CHAPTER 5
CORPORATIONS: REDEMPTIONS AND LIQUIDATIONS

LECTURE NOTES

OVERVIEW

1. Redemptions.
   a. Corporate nonliquidating distributions to shareholders are typically treated as dividend income. However, distributions that qualify as stock redemptions are treated the same as a sale of stock by the shareholders to a third party. Thus, capital gain treatment normally results.
   b. Qualifying stock redemptions provide more tax benefit to noncorporate shareholders than nonqualified redemptions.
      (1) Since qualifying stock redemptions are treated as sales or exchanges, the shareholders can offset their amount realized by the basis of the stock redeemed. Any gain remaining is treated as a capital gain and taxed at the applicable capital gain rates (long-term rates are 0% or 15%).
      (2) If the distributions do not qualify as stock redemptions, they are treated as dividend income (assuming adequate E & P) and taxed at dividend rates (currently 0% or 15%).
      (3) By increasing the amount of capital gains for the year, redemptions may increase the utilization of capital losses from other sources. Distributions treated as dividends cannot provide this same benefit.
   c. Corporate shareholders prefer nonqualified stock redemption (i.e., dividend treatment).
      (1) With dividend treatment, corporate shareholders receive the benefits of the dividends received deduction, and most of the nonqualified stock redemption income escapes taxation.
      (2) Qualifying stock redemptions result in capital gains that are fully taxable at the corporation’s highest marginal rate.
2. Liquidations.
   a. In a complete liquidation, the corporation may recognize gains and losses on the
distribution of its property to its shareholders. The gains/losses are determined in
the same manner as if the property was sold to a third party.
      (1) Gains may be capital or ordinary depending on the asset distributed.
      (2) Losses may be limited by antistuffing rules.
   b. Shareholders recognize gains and losses on the receipt of distributions determined
by the difference between the fair market value of property and cash received and
their basis in their stock.
   c. The liquidation of a subsidiary by the parent corporation generally does not create
recognized gains or losses except for minority interest shareholders.
3. Corporations generally recognize both gains and losses on liquidating distributions, thus
preserving the double taxation inherent in operating a business as a C corporation. Some
major exceptions apply, however.
   a. Antistuffing rules limit loss recognition with respect to certain distributions (and
sales) pursuant to liquidation.
   b. Subsidiary corporations do not recognize gains/losses on liquidating distributions
to its parent corporation and it is also generally tax-free to the parent.
4. Shareholders of liquidating corporations receive sale or exchange treatment; thus, the
difference between fair market value of all properties received and the stock basis is a
capital gain (or loss).

6.1 STOCK REDEMPTIONS—IN GENERAL
5. Stock redemption occurs when a corporation acquires its stock from a shareholder in
exchange for cash or other property.
   a. Essentially the shareholder sells stock back to the issuing corporation.
      (1) Qualifying redemptions receive sales treatment.
      (2) Nonqualified redemptions receive dividend treatment.
   b. Stock redemptions can occur for a variety of reasons.

6.2 STOCK REDEMPTIONS—SALE OR EXCHANGE TREATMENT
   a. Shareholders can offset their amount realized by the basis of the stock redeemed.
   b. Any gain remaining after offsetting capital losses is taxed at the applicable capital
gain rates (long-term rates are currently 0% or 15%).
c. For distributions not qualifying as stock redemptions, the entire amount received is dividend income (assuming adequate E & P) and taxed at dividend rates (currently 0% or 15%).

7. Corporate shareholders prefer nonqualified stock redemption (dividend treatment).
   a. With dividends, corporate shareholders receive the dividends received deduction.
   b. Qualified stock redemptions producing capital gains are taxable at a corporation’s highest marginal rate. There are no special capital gain rates for corporations.

8. Redemptions resulting in a loss may be disallowed under the related party rules (§ 267).

**ADDITIONAL LECTURE RESOURCE**

Reg. § 1.302-2 provides the reporting requirements for every “significant” shareholder transferring stock in a redemption [Reg. § 1.302-2(b)]. A significant shareholder means any person owning, before the exchange, at least 5% (or, for not publicly traded stock, 1%) of the redeeming corporation’s outstanding stock. A statement attached to the shareholder’s return for the taxable year of the redemption should include the fair market value and basis of the stock redeemed, and a description of the property received in the transaction. The reporting requirements apply to all stock redemptions, whether qualifying or not.

Reg. § 1.302-4 provides the specific content of required agreement to notify the IRS when waiving family attribution rules in a complete termination redemption.

Reg. § 1.331-1 provides similar reporting requirements for “significant” shareholders in a liquidation.

**Historical Background and Overview**

9. Stock redemptions qualifying under § 302(b) or § 303 receive sale or exchange treatment. To be qualified, the distribution must meet one of the following requirements.

   • Not essentially equivalent to a dividend under § 302(b)(1).
   • Substantially disproportionate in terms of shareholder effect under § 302(b)(2).
   • Complete termination of a shareholder’s interest under § 302(b)(3).
   • Redemption of noncorporate shareholder in partial liquidation of the corporation under § 302(b)(4).
   • Redemption to pay decedent shareholder’s death taxes and the estate’s administrative expenses under § 303.
Stock Buybacks Stimulate Redemptions. Stock redemptions often are motivated by corporate reasons. For instance, when a corporation considers its stock undervalued, it may repurchase its shares through a “tender offer.” By reducing the number of shares outstanding, the corporation may be able to increase its earnings per share and related financial ratios. Although the purchase is motivated by corporate reasons, each redeeming shareholder must consider the qualifying stock redemption rules to determine whether sale or exchange treatment is available. In most cases, however, the shareholders redeeming stock in these buybacks hold small stakes in the corporation and, as such, are not hindered by the qualifying stock redemption requirements. See, Rev. Rul. 76-385, 1976-2 CB 92 (redemption of stock from shareholder with de minimis interest qualifies as a not essentially equivalent redemption). However, a de minimis shareholder will not qualify for § 302(b)(1) treatment if the redemption is pro rata with respect to all shareholders (Rev. Rul. 81-289, 1981-2 CB 82). Corporate motivated stock redemptions are the subject of the Tax in the News article on text page 6-4.

Stock Redemptions Incident to Divorce. Property transferred pursuant to a divorce under § 1041 results in no gain (or loss) to the transferor ex-spouse and a carryover basis to the recipient ex-spouse. The deferred gain/loss is typically recognized when the recipient disposes of the property in a taxable event. When the property is stock of a closely held corporation (e.g., wholly owned by one or both spouses), and the stock is redeemed pursuant to a divorce agreement, an alternative result can occur. In some cases, the redemption transaction will be treated as a distribution to the transferring spouse and a subsequent transfer of the proceeds to the recipient spouse. The transferring spouse’s remaining stock ownership in the corporation generally precludes qualifying stock redemption treatment, and the result is a dividend distribution to such spouse [See, Craven, 2002-2 USTC ¶50,541; 85 AFTR 2d 2000-2229; 215 F 3d 1201 (CA-11, 2000); and Carol M. Read, 114 TC 14 (2000)]. Regulations for § 1041 permit taxpayers to establish the tax consequences associated with the redemption of stock pursuant to a divorce. Under Reg. § 1.1041-2(c), taxpayers can dictate in the divorce or separation instrument which spouse is to be taxed on the stock redemption.

<table>
<thead>
<tr>
<th>Stock Attribution Rules</th>
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<tbody>
<tr>
<td>10. Generally, § 318 constructive ownership rules apply in determining whether a distribution qualifies as a stock redemption.</td>
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<tr>
<td>a. Individuals are treated as owning stock owned by their spouses, parents, children, and grandchildren.</td>
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<td>Example. Keith owns 60 shares of stock in Purple Corporation. The remaining 40 shares are owned by the following relatives of Keith: Keith’s wife (5); Keith’s son (2); Keith’s daughter (3); Keith’s father (10); Keith’s brother (6); and Keith’s aunt (14). Keith is deemed to own a total of 80 shares in Purple. Only the stock of his brother and his aunt are not attributed to him.</td>
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<tr>
<td>b. Stock owned, directly or indirectly, by a partnership is considered to be owned proportionately by the partners. However, stock owned by a partner is treated as owned in full by the partnership.</td>
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<td>Example. Lori has a 20% interest in a partnership which owns 30 shares in White Corporation. Lori is deemed to own 6 (20% of 30) shares in White. However, if Lori owned 30 shares in White (rather than the partnership), the partnership would be deemed to own all of Lori’s 30 shares.</td>
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Chapter 6 – Solutions to Research Problems

6-5

c. Stock owned, directly or indirectly, by an estate or trust is considered to be owned proportionately by the beneficiaries; but stock owned by or for a beneficiary is treated as owned in full by the estate or trust. See Reg. § 1.318-3(a) for the definition of “beneficiary.”

Example. Arnold has a 10% beneficiary interest in a trust. The trust owns 50 shares in Green Corporation. Arnold is considered as owning 5 (10% of 50) of these shares. However, if Arnold owned the 50 shares (rather than the trust), the trust would be deemed to own all of Arnold’s 50 shares.

d. Stock owned by a corporation is considered to be owned proportionately by any shareholder owning 50% or more of the corporation’s stock. However, stock owned by a shareholder who owns 50% or more of a corporation is considered to be owned in full by the corporation.

Example. Nancy owns 60% of Gray Corporation. Gray owns 20 shares of Blue Corporation, and Nancy owns 50 shares of Blue. Nancy is deemed to own 62 shares in Blue, her own 50 shares plus 60% of Gray’s 20 shares, or 12 more shares. Gray, on the other hand, is deemed to own 70 shares of Blue, its 20 shares and Nancy’s 50 shares.

e. For purposes of the attribution rules, an S corporation is treated the same as a partnership, and a shareholder of an S corporation is treated the same as a partner.

f. Stock constructively owned by one of the attribution rules is treated as actually owned by such person.

(1) Causes constructively owned stock to be “reattributed” to another person.

Example. Stock attributed from a corporation to a 50% or more shareholder can be reattributed to the spouse of such shareholder.

(2) However, stock attributed to an individual by reason of family attribution rules cannot be reattributed to another individual. Further, stock attributed to an entity by reason of entity attribution rules cannot be reattributed to another.

g. Text Exhibit 6.1 summarizes the stock attribution rules.

11. The stock attribution rules do not apply in certain cases.

a. Family attribution rule can be waived in complete termination redemptions.

b. All attribution rules are ignored for partial liquidations and redemptions to pay death taxes.

Not Essentially Equivalent Redemptions

12. A stock redemption under § 302(b)(1) must not be essentially equivalent to a dividend. The Supreme Court in U S v. Davis established the following rules as to § 302(b)(1).

a. It is immaterial that the redemption has a business purpose and is not to bail out dividends with favorable treatment.
b. The redemption must result in a “meaningful reduction” of the shareholder’s interest, with a reduction in voting control being the most important factor.

c. Constructive ownership rules of § 318(a) apply in figuring meaningful reductions.

**ADDITIONAL LECTURE RESOURCE**

The meaningful reduction test is based on the facts and circumstances of each case [Reg. § 1.302-2(b)]. A stock redemption from a shareholder who has a *de minimis* stock interest both before and after the redemption transaction should be able to qualify as a not essentially equivalent redemption (Rev. Rul. 76-385, 1976-2 CB 92). However, the shareholder with *de minimis* stock interest will not qualify for the § 302(b)(1) treatment if the redemption is pro rata with respect to all shareholders (Rev. Rul. 81-289, 1981-2 CB 82).

A § 302(b)(2) disproportionate redemption requires shareholders to own, directly and indirectly, less than 50% of the corporation’s voting stock after the redemption. In rare cases, a redemption may qualify as a not essentially equivalent redemption even though the shareholder owns 50% (or possibly more) of the stock after the transaction. A reduction in shareholder’s interest from 57% to 50% has been held to be a not essentially equivalent redemption when a single unrelated shareholder owned the remaining 50% interest after the redemption (Rev. Rul. 75-502, 1975-2 CB 111).

When a shareholder’s interest after a redemption is more than 50%, the meaningful reduction test will not be satisfied in the IRS’s opinion (See, Rev. Rul. 78-401, 1978-2 CB 127, interest reduced from 90% to 60%; and Rev. Rul. 77-218, 1977-1 CB 81, interest reduced from 60% to 55% did not qualify). However, one court found a reduction in shareholder interest from 85% to 61.7% did satisfy the meaningful reduction test when applicable state law required a two-thirds vote for amending articles of incorporation, for merger and acquisition, and for liquidation [*Wright v. U. S.*, 73-2 USTC ¶9583; 32 AFTR 2d 5490; 482 F 2d 600 (CA-8, 1973)]. For a recent ruling involving § 302(b)(1), see Ltr. Rul. 201002022.

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13. Redemption of preferred stock, that is not § 306 stock, may qualify as a not essentially equivalent redemption.

14. For nonqualifying stock redemptions, the basis of the stock redeemed attaches to the basis of the shareholder’s remaining stock.

a. If the taxpayer owns no stock directly after the transaction, the basis of the redeemed stock attaches to the basis of the stock that was attributed to such taxpayer (see Example 8 in the text). No guidance provided for basis allocation when the stock of more than one related shareholder is attributed to the taxpayer.

b. IRS has aggressively attacked tax shelter transactions that utilize nonqualified stock redemptions to shift stock basis to other shareholders as discussed in the next *Additional Lecture Resource*. 
IRS Attacks Basis-Shifting Tax Shelters. When a stock redemption does not qualify for sale or exchange treatment, the basis in the stock redeemed attaches to the shareholder’s remaining shares or to stock the shareholder owns constructively. Clever planners have created a tax shelter utilizing the shift in basis from one shareholder to another shareholder. The shelter works as follows. A U. S. taxpayer and a foreign corporation indifferent to U. S. tax (e. g., a Cayman Island corporation) each acquire a small number of shares in a foreign bank. The U. S. taxpayer also purchases from the foreign corporation an option to acquire at least 50 percent of the foreign corporation’s stock. The foreign bank then redeems the stock owned by the foreign corporation. Under the attribution rules, the U. S. taxpayer is related to the foreign corporation by reason of the stock option; thus, the redemption results in dividend income to the foreign corporation (which pays no U. S. tax). The foreign corporation’s basis in the redeemed shares shifts to the shares of the U. S. taxpayer and those shares are then sold for a loss that is used to offset gains from other investments.


In February 2009, the IRS issued Prop. Reg. § 1.302-5 which provides that the basis of shares in a failed redemption is treated as a deferred loss. Recognition of the loss is deferred until the “inclusion date” which is the earlier of (1) the date on which the shareholder satisfies a one of the qualifying § 302 provisions, if the facts that exist at the end of such day had existed immediately after the redemption, or (2) the date on which all classes of stock of the redeeming corporation become worthless.

Disproportionate Redemptions

15. Under § 302(b)(2), stock redemptions qualify as substantially disproportionate if the following stock conditions are met after the distribution.

- Shareholder owns less than 80% of her/his corporate interest before the distribution, and
- Shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote.
Example. Wanda owns 150 shares of the 200 shares outstanding (75% of the shares). Wanda has 125 shares redeemed. After the redemption Wanda owns 33% (25 ÷ 75 outstanding after redemption), which is less than 50% of the stock and less than 80% of her original interest (33% ÷ 75% = 44%).

**ADDITIONAL LECTURE RESOURCE**

Disproportionate redemption bootstrap transaction. Rev. Rul. 75-447, 1975-2 CB 113 describes a transaction in which stock is issued to a new shareholder followed by redemption of shares by the two original shareholders. The two transactions are part of integrated plan resulting in disproportionate redemption.

Voting stock requirement. A disproportionate redemption only applies to a redemption of voting stock or to a redemption of both voting stock and other stock (Reg. § 1.302-3). However, for a shareholder owning no common stock (directly or through attribution), a redemption of only voting preferred stock qualifies (Rev. Rul. 81-41, 1981-1 CB 121). Redemption of only nonvoting stock can qualify as a disproportionate redemption if combined with the simultaneous redemption of voting stock of a related taxpayer. Rev. Rul. 77-237, 1977-2 CB 88 has a redemption of nonvoting preferred stock of father owning no common stock directly combined with redemption of voting common stock of son is disproportionate redemption for both taxpayers.

Series-of-redemptions rule. Section 302(b)(2)(D) provides that a redemption will not qualify as disproportionate if it is made pursuant to a plan the purpose or effect of which is a series of redemptions that result in the aggregate in a distribution which does not satisfy the 80% and 50% tests [see, Reg. § 1.302-3(b), for an example]. The determination of whether a plan exists is based on all the facts and circumstances (Reg. § 1.302-3). Although there is scant judicial guidance in the area, it appears that the series-of-redemptions rule will only apply when stock is redeemed from a shareholder who has knowledge of an impending redemption of another shareholder’s stock [See, Rev. Rul. 85-14, 1985-1 CB 93 (rule applied even though no agreement existed between the two shareholders regarding their redemptions); Ltr. Rul. 8316019 (rule does not apply to coincidental redemptions of two shareholders within close proximity of each other); and Ltr. Rul. 200441007 (rule does not apply to redemptions pursuant to corporation’s articles of incorporation and with no redeeming shareholder possessing knowledge of any other impending redemption)]. The series-of-redemptions rule does not apply to a redemption merely because a future redemption could be affected under a buy-sell agreement existing between the corporation and another shareholder. See *Glacier State Electric Supply Co.*, 80 TC 1047 (1983), where an agreement requiring the redemption of another shareholder’s stock upon death was not sufficient for the rule to apply. The series-of-redemptions rule has been applied to two redemptions that were 15 months apart (Ltr. Rul. 8137023).

16. In determining stock ownership before and after a redemption, the attribution rules apply.

**Complete Termination Redemptions**

17. A redemption terminating a shareholder’s complete interest qualifies for sale treatment under § 302(b)(3). The entity attribution rules apply but not the family attribution rules if all of the following requirements are met.
a. Redeemed shareholder has no interest in the corporation for at least 10 years.
   • Being a creditor is not considered an interest for this purpose.
   • Stock acquired by bequest or inheritance is not considered.

b. Redeemed shareholders file agreements to notify the IRS if a prohibited interest is acquired within the 10-year post redemption period. Reg. § 1.302-4(a) provides the specific content of the required agreement.

### ADDITIONAL LECTURE RESOURCE

Section 302(c)(2)(B) provides that the § 318(a)(1) family attribution rules are not waived (despite meeting the requirements in # 17. above) if either of the situations following apply.

- Any part of the redeemed stock was acquired, directly or indirectly, within the previous 10 years by the distributee from a related person.
- Any related person owns stock at the time of the distribution and acquired the stock, directly or indirectly, from the distributee within the previous 10 years, unless the stock so acquired is also redeemed in the same transaction.

However, a family attribution waiver is available if stock transfer in previous 10 years did not have as one of its principal purposes the avoidance of Federal income taxes.

**Example.** Paul owns 100% of the stock in Teal Corporation, which has E & P of $200,000. Paul transfers 40% of the stock to his son Seth. Teal redeems all of Seth’s stock 13 months later for $100,000. The redemption does not qualify as a complete termination of Seth’s stock because the family attribution rules apply. If the transfer of stock to Seth did not have as one of its principal purposes the avoidance of Federal income taxes, the family attribution waiver could apply, and the result would be a complete termination redemption.

**Example.** Susan owns 100% of Plaid Corporation’s stock. Plaid has E & P of $300,000. Susan transfers 35% of the stock to her daughter Katrina. Plaid redeems all of Susan’s stock 15 months later for $150,000. The redemption does not qualify under as a complete termination of Susan’s stock because the family attribution rules apply. If the transfer of stock to Katrina did not have as one of its principal purposes Federal income tax avoidance, the family attribution waiver could apply, and the result would be a complete termination redemption.

For a recent ruling on this issue, see Ltr. Rul. 20093911.

### ETHICS & EQUITY

**Convertible Preferred Stock – Conversion or Redemption?** Members of a board of directors serve in a fiduciary capacity on behalf of corporate shareholders. They are subject to good faith and fair dealing standards with respect to the investors in the corporation’s convertible preferred stock. Given the recently developed invention, a conversion of the preferred stock to common
stock appears to be more favorable for the preferred shareholders than having their shares redeemed. A premium call price is typical of most callable preferred stock, and the presence of a premium on this preferred stock likely does not relieve the board of their fiduciary duties. The preferred shareholders should be informed of the new invention before any redemption transaction transpires. Even though the stock of the corporation is not selling publicly, the corporation may be subject to the anti-fraud provisions of the Securities Acts for a small offering to members of the public. Nonetheless, the board of directors did not act in an ethical manner.

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**Partial Liquidations**

18. Distributions that qualify as partial liquidations under § 302(b)(4) receive sale treatment for noncorporate shareholders.

   a. Partial liquidation redemptions may be pro rata with respect to the shareholders.

   b. An actual surrender of stock is not required in the case of a pro rata distribution.

      (1) In such cases, a constructive redemption of stock is deemed to have occurred.

      (2) The number of shares considered redeemed is determined with reference to the fair market value of the stock of the distributing corporation before and after the distribution. (See, Rev. Rul. 77-245, 1977-2 CB 105.)

19. A partial liquidation must meet the following requirements.

   a. Distribution is not essentially equivalent to a dividend.

      (1) This test is applied at the corporate level not the shareholder level.

      (2) Genuine corporate business contraction must occur. This should be used only when supported by a favorable IRS ruling. For guidance on such ruling requests, see Rev. Proc. 81-42, 1981-2 CB 611 (checklist questionnaire); and Rev. Proc. 2009-3, 2009-1 IRB 107 (rulings limited to distributions resulting in at least a 20% reduction in corporation’s gross revenue, net fair market value of assets, and employees).

   b. Distributions are pursuant to a plan and occur within the taxable year in which the plan is adopted or within the succeeding taxable year.

   c. A safe harbor rule allows termination of a business line actively conducted for at least 5 years to qualify. (See Chapter 7, Type D reorganizations determining whether a corporation is engaged in an active business.)

      (1) Requires that the corporation actively conduct two or more businesses lines for at least five years and at least one of the businesses continues.

      (2) Neither of the businesses can have been acquired in a taxable transaction within the five-year period.

      (3) Distribution can be in form of assets of terminated business or proceeds from the sale of those assets. All of the assets and/or proceeds of the terminated business must be distributed to qualify for the safe harbor rule.
(A distribution of less than the entire assets or proceeds may satisfy the genuine contraction test, however.) Gordon v. Comm., 70-1 USTC ¶9279; 25 AFTR 2d 820; 424 F 2d 378 (CA-2, 1970), cert den. 91 S.Ct. 63 (1970).

d. Parent’s partial liquidation via a subsidiary.

(1) Parent’s distribution to its shareholders of proceeds from the sale of active businesses operated via subsidiaries can qualify as a partial liquidation (see, Ltr. Rul. 200317020).

(2) Parent’s distribution of the proceeds from the sale of stock in a subsidiary may qualify as a partial liquidation when accompanied with an election under § 338 to treat the stock sale as a sale of the subsidiary’s assets (see, Ltr. Rul. 200703021).

**ADDITIONAL LECTURE RESOURCE**

The administrative and judicial guidance surrounding the general contraction of a corporate business test is sparse at best. The IRS has ruled that the distribution of proceeds from the sale of investments or excess inventory does not satisfy the test (Rev. Rul. 60-322, 1960-2 CB 118). However, when a full-line department store reduced its operations by eliminating 33 of 40 departments, a distribution of the proceeds from the sale of discontinued inventory and the collection of accounts receivable related to discontinued departments was held to be a genuine contraction of the corporation’s business (Rev. Rul. 74-296, 1974-1 CB 80).

In applying the genuine contraction test, the courts examine whether the distribution resulted in a significant reduction in the amount of capital committed to the corporation’s business and a correlated reduction in the corporation’s business activities to which the distribution related [See, White’s Ferry, Inc., 66 TCM 1855, TC Memo 1993-639 (distribution of real property constituting minor part of corporation’s business was genuine contraction), and Mains v. U. S., 75-1 USTC ¶9167, 35 AFTR2d 541, 508 F. 2d 1251 (CA-6, 1975) (distribution of proceeds from sale of assets of one of 10 operating units of carnival business was not genuine contraction)].

**Redemptions to Pay Death Taxes**

20. Under § 303, a decedent shareholder’s estate receives sale treatment for a redemption when the stock represents a substantial amount of the gross estate.

a. If qualifying under § 303, the § 302(b) stock redemption and stock attribution rules do not apply.

b. For redemption of a single corporation’s stock, the stock’s value must be in excess of 35% of the value of the decedent shareholder’s adjusted gross estate.

c. In determining whether the 35% of adjusted gross estate test is satisfied, the stock of corporations in which the decedent owned at least 20% of the outstanding value is treated as stock of a single corporation.
d. Sale treatment applies only to the extent of the sum of the death taxes plus funeral and administration expenses allowable as deductions to the estate.

(1) If the redemption exceeds the amount allowed, the excess may qualify for sale treatment under § 302(b) rules. The beneficiary to the estate attribution rule may preclude a qualifying stock redemption.

(2) Waiving the family attribution rules for estates under § 302(c)(2) may assist in satisfying the complete termination redemption requirements [see also § 302(c)(2)(C)].

e. Due to the “stepped-up” basis the stock receives at death, redemptions to pay death taxes generally result in little or no gain (or loss).

6.3 EFFECT ON THE CORPORATION REDEEMING ITS STOCK

Recognition of Gain or Loss

21. Under § 311(b), a distributing corporation recognizes gain (but not loss) when distributing property to redeem its stock.

a. When distributed property is subject to a liability, the value of the property is treated as not being less than the liability.

b. Since losses are not recognized, property with built-in losses should not be distributed.

Effect on Earnings and Profits (E & P)

22. E & P is reduced in a qualifying stock redemption by an amount not to exceed the ratable share of the E & P attributable to the stock redeemed. For a recent application of this rule, see LTR 200830008 (S corporation E & P account).

Redemption Expenditures

23. Expenditures associated with stock redemptions are not deductible [§ 162(k)]. The Tax in the News, on text page 6-13, illustrates application of this disallowance.

6.4 STOCK REDEMPTIONS—ADDITIONAL LIMITATIONS

Preferred Stock Bailouts (§ 306)

24. Sale or redemption of preferred stock received as a nontaxable stock dividend (called § 306 stock) results in ordinary income to the extent of the corporate E & P either on the distribution date of the stock, in the case of a sale, or on the date of the redemption.

a. § 306 stock generally is preferred stock distributed as a nontaxable stock dividend.

b. If a corporation has no E & P on the distribution date, the stock is not § 306 stock.

c. On a sale of § 306 stock, the shareholder has ordinary income to the extent that the preferred stock’s value on the distribution date would have been a dividend.
(1) While shareholder has dividend income, corporation does not reduce its E & P.

(2) Ordinary income is considered a dividend for taxing the shareholder. Consequently, the current 0% or 15% tax rates on dividends apply.

(3) No loss is recognized on the sale of § 306 stock. Any unrecovered basis in the stock sold is added to the basis of the shareholder’s common stock.

d. On a redemption of § 306 stock, the shareholder will have dividend income to the extent of the corporation’s E & P on the redemption date.

(1) Since distributions are treated as dividends, they reduce corporate E & P.

(2) Basis of the preferred stock redeemed is added to the basis of the shareholder’s common stock.

Redemptions through the Use of Related Corporations

25. To prevent circumventing § 302(b), § 304 provides that selling stock in one corporation to a related corporation is treated as a redemption under §§ 302 and 303.

a. Rule applies to a corporation acquiring another corporation’s stock from one of its shareholders when this shareholder has at least a 50% ownership in both corporations.

(1) Thus, § 304 applies to brother-sister and to parent-subsidiary corporations.

(2) For illustrations of § 304 transactions, see Figure 6.1 at the end of this outline on page 6-20.

b. For a recent case involving § 304, see Merrill Lynch & Co., 131 T.C. 293 (2008).

Distribution of Stock and Securities of a Controlled Corporation

26. Stock and security distributions in a controlled corporation (80%) to the shareholders of the parent are tax-free. For more discussion of § 355, see Chapter 7.

6.5 LIQUIDATIONS—IN GENERAL

27. In a complete liquidation, the corporation terminates as does the shareholder’s ownership. Liquidations generally produce sale treatment for the corporation and the shareholders.

The Liquidation Process

28. Liquidations occur when a corporation ceases to be a going concern.

a. Legal dissolution under state law is not required. Rather, courts examine whether it was corporation’s intent to wind up its affairs, pay its obligations, and distribute remaining assets to shareholders [Kennemer v. Comm., 38-1 USTC ¶9297; 21 AFTR 103; 96 F 2d 177 (CA-5, 1938)].

b. Shareholders may decide to liquidate a corporation because it is unsuccessful, if shareholders want the corporation’s assets, or the corporate assets are sold.
Liquidating and Nonliquidating Distributions Compared

29. While losses on nonliquidating distributions are not recognized by the distributing corporation, liquidating distributions may produce recognize losses.

30. Shareholders recognize losses on liquidating distributions even when the shareholders are considered related parties under § 267 (owning, directly or indirectly, more than 50% of the stock outstanding).

6.6 LIQUIDATIONS—EFFECT ON THE DISTRIBUTING CORPORATIONS

General Rule

31. Corporations recognize gain/loss on the distribution of property in a complete liquidation as if the property were sold for its fair market value [§ 336(a)].

a. If property distributed is subject to a liability, the fair market value in the deemed sale cannot be less than the amount of the liability [§ 336(b)].

b. Loss recognition may be limited under the antistuffing rules.

c. Loss recognition is disallowed for liquidating distributions of a subsidiary corporation pursuant to § 332.

Antistuffing Rules

32. Related-Party Losses. Restrictions are imposed on the deductibility of losses from distributions to related parties in the following situations.

- Distribution is not pro rata.
- Property distributed is disqualified property, which is defined as property acquired by the liquidating corporation in a § 351 or contribution to capital transaction, during the five-year period ending on the date of the distribution.

33. Built-in Losses. Losses are disallowed on the distribution or sale of built-in loss property even if the sales involve unrelated parties.

a. Built-in loss property is defined as property acquired in a § 351 or contribution to capital transaction as part of a plan, the principal purpose of which is to recognize loss by the liquidating corporation.

b. Transfers occurring within two years of adopting a plan of liquidation are treated as acquired as part of a tax avoidance plan. This presumptive rule does not apply in the following situations.

- When there is a clear and substantial relationship between the contributed property and the conduct of the corporation’s current or future business.
- When the property is contributed within the corporation’s first two years of existence.
Chapter 6 – Solutions to Research Problems

6.15

**ETHICS & EQUITY**

**Reporting Business Activities – Liquidation Consequences?** The “check-the-box” Regulations do not apply to existing entities. Bagels by Thomas, Inc., either continues to exist in the corporate form or the entity was informally liquidated (probably in 2009). If the entity continues to exist as a corporation, corporate returns should be filed for the years 2009–2011. This would also require the amendment of Thomas’ 2009 and 2010 personal returns to adjust those returns for the removal of any corporate items. Accounting for Thomas’ salary (a corporate deduction), dividend distributions, and other items may prove difficult.

If the corporation informally liquidated, a corporate return for the year of liquidation would be required, as would an amendment of Thomas’ 2009 personal return to account for any related gain or loss. Presumably, further adjustments to his personal returns for the years in question would arise from a step up (or step down) of basis for property deemed distributed in the liquidation. Neither a legal dissolution nor a formal plan to liquidate is conclusive in determining whether a liquidation has occurred. Instead, the courts generally examine whether it was the intent of the corporation to wind up its affairs, pay its obligations, and distribute remaining assets to shareholders. See, e.g., *Kennemer v. Comm.*, 38–1 USTC ¶9297, 21 AFTR 103, 96 F.2d 177 (CA–5, 1938). The fact that Thomas continues to operate the entity in its original form (but reports the entity’s activities on his personal return) may be indicative that a liquidation has not occurred.

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6.7 LIQUIDATIONS—EFFECT ON THE SHAREHOLDER

**The General Rule**

34. The rules under § 331 provide for sale or exchange treatment to the shareholder. In most cases, the gain or loss recognized is treated as a capital gain or loss to the shareholder.

a. Establishing the basis of stock may be problematic in some cases. The taxpayer has the burden of proof in determining the basis.

b. A taxpayer’s failure to adequately document a stock’s basis can result in a zero basis for the stock. The *Calderazzo* case cited in Footnote 34 in the text is an example of such a result.

c. Reporting requirements are found in Reg. § 1.331-1(d).

35. The basis of assets received by the shareholder will be their fair market value on the date of distribution (except for installment obligations arising from sales by the corporation).
Special Rule for Certain Installment Obligations

36. A shareholder’s gain on the receipt of installment obligations resulting from sales by the corporation may be deferred to the point of collection.

6.8 LIQUIDATIONS—PARENT-SUBSIDIARY SITUATIONS

37. If the requirements of § 332 are met, a parent corporation may liquidate a subsidiary with no gain or loss is recognized by either the parent or the subsidiary.

   a. Parent must own at least 80% of the voting stock and at least 80% of the total value of all other stock.
      
      (1) If parent owns both preferred and common stock of the subsidiary, § 332 applies only if the parent receives property in exchange for its common stock.

   b. Subsidiary distributes all its property in complete liquidation within the taxable year or within three years from end of year in which the first distribution occurred.

   c. Subsidiary must be solvent.
      
      (1) Under § 165(g)(3), a parent corporation generally claims an ordinary loss deduction for its basis in worthless subsidiary stock.
      
      (2) In determining solvency, fair market value of all assets, including intangibles such as goodwill and going concern, are considered (Rev. Rul. 2003-125, 2003-2 CB 1243).

   d. Reg. § 1.332-6 indicates parent corporation’s reporting and record keeping requirements in a § 332 liquidation.

38. Liquidation of a U. S. subsidiary into a foreign parent corporation will generally result in some gain recognition to the subsidiary. *Global Tax Issues*, on text page 6-30, discusses this issue.

39. Parent corporation can reduce its ownership below the 80% threshold to avoid application of § 332 and recognize loss on the liquidation of a subsidiary.

   a. Courts generally respect the clear language of § 332 and allow loss recognition.

   b. Where parent corporation retains an interest in the liquidated subsidiary stock (i.e., decreased interest in subsidiary is transitory), the step transaction doctrine may be applied to force nonrecognition treatment under § 332.

40. Deemed liquidation resulting from a change in classification from a wholly owned corporation to a disregarded entity can qualify under § 332 [see, Reg. § 301.7701-3(g)].

Minority Shareholder Interests

41. If the parent owns less than 100% of the stock of the subsidiary (i.e., a minority interest exists), any distribution to the minority interest will be treated as follows.
a. Distribution to a minority shareholder is treated in the same manner as one made pursuant to a nonliquidating distribution; accordingly, gain (but not loss) is recognized to the subsidiary on property distributed to the minority shareholder.

b. Minority shareholder is subject to the general rule of § 331.

   (1) Difference between the fair market value of the assets distributed and the basis of the minority shareholder’s stock is the amount of gain or loss recognized by the minority shareholder.

   (2) Basis of property received by the minority shareholder is the property’s fair market value on the date of the distribution.

Indebtedness of the Subsidiary to the Parent

42. Under § 337(b)(1), a subsidiary recognizes no gain (or loss) on a transfer of property in satisfaction of indebtedness to its parent when the transfer is pursuant to a § 332 liquidation. The receipt of such a property distribution is a taxable event for the parent, however, and the gain (or loss) will equal the difference between the fair market value of the property received and the parent’s basis in the indebtedness.

Basis of Property Received by Parent Corporation—The General Rule

43. Basis of property received by the parent is determined under § 334(b)(1). Property received by the parent has the same basis as it had in the hands of the subsidiary.

   a. Parent’s basis in the subsidiary stock disappears.

   b. Carryover rules of § 381 apply (e. g., losses, tax credits, E & P, etc. of the subsidiary carry over to the parent).

   c. Basis of property acquired by a U. S. parent in the liquidation of a foreign subsidiary may be limited under § 362(e)(1)(B). Under that provision, if the aggregate basis in a foreign subsidiary’s assets exceeds their fair market value, the U. S. parent will take a fair market value basis in the assets acquired. See Global Tax Issues on text page 6-26.

Basis of Property Received by Parent Corporation—§ 338 Election

44. If the parent elects under § 338 and the subsidiary is liquidated, the assets acquired from the subsidiary will have a basis stepped up (or down) to reflect the parent’s basis in the stock of the subsidiary plus the liabilities of the subsidiary.

   a. To qualify under § 338, the parent corporation must make an irrevocable election by the 15th day of the 9th month after the month in which the acquisition of a “qualified stock purchase” occurs.

      (1) This allows the parent corporation to treat the acquisition of stock as a purchase of the assets of the subsidiary.

      (2) An extension of time to make the § 338 election can be requested.
b. A “qualified stock purchase” is a purchase of at least 80% of the total voting power and at least 80% of the total value of the stock of the acquired corporation within a 12-month period. Further, the stock must be acquired in a taxable transaction.

45. Under § 338, the subsidiary is deemed to have sold its assets on the qualified stock purchase date for an amount determined with reference to the parent’s basis in the subsidiary stock plus the liabilities of the subsidiary (“aggregate deemed sale price”).

a. Subsidiary recognizes gain (or loss) from the deemed sale equal to the difference between the aggregate deemed sale price (ADSP) and the basis in its assets.

b. ADSP is described in the Additional Lecture Resource below.

46. On the day following a qualified stock purchase, the subsidiary is deemed to be a new corporation that purchased its assets for a similarly computed amount called the “adjusted grossed-up basis” (AGUB).

a. All corporate attributes of the “old” subsidiary, such as E & P, are eliminated as a result of the § 338 election. If the subsidiary is liquidated, the parent corporation obtains the assets of the subsidiary with the stepped-up (stepped-down) basis.

b. AGUB is described in the Additional Lecture Resource below.

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### ADDITIONAL LECTURE RESOURCE

**Aggregate Deemed Sale Price (ADSP).** Reg. § 1.338-4 provides the following guidance.

- In general, the grossed-up amount realized on the sale to the parent of recently purchased stock is equal to the following.

  1. The parent’s basis in the recently purchased stock divided by the percentage of the subsidiary’s stock (by value) attributable to the recently purchased stock.

  2. Less selling expenses (e.g., brokerage commissions) incurred by the shareholders of the subsidiary in their sale of the recently purchased stock to the parent.

- The liabilities of the subsidiary include any tax liabilities arising from the deemed sale of assets. Since the gain (or loss) resulting from the deemed sale is a function of the ADSP, an algebraic formula is required to compute ADSP.

- For comprehensive examples of calculating ADSP, see Reg. § 1.338-4(g).

**Adjusted Grossed-Up Basis (AGUB).** Reg. § 1.338-5 provides the following guidance.

- The method for allocating the AGUB among the assets of the subsidiary is set forth in Reg. § 1.338-6. Similar to the residual method used in the acquisition of a going
concern, this method segregates the subsidiary’s assets into seven classes, and allocates the AGUB among the assets within each class according to their relative fair market values. Except in the case of Class VII assets (i.e., § 197 intangibles in the nature of goodwill and going concern), the amount allocated to any asset is limited to such asset’s fair market value.

- For comprehensive examples of AGUB allocation to assets, see Reg. § 1.338-6(d).
- The basis allocated to § 197 assets is amortized over a 15-year period.
- The taxpayer has the burden of proof as to the value of the subsidiary’s assets and the associated basis allocation.
- Appraisal data relating to the subsidiary’s assets should be retained to justify the basis allocated to each asset.