Redemptions and Partial Liquidations

The sale of corporate stock ordinarily produces a capital gains/loss event.

What tax impact arises when a “redemption” transaction occurs (i.e., a stock sale to the issuing corporation of its stock)?

If a stock redemption occurs is this:
1) a property sale (§1001), or
2) dividend distribution (i.e., E&P sourced)?
Income Tax Treatment of a Redemption to Shareholder

Options for federal income tax classification of the stock redemption transaction:

1) Stock sale (with tax basis recovery); consider the time value of tax funds.
2) Dividend equivalency (& no basis offset).

What is the relevance of the 2003 tax legislation (15% capital gains and 15% dividend tax rate)?

Code §302(a) - Exchange Treatment for Shareholders

1) §302(b)(1) - the distribution is not “essentially equivalent to a dividend”.
2) §302(b)(2) - the “substantially disproportionate” redemption exception.
3) §302(b)(3) - complete termination of the shareholder’s interest in the corporation.
4) §302(b)(4) – stock redemption occurs after a partial liquidation (measured by reference to events at the corporate level).
**Stock Redemptions & Corporate Level Treatment**

1) §311 gain recognition occurs upon a corporate distribution of appreciated property in a redemption transaction, but no loss recognition.

2) What effect on the E&P account when appreciated or depreciated property is distributed in a redemption transaction?

**Constructive Ownership of Stock - Code §318 Rules**

What is the function of the “constructive ownership” or “attribution of ownership” rules? Based on an assumption that commonality of ownership will cause parties to coordinate their tax planning concerning their joint investment interests.

Example: Father owns 50% of shares and Daughter owns 50% of shares and Father redeems all his shares - what economic treatment of the Father as a continuing stock owner?
Constructive Ownership of Stock - Code §318 Rules

1) §318(a)(1). Family attribution - spouse, children, grandchildren and parents. Not to siblings or to grandchild from grandparent.

2) §318(a)(2). From an entity to an individual owner/beneficiary -
   a) Partnership or estate to the partner or the beneficiary on a proportionate basis.
   b) Trust to beneficiaries.
   c) Corporation to some shareholders.

Constructive Ownership of Stock - Code §318, cont.

3) §318(a)(3). From beneficiary to the entity:
   a) Stock owned by partners or beneficiaries of an estate or trust is considered as owned by the partnership or the estate.
   b) Stock owned by a 50 percent or more shareholder of a corporation is attributed to the redeeming corporation.

4) §318(a)(4). An option to acquire stock is equivalent to the ownership of that stock.
Example 1

W Corp has 100 common shares outstanding.

<table>
<thead>
<tr>
<th>GF</th>
<th>Mother</th>
<th>Daughter</th>
<th>Son</th>
<th>GM Estate</th>
</tr>
</thead>
<tbody>
<tr>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
<td>30</td>
</tr>
</tbody>
</table>

Mother as (i) a 50% GM estate beneficiary, and (ii) holding an option for 5 of son's 10 shares.

Example 1, cont.

Grandfather’s stock

Grandfather - total share interest is 85.

a) 25 directly.

b) 20 from mother to GF - §318(a)(1)(A)(ii).

c) 15 from daughter (granddaughter), and 10 from son (grandson). §318(a)(1)(A)(ii).

d) 15 from GM's estate. §318(a)(2)(A) - from GM’s estate to mother; §318(a)(1)(A)(ii) & onward from mother to GF.
Problem 1, cont.
Daughter's stock

Mother's daughter’s shares - total is 55.

a) 15 directly.

b) 0 shares from son - no sibling attribution.

c) 25 shares from mother - i) 20 shares directly; & ii) 5 shares owned through mother's option. §§318(a)(4) & 318(a)(5)(D).

d) 15 sh. (thru Mom) from GM's estate.

e) GF to (grand) daughter - no.

Problem 1, cont.
GM’s Estate’s stock owned

Grandmother's estate - 100 shares owned.

a) 30 shares owned directly.

b) 20 shares owned by mother - since a beneficiary. §318(a)(3)(A).

c) 50 shares owned through Mother by GF, daughter & son. §318(a)(1)(A) & §318(a)(3)(A).
Example 2

M – (W's mother) owns (unrelated) equal partners Partnership

100 shares owns 100
being shares being
100% of 100% of
Y Corp X Corp

Example 2, cont.

Number of X shares owned by:
1) A - 25 shares are owned by attribution from the partnership. §318(a)(2)(A).
3) M - W's mother - does not own any shares in X. Shares attributed to W from A are not reattributed under the family attribution rules. §318(a)(5)(B).
Example 2, continued

Shares of X owned by Y:
1) Premise: stock owned by a 50 percent or greater shareholder of a corporation is attributed to the corporation - §318(a)(3)(C).
2) Y owns constructively 25 shares owned by W - (a) Partnership to A; (b) A to W; (c) W to Y - since W owns 50 percent or more of Y.

Example 2, cont.

Shares of Y owned by Partnership, B, C, D & X:
1) Partnership - constructively owns the 100 shares in Y; W's 100 shares attributed to A & A's 100 shares reattributed to ptnsh. 2) B, C, & D do not own any Y shares. No sidewise reattribution to another partner.
3) X owns the 100 shares constructively owned by the Partnership.
Substantially Disproportionate Redemp.

§302(b)(2). Requirements to qualify:
1) Own less than 50% of the total combined voting power of voting stock. §302(b)(2)(B).
2) Percentage of voting stock owned after the redemption is less than 80% of the total % owned before the redemption. §302(b)(2)(C).
3) Percentage of ownership of all common stock is less than 80 percent of the prior % total owned. §302(b)(2)(C).

§302(b)(2) Issues

1) How are “voting rights” defined for this purpose? Must be current availability of voting rights, i.e., not rights available only (e.g.) on a dividends payment default.
2) How can nonvoting stock be redeemed under §302(b)(2)? Only by “piggybacking” on a qualifying redemption of voting stock (per Reg. §1.302-3(a)).
Rev. Rul. 85-14

B indicated to A, the majority shareholder, an intention to terminate as shareholder.
A then redeemed and temporarily owned less than 50 percent of the total corp. shares.
B then redeemed one week later & A went back above the 50 percent ownership level.
Issue: Should these two transactions be integrated concerning the tax treatment to A?
Answer - yes. See §302(b)(2)(D).

Example 1

<table>
<thead>
<tr>
<th></th>
<th>Alice</th>
<th>Cathy</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>80 common</td>
<td>20 common</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>100 nonvoting</td>
<td>100 nonvoting</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>preferred</td>
<td>preferred</td>
<td></td>
</tr>
</tbody>
</table>

a) Redeem Alice’s 75 preferred shares.
b) Also redeem 60 of Alice’s common shares.
c) Also redeem 70 of Alice’s common shares.
d) Also redeem 10 of Cathy’s common later.
**Example 2**

<table>
<thead>
<tr>
<th></th>
<th>D</th>
<th>J</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voting</td>
<td>60 voting</td>
<td>40 voting</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>common</td>
<td>common</td>
<td></td>
</tr>
<tr>
<td>Nonvoting</td>
<td>100 nonvoting</td>
<td>100 nonvoting</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>common</td>
<td>common</td>
<td>300</td>
</tr>
</tbody>
</table>

Z redeems only 30 of D’s voting common.
Question: §302(b)(2) qualification?

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**Complete Termination — Code §302(b)(3)**

§302(b)(3)
The redemption will qualify as an exchange transaction if the redemption is “in complete redemption of all of the stock of the corporation owned by the shareholder.”

This is obviously more than a “significant reduction”.

How measure “complete redemption” status?
Is Waiver of Family Attribution Available?

§302(c)(1) & (2).
Attribution of ownership rules can preclude a complete termination, unless the ownership attribution rules are made inapplicable. §302(c)(2) permits waiver of the family attribution rules, but no waiver of the entity or option ownership attribution rules.

Code §302(c) Limitations on Waiving Attribution Rule

1) No continuing interest as an officer, director, or employee; concern about an independent contractor.
2) Ten year look forward rule. §302(c)(2)(A).
3) Ten year look back rule. §302(c)(2)(B).
No acquisition of stock by a relative or from a relative within prior ten years - unless income tax avoidance not one of the principal purposes for that acquisition.
Lynch case

Facts: Total redemption of the father's stock after the sale of some shares to the son.

Consulting agreement for the father - as an “independent contractor” (not as employee).

Tax Court held the post-redemption arrangement was not a prohibited interest.

9th Circuit: Consulting arrangement is a prohibited interest, even when independent contractor status for the seller.

Rev. Rul. 59-119

Facts: Stock sale on an installment basis and shares were retained by an escrow agent. Redeeming shareholder retained the right to designate his lawyer (nominee) to be on the corporation’s board - to protect the former shareholder's creditor interest.

Held: Having one’s lawyer (an agent) on the Board violates the requirement in §302(c)(2)(A)(i). Observer status is OK.
Rev Rul. 77-293

Facts: Father transfers stock to son by gift and, thereafter, corporation redeems all the father's remaining shares. Son then actively manages the business.

Issue: Was pre-redemption disposition for a principal income tax avoidance purpose? No

Concept: Must be an objective to withdraw at capital gains rates when coupled with continued control or an economic interest.

Limitations on the Retained Interest

1) Cannot be a custodian under TUTMA or be a voting trustee.
2) Reacquisition of stock (or only vote as an executor) as a result of an inheritance or bequest is permitted.
3) Deferred payment redemptions are permitted, subject to certain limitations.
4) Leasing property to a corporation on an arm's length basis is acceptable.
Waiver of Attribution of Ownership by Entities

§302(c)(2)(A) & (B) only permit the waiver of family attribution rules.

What if the redeemed shareholder is a trust or estate that completely terminates its actual interest in the corporation (but is attributed ownership from another, e.g., a beneficiary)?

§302(c)(2)(C) permits the waiver by the trust and its beneficiaries (if both are redeeming).

Example 1

J (parent) A (daughter) C (grandson)
100 shares 50 shares 25 shares
R Corp
Example 2

B&B Corporation.

Betty & Billy, husband & wife, own 150 shares common stock of corporation.

Billy & Betty lease the plant to corporation.

Transfer of corp. control to Junior to occur.

(1) Gift of shares - §302(c)(2)(B)(ii) transfer to Junior within ten year period. For an income tax avoidance (principal) purpose?

Example 2, continued

(2) Credit redemption of remaining shares. 20 year term not satisfying IRS ruling standards because of the length of the term.

Securitization of the creditor position by the corporate assets is permitted.

Escrow arrangements are acceptable if not actually reacquiring the shares upon a payment default.
Example 2, continued

3(a) Continued leasing of the plant:
   Can lease if on an arm's length basis.
   FMV purchase option - also acceptable.
3(b) Consulting arrangement - a noncreditor interest which constitutes a prohibited interest under §302(c)(2)(A)(i)?
   Cannot have "financial stake" in enterprise.
   What result here? Lynch vs. the Tax Court.

Example 4

<table>
<thead>
<tr>
<th>John</th>
<th>Mary (sister)</th>
<th>Estate of Sam (father)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>B (mother) as</td>
</tr>
<tr>
<td></td>
<td></td>
<td>estate beneficiary</td>
</tr>
<tr>
<td>50</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>shares</td>
<td>shares</td>
<td>shares</td>
</tr>
</tbody>
</table>

Redemption of the Estate’s 20 shares -
Is a §302(c)(2) waiver of constructive ownership rules available?
Example 4, cont.

John       Mary (sister)       Estate of Sam (father)

B (mother) as resid. bene. of the estate

50  30  20 shares       shares       shares

Estate of Sam:
(i) John & Mary are specific legatees; &
(ii) B is the residuary beneficiary.

Example 4, cont.

John       Mary (sister)       Estate of Sam (father)

50  30  20 shares       shares       shares

John & Mary are residuary beneficiaries of the estate. Any possible cutoff of the attribution of ownership rules? John & Mary cannot terminate their estate beneficiary status here.
Example 4, cont.

John Mary (sister) Estate of Sam (father)
50 30 20 shares
shares shares Trust for B and
shares Nancy (sister)

(d) Shares of the trust redeemed. Is a waiver acceptable to eliminate attribution?
(e) Nancy subsequently acquires shares. Impact of the ten year “look forward” rule?

§302(b)(1) - Not Essentially Equivalent to a Dividend

Davis case
Taxpayer Wife Son Daughter
250 250 250 250
common common common common
& preferred
Taxpayer’s preferred stock was redeemed. “Meaningful reduction” requirement was not satisfied since no reduction in vote %.
Rev. Rul. 85-106

Trust owned common stock.
Redemption of only nonvoting preferred stock. No redemption of any common stock.
18 percent of voting stock owned both before and after. Voting power as a key factor.
Shareholder can still participate in the same voting blocks.
Held: Not a “meaningful reduction” & §302(b)(1) requirements are not satisfied.

Rev. Rul. 75-502

X Corporation
Estate A B
A as bene.
250 shares 750 shares 750 shares
Estate owns A's shares through
§318(a)(3)(A) attribution. Estate’s shares were redeemed. The estate went from 57% to 50% constructive ownership in the corporation.
A meaningful reduction resulted for the estate.
**Rev Rul. 75-512**

X redeemed all 75 shares owned by the trust. Prior to redemption trust owned 300 shares directly and indirectly (or 30 percent). Decreased ownership from 30 percent to 24.3 percent (225 shares owned by C, D & E). Not eligible for (i) complete redemption or (ii) substantially disproportionate; but, held: Not essentially equivalent to a dividend. Why? Reduction of voting rights?

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**Relevance of Family Discord**

Is family discord relevant in determining the applicability/non-applicability of the §318(a)(1) family attribution rules?

Question: How demonstrate this intra-family hostility to the IRS?
Example 1

Z Corporation

Example 2

Common & Preferred

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>20</td>
<td>55</td>
</tr>
<tr>
<td>C</td>
<td>25</td>
<td>10</td>
</tr>
<tr>
<td>D</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>E</td>
<td>0</td>
<td>20</td>
</tr>
</tbody>
</table>
**Example 3**

(1) Five of 15 shares redeemed in a transaction treated as a dividend. Remaining shares have a basis of $15,000. Reg. §1.302-2(c), Examples 1 & 3.

(2) Mystery of the disappearing basis - where all shares redeemed but dividend treatment occurs. Stock basis is transferred to those parties whose shares are attributed to the shareholder; Reg. §1.302-2(c), Example 2.

**Partial Liquidations**

**Corporate Level Testing**

Code §302(b)(4) - redemption treatment for partial liquidations (if non-corporate status). Redemption treatment is available to the shareholder, but the eligibility is dependent upon corporate level events rather than shareholder level events.

Need a genuine contraction of a corporation's business to enable a distribution eligible for redemption/sale or exchange treatment.
Code §302(e)(2) Safe Harbor

1) (a) Termination of a “qualified trade or business”, and  
   (b) continuation of another “qualified trade or business”.
2) Five year prior active conduct for each business to be “qualified.”
3) No acquisition of these businesses within the prior five year period where gain has been recognized upon acquisition.

Rev. Rul. 79-184

Sale of the stock of a subsidiary & the distribution of the proceeds held not to be a distribution in partial liquidation of corp.  
Not a corporate contraction, but the sale of an investment (rather than a sale of one of several directly held businesses).  
Cf., upstream corporate liquidation of the subsidiary into the parent and the relevance of Code §381 (re: tax attribute carryovers).
Consequences to the Distributing Corporation

1. Distributions by Corporation of Appreciated Property in Redemption.
   §311(b) applies to nonliquidating distributions. Gain to be recognized to corp.
2. Effect on Earnings and Profits.
   See §312(n)(7) requiring the ratable reduction of E&P when a redemption occurs, subject to a limit as to the actual distribution amount.
Example:

Facts: 200 shares at price of $1,000 per share. $100,000 basis for each of two shareholders. $100,000 accumulated e&p and $50,000 current e&p.

a) Redemption of A's shares - X distributes land (250x FMV & 200x adjusted basis). 1/2 of corporation’s shares are redeemed; e&p is increased by the 50x appreciation amount; reduced by 100x. Cf., dividend.

Example, cont.

b) X's adjusted basis in the land is 300x. Under §311(a) no recognition of loss results (300x basis and 250x fmv). Therefore, 50x current e&p and 100x accumulated e&p when redemption occurs. 1/2 of the shares are redeemed. §312(n)(7) permits an e&p reduction to 75x (from 150x to 75x). Cf., dividend treatment.
Stock Redemption Expenses

All expenditures incurred by a corporation in purchasing stock are non-deductible, non-amortizable capital expenditures.

“Greenmail” payments must be capitalized. Cf., Woodward case re dissenters' litigation legal costs also requiring capitalization.

Note §162(k)(2)(A)(ii) re amortization of loan costs over the period of the loan.

Bootstrap Acquisitions

Zenz v. Quinlivan - Sale of stock to a third party; three weeks later redemption of the balance of outstanding shares.

Assertion by IRS that this was equivalent to a dividend distribution - even though the shareholder's entire remaining share interest was terminated by the stock redemption.

Held: not a bootstrap dividend distribution; rather, capital gains transaction treatment.
**Rev. Rul. 75-447**

**Situation One:**
Corporation X shares equally owned by A and B (50 each).
25 new shares issued to C by Corporation X and A & B then each redeemed 25 shares.
A & B owned 50% before new shares and 33 1/3% after the stock redemption.
Requirements of §302(b)(2) are satisfied.

**Rev. Rul. 75-447**

**Situation Two:**
(1) Sale of shares to C by A & B and (2) then redemption of part of the remaining shares held by A & B.
A & B held 50% before and 33 1/3% after the transaction.
Held: §302(b)(2) applies when measuring before and after these several transactions.
Example

Strap is the sole shareholder of Target. Target value is $500,000 and Target has $100,000 cash. Strap redeems $100,000 of Target shares and Strap sells remaining Target shares to Boot. Is step transaction treatment applicable to enable the redemption to be part of a sale or exchange/gain recognition transaction?

Buy-Sell Agreement

Objectives of this arrangement:
1) Preserve the limited ownership group.
2) Fix value/binding price required during lifetime; is a right of first refusal acceptable?
3) Possibly fix value for estate tax purposes.
4) Liquidity for the selling shareholder - assurance that his successors are not in a minority/non-controlling shareholder position after death of that shareholder.
Types of Buy-Sell Arrangements

1) Cross-purchase: capital gains event; but, if a sale after death, limited capital gain since tax basis for shares stepped up (down?) (§1014) to FMV of stock at death.

2) Entity purchase: redemption treatment and possible dividend risks.

3) Combination transaction: Zenz situation analysis should be applicable.

Types of Restrictions on Stock Transfers

1) Lifetime: a) right of first refusal
   b) matching a bona fide offer from a potential outside purchaser.

2) Death - mandatory sale/purchase??
   Consider the mandatory nature of a purchase requirement, if (i) shares are to be purchased by the remaining shareholder, and (ii) the corporation assumes that shareholder’s obligation.
Valuation Approaches for the Buy-Sell Agreement

1) Agreed price, with a kick-out clause if no valuation occurs within a specified period.
2) Book value; or “multiple” of book value? But, mark to market (rather than book) for investment assets held by the corporation?
3) Independent appraisal of shares.
4) Apply a “multiple” times: (a) earnings; or (b) cash flow?

Terms of Payment for the Shares Sold

Cash
Deferred payments:
   1) installment reporting for income tax?
   2) what risk to redemption tax treatment?
   3) security: (a) escrow of redeemed stock - but cannot get stock back; (b) assets pledged; or, (c) letter of credit or an indemnity policy.
   4) negative covenants in the loan agreement.
Life Insurance Tax & Related Considerations

Insurance acquired to satisfy liquidity needs.
Each shareholder’s life is insured by others.

A) Cross-purchase agreement - other shareholder(s) acquire life insurance.
B) Entity purchase - insurance proceeds flow into corporation and at death the value of the corporation is increased by the difference between (1) book value and (2) face value of the life insurance coverage.

Transfer Tax Considerations §2703

Value to be determined without regard to:
1) Any option, agreement or other right to acquire property at a price less than FMV.
2) Any restriction on the right to sell or use the property.

§2703(b) provides an exception for an arrangement which has terms "comparable to similar arrangements entered into by persons in an arm's length transaction."
Constructive Dividend Issues in a Redemption

Revenue Ruling 69-608.

Basic question: does the corporation assume a binding obligation of the shareholder when agreeing to purchase shares? If so, a constructive dividend transaction will be treated as occurring, with the dividend distribution being made to the remaining shareholder(s).

Example:

A, B & C each own 1/3 of Y corporation. A cross purchase agreement is in place. Y corporation purchased life insurance on the lives of the shareholders and paid premiums on this life insurance. Y corporation is the owner of the policies and also the beneficiary under the policies. B dies and Y Corp. uses the proceeds to redeem B's stock. continued
Example, cont.
Treatment to Y Corp.

1) Are the premiums deductible by Y Corp.?
   No, §264(a)(1).
2) At death the tax-free insurance proceeds are received by Y Corp. §101(a)(1).
3) The excess of insurance proceeds over aggregate premiums is included in the Y Corp E&P.
   continued

Example, cont.
Treatment to A&C

A&C as the remaining shareholders.
1) No constructive dividends upon the insurance premium payments by Y Corp.
2) A & C do have constructive dividend distribution upon the stock redemption because of the binding obligations of A & C to purchase B's shares.
Divorce Redemptions

Arnes v. United States  He and she each owned 50 percent of Corp.

Divorce agreement for redemption of her 50 percent interest. Installment sale reporting.

She asserts transaction really constitutes a transfer to husband and is protected from gain recognition to her because of §1041.

Issue: Does this constitute a transfer to a third party on behalf of the ex-wife? No.

Treatment of Nontransferor Spouse

If the departing ex-spouse does not engage in a redemption transaction with the corporation, then what is the treatment to the ex-spouse who remains as the shareholder in the corporation?

Treatment of the remaining spouse as receiving a constructive dividend?
**Divorce Redemptions, Final Regulations**

The conflict: “Primary and unconditional obligation” vs. §1041 (carryover basis).

Option One: Tax to the nontransferor if a primary and unconditional obligation exists.

Option Two: Tax to the transferor spouse if no such obligation - capital gains treatment.

Option Three: Treat as a constructive distribution to the nontransferor spouse (enabling negotiation in their divorce deal).

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**Charitable Contribution & Redemption Transaction**

**Grove v. Commissioner**

**Facts:** Grove donated shares of stock to charity & retained a life interest (in a fund). The charity signed the buy-sell agreement. Shares redeemed by the issuing corporation 2-3 years after the charitable contribution.

**Held:** No agreement for the charitable donee to redeem shares. No dividend distribution treatment to the donor of the shares.
Example: Charitable Gift of Shares

Redemption & cash contribution vs. charitable bailout (i.e., charitable deduction for FMV of stock and no dividend income).

a) Distribution to P in redemption of 1,000 shares of stock and then the contribution of $100,000 cash to charity.

Result: $100,000 taxable dividend distribution and deduction of $100,000 for the cash charitable contribution.

Example, cont.

b) Contribution of shares to charity and subsequent redemption of charity's shares. No legal obligation to surrender the shares for redemption. Oral understanding is not a legal obligation. Not a constructive dividend.

No legal obligation to redeem.

c) Pattern of conduct for charitable gifts and redemptions. Still not a problem (pursuant to the Grove decision).
Redemptions through Related Corporations

**Brother-sister acquisitions - §304(a)(1).**

A (individual or corp.) owns

X Corp & Y Corp

Facts: A sells X stock to Y Corp. for cash; the cash comes from Y Corp. to A.

Transaction is treated as a distribution in redemption of Y stock - rather than as a sale or exchange of stock of X corp. “Control” of each of the two corporations must exist.

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Parent-Subsidiary Acquisitions §304(a)(2)

**Facts:**

A - shareholder

P - parent

S - subsidiary

Stock of P is sold by A to S. Must be satisfaction of a 50 percent control test.

Treated for “dividend equivalency” purposes as a distribution in redemption of P's stock.

Next question: Are any Code §302(b) redemption tests satisfied in this transaction?
§304(a)(1) - Collateral Income Tax Effects

If dividend treatment:
1) A §351 contribution to the acquiring corporation.
2) The acquiring corp. receives a transferred basis for the stock received.
3) E&P of the acquiring corporation are reduced when dividend treatment occurs.

If an “exchange” (§302(a)) - then cost basis.

§304(a)(b) - Collateral Income Tax Effects

If dividend treatment:
1) Basis shifting from contributed parent’s stock to remaining parent stock held by the shareholder.
2) Reduce sub’s E&P to extent of dividend treatment; then reduce parent’s E&P.

If an “exchange” (§302(a)) then recovery of basis and capital gain for parent stock sale.
Bernard & Edward Thomas
& Tessie & Walter
22.58% 67.91% 67%

AT&T Lents Industries

Bernard & Tessie sold their AT&T common to Lents & retained their preferred stock.

Issue: Does sale of AT&T common producing capital gain to Bernard & Tessie?

(a) Why did §304(a) apply?

§304(a)(1) - the sale to a related corporation combined with the application of the attribution of ownership rules.

(b) Testing of the redemption (under §302(b)) to determine dividend status:

§304(a)(1) - testing by reference to AT&T, i.e., the issuing corporation.
Re: Niedermeyer case

1(c) Why unable to waive family attribution? No complete termination of the actual interest in AT&T when the sale of the AT&T stock to Lents occurred.

1(d) How avoid this result? Qualify for Code §302(b)(3) - if the AT&T preferred disposition were part of the overall disposition plan; have a written plan; then similar to the Zenz v. Quinlivan decision.

Example 2

Claude

80% 60%

Bail Corp. (buyer) Out Corp.

$40,000 basis $9,000 basis

(80 shares @ $500) (60 shares @ $150)

(Bail--no e&p) (Out--$5,000 acc. e&p)

(a) Claude sells 20 of his Out shares to Bail for $4,000 (basis is $3,000, i.e., 1/3 of $9,000)).
Example 2(b)

Claude sells his Out shares to Bail for 12K. Treated as a redemption of Bail stock tested under §302 with reference to the Out stock. Before redemption Claude owned 60 percent of Out. After redemption he owns 48 percent of Out by attribution through Bail (80 percent of 60 shares, §318(a)(2)(C)). Treat as under §302(b)(1) (yes?) or §302(b)(2) (no)?

Example 2(c)

Same as (a) above, except that Claude receives $3,000 and one share of Bail stock for his 20 Out shares. Claude's argument - this is a §351 transaction (§368(c) control exists), and Bail stock is received. Cf. §351(b) (boot) vs. §304(b)(3)(A) (noting that §351 is not applicable).
**Example 2(d)**

Same as (a) above, except that Claude receives one share of Bail stock (fmv- $1,000) & Bail takes 20 Out shares subject to a $3,000 liability that Claude incurred to buy the 20 shares of Out stock.

Special rule applicable - §304(b)(3)(B) - assuming the stock was not acquired from a related person (under §304(b)(3)(B)(iii)).

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**Redemptions to Pay Death Taxes**

Code §303(a) enables cash availability to pay death taxes.

Under §1014 the basis of stock is stepped-up at death to its FMV.

Therefore, tax choices on the stock redemption are:

1) **zero** capital gain vs.

2) dividend distribution.
Section 303 Requirements

1) Value of redeemed stock must be included in determining the decedent's gross estate.
2) Substantial portion of decedent's estate - 35% of gross estate (less certain expenses).
3) Timing of the redemption: within 90 days after expiration of the 3 year S/L.
4) Eligible shareholders - where the interest of the beneficiary is reduced directly by a liability for death taxes. Code §303(b)(3).

Example

Gross estate $2,000,000
Expenses 100,000
Net estate 1,900,000

Estate includes:
X corp stock 200,000 of 1.4 mil. total fmv;
Y corp stock 400,000 of 1.6 mil. total fmv;
Wife also owns 200,000 of X corp stock.
Issue re qualification under §303.
Example, continued

1) Qualification for §303(b)(2)(B) test:
20% plus of X stock and Y stock counted for this 35% test (when including wife’s stock in the X stock computation).

2) Qualification for §303(b)(2)(A) test:
Wife’s stock is not counted for this purpose.
Estate’s stock: 400k plus 200k equals 600k which is less than 665k (35% of 1.9 mil).