

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 to the issuing corporation of its stock)?

If a stock redemption occurs is this transaction:

- 1) a property sale (§1001), 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 the stock redemption transaction:

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

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

Code §302(a) - Exchange Treatment for Shareholders

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

Basis Allocation Issues

p.209

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.**

Prop. Regs. (withdrawn): deferred loss

Stock Redemptions & Corporate Level Treatment

- 1) §311 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?

Business Objectives for Stock Redemptions

- 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.**

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 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 a grandchild from GP.

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.

c) Corporation to some (50%) 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 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). An option to acquire stock is equivalent to the ownership of that stock.

Constructive Ownership of Stock – Operating Rules

- 1) No family reattribution.
- 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.213

Wham Corp has 100 common shares outstanding.

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

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

Problem 1, p.213

Grandfather's stock

Grandfather - total share interest is 85.

- a) 25 directly.**
- b) 20 from mother to GF - §318(a)(1)(A)(ii).**
- c) 15 from daughter (granddaughter), and
10 from son (grandson). §318(a)(1)(A)(ii).**
- d) 15 from GM's estate. §318(a)(2)(A) - from GM's
estate to mother; §318(a)(1)(A)(ii) & to mother to
GF. Reattribution is permitted here.**

Problem 1, p.213

Daughter's stock

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

- a) 15 directly.**
 - b) 0 shares from son - no sibling attribution.**
 - c) 25 shares from mother - i) 20 shares directly; & ii) 5 shares owned through mother's option.**
- §§318(a)(4) & 318(a)(5)(D).**
- d) 15 sh. (thru Mom) from GM's estate.**
 - e) GF to (grand) daughter - no.**

Problem 1, p.213

GM's Estate's stock owned

Grandmother's estate - 100 shares owned.

a) 30 shares owned directly.

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

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

Reattribution to entity applies.

Problem 2

p.213

M – (W's
mother) W- (A's wife)
owns

100 shares
being
100% of
Yancy Corp

A B C D
(unrelated)

equal partners
Partnership

owns 100
shares being
100% of
Xerxes Corp

Problem 2(a), p.213

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.213

Shares of Xerxes owned by Yancy:

1) Premise: stock owned by a 50 percent 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 percent or more of Yancy (i.e., W can instruct Yancy).

Problem 2(c), p.213

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

- 1) Partnership - constructively owns the 100 shares in Yancy; W's 100 shares are attributed to A & 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 Disproportionate Redemp. P.214

§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.215

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)).

Multiple Stock Redemptions

B indicated to A, the majority shareholder, an intention to terminate as shareholder.

A redeemed & A then (temporarily) 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).

Problem 1 (Y Corp)

§302(b)(2) Eligibility

p.217

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

- Redeem A's 75 preferred shares.
- Also redeem 60 of Alice's common shares.
- Also redeem 70 of Alice's common shares.
- Also redeem 10 of Cathy's common later.

Problem 2, Z Corp., p.217

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

Z redeems only 30 of Don's voting common.

Question: §302(b)(2) qualification?

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

The redemption will qualify as an exchange transaction if the redemption is “in complete redemption of all of the stock of the corporation owned by the shareholder.”

This is obviously more than a “significant reduction”.

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.

Code §302(c) Limitations on Waiving Attribution Rule

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.

Lynch case

p.219

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 for the seller.

Board of Directors Status

Facts: Stock sale on an installment basis and shares were retained by an escrow agent.

Redeeming shareholder retained the right to designate his lawyer (nominee) to be on the corporation's board - to protect the former shareholder's creditor interest.

Held: Having one's lawyer (an agent) on the Board violates the requirement in Code

§302(c)(2)(A)(i). Observer status is OK.

Rev Rul. 77-293
§302(c)(2)(B)(ii)

p.228

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.

Limitations on the Retained Interest

p.230

- 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.**

Waiver of Attribution of Ownership by Entities

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

What if the redeemed shareholder is a trust or estate that completely terminates its actual interest in the corporation (but is attributed 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).

Problem 1

p.235

Complete Redemptions?

John

(parent)

100 shares

Alison

(daughter)

50 shares

Chuck

(grandson)

25 shares

Randall Corp

Problem 2

p.235

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 ten year period. 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.

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

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

Problem 3(a)

Cinelab

p.236

John

Mary (sister)

Estate of Sam (father)

Bella (mother) as the
estate beneficiary

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?

Problem 3(b)

Cinelab

p.236

John

Mary (sister)

Estate of Sam (father)

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

50

30

20

shares

shares

shares

Estate of Sam:

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

Problem 3(c)

Cinelab

p.236

<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? John & Mary cannot terminate their estate beneficiary status here. Estate owns all stock.

Problem 3(d) & (e)

Cinelab

p.236

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?

(e) Nancy subsequently acquires shares.

Impact of the ten year “look forward” rule?

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

Davis case

p.236

Taxpayer	Wife	Son	Daughter
250	250	250	250
common & preferred	common	common	common

Taxpayer's preferred stock was redeemed.

“Meaningful reduction” requirement was not satisfied since no reduction in his vote %.

Rev. Rul. 85-106

p.243

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 beneficiary.

Voting power as the key factor.

Shareholder still participating in same voting blocks.

Held: Not a “meaningful reduction” &

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

Rev. Rul. 75-502

note case

p.246

X Corporation

Estate

A

B

(& A as bene.)

250 shares

750 shares

750 shares

Estate owns A's shares through §318(a)(3)(A) attribution. Estate's shares were redeemed. The estate went from 57% to 50% constructive ownership in the corporation.

A meaningful reduction resulted for the estate.

Rev Rul. 75-512

note case

p.246

X redeemed all 75 shares owned by the trust.

Prior to redemption trust owned 300 shares directly and indirectly (or 30 percent). Decreased ownership from 30 percent to 24.3 percent (225 shares owned by C, D & E).

Not eligible for (i) complete redemption or (ii) substantially disproportionate; but, held:

Not essentially equivalent to a dividend. Why?

Reduction of impact of voting rights?

Limited Participation Situations

p.246-7

- 1) Redemption of nonvoting preferred stock – 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.
- 3) Relevance of “super-majority” rules? E.g., no longer a capacity to quash a merger transaction, but authority to control vote on officers and dividends.

Relevance of Family Discord

p. 247


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?

Problem 1

Meaningful Reduction?

p. 249



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.249

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.249

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.

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 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.

Code §302(e)(2) Safe Harbor

p.250

- 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.**

Rev. Rul. 79-184

p.252

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 corp.

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 the relevance of Code §381 (re: tax attribute carryovers).

Problem

Partial Liquidation?

p.253

Michael

Pamela
(M's wife)

Iris Corp.

ALPHA

Books
(division)

Cram
(division)

Beta, Inc.
(100% sub)

Securities
portfolio

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.

Rev. Rul. 74-338

E&P Determination

p.257

What pro-rata share of E&P is attributable to redeemed shares (when CG 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.260

Facts: 200 shares at price of \$1,000 per share.
\$100,000 basis for each of two shareholders.
\$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.**

**When during the year is the redemption
distribution? Mid-year? End of year?**

Stock Redemption Expenses

§162(k)

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 (funded to pay greenmail costs). Loan is a separate transaction.

Bootstrap Acquisitions **(see Rev Rul. 75-447)**

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

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

Held: not a bootstrap dividend distribution; rather, capital gains transaction treatment.

Integrated Transactions

Situation One:

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

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

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

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

Sale & Redemption Option

Situation Two:

- (1) Sale of shares to C by A & B, and**
- (2) Redemption of part of the remaining shares held by A & B.**

A & B held 50% before and 33 1/3% after the transaction.

Held: §302(b)(2) applies when measuring before and after these several transactions.

Problem

p.265

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?

Buy-Sell Agreement

p.265

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 & 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.

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.

Life Insurance Tax & Related Considerations

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 flow into corporation and at death the value of the corporation (&E&P) is increased by the difference between (1) book value and (2) face value of the life insurance policy.

Transfer Tax Considerations

**§2703
p.267**

**Value 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.

§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.268.

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).

Problem

Buy-Sell Tax Issues

p.271

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

A cross purchase agreement is in place.

Y corporation purchased life insurance on the lives of the shareholders and paid the premiums on this life insurance.

Y corporation is the owner of the policies and is also the beneficiary under these policies.

B dies and Y Corp. uses the proceeds to redeem B's stock.

continued

Problem

p.271

Treatment to Y Corp.

1) Are the premiums deductible by Y Corp.?

No, §264(a)(1).

2) At death the tax-free insurance proceeds are received by Y Corp. §101(a)(1).

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

continued

Problem - Treatment to Shareholders A&C p.271

A&C as the remaining shareholders.

1) No constructive dividends upon the insurance premium payments by Y Corp. (i.e., prior to death of B).

2) A & C do have constructive dividend distribution treatment upon the stock redemption because of the binding obligations of A & C to purchase B's estate's shares.

Divorce Redemptions

p.271

Who Redeemed?

Arnes v. United States He and she each owned 50 percent of Corp. Divorce agreement for redemption of her 50 percent interest. Installment sale reporting.

In refund litigation she asserts 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 ex-wife? No, really a transfer to husband, & no gain to be recognized by her.

Treatment of Nontransferor

Spouse

p. 275

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 to the departing spouse?

What Divorce Tax Planning in this Context? P.276

Get her (departing shareholder) to redeem and obtain LT capital gains treatment (at 15%) & after her tax basis recovery?

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

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

Divorce Redemptions, Final Regulations p.278

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, deal must be in writing.

Charitable Contribution & Redemption Transaction

Grove v. Commissioner

p.279

Facts: Grove donated shares of stock to charity & retained a life interest (in a fund).

The charity signed the buy-sell agreement.

Shares redeemed by the issuing corporation 2-3 years after the charitable contribution.

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

Sequel to the Grove case

p.286

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 trustees/directors violate fiduciary responsibilities if not doing so?

Note alternative (now required) charitable gift techniques, e.g., CRAT & CRUT, to get the charitable contributions income tax deduction.

Problem

p.287

Charitable Gift of Shares

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

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

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

Problem, cont.

p.287

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

No legal obligation to redeem.

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

Redemptions Through Related Corporations p.288

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

A (individual or corp.) owns
X Corp & Y Corp

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

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

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

Facts:

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

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

Treated for “dividend equivalency” purposes as a distribution in redemption of P's stock. Next question: Are any Code §302(b) redemption tests satisfied in this transaction?

§304(a)(1) - Collateral Income Tax Effects p.289

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) Reduce the sub'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 sale.

Niedermeyer v. Comm.

§304(a)(1)

p.292

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

67.91%

22.58%

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.

Taxpayer's arguments in Niedemeyer case

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

2) Not essentially equivalent to a dividend?

But, no “meaningful reduction” of % interest.

- 90.49% reduced to 82.96 %.

3) Terminated interest & §302(b)(3) is applicable – but, only after the preferred is redeemed.

Filed a §302(b)(3)), but two years late.

& no de minimis rule is applicable.

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

Problem 1

p.299

Re: Niedermeyer case

(a) Why did §304(a) apply?

§304(a)(1) – (1) the sale 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.299

Re: Niedermeyer case

1(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). & no established intent to donate the 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 similar to the Zenz v. Quinlivan decision.

Problem 2

p.299

Partial Sale of Shares of Out

Claude

80%

Bail Corp. (buyer)

\$40,000 basis

(80 shares @ \$500)

(Bail - no e&p)

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).

Problem 2(a)

p.300

- 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.**

Problem 2(b)

p.300

Sale of All Shares of Out

Claude sells his 60 Out shares to Bail for 12K.

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 = 3K (CG?)

Problem 2(c)

p.300

Stock of Purchaser Received

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.

Problem 2(d)

Assumed Liability

p.300

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

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

Basis in Bail stock is 0 (3x less the 3x boot).

Redemptions to Pay Death Taxes

p.300

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.

Section 303 Eligibility Requirements

- 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).

Problem

p.302

§303 – Estate Tax Impact

Gross estate	\$2,000,000
Expenses	<u>100,000</u>
Net estate	1,900,000

Estate includes:

X corp stock 200,000 of 1.4 mil. total fmv;

Y corp stock 400,000 of 1.6 mil. total fmv;

Wife also owns 200,000 of X corp stock.

Issue re qualification under §303.

Problem, continued

p.302

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