OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Section 304 – Exchange Treatment under Section 302

This Field Service Advice responds to your request for advice. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>

P =
S1 =
S2 =
S3 =
T1 =
T2 =
T3 =
T4 =
T5 =
T6 =
T7 =
T8 =
T9 =
A1 =
A2 =

A3	=
X	=
Y	=
Y’s Adviser	=
Y sub	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=
<u>e</u>	=
<u>f</u>	=
<u>g</u>	=
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<u>i</u>	=
<u>j</u>	=
<u>k</u>	=
<u>l</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>p</u>	=
year 1	=
year 2	=
date 1	=
date 2	=
date 3	=
date 4	=
date 5	=
date 6	=
date 7	=
date 8	=
date 9	=
date 10	=
date 11	=
date 12	=
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Issue 1: Should the effect of the sale of S2 to X be taken into account in determining whether the section 304 redemption of S2's interest by A1 is a distribution under section 301 or a sale or exchange under section 302(a)? Should the effect of the sale of S1 to Y be taken into account in determining whether the section 304 redemptions of S1's interests by A1, A2, and A3 are distributions under section 301 or sales or exchanges under section 302(a)?

Conclusion 1: The sale of S2 to X in year 1 should be integrated with the section 304 redemption by A1 to find a complete termination of S2's interest in A1 under section 302(b)(3) and, therefore, sale or exchange treatment under section 302(a). Similarly, the sale of S1 to Y in year 2 should be integrated with the section 304 redemptions by A1, A2, and A3 to find a complete termination of S1's interest in A1, A2, and A3 under section 302(b)(3) and, therefore, sale or exchange treatment under section 302(a).

Issue 2: Whether the Service should continue to argue [redacted]

Conclusion 2: [redacted]

Facts: [redacted]

P is the parent of a consolidated group that included S1, S2, S3, T1, T2, T3, T4, T5, T6, T7, T8, T9, A1, A2, and A3, except for S1 and S2 after their sale to Y and X, respectively (6). A statutory notice of deficiency proposed reducing the long term capital loss reported by (i) S1 on the sale of the stock of S2 to X in year 1 by $a, and (ii) S3 on the sale of the stock of S1 to Y in year 2 by $b (5).

Facts relating to the year 1 sale

P wholly owned S1. S1 wholly owned S2. Among S2's businesses was holding leases to which S2 or its subsidiaries were the owner/lessor (the Principal Investments). These leases were generating positive cash flow, but had now “turned around” for tax purposes, that is, they now generated taxable income in excess of pre-tax cash flow (7).

In date 1, P’s tax department recommended a tax strategy of selling the stock of S2 but retaining the non-Principal Investment assets (the Retained Assets) in the P group. P determined to cause S2 to transfer the Retained Assets to other corporations within the P group and leave only Principal Investment assets in S2 (8). On date 2, the P board met and discussed the stock sale of S2 (11). In date 3, P provided X with information regarding the sale of certain S2 assets.[1] X had sufficient net operating losses to offset income generated by the Principal Investments (12). On date 4, a presentation document provided for X by P described the assets that it proposed would be held by S2 at time of the sale of S2 stock to X. The Retained Assets were not included in that list of assets (13).

T1 was wholly owned by S2 (14). By resolution dated date 5, S2 contributed the Retained Assets to T1 (15). On date 6, the Boards of S2 and A1, a wholly owned P subsidiary, approved the sale of T1 to A1. The sale closed on date 7 (16).

P acted as banker to the P group and kept intercompany loan accounts with each of its subsidiaries (18). The purchase price of T1 was $a. The purchase was recorded in P’s books by debiting P’s intercompany loan account with A1 by the amount of the purchase price and crediting P’s intercompany loan account with S2 by the same amount (19). A1’s accumulated earnings and profits exceeded the purchase price for T1's stock (20).

On date 8, there was a presentation to P’s Board regarding approval of a nonbinding letter of intent to sell S2 to X. The transfer of Retained Assets was described in relation to the necessity of isolating the Principal Investments in S2 for purposes of the sale to X and the tax advantages of structuring the transfer as a stock sale within the group. In the section describing Calculation of Tax Basis, the presentation stated, “[I]t’s the tax aspects that make this sale especially attractive. The tax department, in conceiving this transaction, has creatively applied two different tax concepts to maximize the calculation of [P’s] tax basis in [S2].” The second concept involved the sale of T1 to other group members rather than distributing T1 stock to S1. The section titled “The Transaction” described the first portion as a two-step removal of the Retained Assets from S2 by selling certain

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[1] [redacted]

subsidiary stock to A1 and declaring a $d dividend to S1, consisting of cash proceeds from the sale of T1 plus other cash, receivables, and liabilities. The second portion was the sale of S2 for $c to X. In addition, it appears that the sales terms were well established by this date: "Corporate Law and outside counsel have already reviewed a proposed letter of intent. Once both parties have signed the letter of intent, the sales price will be firmly established subject only to changes in the residual value by the appraisers." (21 and Presentation document). The letter of intent was signed by P and X on date 9 (22).

On date 10, the S2 Board approved the $d dividend to S1 (28). On date 11, X indicated that there were certain problems arising with purchase (presumably in regard to financing the acquisition) (24, 27). On date 12, the original letter of intent was extended (25). On date 13, X announced it had obtained the necessary financing (26). Effective date 14, a purchase agreement for the purchase of S2's stock by X was entered into for a price of $e. This amount was amended on date 15, the closing date (29).

Facts relating to the year 2 sale

Based on a perceived opportunity in the tax law, P decided to sell the portion of S1's business consisting of ownership of leased property. In the aggregate, the leases had "turned around" (33). This purpose is identical to the year 1 sale.

P decided to sell subsidiaries of S1 containing the Retained Assets to other P group members (34).

By date 16, P provided a preliminary memorandum regarding the sale of S1 to prospective buyers (36). On date 17, P entered into a confidentiality agreement with Y's adviser regarding Y's proposed purchase of S1 (38).

On date 18, T2, a wholly owned subsidiary of S1, declared a dividend of portfolio stock to S1 (45)].[2] On dates 18 and 19, the sale of T2 to A1 for $f was approved by the boards of S1 and A1, respectively (46). Payment of $g of the purchase price was cleared through the intercompany loan accounts like the year 1 sale. A1 treated the difference as a loan receivable from S1 (48).

Effective as of date 20, S1 (i) contributed some Retained Assets to T3, a wholly owned subsidiary of S1 (39), (ii) contributed $h to T4 to create a positive book net worth (40), and (iii) entered into a purchase agreement for T3, T4, T5, T6, and T7 with A2, a wholly owned subsidiary of P. The sale closed on the same date (41).

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[2] [redacted]

The sales price was $i, $j paid by promissory note from A2 and the remainder debited by S1 as loan receivable from A2 (43).

On date 21, S1 ratified the contribution of a non-leasing subsidiary to T8, a wholly owned subsidiary of S1 (49). On the same date, the boards of S1 and A3 approved the sale of T8 to A3, a wholly owned subsidiary of P, for $k. The sale closed the same day (50, 52).

On date 22, P approved the contribution of P's S1 stock to S3, a newly formed subsidiary of P (53).

On date 23, Y's adviser, on behalf of itself and Y sub, provided P with terms for the purchase of S1 (54). On date 24, P's board approved the sale of S1 for not less than $l (55). The presentation document describes the transaction in similar terms as the year 1 presentation document, describing the need to move S1 assets the P group desired to retain out of S1 before the stock sale and focusing on the tax benefits to the P group and the buyer the proposed structure purportedly afforded. The presentation document identifies the purchaser as Y's adviser and Y sub. The document described the sales to A1 and A2 (but included no description of the A3 purchase) and a dividend of the sales proceeds and other cash, stock, receivables, and liabilities to S3 as preliminary steps in the sale of S1. The document summarized the state of negotiations as follows: "Corporate Law and outside counsel have already prepared a proposed definitive sales agreement. The purchaser has submitted its desired contract changes, which are currently being negotiated. Once both parties have signed, the sale will be firmly established subject only to Hart Scott Rodino approval." (56 and Presentation document).

On date 26, a nonbinding letter of intent was entered into between P and Y regarding the purchase by Y or its affiliate of S1 from S3 (56).

On date 27, the boards of S1 and A1 approved the sale of T9, a wholly owned subsidiary of S1, from S1 to A1. The sale closed the same day (57). The purchase price was $m.

During the time between dates 20 and 27, S1 distributed to S3 all the proceeds from the various subsidiary sales and certain other assets (60). On date 25, S1 declared a $n net asset dividend to S3 (60).[3]

On date 28, P, S1, S3, and Y entered a purchase agreement for sale of S1 for $o plus certain additional contingent amounts. The sale closed the next day (64).

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[3] [redacted]

Each of A1, A2, and A3 had earnings and profits in excess of the purchase price of the subsidiaries it acquired (66). The price of T2 was adjusted upwards to $p based on a valuation report (65).

The $b adjustment to the basis in S1's stock in the Deficiency Notice equals the sum of $i (the purchase price for T3-7), $g (the initial price for T2), $k (the final purchase price for T8), and $m (the purchase price of T9) (67).[4]

Discussion of Issue 1:

Law:

Section 304 of the Code was enacted to prevent the bailout of earnings and profits at capital gains rates through the sale of stock of one corporation ("Issuing") to a related corporation ("Acquiring") by a person in control of both corporations ("Transferor"). If Transferor and Acquiring are "brother/sister" corporations, §304(a)(1) recasts a sale by Transferor of Issuing stock to Acquiring as follows: (1) the sale proceeds received by Transferor from Acquiring are treated as a distribution in redemption of Acquiring stock under §302, and (2) the transfer of Issuing stock by Transferor to Acquiring is treated, to the extent §301 applies to the §304 redemption distribution, as a contribution to Acquiring's capital by Transferor.

Section 302 treats the §304 redemption as a sale or exchange if certain requirements set out in §302(b) are met. If none of the requirements are met, §302(d) provides that §301 applies to the distribution. Rev. Rul. 70-496, 1970-2 C.B. 74, illustrates how § 304(a)(1) has been applied where Transferor does not directly own any Acquiring stock. In Rev. Rul. 70-496, corporation P ("Parent") owns 70 percent of the stock of X ("Transferor") and 100 percent of the stock of Z ("Acquiring"). Transferor owns 100 percent of the stock of Y ("Issuing"). Transferor transfers all the stock of Issuing to Acquiring in exchange for cash equal to the value of the Issuing stock. Transferor is in control of both Issuing and Acquiring before the transaction under §§304(c)(3) and 318(a)(3)(C). The sales proceeds are treated as a distribution by Acquiring in redemption of Acquiring stock held by Transferor, even though Transferor actually holds no Acquiring stock. To the extent §301 applies to the distribution, the transfer of the Issuing stock is treated as a contribution to Acquiring's capital by Transferor. However, if one of the tests of §302(b) is met, the deemed redemption is treated as a sale or exchange of property under §302(a).

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4 [redacted]

Section 1.1502-80, before it was amended effective July 24, 1991, specifically makes §304 applicable to the consolidated return regulations. Consolidated return groups have used § 304(a)(1) transactions where Transferor owns no Acquiring stock in conjunction with the investment adjustment rules of §1.1502-32 and the earnings and profits adjustment rules of §1.1502-33 to create an artificial loss in Transferor stock and, thereafter, to attempt to recognize loss on a sale of Transferor.

[redacted]

In Zenz, a sole shareholder sold part of her stock in a corporation to an unrelated purchaser, and three weeks later had the corporation redeem the rest of her shares, both steps occurring under the same plan. The Service argued that the redemption was a disguised dividend because it would have been treated as such if the redemption had occurred before the sale. The court disagreed, holding that the redemption was part of a transaction that completely terminated the shareholder's interest in the corporation and thus was entitled to capital gain treatment.

The Service agreed to follow Zenz in Rev. Rul. 55-745, 1955-2 C.B. 223, emphasizing that the sequence of planned transactions is irrelevant where the overall result is the complete termination of a shareholder's interest. Consistent with that ruling, the Service conceded in U.S. v. Carey, 289 F.2d 531 (8th Cir. 1961), and the court held, that Zenz applies when the redemption precedes the stock sale pursuant to a plan. *See also* Rev. Rul. 75-447, 1975-2 C.B. 113 (sequence of events irrelevant if both "clearly part of an overall plan").

While Zenz is typically used by individual shareholders seeking capital gain treatment, it has also been asserted by the Service against corporate shareholders looking for dividend characterization. In Rev. Rul. 77-226, 1977-2 C.B. 90, corporation Y purchased 4,000 shares of stock of corporation X, which was offering to redeem stock tendered by its shareholders. The shares were purchased on the market at the tender price. Y then tendered 800 shares to X, treated the proceeds as a dividend (because the redemption was not substantially disproportionate under § 302(b)(2)), sold the remaining 3,200 shares at a price reflecting X's reduced net worth, claimed the dividends received deduction for the redemption proceeds, and reported a short-term loss on the 3,200 shares. Citing Zenz, the Service ruled that:

> In this case, the redemption and the sale were undertaken pursuant to an integrated plan. Therefore, even assuming the redemption distribution, standing by itself, would have been essentially equivalent to a dividend, the redemption and sale combined completely terminated Y's interest in X within the meaning of §302(b)(3) of the Code. That the redemption occurred before the sale is irrelevant.

Thus, because the aggregate amount received by Y for the 4,000 shares equaled its cost for the shares, Y realized no gain or loss. *See* Bleily & Collishaw, Inc. v. Commissioner, 72 T.C. 751 (1979), *aff'd* 647 F.2d 169 (9th Cir. 1981).

Courts have used the Zenz doctrine to analyze not only actual redemptions, but also deemed redemptions under section 304. Niederrmeyer v. Commissioner, 62 T.C. 280 (1974), *aff'd,* 535 F.2d 500 (9th Cir. 1976); Paparo v. Commissioner, 71 T.C. 692 (1979) (Zenz doctrine used to analyze the section 302(b)(1) consequences of a redemption deemed under section 304(a)(1)).

There are several different articulations of when the Zenz doctrine will apply to take into account the effects of another transaction when analyzing a redemption.[5] The court has articulated its standard several times, including in Niedermeyer v. Commissioner, 62 T.C. 280 (1974): "Where redemptions were executed pursuant to a plan to terminate one's interest in a corporation, it has been held that dividend equivalency may be avoided where the individual redemptions are component parts of a single sale or exchange of an entire stock interest. [citations omitted.] Where there is a plan which is comprised of several steps, one involving the redemption of stock that results in a complete termination of the taxpayer's interest in a corporation, section 302(b)(3) may apply. [citations omitted.] However, the redemption must occur as part of a plan which is firm and fixed and in which the steps are clearly integrated. [citation omitted.]"

Niedermeyer concerned a section 304 sale of most of the taxpayer's stock in a corporation followed three months later by a charitable contribution of the taxpayer's remaining stock. The Service characterized the deemed redemption under section 304 as a dividend and the court agreed, finding the evidence too insubstantial to prove the redemption and contribution were part of a plan. The court disregarded the taxpayers self serving statements during trial regarding intent at the time of the section 304 sale. The court also noted that the plan was not in writing, nor was there any evidence that the taxpayer had communicated its donative intent to anyone. It continued, "By the above discussion, we do not mean to indicate that all such plans need to be in writing, absolutely binding, or communicated to others, but we do think that the above-mentioned factors, all of which are lacking here, tend to show a plan which is fixed and firm."[6]

Bleily & Collishaw, Inc. v. Commissioner, 72 T.C. 751 (1979), was more similar to the instant case in that in Bleily, the taxpayer, a corporation, treated a redemption as essentially equivalent to a dividend, but the Service argued it was part of a plan of complete termination under section 302(b)(3). In Bleily, the taxpayer owned 30 percent of another corporation. The 70 percent shareholder wanted sole control

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[5] Early cases discussing this issue, decided under section 115 of the 1939 Code, include *In re Lukens' Estate*, 246 F.2d 403 (3d Cir. 1957), *rev'd on other grounds*, 246 F.2d 403 (3d Cir. 1957) and Jackson Howell v. Commissioner, 26 T.C. 846 (1956), aff'd sub nom. Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957).

[6] Two additional cases similar to Niedermeyer in posture and result are Leleux v. Commissioner, 54 T.C. 408 (1970) and Benjamin v. Commissioner, 66 T.C. 1084 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979). In each case, the taxpayer claimed a redemption was part of a plan of complete termination, the Service took the position that the redemption was essentially equivalent to a dividend, and the court found for the Service, finding no plan existed.

and the taxpayer agreed to sell its shares to the issuing corporation at an agreed price. The corporation did not have enough cash to purchase all of the shares at once, but purchased all of the taxpayer's shares over a 23 week period. Each sale was supported by a separate written redemption agreement. After reiterating the Niedermeyer standard, the court stated, "Each case is necessarily a factual determination and based upon the record we are convinced that [the issuing corporation] planned to eliminate [the taxpayer] as a shareholder." Although there was no binding agreement, the taxpayer clearly had agreed to sell all of its shares. The entire sale did not take place immediately due to lack of funding. The court found that the issuing corporation planned to purchase stock from the taxpayer as funds became available. Lack of a binding agreement did not prevent the court from finding a integrated plan for complete redemption.

Roebling v. Commissioner, 77 T.C. 30 (1981), was a section 302(b)(1) case in which the litigants framed the issue as whether a series of redemptions were part of a "fixed and firm" plan to reduce meaningfully the taxpayer's interest in the redeeming corporation.[7] As part of a recapitalization, the redeeming corporation, a bank, adopted a plan to redeem a certain amount of series B preferred stock each year until no series B preferred remained outstanding. It established a sinking fund for that purpose. The bank redeemed some preferred stock, in varying amounts, each year for several years. The bank had to have adequate capital and obtain regulatory approval for each redemption.

The court noted that whether there was a firm and fixed plan is a factual determination and found that the series of redemptions was part of a plan to eliminate the series B preferred stock, despite the need for adequate capital and regulatory approval. The court stated, "We do not believe the requirement of a firm and fixed plan for redemptions need be as rigid under the circumstances here involved as would be required in a closely held family corporation situation where the plan could be changed at any time by the actions of one of two shareholders."

Analysis of Issue 1:

Section 304(a)(1) applies to each of sales of the stock of T1 (by S1), T2, and T9 (by S2) to A1, the sales of the stock of T3, T4, T5, T6, and T7 stock (by S2) to A2, and the sale of the stock of T8 (by S2) to A3. The proceeds of each sale are treated as received by S1 or S2 in redemption of the stock of A1, A2, or A3, as appropriate for purposes of §302. Each redemption is tested under §302(b) to determine whether the proceeds will be treated as received in a sale or exchange under §302(a) or as a §301 distribution.

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[7] [redacted]

The Zenz doctrine provides that the effect of other transactions is taken into account in testing whether a redemption is a distribution under § 301 or a sale or exchange under § 302(a) under certain circumstances. The court applies the Zenz doctrine if the redemption and the other disposition of stock are “part of a plan which is firm and fixed and in which the steps are clearly integrated.” Niedermeyer. Under the Niedermeyer test, the sale of S2 to X in year 1, which removed S2 from the P consolidated group thereby ending its constructive ownership of A1, should be integrated with the section 304 redemption by A1 to find a complete termination of S2's interest in A1 under section 302(b)(3). Similarly, the sale of S1 to Y in year 2 should be integrated with the section 304 redemptions by A1, A2, and A3 to find a complete termination of S1's interest in A1, A2, and A3 under section 302(b)(3).

[redacted] [8] [redacted]

The section 304 redemption and the sale of S2 to X were clearly integrated. [redacted]

[redacted]

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8 [redacted]

[redacted]

[redacted][9]

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[9] [redacted]

[10] [redacted]

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If you have any further questions, please call (202) 622-7930.

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