Presentation:

Corporate Taxation
Chapter Five: Redemptions & Partial Liquidations
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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, then §302(b) will treat the redemption as either:

1. A property sale (§1001), or
2. A dividend distribution (i.e., E&P sourced).
Options for federal income tax classification of the stock redemption transaction:

1) Stock sale (with a tax basis recovery); consider the time value of the tax funds.

2) Dividend equivalency (and no basis offset).

Now that capital gains are generally taxed at 20% and qualified dividend are also taxed at 20%, the distinction has less significance today versus the past. But, it still matters. A sale or exchange treatment allows basis recovery where a dividend is taxable as a dividend for the full proceeds to the extent of the corporation’s E&P.
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).
When a stock redemption is treated as a dividend distribution: what happens to the tax basis of the disappeared shares?

1) Allocation to the shareholder’s remaining shares.

2) If all shares are sold (but dividend treatment occurs because of §318) – basis allocation to related parties.

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

2) The effect on the distributor corporation’s E&P account when appreciated or depreciated property is distributed is governed by §312. If treated as a dividend, then same result as Chapter 4 (see §312(a) and §312(b)). If the redemption is treated as a sale or exchange, then §312(n)(7) controls (see Chapter 5, Section E of casebook).
1) Enable the shift of corporate control (e.g., to younger generation members in a closely-held corp.).

2) Buy out of the share interest of a disgruntled or deceased shareholder.

3) Stock buyback program for a publicly held corporation, e.g., to reduce the equity base.
What is the function of the “constructive ownership” or “attribution of ownership” rules?

Assumption: commonality of ownership causes parties to coordinate tax planning for their joint investment interests.

Example: Father owns 50% of shares and Daughter owns 50% of shares and Father redeems all his shares – treatment of Father as a continuing stock owner? Possibly.
1) §318(a)(1). **Family attribution** – to spouse, children, grandchildren, and parents. Not to grandchild→ grandparent or to siblings.

2) §318(a)(2). **Entity Attribution.** 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 the beneficiaries.

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

4) §318(a)(4). **Option Attribution.** An option to acquire stock is equivalent to the ownership of that stock.
1) No double family reallocation but do apply constructive attribution and then apply family attribution. See §318(a)(5)(B).

2) No “sidewise” attribution – e.g., attribution (a) from one partner to the partnership and then (b) from partnership back to different partner. See §318(a)(5)(C).

3) S Corporations are treated as partnerships and S corporation shareholders are treated as partners. See §318(a)(5)(E).
Wham Corp has 100 common shares outstanding. Mother as (i) a 50% GM estate beneficiary and (ii) holding an option for 5 of son’s 10 shares.

Grandfather – 85 shares.

a) 25 directly
b) 20 from mother to GF - §318(a)(1)(A)(ii).
c) 15 from daughter & 10 from son - §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) and from mother to GF.

Reattribution is permitted here.
Daughter's Stock

Daughter shares = 55
a) 15 directly.
b) 0 shares from son – no sibling attribution.
c) 25 shares from mother – (i) 20 shares directly; and (ii) 5 shares owned through mother’s option. §§318(a)(4) & 318(a)(5)(D).
d) 15 shares (through Mom) from GM’s estate.
e) GF to (grand)daughter – no.
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 and son. §318(a)(1)(a) & §318(a)(3)(A).

Reattribution to entity applies.
Problem 2(a)

Issue: How many shares of Xerxes is owned by A (W’s husband), W and M (W’s mother)?

A: 25 shares. Stock owned by P/S is considered as owned pro ratably by partners. § 318(a)(2)(A).


M: Zero. The shares attributed from A to W may not be reattributed to M under the family attribution rules. § 318(a)(5)(B).
Question: How many shares in Xerxes is constructively owned by Yancy?

Answer: 25 shares

1) Stock owned by a 50% or greater shareholder of a corporation is attributed to the corporation - §318(a)(3)(C).

2) Yancy owns constructively 25 shares owned by W: (a) Partnership to A; (b) then, A to W; (c) then, W to Yancy – since W owns 50% or more of Yancy (i.e., W can instruct Yancy).
QUESTION: How many shares of Yancy are constructively owned by Partnership, B, C, D & Xerxes?

1) Partnership – constructively owns the 100 shares in Yancy; W’s 100 shares are attributed to A and A’s 100 shares are reattributed to partnership.

2) B, C, & D do not own any Yancy shares. No “sidewise reattribution” to another partner.

3) Xerxes owns the 100 shares constructively owned by the partnership.
Substantially Disproportionate Redemptions

§302(b)(2). Requirements to qualify:

1) Own less than 50% of the total combined voting power of the voting stock. §302(b)(2)(B).

2) Percentage of voting stock owned after the redemption is less than 80% of the total voting % owned before the redemption. §302(b)(2)(C).

3) Percentage of ownership of all common stock is less than 80 percent of the prior % of the total common stock owned. §302(b)(2)(C).
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) (since no reduction in vote)? Only by “piggybacking” on a qualifying redemption of voting stock (per Reg. §1.302-3(a)).
FACTS: B indicated to A, the majority shareholder, an intention to terminate as shareholder.

Step One: A redeemed so that A (temporarily) owns less than 50%.

Step Two: B is redeemed one week later with the consequence that A’s ownership goes back above 50%.

Issue: Should these two transactions be integrated for purposes of testing the §302(b) treatment for the A redemption?

Answer – Yes. See §302(b)(2)(D). “A “plan” 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 control that was apparently reduced.”
Problem 1 (Y Corp.)
§302(b)(2) Eligibility

a) Redeem A’s 75 pfd stock

b) Redeem A’s 75 pfd stock + 60 c.s.

c) Redeem A’s 75 pfd + 70 Alice c.s.

d) Redeem A’s 75 pfd stock + 70 Alice c.s. + 10 Cathy c.s.
FACTS: Z redeems 30 of Don’s voting common stock.

QUESTION: §302(b)(2) qualification?

ANSWER: No.

ANALYSIS:
1. After the redemption, Don owns 42.9% (30 of 70 shares). The redemption satisfies § 302(b)(2)(B) (below 50% of total combined voting power test) and the first 80% requirement in § 302(b)(2)(C) (80% of 60% is 48%).
2. But, Don's redemption fails the second 80% test in § 302(b)(2)(C). After the redemption, Don owns 48.1% of the value of all common stock outstanding ($13,000 out of $27,000 of total value). To qualify the redemption as an exchange, Don would have to own below 42.66% of the total common stock (80% of 53.33%).
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”.

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

Code §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.
1) Can have no continuing interest as an officer, director, or employee; cf., 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 the prior ten years – unless income tax avoidance not one of the principal purposes for that acquisition.
FACTS: Dec. 17: Son buys 50 shares. Dec. 31: all remaining father stock is redeemed. Father enters into a consulting agreement to act as an “independent contractor” (not as an employee).

ISSUE: Was redemption a dividend?

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

9th Circuit: Consulting arrangement is a prohibited interest, even if the status is that of an independent contractor because that is more than a mere creditor.
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 complete termination requirement of §302(c)(2)(A)(i). Observer status is OK, but direct board representation is not.
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 the 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 in the corp.
1) Cannot be a custodian under TUTMA or be a voting trustee.

2) Reacquisition of stock (or only interest 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 the corporation on an arm’s length basis is acceptable.
§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 constructive ownership from another, e.g., a beneficiary)?

§302(c)(2)(C) permits the waiver by the trust and its beneficiaries (if both are redeeming).
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems all 50 shares from Allison.

ANSWER: Alison can utilize a §302(c)(2) waiver of family attribution so that she is entitled to redemption treatment.
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems all 50 shares from Allison, but Allison fails to file the agreement required by §302(c)(2)(A)(iii).

ANSWER: Allison cannot utilize a §302(c)(2) waiver of family attribution. Agreement must be filed to be eligible for §302(c)(2) waiver of family attribution.
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems all 50 shares from Allison, but redemption price is contingent on Randall’s profitability.

ANSWER: Alison cannot utilize a §302(c)(2) waiver of family attribution because Allison retained a forbidden interest. See Treas. Reg. §1.302-4(d).
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems 20 shares from Allison in year one and the remaining 30 shares in year 2.

ANSWER: The 30 shares in year 2 clearly get redemption treatment. The 20 shares in year one may receive redemption treatment if there was a “fixed and firm plan” for the 2 redemptions before the year one redemption. See Niedermeyer case on p. 279.
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems all 50 shares from Allison, but Allison remains as a director.

ANSWER: Alison cannot utilize a §302(c)(2) waiver of family attribution because remaining a director is a prohibited interest. See Rev. Rul. 59-119.
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems all 50 shares from Allison, but two years later Allison becomes an employee of a subsidiary of Randall Corporation.

ANSWER: Alison cannot utilize a §302(c)(2) waiver of family attribution because becoming an employee represents a prohibited interest. See Treas. Reg. §1.302-4(c).
FACTS: Allison is John’s daughter and Chuck’s mother. Randall redeems all 50 shares from Allison, but two years later Chuck dies and leaves all his shares to Allison.

ANSWER: Alison utilize a §302(c)(2) waiver of family attribution. §302(c)(2)(A)(ii) permits an acquisition of stock within the proscribed 10-year period "by bequest or inheritance." Thus, receipt of Chuck's stock does not violate § 302(c)(2)(A)(ii).
Betty & Billy, husband & wife, own 150 shares common stock of corporation. Billy & Betty plan to transfer corporate control to Junior as follows:

1) Gift of 30 shares
2) B&B redeem remaining 120 shares for $50,000 cash and $400,000 note
3(a) Betty & Billy will lease plant to B&B with escalating rent.
3(b) Betty establishes a consulting agreement.

ISSUE: Can Betty and Billy receive redemption treatment?
Redemption of the Estate’s 20 shares – Is a Code §302(c)(2) waiver of constructive ownership rules available?

Answer: Yes, estate may file § 302(c)(2) waiver. Under §302(c)(2)(C)(ii)(II), attribution under §318(a)(1) is turned-off. Both the Estate and Bella must satisfy the conditions in §302(c)(2)(A), and Bella must agree to be liable for any deficiency during the 10-year period following the date of the redemption. §302(c)(2)(C)(i).
Redemption of the Estate’s 20 shares – Is a Code §302(c)(2) waiver of constructive ownership rules available?

Answer: No. § 302(c)(2)(C) specifically would turn-off family attribution under §318(a)(1) but the estate’s shares are attributed to the estate beneficiaries under §318(a)(2) which is not excepted under §302(c)(2)C). Estate thus does not qualify for exchange treatment under § 302(b)(3).
Redemption of the Estate’s 20 shares – Is a Code §302(c)(2) waiver of constructive ownership rules available?

Answer: No. John & Mary Cinelab stock will be attributed to the Estate under § 318(a)(3)(A). As residual beneficiaries, they cannot terminate their estate beneficiary status. Thus, the Estate owns all Cinelab stock before and after the redemption by attribution.
3(d) Redemption of the Estate’s 20 shares in 3(d). Is a Code §302(c)(2) waiver of constructive ownership rules available?

Answer: Yes, the trust can obtain a §302(b)(3) complete redemption by waiving family attribution between Bella and John and Mary. Nancy is not a related person since her siblings' Cinelab stock cannot be attributed to her under §318(a)(1).

3(e) Nancy subsequently acquires share. Discuss impact of the ten year “look forward” rule.
FACTS: Taxpayer’s preferred stock was entirely redeemed.

Supreme Court: To be a redemption under §301(b)(1) (i.e., not essentially equivalent to a dividend), the taxpayer must have a “meaningful reduction of the shareholder’s proportionate interest in the corporation.”

Court said that there was no reduction in Davis’ vote % or in proportionate interest due to attribution.
Redemption of only nonvoting preferred stock. No redemption of any common stock. 18 percent of voting stock owned both before and after by Trust beneficiary.

Held: Not a “meaningful reduction” & §302(b)(1) requirements are not satisfied.

Reasoning: Essentially equivalent to a dividend. Voting power is the key factor. C still participating in same voting blocks.
FACTS: 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.

HELD: A meaningful reduction resulted for the estate. Reduction in voting rights to 50% where the other 50% voting rights were held by a single unrelated shareholder is a meaningful reduction in voting power as to A. A reduction from 57% to 51% would not have been meaningful.
X redeemed all 75 shares owned by the trust. Prior to redemption trust owned 75 shares directly and indirectly another 225 shares (30% overall). Thus, the Trust’s ownership decreased from 30% to 24.3% (225 shares owned by C, D, & E).

HELD: The redemption is not eligible for complete redemption (since still own 225 shares indirectly) or substantially disproportionate (since Trust still owned 81% after the redemption), but it was not essentially equivalent to a dividend because Trust was a minority shareholder that experienced reduction in voting rights.
1) Redemption of nonvoting preferred stock from stockholder only owning nonvoting preferred stock is not essentially equivalent to a dividend.

2) Redemption of a minor interest in a public corporation, i.e., a “stock buy-back program” is not essentially equivalent to a dividend. This is given exchange treatment since the minority shareholder has no ability to impact on corporate management.

3) Redemption causes shareholder to lose “super-majority” rights but retains majority control. The Eighth Circuit in Wright v. US says such redemptions are not essentially equivalent to a dividend, but the IRS in Rev. Rul. 78-401 disagrees.
Is family discord relevant in determining the applicability/non-applicability of the §318(a)(1) family attribution rules in the stock redemption context?

Answer: Most courts say family discord does not turn-off the §318(a)(1) family attribution rules, but the Tax Court in Cerone v. Commissioner said that family discord is relevant for purposes of applying the “facts and circumstances” test of §302(b)(1) to determine whether a reduction is a meaningful reduction under §302(b)(1).
Problem 1
Meaningful Reduction?

a) Z redeems 7 shares from A
b) Z redeems 5 shares from A; A and D are mother and daughter
c) Z redeems 5 shares from A; A and B are mother and daughter
d) Same as c) except that A has not spoken to B since B married “outside the faith.”
Problem 2
Common & Preferred

A | B | C | D | E
---|---|---|---|---
40 C.S.| 20 C.S.| 25 C.S.| 15 C.S.| 0 C.S.
0 Pfd | 55 Pfd | 10 Pfd | 15 Pfd | 20 Pfd

a) Y redeems 5 preferred shares from E
b) Y redeems all preferred stock from all shareholders
1) Five of 15 shares are redeemed in a transaction treated as a dividend. The remaining shares have a basis of $15,000. Reg. §1.302-2(c), Examples 1 & 3.

2) What if all of the remaining 10 shares are then also redeemed in a transaction classified as a dividend. This sets up the “mystery of the disappearing basis.”

Answer: Stock basis is transferred to those parties whose shares are attributed to the shareholder; Reg. §1.302-2(c), Example 2.
Code §302(b)(4) – redemption treatment for partial liquidations (if non-corporate status of shareholder).

Redemption treatment is available to the shareholder, but the eligibility is dependent upon corporate level events rather than upon shareholder level events.

Need a genuine contraction of a corporation's business to enable a distribution eligible for redemption/sale or exchange treatment.
1) (a) Termination of a “qualified trade or business, and (b) the 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.
Sale of the stock of a subsidiary & distribution of the proceeds held not to be a distribution in partial liquidation of corporation.

Held: This is not a corporate business contraction, but rather the sale of an investment (rather than a sale of one of several directly held businesses).

However, Rev. Rul. 75-223 holds that an upstream corporate liquidation of the subsidiary into the parent can qualify because Parent inherits tax history of subsidiary per §381. Check-the-Box planning.
Problem
Partial Liquidation?

a) Alpha distributes its Book division to each of its shareholders. Does it matter whether any stock is redeemed?

b) Is there a different result if Book was acquired 3 years ago with cash?
c) What if Book assets destroyed and ½ of insurance proceeds distributed?

d) Suppose Books only distributed to Michael in complete redemption of Michael’s stock.

e) Alpha distributes Books to Iris in complete redemption of Iris’ stock in Alpha.

f) Distribute securities portfolio to each shareholder
g) Alpha sells its Beta stock and distributes the proceeds pro rata to the shareholders in redemption for 20 shares each

h) Same as g) except that Alpha first liquidates Beta and then distributes the assets of Beta’s business, which business has been operated for more than five years
1) **Distributions by Corporation of Appreciated Property in Redemption.** §311(b) applies to **nonliquidating** distributions. Gain to be recognized to corp. on distribution.

2) **Effect on Earnings and Profits.** See §312(n)(7) requiring the **ratable** reduction of E&P when a redeemed occurs, subject to a limit as to the actual distribution amount.
Dividends in June & August and 25% of stock redeemed in July. Issue: what prorata share of E&P is attributable to redeemed shares (when CG treatment)?

Ordering rules: Dividend distributions first, prorata; then redemption distributions in chronological order (proportionate allocation).

**Situation 1**

- **June**: Current E&P $12,000, Dividend $4,000, Acc. E&P $2,000
- **July**: 25% of 25% redeemed, Current E&P $7,000, Acc. E&P $2,000
- **August**: Current E&P $12,000

1. Current E&P of $7,000 ($12,000 – $5,000 distributions) is prorated to July 1.
2. Acc. E&P ($2,000) + Prorated C. E&P ($3,500) = $5,500 x 25% = $1,375
3. Ending E&P = $14,000 – $5,000 – $1,375 = $7,625
Ordering rules: Dividend distributions first, prorata; then redemption distributions in chronological order (proportionate allocation).

**Situation 2**

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Acc. E&P 2,000
Current E&P 2,000

June: 400 Cur. E&P \[1,000 \times 2,000/5,000\] + 600 Acc.

July: 25% of 1,400 Acc. E&P (i.e., 2,000 – 600 June distribution) = 350

August: 1,600 Cur. E&P + 1,050 Acc. E&P \[2,000 – 600 – 350\]
Redemption of A’s shares – X distributes cash to redeem ½ of corporation’s shares at mid-year.

Acc. E&P 100,000
50% of C. E&P 50,000 (At Mid-Year)
E&P (@ Redemption) 150,000 (As of July 1)
50% E&P (@ Redemption) 75,000
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 required capitalization of legal costs incurred in litigation by dissenters.

Note §162(k)(2)(A)(ii) re amortization of loan costs over the period of the loan. Loan is a separate transaction and so even if incurred for stock-buybacks it is not subject to §162(k)’s disallowance rule.
Zenz v. Quinlivan – Sale of stock to a third party; three weeks later redemption of the balance of outstanding shares.

Held: capital gains transaction treatment. Court endorsed a before versus After analysis. Regardless of order, compare stock ownership before versus at the end of the completed plan to determine dividend equivalency.
FACTS: Strap is the sole shareholder of Target.

Alternative 1: Redeem $100,000 of Target shares and Strap sells remaining Target shares to Boot.

Alternative 2: Strap receives dividend and then sells shares

Alternative 1:
1. Redemption qualifies for exchange treatment under §302(b)(3) per Zenz.
2. Sale creates LTCG.
3. X E&P reduced by $20,000 on redemption

Alternative 2:
1. Dividend of $100,000.
2. Sale creates LTCG.
3. X E&P reduced by $100,000 dividend

Issue: Waterman Steamship v. TSN Liquidating Corp
Objectives of the buy-sell 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 federal 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**: A capital gains event; but, if a sale after death, limited capital gain since tax basis for shares is stepped up (down?) (§1014, in 2011 and thereafter) to FMV of stock at death.

2) **Entity Purchase**: Redemption treatment and possible dividend risks.

3) **Combination transaction**: Zenz situation analysis should be applicable to enable CG status.
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 (as of date of death), 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. “Shout-Out” clauses

2) **Book value**; or a “multiple” of book value? But, mark to market (rather than book) for certain (e.g. investment) assets held by the corporation?

3) Independent **appraisal** of the 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 stock redemption tax treatment?
3) Security arrangements: (a) escrow of the redeemed stock but cannot get the stock back; (b) assets pledged; or, (c) letter of credit or an indemnity policy.
4) Negative covenants in the loan agreement.
Insurance acquired to satisfy liquidity needs.

Each shareholder’s life is insured by the others.

A) Cross-purchase agreement – other shareholder(s) acquire life insurance.

B) Entity purchase – insurance proceeds slow into corporation and at death the value of the corporation (and E&P) is increase by the difference between (1) book value, and (2) face value of the life insurance policy.
Value to be determined for the transfer tax purposes 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/use property.

§2703(b) provides an exception for an arrangement which has terms “comparable to similar arrangements entered into by persons in arm’s length transaction”.
Basic question: Does the corporation assume a binding obligation of the remaining 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).
A cross purchase agreement in place.

a) B sells shares to A&C for $200,000 each
b) Pursuant to entity level buy-sell, X redeems B for $400,000
c) Shareholder level buy-sell, but X redeems B for $400,000
d) A&B had option, but not obligation to buy-out B but X redeems
e) X had life insurance policy on C’s life and uses proceeds to redeem C when a shareholder-level buy-sell agreement existed

Note: Fact patterns “in red” treated as constructive distribution to A & C.
Divorce agreement for redemption of her 50 percent interest.

Installment sale reporting. In refund litigation Joanne Arnes asserts that the transaction really is a stock transfer from Joanne to John and she is protected from gain recognition because of §1041.

IRS issues protective deficiency assessment to John for deemed dividend to John if Joanne were right.

Held: For Joanne. Moriah relieved John of a personal shareholder obligation and so this is a deemed dividend to him and constructively his settlement of his divorce decree obligations. But, John won in Tax Court stating that he did not have a primary obligation to redeem stock. Classic “whipsaw.”
Application of §1041 to the redeeming spouse is contingent on taxing the nontransferor (nonredeeming) spouse on a constructive distribution.

1. If redemption is **NOT** treated as constructive distribution to nontransferring spouse, then redeeming spouse **IS** treated as having made a redemption. Treas. Reg. §1.1041-2(a)(1).

2. If redemption **IS** treated as constructive distribution to nontransferring spouse, then redeeming spouse is **NOT** treated as having made a redemption. Treas. Reg. §1.1041-2(a)(2).

3. The parties can agree to be bound by tax treatment as part of the divorce settlement agreement and that agreement will be controlling. Treas. Reg. §1.1041-2(c).
H and W each own 50 of the 100 outstanding shares of common stock (the only class outstanding) of F (FMV = $1 million; Acc. E&P = $500,000). H and W each have a $100,000 basis. Upon the effective date of their divorce, H will own all the stock of F and W will receive $500,000 for her 50 shares. Consider the tax consequences of the following proposals to meet these goals:

(a) H buys W’s stock for $500,000 cash.

   W: No gain per §1041.  H: $100,000 basis in the W shares.

(b) H and W agree that F will redeem W’s stock for $500,000 cash.

   If H had primary obligation, then W deemed to transfer shares to H and H has its shares redeemed (constructive dividend to H).

   Even if H did not have a primary obligation, the parties can agree as part of the divorce decree to treat the redemption as a constructive dividend to H.
**Facts:** Grove donated shares of stock to charity and 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.

**Taxpayer:** Charitable contribution of shares to RPI followed by RPI redemption.

**IRS:** Recast transaction as a deemed dividend from GSW&K to Grove followed by a charitable cash contribution (not stock) to RPI.

**Held:** Original form respected. Charitable stock gifts were completed gifts and no formal or informal agreement to redeem.
Rev. Rul. 78-197 – IRS announces that corporation’s redemption of shares owned by a charity will be treated as a dividend to the original contributor only if the charity is legally obligated to surrender shares for redemption.

But, are most charities obligated to sell illiquid shares as quickly as possible, and do trustees/directors violate fiduciary responsibilities if not doing so?

Note alternative (now required) charitable gift techniques, e.g., Charitable Remainder Annuity Trust, Charitable Remainder Unitrust, and pooled income funds.
Charitable Gift of Shares

Redemption and 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: (1) $100,000 taxable dividend distribution and (2) deduction of $100,000 for the cash charitable contribution.

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).
Brother-Sister Acquisitions

Facts: A sells X stock to Y Corp. for 100x of cash. Shareholder’s X stock basis is 100x.

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. §302 is applied to issuing corporation.

Bonus Thought Question: What happens to Shareholder’s basis in its X stock now that it no longer owns X stock?
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 from parent (Y) in redemption of parent’s (Y’s) stock.

Next question: Are any Code §302(b) redemption tests satisfied in this transaction? “Control” of each of the two corporations must exist. §302 is applied to issuing corporation.
If ordinary dividend treatment for tax purposes:
1) A §351 contribution to the acquiring corporation.
2) The acquiring corp. receives a transferred stock basis
3) E&P of the acquiring corporation is reduced when the dividend treatment occurs.

If an “exchange” occurs (§302(a)) then a cost basis for the shares received.
§304(a)(2)  
Collateral Income Tax Effects  

If ordinary dividend treatment for tax purposes:

1) Basis shifting from the contributed parent’s stock to the remaining parent stock held by the shareholder.

2) Reduce the acquiring subsidiary’s E&P to the extent of dividend treatment; then reduce the parent’s E&P.

If an “exchange” (§302(a)) occurs then (a) recovery of basis, and (b) capital gain for the parent stock.
Bernard & Tessie sold their AT&T common to Lents and retained their AT&T pref. stock. Does the sale of AT&T common produce capital gain treatment to Bernard & Tessie? **No!**

**Taxpayer Arguments:**

1) Bad blood and no attribution rules are applicable. **Rejected.**
2) Not essentially equivalent to a dividend? **Rejected:** no “meaningful reduction” of % interest. -90.49% reduced to 82.96%.
3) Terminated interest and §302(b)(3) is applicable but, **only after the preferred is redeemed.**Filed a §302(b)(3)), but two years late and no de minimis rule is applicable. No evidence of integrated plan says the majority.
4) Preferred stock as debt, not stock? No, rejected.
(a) Why did §304(a) apply? §304(a)(1) – (1) the sale to a related corporation and (2) combined with the application of attribution of ownership rules.

(b) Testing of the redemption (under §302(b)) to determine dividend status: §304(a)(1) – testing by reference to stock ownership in AT&T, i.e., the issuing corporation.

(c) Why unable to waive the family attribution rules? [No complete termination] of the actual interest in AT&T when the sale of the AT&T stock to Lents occurred (or part of a total sale plan) and no established intent to donate the preferred stock.

(d) How avoid this result? Qualify for §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.
Claude sells 20 of his Out shares to Bail for $4,000 (basis is $3,000, i.e., 1/3 of $9,000).

Results:
1) Constructive redemption of Bail stock.
2) Test the redemption % of Out stock (from 60% to 56%, 40% directly + 16% indirect).
3) Deemed transfer of Out stock to Bail.
4) Basis increase to Claude for Bail stock.
5) $4,000 dividend (qualified) to Claude.
6) Basis increase to Bail for Out stock.
Claude sells his 60 Out shares to Bail for 12K.

Answer: Treated as a redemption of Bail stock tested under §302 with reference to the Out stock. Before Claude owned 60% 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?).

Gain to Claude: 12K less 9AB = 3,000 capital gain
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).

This redemption produces a $3,000 dividend.
Same as (a) above, except that Claude receives one share of Bail stock (FMV - $1,000) and 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)).

Basis in Bail stock is 0 (3x less the 3x boot).
Redemptions to Pay Death Taxes

Code §303(a) enables cash availability to pay “death taxes” with no dividend effect.

Under §1014 the basis of stock is stepped-up at death to its FMV. Therefore, the income tax choices on the post-death stock redemption are:

1) **Zero** capital gain vs.

2) Ordinary dividend distribution.
1) Value of the redeemed stock must be included in determining the decedent’s gross estate.

2) Substantial portion of decedent’s estate – 35% of the 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).
§303 – Estate Tax Impact

Gross Estate $7,000,000 Estate Includes:
Expenses $300,000 Y: $1.2 mil/$4.8 mil = 25%
Net Estate $5,700,000 X: $1.2 mil / $4.2 mil = 28.57%
35% of Net Estate $2,345,000 (include Adele’s stock)

Wife also owns 14.2% of X corp. stock. Y corp redeems shares from estate. Does the redemption qualify for exchange treatment under §303?

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

2) Qualification for §303(b)(2)(A) test: Wife’s stock is not counted for this purpose. Estate’s stock: 600k plus $1.2 million is less than $2,345,000 (35% of 6.7 million).