Proposed Redemption Regulations Withdrawn

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Disappearing basis in redemptions is one of the more peculiar aspects of subchapter C. A redemption is the purchase of corporate stock by the issuing corporation. As most M&A TAX REPORT readers know, the income tax consequences of a redemption are governed by either the redemption rules of Code Sec. 302, or the general distribution rules of Code Sec. 301. The rules for both sections are generally mechanical, and their application traditionally has been straightforward. Yet, the finer points of the redemption rules do include shading. In fact, sometimes determining the tax consequences of a redemption can be complicated.

Generally speaking, a shareholder treats the amounts received in a redemption as a distribution under Code Sec. 301. Of course, a Code Sec. 301 distribution is characterized as a dividend to the extent of the redeeming corporation's earnings and profits ("E&P"). Although the determination of a corporation's E&P should be simple, it is not uncommon for it to be messy and complicated, especially if the corporation has previously taken part in a reorganization. E&P is sometimes referred to as the "retained earnings" listed on the company's financial statements. In fact, though, there can be significant variations between retained earnings and E&P. The reason E&P is critical, of course, is that amounts distributed in excess of E&P are treated as return of capital to the extent of a shareholder's basis in his stock. Any amounts distributed in excess of a shareholder's basis is treated as capital gain.

Although Code Sec. 301 is the general rule, Code Sec. 302 can override it. Code Sec. 302 will apply if a redemption qualifies under one of four tests described in Code Sec. 302:

1. Redemptions not essentially equivalent to a dividend
2. Substantially disproportionate redemptions
3. Complete terminations of a shareholder's interest
4. Partial liquidations

Individual shareholders usually want Code Sec. 302 treatment, since they hope for the capital gain rate. Corporate shareholders often want Code Sec. 301 treatment, since they receive a dividends received deduction.

Disappearing Basis

When a corporation redeems a shareholder's stock, the shareholder exchanges his stock for cash (or other property). If it is treated as a distribution, the problem of disappearing basis can surface. However, this problem only occurs when the distribution is treated as a dividend, and not when it is treated as a return of basis or as capital gain.

Yet, the issue doesn't arise for all redemptions treated as a dividend. If only a portion of a shareholder's total shares are redeemed, there is no problem with basis disappearing. However, if all of a shareholder's stock is redeemed, the shareholder's basis could disappear. In this situation, the shareholder no longer owns any shares in the corporation. Without a special rule to re-allocate or use the basis associated with the redeemed shares, the basis would just disappear. Thus, the shareholder could be subject to tax on the total payment, not taking into account the amount the shareholder paid for the stock.

For over 50 years, the regulations have provided only limited guidance how to re-allocate basis when all of a shareholder's shares are redeemed and the shareholder completely terminates his interest. The regulations only contain one sentence and three brief examples. [*See* Reg. §1.302-2(c).] The regulations merely provide that when a redemption is treated as a dividend, "proper adjustment" of the basis of the remaining stock should be made with respect to the stock redeemed.

Proper Adjustment

Practitioners have long debated what is a "proper adjustment." In some cases there is not much to debate. Thus, when a redeemed shareholder continues to own shares in a corporation, the basis of the redeemed shares simply gets added to the retained shares. Yet, given the brevity of the regulations, practitioners often have been forced to extrapolate solutions when the redeemed shareholder does not continue to own any corporate stock.

The three examples in the regulations only provide limited assistance. Two of the three examples describe simple cases where the redeemed shareholder continues to own other shares of the corporation after the redemption. In these two examples, the basis of the redeemed shares merely gets added to the basis of the shares not redeemed. The remaining example is relevant only when the shareholder constructively owns additional shares after the redemption.

In the example, a husband ("H") and wife ("W") each own half of the stock of a corporation. H purchased all of the stock for $100,000 and later gave half to W when the value of the transferred stock was greater than $50,000. Here, though, *all* of H's shares are redeemed, and the redemption is treated as a dividend. The example concludes that the basis of H's redeemed shares get added to the basis of W's shares.

Proposed Regulations

The IRS has issued various notices, rulings and other pronouncements over the past few years. In particular, it issued Notice 2001-45, IRB 2001-33, 1, stating that it would disallow tax benefits derived from basis shifting tax shelters. On October 18, 2002, the IRS proposed regulations concerning the basis shifting aspects of redemptions which are treated as dividends. The proposed regulations provided for the elimination of Reg. §1.302-2(c) and its three examples when there is a complete termination of a shareholder's interest.

Under the proposed regulations, basis no longer would shift to other shares directly owned by the redeemed shareholder or to any other shares constructively owned. Instead, when there was a complete termination, the basis would remain with the redeemed shareholder as a floating loss that could be taken into account when the redeemed shareholder had sufficiently reduced its actual and constructive ownership interest in the redeeming corporation.

The date when the loss would be triggered and could be claimed under the proposed regulations was called the final inclusion date. If the redeemed shareholder was a foreign corporation, the final inclusion date included the date the corporation transferred its assets to a domestic corporation in either a liquidation described in Code Sec. 332 or a reorganization described in Code Sec. 368 to which Code Sec. 381 applied.

The proposed rules were also going to apply to a Code Sec. 304 redemption which is treated as a dividend. For example, if a 100-percent shareholder of two corporations sold one corporation to the other, the sale would probably be treated as a dividend under Code Sec. 304. Under the former proposed regulations, the basis in the shares that were sold would not attach to any remaining shares, but rather would subject to the floating loss rules.

Withdrawn Regulations

On April 19, 2006, the IRS withdrew its proposed regulations. Yet, the IRS will continue to study the issue and has asked practitioners for comments. The IRS has wondered whether a difference should be drawn between a redemption in which a redeemed shareholder continues to have direct ownership of stock in the redeemed corporation (whether the same class of stock as that redeemed or a different class) and a redemption in which the redeemed shareholder only constructively owns stock in the redeemed corporation. It also wants comments in the following two areas: whether a different approach is warranted for corporations filing consolidated income tax returns, and whether a different approach is warranted for a Code Sec. 304 transaction.

Finally, the IRS is studying other basis issues that arise in redemptions that are treated as Code Sec. 301 distributions. The IRS is reviewing whether the basis reduction rules under Code Sec. 301 should be limited to the basis of the actual shares redeemed, or whether it is appropriate to reduce the basis of both the retained shares and the redeemed shares before applying the capital gain treatment. Currently, the IRS believes that the better view is that only the basis of the shares redeemed should be recoverable.

Another approach would be to allocate the basis reduction portion of the distribution *pro rata* among the redeemed shares and the retained shares. A third approach would be to shift the basis of the shares redeemed to the remaining shares, and then reduce the basis of those shares.

Conclusion

Based on the complexity of these outstanding questions (and other questions which are surely to arise), it may be some time before disappearing basis problems disappear. Yet, basis shifting will probably receive strict scrutiny. The IRS may take a default position that any disappearing basis which provides consequential tax benefits is too aggressive, and not a "proper adjustment." Until we receive more guidance, practitioners should be wary of this invisible line (wherever it may lie).