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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant
Chief
Counsel
(Field
Service)

CC:DOM:FS

SUBJECT: Acquisition of C Corporation Stock by S Corporation

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LEGEND

Date 1	=
Date 2	=
C Co.	=
S Co.	=
A	=
B	=
a%	=
b%	=
c%	=
d%	=
e%	=
\$a	=
\$b	=
\$c	=
\$d	=
\$e	=
\$f	=

ISSUES

1. Does section 304 apply to the acquisition of stock of a C corporation by an S corporation owned, in part, by the same shareholders?
2. If section 304 applies to the acquisition, is the redemption created thereunder treated as a sale or exchange under section 302(a)?
3. If the redemption is not treated as a sale or exchange under section 302(a), what is the appropriate treatment of the redemption?

CONCLUSIONS

1. Under the facts presented, section 304 applies, so that the property received in return for the stock is treated as a distribution in redemption of the stock of the acquiring corporation.
2. Under the facts presented, section 302(a) does not apply to the redemption, and thus the redemption will not be given sale or exchange treatment.
3. In general, sections 1368(b) and 1368(c) apply to the distribution; however, there exists an unresolved issue that must be addressed before a determination can be made as to the taxability of the transaction.

FACTS

S Co, an S corporation, was converted from a C corporation to an S corporation on Date 1. A and B are brothers and own, respectively, a% and b% of the outstanding stock of S Co. Various trusts, the beneficiaries of which are the children of A and B, own c% of the outstanding stock of S Co. The remaining d% of the outstanding stock of S Co. is owned by an unrelated party.

Prior to Date 2, A and B, each owned 50 percent of the outstanding stock of C Co., a C corporation. A and B each had an adjusted basis of \$a in their C Co. stock. On Date 2, A and B sold their C Co. stock to S Co., each receiving \$b for their interest in the stock of C Co. C Co. continued its operations as a wholly owned subsidiary of S Co. As of the beginning of the year of the sale, S Co.'s accumulated adjustment account (AAA) balance was approximately \$c and S Co. had accumulated earnings and profits in the amount of \$d. During the year of the sale, S Co. made actual distributions to its shareholders totaling \$e and had ordinary income of \$f.

LAW AND ANALYSIS

Section 1371(a)(1) provides that, except as otherwise provided in Title 26, and except to the extent inconsistent with subchapter S, subchapter C applies to an S corporation and its shareholders.

Issue 1

Section 304(a)(1) of subchapter C provides that if one or more persons are in control of each of two corporations, and if one of the corporations acquires stock in the other from a controlling person, then the money or other property distributed in

exchange for the stock shall be treated as a distribution in redemption of the stock of the acquiring corporation. Section 304(a)(1)(B) further provides that to the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

Section 304(c)(1) defines “control” as the ownership of at least 50 percent in total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. The attribution rules of section 318(a) apply in determining control for purposes of section 304; however, sections 318(a)(2)(C) and 318(a)(3)(C) are applied without regard to the 50 percent limitation. Section 304(c)(3).

Before the transaction, A and B together directly owned one hundred percent of C Co. Before the transaction, A and B directly owned $e\%$ ($a\% + b\%$) of S Co. and constructively owned $c\%$ of S Co. Because A and B owned, actually and constructively, more than 50 percent of the value of the stock of both corporations, and S Co. acquired stock from A and B (controlling shareholders of C Co.), section 304 is applicable and the money distributed by S Co. will be treated as a distribution in redemption of the S Co. stock deemed received in the section 351(a) exchange.

Issue 2

Section 302 is applied to distributions made in redemption of stock to determine whether the distribution will be treated as a sale or exchange, or as a distribution under section 301. Under section 302(a), a redemption is treated as a sale or exchange if the redemption meets one of the four following requirements:

1. The redemption is “not essentially equivalent to a dividend” under section 302(b)(1);
2. The redemption is substantially disproportionate under section 302(b)(2);
3. The redemption completely terminates the shareholder’s interest under section 302(b)(3), or:
4. The redemption is a partial liquidation under section 302(b)(4).

In determining whether the redemption meets one of the four requirements for exchange treatment set forth in section 302(b), the constructive ownership rules of section 318(a) will apply, and, in the case of a section 304(a) transaction, the

requirements in section 302(b) will be applied by reference to the issuing (acquired) corporation's stock. Sections 302(c) and 304(b)(1).

The distribution in the instant case does not satisfy the requirement for exchange treatment under section 302(b)(1) that it be not essentially equivalent to a dividend because there is no "meaningful reduction" in either A's or B's interest in C Co. United States v. Davis, 397 U.S. 301 (1970) (holding that a distribution in redemption of stock must result in a "meaningful reduction" in the shareholder's proportionate interest in the corporation for section 302(b)(1) to apply). Further, the distribution is not substantially disproportionate with respect to A or B for purposes of section 302(b)(2). Neither does the distribution completely terminate either A's or B's interest in C Co. as contemplated in section 302(b)(3) (once the constructive ownership provisions of section 318(a) are considered). Finally, under the facts of this case, the distribution was not made in partial liquidation of S Co. for purposes of section 302(b)(4). Accordingly, the distribution does not satisfy any of the requirements for sale or exchange treatment under section 302(b) and section 302(a) is inapplicable.

Issue 3

If a redemption does not qualify for sale or exchange treatment under section 302(a), section 302(d) provides that it will be treated as a distribution to which section 301 applies. Section 301(a) generally treats a distribution of property in the manner provided in section 301(c). However, under section 1371(a), subchapter C applies to an S corporation and its shareholders except as otherwise provided in Title 26, and except to the extent inconsistent with subchapter S. Section 1368(a) provides that a distribution of property made by an S corporation with respect to its stock to which (but for section 1368(a)) section 301(c) would apply is treated in the manner provided in section 1368(b) or section 1368(c), whichever is applicable.

Section 1368(b) applies to distributions made by an S corporation having no accumulated earnings and profits and section 1368(c) applies to distributions made by an S corporation having accumulated earnings and profits. In the instant case, S Co. has accumulated earnings and profits, and thus, section 1368(c) applies to the distribution.

Under section 1368(c)(1) and the reference therein to section 1368(b), the portion of the distribution that does not exceed the accumulated adjustments account is not included in gross income to the extent that it does not exceed the adjusted basis of the stock and is treated as gain from the sale or exchange of property to the extent it exceeds such adjusted basis. The facts presented indicate that for the year of the sale, S Co. has a balance in its accumulated adjustments account that exceeds the amount of the total distributions to A and B.

At this time, we are unable to fully respond to the question of whether the instant transaction will result in the inclusion of any amount of the distribution in the gross income of A or B because a final issue remains concerning the proper application of section 1368(b)(2) in a transaction to which section 304(a) applies. After further consideration of this issue, appropriate guidance will be forthcoming.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We note that the examining agent has recently determined that the adjusted basis in A and B's C Co. stock at the time of the sale does not exceed the amount of the distribution. A question exists as to whether it is only the C Co. stock basis that serves as A and B's basis in the S Co. shares redeemed under section 304. Depending on the answer to the first question, a second question may exist as to whether section 1368(c)(1) provides a different result from section 304. The resolution of these questions depends, first, on the interpretation of a 1997 amendment to section 304 and, second, in regard to a section 304 transaction involving one or more S corporations, as we have in the instant case, whether the interpretation of the amendment has the effect of changing the treatment of basis for purposes of subchapter S.

When Congress amended section 304(a) in 1997, it did not address the question of the transferor's stock basis in the acquiring corporation. Furthermore, no regulations have been promulgated or proposed and no other Chief Counsel guidance has been issued to address the basis issue. Accordingly, at this time, the Service position on this matter is not clear. Because these questions are ones of first impression, it is appropriate that our office consider these issues more carefully. Accordingly, we will obtain the views of the divisions within the National Office that have jurisdiction over these provisions and be prepared to issue more elaborate guidance on this matter at our earliest convenience.

Please call if you have any further questions and we shall shortly contact your office with respect to the questions not resolved in this memorandum.

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