

Chapter 5 - 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 by shareholder to the issuing corporation of corp’s own stock?

If a stock redemption occurs is this transaction:

- 1) a property sale (§1001 realization event), or
- 2) a dividend distribution (i.e., E&P sourced)?

Income Tax Treatment of a Redemption to Shareholder

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

- 1) Stock sale (with an income tax basis recovery).
- 2) Dividend equivalency (& no tax basis offset).

What is the relevance of the 2013 tax legislation (20% capital gains and 20% dividend tax rate)?

The difference: income tax basis recovery in the stock sale transaction.

Code §302(a) – “Exchange” Treatment to 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) – the stock redemption occurs after a partial liquidation (measured by reference to events at the corporate level).

Tax Basis Consequences if No Dividend Treatment p.200



Corporation buys back only certain shares held by the shareholder & no dividend treatment occurs:

How is the tax basis to be recovered (particularly for the shares which are redeemed)?

Tax basis allocation is to be made prorata to all shareholder's shares (both redeemed and remaining shares).

Amounts in excess of tax basis produce gain under §301(c)(3).

Tax Basis Consequences if Dividend Treatment p.200



**Corporation buys back only certain shares held by the shareholder & dividend treatment occurs:
Tax basis for the disappeared shares is allocated proportionately to the remaining shares.**

Stock Redemptions & Corporate Level Treatment

- 1) §311 (p. 202) - gain recognition occurs upon a corporate distribution of appreciated property in a stock redemption transaction, but no loss recognition is permitted.
- 2) What effect on the distributor corporation's E&P account when appreciated (or depreciated) property is distributed in a redemption transaction? See §312(b) re an E&P increase.

Business Objectives for Stock Redemptions

p.202

- 1) Enable shift of corporate control (e.g., to younger generation members in a closely-held corporation).**
- 2) Buy-out of the share interest of a disgruntled or deceased shareholder.**
- 3) Liquidity to one or more shareholders.**
- 4) Stock buyback program for a publicly held corporation, e.g., to reduce the equity base (and increase the earnings per share, etc.).**

Constructive Ownership of Stock - Code §318 Rules

What is the function of the “constructive ownership” or “attribution of ownership” rules?

Assumption: commonality of ownership causes parties to coordinate the income 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 the Father as a continuing stock owner? Possibly.

Constructive Ownership of Stock - Code §318 Rules

1) §318(a)(1). Family deemed ownership attribution – to spouse, children, grandchildren and parents. Not to siblings and not to GP from GC (but from GP to GC).

Consider the impact of the Windsor case (DOMA illegal) and Rev. Rul. 2013-17 recognizing same sex marriages. What impact if filing an income tax refund claim based on same sex marital status for an earlier year (& joint return benefit) when a stock redemption occurred – §318(a)(1) applicable?

Constructive Ownership of Stock - Code §318 Rules

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 the beneficiaries (allocation based on actuarial interest of the beneficiary).

c) Corporation to some (i.e., 50% or more) shareholders.

Constructive Ownership of Stock - Code §318, cont.

3) §318(a)(3). From owner to the entity:

a) Stock owned by partners or by beneficiaries of an estate or trust (not a grantor trust) is considered as owned by/attributed to the partnership or estate.

b) Stock owned by a 50% or more shareholder is attributed to the corporation.

4) §318(a)(4). An option to acquire stock is equivalent to the ownership of that stock (even if the option is seriously “underwater”?).

Constructive Ownership of Stock – Operating Rules

- 1) No family reattribution (e.g., child to mother to father).
- 2) No “sidewise” attribution – e.g., attribution
 - (a) from one partner to the partnership, and
 - (b) then to another partner.
- 3) S corporations are treated as partnerships and S corporation shareholders are treated as partners.

Problem 1

Family Attribution

p.205

Wham Corp has 100 common shares outstanding:

<u>GF</u>	<u>Mother</u>	<u>Daughter</u>	<u>Son</u>	<u>GM's Estate</u>
25	20	15	10	30

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

Problem 1, p.205

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) – (a) from GM's estate to mother & (b) then from mother to GF - §318(a)(1)(A)(ii). Reattribution is permitted here. §318(a)(5)(A).

Problem 1, p.205

(Grand) 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 (only) shares owned through mother's option. §§318(a)(4) & 318(a)(5)(D). No double attribution for the other 5 shares.**
- d) 15 sh. (thru Mom) from GM's estate. 318(a)(2)(A)**
- e) GF to (grand) daughter – no & not thru Mom.**

Problem 1, p.205

GM's Estate's stock owned

Grandmother's estate - 100 shares owned.

- a) 30 shares are owned directly.
- b) 20 shares are owned by mother - since Mom is an estate beneficiary. §318(a)(3)(A).
- c) 50 shares are owned through Mother by GF (25), daughter (15) & son (10). §318(a)(1)(A) & §318(a)(3)(A). No limit on reattribution to an entity.

Problem 2

p.205

M –
(W's
Mother)

W- (A's wife)
owns

A B C D
(unrelated)

equal partners in
Partnership

100 shares
being
100% of shares of
Yancy Corp

which owns 100
shares - being
100% of shares of
Xerxes Corp

Problem 2(a), p.205

Number of Xerxes shares owned by:

- 1) A - 25 shares are owned by attribution from the partnership. §318(a)(2)(A).
- 2) W- 25 owned by A & attributed to W - through family attribution. §318(a)(1)(A)(i).
- 3) M - W's mother - does not own any shares in Xerxes. Shares attributed to W from A are not reattributed under the family attribution rules. §318(a)(5)(B).

Problem 2(b), p.205

Shares of Xerxes owned by Yancy:

Premise (re W to Yancy): stock owned by a 50 percent or greater shareholder of a corporation is attributed to the corporation - §318(a)(3)(C).

Result: 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 percent or more of Yancy (i.e., W can instruct Yancy).

Problem 2(c), p.205

Determination of shares of Yancy owned by Partnership, B, C, D & Xerxes:

- 1) Partnership - constructively owns the 100 shares in Yancy: (a) W's 100 shares are attributed to A, & (b) A's 100 shares are reattributed to Ptnshp.
- 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 **P.205** **Disproportionate Redemp.**

§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).**

§302(b)(2) Issues

p.206

- 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 (e.g., cumulative preferred stock).
- 2) How can nonvoting stock be redeemed under §302(b)(2) (since no reduction in the “vote”)?
Only by “piggybacking” on a qualifying redemption of voting stock (per Reg. §1.302-3(a)) .

Multiple Stock Redemptions

B indicated to A, the majority shareholder, B's intention to terminate status as a shareholder.

A redeemed & (temporarily) A then owned less than 50% 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). Transactions “causally related.”

Problem 1 (Y Corp)

§302(b)(2) Eligibility

p.209

<u>Alice</u>	<u>Cathy</u>	<u>Totals</u>
80 common	20 common	100
100 nonvoting	100 nonvoting	200
<u>preferred</u>	<u>preferred</u>	

a) Redeem A's 75 preferred shares.

Not qualified – Reg. §1.302-3(a).

No reduction in A's voting shares.

Problem 1 (Y Corp)

§302(b)(2) Eligibility

p.209

<u>Alice</u>	<u>Cathy</u>	<u>Totals</u>
80 common	20 common	100
100 nonvoting <u>preferred</u>	100 nonvoting <u>preferred</u>	200

b) Also redeem 60 of Alice's common shares.

Not qualifying – Alice owns before: 80/100

Alice owns after: 20/40 – therefore, not owning less than 50 percent of the stock after transaction.

Problem 1 (Y Corp)

§302(b)(2) Eligibility

p.209

<u>Alice</u>	<u>Cathy</u>	<u>Totals</u>
80 common	20 common	100
100 nonvoting	100 nonvoting	200
<u>preferred</u>	<u>preferred</u>	

c) Also redeem 70 of Alice's common shares.

Yes, qualifies under §302(b)(2). After redemption Alice owns 10/30 or 1/3 of voting power (not 50%).

Also, 1/3rd is less than 80% of 80% of vote before.

& redemption of preferred piggybacks voting stock.

Problem 1 (Y Corp)

§302(b)(2) Eligibility

p.209

<u>Alice</u>	<u>Cathy</u>	<u>Totals</u>
80 common	20 common	100
100 nonvoting	100 nonvoting	200
<u>preferred</u>	<u>preferred</u>	

d) Also redeem 10 of Cathy's common later.
Application of the step-transaction doctrine?

Is Cathy's redemption part of a coordinated plan?

See §302(b)(2)(D) & Reg. § 1.302-3(a) – use all “facts & circumstances” to determine whether a plan exists. Use either the Code § or tax common law.

Problem 2, Z Corp., Voting & Nonvoting

p.209

<u>Don</u>	<u>Jerry</u>	<u>Total</u>
60 voting com.	40 voting com.	100
100 nonvoting	100 nonvoting	<u>200</u>
<u>common</u>	<u>common</u>	<u>300</u>

Z redeems only 30 of Don's voting common.

Question: §302(b)(2) qualification?

- 1) 60/100 voting to 30/70 = 42.9% (less than 48%).
- 2) 160/300 (53.3%) total to 130/270 – not sufficient.
(needs 80% of 53.3% = 42.66%; here 48.1%)

Complete Termination —

Code §302(b)(3) P.210

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 to enable capital transaction treatment for tax purposes? Consider the applicability of the §318 constructive ownership rules.

Can Family Attribution Rules be Waived?

Code §302(c)(1) & (2).

Attribution of ownership rules can preclude a complete termination occurring, unless the ownership attribution rules are made inapplicable.

§302(c)(2) permits (1) a possible waiver of the family attribution rules, but (2) no waiver of the entity or option ownership attribution rules.

Code §302(c) Limitations on Waiving Attribution Rule

1) Can have no continuing interest as an officer, director, or employee; cf., concern about status as 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 (a) by a relative or (b) from a relative within the prior ten years - unless income tax avoidance is *not* one of the principal purposes for that acquisition.

Lynch case

p.211

Attribution Cut-off? §302(c)(2)

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 an 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 exists for the seller (i.e., other than officer, director or employee status).

Board of Directors Status

Facts: Stock sale made on an installment basis and the 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 Code §302(c)(2)(A)(i).

Observer status at the Board meetings is OK.

Rev Rul. 77-293

§302(c)(2)(B)(ii)

p.220


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

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

Query: Does an objective exist to withdraw value at capital gains rates when coupled with continued control or an economic interest in the corp.?

Limitations on the Retained Interest

p.222

- 
- 1) Cannot be (a) a custodian under TUTMA or (b) a “voting trustee” of the corp. stock.
 - 2) Re-acquisition of the redeemed stock is permitted only as a result of an inheritance or bequest (or only an interest as an executor).
 - 3) Deferred payment redemptions are permitted, subject to certain limitations (e.g., how long?).
 - 4) Leasing property to the corporation on an arm's length basis is acceptable.

Waiver of Attribution of Ownership by Entities

P. 225. §302(c)(2)(A) & (B) only permit the waiver of the 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 (but the individual shareholder(s) also must waive).

Problem 1

p.227

Complete Redemptions?

John

(parent)

100 shares

Alison

(daughter)

50 shares

Chuck

(grandson)

25 shares

Randall Corp

Problem 2

p.227

Estate Planning Structure

B&B Windshield Wiper 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 the prior ten year period. Query: For an income tax avoidance (principal) purpose?

Problem 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 by corporation.

Problem 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 - is this a noncreditor interest which constitutes a prohibited interest under §302(c)(2)(A)(i)? Yes?

Cannot have a "financial stake" in enterprise.
What result here? Lynch vs. U.S. Tax Court.

Problem 3(a)

Cinelab

p.228

<u>John</u>	<u>Mary (sister)</u>	<u>Estate of Sam (father)</u>
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		Bella (mother) as the estate beneficiary
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50	30	20
shares	shares	shares

Redemption of the Estate's 20 shares - Is a Code §302(c)(2) waiver of constructive ownership rules available? Estate files waiver to cut off attribution. Estate and Bella both to sign waiver.

Problem 3(b)

Cinelab

p.228



<u>John</u>	<u>Mary (sister)</u>	<u>Estate of Sam (father)</u>
		Bella (mother) as resid. bene. of the estate
50	30	20
shares	shares	shares

Re: Estate of Sam

- (i) John & Mary are specific legatees; &
- (ii) Bella is the residuary beneficiary.

No cutoff – unless the legacies are first distributed.

Problem 3(c)

Cinelab

p.228

<u>John</u>	<u>Mary (sister)</u>	<u>Estate of Sam (father)</u>
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50

30

20

shares

shares

shares

John & Mary are residuary beneficiaries of the estate. Any possible cutoff of the attribution of ownership rules?

No: John & Mary cannot terminate their estate beneficiary status here. Estate is deemed to own all the stock under constructive ownership rules.

Problem 3(d) & (e)

Cinelab

p.228

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

(d) Shares of the trust are redeemed. Is a waiver acceptable to eliminate attribution? Yes.

(e) Nancy subsequently acquires shares.

Impact of the ten year “look forward” rule?
Violated? Uncertain.

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

Davis case

p.229

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 his vote %.

Constructive ownership rules do apply.

Voting Power Controls

Trust owned nonvoting common & preferred stock.

Redemption of only nonvoting preferred stock. No redemption of any common stock.

18 percent of voting stock owned both before and after by Trust's beneficiary & therefore, by Trust.

Reduction in *voting power* as the *key factor*.

Shareholder still participates in same voting blocks.

Held: Not a “meaningful reduction” & the

§302(b)(1) requirements are not satisfied.

Rev. Rul. 75-502

note case

p.238

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% for its constructive ownership in the corporation.

A meaningful reduction resulted for the estate.

Rev Rul. 75-512

note case

p.238

Corp. redeemed all 75 shares owned by the trust.

Prior to redemption the 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 the impact of trust's voting rights.

Limited Participation Situations

p.239-240

- 1) Redemption of nonvoting preferred stock (only owned) – not essentially equivalent to a dividend.
- 2) Redemption of a minor interest in a public corporation, i.e., a “stock buy-back program.” No meaningful reduction – but no impact on corporate management & therefore?
- 3) Relevance of “super-majority” rules? E.g., no longer a capacity to quash a merger transaction, but authority to control the vote on officers and dividends. When relevant? Imminent deal?

Relevance of Family Discord

p. 239

Is family discord relevant in determining the applicability/non-applicability of the §318(a)(1) family attribution rules in the stock redemption context? No.

Question: How demonstrate this intra-family hostility (i.e., the “family fight”) to the satisfaction of the IRS? Assuming no “complete termination” treatment (§302(b)(3)) because of a continuing employment relationship (Cerone case, p. 239).

Tax Basis Allocation Issues

p.241


When a stock redemption is treated as a dividend distribution: what happens to the tax basis of the disappeared shares?

- 1) Allocation to shareholder's remaining shares.
- 2) If all shares are sold (but dividend treatment still occurs because of §318) – basis allocation to related parties? Or: Prop. Regs. (p. 241): deferred loss to the selling shareholder & deferral until later redemption transaction qualification.

Problem 1

Meaningful Reduction?

p. 242



A	B	C	D
28	25	23	24
shares	shares	shares	shares

Z Corporation

100 total shares

Effect of various redemptions by A?

Problem 2, p.242

Common & Preferred

Shareholder	Common <u>Shares</u>	Preferred <u>Shares</u>
A	40	0
B	20	55
C	25	10
D	15	15
E	0	20

Problem 3

p.242

Treatment of Tax Basis

(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) 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. Or, deferred loss?

Partial Liquidations

Corporate Level Testing

Code §302(b)(4) - redemption treatment for partial liquidations (if non-corporate status of shareholder).

Redemption treatment is available to the shareholder, but 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.

Code §302(e)(2) Safe Harbor for a partial liquidation p.244

- 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 the acquisition.

Rev. Rul. 79-184

p.245

Stock vs. Assets Disposition

Sale of the stock of a subsidiary & the distribution of the proceeds held not to be a distribution in partial liquidation of the distributing corporation.

Not a corporate business 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 relevance of Code §381 (re: tax attribute carryovers to parent).

Problem

Partial Liquidation?

p.247

Michael
(1/3)

Pamela
(M's wife)(1/3)

Iris Corp.
(1/3)

ALPHA

Books
(division)

Cram
(division)


Beta, Inc.
(100% sub)

Securities
portfolio

Problem

Partial Liquidation?

p.247

- 
- (a) Michael & Pamela – exchange treatment under §302(b)(4) & 302(e)(2). Iris is not eligible (as corp) & §301 distribution (under §302(d)) & is subject to §1059 (extraordinary dividend treatment – tax basis reduced for nontaxed portion of the dividend).
- (b) Not satisfying §302(e)(2) for individuals because of time limit? But, eligible under §302(e)(1)?
- “Tacking” when tax-free reorg. occurs – if the business was conducted for five years.

Problem

p.247

Partial Liquidation?

(c) Fire & ½ the insurance proceeds distributed.
Not qualifying under §302(e)(2) (not ceasing business), but §302(e)(1) – not essentially equivalent to a dividend? A sufficient corporate contraction?

(d) Books assets distributed to Michael:

(1) partial liquidation under §302(b)(4) (and no family attribution rules apply); and, (2) §302(b)(1) – since Michael's interest goes from 66 2/3rd to 50% (with attribution of ownership). Rev. Rul. 75-502.

Problem

p.247

Partial Liquidation?

(e) Assets of Books to Iris (corp) to redeem all its Alpha stock. §302(b)(3) complete termination of Iris's interest in Alpha results.

(f) Distribution of the securities portfolio: this is not a qualified corporate contraction. All the shareholders have a §301 (dividend) distribution.

Problem

p.247

Partial Liquidation?

(g) Alpha sells Beta stock and pro-rata distribution of the proceeds occurs. Sale of sub's stock is not a qualifying partial liquidation. Rev. Rul. 79-184. Therefore, a §301 (dividend) distribution.

(h) Alpha liquidates Beta and then Alpha distributes the Beta assets. A qualifying partial liquidation distribution occurs under §302(b)(4). Later discussion: this is a tax-free liquidation of sub into parent under §332.

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. on distribution.

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. Cf., §301 distribution.

Rev. Rul. 74-338 p.249 (note)

E&P Determination

What pro-rata share of E&P is attributable to redeemed shares (when cap gain treatment)?

Consider both: (1) current E&P and accumulated E&P; and (2) current dividend distributions and redemption distributions.

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

Problem

Stock Redemption

p.250

Facts: 200 shares at price of \$1,000 per share.

Each of two shareholders has 100 shares & \$100,000 basis. \$100,000 accumulated e&p and \$100,000 current e&p.

Redemption of A's shares - X distributes cash. 1/2 of corporation's shares are redeemed; cf., dividend treatment. Redemption distribution is mid-year.

Here: 7-1 redemption; E&P then is 100 acc. E&P & 50% of current e&p = 150,000 e&p times 50% shareholder = 75,000 charge to E&P.

Stock Redemption Expenses §162(k) p.251

All expenditures incurred by a corporation in purchasing stock are non-deductible, non-amortizable (i.e., “frozen”) 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 (when funded to pay greenmail costs). Loan is a separate transaction.

Bootstrap Acquisitions

(Rev Rul. 75-447)

P.253

Zenz v. Quinlivan – (1) Sale of stock to a third party; & (2) three weeks later a redemption of the balance of outstanding shares. Shareholder terminated entire interest in the corporation.

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, a capital gains transaction treatment.

Integrated Transactions



Situation One:

Corporation X shares are equally owned by A and B (50 each).

- (1) 25 new shares issued to C by Corporation X, and**
- (2) A & B then each redeem 25 shares.**

A & B owned 50% before new shares and 33 1/3% after the stock redemption.

Requirements of §302(b)(2) are satisfied.

Sale & Redemption Option

Situation Two:

- (1) Sale of shares to C by A & B, and
- (2) Redemption of a 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.

Problem

p.255

Redemption Occurs First

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 (i.e., tax basis is to be fully recovered)?

Buy-Sell Agreement

p.256

Objectives of the “buy-sell agreement”:

- 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/deceased shareholder - assurance that his successors (spouse & children) are not in a minority/non-controlling shareholder position after the death of that shareholder.**

Types of Buy-Sell Arrangements

- 1) Cross-purchase: a capital gains event; but, if a sale occurs after death, limited capital gain since the tax basis for shares is stepped up (down?) (§1014, in 2011 & thereafter) to the FMV of the stock at the death of the stockholder.
- 2) Entity purchase: redemption treatment and possible dividend risks.
- 3) Combination transaction: Zenz situation - analysis should be whether cap gain status exists.

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 tax effect of 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. Rev. Rul. 69-608, p.258

(later slide)

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 a “multiple” of the book value?
But, mark to market (rather than book) for certain (e.g., investment) assets held by the corporation?
- 3) Independent appraisal of the corporation’s shares. Who appoints appraiser? MAI appraisal.
- 4) Apply a “multiple” times: (a) earnings (which years? most recent?); or, (b) cash flow?

Terms of Payment for the Shares Sold



1) Cash

2) Deferred payments:

a) installment reporting for income tax?

b) what risk to stock redemption tax treatment?

c) security arrangements: (i) escrow of the redeemed stock - but cannot get the stock back; (ii) assets are pledged; or, (iii) a letter of credit or an indemnity policy.

d) use negative covenants in the loan agreement.

Life Insurance Tax & Related Considerations

Life 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. Use a trust?

B) Entity purchase - insurance proceeds flow into the corporation and at shareholder's death the value of the corporation & E&P are increased by the difference between (1) book value and (2) face value of the life insurance policy. Who benefits?

Transfer Tax Considerations

**§2703
p. 257**

Value of shares is to be determined for 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.

But, §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, p.258.

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 a dividend distribution being treated as made to the remaining shareholder(s).

Problem

Buy-Sell Tax Issues

p.262

A, B & C each own 1/3 of X corporation.

A cross purchase agreement is in place.

a) Sale by B of 1/2 of shares to each of A & C:

Proceeds to B equal B's stepped-up basis.

b) B's stock redemption by X results in a complete termination (§302(b)(3) – unrelated parties) and the distribution equals B's stepped-up basis.

X's E&P is reduced - §312(n)(7).

continued

Problem

Buy-Sell Tax Issues

p.262

A, B & C each own 1/3 of Y corporation.

(c) A & C to buy B's stock over ten years, but the obligation is assigned to X corp:

If gain to B on the redemption - installment sale reporting would be available (but no gain here).

But, for A & C, the primary obligation is assumed by X corp. and constructive dividend distribution occurs to A & C when X corp. makes installment payments.

continued

Problem

Buy-Sell Tax Issues

p.262

A, B & C each own 1/3 of Y corporation.

(d) A & C have options to buy B's stock when B retires, but X corp. actually buys B's stock.

B has no gain since the sale was for tax basis.

No constructive dividend to A & C since the options were not primary and unconditional obligations on them when assumed by the corp.

continued

Problem

Buy-Sell Tax Issues

p.262

A, B & C each own 1/3 of X corporation.

(e) A cross purchase agreement is in place.

X Corp. purchased life insurance on the lives of the shareholders and paid the premiums on this life insurance. X Corp. is the owner of the policies and is also the beneficiary under these policies.

B dies and X Corp. uses the proceeds to redeem B's stock. B has sale proceeds (but no actual gain due to tax basis step-up)

continued

Problem (e) cont. p.262

Treatment to X Corp.

1) Are the premiums deductible by X Corp.?

No, §264(a)(1).

2) At death the insurance proceeds are received tax-free by X Corp. §101(a)(1), i.e., not gross income.

3) The excess of the insurance proceeds over the aggregate premiums is included in the X Corp E&P upon the collection of the proceeds.

continued

Problem - Treatment to Shareholders A&C p.262

(e) cont.

A&C as the remaining shareholders.

- 1) No constructive dividends upon the insurance premium payments by X Corp. (i.e., prior to the death of B).
- 2) A & C do have constructive dividend distribution treatment upon the *stock redemption* because of the pre-existing binding obligations of A & C to purchase B's estate's shares.

Divorce Redemptions p.262

Who Has Redeemed?

Arnes v. United States He and she each owned 50 percent of Corp. Divorce agreement for the redemption of her 50 percent interest (required by franchisor). Installment sale reporting of gain.

In refund litigation she asserts the transaction really is a stock transfer to husband and she is protected from gain recognition because of §1041.

Issue: Does this constitute a transfer to a third party by the ex-wife? Held: No, really a transfer to the husband, & no gain to be recognized by her.

Treatment of Nontransferor Spouse

p. 267

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

Treatment of the remaining shareholder spouse as

- (1) receiving a constructive dividend, and
- (2) transferring the proceeds to the ex-spouse –

since tax-paid cash is received by the departing Spouse & sourced from the corporation?

What Divorce Tax Planning in this Context? P.270

Get her (departing shareholder) to redeem and obtain LT capital gains treatment (at 20%) after her income tax basis recovery for the shares?

Or, does he redeem from the corporation to get cash to pay her and (as the remaining shareholder) he has 20% dividend treatment on his stock redemption (since he is not eligible for “sale or exchange” treatment)?

Ultimate question: Does he have (1) primary or (2) secondary liability for this payment to her?

Divorce Redemptions, Final Regulations p.269

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

Option One: Dividend tax to the nontransferor if a primary and unconditional obligation exists on him.

Option Two: Tax to the transferor spouse if no such obligation - capital gain treatment – no §1041.

Option Three: Choose which spouse is to be taxable - enabling negotiation in their divorce deal.

But, the deal must be in writing. And, timely.

Divorce Redemptions, Problem p.270

How structure H's buy-out of W?

(a) H buys W's stock: Incident to divorce and no gain to W. §1041. Built-in gain on stock is deferred.

(b) Corp. to redeem: Arnes case – no gain to W since her stock transfer to Corp. is on behalf of H.

Therefore, §1041 treatment to W.

As if W transferred shares to H and Corp.

Redeemed shares from H and H used cash to buy W's stock. *continued*

Divorce Redemptions, Problem p.270

(c) How structure H's buy-out of W?

Redeem W's shares and (1) avoid constructive dividend treatment to H, and

(2) reduce E&P when this redemption occurs.

H & W make a deal on the capital gains tax burden.

Use this “special rule” to get best after-tax results.

Or, seek to exploit possible inconsistent treatment (by litigating in different courts?)

Charitable Contribution & Redemption Transaction

Grove v. Commissioner

p.271

Facts: Grove donated to charity shares of closely-held corporation's stock & retained a life interest.

The charity (RPI) signed the buy-sell agreement.

Shares were redeemed (at book value) by the issuing corporation 1-2 years after charitable contribution.

Held: No agreement was made for the charitable donee to redeem shares. Therefore, gifts of stock and no dividend distribution.

Sequel to the Grove case

p.278

Rev. Rul. 78-197 – dividend treatment 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 the trustees/directors violate fiduciary responsibilities if not selling illiquid shares?

Note alternative (now required) charitable gift techniques, e.g., CRAT & CRUT, to get the charitable contributions income tax deduction when only remainder interest is gifted to charity.

Problem

p.279

Charitable Gift of Shares

Query: 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: (1) \$100,000 taxable dividend distribution, and (2) income tax deduction of \$100,000 for the cash charitable contribution. *continued*

Problem, cont.

p.279

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

No legal obligation to redeem.

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

Redemptions Through Related Corporations p.279

Brother-sister acquisitions - §304(a)(1) & (b)(2).

A (individual or corp.) owns 100% of:

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. Note §318 applies.

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

Facts:

- A - shareholder
- P - parent
- S - subsidiary

Stock of P is sold by A to S. Satisfaction of a 50 percent control test must occur.

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?

Considering the Collateral Income Tax Effects p.282

- 1) Dividend treatment or redemption treatment?
- 2) How test for dividend treatment?
- 3) If a dividend results, where is the distribution of E&P sourced from (a) first and (b) second?
- 4) What is the tax basis for stock acquired by the purchasing corporation (cost or transferred)? & what basis reduction for the deemed distribution?
- 5) What is the reduction of the E&P account (whether dividend or redemption)?

§304(a)(1) - Collateral Income Tax Effects p.282

If ordinary dividend treatment for tax purposes:

- 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 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) Sub's basis for parent stock is cost.
- 3) Reduce the sub's E&P when dividend treatment; then, reduce the parent's E&P. If an "exchange" (§302(a)) occurs: (a) recovery of basis, & (b) capital gain for parent stock sale.

Niedermeyer v. Comm.

§304(a)(1)

p.284

Bernard, Jr. Bernard(F) Ed Linus Thomas
& Walter & Tessie(M)

67.91% 22.58% *com.+pref.* 67%

AT&T

Lents Industries

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

Issue: Does the sale of AT&T common produce
capital gain treatment to Bernard & Tessie? No.

§304(a)(1) applies (constructive ownership rules).

Taxpayer's arguments in Niedemeyer case

1) Bad blood and no ownership attribution rules are applicable. Rejected. P.286.

2) Not “essentially equivalent” to a dividend?

But, no “meaningful reduction” of % interest.

- 90.49% reduced to 82.96 %. P.288.

3) Terminated interest & §302(b)(3) is applicable –

a) but, only after the preferred has been redeemed.

b) filed a §302(b)(3) agreement, but two years late,

& c) no de minimis rule is applicable.

4) Preferred stock as debt, not stock? No, rejected,

Problem 1

p.292

Re: Niedermeyer case

(a) Why did §304(a) apply?

§304(a)(1) – (1) the sale of controlled shares made to a related corporation & (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.

Problem 1, cont., p.292

Re: Niedermeyer case

1(c) Why unable to waive the family attribution rules? (1) 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), & (2) no established intent to donate preferred stock.

1(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 treated similar to the Zenz v. Quinlivan decision re an integrated transaction.

Problem 2

p.292

Partial Sale of Shares of Out

Claude

owns 80%

Bail Corp. (buyer)

\$40,000 basis

(80 shares @ \$500)

(Bail - no e&p)

owns 60%

Out Corp.

\$9,000 basis

(60 shares @ \$150)

(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). Claude controls both Bail and Out. *continued*

Problem 2(a)

p.292

- 1) Constructive redemption of Bail stock.**
- 2) Test the redemption % of Out stock**
(from 60% to 56%, 40% directly + 16% indirect,
i.e., 80% of 20 shares)
- 3) Deemed transfer by Claude of Out stock to Bail.**
- 4) Bail basis increase by 3x (to 43x) to Claude.**
- 5) \$4,000 dividend distribution to Claude & Out's**
E&P reduction is \$4,000. No §302(b) redemption.
- 6) \$3,000 basis to Bail for Out stock - §362(a)(2).**

Problem 2(b)

p.292

Sale of All Out Shares to Bail

Claude sells all his 60 Out shares to Bail for 12x.
Treated as a redemption of Bail stock tested under §302 with reference to the Out stock.

Before redemption Claude owned 60% of Out.

After this redemption he owns 48% of Out by attribution through Bail (80% of 60 shares);
§318(a)(2)(C). Treat as under §302(b)(1) (yes?) or §302(b)(2) (no, since reduction is exactly 80%)?

Gain to Claude: 12x sale less 9x basis = 3x (CG?)

E&P reduction (to Bail?) - §312(n)(7) since a sale.

Problem 2(c)

p.292

Stock of Purchaser Received

Same as (a) above, except that Claude receives \$3,000 and one share of \$1000 Bail stock for his 20 Out shares. Claude's argument - this is a §351 transaction (& §368(c) control exists), and Bail stock is received (& boot = \$4x received less 3x basis = 1x gain).

But, cf., §351(b) (boot) vs. §304(b)(3)(A) (noting that §351 is not applicable).

This redemption then produces a \$3,000 dividend.

Problem 2(d)

Assumed Liability

p.292

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

“Acquisition debt” - §357 applies and no gain is recognized on this transfer. Basis in Bail stock is 0 (3x less the 3x boot), per §358(d).

Redemptions to Pay Death Taxes

p.292

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

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 (i.e., tax basis recovery)

vs.

2) ordinary dividend distribution (if E&P).

Section 303 Eligibility Requirements

p.293-4

- 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). §303(b)(2).
- 3) Timing of the redemption: within 90 days after expiration of the 3 year S/L. §303(b)(1)(A).
- 4) Eligible shareholders - where the interest of the beneficiary is reduced directly by a liability for death taxes (e.g., residuary estate). §303(b)(3).

Problem

p.294

§303 – Estate Tax Impact

Gross estate \$7,000,000

Expenses 300,000

Net estate 6,700,000 x 35% = 2.345 mil.

Estate includes:

X corp. stock, \$600,000 of 4.2 mil. total X corp. fmV.

(Wife also owns \$600,000 of X corp. stock).

Y corp. stock - 1.2mil. of 4.8 mil. total Y corp. fmV.

Issues concern qualification under §303. *continued*

Problem, continued

p.294

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

Y Corp: $1,200,000 / 4,800,000 = 25\%$

(owned 1.2 million with wife as co-owner)

X Corp: $1,200,000 / 4,200,000 = 28.57\%$

(includes wife's separately owned stock)

continued

Problem, continued

p.294

2) Qualification for §303(b)(2)(A) test (no):

Wife's stock is not counted for this purpose.

Therefore, Estate's stock is:

(1) 600,000 plus (2) 1,200,000 equals \$1,800,000.

This \$1,800,000 is less than the \$2,345,000 minimum (35% of 6.7 mil.).