CHAPTER 5 - REDEMPTIONS AND PARTIAL LIQUIDATIONS

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5-1. Under plan (a), Father can qualify for exchange treatment pursuant to §302(b)(3) if a §302(c)(2) election is made. Father will have an amount realized of $500,000 and an adjusted basis of $300,000, producing a taxable capital gain under §1001(a) of $200,000. Son will then take the proceeds in cash, and Son will not change his stock basis. Will the constructive ownership rules of §318(a)(1) prevent Father from obtaining exchange treatment? While it is true that Father will be deemed own 100% of the stock before and after the transaction pursuant to §318, the family attribution rules can be waived so that Father will qualify for exchange treatment. §302(c)(2). This plan takes advantage of the exchange treatment provided by §302(a) but does not take advantage of the step-up in basis provided by §1014(a). (The estate and gift tax implications of this problem should be ignored.)

Under plan (b), Father's estate will be entitled to a step-up in basis under §1014(a) but the redemption will be taxed as a distribution because Son is a beneficiary of the estate and the entity attribution rules of §318(a)(2) cannot be waived. Accordingly, the estate will have ordinary income of $500,000 because the corporation has plenty of earnings and profits, and, under the *Levin* case cited at page 166 of the text, Son will probably increase his stock basis by Father's post-death basis of $500,000 (for a total basis of $850,000). This plan takes advantage of the basis step-up provided by §1014(a) but it fails to qualify for exchange treatment under §302(a). Note that Father's basis will not shift to Son under the proposed regulations discussed at pages 43-44 of this Manual.

Under plan (c), Son takes a carry-over basis in Father’s stock of $300,000 under §1015(a). The redemption will be taxed as a distribution under the *Davis* rule because Son is the sole shareholder. Thus, Son will have ordinary income of $500,000 because the corporation has plenty of earnings and profits , and will increase his stock basis by $300,000 (for a total basis of $650,000). This plan fails to exploit both §1014(a) and §302(a).

If plan (d) is followed, Son will take the stock with a fair market value basis of $500,000 under §1014(a), but the redemption will be taxed as a distribution because Son is the sole shareholder and because the corporation has plenty of earnings and profits. See *Commissioner v. Roberts*, 203 F.2d 304 (4th Cir. 1953). Accordingly, Son will have ordinary income of $500,000 and an increase in stock basis of $500,000 (for a total basis of $850,000). As with plan (b), the basis step-up of §1014(a) is obtained but exchange treatment of §302(a) is lost.

The best result is plan (a), since that plan produces only a single capital gain. The worst result is plan (c), where the distribution is taxed as ordinary income and the benefit of §1014(a) is lost. Plan (d) is better than plan (b) because the *Levin* issue need not be faced: the basis carryover is automatic.

5-2. Plan (a) produces the same tax consequences to Mother as it did for Son, again assuming that attribution from Father to Son is avoided by means of an election under §302(c)(2).

Plan (b) now becomes much more attractive because Son is no longer a beneficiary of the estate. If no election is filed under §302(c)(2)(C) by the estate, Son's actual ownership will be imputed to Mother under §318(a)(1)(A)(ii) and then re-attributed to the estate pursuant to §§318(a)(5)(A) and §318(a)(3)(A), causing the estate to have distribution treatment because it will constructively own 100% of the corporation. However, a waiver of the *family* attribution rules made by the estate breaks the chain between Son and Mother, allowing the estate to obtain exchange treatment on the redemption. (The estate cannot waive attribution of Mother's actual stock ownership because only the family attribution rules can be waived under §302(c)(2). Fortunately for the estate, Mother's actual ownership is zero.) Further, this plan allows the estate to obtain the benefit of the basis increase of §1014(a), producing the result that no gain is realized on the redemption.

Plan (c) should give Mother exchange treatment on the redemption, if an election under §302(c)(2) is filed, producing a taxable capital gain of $200,000. If the waiver is not filed, then Mother will have $500,000 of ordinary income because Son's stock ownership will be imputed to Mother, giving her 100% constructive ownership of the corporation after the redemption and because the corporation has plenty of earnings and profits. If Mother has ordinary income, Son will be entitled to a $500,000 basis increase under the *Levin* case. Note the potential problem under §302(c)(2)(B): Mother obtained the stock from a person to whom attribution is applied under §318(a). The last sentence should save the redemption because the transfer from Father to Mother does not have income tax avoidance as a purpose, especially since Father could have waived the attribution rules.

Plan (d) will be taxed just like (c) except that Mother will obtain the benefit of the §1014(a) basis increase, thereby reducing her gain to zero pursuant to §302(b)(3) if she properly files the §302(c)(2) election. The §302(c)(2)(B) problem arises here also because the estate is a person (see §7701(a)(1)) to whom Mother is related under §318(a); however, §302(c)(2)(B) will probably not prevent the waiver because the acquisition of stock was the result of Father's death, not tax avoidance.

Plans (b) and (d) produce the best results for Mother, and Plan (b) is superior to (d) only because the possible problem under §302(c)(2)(B) is avoided.

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5-3a. Since P's amount realized is $1,000 and his adjusted basis is $600, P will have a taxable gain of $400 under §1001(a). P's basis in his remaining shares will be $3,000. Q takes the shares with a basis of $1,000 pursuant to §1012 (total basis of $3800 in his 50 shares).

5-3b. P's ownership has gone from 60 of 100 shares (60%) to 50 of 90 shares(56%). P cannot qualify under §302(b)(2) because (1) his post-redemption ownership exceeds 50% and (2) his ownership has not gone below 80% of his pre-redemption ownership (since 80% of 60% is 48%). Without more facts, §302(b)(l) may not apply. Thus, pursuant to §302(d), P should have a distribution of $1,000 of ordinary income taxable under §301(c)(1). P's basis in his remaining shares should increase by $600 to $72 per share. See Treas. Regs. §1.302-2(c).

5-3c. P owns 39 of 79 shares outstanding (49.37%), after the redemption. Since he owned 60% prior to the redemption, qualification under §302(b)(2) requires that he drop below 48%. Will P qualify for exchange treatment under §302(b)(1)? It should - note that, because all of the remaining shares are owned by Q, the effect of the redemption is to give Q control of the corporation. See *Rev. Rul.* 75-502, cited at page 178 of the text. If P qualifies for exchange treatment, he will have a capital gain of $840 (amounted realized of $2,100 less adjusted basis of $1,260), and a basis of $2,340 in his remaining 39 shares. If P fails to qualify for exchange treatment, then he should have distribution treatment of $2,100 under §302(d). With e & p of $2,000, P should report a $2,000 dividend and reduce his stock basis by $100. His aggregate basis in the remaining 39 should be $3,500.

5-3d. P's post-redemption ownership is 10 of 50 shares, or 20%. Thus, he qualifies for exchange treatment under §302(b)(2), giving him a taxable gain (likely capital gain) of $2,000 under §§302(b)(2), 302(a) and 1001(a). P's basis in his remaining 10 shares is $600.

5-3e. (i) Many students will be surprised to discover that there is no sibling attribution under §318(a). (Compare §267(c).) Another peculiar omission in §318(a) is the lack of attribution from grandparents to grandchildren - there is attribution from grandchildren to grandparents, §318(a)(1)(A)(ii). Because there is no sibling attribution, there is no change to part (d).

(ii) There is attribution from parent to child, §318(a)(1)(A)(ii), so that P will be considered to be a 100% owner both before and after the redemption. Under *Davis*, such a redemption cannot qualify under §302(b)(l), and it also fails to qualify under §302(b)(2)-(3). Thus, P will have distribution treatment, assuming that the redemption is not a partial liquidation under §302(b)(4). It is appropriate at this point to ask why the answer to (i) did not come out the other way via the chain from P to P's mother to Q, citing §§318(a)(1)(A)(ii) and §318(a)(5)(A). Then, when someone points out §318(a)(5)(B), observe that chains of attribution can be constructed such as from P to P's mother to a corporation controlled by P's mother - all that §318(a)(5)(B) does is prevent a chain with two consecutive links under §318(a)(1).

(iii) The students should first be shown the chain of attribution from Q to P under §318(a)(3) followed by §318(a)(2). Under this chain, all of Q's ownership would be imputed to the partnership but only half would be imputed out. However, even that much attribution is ruled out by the anti-sidewise rule of §318(a)(5)(C). Accordingly, none of Q's stock ownership is imputed to P, so that there is no change to the answer for part (d).

(iv) P will be deemed to own 30 of 50 shares after the redemption, 10 directly and 20 constructively under §318(a)(2)(C). Accordingly, P will fail the 50% test of §302(b)(2). Can P qualify for exchange treatment under §302(b)(1)? Probably not, because there has not been a "meaningful reduction" in P's ownership. See the *Patterson Trust* case. Suppose the remaining stock of Q is owned by shareholders, unrelated to P, and that P and the shareholders often cannot agree on the management of Q. Those circumstances may favor exchange treatment on the redemption of P's X Corp. stock. If P fails to qualify for exchange treatment, P will have a distribution of $5,000 taxable under §301. Under §301(c)(l), P will have ordinary income of $2,000. The remaining $3,000 of the distribution will reduce P's basis in his X Corp. stock, see §301(c)(2) leaving that basis at $600.

(v) This variation raises the issue of back-to-back application of the constructive ownership rules of I.R.C. §318. Under §318(a)(5)(B), the family constructive ownership rules cannot be applied back-to-back. Under §18(a)(5)(C), the entity constructive ownership rules cannot be applied back-to-back. However, no rule prevents the operation of the entity attribution rules under §318(a)(2) followed by family attribution rules under §318(a)(1). Consequently, P is deemed to own 80% of the X Corp. shares prior to the redemption (60 directly and 20 constructively) and 60% after the redemption (10 directly and 20 constructively). See the discussion of in (iv) to determine of redemption treatment applies.

5.4 If the form of the transaction is respected, then the redemption by Z of the stock held by X will be treated as a distribution described in §301 because X's constructive ownership of Z both before and after the redemption is 100% (Y's stock of Z is attributed to O under §318(a)(2)(C), and then reattributed to X under §318(a)(3)(C).) Because Z has adequate earnings and profit to cover this distribution, it will be treated as a dividend to X qualifying for an 80% dividends-received deduction under §243 (X and Y do not constitute an "affiliated group" within the meaning of §1504 because there is no common parent).

X's basis of $10,000 in the Z stock should shift to Y. Treas. Regs. §1.302-2(c) and the *Levin* case cited at page 166. Accordingly, gain on Y's sale of the Z stock is only $25,000 (amount realized of $50,000 less adjusted basis of $25,000). Total income to X and Y, therefore, equals 20% of $50,000 (or $10,000) plus $25,000, for a total of $35,000. That compares favorably with a direct sale by X and by Y, because structured that way there would be a combined gain of $75,000. *Note that the results in this problem will change significantly if the proposed regulations discussed at pages 51-52 of this Manual are finalized.*

Has something gone wrong? In general, a corporate subsidiary should distribute its earnings and profits prior to a sale of its stock by its corporate parent. See the discussion of *Waterman Steamship* and related cases at pages 149 and 152. Reading *Litton* (page 142) narrowly, careful corporate tax planners believe that the distribution should occur before any negotiations for a subsequent stock sale occur. It is not clear whether Z, in this problem, has met that narrow standard.

Note in particular that if the distributed cash can somehow be traced to the purchaser of Y's Z stock (*e.g.,* if the $50,000 distributed cash was Z's operating capital that the purchaser

replaced), the initial redemption might be combined with the subsequent sale into a single, integrated sale transaction. Note as well that if Y's sale was "clearly planned" when the redemption occurred, the Service may argue that the redemption should be deemed a complete termination of interest under the *Zenz* doctrine. *See* Rev. Rul. 75-447 (discussed at page 196).

As an alternative to Z's redemption of the stock held by X, Z could distribute $25,000 dividends to X and Y on their Z stock, each qualifying for the 80% dividends received deduction. X and Y could then sell their Z stock to the unrelated purchaser for an aggregate consideration of $50,000, resulting in an aggregate $25,000 gain. If the dividends were distributed before the sale was negotiated and the purchaser did not replace the distributed funds, the dividend distributions and sales should be respected as independent steps for tax purposes. Then, X and Y would have a net $35,000 of income, $25,000 from the sales and $10,000 from the dividend distributions.

5.5 Section 302(b)(2) applies to the redemption of P's X stock only if the two redemptions are tested separately for tax purposes. Then, if P's redemption occurs first, P will own 60% of the X stock before the redemption (60/100) and 27.3% after the redemption (15/55). Because 27.3% is less than both 50% and 48% (80% of 60%), the redemption would be described in §302(b)2).

If the redemptions are part of a plan, the effect of P's redemption should be determined by considering P's ownership before the first redemption and after the second. §302(b)(2)(D). In that case, P would own 60% of the X stock before the first redemption and 75% of that stock after the second (15/20), and the redemption would not be described in §302(b)(2).

Whether or not the two redemptions were part of one plan, the redemption of Q's X stock would be described in §302(b)(2). Q would own at a minimum 40% of the stock before the relevant redemption (40/100) and would own at most 25% of the stock after the relevant redemption (5/20). Because 25% is less than both 50% and 32% (80% of 40%), the redemption would be described in §302(b)(2).

If Q owns 40 shares of X voting preferred stock, rather than 40 shares of X voting common stock, and each share has one vote per share, the results are the same, even though Q does not meet the third arithmetic test of §302(b)(2) (*i.e.,* the "common stock" test): Q's percentage of common stock after the transaction (0%) *is not less than* 80% of her percentage before the transaction (80% of 0); instead the two amounts are equal. However, the Service has ruled that the "common stock" test is disregarded if a corporation redeems a shareholder's voting preferred stock and the shareholder owned no common stock, actually and constructively, before the redemption. Rev. Rul. 81-41, 1981-1 C.B. 121) (discussed at page 164 in the text). Because Q owns no X common stock, the third test can be disregarded, and Q's redemption is described in §302(b)(2).

Note that it may have made more sense for the Service to conclude in Rev. Rul. 81-41 that the redemption was described in §302(b)(1) (*i.e.,* not essentially equivalent to a

dividend). That interpretation would not have required the Service to disregard relevant statutory language.

Problems, page 182

5-6. This problem helps students explore the reach (and ambiguity) of §302(b)(1). Although its reach is unclear, it certainly cannot apply unless the redeemed shareholder's *relative* economic interest in the redeeming corporation is reduced as a result of the redemption. It may also apply if the shareholder has a significant reduction in control or the shareholder did not have meaningful control in the corporation before or after the redemption. Those points are discussed in the text at page 178.

5-6a. Part (i): In a comparable case, the Service has concluded that the redemption was described in §302(b)(1), because the redeemed shareholder lost voting control. *See* Rev. Rul. 75-502, 1975-1 C.B. 111 (concluding that a reduction from 57% to 50% was meaningful when an unrelated shareholder owned the other 50 percent). Thus, Because B has lost voting control, reducing her interest from 54% to 50%, with an unrelated shareholder owning the remaining 50% interest, the redemption should be treated as not essentially equivalent to a dividend. Rev. Rul. 75-502 likely assumes that the redeeming corporation does not have cumulative voting. If X Corp. has cumulative voting, the redemption may not be described in §302(b)(1), because B may be able to elect exactly the same number of directors before and after the redemption (at least if the total number of directors is an even number)..

5-6a. Part (ii): Unless the 50 unrelated shareholders have banded together to vote their stock as a block (*e.g.*, through a voting trust), the redemption likely is not essentially equivalent to a dividend, because Q retains essentially the same control over the corporation before and after the redemption. Note that, statistically, the chances that the other 50 shareholders would be united against B are only $1/2^{50}$ (or 1/1,125,899,906,842,624).

5-6b. Part (i): Because one unrelated shareholder owns more than 50% of the stock (assuming only one class of stock), the redemption has not affected B's control over the corporation. Before and after the redemption she had no effective control. Rev. Rul. 56-183, 1956-1 C.B. 161 (concluding that a redemption was described in §302(b)(1) when a shareholder's interest was reduced from 11% to 9% and remaining stock was owned by unrelated shareholders). Note, however, that this analysis may be affected if the corporation elects its board using cumulative voting and B can be assured that she can elect one member of the board before and after the redemption.

5-6.b. Part (ii): As written, Rev. Rul. 56-183 appears to apply with the same force to the situations in 5-6.b.i. and ii. However, if the stock of a corporation is publicly traded, a shareholder owning 10% or 12% of the stock may exercise significant control over the corporation. (Ross Perot's ownership of General Motor's stock is one notorious example.) Thus, both before and after the redemption, B may exercise meaningful

control over the corporation and arguably the redemption should not be described in §302(b)(1).

5-7. This problem implicates §303. Under §303(a), the benefit of §303 cannot exceed the amount of taxes imposed on the estate plus the amount, if any, of administration expenses allowed as a deduction against the estates estate tax liability. Here, that amount is $400,000. Accordingly, §303 can only apply to $400,000 of the $500,000 distributed.

Does §303 apply at all? Under §303(b)(2)(A), the value of stock in the redeeming corporation held by the estate must exceed 35% of the value of the gross estate less the estate tax deductions for expenses, debts, taxes, and losses allowed by §§2053 and 2054 which are here assumed to be zero. When the estate consists of the redeemed shares worth $500,000 and cash of $800,000, the stock equals about 38% of the value of the gross estate. Accordingly, §303 applies to treat $400,000 of the $500,000 as received in exchange for 400 of the shares redeemed, and the remaining $100,000 and 100 shares are taxed as considered in problem 5-2.

If Father's estate consists of the $500,000 in stock of X Corp. as well as $2,000,000 in stock of other corporations, the transaction will not be described in §303(b)(2)(A) because the value of the stock in the redeeming corporation ($500,000) is less than 35% of the value of the gross estate ($2,500,000). However, because the value of the X Corp. stock in Father's estate equals 20% of the value of all X stock, §303(b)(2)(B) is implicated. Under that section, if Father's estate includes other stock of another corporation that comprises at least 20% of the value of all stock of that corporation, the estate will treat that stock and its X stock as stock of a single corporation for purposes of meeting the 35% threshold of §302(b)(2)(A).

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5-8a. This may well be a partial liquidation, not under the safe harbor of §302(e)(2)(there is no termination of a business) but under the general rule of §302(e)(1)(A). Two problems arise: was the distributed working capital needed before the contraction and not needed after, or is the closing of one furnace a masquerade for the distribution of excess working capital property taxable as a dividend? In addition, the furnace has been "closed down" but not sold leaving open the possibility that the company can reactivate the furnace without incurring substantial expense.

If T is a corporation, the distribution will not be taxed as an exchange under §302(b)(4). See §302(b)(4)(A). See Note 4 at page 186 of the text.

No stock need be turned in to qualify under §302(b)(4). See Note 3 at page 185 of the text.

5.8b. This transaction will qualify as a partial liquidation if operation of the log mill satisfies the requirements of §302(e)(3). At issue is whether a captive supplier of the lumber yard

can be considered to be in an active trade or business. Under Regs. §1.346-1(c), the "active conduct of a trade or business" for a partial liquidation is the same as the "active conduct of a trade or business" under §355. Under Regs. §1.355-3(c) (ex 11), the answer seems to be that a captive supplier *is* considered to be in a trade or business.

If the lumber yard his been operated for only 4 years, then §302(e)(2) will not apply. See §302(e)(3)(A). If the lumber yard has been operated for at least five years but Y acquired it only four years ago, §302(e)(2) will apply if that acquisition by Y was tax-free. See §302(e)(3)(B). An incorporation under §351 or a tax-free reorganization will satisfy §302(e)(3)(B). Of course, if the benefit of §302(e)(2) is unavailable, partial liquidation treatment might be available under §302(e)(2)(A) anyway.

What is the effect of distributing $250,000 to T in exchange for stock worth only $200,000? One would like to say that the transaction should be bifurcated into two transactions: a distribution of $200,000 in partial liquidation and a distribution of $50,000 taxable directly under §301. Is this the proper approach? Note that if only $200,000 had been distributed in exchange for T's stock, that distribution presumably would not have qualified as a partial liquidation because some of the sale proceeds generated by terminating the log mill would have been retained by the corporation.

Should the transaction be treated as a redemption of stock worth $250,000 followed by a stock dividend worth $50,000? Probably not: what if T owned only $200,000 worth of stock?

5.8c. At issue is whether the growth from within has risen to the level of a distinct trade or business. Example 10 of Regs. §1.355-3(c) treats the selling and processing of meats as two separate trades or businesses. Are the facts of this problem close enough to this example? Probably not: note in particular that the ice cream parlor and food service share seating. On the other hand, the ice cream business will be run at a separate location *after* the distribution so that it then will be a separate trade or business. Is that enough? But note, this transaction will probably still qualify under §302(b)(3) because it is a complete redemption; this assumes, of course, that there are no constructive ownership problems.

Problems, page 195

5.9 C's purchase of D's shares will result in a $2,400 capital gain to D. C's basis in his 80 shares will be $5,600 (old basis of $1,600 plus cost basis in new shares of $4000). When C dies, the basis in his 80 shares will be stepped up to a fair market value of $10,000 pursuant to §1014. Although B had agreed to buy all of C's shares, B only wants to buy 40 of the shares. The estate of C and B agree that B will buy 40 shares and that X Corp. will redeem the remaining 40 shares from C's estate. This question raises the *Holsey/Sullivan* problem. To the extent that X Corp. is satisfying an unconditional obligation of B to purchase C's shares, there should be a constructive distribution $5,000 to B. Here, though, it is unclear whether such an obligation exists as to the 40 shares acquired by C from D. Can B argue that to settle the unliquidated dispute, the original

buy-sell contract between B and C was cancelled by agreement of the parties and a new agreement was put in its place? If so, then there should be no constructive distribution to B; the estate will not have any gain on the sale or redemption, and B will have a basis of $6,600 in the 80 shares (old basis of $1,600 plus a cost basis of $5,000.) Thus, in structuring the eventual transaction, individual B should insist that there be language in the final document indicating that the transaction reflects a settlement of unresolved claims and represents a novation of the original contract.

If B is a corporation, then presumably B will desire dividend treatment because of the dividends-received deduction (§243). Accordingly, X Corp. should make an explicit distribution to B and then B should purchase the shares directly. Further, the parties should agree that B has an unambiguous obligation to purchase all of C's shares including those acquired from D.

Problems, page 197

5-10a. A will have a dividend of $50,000 under §301 followed by a capital gain of $10,000 on the sale of shares, taxable under §1001(a). P will have no gain or loss on the transaction and will take the stock with a basis of $50,000 under §1012. The corporation will reduce its current earnings and profits account by $50,000 as a result of the dividend pursuant to §312(a)(1). Note that the dividend income may be qualified dividend income, taxed at the same rate as long-term capital gain.

5-10b. A will have a gain of $60,000 on the sale, half reportable at the time of sale and half at the time the note is satisfied. See §§1001(a), 453. P will have dividend income of $50,000, whether or not there is a redemption of some of his shares, under *Davis*. P's basis in the stock will be $100,000 under §1012 and *Crane.*

5-10c. The sale will produce a capital gain of $30,000, taxable under §1001(a), and the redemption will qualify for exchange treatment under the complete termination of interest safe harbor of §302(b)(3), see *Zenz v. Quinlivan*, page 196, producing another taxable capital gain of $30,000. P will take a cost basis of $50,000 in the shares. §1012. So long as the sale and redemption are part of a single transaction, the order does not matter. See Rev. Rul. 75-447,1975-2 C.B. 113, page 196. Here, A has been "Zenzed" out. Note that the Service extended *Zenz* in Rev. Rul. 54-458 , page 190**,** to a part sale, part redemption transaction producing exchange treatment on the redemption under §302(b)(2).

5-10d. If A is a corporation, the dividends received deduction of §243 makes route (a) the most advantageous. The ideal transaction would be for A Corp. to receive a dividend of $60,000 followed by a sale of stock for $40,000, letting A recover all of its basis before being taxed on its profit. Such an approach would produce no income if A qualified for a 100% dividends received deduction under §243 or at most $18,000 of income if A qualified for only the 70% dividends received deduction (since 30% of the $60,000 dividend is $18,000). See also the discussion of problem 5-4 above.

5-11. If the form of the transaction is respected, the $15,000 payment is not includible in B's income. §104. On the redemption, B will not recognize any gain pursuant to §302(b)(3). Despite the form of the transaction, the substance seems to be that X Corp. is redeeming 10 shares owned by B for $550 per share ($5,500 total) and is paying B only $10,000 to settle the slip-and-fall. Thus, B should report a gain of $5,000 on the redemption via §302(b)(3) and should exclude the $10,000 under §104(a)(2). Consistent with this characterization, the corporation presumably should deduct the $10,000 paid on the slip-and-fall.

But suppose we know that the true value of the slip-and-fall is only $10,000. The Commissioner might argue that the additional $5,000 is taxable to B as a distribution under §301 on the theory that overpayment by a corporation to a shareholder should be treated as a distribution made with respect to the shareholder's stock. See under *Durkin v. Commissioner,* 99 T.C. 561 (1992). Of course, this analysis turns on knowing that the $15,000 nominally paid by X Corp. to settle the slip-and-fall was excessive, but that fact seems evident once we recognize that the corporation paid too little for the shares turned in by B.

If B sells his shares to C, the Service may argue that C has received a dividend from X Corp. in the amount of $5,000. C would then be deemed to have purchased B's shares of $550 per share.

Problem, page 203

5-12. The Commissioner will argue that this transaction should be recharacterized as a surrender of 2 shares by T to X Corp., followed by a distribution by X Corp. of those shares in exchange for the services performed by U. If this recharacterization is accepted, T's adjusted basis in the remaining 8 shares will go from $100 per share to $125 per share, with no other tax consequence to T. X Corp. presumably should be entitled to a §162 deduction equal to the value of the services provided by U, or $150. U should have compensation of income of the same amount, $150, and then that value should become U's basis in the 2 shares received in the transaction.

T might argue for a loss equal to the basis of the 2 shares transferred, but that seems unlikely to be successful after *Fink.* T could argue that the 2 shares were sold to U for their fair market value of $150 per share, giving T a $25 per share capital loss. Consistent with that recharacterization, T then contributed the right to accounting services to X Corp., allowing T to increase her basis in the 8 remaining shares by $150, to $118.75 per share. U would again have compensation income of $150 as well as a $150 adjusted basis in the 2 shares, though under this approach the corporation would have no deduction.

Who should win? The Commissioner, because Regs. §1.83-6(d) covers just this situation. This regulation was upheld in *Tilford v. Commissioner*, 705 F.2d 828 (6th Cir. 1983)), *rev'g* 75 T.C. 134 (1980).

Problems, page 210

5-13a. This is the easiest §304(a)(1) case. Section 304(a)(1) applies to this transaction because F owns at least 50% of X and Y prior to the transaction, see §302(c)(1). Accordingly, F will be taxed under §301 on the sale proceeds unless he qualifies for exchange treatment under §302(a), see §304(a)(1), with the tests of §302(b) applied to F's ownership of X Corp., see §304(b)(l). Because the attribution rules of §318(a) apply to §304 transactions, see §304(c)(3), and because F is the sole shareholder of Y Corp. (called the acquiring corporation in §304), F's post-redemption ownership of X Corp. (the issuing corporation) does not decline as a result of the transaction: see §318(a)(2)(C). Accordingly, F will be taxed on a distribution of $7,000 under §301, and because the earnings and profits of both corporations are available, see §304(b)(2), F will have dividend income of $7,000. Under §304(b)(2), Y Corp. will reduce its earnings and profits account to $0, and X Corp. will reduce its earnings and profits account to $3,000. F's basis in his Y Corp. stock should be increased by $1,750. See the last sentence of §304(a)(1).

As to Y, the X stock is deemed received in a §351 transfer, see §304(a)(1) (last sentence), giving Y a carryover basis of $1,750 in that stock under §362.

If P Corp. is the sole shareholder of both X Corp. and Y Corp., then §§1059(e)(1)(A)(iii) and (a) act to prevent P Corp. from claiming a dividends-received deduction under §243 (*i.e.*, reporting no net income on the deemed distribution under §304) but then using the basis of the redeemed stock to generate a loss (or less gain) on a later sale (*i.e.* the basis would flow to P Corp.'s basis in the Y Corp. or to P Corp.'s basis in the remaining X Corp. stock if P did not directly own Y Corp. stock). Under current law, the "tax-free" dividend under §243 is treated as an extraordinary dividend under §1059 which reduces the basis of the shares redeemed so that P Corp. cannot get tax-free income and keep all the basis of the shares redeemed.

Accordingly, P Corp. cannot take a dividends-received deduction under §243, thereby excluding income while using the basis of the redeemed shares to help generate a loss or less gain when P Corp. sells Y Corp. shares (*i.e.* the value of the Y Corp. stock remains the same but P Corp.'s basis appears to go up by $1,750). However, the last sentence of §304(a)(1) triggers §1059 because X Corp. has held the deemed Y Corp. stock for less than two years. Consequently, §1059 reduces the basis of the shares redeemed down to $0 on the $7,000 "extraordinary" dividend. Moreover, P Corp. would recognize a gain of $7,000 minus $1,750 — $5,250 under §1059(a)(2). No basis flows into P Corp.'s shares in Y Corp.

5-13b. Section 304(a)(1) still applies because F's 50% ownership of Y, coupled with his 50% or more ownership of X, triggers application of §304. See §304(c)(1). After the redemption, F will own 30 shares of X outright and will constructively own 35 more from Y. See §318(a)(2)(C). A decline from 100% to 65% will not qualify under §302(b)(2), so F should have distribution treatment under §302(d) unless §302(b)(1) applies to this transaction. Should it? Without more facts, there is no reason that it should, but recall *Henry Patterson Trust.* Assuming that F has distribution treatment under §§302(d) and §301, the

change in earnings and profits and the basis consequences of part (a) should obtain. If §302(b)(1) applies, F will have a capital gain on $5,250 (amount realized of $7,000 less an adjusted basis of $1,750), and Y Corp. will take a cost basis on $7,000 in the stock pursuant to §1012.

5-13c. Application of §304 is appropriate because the control test is met prior to the transaction, actually with respect to X Corp. and constructively through F's son as to Y Corp. See §§304(c)(l), 304(c)(3), 318(a)(1)(A)(ii). F actually and constructively owns 100% of X Corp. after the transaction, so that distribution treatment under §301 (see problem 5-13a for tax consequences) is mandated under the *Davis* rule. Because F has no actual ownership of Y, the basis implications of the transaction are unsettled. Rev. Rul. 71-563 says that F's basis in the transferred shares flow into F's basis in the 30 X Corp. shares retained by F. However, as observed in *Coyle v. United States,* 413 F.2d 488, 493 (4th Cir. 1969), "it would be consonant with the underlying rationale of [§304(a)(1)] to increase pro rata the basis of the [son's] shares in [Y Corp.]."

5-13d. F will have a dividend of $5,000 and X Corp. will reduce its earnings and profits account to $0. Note that the earnings and profits accounts of X and Y are not simply combined — a deficit in one corporation's earnings and profits account cannot offset a surplus in the account of the other corporation. See §304(b)(2). Under §301(c)(2), F should apply the remainder of the distribution, i.e., $2,000, against his stock basis. Does he apply it against his basis in the X stock transferred to Y, against his basis in his remaining X stock, or against his basis in his Y stock? Under the last sentence of §304(a), the basis offset is F's basis in the Y Corp. stock. Thus, F's basis in his Y stock will equal $1,750 plus his pre-transaction basis in the Y stock, because F's basis in the X stock transferred to Y was $1,750. Accordingly, if F had a basis in the Y stock of at least $250, he reduces his Y stock basis by $2,000 under §302(c)(2) and will have no further gain or loss on the transaction.

5-13e. *Reconsideration of part (a).* If F received nothing but Y stock, §304 would not apply because stock of the acquiring corporation is not treated as "property" under §304. See §317(a). On the other hand, the transaction would be described by §351, and under that provision, F would have no gain or loss and there would be a double carry-over of basis under §§358 (to F) and 362 (to the corporation). Given the $5,000 of cash in the problem, the situation seems to be described in both §304 and §351. In such cases, taxpayers argue for taxation under §351 - producing taxable capital gain of $5,000 on the transaction under §351(b) - rather than taxation under §304, since application of §304 might subject the entire amount of the boot ($5,000) to ordinary income treatment under §§302(d) and 301(c)(l). In *Commissioner v Stickney*, 399 F.2d 828 (6th Cir. 1968), it was held that application of §351 precluded the application of §304. F should be treated as engaging in a §304 transaction as to only 50 of the shares.

As part of the Tax Equity and Fiscal Responsibility Act of 1982, §304(b)(3)(A) was added to the Code to provide that §304 overrides §351 to transactions described in both sections. Accordingly, F will have a taxable distribution of $5,000 under §304(a)(1) and will have transferred 20 shares of X Corp. to Y Corp. in a transaction described in §351.

Reconsideration of part (b). Assuming that $2000 worth of Y stock does not increase F's percentage ownership of Y to 80%, there is no over-lap between §304 and 351 in this case because F's post-transaction percentage ownership of F fails to satisfy the 80% control test of §368(c), made applicable to §351 by §35l(a).

In applying the test of §302(b) to F's ownership of X Corp., we must impute some of Y Corp's ownership of X back to F under §3l8(a)(2)(C). However, we cannot determine F's precise constructive ownership of X because we do not know his post-transaction ownership of Y, yet the imputation of ownership from Y to F is in proportion to F's ownership of Y, see §318(a)(2)(C). However, we do know that F's ownership of Y is at least 50%, so F will be treated as owning at least 50% of the 70 shares of X Corp. transferred to Y. Accordingly, F's ownership of X will have dropped from 100% to at least 65%, 30 shares actually owned and at least 35 shares constructively owned. F cannot qualify for exchange treatment under §302(b)(2) or (3), so F will be taxed on a distribution of $5,000 pursuant to §302(d) unless F's reduction in ownership of X is sufficiently meaningful to qualify under §302(b)(1).

If F fails to qualify for exchange treatment under §302(b)(1), he will be taxable under §301 on a distribution of $5,000 and will increase his basis in his Y Corp. stock by $1,250 (that being his basis in the 50 shares exchanged for the cash). If F qualifies for exchange treatment under §302(b)(1), he will have a gain of $3,750 taxable under §1001(a) (amount realized equals $5,000 and adjusted basis in the shares sold equals $1,250. Note that the exchange of 20 shares of X Corp. stock for $2,000 worth of Y Corp. stock is not described in §§304 or 351, so that F should have a taxable gain on this component of the exchange of $2,000 less his $500 basis in the shares, for a net gain of $1500. Note that by receiving Y stock rather than property, F was able to avoid distribution treatment under §§304 and 302. If the Y stock is preferred stock, F may have successfully begun a preferred stock bailout, discussed in Chapter 6.