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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ROBERT D. HEITMEYER
ASSOCIATE AREA COUNSEL
SMALL BUSINESS/SELF-EMPLOYED, AREA 4
CC:SB:4:DET

FROM: Jasper L. Cummings
Associate Chief Counsel (Corporate)
CC:CORP

SUBJECT: Section 302(c)(2)

This Chief Counsel Advice responds to your memorandum dated July 17, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =
B =
S =
Corp =
Date z =
m =
State X =
Statute Y =
Statute Z =

ISSUES

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1. Whether a redeemed shareholder's enjoyment of certain fringe benefits relating to his spouse's post-redemption employment with the redeeming corporation is a "prohibited interest" in the corporation under I.R.C. § 302(c)(2)(A) that disqualifies him from a waiver of family attribution.
2. Whether an installment note held by the redeemed shareholder that accelerates the installment loan if the redeeming corporation breaches an employment contract with his spouse or a lease between the redeemed shareholder and the corporation is a prohibited interest under I. R.C. § 302(c)(2)(A).
3. Whether a pledge of the redeemed stock held by the redeemed shareholder is a prohibited interest under I. R.C. § 302(c)(2)(A).
4. What if the redeemed shareholder in fact continues to control the operations of the corporation?

FACTS¹

A, an individual, was the sole shareholder of Corp from its incorporation until Date z. On that date, Corp redeemed 90 percent of A's stock with a note having a face amount of m dollars, to be paid in installments over a 15-year period, secured by a pledge of the redeemed stock (as described below). A resigned as a director, officer, and employee of Corp as of Date z. Also on that date, A sold 51 percent of the remaining stock of Corp to A's son, S, and the other 49 percent to two unrelated individuals who were employees of Corp, for 15-year installment notes with provisions (including a pledge) similar to the note used in the redemption.

Also on Date z, Corp entered into a new lease of Corp's business premises from A, and Corp entered into a new employment agreement with A's spouse, B. It is assumed that the lease provides for arm's-length lease payments. It is not clear whether the employment contract provides excessive compensation in relation to the services provided. Corp had leased the same property from A and employed B before the redemption.

¹This memorandum assumes that the parties have acted in accordance with their agreements, and (except as otherwise stated herein) nothing more. If it were learned, for instance, that A is actually providing consulting services to Corp, then A would have a prohibited interest. See Rev. Rul. 56-556, 1956-2 C.B. 177 (implying that rendering of services to corporation, with or without compensation, is a prohibited interest); but see Lynch v. Commissioner, 83 T.C. 597 (1984), rev'd, 801 F.2d 1176 (9th Cir., 1986). If it were learned that A did not in fact sell his stock to Corp and to the unrelated individuals, section 302(b)(3) would not apply.

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A had spousal benefits in B's health insurance plan provided by Corp. Corp also prepared the joint federal income tax return filed by A and B. Corp also provided a pickup truck for the use of B, but the truck was primarily used by A.

In addition, under the Stock Pledge Agreement entered into on Date z, the redeemed Corp stock was pledged to A as security for his installment note. The Stock Pledge Agreement assigns the dividend and voting rights on the pledged stock to the pledgor (not A) as long as there is no default on the note. The Stock Pledge Agreement provides that, if there is a default on the note, A may, subject to Statute Y, elect to foreclose on the pledged stock by causing it to be sold at public or private sale at a price that A may determine. A may purchase all or part of the pledged shares at the sale. We understand that, under Statute Y, A may not obtain more than the unpaid balance on the note plus reasonable related expenses, and that any surplus over that amount must be accounted for to the debtor. See Statute Z. It also appears that, under Statute Y, a debtor is responsible for any deficiency that remains after the sale of collateral. See Statute Z.

The installment notes provide that if Corp breaches either the employment agreement or the lease, the remaining principal on the note will become immediately due and payable. If Corp does not pay the full amount due, that may trigger the default provisions of the Stock Pledge Agreement.

Notwithstanding the agreements between A, Corp and the unrelated individuals, there is some question regarding whether the stock was actually registered in the names of the new shareholders, as we believe was contemplated by the agreements and hence a question of whether a sale actually occurred, or, on the other hand, whether the parties' rights vis-a-vis the stock are simply determined by the agreements and common law. Moreover, we understand that at least one business decision of Corp (whether to exercise an option to buy Corp's business premises from A) was influenced by the wishes of A.

LAW AND ANALYSIS

General

Section 302(a) provides that if a corporation redeems its stock, and if § 302(b)(1), (2), (3), or (4) applies, the redemption will be treated as a distribution in part or full payment in exchange for the stock. However, § 302(d) provides that a redemption to which § 302(a) does not apply is treated as a distribution to which § 301 applies.

Section 302(b)(3) applies if the redemption is in complete termination of all the stock of the corporation owned by the shareholder. In determining whether there is such a complete termination of interest, § 302(c)(1) generally provides that the attribution rules of § 318 apply. Under § 318(a)(1)(A)(ii), stock owned by a

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shareholder's child is considered owned by the shareholder. However, section 302(c)(2)(A)(i) provides that the family attribution rules of § 318(a)(1) will not apply if, in relevant part, immediately after the distribution, the distributee has no interest in the corporation (including an interest as officer, director, or employee) other than an interest as a creditor.

The legislative history to section 302(c)(2) states without equivocation that 302(c)(2) is intended to clarify the application of section 302(b)(3) when family attribution applies "so that the administration of the problem presently uncertain under [the 1939 Code redemption provision] may be definitive". H. Rep. No. 1887, 83rd Cong., 2d Sess. A75-A76 (1954).

The Service's interpretation of section 302(c)(2)(A)(i) generally asks whether the distributee is a creditor. The Tax Court's approach, on the other hand, generally asks whether the distributee has a "financial stake in the corporation or continued to control the corporation after the redemption of his stock." See Lynch v. Commissioner, 83 T.C. 597, 606 (1984), rev'd by 801 F.2d 1176 (9th Cir., 1986).

Treas. Reg. § 1.302-4(d) provides that a person will be considered to be a creditor for purposes of § 302(c)(2)(A)(i) "only if the rights of such person with respect to the corporation are not greater or broader in scope than are necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors." For example, claims that may be repaid only out of or by reference to earnings do not constitute a creditor interest.

Treas. Reg. § 1.302-4(e) provides that, as to the distributee in a § 302(b)(3) redemption who is a creditor after the transaction, the acquisition of the assets of the corporation in the enforcement of the creditor's rights is not a prohibited interest in the corporation for purposes of § 302(c)(2) unless stock of the corporation or certain related corporations is acquired.

Rev. Rul. 84-135, 1984-2 C.B. 80, holds that a redeemed shareholder's right to receive payments under an unfunded pension agreement after the redemption relating to his pre-redemption employment with the corporation is not a prohibited interest under § 302(c)(2)(A)(i) because the payments were not dependent on the corporation's earnings and the ex-shareholder's pension claim is not subordinate to general creditors.

Rev. Rul. 77-467, 1977-2 C.B. 92 holds that a redeemed shareholder's continuing lease of real estate to the corporation that redeemed his stock is a creditor interest and therefore not a prohibited interest as to the redeemed shareholder.

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Rev. Rul. 71-562, 1971-2 C.B. 173 holds that the acquisition of a stock interest in the corporation by the son of a redeemed shareholder is not a prohibited interest as to the redeemed shareholder. That revenue ruling suggests that a section 318(a)(1) relative may acquire what would be a prohibited interest in the hands of the redeemed shareholder without causing such shareholder to have a prohibited interest.

Issue (1): Fringe benefits of a spouse enjoyed by redeemed shareholder

We have found no authorities addressing whether a redeemed shareholder's participation in a spouse's fringe benefits are prohibited interests. A taxpayer might be able to argue that if Revenue Ruling 84-135 were broad enough to permit spousal employment, a reasonable amount of spousal fringe benefits might not be economically different, depending on the circumstances.

In Lynch v. Commissioner, 83 T.C. 597 (1984), rev'd by 801 F.2d 1176 (9th Cir., 1986), a redeemed shareholder had a post-redemption consulting agreement with the redeeming corporation. That former shareholder also was covered by the corporation's medical plan and had the use of a pickup truck provided by the corporation. The Tax Court held that the redeemed shareholder's consultancy, even when combined with the fringe benefits (and a stock pledge), was not a prohibited interest because it was not a significant interest in the success of the business and because such shareholder did not exercise control over the corporation. The Ninth Circuit reversed the Tax Court on the ground that performing services, either as an employee or an independent contractor, is a prohibited interest, but did not rule on whether the fringe benefits by themselves were prohibited interests.

We conclude that the fringe benefits enjoyed by A in this case are comparable to those enjoyed by the redeemed shareholder in Lynch. Since it is not known whether A performed services for Corp after the redemption, one of the grounds for reversal by the Ninth Circuit in Lynch does not apply to our case.²

Issue 2: Acceleration Provisions of Installment Note

We have not found authority on the specific question of whether a redeemed shareholder's "rights ... are greater or broader in scope than necessary for the enforcement of his claim" under § 1.302-4(d). In this case, the conditions in the installment note, which impose a default if Corp breaches the spouse's employment agreement or the lease agreement, are not necessary to protect A's claim. These

²The Ninth Circuit decision also was based on the broader rationale that the Tax Court's approach was "inconsistent with Congress' desire to bring a measure of certainty to the tax consequences of a corporate redemption." 801 F.2d 1176, 1179.

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conditions also give X some continuing influence and a continuing financial stake in the corporation. This argument might be even more compelling if the employment contract were not for fair market value.

It appears that, under the “greater or broader in scope” rule, A’s interest does not constitute a creditor interest for purposes of section 302(c)(2) and is therefore a prohibited interest. Note, however, that even where a distributee has run afoul of one of the rules of Treas. Reg. section 1.302-4(d), the Tax Court has ruled that the distributee was nevertheless a creditor. In Estate of Lennard v. Commissioner 61 T.C. 554, 563 (1974), the court noted that even though the distributee failed the non-subordination rule, satisfaction of the non-proprietary requirement (and the other indicia of creditor status) rendered the distributee a creditor under section 302(c)(2).

Issue 3: Pledge of redeemed stock to redeemed shareholder

We have not found a case in which the redeemed stock was pledged by the corporation to the redeemed shareholder. However, in Lynch, where the stock of the redeemed shareholder’s son was pledged to the redeemed shareholder to secure the corporation’s installment note to the redeemed shareholder, the Tax Court held that the pledge was a security interest that is common in sales agreements and was not inconsistent with an interest as a creditor. (As noted above, the case was reversed because of post-redemption services provided by the redeemed shareholder).³ The Second Circuit also has noted, in dicta, that a pledge would constitute a prohibited interest. See Dunn v. Commissioner, 615 F.2d 578, 582 (2d Cir. 1980) .

In this case, the pledge agreement does not directly return the stock to A, but allows him to sell the stock at public or private sale and to buy all or part of the stock at that sale. More importantly, as we understand the controlling state law, A

³Although we have not found cases involving situations when the redeemed shareholder held the stock as pledgee, two cases on analogous tax issues hold that a pledgee is not the owner of the stock for tax purposes. See Rev. Rul. 56-153, 19, 1956-1 C.B. 166; Hoffman v. Commissioner, 47 T.C. 218 (1966). Other cases have upheld “exchange” treatment when the redeemed stock was held under an escrow agreement. Estate of Mathis v. Commissioner, 47 T.C. 248 (1966), acq., 1967-1 C.B. 1. Regarding Mathis, note that the Service will not issue advance rulings on whether § 302(b) applies to a redemption when the consideration given in redemption by a corporation consists of its notes payable, and the shareholder’s stock is held as security with the possibility that the stock may be returned to the shareholder upon the happening of specific defaults by the corporation. Section 3.01(22) of Rev. Proc. 2001-3, 2001-1 I.R.B. 111, 113.

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may not obtain, under this pledge, more than the unpaid balance on the note plus reasonable expenses related to the sale. Any surplus over that amount must be accounted for to the debtor. See Statute Z.

If, contrary to our understanding, the pledge allows A to recover more than the unpaid balance on the note (or that the note was not likely to be paid), the IRS could argue more forcefully that the pledge gave A more than a creditor interest under Treas. Reg. § 1.302-4(d) and that A has a “proprietary interest” under such regulation.

Issue 4: Continuing influence by redeemed shareholder

There is some indication that the wishes of the redeemed shareholder are being honored as far as the decision-making of the corporation. If the redeemed shareholder was exercising continuing control over the corporation, then such interest would constitute a prohibited non-creditor interest under 302(c)(2)(A). See Rev. Rul. 56-556, 1956-2 C.B. 177; Lynch, 83 T.C. 597, 608 (dicta), rev'd on other grounds, 801 F.2d 1176 (9th Cir., 1986); Chertkof v. Commissioner, 72 T.C. 1113.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

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