USE OF CORPORATE ASSETS TO BUY OUT A SHAREHOLDER IN A CLOSELY HELD BUSINESS

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I. INTRODUCTION: Overview

A. Non-tax Uses/Advantages of Corporate Buy-out

1. Assures marketability of closely held shares.

2. Prevents dilution of ownership and intervention in management by outsiders.

3. Permits ownership to shift wholly via corporate funding, or, if partial purchase then at least at cheaper price due to shrinkage in corporate size attributable to asset drain from bootstrap funding.

4. Simplifies the terms, mechanics and insurance funding of buy-sell agreements (e.g. avoids multiplicity of insurance policies, cross covenants, etc., entailed by cross-purchase agreement).

5. Furnishes a pool of stock resulting from redemptions for use in employee compensation.

6. Similarly, provides a source of available stock for use as stock dividends.

7. Enhances financial profile of the company (e.g., increased earnings per share).


B. Tax Considerations/Advantages in Corporate Buy-out

1. Reduces earnings and profits account and hence potential dividend income.


b. Similarly, already consummated redemption may lessen risk, because of reduction in liquid assets available for dividend distributions, as well as in earnings and profits automatically permitted to be accumulated without risk of tax due to credit of IRC § 535(c).

3. Furnishes opportunity for ongoing corporation to rid itself of unwanted appreciated corporate property, or for shareholder to obtain corporate assets, without tax to distributing entity yet without dividend consequences to distributee. See details infra in II.


5. Minimizes taxes where distribution treated as either dividend to corporate buyer (on grounds discussed at I-C-9-c, infra), or as dividend to corporate seller (since not deemed part of sales price), qualifying for intercorporate dividend credit of IRC § 243.

a. Re: dividend to seller: compare Pacific Vegetable Oil Corp. v. Comm'r, 251 F.2d 682 (9th Cir. 1957) (dividend to corporate seller), and Rev. Rul. 75-493, 1975-2 C.B. 109 (dividend to individual seller on distribution immediately preceding sale), with Comm'r v. Waterman Steamship Corp.,
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430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (distribution part of sales price, not dividend to seller since despite "form" of distribution to seller, in "substance" the funds were furnished by buyer as part of sales price); and Rev. Rul. 77-226, 1977-2 C.B. 90 (no I.R.C. § 243 credit since redemption part of integrated plan of sale).

b. Re: dividend to buyer, see Television Industries, Inc v. Comm'r, 284 F.2d 322 (2d Cir. 1960) (dividend to 100% parent on redemption of purchased stock); Casner v. Comm'r, 450 F.2d 379 (5th Cir. 1971), nonacq. Rev. Rul. 75-493, supra (distribution to seller held in substance to be dividend distribution to buyer and not seller because integrated with sale, justifying disregard of form for substance).


6. Facilitates tax-free corporate combinations and take-overs, or tax-free liquidations of subsidiaries, by: 1) stripping out unwanted assets prior to a reorganization: see generally BITTKER & EUSTICE ¶ 14.52; and by 2) retiring sufficient minority interests to set the stage for tax-free liquidation of 80% owned subsidiary per IRC § 332; see, e.g., Madison Square Garden Corp. v. Comm'r, 500 F.2d 611 (2d Cir. 1974).

7. Creates opportunity for tax free division and split up of previously combined ownership and operations, by a split up or split off under I.R.C. § 355. But see Kuper v. Comm'r, 533 F.2d 152 (5th Cir. 1977) (recharacterized events as a taxable stock exchange at shareholder level); accord, Portland Mfg. Co., 56 T.C. 58 (1971), aff'd per curiam, 75-1 U.S.T.C. ¶ 9449 (9th Cir. 1975).

8. Avoids lock-in of "previously taxed income" of a Subchapter S Corporation by distribution tax free to the person to whom that income was earlier taxed.
9. Creates potential interest deduction for corporation where either: 1) corporate debt distributed in redemption of stock (but see Proposed Regs to IRC § 385); or, 2) corporate buyer purchased stock with debt to be retired out of dividends qualifying for IRC § 243 intercorporate dividend credit. (But see IRC § 279, and see generally limitations discussed in BITTKER & EUSTICE ¶¶ 4.20-4.22).

10. Eliminates ordinary income treatment on disposition of Section 306 stock when at time of distribution either company has no earnings and profits, see IRC § 306(a)(2); or, distribution is in complete termination of distributee's interest, per IRC § 306(b)(1)(B); see also Rev. Rul. 77-455, 1977-2 C.B. 93 (approving combined redemption and sale of Section 306 stock to key employees including seller's son).

C. Disadvantages and Limitations

1. Corporate pay-out subject to federal and state "Blue Sky" laws, as well as restrictions by creditors in existing loans (and hence the importance of securing back-up protection for redemptions through guarantees by other shareholders.).


3. Similarly, in financial statements and reports, improper to use "pooling of interests" rather than "purchase" method of accounting following a combination of two or more corporate businesses if, within two years preceding combination, either acquired more than a minimum amount of its own voting common stock and had not reissued that treasury stock.

4. Distributee exposed to transferee liability for taxes or other debts of distributor-corporation.

5. Potential ordinary income to seller as disguised compensation, or per IRC § 83. See, e.g., Joseph E. Russo, T.C.M. 1979-497, on appeal to 5th Cir.
6. Outgoing shareholder of potentially collapsible corporation guaranteed against risk of ordinary income through technique of securing corporation's consent to recognizing income, under IRC § 341(f), available as protection only for "sale" of stock and not for proceeds of corporate distribution. See IRC § 341(f)(1).

7. Potential income to corporation on property distributed in kind. See details infra in I-D.

8. Private foundation self-dealing rules of IRC § 4941 perhaps violated if stock of private foundation is redeemed by corporation which is a "disqualified person."

   a. But note that dividend treatment is advantageous if distributee is a corporation to which intercorporate dividend credit of IRC § 243 is available.
   b. Grounds for dividend income to seller
      i. Potential dividend income to seller under IRC 302(d) if distribution in purported redemption not in compliance with tests for exchange treatment under IRC § 302(b). See details infra on IRC § 302(b), and planning to avoid dividend treatment in II-C infra.
      ii. Distribution may confer a constructive dividend where disparity between redemption proceeds and the fair market value of redeemed stock.
         (a) Excess of redemption proceeds over fair market value of redeemed stock may represent disguised dividend on retained shares of seller; or, an ongoing interest that is prohibited if family attribution rules are to be effectively waived to avoid dividend income. See Rev. Rul. 77-467, 1977-2 C.B. 92 (by implication, since no dividend resulted where distributions equalled in value interests
received from redeemed shareholder): accord, Priv. Ltr. Rul. 8020018.

(b) If redemption proceeds inadequate, deficiency may represent constructive receipt in exchange for redeemed shares followed by constructive gift over to remaining shareholders.

c. Numerous possible grounds for dividend income to buyer. (See generally Rev. Rul. 69-608, 1969-2 C.B. 42, for guidelines on Service's approach to tax consequences to buyer in a bootstrap acquisition; and discussion in II-A infra on planning to avoid dividend income.)

i. Constructive dividend from benefit to buyer from use of corporate funds to discharge either buyer's obligation to purchase, or buyer's accrued debt from completed purchase. E.g., Wall v. United States, 164 F.2d 462 (4th Cir. 1947); James G. McKeown, T.C.M. 1980-18.

ii. Constructive dividend per IRC § 302(d) if stock redeemed after the purchase but without adequately reducing buyer's interest to satisfy IRC § 302(b). E.g., Adams v. Comm'r, 594 F.2d 657 (8th Cir. 1979), and cases there cited.


iv Constructive dividend to buyers attributable to benefit they receive
from paying a reduced price for stock because of corporation's distribution of property in redemption having a value in excess of the redeemed stock. See Charles D. Missimer, 38 T.C.M 192 (1979).

v. Danger to ongoing shareholders per IRC § 305, particularly for periodic redemption plans. But see Rev. Rul. 77-149, 1977-1 C.B. 83, holding that § 305(c) inapplicable even though 20 redemptions of retiring and deceased owners over prior several years. Compare Rev. Rul. 78-60, 1978-1 C.B. 81, applying IRC § 305(c) because of classic periodic redemption plan. See generally, Reg. § 1.305-3(e), Examples 8 and 9.

d. Immaterial that dividend income could have been avoided by structuring transaction so as to avoid same, if in fact method chosen represents constructive dividend; courts hold taxpayers bound by the method chosen. E.g., William K. Edmister, 46 T.C. 651 (1966), aff'd per curiam, 391 F.2d 584 (6th Cir. 1968); Roy M. Berger, 33 T.C.M. 737 (1974), aff'd unpublished opinion (9th Cir. 1976).

D. General Tax Treatment of Corporate Distribution in Purported Exchange for Stock

1. Tax consequences of redemption per IRC §§ 302 or 303.

a. To shareholder-distributee

i In general, sale or exchange of stock, with capital gain or loss recognized on difference between redemption price and basis.

(a) But again, ordinary income possible if shareholder is a dealer, or if corporation is collapsible, or if stock has a Section 306 taint.

(b) Capital gains potentially subject to a new alternative minimum tax of IRC § 55.
ii. Property in kind received in distribution in exchange for redeemed stock acquires a cost basis under IRC § 1012 equal to fair market value.

b. Tax consequences to distributing corporation.

i. Re recognition of gain or loss

(a) In general, corporate payment in redemption of its own stock is a nonrecognition event per IRC § 311(a). But see explicit exceptions in IRC § 311, particularly IRC § 311(d), requiring recognition of gain on some distributions of appreciated property in redemption. However, nonrecognition applies if the redemption, inter alia, completely terminates stock interest of distributee who owned at least 10% in value of the corporation's stock during preceding 12 months. IRC § 311(d)(2)(A).

(b) Recognition of recaptured depreciation on distributions of depreciable property in kind, per IRC §§ 1245: 1250.

(c) Recognition possible where "Section 341(f) consents" to corporate recognition of income by potentially collapsible corporation were earlier filed, whether or not corporation was eventually determined to be collapsible.

(d) Recognition of recaptured investment credit on premature disposition of qualified investment property.

ii. Effect on earnings and profits: reduction per I.R.C. § 312(e), except for amount "properly chargeable to capital account."

70-531, 1970-2 C.B. 76, and withdrawing previous non-acquiescence in William D.P. Jarvis, 43 B.T.A. 439 (1941), and Herbert Enoch, 57 T.C. 781 (1972), with the effect of allowing disproportionate reduction in earnings and profits beyond amount representing ratable share of the redeemed shares.

(b) But see G.P.D. Inc. v. Comm'r, 508 F.2d 1076 (6th Cir. 1974), indicating that the reduction does not preclude current year's income from being subjected to accumulated earnings tax (or indeed imposition of personal holding company tax on current undistributed income), even though redemption depleted earnings and profits account by an amount in excess of current income.

2. Tax consequences of recharacterizing the purported redemption as actual or constructive dividend.

a. To shareholder-distributee

i. If noncorporate distributee:

(a) Ordinary dividend income equal to value of the distribution, but only up to amount of distributing corporation's current and accumulated earnings and profits; IRC § 301(b)(1)(A) and (c)(1); excess a tax-free return of capital up to basis in stock; and surplus treated as sale or exchange per description in D-1 supra. IRC § 301(c). But if stock in a collapsible corporation, then excess over basis of stock either short-term capital gain or ordinary income, per IRC § 341(a)(3).

(b) Basis of property received as dividend in kind equal to fair market value. IRC § 301(d)(1).

ii If corporate distributee:
(a) Recognition and nature of income generally same as with noncorporate distributee, except for: 1) intercorporate dividend credit of IRC § 243 rather than individual's dividend exclusion, and, 2) property in kind treated as dividend only up to basis of that property to distributing corporation, increased by gain recognized to the distributing corporation, per IRC § 301(b)(1)(B).

(b) Basis of property received in kind remains same as in hands of distributing corporation, increased by gain recognized by latter. IRC § 301(d)(2)

b. To corporate distributor

i. In general, no recognition of gain or loss per IRC § 311. But subject to same statutory exceptions described supra as for redemption, including potential income per IRC § 311(d) when distribution treated as dividend equivalent rather than redemption of stock of a shareholder having 10% or lesser stock interest during past year. Rev. Rul 79-278, I.R.B. 1979-37, 9.

ii. In general, earnings and profits reduced by full amount of cash taxed as dividend to distributee, or by adjusted basis to distributor of property distributed in kind. IRC 312(a).

3. Tax consequences of a liquidating distribution

a. To distributee

i. In general, sale or exchange of stock with capital gain or loss reported on difference between liquidation proceeds and basis of retired stock. I.R.C. §§ 331; 346.

(a) But again, ordinary income possible if shareholder is a dealer, or corporation is collapsible; although if
§ 306 stock, may be able to avoid ordinary income where interest completely terminated.

(b) If distributee is parent corporation of at least 80% owned liquidating subsidiary, no gain or loss to parent per IRC § 332.

(c) Nor is one-month liquidation under IRC § 333 a fully taxable event. See generally BITTKER & EUSTICE ¶¶ 11.20-11.24.

ii. Basis of property received in kind equals fair market value per IRC § 334(a), except for basis determined under § 334(b) for an 80% parent--either price of purchased subsidiary's stock, per IRC § 334(b)(2), or carryover of subsidiary's basis per IRC § 334(b)(1).

b. To liquidating corporation.

i. Generally no gain or loss recognized on distributions, per IRC § 336, or on sales incident to complete liquidation and in compliance with IRC § 337.

(a) Possibility of income recognition less than on redemption or dividend distribution because of greater breadth of protections per IRC §§ 336 and 337 than under IRC § 311 (e.g., no counterpart to IRC § 311(d)).

(b) Nonetheless, some recognition possible because of statutory overrides to Section 337 for, e.g., depreciation and investment credit recapture, and inapplicability of Section 337 to certain corporations (collapsible; and 80% owned subsidiaries eligible for liquidation under rules of IRC § 334(b)(1)); or possibility of income due to judicial doctrines of anticipatory assignment of income, tax benefit, etc. See
generally BITTKER & EUSTICE ¶ 11.60 et seq.

ii. In partial liquidation, earnings and profits account reduced to same extent as with redemptions. IRC § 312(e).

4. Tax consequences of distributions pursuant to split ups/offs under IRC § 355, which divisions of corporate operations and concomitant distributions of stock are undertaken to separate ownership of former co-shareholders.

a. To distributee shareholder.

i. Nonrecognition event to extent only stock distributed, or stock plus debentures having face amount no larger than face amount of debentures turned in.

ii. Boot taxed per IRC § 356(b) as dividend governed by IRC § 301.

b. To distributing corporation.

i. Under IRC § 351, no gain or loss on transfer of assets to subsidiary company that sets the stage for split off/separated ownership.

ii. Earnings and profits divided proportionately between parent and subsidiary. IRC § 312(h).

5. Tax consequences of distributions in partial liquidation.

a. To distributee, same results as with distributions in complete liquidation, except that taxable event on one-month liquidation or on liquidation of controlled subsidiary (unlike complete liquidations governed by IRC §§ 332 and 333).

b. To distributing corporation, generally same results as with distribution in complete liquidation, except for absence of statutory analogue to IRC § 337 that insulates company from tax on liquidating sales of property in kind by corporation (or on its behalf by its shareholders).
II. PLANNING TO OPTIMIZE TAX CONSEQUENCES

A. Methods of Avoiding Dividend Treatment to "Buyer"-Ongoing Shareholder

1. Avoid agreeing to incur primary obligation to purchase shares.
   a. IRS concedes that guarantee of corporate obligation, or secondary liability, will not create dividend income to guarantor. See generally Rev. Rul. 69-608, 1969-2 C.B. 42; BITTKER & EUSTICE ¶ 9.25
   b. If seller refuses to receive distribution in redemption as payment for shares, and insists on "sale of stock" instead, consider establishing holding company to become purchaser (with price eventually to be funded through intercorporate dividend or downstream merger). See, e.g., Arthur J. Kobacker, 37 T.C. 882 (1962)(no dividend to individual ongoing shareholder who never became personally liable to buy).

2. Techniques to avoid dividend income from corporate funding if in fact primary obligation already incurred.
   b. Assign obligation to pay, along with newly acquired stock, to another controlled corporation so that latter can provide the funding.

   i. Conflict in cases as to whether this assumption of liability can be tax-free either pursuant to IRC §§ 357(a)/351, or because at time of assumption assignee had no earnings and profits to support dividend treatment under IRC § 304, or because assignee made no constructive distribution to assignor in that it acquired asset of value equivalent to the distribution. Compare Citizens Bank & Trust Co. v. United States, 580 F.2d 442 (Ct. Cl. ...
ii. Funding can be achieved, even though assignee is newly created or otherwise lacks assets to pay the assumed debt, through intercorporate dividend from corporation whose shares were acquired on the assignment, or by ultimate downstream merger of assignee into corporation whose shares assignee acquired. See Kobacker, supra.

B. Methods of Avoiding Dividend Treatment to Seller

1. Exchange treatment per IRC § 302(b), applicable to "redemptions." See details infra in II-C.

2. Exchange treatment pursuant to partial liquidation under IRC § 346. See details infra in II-E.

3. Automatic non-dividend treatment for distributions to fund death taxes and expenses per the relief provision of IRC § 303. See details infra at II-D.

4. Tax-free exchange treatment pursuant to recapitalization provisions, IRC § 368(a)(1)(E), particularly in light of recent Proposed Regs under IRC § 385, which increase the possibility that distributee will be treated as having received stock rather than debt in exchange for stock turned in.

5. Possible exchange treatment for boot received along with stock incident to a reorganization in which the company whose stock is turned in is acquired or combined with another entity. See Wright v. United States, 482 F.2d 600 (8th cir. 1973), nonacq., Rev. Rul. 75-83, 1975-1 C.B. 112, corrected in Announcement 75-41, 1975-1 C.B. 323, (concluding that dividend equivalency per IRC § 356 is to be determined as though the distribution were from the acquired company and
not the acquiring company as held in Wright, thus making dividend treatment more likely when a small target company is acquired by a much larger corporation).

6. Non-taxable receipt pursuant to a spin-off or split-off under IRC § 355, in which formerly common ownership is separated by dividing corporation into two or more separately owned entities.

7. Charitable gift of stock, followed by redemption from charity, may avoid dividend treatment to donor, provided that the donee charity was not bound to have the stock redeemed. See, e.g., concession in Rev. Rul. 78-197, 1978-1 C.B. 83.

C. Requirements For "Redemption" (Rather Than Dividend) Treatment Under IRC § 302

1. Statutory tests of IRC § 302(b)


i. The Supreme Court, in United States v. Davis, 397 U.S. 301 (1970), made "business purpose" for the redemption an irrelevant inquiry, holding instead that any pro rata reduction that fails to effect a "meaningful reduction in interest," taking full account of attribution of ownership under IRC § 318, is essentially equivalent to a dividend.

ii. "Meaningful reduction in interest" seems to necessitate that redeemed shareholder not have voting control after the redemption, and that other interests have dropped significantly. See, e.g., Niedermeyer v. Comm'r, 62 T.C. 280 (1974), aff'd per curiam, 535 F.2d 500 (9th Cir. 1976) (reduction from 90.49% to 82.96%, inadequate); accord, Fehrs Finance Co. v. Comm'r, 487 F.2d 184 (8th Cir. 1973) (98.2% to 88.69%), Rev. Rul. 77-218, 1977-1 C.B. 81 (60% to 55%); Rev. Rul. 73-2, 1973-1 C.B. 171 (100% to 81%). See also Rev. Rul. 75-502, 1975-2 C.B. Ill (57% to 50% non-controlling
b. IRC § 302(b)(2): "substantially disproportionate reduction in interest."

Three tests must be met:

i. Shareholder's voting stock must have dropped to less than 80% of what it was prior to the redemption;

ii. Accord, as to requisite 80% drop in common stock, nonvoting as well as voting;

iii. Shareholder's voting interests must amount to less than 50% of total voting power.

c. IRC § 302(b)(3): complete termination of interest.

2. In general, actual as well as constructive ownership by redeemed shareholder must drop if distribution is to qualify as an exchange rather than a dividend.

a. Requisite amount of reduction in ownership:

i. "Meaningful reduction" in interest required to qualify under the amorphous test of IRC § 302(b)(1) of "not equivalent to a dividend."

ii. "Substantially disproportionate reduction in interest" required to meet the safe-harbor rules of § 302(b)(2).

iii. "Complete termination" of interest required to qualify for the safe haven of § 302(b)(3).

b. If redemption and cross purchase combined, end result is determinative. E.g., Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 75-447, 1975-2 C.B. 113.

c. Applicability of constructive ownership rules of IRC § 318.

i. IRC § 302(c)(2) authorizes waiver of family attribution in the event of an
otherwise complete termination of interest.

(a) Waiver disallowed if termination of interest made possible by earlier "tax avoidance" transfer, within preceding ten years, dividing interests between family member and redeemed shareholder. IRC § 302(c)(2)(B).

(b) Nature of attribution that can be waived by statute, and by whom.

(1) Can an entity (trust, corporation, partnership) waive family attribution from one relative to another, so as to avoid reattribution to itself from latter relative; or can only a family member who is the distributee of redemption proceeds waive family attribution? Permitting the former, see Lillian M. Crawford, 59 T.C. 830 (1973), nonacq., 1974-2 C.B. 5; accord, Rodgers P. Johnson Trust, 71 T.C. 941 (1979), gov't appeal to 10th Cir. dism'd.

(2) Can entity attribution (i.e., from or to persons who are owners of the entity) be waived? See the much criticized positive response in Rickey v. United States, 592 F.2d 1251 (5th Cir. 1979).


(d) Effective waiver requires filing agreements per statutory requirements; and nonacquisition
of company stock or other prohibited interest for ten years.

ii. Courts have also allowed waiver of family attribution where family hostility negates an identity of economic interest or control among those who would otherwise be affected by family attribution rules. See, e.g., Robin Haft Trust v. Comm'r, 510 F.2d 43 (1st Cir. 1975); Estate of Arthur H. Squier, 35 T.C. 950 (1961), acq. withdrawn and nonacq. substituted, 1978-37 I.R.B. 5.

iii. Recent Revenue Ruling indicates that IRS now takes the position that constructive ownership rules are to be mechanically applied and without subjective inquiry into actual relationships of the parties. Rev. Rul. 80-26, 1980-4 I.R.B. 7.

iv. Revision of attribution rules now under Congressional study.

3. Nature of interests that, unless relinquished, amount to ongoing ownership that would preclude sale or exchange treatment.

a. If family attribution is to be waived per IRC § 302(c), must relinquish for ten years all interests--other than as creditor--to prevent redeemed shareholder from having any ongoing voice or stake in company, whether as a consultant, employee, etc., and notwithstanding that these are not ongoing "ownership" interests. See, e.g., Jack O. Chertkof, 72 T.C. 1113 (1979), taxpayer on appeal to 4th Cir. (proscribed management agreement obtained 6 months after redemption). But cf. permissible interests as fiduciary (executor or testamentary trustee) acquired from decedent: Rev. Rul. 79-334, 1979-43 I.R.B. 14. See also Rev. Rul. 77-467, 1977-2 C.B. 92 (waiver valid despite ongoing relationship as lessor to corporation, since arms' length charge for rent).

b. But, if no need to waive family attribution (i.e., either because family members do not own stock, or have simultaneously redeemed, see Rev. Rul. 76-524, 1976-2 C.B. 94), can retain quite broad interests, including
position as officer, consultant, etc. See Priv. Letter Rul. Doc. 7840051, permitting redemption treatment under IRC § 302(b)(3), despite ongoing consulting agreement, inasmuch as no family attribution waiver was entailed.

i. For demonstration of broad interests permitted, see Claude J. Lisle, 35 TCM 627 (1974)(20-year payout plus numerous "security" interests).


c. However, see Rev. Proc. 80-22, I.R.B. 1980-26, 26 indicating that no advance rulings or determination letters will issue on whether IRC § 302(b) applies when consideration for the purported redemption consists wholly or partially of an amount based on or contingent on the corporation's future earnings.

4. Installment redemptions: periodic redemptions and redemptions on deferred payment plan.

a. Comparison of these two installment methods.

i. Both effectively spread the gain, as well as easing liquidity pressures on payor.

ii. Differences to recipient: 1) in computation of extent of basis to be offset against consideration received, and hence amount of gain or loss recognized; 2) size/meaningfulness of drop in ownership; 3) ability to waive attribution (available only if shares completely redeemed); 4) existence of requisite "plan" of periodic redemptions to satisfy tests for reduction of interests; 5) applicability of IRC § 483 rules on imputed interest relevant only for deferred payments, not deferred redemptions; 6) qualification under IRC § 453: see, e.g., Dean W. Cox, 62 T.C. 247 (1974), holding that, because of recomputed selling price to reflect imputed interest on deferred payments,
more than 30% of selling price was received in year of sale in violation of IRC § 453(b)(2)(B), thus disqualifying installment reporting under existing -- but not pending reform -- rules. Similar danger of exceeding 30% limit where Zenz v. Quinlivan model of combined sale and redemption; see Farha v. Comm'r, 483 F.2d 18 (10th Cir. 1973); 7) conformity to timetables of IRC § 303 for qualified redemptions; and, 8) possible acceleration of deferred estate taxes under IRC §§ 6166 or 6166A, depending upon proportion of shares deemed redeemed.

iii. Similarly, possible differences in result to payor-distributing corporation: 1) under IRC § 267, potential disallowance of interest deduction or recognition of loss on distribution, depending upon whether and extent to which payee is ongoing shareholder; see Hendershot and Smith, Inc., 34 T.C.M. 788 (1975); 2) under IRC § 311(d), potential recognition of gain on distributed property (e.g., where distributee was formerly a substantial shareholder whose stock was redeemed earlier by a note later satisfied by deferred payment in form of property in kind; see Rev. Rul. 77-256, 1977-2 C.B. 96); 3) under IRC § 1239, nature of recognized gain on property distributed in kind possibly affected, depending upon whether distributee's stock was earlier redeemed wholly or only in part; 4) under IRC § 483, potential imputed interest deductions on installment payments, but not on periodic redemptions.

b. Formalities and necessity of obligation to redeem in order for deferred distributions to qualify for redemption treatment: e.g., compare Bleilly & Collishaw, Inc., 72 T.C. 759 (1979) (approving redemptions over 23 weeks per unwritten "gentleman's agreement"), with Blanche S. Benjamin, 66 T.C. 1084 (1976), aff'd, 592 F.2d 1259 (5th Cir. 1979) (disapproving as redemptions two distributions four years apart).
c. Pending reforms relevant to installment redemptions: liberalization of requirements of IRC § 453; Proposed Regs on IRC § 385 (applicable to purported debt issued per deferred payment plan of redemption).

D. Automatic Redemption/Non-Dividend Treatment of IRC § 303

1. Comparison to redemption treatment under IRC § 302.

a. Most importantly, amount of effective change in ownership irrelevant.

b. IRC § 311(d) inapplicable, thus reducing threat of corporate gain on distribution of appreciated property in Section 303 redemption. See IRC § 311(d)(2)(D).

c. Effective method to bail out corporate funds in retirement of Section 306 stock and without dividend income, even though corporate distributor has earnings and profits and is not in process of liquidation. See Reg. § 1.303-2(d).

d. Will not cause acceleration of estate taxes otherwise deferrable under IRC §§ 6166 and 6166A.

e. But, Section 303 treatment subject to unique timetables requiring redemption occur within period set forth in IRC § 303(b)(1).

2. Per Tax Reform Act of 1976, Section 303 relief of automatic non-dividend treatment on redemption of deceased shareholder's stock available only to distributees burdened by decedent's death taxes and expenses.


b. Similarly, relief possibly jeopardized if redemption proceeds used to fund certain kinds of bequests. Ibid.
E. Distributions Pursuant to Bona Fide Contraction of Corporate Operations

1. Non-dividend treatment available to distributee upon compliance with either of alternative statutory tests of IRC § 346.
   a. Bona fide contraction of operations. See generally, BITTKER & EUSTICE ¶ 9.52; or,
   b. Distribution of proceeds from sale, or assets themselves, of one of two trades or businesses that have both been actively conducted for at least the past five years, neither of which business was acquired in taxable transaction during that period.

2. To qualify for treatment per IRC § 346, must only distribute assets of terminated business or proceeds of their sale.

3. Advantages to characterization of distribution as partial liquidation under IRC § 346 rather than redemption under IRC § 302.
   a. Exchange treatment under IRC § 346 unaffected by whether distribution is pro rata among shareholders, or by existence of ongoing ownership by relatives from whom ownership is attributed to taxpayer under IRC § 318.
   b. Risk of ordinary income on retirement of Section 306 stock eliminated if liquidating distribution rather than simple redemption. See IRC § 306(b)(2); Reg. § 1.306-2(b)(1).
   c. To distributing company, more limited risk of income recognition than with distribution in redemption. Compare IRC § 336 with § 311.
F. Distributions to Split Up Mutual Ownership Into Ownership of Separate Companies

1. Possible to achieve in several ways:
   a. Tax-free split-off per Section 355.
   b. Partial liquidation in complete redemption of one of the owner's stock, pursuant to IRC § 346 discussed above. But note that partial liquidation followed by reincorporation of a portion of the assets received in the distribution may be recharacterized as a Section 355 split up or "D" reorganization, causing any retained assets to be taxed as boot under IRC §§ 356/301. Rev. Rul. 77-191, 1977-1 C.B. 94.
   c. Taxable exchange of stock between co-shareholders of brother-sister corporations so that each shareholder becomes sole shareholder of one or the other corporation. See Kuper v. Comm'r, 533 F.2d 152 (5th Cir. 1976); Rev. Rul. 77-11, 1977-1 C.B. 93. See also Rev. Rul. 71-336, 1971-2 C.B. 299.
   d. Attempted tax-free stock swap by creating new subsidiary corporations and then splitting up ownership of them per Section 355. But note the possibility that this may be recharacterized as a taxable stock exchange at the shareholder level. Ibid.

2. Requirements of IRC § 355 for nontaxable split off/division of corporate businesses into separate corporate shells separately owned: see generally BITTKER & EUSTICE Ch. 13.

3. Advantage of severing joint ownership pursuant to IRC § 355: potential tax free event, with taxable gain or loss deferred until future (or perhaps completely avoided since reinstatement of stepped-up basis at death under IRC § 1014).