LexisNexis® Tax Center
Switch Client | Sign Out | Help
Dossier | History
Research | My Tax Center | Get a Document | Shepard's® | Tax News | Tax Forms

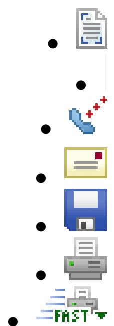
FOCUS™ Terms Search Within Advanced...

LexisNexis® Tax Advisor (TOC)

Retrieve Another Code Section

IRC Sec.
(e.g. IRC Sec. 61)

- § 302. Distributions in redemption of stock.
  - IRC Sec. 302.
  - Final and Temporary Regulations
  - Proposed Regulations & Treasury Decisions
  - Legislative History
  - IRC Annotations
  - LexisNexis IRC Explanations
    - IRC § 302(a)
    - IRC § 302(b)
    - IRC § 302(c)
    - IRC § 302(d)
    - IRC § 302(e)
    - IRC § 302(f)
  - Analytical Materials
- Search for Recent Developments



View: **Full** | Custom 1 of 1

Book Browse

Lexis Explanation IRC Sec. 302(b) (Copy w/ Cite) Pages: **7**

Lexis Explanation IRC Sec. 302(b)

LexisNexis Explanation

Copyright 2009, Matthew Bender & Company, Inc., a member of the LexisNexis Group

IRC § 302(b)
Distributions in Redemption of Stock
Redemptions Not Equivalent to Dividends

Authored By

Zolman Cavitch, A.B., J.D. and Matthew P. Cavitch, A.B., J.D.
Authors: Tax Planning for Corporations and Shareholders
(LexisNexis Matthew Bender & Co., Inc.)

Updated By

Maria S. Domingo, J.D.
LexisNexis Federal Tax Analyst

Lexis Explanation IRC Sec. 302(b)

SYNOPSIS

- **I.**
  The 20 Percent Cut-back, or "Substantially Disproportionate," Exception
- **II.**

- The Complete Termination Exception
- III. The Dividend Equivalence Exception

I. The 20 Percent Cut-back, or "Substantially Disproportionate," Exception

Under the redemption rules of Internal Revenue Code Section 302, a redemption is treated favorably as a sale or exchange (and not as a dividend distribution) if the redemption comes within one of three exceptions.[1] In most cases it will be prohibitive as far as taxes are concerned to effect a redemption unless one of these exceptions is met.[2]

Favorable sale treatment will obtain if the redemption is substantially disproportionate with respect to the particular shareholder.[3] A redemption is substantially disproportionate if *all three* of the following factors are present:

- (1)
  The particular shareholder must own after the redemption less than 50 percent of the total combined voting power of all classes of voting stock;[4] and
- (2)
  the shareholder's percentage ownership of voting stock after the redemption must be less than 80 percent of his percentage ownership of voting stock immediately before the redemption;[5] and
- (3)
  the shareholder's percentage ownership of common stock— both voting and nonvoting common—after the redemption must be less than 80 percent of his percentage ownership of common stock immediately prior to the redemption.[6]

If we assume that a particular shareholder will own less than 50 percent of the total voting power of the corporation after the redemption, and the corporation has outstanding only one class of stock, the "substantially disproportionate" test will be met if the shareholder's stock interest percentage is cut back by more than 20 percent.

Example 1:

Mr. *X* owns 450 shares out of 1,000 outstanding shares, being 45 percent of the outstanding shares. To qualify under the substantially disproportionate test, it is necessary that Mr. *X* own after the redemption less than 36 percent (80 percent of 45 percent) of the *then* outstanding shares.

- (1)
  It is proposed that the corporation purchase 91 of *X*'s shares (being one share in excess of 20 percent of *X*'s *numerical* share interest). The redemption will not qualify under the "substantially disproportionate" test inasmuch as after the redemption *X* will continue to own 39 percent of the outstanding stock (being 359 out of the *then* outstanding shares of 909). Since 39 percent is more than 80 percent of his *percentage* ownership (i.e., 45 percent) before the redemption, there has not been a sufficient cut-back of *X*'s interest.
- (2)
  Suppose that 141 of *X*'s shares are redeemed. After the redemption *X* will own 309 shares out of a total outstanding of 859, and his percentage ownership of all outstanding shares will therefore be 35.9 percent. This redemption will qualify as being substantially disproportionate since *X*'s

interest after the redemption is less than 80 percent of his 45 percent ownership interest immediately prior to the redemption.

The effect of the cut-back requirement cannot be frustrated by a planned series of redemptions. The statute provides that this favorable test will not apply if the purpose or effect of a series of redemptions results in the redemption from a particular shareholder not being substantially disproportionate.[7]

Example 2:

A, B and *C* each own 20 shares of *X* corporation's stock, being all of the outstanding shares. Pursuant to a prearranged plan, *X* corporation redeems ten of *A*'s shares in year one, ten of *B*'s shares in year two, and ten of *C*'s shares in year three. Upon the completion of the planned redemptions, the shareholders are still equal shareholders. None of the redemptions will be treated as substantially disproportionate.

Although the statute is silent on the point, it is likely that a planned series of redemptions from a particular shareholder which, in the aggregate, but not singly, result in a sufficient cutback in his percentage interest will be treated as a substantially disproportionate redemption. This would seem to be particularly likely if the shareholder is committed by a legally binding contract to the series of redemptions.[8] Again, though, a legally binding contract to a series of transactions is not required. It is enough if there is a "firm and fixed plan" to do the multiple transactions. The plan does not have to be in writing, absolutely binding, or even communicated to others to support integration, though these would be good factors supporting integration.[9] Nor does a firm and fixed plan require that all of the details of a subsequent transaction be known at the time of the earlier transaction. In one case, the taxpayer, trying to avoid integration, correctly argued that the buyer in the later transaction had not been identified at the time of the earlier transaction, but the Tax Court and the Second Circuit still integrated the transactions.[10]

The Service has ruled that if a single plan involving a redemption and a sale of stock, or a redemption and an issuance of stock, effects a more than 20 percent cutback in the percentage interest of the redeemed shareholder, the redemption will satisfy the substantially disproportionate test even though the redemption, taken alone, would not qualify.[11] This is an important ruling, and the examples given in the ruling are helpful:

Example 3:

Corporation *X* had 100 shares of voting common stock outstanding, of which *A* and *B* each owned 50. In order to bring *C* into the business with an equal stock ownership, *A* and *B* caused *X* to sell 25 new shares to *C*. Immediately thereafter, and as part of the same plan, *A* and *B* caused *X* to redeem 25 shares from each of them. When the smoke cleared away, each of *A* and *B* owned 33 percent of *X*'s stock, which was a cutback of more than 20 percent from the prior 50 percent ownership. The Service ruled that the redemption met the substantially disproportionate test. (If the redemption were treated as a separate transaction, each of *A* and *B* would have been cut-back from 40 percent (50/125 to 33 percent which is less than the 20 percent cutback.)

Example 4:

Corporation *X* had 100 shares of voting common stock outstanding, of which *A* and *B* each owned 50 shares. In order to bring *C* into the business with an equal stock ownership, *A* and *B* each sold 15 shares to *C*, and then caused *X* to redeem five shares

from each of them. The effect of the entire transaction was to cut-back each of *A* and *B* from 50 percent to 33 percent. The Service ruled that the redemption met the substantially disproportionate test.

II. The Complete Termination Exception

Favorable sale treatment will obtain if the redemption *completely terminates* the stock interest of the particular shareholder.[12] In order to satisfy this test, it is necessary that *all* of the shareholder's stock—voting and nonvoting, preferred and common—be redeemed. At first blush, it appears that this test is redundant, since a complete termination of all stock interest always affects a more than 20 percent cut-back in percentage interest. But the broad and pervasive constructive ownership rules which are discussed in a later subdivision are less strictly applied in testing for a complete termination than in testing for a more than 20 percent cut-back. As a consequence, this complete termination exception is perhaps the most frequently available exception for planning purposes.

A series of redemptions can be integrated to constitute a complete termination. Similarly, a redemption and subsequent sales can be integrated to constitute a complete termination.[13]

III. The Dividend Equivalence Exception

Favorable sale or exchange treatment will be applicable, even though the redemption satisfies neither of the preceding exceptions, if the redemption is not essentially equivalent to a dividend.[14] This is virtually the same vague and general test which was in the Code prior to 1954 and is not ordinarily reliable as a planning guide. There are, however, some instances in which the dividend equivalence exception is emerging as a reliable guide, particularly with respect to partial redemptions from minority shareholders. This is true notwithstanding the limiting effect of the Supreme Court's 1970 decision in *United States v. Davis.*[15] Indeed, it is largely on account of the *Davis* case that the National Office has issued a series of rulings involving the dividend equivalence exception. These rulings, in turn, presently form the nucleus around which a degree of significant planning can be affected.

FOOTNOTES

(1) IRC § 302(a).

(2) If the corporation has no earnings and profits, the redemption distribution will not give rise to ordinary income even though none of the favorable tests in Section 302 is satisfied.

(3) IRC § 302(b)(2).

(4) IRC § 302(b)(2)(B).

(5) IRC § 302(b)(2)(C).

(6) IRC § 302(b)(2)(C). The statutory requirement that the shareholder's percentage ownership of common stock be reduced applies only where the shareholder owns, either actually or constructively, some amount of common stock prior to the redemption. Thus, where a shareholder owned only voting preferred stock possessing 49 percent of the total voting power of all outstanding classes of stock, and all of the common stock was owned by unrelated persons, a redemption of an amount of his voting preferred stock which reduced his voting power by more

than 20 percent qualified as a sale or exchange under the 20 percent cut-back test of Section 302 (b)(2). The National Office so concluded even though the shareholder, owning no common stock (actually or constructively) before the redemption, could not possibly have a reduction in common stock ownership. Rev Rul 81-41, 1981-1 CB 121.

If the shareholder owns both voting and nonvoting common stock before the redemption, the reduction in his common stock interest is determined by aggregating the common stock. It is not necessary that each class of common stock be cut back by more than 20 percent. Thus, even if the shareholder's percentage of nonvoting common stock is not cut back at all, the redemption will satisfy the 20 percent cut-back test if his percentage of total common stock is sufficiently reduced. Rev Rul 87-88, 1987-2 CB 81.

(7) IRC § 302(b)(2)(D).

A "plan" for a series of redemptions may exist, thereby requiring the integration of the several redemptions for this purpose, even though there is no contractual commitment at the time of the first redemption to proceed with the subsequent redemptions. It is enough if there is an intended course of conduct designed to restore the first redeemed shareholder to a percentage interest that does not meet the 20 percent cutback test. See Rev Rul 85-14, 1985-1 CB 92.

(8) Bleily & Collishaw, Inc v Commr, 72 TC 351 (1979); Roebling v Commr, 77 TC 30 (1981). But the mere existence of a written contract calling for a series of redemptions will not necessarily require the integration of the various redemptions, where the parties have shown that they do not consider the contract binding. Johnston v Commr, 77 TC 679 (1981).

(9) Niedermeyer v Commr, 62 TC 280 (1974), affd, 535 F2d 500 (9th Cir 1976); Bleily & Collishaw, Inc v Commr, 72 TC 751 (1979), affd, 647 F2d 169 (9th Cir 1981).

(10) Merrill Lynch & Co v Commr, 120 TC 12 (2003), affd, 386 F3d 464 (2nd Cir 2004) on remand, 2008 US Tax Ct LEXIS 36 (Dec 30, 2008).

(11) Rev Rul 75-117, 1975-1 CB 273.

(12) IRC § 302(b)(3).

(13) Merrill Lynch & Co v Commr, 120 TC 12 (2003), affd, 386 F3d 464 (2nd Cir 2004), on remand, 2008 US Tax Ct LEXIS 36 (Dec 30, 2008).

(14) IRC § 302(b)(1).

(15) 397 US 301 (1970).

About LexisNexis | Terms & Conditions | Contact Us
Copyright © 2009 LexisNexis, a division of Reed Elsevier Inc. All rights reserved.