to stock issued or provided by the §4501(d) corporation to its own employees.[827]

(b) Funding Rule

An applicable specified affiliate is treated as acquiring the stock of an applicable foreign corporation if the following conditions are met:

- the affiliate funds (a covered funding), by any means (including through distributions, debt, or capital contributions), directly or indirectly, the acquisition or repurchase (a covered purchase) of the applicable foreign corporation's stock by the corporation itself or another specified affiliate, and
- the funding, which may occur before or after a covered purchase, is undertaken for a principal purpose of avoiding the stock repurchase excise tax.[828]

If a principal purpose of the covered funding is to fund a covered purchase, then there is a principal purpose of avoiding the excise tax. The principal purpose inquiry is based on all facts and circumstances.[829]

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[815] *See* §4501(d)(1)–§4501(d)(2); Prop. Reg. §58.4501-7(b)(2)(xxii)–§58.4501-7(b)(2)(xxiii).

[816] Prop. Reg. §58.4501-7(c)(1). As discussed below, a §4501(d) covered corporation includes (1) an applicable specified affiliate of an applicable foreign corporation that is treated as a covered corporation under §4501(d)(1)(A) because of a §4501(d)(1) repurchase, or (2) any expatriated entity with respect to a covered surrogate foreign corporation that is treated as a covered corporation under §4501(d)(2)(A) because of a §4501(d)(2) repurchase. Prop. Reg. §58.4501-7(b)(2)(xv).

[817] Prop. Reg. §58.4501-7(c)(3)(i). Examples illustrating the proposed rules under §4501(d)(1) and §4501(d)(2) are provided in Prop. Reg. §58.4501-7(p)–§58.4501-7(q).

[818] Prop. Reg. §58.4501-7(c)(2).

[819] Prop. Reg. §58.4501-7(c)(3)(ii).

[820] Prop. Reg. §58.4501-7(l)(1).

[821] Prop. Reg. §58.4501-7(l)(2)–§58.4501-7(l)(3). *See* Preamble to REG-115710-22, 89 Fed. Reg. 25,980, 26,021 (Apr. 12, 2024).

[822] Prop. Reg. §58.4501-7(l)(4). *See* Reg. §1.988-1(d)(1) for the definition of spot rate.

[823] Prop. Reg. §58.4501-7(c)(4).

[824] Prop. Reg. §58.4501-7(b)(2)(iv). "Specified affiliate" is defined in X.G.1.f., above.

[825] Prop. Reg. §58.4501-7(b)(2)(xv)(A), §58.4501-7(b)(2)(xxii)(A).

[826] Prop. Reg. §58.4501-7(b)(2)(xxii).

[827] §4501(d)(1)(A)–§4501(d)(1)(C); Prop. Reg. §58.4501-7(n)(1), Notice 2023-2, §3.04(2)(a)(i) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

[828] *See* Prop. Reg. §58.4501-7(e)(1), applicable to fundings that occur on or after December 27, 2022, in taxable years ending after that date; Notice 2023-2, §3.05(2)(a)(ii)(A) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). *See also* Prop. Reg. §58.4501-7(b)(2)(vii) (covered purchase).

[829] Prop. Reg. §58.4501-7(e)(1). The proposed funding rule would replace the "per se rule" of Notice 2023-2 that a funding by any means other than a distribution within two years of a purchase would be treated as funding that purchase. *See* Notice 2023-2, §3.05(2)(a)(ii)(B) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). *See also* Timothy Nichols,

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A principal purpose is presumed to exist if (1) the applicable specified affiliate funds a downstream relevant entity, and (2) the funding occurs within two years of a covered purchase by or on behalf of the downstream relevant entity. The presumption may be rebutted only if facts and circumstances clearly establish that there was not a principal purpose to avoid the excise tax.[830]

An applicable specified affiliate that takes the position the presumption is rebutted must, for the taxable year that includes the date on which the affiliate would be treated as acquiring the stock of an applicable foreign corporation, absent the rebuttal, attach a statement to its repurchase excise tax return disclosing the relevant fundings and covered purchases and the facts that rebut the presumption, along with any additional information the return instructions require.[831] The affiliate is treated as acquiring the stock of an applicable foreign corporation on the later of the date of the covered funding or the covered purchase.[832]

The amount of stock of an applicable foreign corporation treated as acquired in a covered purchase by an applicable specified affiliate is equal to the amount of the affiliate's covered fundings that are allocated to the covered purchase.[833] The allocable amount of the covered purchase is the aggregate FMV of shares repurchased or acquired in the covered purchase, reduced by the FMV of certain stock not included in the §4501(d) excise tax base,[834] and is treated as made first from covered fundings.[835]

A covered funding is allocated to multiple covered purchases in the order in which they occur. If multiple covered purchases occur simultaneously, a covered funding is allocated to the allocable amount of the covered purchases on a pro rata basis.[836] If there is a single covered funding, the covered funding is allocated to a covered purchase to the extent of the lesser of the amount of the covered funding or the allocable amount of the covered purchase.[837]

If there are multiple covered fundings and the aggregate amount of those fundings exceeds the allocable amount of the covered purchase, the covered fundings are allocated in the order in which the fundings occur. If multiple covered fundings occur simultaneously, they are allocated to the allocable amount of the covered purchase on a pro rata basis, based on the relative amounts of those covered fundings. Any amount of covered fundings in excess of the covered purchase is allocated to the allocable amount of other covered purchases.[838]

(c) Applicable Foreign Corporation Status

Similar to a "covered corporation," an "applicable foreign corporation" is defined as a foreign corporation trading stock on an established securities market (within the meaning of §7704(b)(1)).[839] A corporation becomes an applicable foreign corporation at the beginning of its initiation date,[840] and ceases to be an applicable foreign corporation at the end of its cessation date.[841] However, if a corporation ceases to be an applicable foreign corporation pursuant to a plan that includes a repurchase, and if the cessation date precedes the date on which any §4501(d)(1) repurchase undertaken pursuant to the plan occurs, the corporation continues to be an applicable foreign corporation with regard to each planned repurchase until the end of the date on which the last planned repurchase occurs.[842]

Clarifying rules are proposed for determining if a corporation is a foreign corporation in the context of inbound and outbound F reorganizations. If a foreign corporation transfers its assets (or is treated as transferring its assets) to a domestic corporation in an F reorganization, the corporation is not treated as a domestic corporation until the day after the reorganization. Similarly, if a domestic corporation transfers its assets (or is treated as transferring its assets) to a foreign corporation in an F reorganization, the corporation is not treated as a foreign corporation until the day after the reorganization.[843]

(d) Applicable Specified Affiliate Status

The determination of whether a corporation or partnership is an applicable specified affiliate of an applicable foreign corporation is made whenever the determination is relevant for purposes of the excise tax.[844] If a corporation or partnership becomes a specified affiliate of an applicable foreign corporation, and, at that time, the corporation or partnership owns stock of the applicable foreign corporation acquired after December 31, 2022, representing more than one percent of the FMV of the assets of the corporation or partnership, then the stock is treated as acquired immediately after the corporation or partnership becomes a specified affiliate.[845]

Shares of an applicable foreign corporation's stock already held by the corporation or partnership at the time it becomes a specified affiliate are not treated as repurchased if the §4501(d) covered corporation identifies those shares as previously having been treated as repurchased. If the §4501(d) covered corporation is unable to specifically identify which shares of applicable foreign corporation stock the corporation or partnership is treated as holding at the time it becomes a specified affiliate,

Treasury's Stock Buyback Rule Offers Corporations Little Clarity, DTR (Apr. 30, 2024), for commentary on the proposed funding rule.

[830] Prop. Reg. §58.4501-7(e)(2); Notice 2023-2, §3.05(a)(ii)(B) (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024). A "downstream relevant entity" is a specified affiliate of an applicable foreign corporation (but not an applicable specified affiliate) where at least 25% of its stock, or capital or profits interests, is owned by one or more applicable specified affiliates of an applicable foreign corporation. Ownership can be direct or indirect, by vote or value, and individually or in the aggregate. Prop. Reg. §58.4501-7(b)(2)(xi), §58.4501-7(b)(2)(xiv).

[831] Prop. Reg. §58.4501-7(e)(2).

[832] Prop. Reg. §58.4501-7(e)(3).

[833] Prop. Reg. §58.4501-7(e)(4) (reference to Prop. Reg. §58.4501-7(e)(7)).

[834] Prop. Reg. §58.4501-7(e)(5) (reference to §4501(d) statutory exceptions for reorganizations, dealers in securities, and dividend treatment under Prop. Reg. §58.4501-7(m)(2), §58.4501-7(m)(4), and §58.4501-7(m)(6).

[835] Prop. Reg. §58.4501-7(e)(6).

[836] Prop. Reg. §58.4501-7(e)(7)(ii).

[837] Prop. Reg. §58.4501-7(e)(7)(iii).

[838] Prop. Reg. §58.4501-7(e)(7)(iv).

[839] §4501(d)(3)(A); Prop. Reg. §58.4501-7(b)(2)(iii), §58.4501-1(b)(13).

[840] Prop. Reg. §58.4501-7(f)(1). The "initiation date" is defined in X.G.1.b., above.

[841] Prop. Reg. §58.4501-7(f)(2)(i). The "cessation date" is defined in X.G.1.b., above.

[842] Prop. Reg. §58.4501-7(f)(2)(ii).

[843] Prop. Reg. §58.4501-7(f)(3). *See* Reg. §1.367(b)-2(f) and Reg. §1.367(a)-1(e) regarding deemed asset transfers in the context of inbound and outbound F reorganizations, respectively.

[844] Prop. Reg. §58.4501-7(g)(1).

[845] Prop. Reg. §58.4501-7(g)(3)(i).

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the §4501(d) covered corporation must treat the corporation or partnership as holding the most recently acquired shares of the applicable foreign corporation stock.[846]

A foreign partnership is an applicable specified affiliate of an applicable foreign corporation if:

- more than 50% of the capital interests or profits interests of the foreign partnership are held, directly or indirectly, by the applicable foreign corporation; and
- at least one domestic entity is a direct or indirect partner with respect to the foreign partnership.[847]

A domestic entity is a direct partner with respect to a foreign partnership if it directly owns an interest in the foreign partnership. A domestic entity is an indirect partner with respect to a foreign partnership if the domestic entity owns an interest in the foreign partnership indirectly through:

- one or more other foreign partnerships;
- one or more foreign corporations controlled by one or more domestic entities; or
- an ownership chain with one or more entities described in the previous two bullets.[848]

(2) Covered Surrogate Foreign Corporations

When a "covered surrogate foreign corporation" repurchases its own stock or a specified affiliate acquires stock of a covered surrogate foreign corporation (a "§4501(d)(2) repurchase"):

- the expatriated entity with respect to the covered surrogate foreign corporation is treated as a §4501(d) covered corporation for the repurchase or acquisition;
- the repurchase or acquisition is treated as a repurchase of stock by such covered corporation; and
- the netting rule adjustment under §4501(c)(3) is determined only with respect to stock issued or provided by the expatriated entity to its employees.[849]

A covered surrogate foreign corporation means a surrogate foreign corporation determined under §7874(a)(2)(B) (applicable to corporate inversions occurring after September 20, 2021), the stock of which is publicly traded, but only with respect to taxable years that include a portion of the corporation's applicable period under §7874(d)(1).[850] An expatriated entity has the same meaning as under §7874(a)(2)(A).[851] For a discussion of the rules and definitions under §7874, see 6105 T.M., *Corporate Inversions* (Foreign Income Series).

To the extent any repurchase or acquisition of covered surrogate foreign corporation stock would be both a §4501(d)(1) repurchase and a §4501(d)(2) repurchase, the repurchase or acquisition will be only a §4501(d)(2) repurchase.[852]

Each §4501(d) covered corporation with respect to a covered surrogate foreign corporation is liable for any §4501(d) excise tax with respect to §4501(d)(2) repurchases that occur during a taxable year of the §4501(d) corporation. If there are multiple §4501(d) covered corporations with respect to a covered surrogate foreign corporation, then, if one of those §4501(d) covered corporations pays the amount of §4501(d) excise tax with respect to all §4501(d)(2) repurchases relating to the covered surrogate foreign corporation and its specified affiliates that occur during that §4501(d) covered corporation's taxable year and fulfills the filing obligations for the taxable year regarding those §4501(d)(2) repurchases, no other covered corporation is liable for the applicable excise tax.[853]

Rules regarding the status of a corporation as a covered surrogate foreign corporation are the same as those described in X.G.1.g.(1)(c), above, with respect to applicable foreign corporations.[854] Likewise, rules regarding the status of a specified affiliate of a covered surrogate foreign corporation are the same as those described in X.G.1.g.(1)(d), above, with respect to applicable specified affiliates of applicable foreign corporations.[855]

(3) Scope of AFC Repurchases and CSFC Repurchases

An AFC repurchase or CSFC repurchase means solely (1) a redemption, as defined in §317(b), of the stock of an applicable foreign corporation or a covered surrogate foreign corporation, or (2) any other transaction that is economically similar.[856] Prop. Reg. §58.4501-7(j) would provide rules for determining whether an acquisition by an applicable foreign corporation of its stock is an AFC repurchase and whether an acquisition by a covered surrogate foreign corporation of its stock is a CSFC repurchase.[857] The rules are relevant for determining whether there is a covered purchase that could be subject to the proposed funding rule and whether a covered surrogate foreign corporation's repurchase of its stock is subject to §4501(d)(2).[858] The rules are based on those provided in Prop. Reg. §58.4501-2(e), discussed at X.G.1.e., above, for determining whether a transaction is a repurchase for purposes of the excise tax.[859]

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[846] Prop. Reg. §58.4501-7(g)(3)(ii)–§58.4501-7(g)(3)(iii).

[847] Prop. Reg. §58.4501-7(h)(1). A foreign partnership that has one or more domestic entities as direct or indirect partners is not considered an applicable specified affiliate if the domestic entities hold, directly or indirectly, in aggregate, less than five percent of the capital interests and profits interests in the foreign partnership. Prop. Reg. §58.4501-7(h)(5).

[848] Prop. Reg. §58.4501-7(h)(2). A foreign corporation is controlled by one or more domestic entities if more than 50% of the total combined voting power of all classes of voting stock or the total value of the corporation's stock is owned, directly or indirectly, by one or more domestic entities. Prop. Reg. §58.4501-7(h)(3).

[849] §4501(d)(2); Prop. Reg. §58.4501-7(b)(2)(xxiii); *see also* Prop. Reg. §58.4501-7(b)(2)(xv)(B).

[850] §4501(d)(3)(B); Prop. Reg. §58.4501-7(b)(2)(viii).

[851] §4501(d)(3)(C); Prop. Reg. §58.4501-7(b)(2)(xii).

[852] Prop. Reg. §58.4501-7(d)(1).

[853] Prop. Reg. §58.4501-7(d)(2).

[854] *See* Prop. Reg. §58.4501-7(f).

[855] *See* Prop. Reg. §58.4501-7(g).

[856] Prop. Reg. §58.4501-7(j)(2).

[857] *See* Prop. Reg. §58.4501-7(j)(3) (providing an exclusive list of transactions that are §317(b) redemptions, but are not AFC repurchases or CSFC repurchases), Prop. Reg. §58.4501-7(j)(4) (providing an exclusive list of transactions that are §4501(d) economically similar transactions for purposes of the excise tax), Prop. Reg. §58.4501-7(j)(5) (providing a non-exclusive list of transactions that are not AFC repurchases or CSFC repurchases).

[858] *See* X.G.1.g.(1)(b), above, for discussion of the proposed funding rule.

[859] *See* Preamble to REG-115710-22, 89 Fed. Reg. 25,980, 26,028 (Apr. 12, 2024).

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(4) Section 4501(d) Statutory Exceptions

The §4501(d) statutory exceptions would be based on the rules in Prop. Reg. §58.4501-3, discussed in X.G.1.c.(3), above, with certain modifications described below.[860]

The §4501(d) reorganization exception applies only with respect to (1) stock of an applicable foreign corporation repurchased in an AFC repurchase that is a §4501(d)(1) repurchase, and (2) stock of a covered surrogate foreign corporation repurchased in a CSFC repurchase that is a §4501(d)(2) repurchase.[861]

The §4501(d) stock contribution exception applies only with respect to contributions of stock of an applicable foreign corporation or covered surrogate foreign corporation to an employer-sponsored retirement plan of the §4501(d) covered corporation.[862]

The §4501(d) dealer in securities exception applies to any repurchasing or acquiring entity that is a dealer in securities, including an applicable foreign corporation, covered surrogate foreign corporation, or a specified affiliate of either.[863]

The statutory exception for RICs and REITs does not apply for purposes of §4501(d) because neither an applicable foreign corporation nor a covered surrogate foreign corporation can qualify as a RIC or a REIT.[864]

The §4501(d) dividend equivalence exception would differ from the general rule with respect to rebutting the presumption of no dividend equivalence. To rebut the presumption with respect to a specific shareholder of an applicable foreign corporation or a covered surrogate foreign corporation, a §4501(d) covered corporation must show with sufficient evidence that the shareholder treats the AFC repurchase or CSFC repurchase as a dividend on its federal income tax return (or would treat it as such if the shareholder had a federal income tax filing obligation for the repurchase).[865]

(5) Section 4501(d) Netting Rule

As discussed in X.G.1.g., above, the §4501(d) excise tax base is reduced, under the §4501(d) netting rule, only by the FMV of stock of the applicable foreign corporation or covered surrogate foreign corporation, as applicable, issued or provided by the §4501(d) covered corporation to an employee in connection with the employee's performance of services as an employee of the §4501(d) covered corporation.[866] Any stock issued or provided prior to the initiation date or after the cessation date of the applicable foreign corporation or covered surrogate foreign corporation is not taken into account.[867] A §4501(d) covered corporation with a taxable year that begins before January 1, 2023, and ends after December 31, 2022, must include the FMV of issuances or provisions of stock that occur in that taxable year before January 1, 2023, in determining the netting reduction.[868]

For purposes of the §4501(d) netting rule, stock is transferred by the §4501(d) covered corporation in connection with the performance of services only if the transfer is described in §83, including pursuant to a nonqualified stock option described in Reg. §1.83-7 or a stock option described in §421.[869] If a third party pays the exercise price of a stock option on behalf of an employee or advances to the employee an amount equal to the exercise price, then any stock transferred by the §4501(d) covered corporation to the employee or third party in connection with exercising the option is treated as issued or provided in connection with the performance of services. Likewise, if a third party advances an amount equal to the employee's withholding obligation, then any stock transferred by the §4501(d) covered corporation to the employee or third party in connection with this arrangement is treated as issued or provided in connection with the performance of services.[870]

Stock of an applicable foreign corporation or a covered surrogate foreign corporation is issued or provided to an employee of a §4501(d) covered corporation as of the date the employee is treated as the beneficial owner for federal income tax purposes, i.e., when the stock is both transferred and substantially vested within the meaning of Reg. §1.83-3(b). In the case of stock options and stock appreciation rights, stock transferred by a §4501(d) covered corporation is issued or provided as of the date the option or stock appreciation right is exercised. Stock transferred by a §4501(d) covered corporation when it is not substantially vested, but as to which a valid §83(b) election is made, is treated as issued or provided as of the transfer date.[871]

The FMV of stock of an applicable foreign corporation or covered surrogate foreign corporation that is issued or provided is determined under §83 as of the date the stock is issued or provided to an employee by the §4501(d) corporation, regardless of whether an amount is includible in the employee's income. The market price of any stock that is denominated in a currency other than the U.S. dollar must be converted into U.S. dollars at the spot rate on the date the stock is issued or provided.[872]

Issuance of stock of an applicable foreign corporation or a covered surrogate foreign corporation in the following circumstances, and only those circumstances, is disregarded for purposes of the §4501(d) netting rule:

- any stock (1) contributed, or treated as contributed, to an employer-sponsored retirement plan, or (2) sold to a leveraged or non-leveraged ESOP;
- any stock withheld by a §4501(d) covered corporation to satisfy the exercise price of a stock option issued to an employee or to pay any withholding obligation;
- settlement of an option contract using any consideration (including cash) other than stock of the applicable foreign corporation or covered surrogate foreign corporation; and

[860] Preamble to REG-115710-22, 89 Fed. Reg. 25,980, 26,028 (Apr. 12, 2024).
[861] *See* Prop. Reg. §58.4501-7(m)(2).
[862] *See* Prop. Reg. §58.4501-7(m)(3).
[863] *See* Prop. Reg. §58.4501-7(m)(4).
[864] *See* Prop. Reg. §58.4501-7(m)(5).
[865] *See* Prop. Reg. §58.4501-7(m)(6).
[866] Prop. Reg. §58.4501-7(n)(1).
[867] Prop. Reg. §58.4501-7(n)(2).
[868] Prop. Reg. §58.4501-7(n)(3).
[869] Prop. Reg. §58.4501-7(n)(5)(i).
[870] Prop. Reg. §58.4501-7(n)(5)(ii).
[871] Prop. Reg. §58.4501-7(n)(6).
[872] Prop. Reg. §58.4501-7(n)(7). *See* Reg. §1.988-1(d)(1) for the definition of spot rate.

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• the issuance or provision, generally, of an instrument that is not in the legal form of stock but is treated as stock for federal income tax purposes.[873]

h. Date of Repurchase

In general, stock of a covered corporation is treated as repurchased by the covered corporation or acquired by a specified affiliate of the covered corporation on the date on which ownership transfers to the covered corporation or specified affiliate for federal income tax purposes.[874]

Stock of an applicable foreign corporation or a covered surrogate foreign corporation generally is treated as subject to a §4501(d)(1) repurchase or §4501(d)(2) repurchase, as applicable, on the date on which ownership of the stock transfers to the specified affiliate of the applicable foreign corporation, the applicable foreign corporation, the specified affiliate of the covered surrogate foreign corporation, or the covered surrogate foreign corporation, as applicable, for federal income tax purposes.[875]

The manner of determining the date of purchase may vary depending on the situation in which ownership of stock is transferred.

(1) Regular-way Sale

A regular-way sale of covered corporation stock is a transaction in which a trade order is placed on the trade date, and settlement of the transaction, including payment and delivery of the stock, occurs a standardized number of days after the trade date that is set by a regulator. In a regular-way sale, a repurchase by the covered corporation or an acquisition by a specified affiliate is treated as occurring on the trade date.[876] Similarly, a regular-way sale of stock of an applicable foreign corporation or a covered surrogate foreign corporation is treated as subject to a §4501(d)(1) repurchase or §4501(d)(2) repurchase on the trade date.[877]

(2) Repurchase Pursuant to Certain Economically Similar Transactions

Stock of a covered corporation repurchased in an economically similar transaction is treated as repurchased on the date the covered corporation shareholders exchange their stock in the covered corporation.[878]

Stock of an applicable foreign corporation or a covered surrogate foreign corporation repurchased in an AFC repurchase or a CSFC repurchase that is a §4501(d) economically similar transaction is treated as repurchased on the date the shareholders of the applicable foreign corporation or covered surrogate foreign corporation exchange their stock in such corporation.[879]

(3) Constructive Specified Affiliate Acquisition

Covered corporation stock that is treated as repurchased by the covered corporation under Prop. Reg. §58.4501-2(f)(3)(i) is treated as acquired by a specified affiliate on the date on which the other corporation or partnership becomes a specified affiliate.[880]

(4) Section 4501(d)(1) Repurchase Pursuant to a Covered Funding

To the extent an applicable specified affiliate of an applicable foreign corporation is treated as acquiring stock of the applicable foreign corporation that is repurchased or acquired in a covered purchase, the stock is treated as acquired by the applicable specified affiliate on the date of the covered purchase. However, if the date of the covered funding occurs after the date of the covered purchase, then the stock is treated as acquired by the applicable specified affiliate on the date of the covered funding.[881]

i. Reporting and Payment of Stock Repurchase Excise Tax

The proposed regulations would require any covered corporation, or any person treated as a covered corporation, that makes, or is treated as making, a repurchase of stock of the covered corporation after December 31, 2022, to file a stock repurchase excise tax return once per taxable year on Form 720, *Quarterly Federal Excise Tax Return*, with an attached Form 7208, *Excise Tax on Repurchase of Corporate Stock*.[882] The stock repurchase excise tax return must be filed by the due date of the Form 720 for the first full calendar quarter after the close of the taxable year of the covered corporation, or person treated as a covered corporation, but no earlier than the due date of the Form 720 for the first full calendar quarter after the date final regulations are published in the Federal Register.[883] In addition, the proposed regulations provide that the deadline for payment of the tax is the same as the filing deadline, and no extensions for reporting or paying the tax are permitted.[884]

Because the proposed regulations do not require reporting of any excise tax liability on any Form 720 that might be due before the date of publication of final regulations, no addition

[873] Prop. Reg. §58.4501-7(n)(8).
[874] Prop. Reg. §58.4501-2(g)(1).
[875] Prop. Reg. §58.4501-7(k)(1).
[876] Prop. Reg. §58.4501-2(g)(2).
[877] Prop. Reg. §58.4501-7(k)(2).
[878] Prop. Reg. §58.4501-2(g)(3).
[879] Prop. Reg. §58.4501-7(k)(3).

[880] Prop. Reg. §58.4501-2(g)(4). *See also* X.G.1.f., above.

[881] Prop. Reg. §58.4501-7(k)(4). For discussion of the proposed funding rule, see X.G.1.g.(1)(b), above.

[882] Prop. Reg. §58.6011-1(a)–§58.6011-1(b), REG-118499-23, 89 Fed. Reg. 25,829 (Apr. 12, 2024). Prop. Reg. §58.6011-1 would apply to stock repurchase excise tax returns required to be filed after the date final regulations are published in the Federal Register, during taxable years ending after that date. Prop. Reg. §58.6011-1(d).

[883] Prop. Reg. §58.6071-1(a), §58.6071-1(c). If a covered corporation, or person treated as a covered corporation, has more than one taxable year ending after December 31, 2022, and on or before the publication date of final regulations, only one Form 720 should be filed, with a separate Form 7208 for each taxable year attached. Prop. Reg. §58.6071-1(c). Prop. Reg. §58.6071-1 would apply to stock repurchase excise tax returns required to be filed after the date final regulations are published in the Federal Register, during taxable years ending after that date. Prop. Reg. §58.6071-1(e).

[884] Prop. Reg. §58.6151-1(a), proposed to apply to stock repurchase excise tax required to be paid after the date final regulations are published in the Federal Register, and during taxable years ending after that date. Prop. Reg. §58.6151-1(b). *See also* Notice 2023-2, §4 (obsoleted for stock repurchases, issuances, and provisions after April 12, 2024).

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to tax under §6651(a) (or any other Code section) will be imposed for failure to file a return reporting stock repurchase excise tax, or for failure to pay the excise tax, before the time final regulations are adopted.[885]

2. *Excise Tax on Greenmail Payments*

Under §5881, a nondeductible 50% excise tax on gain or other income is imposed on gain or other income realized by any person who receives "greenmail" payments,[886] whether or not the gain or other income is realized.[887] "Greenmail" generally is defined as payments made to redeem the stock of particular shareholders on terms not offered to other shareholders.[888]

The term "greenmail" is any consideration paid by a corporation (or any person acting in concert with the corporation) to directly or indirectly acquire its stock from any shareholder if all of the following are true: (1) the shareholder held the stock for less than two years before entering into the agreement to transfer the stock; (2) the shareholder (or any person acting in concert with the shareholder, or any person related to either the shareholder[889] or to the person acting in concert with the shareholder) made or threatened to make a public tender offer for the stock of the corporation within the two-year period ending on the date of acquisition; and (3) the corporation acquired the stock pursuant to an offer that was not made on the same terms to all shareholders.[890] The tax is also imposed if a shareholder sells the stock to an entity related to the issuing corporation (e.g., a controlled subsidiary) rather than the issuing corporation, if the other requirements for the imposition of the tax are met.[891]

This provision was enacted in 1987 to penalize a practice commonly associated with hostile takeovers.[892] The provision discourages raiders from buying up shares of a target corporation and threatening a hostile takeover with the hope that their shares will be redeemed for a substantial premium. See 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects*, at XIII.C., for an analysis of the provisions in §5881. See also 507 T.M., *Income Tax Liability: Concepts and Calculation*, at VII.J.

H. Reporting Requirements

1. *Reporting Requirements Under §6043(a)*

Information reporting is required under §6043(a), for the liquidation of "the whole or any part of" a corporation's capital stock. If a corporation distributes $600 or more in a calendar year to any shareholder in liquidation of all or any part of its stock, the corporation must file Form 1099-DIV, *Dividends and Distributions*, with respect to the shareholder.[893] The corporation must send Form 1099-DIV to the shareholder on or before January 31 of the year following the calendar year in which the distribution occurs, and must file the form with the IRS, accompanied by transmittal Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, on or before February 28 (March 31 if filed electronically) of the year following the calendar year of the distribution.[894] For further discussion of the reporting requirements for a corporation that makes a distribution to its shareholders in complete or partial liquidation of its stock, see 784 T.M., *Corporate Liquidations*, at VIII.A.1.b., and XV.B.

2. *Reporting Requirements Under §6043(c)*

Information reporting under §6043(c) is also required if there is an acquisition of control or a substantial change in the capital structure of a U.S. corporation and the corporation or any shareholder is required to recognize gain under §367(a). A corporation's redemption (or deemed redemption) of its stock is not considered a change in its capital structure.[895] Information reporting is not required under §6043(c) if reporting is otherwise required and properly undertaken under §6043(a).[896]

3. *Reporting Requirements Under §302*

a. *Reporting Requirements of the Shareholder Whose Stock Is Redeemed*

Every "significant holder" that transfers stock to the issuing corporation in exchange for property from such corporation must include on or with such holder's return for the taxable year of such exchange a statement titled, "STATEMENT PURSUANT TO §1.302-2(b)(2) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER OF THE STOCK OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF ISSUING CORPORATION]."[897] A "significant holder" is defined as any person that, immediately before the exchange: (1) owned at least 5% (by vote or value) of the total outstanding stock of the issuing corporation if the stock owned by such person is publicly traded; or (2) owned at least 1% (by vote or value) of the total outstanding stock of the issuing corporation if the stock owned by such person is not publicly traded.[898] Each significant holder's statement must include (1) the fair market value and basis of the stock transferred by the significant holder to the issuing corporation; and (2) a

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[885] Announcement 2023-18. *See* Instructions for Form 720. Form 1065, Schedule B, includes a question on the excise tax filing requirement for a partnership that is a specified affiliate of an applicable foreign corporation or an expatriated entity with respect to a covered surrogate foreign corporation. A partnership is not required to respond to the question before final regulations are published in the Federal Register. *See* Prop. Reg. §58.6071-1(c), REG-118499-23, 89 Fed. Reg. 25,829 (Apr. 12, 2024).

[886] §5881(a).

[887] §5881(d). Reg. §156.5881-1(a).

[888] §5881(b). Reg. §156.5881-1(b)(3).

[889] For this purpose, a person is related to another person if the relationship between such persons would result in the disallowance of losses under §267 or §707(b). §5881(c)(2).

[890] §5881(b). Reg. §156.5881-1(b).

[891] H.R. Rep. No. 100-495, at 971 (1987) (Conf. Rep.).

[892] Revenue Act of 1987, Pub. L. No. 100-203, §10228(a).

[893] Reg. §1.6043-2(a). If reporting is required under Reg. §1.332-6(b), Reg. §1.368-3(a), or Reg. §1.1081-11, this requirement does not apply. *See* Reg. §1.6043-2(a).

[894] Reg. §1.6043-2(a).

[895] *See* Reg. §1.6043-4(d)(2).

[896] Reg. §1.6043-4(a)(4).

[897] Reg. §1.302-2(b)(2).

[898] Reg. §1.302-2(b)(3)(i). "Publicly traded stock" means stock that is listed on: (1) a national securities exchange registered under §6 of the Securities Exchange Act of 1934 (15 USC §78f); or (2) an interdealer quotation system sponsored by a national securities association registered under §15A of the Securities Exchange Act of 1934 (15 USC §78o-3). Reg. §1.302-2(b)(3)(ii). "Issuing corporation" means the corporation that issued the shares of stock, some or all of which were transferred by a significant holder to such corporation in the exchange described in Reg. §1.302-2(b)(2).

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description of the property received by the significant holder from the issuing corporation.[899]

b. Reporting Requirements in Redemptions that Terminate a Shareholder's Interest; Waiver of Family Attribution Rules by Individuals

Except as otherwise provided, a shareholder may waive the family attribution rules (discussed at IV.C., above) for purposes of determining whether a redemption qualifies as a redemption in complete termination of a shareholder's interest if the following requirements are met:

- immediately after the redemption, the shareholder has no interest in the corporation (including an interest as officer, director or employee) other than an interest as a creditor;
- the shareholder does not acquire such an interest within 10 years from the date of the redemption other than stock acquired by bequest or inheritance; and
- the shareholder agrees to notify the IRS if the shareholder does acquire such an interest within the 10-year period and to retain certain records.[900]

In order to waive the family attribution rules, a shareholder must file an agreement with the IRS in the form of a statement titled, "STATEMENT PURSUANT TO SECTION 302(c)(2)(A)(iii) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER OR RELATED PERSON, AS THE CASE MAY BE], A DISTRIBUTEE (OR RELATED PERSON) OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF DISTRIBUTING CORPORATION]."[901] The shareholder must include the statement with its first return for the taxable year in which the distribution occurs. The statement must represent that: (1) the distributee (or related person) has not acquired, other than by bequest or inheritance, any interest in the corporation since the distribution; and (2) the distributee (or related person) will notify the IRS of any acquisition, other than by bequest or inheritance, of such an interest in the corporation within 30 days after the acquisition, if the acquisition occurs within 10 years from the date of the distribution.[902]

The shareholder must retain records, including copies of income tax returns and any other records indicating the amount of tax that would have been payable if the redemption had been treated as a corporate distribution.[903]

4. Reporting Requirements Under §6045B

The issuer of a "specified security" (as defined in §6045(g)(3)(B)) must file an information return describing any organizational action affecting the basis of the security, the quantitative effect thereof on the basis, and any other information required by the Treasury.[904]

"Specified securities" generally include:

- shares of corporate stock;
- notes, bonds, debentures and other evidence of indebtedness;
- commodities, contracts or derivatives with respect to commodities, if the Secretary determines that adjusted basis reporting is appropriate; and
- any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate.

Note: The Infrastructure Investment and Jobs Act added digital assets to the definition of "specified security" in §6045(g)(3)(B).[905] Section 6045B reporting requirements still apply to issuers of specified securities notwithstanding that such securities are also digital assets. Conversely, issuers of digital assets which are not also legacy specified securities may, but are not required to, file and furnish §6045B statements. Issuers that choose to do so are exempt from penalties under §6721 and §6722.[906] For a detailed discussion on the taxation of digital assets, including reporting requirements and basis determinations, see 190 T.M., *Taxation of Cryptocurrencies and Other Digital Assets.*

The issuer return must be filed with the IRS on or before the 45th day after the organizational action, or, if earlier, January 15 of the year following the calendar year during which the action occurred. The return may be filed before the date of the organizational action if the quantitative effect on basis is determinable beforehand.[907]

To this end, the regulations require the issuer return to include the following information: (1) the issuer's name and taxpayer identification number; (2) various identifiers of the security; (3) the contact information of someone at the issuer; (4) the type or nature of the organizational action; (5) a description of the effect of the action; and (6) the date of the action or the date against which shareholders' ownership is measured for the action.[908]

In addition, the issuer must furnish a written statement with the requisite information to security holders or their nominees.[909] However, waiver of both the issuer return and information statement is available if the information contained therein is made publicly available on the issuer's primary website.[910]

For further discussion of the issuer reporting requirements under §6045B, or reporting requirements under §6045, §6045A, and §6050W, see 560 T.M., *Income Tax Basis:*

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[899] Reg. §1.302-2(b)(2).

[900] §302(c)(2)(A).

[901] Reg. §1.302-4(a).

[902] Reg. §1.302-4(a).

[903] Reg. §1.302-4(b).

[904] §6045B(a); Reg. §1.6045B-1(a)(1). Regulated investment companies described in Reg. §1.6045-1(c)(3)(vi) are exempt from reporting requirements under §6045B. *See* Reg. §1.6045B-1(a), T.D. 10000, 88 Fed. Reg. 56,480 (July 9, 2024) (partially exempting from §6045B reporting requirements any issuer of a specified security which is also a digital asset).

[905] Pub. L. No. 117-58, §80603(b)(1) (Nov. 15, 2021). *See* Reg. §1.6045-1(a)(14), *modified by* T.D. 10000, 89 Fed. Reg. 56,480 (July 9, 2024) (including digital assets and forward contracts for digital assets into the definition of specified securities).

[906] Reg. §1.6045B-1(a)(6); *see also* Preamble to T.D. 10000, 89 Fed. Reg. 56,480 at 56,532 (July 9, 2024). Legacy specified securities are those described in Reg. §1.6045-1(a)(14)(i) to §1.6045-1(a)(14)(iv).

[907] §6045B(b); Reg. §1.6045B-1(a)(2)(i).

[908] Reg. §1.6045B-1(a)(1)(i)–(v).

[909] §6045B(c); Reg. §1.6045B-1(b)(1).

[910] §6045B(e); Reg. §1.6045B-1(a)(3), (b)(4). An issuer may electronically sign a return that is publicly reported if the electronic signature identifies the individual who attests to the declaration in the jurat. *See* Reg. §1.6045B-1(a)(3).

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Overview and Conceptual Aspects, and 643 T.M., *Information Reporting to U.S. Persons —Payments Subject to Back-up Withholding.*

I. Disclosure Requirements: Listed Transactions — Basis Shifting Shelters

1. Notice 2001-45

Current regulations continue to accommodate basis migration between related taxpayers.[911] Where basis migration occurs as a result of a tax indifferent party recognizing income as part of a redemption, then certain disclosure requirements exist.[912]

In Notice 2001-45, the IRS identified certain basis shifting transactions as tax shelter transactions and as listed transactions under former Reg. §1.6011-4T(b)(2).[913] Such transactions typically involved redemptions of stock of a shareholder (other than the taxpayer) that is not subject to U.S. income tax or was otherwise indifferent to the federal income tax impact of the redemption (e.g., a tax-exempt entity). Through the use of the attribution rules under §318, such redemptions were treated as dividends under §301 rather than payments in exchange for stock under §302. The taxpayer would typically then apply Reg. §1.302-2(c) to shift the basis in the redeemed shares to the shares owned by the taxpayer thereby increasing the taxpayer's basis. Subsequently, the taxpayer would then dispose of the stock and claim a tax loss on the high basis stock.[914] Variations identified by the IRS include transactions that reduced income or gain (as opposed to generating a loss) and the transfer of stock with an increased basis as a result of the redemption in a carryover basis exchange followed by a disposition of the shares.[915] Congress has since codified the economic substance doctrine, which limits taxpayers' ability to shift basis utilizing the transactions described above.[916]

2. Listed Transaction Disclosures

As a result of the characterization of these transactions as listed transactions, taxpayers may need to disclose their participation in these transactions as required under Reg. §1.6011-4, and material advisors may need to disclose these transactions under Reg. §301.6111-3.[917] Failure to disclose such transactions will subject taxpayers and material advisors to penalties. The transactions should be disclosed on Form 8886, *Reportable Transaction Disclosure Statement.*[918]

[911] Reg. §1.302-2(c). The 2009 proposed regulations would have effectively eliminated basis migration in the context of a redemption transaction, however those proposed regulations were withdrawn in 2019. *See* former Prop. Reg. §1.302-5, REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009), *withdrawn by* 84 Fed. Reg. 11,686 (Mar. 28, 2019). For a discussion of the former proposed regulations, see NYSBA *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities*, reprinted in 26 Daily Tax Rep. G-5 (Feb. 9, 2015).

[912] For further discussion of basis shifting, see III.B.1.d.(2), above.

[913] Former Reg. §1.6011-4T(b)(2) was removed and replaced with Reg. §1.6011-4(b)(2) without substantive changes.

[914] Notice 2001-45.

[915] Notice 2001-45.

[916] §7701(o).

[917] Notice 2009-59.

[918] Reg. §1.6011-4(d).

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