

GA/6B

LESSON 6

Stock Redemptions and Partial Liquidations

6A General

Note: The 2003 legislation reducing the top rate on dividends to the same rate as capital gains (15 percent) has greatly reduced the importance of the § 302 qualification (the principal remaining advantage now is the ability to offset basis in computing gain or loss).

(1) *A* has \$200 in amount realized and \$100 in capital gain realized and recognized. IRC § 1001; Regs. § 1.61-6(a) (which requires *A* to spread the \$600 basis, \$10 per share). If *A* has 10 shares with \$20 basis per share, *A* will be well advised to select these shares to sell, yielding no gain under Regs. §§ 1.1012-1(c)(1) through 1.1012-1(c)(5). B&E ¶¶ 9.21, 12.44[3][c]. Note that in contrast to the following questions involving redemptions, as a seller of stock to *B*, *A* clearly uses stock basis to prevent income recognition, *A* clearly benefits from any capital gains preference (currently 15 percent) that the tax law may provide, and *A* is unconcerned with *X*'s E&P.

The pattern of the *Schneider* case could apply, however, to convert *A*'s sale to *B* into a constructive redemption by *X*, if *X* really were obligated to provide the 10 shares to *B* and in effect paid the \$200 to *A*.

Discuss other patterns that are treated as redemptions but do not appear to be in form: *Rogers*, *Casco*, and Rev. Rul. 78-250; but cf. Rev. Rul. 73-427, where source of payment to cashed-out minority was the acquirer rather than the corporation, and minority had a sale to the acquirer, not a redemption. B&E ¶¶ 9.01[3], 9.01[6].

(2) This is a redemption under § 317(b). Under § 302(d) (the general rule, although not labeled as such), it is a distribution governed by § 301, unless, *inter alia*, § 302(a) otherwise provides. Section 302(a) does so provide if § 302(b)(1), § 302(b)(2), §

302(b)(3), or § 302(b)(4) applies, in which case the redemption is treated as a sale or exchange of the stock by A. B&E ¶ 9.01[3].

At this point, survey § 302(b) from the bottom up. Section 302(b)(5) provides operating rules. No facts indicate a § 302(b)(4) partial liquidation, to which we will return. A's interest as a stockholder was not terminated. However, § 302(b)(2) does apply. A now has 30/70, which is less than 50 percent of the vote; A's percentage of the vote and of the common stock has dropped from 60 percent (of which 80 percent is 48 percent) to 42.86 percent, so the substantially disproportionate test is met. Therefore, A has \$300 capital gain. B&E ¶ 9.03.

Discuss possible variations. Could § 302(b)(2) apply if A held only voting preferred stock? Yes, because the reduction of common stock is required only if A has common. Rev. Rul. 81-41. Could § 302(b)(2) apply if A held only nonvoting stock? No. Regs. § 1.302-3(a); B&E ¶ 9.03.

X would have an E&P reduction of \$600 under § 312(a), but the reduction is limited to $30/100 \times \$500$, or \$150, by § 312(n)(7) because (and only when) § 302(a) applies. The remaining \$450 is a charge to X's capital account. B&E ¶ 9.24[3][b].

Consider discussing E&P results when X makes both a redemption (treated as sale or exchange) and ordinary distributions in a tax year. Ordinary distributions take priority over redemption/sales for E&P of the current year. Rev. Ruls. 74-338, 74-339. Also note issues of apportioning E&P to multiple classes of stock and limitation of reduction to amount of the distribution. B&E ¶¶ 8.02, 8.03, 9.24.

(3) A has not terminated his stock ownership and has not had a substantially disproportionate redemption, because his vote did not drop below 50 percent but rather went down to 50 percent (40/80). This is sufficient for § 302(b)(1) under Rev. Rul. 75-502, which also involved a two-shareholder corporation. (The results might be different if the other 50 percent were owned by several shareholders.) Therefore, A has \$200 in capital gain, and X's E&P is reduced to \$400. B&E ¶¶ 9.05, 9.24.

Either before or after reaching the answer to this problem, consider reviewing the history of and major authorities in the NEED area. *Himmel* properly identified the three rights inhering in stock that may be reduced in a true redemption/sale, but, since nonvoting stock was redeemed, that opinion pursued a confusing search for comparison with results of a hypothetical pro rata dividend on common stock. Davis called for a "meaningful reduction of . . . proportionate interest." B&E ¶ 9.05. Note that corporate shareholders often want dividends to take advantage of § 243. Since 2003, noncorporate shareholders pay the same tax rate on dividends and capital gains (the top

rate is 15 percent), so the tax stakes now relate solely to the ability to offset basis in computing gain or loss if § 302(a) applies.

It may help to organize and present the authorities in the following order (B&E ¶ 9.05):

1. Redeemed shareholder owns only nonvoting stock:
 - a. Regs. § 1.302-2(a). Redemption of one half of shareholder's nonvoting stock is NEED.
 - b. Rev. Rul. 77-426. Redemption of any of shareholder's pure preferred stock is NEED.
2. Redeemed shareholder owns both voting and nonvoting stock and the nonvoting stock is redeemed:
 - a. Davis: Dividend where shareholder owns 100 percent of stock (but the top tax rate is 15 percent).
 - b. *Himmel*: The approach of this opinion is to compare the redemption results with a pro rata dividend on common stock; it is inconsistent with the (later) Davis rule and has been rejected by Rev. Rul. 85-106, which treats the redemption of shareholder's vote as a super-factor.
 - c. Rev. Rul. 85-106. Dividend where the potential for joint control is not lost (but taxed at a top rate of 15 percent).
 - d. Regs. § 1.302-2(b). Dividend where all of one class of stock is redeemed and all classes are held in the same proportion (but now taxed at the same rate as capital gains—a top rate of 15 percent).
3. Voting stock is redeemed; the crossing of some control line is key:
 - a. *Pro rata redemption*. Always dividend; Regs. § 1.302-2(b).
 - b. "Super control." Where no super control line is crossed as the redeemed shareholder's percentage of the total vote drops, there is no authority for NEED treatment.
 - c. *Patterson Trust, Wright*. Super control line is apparently crossed; NEED. Contra, absent special facts, Rev. Rul. 78-401 (90 percent to 60 percent); dividend.
 - d. Rev. Rul. 75-502. Down to 50 percent NEED where there

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is one other unrelated shareholder. Maybe not so where the other 50 percent is dispersed and 50 percent represents effective control.

- e. *Johnson Trust*, 71 TC 941 (1979), *Block*, 261 F. Supp. 597 (1966), 43.6 percent to 40 percent and 45 percent to 42.8 percent, dividend; no loss of potential conjunctive control.
- f. *Rev. Rul. 76-364* and *Rev. Rul. 84-114*. Loss of potential conjunctive control, 27 percent to 22.27 percent and 28.57 percent to 23.08 percent, **NEED**.
- g. *Rev. Rul. 75-512*, 27 percent to 22 percent and "look no part in management," **NEED**.
- h. *Rev. Rul. 76-385*. Tiny to teeny, **NEED**. This is critical for redemptions by public companies.
- i. *Rev. Rul. 81-289*. Tiny but still tiny, same as pro rata, dividend; a worrisome ruling for public company redemption tender offers (but much less so since 2003 because the tax rate for dividends is the same as for capital gains).

(4) *B* drops from 40/100 to 30/90. This does not satisfy § 302(b)(2) but probably is **NEED** under *Rev. Rul. 76-364*, since *B* could not form a control group with anyone other than *A* himself. *B* recognizes a \$100 loss on the sale. To be assured of sale treatment, however, *B* must satisfy § 302(b)(2). *B* already is below 50 percent of the vote, so the number of shares, *X*, slightly more than which must be redeemed, can be determined by solving the following equation:

$$\frac{40 - X}{100 - X} = .8(.4)$$

In this equation, "*X*" is approximately 11.7, so a redemption of 12 shares from *B* will drop him to less than 80 percent of his prior vote and will be substantially disproportionate.

(5) *A*'s vote drops from 60/100 to 50/90. *A*'s stock ownership has not terminated and *A* has not had a substantially disproportionate redemption because his vote does not drop below 50 percent. This is essentially equivalent to a dividend because 60 percent to 55 percent crosses no recognized control line. *A* has a \$200 dividend, and *X*'s final E&P is \$300. The \$100 basis in the 10 shares snaps back to be redistributed among *A*'s

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remaining 50 shares. Regs. § 1.302-2(c); B&E ¶ 9.22. But see Prop. Regs. § 1.302-5 (anti-basis-shift rules).

Alternative: If *A* is a corporation, *A* will be allowed an 80 percent DRD (which is better here than subtracting the stock basis to determine gain as the result of treating the redemption as a sale). Since the redemption was not pro rata, it will be treated as an extraordinary dividend under § 1059(e)(1) unless § 1059(d)(6) applies. Indeed, this may be the most common way to stumble into § 1059. Note that corporate shareholders have no capital gains preference.

(6) If *B*'s sale is separate from *A*'s, then *B*'s vote drops from 40/70 to 30/60, and *B* should have a sale under *Rev. Rul. 75-502*. *B* realizes and recognizes a \$100 loss, which § 267(a)(1) disallows because *B* owns more than 50 percent of the value of the stock of *X* at least up through the instant of sale. See *Drake, Inc.*, 3 TC 33 (1944), *aff'd*. If *B*'s sale is combined with *A*'s as part of a single transaction, then *B* rises from 40/100 to 30/60; § 267 cannot apply, but that is irrelevant because *B* has a distribution that is a \$200 dividend and the basis in the redeemed shares is added back to the basis in *B*'s remaining shares (but not under Prop. Regs. § 1.302-5).

Regs. § 1.302-2(b) states that all the "facts and circumstances" bear on the **NEED** issue and certainly the usual step transaction doctrine considerations could require the two redemptions to be viewed together.

If *B* sold 11 shares to *X*, lacking a specific § 302(b)(2)(D) "plan," *Rev. Rul. 85-14* has ruled that *A*'s knowledge of *B*'s impending redemption can trigger the "series of redemptions" provision. If that applies here, instead of dropping from 60/100 to 30/70, *A* drops to 30/59. Section 302(b)(2) will not apply because *A* has not dropped below 50 percent of the vote. *Rev. Rul. 85-14* limits itself to § 302(b)(2), so the usual STD analysis mentioned above should apply to determine whether *Rev. Rul. 75-502* and § 302(b)(1) should apply, which they would not, since *A* does not drop to 50 percent of the vote. Thus *A*'s effort to temporarily lose control and thereby obtain sale treatment probably will fail. B&E ¶ 9.05.

(7) If the two sales are not combined, we cannot be sure of the answer. If *A*'s redemption occurs first, he drops from 60/100 to 50/90 and has a dividend. If *A*'s sale to *B* occurs first, *A* drops from 40/100 to 30/90, and he probably has a sale. If the two are combined, *A*'s vote drops from 60/100 to 30/90, and this would satisfy § 302(b)(2) for sale treatment on the redemption of 10 shares. The sales will be combined if they

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are part of an overall plan and "same transaction" as in this problem. Rev. Rul. 75-447, relying on *Zenz v. Quinlivan*. B&E ¶ 9.03[3]; see also *Merrill Lynch Co.*, 120 TC 12 (2003).

(8) Now that we have covered §§ 302(b)(1) and 302(b)(2) and their STD variations, we will move into the (until now) unfamiliar area of stock ownership attribution. Recall that no attribution rules applied in § 351, attribution rules apply only when they are specifically adopted into a specific Code section, as they are here by § 302(c)(1), and the different sets of attribution rules are different (cf. treatment of siblings by §§ 267(c)(4) and 318(a)(1)(A)). Review the five parts of § 318 that are typical of attribution rules: the family, from-entity, to-entity, and option attribution rules and the operating rules. B&E ¶ 9.02.

If the relationship results in B's shares being attributed to A, the result of A's selling 30 shares back to X for \$600 will be that A has a dividend on redemption of the 30 shares. If none of B's shares are attributed to A, then A will have a sale.

(8)(a) Under § 318(a)(1)(A), there is no sibling attribution. Even though B's shares would be attributed to his father, and his father thereby would be considered as actually owning the shares, under §§ 318(a)(5)(A) and 318(a)(5)(B), shares owned by the father by family attribution from B cannot be reattributed to A. Furthermore, the § 318(a)(1)(A) reference to "directly or indirectly" includes only beneficially owned shares and provides no additional route to attribution. Therefore, A still has a sale. B&E ¶ 9.02[2].

(8)(b) All of B's stock is attributed into the partnership by § 318(a)(3), but none is reattributed out to A, because of §§ 318(a)(5)(A) and 318(a)(5)(C).

Alternative: If the partnership has an option on B's X shares, that § 318(a)(4) ownership will be reattributed to A proportionately under § 318(a)(2)(A). Assume A's interest is 50 percent, so that 20 of B's shares are attributed to A. A drops from 80/100 to 50/70, which makes the sale a distribution/dividend. Note that there is ambiguity about measuring a partner's "interest" in the partnership for purposes of the percentage of attribution from the partnership. See Regs. § 1.318-2(c), Ex. (1); B&E ¶ 9.02[3]-9.02[5].

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Consider discussing a variation: If A and B are two partnerships and C is a common partner, B's stock is attributed proportionately to C and reattributed 100 percent to A.

(8)(c) A owns at least 50 percent of the value of B stock, and so under § 318(a)(2)(C), A is attributed the proportion of B's X stock that equals the proportion of A's B stock value to all B stock—50 percent. The result is the same as (8)(b) *Alternative*. Note that 100 percent of A's stock in X is attributed to B because A owns 50 percent of the value of the B stock. IRC § 318(a)(3)(C).

(8)(c)(i) If A owns 45 percent of B, there will be no attribution to or from B.

(8)(c)(ii) The 5 percent owned constructively by A boosts A to 50 percent status for purposes of attribution from B. Regs. § 1.318-4(b)(3). B&E ¶ 9.02[3]. Since attributed ownership is real ownership for all purposes of §§ 318(a)(2) and 318(a)(3), half of B's X stock will be attributed to A, not 45 percent.

(8)(c)(iii) If B is an S corporation, § 318(a)(5)(E) treats B as a partnership, so 45 percent of B's 40 percent of the X stock will be attributed to A, and A's vote drops from 78/100 to 48/70, which crosses no known control line. A will have a dividend.

(8)(d) All of B's X stock will be attributed to A unless B is a contingent and remote beneficiary under § 318(a)(3)(B)(i), which B obviously is not here.

Conversely, A's stock would be attributed to B in proportion to B's actuarial interest in the trust. The remainder interest is counted in determining B's actuarial interest. Regs. § 1.318-3(b). Consider discussing grantor trusts, sprinkling trusts, and qualified plan trusts. B&E ¶ 9.02[3], 9.02[4].

You may use the S corporation question to discuss the circumstances in which a trust is a permitted shareholder of an S corporation. IRC §§ 1361(b)(1)(B), 1361(c)(2), 1361(d).

We do not have a problem for attribution to and from estates, but see Regs. § 1.318-3(a) and B&E ¶ 9.02[3], 9.02[4].

(8)(e) Section 318(a)(4) creates attribution by option. Therefore, A is deemed to own all of B's shares, but not if the option is contingent, according to Rev. Rul. 68-601. See B&E ¶ 9.02[5].

Alternative: If the shares optioned to *B* from *X* are considered, then *A* drops from 60/121 to 30/91, which qualifies as substantially disproportionate. Although Regs. § 1.302-3(a) states that at least for § 302(b)(2), only stock issued and outstanding in the hands of the shareholders is considered, the Service considers stock optioned from the corporation to the taxpayer whose percentage ownership is being tested as outstanding. Rev. Rul. 89-64. The Service disagrees, however, with cases holding that options to other persons from the corporation count. Rev. Rul. 68-601. Obviously, this use of attribution has manipulative potential to increase the denominator and make satisfaction of § 302(b)(1) or § 302(b)(2) tests easier. B&E ¶ 9.02[5].

(9) Only on these facts might *X* stock owned by one shareholder be attributed through *X* to another shareholder, since there is a 50 percent threshold in and out. There will be no attribution, however, for two reasons: (1) *X* cannot be attributed ownership of its own stock (Regs. § 1.318-4(b)(1)) and (2) no in-and-out reattribution is allowed here. IRC §§ 318(a)(5)(A), 318(a)(5)(C); B&E ¶ 9.02[3], 9.02[4].

6B Termination of Interest; Partial Liquidations; Related Matters

GENERAL COMMENTS: Although there is no good breaking point within the redemption topic, this lesson focuses on the third and fourth routes to stock sale treatment, plus related matters such as greenmail, family hostility, bootstrap redemptions (LBOs), STD applications generally, and some *GU* repeal avoidance efforts. However, there is more to come in Lesson 8 Complete Liquidations.

(1) This question identifies the conflicting interests of the shareholders. *A* must sell more than 20 shares to *X* to be assured of § 302(b)(2) sale treatment, but can enjoy sale treatment on any number of shares sold to *B*. Furthermore, *A*'s control position relative to *B* can drop much more rapidly as a result of a sale to *B*, as compared with a redemption; *A* will drop to deadlock by selling *B* only 10 shares. Therefore, *A* may prefer to sell to *B* or to a fourth party. *B*, however, normally wants to use *X*'s cash to buy *A*'s stock without *B* having to pay a shareholder-level tax on the cash first as a dividend (even at the new low capital gains rate of 15 percent). Thus, *B* may prefer a redemption by *X* of *A*'s shares, which also has the advantage of decreasing *X*'s E&P (but provides *B* no additional stock basis).

If *X* is an S corporation, *A* may prefer a redemption treated as a distribution, which will be tax-free to the extent of *A*'s entire \$600 stock basis rather than only to the extent of the basis of the shares actually redeemed. IRC §§ 1368(a), 1368(b). Conversely, *B* may want to buy *A*'s stock in order to increase *B*'s stock basis, thereby possibly increasing his capacity to deduct future (or suspended) loss pass-throughs and shielding himself from gain on future distributions. IRC §§ 1366(d)(1), 1368(a), 1368(b).

(2)(a) *A* realizes \$600 capital gain, and half of each cash payment is recognized gain under § 453. *B* takes a § 1012 \$1,200 basis in this block of stock, enjoying the *Crane* benefits of acquiring basis in property by paying with debt. *X* is unaffected, unless *X* has NOLs and the change of ownership is important under § 382. Compare the benefits of the § 743(b) inside basis increase, which are not available in the corporate setting.

(2)(b) *A* has a § 302(a) sale because of § 302(b)(3), and § 453 should apply. *Stiles*, 69 TC 538 (1978) acq. The note possibly could be recharacterized by the Service as equity of *X*, but, even if it is, it should be nonvoting preferred and §§ 302(b)(1) and 302(b)(2) should still be satisfied if the exchange were treated as a redemption. However, § 317 prevents a redemption from occurring for stock of the redeeming corporation, and so possibly *A* would enjoy recapitalization treatment with \$200 boot. Rulings may not be issued on § 302 in several complete or partial redemption situations involving either a note payable in more than 15 years, a note secured by the stock, or other disguised continuing equity-like interests. See current no-ruling revenue procedure references to §§ 301 and 302. *B* is unaffected taxwise, even though he has acquired 100 percent control. *X* has an E&P reduction of \$300 under § 312(a)(7). B&E ¶ 9.04, 9.24. A gain, § 382 could apply. Contrast the § 734(b) partnership inside basis increase.

Note that a LBO can be effected by redemption. In a typical fact pattern, *A* is the public or family owners and *B* is management or a "raider." In such case, the debt is likely to have junk characteristics if the price is relatively high. *B* has created no tax problems for itself by having *X* buy the *A* stock at the outset, in contrast to possible problems in (2)(d) below.

A's continuance as president of *X* is largely a red herring, since a continuing relationship with *X* is a problem principally when waiver of attribution is needed to make § 302(b)(3) apply, which it is not here. However, be worried about the Service's refusal to rule under § 302(b) generally where *A* continues to rent property with rental based on *X*'s profits. See current no-ruling revenue procedure; B&E ¶ 9.04[1].

If *A* were a corporate raider, *X* will have to capitalize any expenses of the redemption under § 163(k) (which disallows the deduction of redemption expenses in most cases, whether or not involving a raider). B&E ¶ 5.04[6]. Next, the greenmail excise tax may apply. B&E ¶ 9.25.

Note that § 302(b)(2) would also apply to the redemption in the original question. There cannot be an overlap of §§ 302(b)(2) and 302(b)(3), however, in complete redemptions involving nonvoting stock, requiring waiver of attribution, or involving § 306(b)(1)(B), to all of which only § 302(b)(3) can apply.

(2)(c) None of these additional facts matters in (2)(a), except to reduce the gain by \$200. In (2)(b), however, *B*'s shares are attributed to *A* and *A* maintains 100 percent of the vote; therefore, the redemption will be treated as a dividend of \$500 (to which § 453 does not apply) and a return of basis of \$500, leaving *A* with \$100 stock basis but no stock. B&E ¶ 8.72. This \$100 of lost basis jumps over to *B*'s stock basis. B&E ¶ 9.22[2]. But Prop. Regs. § 1.302-5 prevents this basis shift effect; instead, *A* has a suspended loss of \$100, which can be taken at a later time (typically as a capital loss) on the occurrence of designated trigger events. The lack of continuing connection with *X* is not enough to give *A* sale treatment; *A* must satisfy the § 302(c) waiver of attribution requirements. Outside the *Hafif* circuit, any family hostility (which is most likely to be a factor in the complete redemption cases) probably will not prevent the family attribution, under any part of § 302(b). See *Mezger Trust*, B&E ¶¶ 9.04, 9.05.

However, under the original facts, but probably not under the alternative, *A* could waive the attribution of *B*'s stock to *A*. Discuss waiver of family (only) attribution of stock to *A* by § 302(c) procedure. Waiver is not permitted if *A* has a prohibited interest in *X*. *Lynch* court would view consultant status (and anything other than pure creditor status) as bad. Discuss *Perry Lewis, Seda, Leonard, and Cheriof*. Note that recharacterization of debt as equity here will void the waiver, even if the equity is nonvoting. B&E ¶ 9.04[2][c]. Discuss the three other requirements of waiver: (1) not acquire tainted interest for 10 years ("forward Siberia"); (2) filing agreement; and (3) 10-year look-back rule and reference thereto in no-ruling revenue procedure (if, in this case, *B* acquired his stock from *A* in the prior 10 years, a lack of tax avoidance motive must be shown). Hypothetical: What if *A* waives attribution and three years later acquires half the stock of *Y*, which owns one share of *X*? One-half share of *X* is attributed to *A* because only family attribution was waived, and the waiver is terminated retroactively and *A*'s redemption becomes a distribution because all of *B*'s shares are attributed to *A*. Discuss the extended statute of limitations aspect of § 302(c) and the

waiver of family attribution (not to entitle attribution, as in *Rickey*) by entities. B&E ¶ 9.04. Note choice faced by father *A* in selling stock prior to § 1014 "year of Jubilee."

This problem illustrates vacillation in this area between bright-line tests and fuzzy tests: while §§ 302(b)(2) and 302(b)(3) seem to be clear paths to sale treatment, attribution can apply to cause them not to apply; however, waiver can apply to cause § 302(b)(3) to apply, but waiver will not apply if stock is acquired by or from a related party within the prior 10 years, unless the acquisition was without tax avoidance motive. With dividends since 2003 taxable at the same low rate as capital gains (with a top rate of 15 percent), it would seem that the time has come to lighten up on these overly complex and restrictive rules.

(2)(d) *B* receives a constructive distribution annually in the amount of the payments under *Wall* and *Durkin*. B&E ¶¶ 9.06[4], 9.06[6]. Note that if there were a novation and *B* were released from the obligation and *X* assumed it, the entire unpaid amount would be a constructive distribution at that time. Rev. Rul. 77-360.

This is not a smart way to do an LBO, because *B* must pay tax on dividends (although now at a new low 15 percent rate) in order to pay off the note, except possibly if *B* were a corporation. Then *B* not only would enjoy an interest deduction on the debt (*B* as an individual would be limited as to the interest deduction by § 163(d)) but could also deduct at least 80 percent of a constructive dividend and avoid a § 1059 basis reduction if it qualifies for the 100 percent DRD or if it keeps the early year annual dividend payments low enough to meet the 10 percent test. *B* will qualify for the 100 percent DRD with respect to distributions of *X*'s E&P earned after the stock purchase from *A* and such constructive dividends will not be extraordinary dividends (unless attributable to gains on property accrued before affiliation). IRC § 1059(c)(2). Note the likelihood that the § 1059(a) two-year rule will apply block by block, based on different stock acquisition dates. If a 100 percent DRD cannot be obtained and § 1059 avoided, this may be a poor way to do an LBO; it would be better to have *X* redeem all of *A*'s shares. Note the relationship between § 1059 basis reduction and § 301(c)(2) basis reduction.

(2)(e) Since no contractual debt of *B* was satisfied, *B* receives no constructive distribution here. *Holsey*. B&E ¶ 9.06[6]. Note Regs. § 1.1041-2's return to normalcy and rejection of *Carol Reed*.

(2)(D) Under *Sullivan* and Rev. Rul. 69-608 (Situation 1), *B* as a 100 percent shareholder receives a constructive distribution (and possibly a constructive redemption, although the authorities do not so state) from *X*'s satisfaction of his obligation. As a constructive \$1,200 distribution, this results in a \$500 dividend and \$700 basis reduction down to \$500 remaining basis; *X*'s E&P is reduced to zero. If *B* were a corporation, there would be an additional \$400 stock basis reduction under § 1059. The way to do this transaction is Situation 4 described in Rev. Rul. 69-608. *B* should have made sure the contract gave him the option of buying the stock himself or assigning the contractual obligation to *X*, in which case *B* would be relieved of the obligation to purchase and would not have a constructive distribution when *X* purchases. Consider comparing *Citizens Bank*, B&E ¶ 9.06[6].

(2)(E) Same result to *A* as in (2)(A) because of pure application of *Zenz*. *B* can have no constructive distribution on the redemption because he never was obligated to buy the redeemed shares. *B*'s total stock basis increases to \$1,400, and *X*'s E&P decreases by 50/100 under § 312(a)(7), to \$250. B&E ¶ 9.06[2]. If *A* is a corporation *A* will not sell some shares to *X* in hopes of using the DRD, because application of *Zenz* will result in a complete termination of stock ownership and sale treatment. Rather, *A* will prefer to receive a nonredemption dividend distribution of \$1,000 as in *TSN* and *Liton* and then sell all its shares to *B* at a reduced price to reflect that dividend.

(2)(h) No change to *A* and *B*; the change here is that *X* recognizes \$800 gain under § 311(b), accrues liability for tax of \$280, has a net E&P increase of \$520, producing interim E&P of \$1,020, which probably is reduced by 50/100 to \$510. *A*'s basis in the property is \$1,000. IRC § 1012. Note the possible application of Regs. § 1.1060-1(b)(3) to *A*. Also note Regs. § 1.1041-2 (which cleaned up the decisional mess created by the *Carol Reed* decision).

(3) The changes are that *X* accrues no tax liability or E&P increase on account of the \$800 recognized gain, *A* recognizes capital gain on the pass-through of \$480 (*B* recognizes \$320), *A*'s stock basis increases by \$480, to \$1,080, and *A* has a \$120 gain on the sale, all of which is recognized in the year of sale. IRC §§ 1368(a) (which is not applicable), 1371(a), 1367(a), 1366(a). This assumes that the shareholders agree to close the year upon the redemption as permitted by § 1377(a)(2). If not, then the pass-through income (and consequent stock basis increase) will be allocated to *A* on the

basis of the number of days in the tax year that *A* held the stock, as well as on the number of shares owned. IRC § 1377(a)(1); B&E ¶ 6.08.

(4) Since redemptions of the stock of *A* and *B* would be pro rata, they will be treated as § 302(b)(4) applies. This will most surely be the case if the safe harbor rule for termination of an actively conducted trade or business applies. The sale by *Z* of its assets followed by the distribution of *Z*'s net assets to *X* followed by the distribution of those assets to *A* and *B* will qualify for partial liquidation treatment, but *X*'s sale of the stock of *Z* followed by distribution of the net sale proceeds will not. Note the current no-ruling revenue procedure references to § 302(b)(4), particularly including a refusal ordinarily to rule if there has not been a 20 percent cut in employees. B&E ¶ 9.07. If the distribution otherwise would be treated as a partial liquidation, the fact that *A* and *B* did not surrender any shares would not prevent partial liquidation treatment and *A* and *B* would be deemed to have surrendered the proportion of their shares equal to the proportion of the corporate value distributed. Rev. Rul. 90-13; B&E ¶ 9.21.

Note: Consider discussing *Esmark*.

Half of *Esmark*'s shareholders got cash for their stock and *Mobil* provided the cash and received the wanted *Esmark* subsidiary. Instead of the transaction being treated as a taxable sale of the subsidiary by *Esmark* to *Mobil* and a redemption of the shareholders with the cash (or as a taxable distribution of the subsidiary in redemption of the historic public shareholders and their sale of the subsidiary stock to *Mobil* for cash), it was treated as a (then) nontaxable distribution of the subsidiary stock to *Mobil* as a shareholder, utilizing a narrow former exception to the *GU* repeal in the redemption area. *Esmark* is still a useful case when the Service tries to "resequence" the steps of a transaction into a different order.

The *GU* repeal encourages corporations to milk the few remaining Code provisions that permit moving assets (a favorite pastime in the bust up acquisition era) without gain recognition. Section 337(d) authorizes regulations to stop such efforts. May Department Stores (like *Esmark*) wanted to sell its real estate subsidiary to a buyer (like *Mobil*). May tendered for and redeemed an amount of its stock equal to the value of the subsidiary (some May shareholders were thus cashed out, as were *Esmark* shareholders). May and the buyer formed a 50-50 partnership to which May contributed the subsidiary's stock (utilizing § 721(a) to avoid gain recognition) and to which the

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buyer contributed cash of equal value. The cash was used to buy May stock from May. In effect, May sold all of its subsidiary's stock without tax and would avoid all gain recognition if it could later utilize § 731 to shield it from recognition in a partnership liquidation in which May received back its shares and the buyer received all the subsidiary's shares. IRS Notice 89-37 and Prop. Regs. § 1.337(d)-3 prevent this result, and related ploys (although the regulations are still in proposed form). B&E ¶¶ 8.21[4], 9.23[2].

6C Redemptions by Affiliated Corporations

GENERAL COMMENTS: This subject is simple in concept but insidiously elusive (read sneaky and ubiquitous) in application and maddening in working out its details since the regulations are convoluted and largely out of date (although some regulations were proposed in October 2002). Ask students to organize their answers in the following chart. (Holding period also could be investigated, but that seems less important (though relevant) under current law.) Assist students in unscrambling the regulations before applying them to the questions. But 1997 legislation largely neutralized corporate shareholder games with § 304, and 2003 legislation greatly reduced the sting of § 304 for noncorporate shareholders by taxing dividends at the same low rate (15 percent) as capital gains. Thus, time and effort spent on this subject can be sharply (and wisely) reduced.