INTRODUCTION AND STUDY OBJECTIVES

The redemption of a shareholder’s stock may be treated as a dividend unless there is a significant reduction of his or her interest in the corporation or a noncorporate shareholder’s stock is redeemed in partial liquidation.

Section 306 stock, which is usually preferred stock previously issued as a nontaxable stock dividend, may bring ordinary income not only upon its redemption, but also on its sale or other disposition.

Distributions of stock and securities of controlled corporations may receive special treatment. A division of a corporation through a spin-off, split-off, or split-up can be tax-free.

In studying the rules of redemptions and certain corporate distributions, the student should have these objectives:

1. To learn the rules of corporate redemptions and their effects on both the shareholder and corporation.

2. To understand how a corporate division takes place and what tax effects it may have on all taxpayers who are a party to the division.

3. To become familiar with preferred stock bailout techniques.

STUDY HIGHLIGHTS

STOCK REDEMPTIONS

1. If a corporation redeems (buys back) its own stock from its shareholders, the transaction will be treated as a sale or exchange that results in capital gain treatment to the shareholder. To qualify as a redemption the corporation must satisfy the provisions of § 302(b) or § 303. Nonqualifying redemptions are treated as distributions under § 301 and the basis of any stock surrendered will be added to the basis of the stock directly or constructively retained.

2. Under § 302(b)(1), a redemption is treated as a sale or exchange if it is not essentially equivalent to a dividend. The term essentially equivalent is not defined in the Code, and as a result of the Supreme Court decision in the Davis case, a judicial interpretation has become somewhat of a gray area of the law. Thus, in determining whether a redemption is not essentially equivalent to a dividend, the courts will look at factors such as whether a meaningful reduction of control by the redeemed shareholder takes place, as well as a meaningful reduction in his interest in corporate earnings.

Example. M, an individual, owns 58% of the common stock of K Corp. After a redemption of part of M’s stock, he owns 51% of the stock. M would continue to have dominant voting rights in K, so the redemption would be treated as essentially equivalent to a dividend and M would have dividend income on the entire amount of the distribution, provided sufficient earnings and profits existed.
3. Under § 302(b)(2), a redemption is treated as a sale or exchange if it is substantially disproportionate. A redemption is substantially disproportionate if, in addition to owning less than 50 percent of the total number of voting shares outstanding (after the redemption), the redeeming shareholder immediately after the exchange owns a percentage of the total stock that is less than 80 percent of the percentage owned immediately before the redemption. In determining whether the required 50 percent and 80 percent tests have been met, stock owned indirectly (constructively under § 318) as well as directly must be considered.

**Example.** M Corporation has 400 shares of common stock outstanding that are owned equally by individuals W, X, Y, and Z (100 shares each). No stock is constructively owned by W, X, Y, or Z under § 318. M redeems 55 shares from W, 25 shares from X, and 20 shares from Y for a total of 100 shares redeemed. For the redemption to be substantially disproportionate, after the redemption a shareholder must own less than 60 shares of the outstanding stock (80% × [25% of the 300 remaining shares]). After the redemptions, W owns 45 shares (15%), X owns 75 shares (25%), and Y owns 80 shares (26 2/3%). The distribution is disproportionate only with respect to W.

4. Under § 302(b)(3), a redemption is treated as a sale or exchange if it completely terminates the shareholder’s interest in the corporation. If all of the stock actually owned by the redeeming shareholder is redeemed and immediately after the redemption the shareholder has no interest in the corporation (other than as a creditor), the family attribution rules of § 318 will be waived. Section 302(c) provides all the requirements for waiving family attribution.

**Example.** Mr. and Mrs. B each own a half interest in Y Corporation and purchased it for $50,000. The corporation redeems all of Mr. B’s stock. Assuming the rules governing the complete termination of a shareholder’s interest under § 302(b)(3) do not apply, the redemption would be treated as a taxable dividend since Mr. B is determined to still own 100% of the company constructively. Mr. B’s basis in the stock of $25,000 would attach to his wife’s stock so that she would have a new basis of $50,000 in the 50 shares she currently owns in Y Corporation.

5. Under § 302(b)(4), a redemption is treated as a sale or exchange if it is a partial liquidation of a noncorporate shareholder’s interest. This section redefines the meaning of partial liquidations due to perceived abuses involving the acquisition and selective liquidation of corporations with favorable tax attributes. A distribution is a partial liquidation if it is not essentially equivalent to a dividend (determined at the corporate level and not the shareholder level). This generally requires a business contraction or termination of one of the corporation’s businesses that has been in operation by the corporation for at least five years. This section applies to distributions that are one of a series of a complete liquidation.

**Example.** A building owned by H Corporation has several floors that are rented, and those that are not rented are used directly by H for its business. A tornado destroyed the two top floors, and H received insurance proceeds. For bona fide business reasons, H did not rebuild the floors, but instead used the excess funds collected from the insurance company to purchase some of its stock from the shareholders. The distribution will qualify as a partial liquidation under § 302(b)(4).
6. Under § 303, a redemption is treated as a sale or exchange if it is a redemption to pay death taxes. A redemption from a decedent’s estate will qualify for sale or exchange treatment if the fair market value of the stock owned by the estate is greater than 35 percent of the value of the adjusted gross estate (gross estate less funeral and administrative expenses). The amount that will qualify for redemption treatment is limited to the sum of funeral and administrative expenses as well as the death taxes paid. A special rule exists to treat multiple corporations owned by a decedent as a single corporation for purposes of determining the 35 percent qualification test.

Example. The adjusted gross estate of a decedent is $300,000. The gross estate includes stock in S and J corporations valued at $100,000 and $80,000, respectively. Unless the corporations can be treated as a single corporation, § 303 will not apply to a redemption of the stock. Assume the decedent owned all the stock of S and 80% of the stock of J. Section 303 would then apply because 20% or more of the value of the outstanding stock of both corporations would be included in the decedent’s estate. Accordingly, the 35% test would be met if the stock were treated as that of a single corporation.

7. Section 318 provides that in applying the stock ownership tests for redemptions, the shareholder is treated as not only owning the shares that he or she actually owns, but also those shares of certain related parties. The following related parties compose the attribution rules:

- **Family Members:** An individual is considered as owning the stock owned by a spouse, children, grandchildren, and parents.

- **Entity to Owner Attribution:** Stock owned either directly or indirectly (constructively) by an entity is considered to be owned proportionally by those having an interest in the entity.

- **Owner to Entity Attribution:** Stock owned by those having an interest in an entity is attributed in full to that entity.

- Special qualifying rules exist under each of these separate attribution rules.

8. The effect of a redemption on a distributing corporation’s taxable income is determined under § 311. After the 1986 Tax Reform Act, these rules are exactly the same as those discussed in Chapter 3 pertaining to the effect of a dividend distribution. In other words, the corporation must recognize its gains but not its losses on a distribution of property.

9. The earning and profits (E&P) of a corporation must be adjusted to reflect any redemption distributions. The DRA of 1984 provided rules stating that E&P is reduced by the redeemed stock’s proportionate share of E&P but never by more than the amount of the redemption distribution.

10. See Exhibit 4-1 of the textbook for an excellent summary of the constructive ownership rules.

### STOCK REDEMPTION BY RELATED CORPORATIONS

11. To prevent shareholders from effectively redeeming stock through their controlled corporation, Congress enacted § 304, “Redemptions through Related Corporation.” This provision provided rules for two types of redemptions, brother-sister and parent subsidiary.

12. A brother-sister redemption occurs where one or more persons controlling each of two corporations sell the stock of one corporation to the other corporation. The sale proceeds are considered as distributed in redemption of the stock of the corporation that acquired the stock and subject to the rules of §§ 302 and 303.
A parent-subsidiary redemption occurs when stock of the issuing corporation is acquired by a corporation controlled by the issuing corporation. The amount paid for the stock will be a dividend by the issuing corporation if the rules of §§ 302 or 303 do not apply.

**Example.** Individual A owns 50% of B Corporation, which in turn owns 50% of C Corporation. B has 200 shares of stock outstanding, 100 of which are owned by D (an individual unrelated to A). A sells 20 of his 100 shares to C for $40,000. He purchased the 20 shares two years ago for $10,000. After the sale, A is considered to own 84 shares in B (80 shares directly + 4 shares owned constructively). Constructive ownership is determined by examining the 20 shares acquired by C, of which 50% are constructively owned by B (10 shares). Of these 10 shares, 40% are now owned constructively by A, thus totaling 4 shares. Since A’s 84 shares represent a 42% in B, the substantially disproportionate ownership test of § 303(b)(2) will not be satisfied. Consequently, the $40,000 will be treated as a dividend to A to the extent of the E&P of C and then to the extent of the E&P of B Corporation. The cost of the 20 shares, $10,000, attaches to A’s basis in his remaining B shares. B is also deemed to have received a dividend from C Corporation in the amount of $40,000.

**PREFERRED STOCK BAILOUTS: § 306**

14. A special provision is designed to prevent a stockholder from receiving a nontaxable stock dividend (usually preferred stock) or receiving a stock distribution (other than common) and disposing of it to avoid reporting dividend income. If the requirements of § 306 are enforced, the amount realized on a sale of the stock is treated as ordinary income to the extent of the *taint*. The taint is the amount that would have been realized as a dividend if, instead of stock, the corporation had distributed cash in an amount equal to the fair market value of the stock. Accordingly, it would be ordinary income to the extent of the shareholder’s prorated share of E&P. Classifying this as ordinary income (not dividend income) means no dividend exclusion nor any reduction in E&P to the extent of the ordinary income may be taxed to the shareholder.

15. If § 306 stock is redeemed by the issuing corporation, the amount realized is treated as a distribution of property under § 301 and therefore qualifies as a dividend distribution to the extent of E&P.

16. Certain exceptions exist to § 306 that do not apply to taint the stock for future disposition. These include:
   - Termination of a shareholder’s interest
   - Complete liquidations
   - Tax-free exchanges
   - Transaction not to avoid tax
STUDY QUESTIONS

True or False

_____ 1. Because the tax consequences of stock redemptions are so complex, an advance ruling is required from the IRS before a redemption can be made.

_____ 2. Corporation A had 400 shares of common stock issued and outstanding, held by four shareholders equally. Corporation X distributed $10,000 to each in a nonliquidating redemption of 5 percent of each of their shares. This transaction qualifies for sale and exchange treatment.

_____ 3. Proportionate redemptions will always be taxed as dividend distributions, provided earnings and profits exist.

_____ 4. A shareholder can waive family attribution rules, provided certain circumstances are met in a complete termination of his or her interest.

_____ 5. A shareholder qualifies for a substantially disproportionate redemption when his interest drops from 60 percent to 45 percent.

_____ 6. A redemption of § 306 stock by the issuing corporation will not be treated as ordinary income if no earnings and profits exist at the time of the redemption.

_____ 7. The “taint” from § 306 stock can be removed by making a gift of the stock to another individual.

_____ 8. For purposes of § 318 attribution rules, brothers and sisters are not considered related to each other.

_____ 9. Individual B owns 160 shares of Corporation X’s outstanding shares of voting stock. Corporation X redeems 60 of B’s shares, leaving her with less than 30 percent of the outstanding shares. The redemption is considered to be substantially disproportionate.

_____ 10. A corporation must request an advance ruling from the Internal Revenue Service before entering into a partial liquidation.

_____ 11. D wishes to redeem all of his interest in Z Corporation and then retire. D owns a 45 percent interest and his son owns the other 55 percent. Because of § 318, D may not receive capital gain treatment on the redemption.

_____ 12. If a distribution qualifies as a complete termination of interest, the stock attribution rules of § 318 are waived.

_____ 13. Distributions that qualify as partial liquidations can be made only to noncorporate shareholders.

_____ 14. Section 317 defines a stock redemption as an exchange between a corporation and a shareholder of that corporation’s stock for property.

_____ 15. A shareholder’s basis in property that is received in a taxable partial liquidation will be the same as the basis to the distributing corporation.
Multiple Choice

1. T, an individual shareholder, owned 200 shares (25 percent) of R Corporation’s stock. R Corporation redeemed 20 shares of stock T owned in exchange for land, held as an investment, having a fair market value of $30,000 and an adjusted basis of $10,000. T’s basis for all of her R Corporation stock was $200,000. T reported the redemption transaction as if it were a dividend. What is T’s basis in the land and her R Corporation stock immediately after the redemption?
   a. Land $30,000; stock $200,000.
   b. Land $10,000; stock $180,000.
   c. Land $30,000; stock $180,000.
   d. Land $10,000; stock $200,000.
   e. None of the above.

2. Assuming the same facts presented in problem 1, how much gain or loss (if any) must R Corporation recognize?
   a. $0.
   b. $10,000 ordinary loss.
   c. $10,000 ordinary gain.
   d. $20,000 ordinary gain.
   e. $20,000 capital gain.

3. In Problem 1, assume T’s share of E&P is $60,000 and R redeemed 50 shares of stock for cash of $75,000. What would be T’s recognized gain?
   a. $25,000 capital gain.
   b. $25,000 ordinary income.
   c. $60,000 ordinary income.
   d. $75,000 return of capital.
   e. None of the above.

4. Corporation H has 1,000 shares of stock issued and outstanding. K, the founder, owns 40 percent of the stock, his wife owns 10 percent, his son owns 20 percent, and the balance is owned by unrelated parties. Under the constructive ownership rules of the stock redemption provisions, what percentage of stock is K considered to own?
   a. 40 percent.
   b. 50 percent.
   c. 60 percent.
   d. 70 percent.
   e. 100 percent.

5. Corporation X distributed $50,000 cash to Shareholder M in redemption of all her stock. M’s basis in the stock is $12,500 and her pro rata share of earnings and profits is $25,000. Assume all the requirements for a redemption are met. What is the effect on M’s taxes?
   a. $0.
   b. $12,500 dividend.
   c. $12,500 capital gain.
   d. $25,000 dividend.
   e. $37,500 capital gain.
Questions 6 through 9 are related and are based upon the following information:

T, an individual, owns a 30 percent interest in a partnership. D, T’s father, owns a 40 percent interest in P. B, T’s brother, owns a 20 percent interest in P, and U, an unrelated party, owns a 10 percent interest in P. The stock of C Corporation is also owned as follows:

T  —  5 percent.
D  —  20 percent.
B  —  15 percent.
U  —  50 percent.
P  —  10 percent.

6. Under § 318, how much of C Corporation does T own?

a. 8 percent.
b. 28 percent.
c. 32 percent.
d. 43 percent.
e. None of the above.

7. Under § 318, how much of C Corporation does P own?

a. 10 percent.
b. 27.5 percent.
c. 50 percent.
d. 100 percent.
e. None of the above.

8. If C Corporation owns 100 shares of IBM, according to § 318, how many shares of IBM does U own constructively?

a. 0.
b. 50.
c. 51.
d. 100.
e. None of the above.

9. Using the same facts as represented in Problem 8, how many shares of IBM does T own constructively?

a. 0.
b. 5.
c. 8.
d. 32.
e. None of the above.
The following facts relate to Questions 10 through 12:

R Corporation has 500 shares of stock issued and outstanding, owned equally by the shareholders A, B, C, D, and E. On July 20, when E&P is $10,000, R Corporation redeems 100 shares from A, 60 shares from B, and 40 shares from C. The redemption price was $80 per share and the basis to all the shareholders was $50 per share. Assume that none of the shareholders are related.

10. What is the tax effect to A of the redemption?
   a. $3,000 ordinary income.
   b. $3,000 capital gain.
   c. $8,000 capital gain.
   d. $8,000 ordinary income.
   e. None of the above.

11. What is the tax effect to B of the redemption?
   a. $1,800 ordinary income.
   b. $1,800 capital gain.
   c. $4,800 capital gain.
   d. $4,800 ordinary income.
   e. None of the above.

12. What is the tax effect to C of the redemption?
   a. $1,200 capital gain.
   b. $1,200 ordinary income.
   c. $2,000 ordinary income.
   d. $3,200 ordinary income.
   e. None of the above.

13. C, an individual, owns 80 of the 100 shares of T Corporation stock outstanding while the remaining shares are owned by unrelated parties. T's basis in the 80 shares is $1,600, or $20 per share. This year T redeemed 10 shares of C for $4,000. Assuming the redemption does not qualify for sale treatment and T has substantial E&P, C’s dividend income and basis in his remaining shares will be
   a. a dividend of $4,000 and a basis of $1,600.
   b. a dividend of $3,800 and a basis of $1,400.
   c. a dividend of $4,000 and a basis of $1,400.
   d. a dividend of $3,800 and a basis of $1,600.
   e. none of the above.
14. Pennypincher Corporation has 100 shares of stock outstanding owned by the following taxpayers.

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Shares Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr. Penny</td>
<td>30</td>
</tr>
<tr>
<td>Mrs. Penny (Mr. Penny’s wife)</td>
<td>10</td>
</tr>
<tr>
<td>John (the Pennys' son)</td>
<td>10</td>
</tr>
<tr>
<td>Abby (the Pennys’ granddaughter)</td>
<td>10</td>
</tr>
<tr>
<td>Buddy Penny (Mr. Penny’s brother)</td>
<td>20</td>
</tr>
<tr>
<td>P&amp;P Partnership (Mr. Penny is a 20% partner)</td>
<td>10</td>
</tr>
<tr>
<td>PPP Corporation (Mr. Penny is a 40% shareholder)</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

None of Mr. Penny’s relatives nor the partnership or corporations are partners in P&P or shareholders in PPP. Under the constructive ownership rules of § 318, what percentage of Pennypincher Corporation does Mr. Penny own?

- a. 52 percent
- b. 60 percent
- c. 62 percent
- d. 66 percent
- e. 82 percent
- f. Some other amount

15. In which of the following situations would the redemption most likely be treated as a sale under the subjective dividend equivalency test of § 302(b)(1)?

- a. A shareholder’s interest drops from 89 percent to 70 percent.
- b. A shareholder’s interest drops from 55 percent to 45 percent.
- c. A shareholder’s interest drops from 40 percent to 35 percent and there is a valid business purpose for the redemption.
- d. Both b and c above.

16. SOS Corporation has 200 shares of outstanding stock (one class of voting common), which are owned by three unrelated individuals as follows: A owns 120 shares, B owns 60 shares, and C owns 20 shares. During the year, SOS has redeemed a portion of A’s shares for $20,000. In order for the redemption to qualify for sale treatment the lowest number of shares that SOS must redeem must exceed

- a. 20.
- b. 24.
- c. 46.
- d. 60.
- e. none of the above.

17. During the year, Oak Corporation distributed land worth $100,000 (basis $20,000) to one of its shareholders, T. The corporation will recognize gain if the distribution

- a. is treated as a dividend out of Oak’s E&P.
- b. qualifies for sale treatment under the basic redemption rules of § 302.
- c. qualifies for sale treatment under the partial liquidation rules.
- d. more than one of the above.
- e. all of the above answers are correct.
Fill In the Blanks

1. A transaction in which a corporation buys back the stock from a shareholder is referred to as a ________.

2. Under § 302(b)(1), a redemption is treated as a sale or exchange if the transaction is not ________ ________ to a dividend.

3. Under § 302(b)(2), a redemption will be treated as a sale or exchange if it is ________ ________.

4. Under § 302(b)(3), a redemption is afforded sale or exchange treatment if it is a ________ ________ of a shareholder’s interest in the corporation.

5. In order to qualify for § 303 treatment, the fair market value of the corporate stock must ________ 35 percent of the value of the adjusted gross estate.

6. Section 318 applies ownership tests that are commonly referred to as ________ rules.

7. When one corporation buys stock from its sole shareholder of another corporation controlled by the same shareholder, the transaction is referred to as a ________ - ________ redemption.

8. Distributions of nontaxable preferred stock become known as ________ stock.

Code Section Recognition

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1. § 302(b)(2) a. redemptions—complete terminations

2. § 302(b)(3) b. redemptions—related corporations

3. § 304 c. redemptions to pay death taxes

4. § 306 d. redemptions—substantially disproportionate

5. § 318 e. corporate attribution rules

6. § 303 f. tained stock distributions
SOLUTIONS TO STUDY QUESTIONS

True or False

1. False. No ruling is necessary.
2. False. No sale or exchange will take place on a proportionate redemption unless it qualifies as a partial liquidation.
3. False. A partial liquidation would be one exception.
4. True.
5. True.
6. True.
7. False. The taint is only removed by the death of the distributee.
8. True.
9. True. The shareholder owns less than 80 percent of prior holdings and the total ownership after the redemption is less than 50 percent.
10. False. No ruling is necessary for a partial liquidation.
11. False. If certain requirements are met, the family attribution rules under § 318 may be waived.
12. False. A complete termination of interest can only serve to waive the family attribution rules and not all the attribution rules.
15. False. The basis will be FMV in a taxable partial liquidation.

Multiple Choice

1. a. Land is FMV with no basis reduction.
2. e. Section 311(d)—Land is held as an investment.
3. c. Reduction is from 25% to 20%, so this is treated as a distribution subject to § 301.
4. d. 40% directly 10% from wife and 20% from son constructively.
5. e. Section 302(b)(2) or § 302(b)(3).
6. c. 5% directly + (3% + 20% + 4%) indirectly.
7. d. 10% directly + 90%.
8. c. (100 @ 50) + ([100 @ 10%] @ 10%).
9. a. No corporate attribution unless 50% ownership exists directly or indirectly.
10. b. Section 302(b)(3)—Complete termination.
11. b. Section 302(b)(2)—Substantially disproportionate.
12. c. A distribution limited to C’s pro rata share of E&P (20% of $10,000).
13. a. The entire distribution is a dividend.
14. c. He owns 30% directly plus 32% indirectly (10 + 10 + 10 + 2) for a total of 62%.
15. b. Shareholder no longer has control; therefore something appears to be given up.
16. c. A must own less than 73 shares of the 153 outstanding after A’s redemption of 47 shares.
17. e. § 311(b) applies in each case.

Fill In the Blanks

1. Redemption.
2. Essentially equivalent.
3. Substantially disproportionate.
4. Complete termination.
5. Exceed.
6. Attribution.
7. Brother; sister.
8. Tainted.
Code Section Recognition

1. d.
2. a.
3. b.
4. f.
5. e.
6. c.