

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **20064401F**

Release Date: 11/3/2006

CC:SB:2:PHI:2:GAThorpe
POSTF-117599-06

UILC: 302.01-00

date: June 07, 2006

to:
()

from: Area Counsel 2 (Philadelphia)
(Small Business/Self-Employed)

subject: Redemption of Stock

This Field Advice responds to your request for assistance, dated March 3, 2006. This advice may not be used or cited as precedent.

LEGEND

ISSUE

Whether the redemption of a portion of the stock of Corporation held by Taxpayer satisfies the “not essentially equivalent to a dividend” requirement set forth in I.R.C. § 302(b)(1).

CONCLUSIONS

We recommend that you take the position that the § 302(b)(1) requirement has not been met. Consequently, we recommend that you issue a claim disallowance letter denying Taxpayer’s claim for refund.

FACTS¹

On or about Date 1, Corporation made an offer to purchase up to Number 1 shares of its Common Stock and up to Number 2 shares of its Class A Common Stock for Amount 1. Corporation's Common Stock is publicly traded on the New York Stock Exchange; its Class A Common Stock is not publicly traded. The principal difference between the two classes of stock is that each share of Common Stock is entitled to one vote while each share of the Class A Common Stock is entitled to ten votes. Both classes of stock are

¹ Unless otherwise indicated, we assume that the factual representations made in Taxpayer’s request for a private letter ruling are correct.

entitled to receive dividends and liquidating distributions and exercise other rights on a pro rata basis.

At the time of the tender offer, there were Number 3 shares of Common Stock and Number 4 shares of Class A Common Stock outstanding. Taxpayer held Number 5 shares of the Common Stock and Number 6 shares of the Class A Common Stock. At that time, the decedent's widow and her children held Number 7 shares of Common Stock and Number 8 shares of the Class A Common Stock. Corporation's directors and/or executive officers collectively held Number 9 shares of the Common Stock and Number 10 shares of the Class A Common Stock. (The tender offer indicated that Corporation's directors/executive officers would not tender any of their stock for redemption.) Person 1, the chairman of Corporation's board of directors and Taxpayer's executor, held Number 11 shares of the Class A Common Stock and exercised voting control over another Number 12 shares of that stock. Thus, by virtue of his personal holdings and his position as Taxpayer's executor, Person 1 controlled Corporation both before and immediately after the redemption.

Under the decedent's will, Corporation's stock held by Taxpayer passed to a residuary marital trust. The decedent's widow is entitled to the trust income during her lifetime. Upon her death, the corpus of the trust will be distributed to nine of the decedent's children and one of his grandchildren per stirpes.² The decedent's widow, Person 1, and Person 2 are the trust's co-trustees.³ Any two co-trustees can make decisions for the trust.

As indicated in the tender offer, Taxpayer tendered Number 13 shares of Common Stock and Number 14 shares of the Class A Common stock for redemption. Corporation accepted for redemption all of the Class A Common Stock and Number 15 shares of the Common Stock tendered by Taxpayer.⁴ (Taxpayer received Amount 2 for its stock.) One other shareholder tendered Number 16 shares of Class A Common Stock, which were accepted for redemption by Corporation. Overall, less than 20% of the shareholders participated in the tender offer. All of the redeemed stock was cancelled.

On or about Date 2, Taxpayer filed its original income tax return (Form 1041) for the taxable Year 1 reporting the redemption proceeds as a dividend.⁵ This resulted in taxable income of Amount 3 and a tax liability of Amount 4, which Taxpayer paid. After filing its original return, Taxpayer requested a private letter ruling as to whether the

² Five of the children were by a previous marriage and, thus, are not related to the decedent's widow. Also, the decedent's grandchild is not related to the decedent's widow.

³ We could not determine the relationship between the decedent and Person 2, but we do know that he is not one of the decedent's children.

⁴ The tender offer for the Common Stock was oversubscribed. Thus, pursuant to the terms of the tender offer, the redemption was prorated amongst those shareholders who tendered shares.

⁵ Corporation's earnings and profits exceeded the total amount distributed to the shareholders for their redeemed stock.

redemption should be considered “a distribution in part of full payment in exchange for the stock” pursuant to I.R.C. § 302. Specifically, Taxpayer asserted that § 302 applies because the distribution is not essentially equivalent to a dividend. It is our understanding that the request for a ruling was rejected because the tax year was under examination. On or about Date 3, Taxpayer filed an amended Form 1041 for the taxable Year 1 treating the redemption distribution as proceeds from the sale or exchange of its stock covered by § 302. This reduced the dividends reported by Amount 5, resulting in taxable income of (Amount 6), no tax liability, and an overpayment of Amount 7.⁶

LAW AND ANALYSIS

Section 302(a) provides that “[i]f a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.” Thus, § 302 redemptions are subject to the provisions of I.R.C. § 1001. A redemption occurs when “the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.” I.R.C. § 317(b). If a redemption does not satisfy the requirements of § 302, then it is treated as a distribution subject to the provisions of I.R.C. § 301. I.R.C. § 302(d). Under § 301, distributions made from earnings and profits are considered dividends, which are treated as ordinary income. I.R.C. §§ 301(c)(1), 316(a), and 61(a)(7).

There is no question that the tender offer in question qualifies as a redemption under § 317(b). There is also no question that the distribution was made from earnings and profits. Nevertheless, if one of the conditions set forth in § 302(b) is satisfied, then § 302(a) would apply. If not, then the distribution would be subject to the provisions of § 301.

Taxpayer contends that the redemption satisfies the condition set forth in § 302(b)(1), which accords § 302 treatment to any redemption that is “not essentially equivalent to a dividend.”⁷ The Code does not specifically state what the language “not essentially equivalent to a dividend” means, and the regulations simply indicate that the resolution of that issue “depends upon the facts and circumstances of each case.” Treas. Reg. § 1.302-2(b). However, when considering the facts and circumstances of a particular case, the courts and the Service generally focus on the effect of the redemption on the following shareholder rights: (1) the right to vote and thereby exercise some degree of control, (2) the right to receive dividends, and (3) the right to receive liquidating distributions. See *Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964); Rev. Rul. 85-106, 1985-2 C.B. 116; Rev. Rul. 81-289, 1981-2 C.B. 82. In cases involving voting stock, the effect of the redemption on the taxpayer’s control of the

⁶ The gain reported from the redemption was offset by a capital loss carryover.

⁷ Taxpayer does not contend that any of the other conditions set forth in § 302(b) apply.

corporation is considered the most significant factor.⁸ Rev. Rul. 85-106. See also Johnson Trust v. Commissioner, 71 T.C. 941, 947-48 (1979), acq., 1984-2 C.B. 1.

The Supreme Court has held that for § 302(b)(1) to apply, “a redemption must result in a meaningful reduction of the shareholder’s proportionate interest in the corporation.” Davis, 397 U.S. at 313 (emphasis added) (holding that there was no meaningful reduction of the trust’s interest in the corporation because, after applying the § 318 attribution rules, it was considered the corporation’s sole shareholder both before and after the redemption). When applying this standard in cases where the taxpayer controls the corporation but is not its sole shareholder, the test is whether the redemption causes any meaningful change in the control exercised by the taxpayer before the redemption. See, e.g., Rev. Rul. 78-401, 1978-2 C.B. 127 (reduction of ownership interest from 90% to 60% was not “meaningful” because the taxpayer still controlled the corporation after the redemption); Rev. Rul. 77-218, 1977-1 C.B. 81 (same conclusion where the ownership interest was reduced from 60% to 55%). Similarly, in cases involving minority shareholders, the focus is on whether the redemption caused any meaningful change in the taxpayer’s ability to control the corporation by acting in concert with one or more of the other shareholders (the so-called “control group”). See Johnson Trust, 71 T.C. at 947-48 (2.8% reduction was not “meaningful”); Bloch v. United States, 261 F. Supp. 597 (S.D. Tex. 1966) (one-third reduction was not “meaningful”), aff’d, 386 F.2d 839 (5th Cir. 1967). See also Rev. Rul. 85-106; PLR 9147035, 1991 PLR LEXIS 1802.

While clearly the redemption in this case reduced Taxpayer’s economic interest in Corporation and the number of votes it held, we do not believe that there was a meaningful reduction or change in Taxpayer’s ability to control corporate decisions. Since there was no majority shareholder either before or after the redemption, at least two shareholders would have to act in concert to control the corporation. Before the redemption, the estate held Percentage 1 of the voting power, Person 1 held Percentage 2, Person 2 held Percentage 3, and Person 3 held Percentage 4.⁹ Theoretically, the estate could have combined with any of these shareholders to control Corporation. After the redemption, Taxpayer held Percentage 5 of the voting power, Person 1 held Percentage 6, Person 2 held Percentage 7, and Person 3 held Percentage 8. Thus, after the redemption, Taxpayer could only control Corporation by acting in concert with Person 1.

We do not believe that the change in the potential “control groups” was meaningful. Since Person 1 is Taxpayer’s executor, we believe the only meaningful relationship for control purposes is between him and Taxpayer. As indicated, both before and after the redemption, Person 1 controlled Corporation through his personal holdings and by exercising his power as Taxpayer’s executor. Therefore, applying the Johnson

⁸ For purposes of determining the degree of control exercised by the taxpayer, the attribution rules set forth in I.R.C. § 318 apply. United States v. Davis, 397 U.S. 301, 313 (1970)

⁹ No other shareholder had sufficient holdings to gain control of Corporation by acting in concert with one other shareholder either before or after the redemption.

Trust/Bloch rationale, we believe that you should take the position that there was no “meaningful reduction” in Taxpayer’s interest in Corporation as required by Davis.

Taxpayer incorrectly contends that the facts considered in Rev. Rul. 75-512, 1975-2 C.B. 112 (5.8% reduction in the taxpayer’s interest) and Rev. Rul. 76-364, 1976-2 C.B. 91 (4.5% reduction in the taxpayer’s interest) are indistinguishable from those in this case. In each case, the Service ruled that the redemption of stock held by a minority shareholder was not essentially equivalent to a dividend. However, in Rev. Rul. 75-512, another shareholder controlled the corporation both before and after the redemption and, therefore, the Johnson Trust/Bloch rationale did not apply. Similarly, in Rev. Rul. 76-364, the Service’s ruling was based, in part, on a finding that the redemption “caused A [the taxpayer] to go from a position of holding a block of X [the corporation] stock that afforded A control of X if A acted in concert with only one other shareholder, to a position where such action was not possible.” Clearly, the facts in both of these revenue rulings are distinguishable.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ if you have any further questions. We have enclosed the documents you sent to us along with your request for advice.

Gerald A. Thorpe
Senior Counsel (Philadelphia, Group 1)
(Small Business/Self-Employed)

Enclosures:
As stated.