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Is It or Isn't It a Dividend?

By Richard C. Morris • Wood & Porter • San Francisco

Redemptions are commonplace, and they occur in a variety of scenarios. For example, minority partners are often redeemed out of joint ventures. Buy-sell agreements typically contain mandatory redemption clauses. Likewise, corporations often redeem the shares held by key executives who are no longer needed by a post-merger entity.

Recently, the IRS issued Field Attorney Advice ("FAA") 20064401F [June 7, 2006] in which a corporation made a tender offer to redeem its own shares. Unlike the typical tender offer where one corporation is attempting to purchase the shares of another corporation, this tender offer was more akin to a shareholder buy-back. The IRS was forced to confront the age-old question surrounding virtually every redemption: Should a shareholder characterize the proceeds as a dividend, or is it something else?

More specifically, the FAA discusses whether the redemption should be treated as an exchange of stock (and taxed under Code Sec. 1001) or treated as a distribution from the corporation (and taxed under Code Sec. 301). The taxpayer argued the redemption was an exchange, since it was "not essentially equivalent to a dividend."

Field Attorney Advice

Before discussing FAA 20064401F, I should explain this new type of advice. Despite its short-form moniker, an FAA has nothing to do with air travel. The FAA form of IRS guidance is relatively new, and it is likely that many M&A Tax Report readers have never heard of an FAA. An FAA is issued by IRS Chief Counsel field attorneys. That stands in contrast to most other Chief Counsel advice which is issued by attorneys from the IRS' Washington, D.C. headquarters. An FAA is written by a Chief Counsel field attorney, but is then reviewed by an associate office, and eventually issued to IRS field or service center campus employees.

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FAAs are not released each week with other Chief Counsel advice, such as letter rulings. Instead, the IRS only posts FAAs on their Web site at *www.irs.gov/foia/article/0,,id=103755,00.html.* However, FAAs are typically made available by the tax reporting services. According to the IRS Web site, an FAA, like a letter ruling, cannot be cited or used as precedent.

The Tender Offer

Returning to the redemption, FAA 20064401F concerns XYZ corporation which has two classes of stock: common stock and Class A common stock. The principal difference between the two classes is that each share of common stock is entitled to one vote, while each share of the Class A common stock is entitled to 10 votes. Both classes are entitled to receive dividends and liquidating distributions, and can exercise other rights on a *pro rata* basis.

XYZ made a tender offer to purchase a certain amount of its shares of its common stock and Class A common stock. XYZ's common stock is publicly traded on the New York Stock Exchange; its Class A common stock is not publicly traded. At the time of the tender offer, our taxpayer—a marital trust created upon the death of Ralph Redeemer—held shares of common stock and Class A common stock. Ralph's widow and children also held shares of common stock as well as Class A common stock.

Many of XYZ's management (including directors and executive officers) held shares of common stock and Class A common stock. The tender offer indicated that XYZ's directors and executive officers would not tender any of their stock for redemption. Carl Chairman, the chairman of XYZ's board of directors as well as Ralph's executor, held shares of the Class A common stock and exercised voting control over another block of Class A common stock. Thus, by virtue of his personal holdings and his position as Ralph's executor, Carl Chairman controlled XYZ corporation both before and immediately after the redemption. As we'll see below, that is an important fact.

Under Ralph's will, XYZ's stock held by Ralph passed to a residuary marital trust (the "Trust"). Under the terms of the marital trust, Ralph's widow was entitled to the trust income during her lifetime. Upon her death, the corpus of the Trust will be distributed to her children and grandchildren. There are three trustees of the Trust: Ralph's widow, Carl Chairman and Y. (All the FAA reveals about Y is that he is not one of the Ralph's children.) Under the Trust, any two co-trustees can make decisions for it.

Ralph Redeemer's marital trust tendered shares of both common stock and Class A common stock for redemption. However, the tender offer for the common stock was oversubscribed. Pursuant to the terms of the tender offer, the redemption was prorated amongst those shareholders who tendered shares.

XYZ accepted for redemption all of the Class A common stock tendered by the Trust, but only a portion of its common stock. Evidently, only one other shareholder tendered shares of Class A common stock. Overall, less than 20 percent of XYZ's shareholders participated in the tender offer. Notably, all of the redeemed stock was cancelled.

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After the redemption, the Trust filed its income tax return reporting the redemption proceeds as a dividend. XYZ's earnings and profits ("E&P") exceeded the total amount distributed to the shareholders for their redeemed stock. The dividend reporting resulted in taxable income to the Trust, and created a tax liability, which the Trust paid.

After filing its original return, the Trust requested a private letter ruling as to whether the redemption should be considered "a distribution in part of [sic] full payment in exchange for the stock" pursuant to Code Sec. 302. Specifically, the Trust asserted that Code Sec. 302 applied to provide exchange treatment because the distribution was not essentially equivalent to a dividend. However, the request for a ruling was rejected because the Trust's tax year was under examination.

Not giving up easily, the Trust then filed an amended return, treating the amounts distributed in redemption as proceeds from the sale or exchange of stock. This reduced the dividends reported on the Trust's original return, resulting in an overpayment of tax.

Is It a Dividend?

The dividend versus redemption dichotomy is peripatetic. M&A TAX REPORT readers know that Code Sec. 302 controls the tax treatment of redemptions. Indeed, if at least one of the four tests of Code Sec. 302(b) applies in a corporate redemption, then the redemption is treated as a distribution in payment in exchange for the stock. Code Sec. 302 redemptions are subject to the provisions of Code Sec. 1001.

If a redemption does not satisfy the requirements of Code Sec. 302, it is treated as a distribution subject to the provisions of Code Sec. 301. Under Code Sec. 301, distributions made from E&P are considered dividends, which are treated as ordinary income. Of course, distributions in excess of E&P are treated as return of capital to the extent of basis, and then as capital gain.

Characterization, of course, is key. A redemption occurs when a "corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." Code Sec. 317(b). Hence, the IRS noted that there was no question that the tender offer qualified as a redemption. There was also no question that the distribution was made from E&P.

Nevertheless, there was a question whether any of the four tests set forth in Code Sec. 302(b) were satisfied. If so, the redemption would be treated as an exchange. If not, the redemption would be treated as a dividend.

The Trust contended that the redemption satisfied the test in Code Sec. 302(b)(1), which accords exchange treatment to any redemption that is "not essentially equivalent to a dividend." This language is one of the classic tautologies of subchapter C. The Code does not specifically state what the language "not essentially equivalent to a dividend" means. The regulations simply indicate that the resolution of that issue depends upon the facts and circumstances of each case. [Reg. §1.302-2(b).]

When considering the facts and circumstances of a particular case, the courts and the IRS generally focus on the effect the redemption has on the following shareholder rights: (1) the right to vote and thereby the ability to exercise some degree of control; (2) the right to receive dividends; and (3) the right to receive liquidating distributions. [*See I. Himmel,* CA-2, 64-2 USTC ¶9877, 338 F2d 815 (1964); Rev. Rul. 85-106, 1985-2 CB 116; Rev. Rul. 81-289, 1981-2 CB 82.] In cases involving voting stock, the effect of the redemption on the taxpayer's control of the corporation is considered the most significant factor. [Rev. Rul. 85-106. *See also Johnson Trust*, 71 TC 941, 947–48, Dec. 35,903 (1979), *acq.*, 1984-2 CB 1.] For purposes of determining the degree of control exercised by the taxpayer, the attribution rules set forth in Code Sec. 318 apply. [*M.P. Davis*, SCt, 70-1 USTC ¶9289, 397 US 301, 313 (1970).]

Meaningful Reductions?

The Supreme Court has held that for Code Sec. 302(b)(1) to apply, "a redemption must result in a *meaningful reduction* of the shareholder's proportionate interest in the corporation." [*Davis, supra,* 397 US, at 313 (emphasis added).] In *Davis,* there was no meaningful reduction of a trust's interest in a corporation because, after applying the Code Sec. 318 attribution rules, the trust was considered the corporation's sole shareholder both before and after the redemption.

When applying the *Davis* standard in cases where the taxpayer controls the corporation but is not its sole shareholder, the test is whether the redemption causes any meaningful change in the control exercised by the taxpayer before the redemption. For example, in Rev. Rul. 78-401, 1978-2 CB 127, the reduction of ownership interest from 90 percent to 60 percent was not "meaningful" because the taxpayer still controlled the corporation after the redemption. In Rev. Rul. 77- 218, 1977-1 CB 81, the IRS reached the same conclusion where the ownership interest was reduced from 60 percent to 55 percent.

Similarly, in cases involving minority shareholders, the focus is on whether the redemption causes any meaningful change in the taxpayer's ability to control the corporation by acting in concert with one or more of the other shareholders—the so-called control group. For example, in *Johnson Trust, supra,* 71 TC, at 947–48, a 2.8-percent reduction was not "meaningful," and in *W.H. Bloch,* DC-TX, 67-1 USTC ¶9126, 261 FSupp 597 (1966), *aff'd,* CA-5, 68-1 USTC ¶9120, 386 F2d 839 (1967), a one-third reduction was not "meaningful." [*See also* Rev. Rul. 85-106, *supra;* LTR 9147035 (Aug. 26, 1991).]

While clearly the redemption in this case reduced the Trust's economic interest in XYZ corporation and the number of votes it held, the IRS did not believe there was a meaningful reduction or change in the Trust's ability to control corporate decisions. Since there was no majority shareholder either before or after the redemption, at least two shareholders would have to act in concert to control the corporation.

Indeed, before the redemption, only a few shareholders held any significant voting power, including the Trust, Carl Chairman, Y and Z. No other shareholder had sufficient holdings to gain control of XYZ by acting in concert with only one other shareholder either before or after the redemption. Theoretically, the Trust could have combined with any of these shareholders to control the XYZ corporation.

However, after the redemption, the Trust could only control XYZ corporation by acting in concert with Carl Chairman. Thus, the IRS found that the change in the potential "control groups" was not meaningful. Since Carl Chairman is Ralph's executor, the only meaningful relationship for control purposes is between Carl and the Trust.

Both before and after the redemption, Carl controlled XYZ through his personal holdings and by exercising his power as Ralph's executor and as trustee of the Trust. Therefore, applying the *Johnson Trust/Bloch* rationale, the IRS found that there was no "meaningful reduction" in the Taxpayer's interest in XYZ. No meaningful reduction, of course, means the distribution could not qualify as a redemption, at least not based on this particular test.

The Trust had incorrectly contended that the facts considered in Rev. Rul. 75-512, 1975-2 CB 112—a 5.8-percent reduction in the taxpayer's interest—and Rev. Rul. 76-364, 1976-2 CB 91—4.5-percent reduction in the taxpayer's interest—were indistinguishable from those in this case. In those cases, the IRS ruled that the redemption of stock held by a minority shareholder was not essentially equivalent to a dividend.

However, in Rev. Rul. 75-512, another shareholder controlled the corporation both before and after the redemption. Therefore, the *Johnson Trust/Bloch* control group rationale did not apply. Similarly, in Rev. Rul. 76-364, the IRS' ruling was based, in part, on a finding that the redemption caused the taxpayer to go from a position of holding a block of the corporation's stock that afforded the taxpayer control if he acted in concert with only one other shareholder, to a position where such action was not possible. Clearly, the facts in both of these revenue rulings are distinguishable.

Conclusions

Ultimately, the FAA recommended the IRS field office to take the position that the redemption did not meet the "not essentially equivalent to a dividend" requirement found in Code Sec. 302(b)(1). In other words, the IRS believed the redemption should be characterized as a dividend, and not an exchange. Consequently, the FAA recommended that the field office deny the Trust's claim for refund.

Of course, rulings are only rulings. Outside the scope of the FAA, the Trust probably still has the right to challenge the refund denial, so all may not be lost yet. Of course, a negative FAA can hardly be good news when there is also an exam underway.

Redemptions have long been an area fraught with difficulties. Taxpayers and the IRS both must ascertain the factual details and make close judgment calls. Given Code Sec. 302(b)(1)'s amorphous nature, taxpayers should be careful when relying on the "not essentially equivalent to a dividend test" as a first line of defense. No matter whether it's on an original return, an amended return, or in a letter ruling, the IRS may challenge taxpayers in any and all mediums.