



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

DISTRICT COUNSEL

ATT:

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

SUBJECT: Redemptions and Related Corporations

This Field Service Advice responds to your memorandum dated December 7, 1999. 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.

LEGEND

Corp1	=	
Corp2	=	
Date1	=	
Date2	=	
Year1	=	
Year2	=	
Month1	=	
\$a	=	
\$b	=	
\$c	=	

Business X	=	
Date3	=	
Date4	=	
\$d	=	

### ISSUES

1. Whether the taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by the taxpayer, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1), constitutes a dividend under I.R.C. § 301 pursuant to I.R.C. § 304(a).
2. Whether the exception provided by I.R.C. § 304(b)(3)(B) applies to the taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by him, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1).

### CONCLUSIONS

1. The taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by the taxpayer, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1), constitutes a dividend under I.R.C. § 301 pursuant to I.R.C. § 304(a).
2. The exception provided by I.R.C. § 304(b)(3)(B) does not apply to the taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by him, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1).

### FACTS

The taxpayer incorporated Corp1 on Date1. The taxpayer has always owned 100 percent of the stock of Corp1. Corp1 engaged in Business X and computed taxes under the Subchapter C rules.

On Date2, the taxpayer incorporated Corp2. At all relevant times, the taxpayer owned all the outstanding Corp2 stock. Corp2 is a Subchapter C Corporation.

Beginning in Year1, and continuing through Month1 of Year2, through a series of at least twelve transactions, the taxpayer borrowed funds from Corp1 in amounts that totaled \$a. At least some of those loans were documented by notes issued by the taxpayer to Corp1.

The taxpayer loaned funds to Corp2 between Year1 and Year2. However, it is not known whether the money loaned to Corp2 actually came from the Corp1 borrowings. On Date3, the taxpayer and Corp2 agreed to convert two promissory notes payable by Corp2 to the taxpayer that totaled \$b into one promissory note in the amount of \$c and \$d of paid in capital. On Date4, the taxpayer transferred all 100 of his shares of Corp2 to Corp1 in exchange for Corp1's forgiving the taxpayer's \$a debt. As a result, the taxpayer still owned 100 percent of Corp1, and Corp1 now owns 100 percent of Corp2.

## LAW AND ANALYSIS

### LAW

A stock redemption is defined by I.R.C. § 317(b) as a situation where a corporation acquires its stock from a shareholder in exchange for property.

I.R.C. § 302 provides the taxability rules for these stock redemptions.

Under I.R.C. 304(a)(1), when the same shareholder controls two corporations, and that shareholder contributes stock of one of the controlled corporations to the other controlled corporation in exchange for property, then the property received by the shareholder shall be treated as received in a stock redemption. Therefore, I.R.C. §302 will apply to provide the taxability rule for the stock redemption. Thus, the shareholder's interest in the issuing corporation will be tested under I.R.C. § 302 to determine whether the redemption will be treated as an exchange or a dividend.

There are two ways in which I.R.C. § 302 treats stock redemptions. One is under I.R.C. § 302(a) and the other is under I.R.C. § 302(d).

When I.R.C. § 302(a) applies, the redemption is essentially treated as a sale of stock. When I.R.C. § 302(a) does not apply, then according to I.R.C. 302(d), the redemption is treated as a distribution of property to which the dividend rules of I.R.C. 301 apply.

I.R.C. 302(a) applies if either (1) the redemption is not essentially equivalent to a dividend; (2) the distribution is substantially disproportionate with respect to the shareholder; (3) the redemption is a termination of the shareholder's interest; or (4) the distribution is in partial liquidation of its non-corporate shareholder. I.R.C. §302(b). The attribution rules under I.R.C. § 318 apply in determining if the

redemption will be taxed as a exchange under I.R.C. § 302(a) or a dividend under I.R.C. 302(d).

There is an exception whereby I.R.C. § 304(a) does not apply. Under I.R.C. §304(b)(3)(B), I.R.C. § 304(a) does not apply if: (1) the acquiring corporation acquired the transferred stock in an I.R.C. § 351 transaction; (2) the acquiring corporation assumed a liability; (3) the shareholder incurred the liability in order to acquire the transferred stock; and (4) the stock was not acquired by the shareholder from a person whose stock was attributable to the shareholder under the I.R.C. § 318(a) attribution rules.

## ANALYSIS

### Issue1-Whether transfer qualifies under I.R.C. § 304(a)

The issue here is whether the taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by the taxpayer, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1), constitutes a dividend under I.R.C. § 301 pursuant to I.R.C. § 304(a)(1).

In the instant case, the shareholder owned and controlled 100% of both Corp1 and Corp2. In addition, Corp1 acquired all of the stock of Corp2 from the taxpayer in exchange for Corp1 forgiving the taxpayers debt. (The forgiving of debt is considered property to the taxpayer.) Therefore, this transfer qualifies as a transaction under I.R.C. § 304(a)(1), and the property received by the shareholder shall be treated as received in a stock redemption. Thus, the shareholder's interest in the issuing corporation (Corp2) will be tested under I.R.C. § 302, to determine whether the redemption will be treated as an exchange or a dividend.

In applying I.R.C. § 302 to I.R.C. § 304(a)(1), the shareholder's interest in the issuing corporation is compared before and after the exchange of stock of the issuing corporation for property. In the instant case, before the transfer, the taxpayer owned directly all the stock in Corp2. After the shareholder's transfer, the shareholder still owned all the stock of Corp2 constructively. Since the shareholder owned all of Corp1, and Corp1 owned all the Corp2 stock after the shareholder's transfer of the Corp2 stock to Corp1 in exchange for property, the taxpayer, by attribution, under I.R.C §§ 304(c)(3) and 318(a)(2)(C), still owned all of the stock of Corp2 constructively.

Since the transfer resulted in no change in the taxpayers ownership interest in Corp2, there was no substantially disproportionate distribution redemption to the taxpayer under I.R.C. § 302(b)(2). Further, there was no termination of the shareholder's interest under I.R.C. § 302(b)(3). In addition, since the taxpayer

owned all the Corp2 stock, both before and after the taxpayer's transfer of the Corp2 stock to Corp1, the transfer will not qualify as "essentially not equivalent to a dividend" to the taxpayer under I.R.C. § 302(b)(1). United States v. Davis, 397 U.S. 301 (1970).

Therefore, the transfer of Corp2 stock by the taxpayer to Corp1 in exchange for property will be considered a dividend under I.R.C. § 301 to the taxpayer, pursuant to I.R.C. § 304, instead of a sale or exchange of Corp2 stock.

#### ISSUE-2-Whether the exception to I.R.C. § 304 applies

The issue here is whether the exception provided by I.R.C. § 304(b)(3)(B) applies to the taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by him, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1).

There is an exception whereby I.R.C. § 304(a) does not apply. Under I.R.C. § 304(b)(3)(B), I.R.C. § 304(a) does not apply if all of the following requirements are met: (1) the acquiring corporation acquired the transferred stock in an I.R.C. § 351 transaction; (2) the acquiring corporation assumed a liability; (3) the shareholder incurred the liability in order to acquire the transferred stock; and (4) the stock was not acquired by the shareholder, from a person whose stock was attributable to the shareholder under the I.R.C. § 318(a) attribution rules.

In the instant case, the acquiring company, Corp1, did not assume a liability. Rather, it forgave its sole shareholder's debt in exchange for the Corp2 stock.

In addition, all of the equity the taxpayer had in Corp2 before the transfer was as a result of contributions to Corp2, a company controlled by the taxpayer. Under I.R.C. § 318(a), a controlled corporation is a related party. Thus the Corp2 stock was acquired by the shareholder from Corp2, a person whose stock was attributable to the shareholder under the I.R.C. § 318 attribution rules.

Thus, the exception provided by I.R.C. § 304(b)(3)(B) does not apply to the taxpayer's transfer of all of his stock in his controlled corporation (Corp2) to a second corporation (Corp1), controlled by him, in exchange for the forgiveness of debt the shareholder owed to the second corporation (Corp1). Therefore, I.R.C. § 304(a) will apply to the transfer.





Please call Daniel Heins if you have any further questions.

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