

Rev. Rul. 77-293 (IRS RRU), 1977-2 C.B. 91, 1977 WL 43696

Internal Revenue Service (I.R.S.)
Revenue Ruling

REDEMPTION; TERMINATION OF INTEREST; SOLE SHAREHOLDER'S GIFT TO SON

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26 CFR 1.302-4: Termination of shareholder's interest.

***1 Redemption; termination of interest; sole shareholder's gift to son.** The redemption by a corporation of a shareholder's remaining stock immediately after the retirement of the shareholder who had been president and sole shareholder, but who, prior to retirement and as part of a plan to retire and turn the business over to a son who was vice-president and a long-time employee, made a gift of half the stock to the son, qualifies for treatment as a distribution in full or part payment in exchange for the stock under section 302(a) of the Code; Rev. Rul. 57-387 modified.

Advice has been requested concerning the Federal income tax treatment of a redemption by a corporation of a retiring shareholder's stock under the circumstances described below.

Corporation *X* had 120 shares of common stock outstanding, all of which were owned by *A*, its president. *A*'s son, *B*, had been employed by *X* for many years as its vice-president and general assistant to the president. Realizing that the future successful operation of *X* required a thorough knowledge of its operation, products lines, and customer needs, *A* had trained and supervised *B* in all phases of the business so that upon *A*'s retirement *B* would be able to assume responsibility for managing the business.

As part of *A*'s plan to retire from the business and to give ownership of the business to *B*, *A* gave 60 shares of *X* stock to *B* as a gift, and not as consideration for past, present, or future services. Shortly thereafter, *A* resigned and *B* assumed the position of chairman of the board and president of *X*. *X* redeemed the remaining 60 shares of stock owned by *A* in exchange for property. Immediately after the redemption, *A* was not an officer, director, or employee of *X* and no longer had any interest in *X*. *A*'s gift of stock to *B* was for the purpose of giving *B* complete ownership and control of *X*. The earnings and profits of *X* exceeded the amount of the distribution in redemption of the *X* stock.

Section 302(a) of the Internal Revenue Code of 1954 provides, in part, that if a corporation redeems its stock and if section 302(b)(1), (2), (3) or (4) applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock. Section 302(c)(1) provides that section 318(a), relating to constructive ownership of stock, will apply in determining the ownership of stock for purposes of section 302.

Section 302(b)(1) of the Code provides that section 302(a) will apply if the redemption is not essentially equivalent to a dividend. Section 302(b)(2) provides that section 302(a) will apply if the redemption is substantially disproportionate with respect to the shareholder. Section 302(b)(3) provides that section 302(a) will apply if the redemption completely terminates the shareholder's interest in the corporation. Section 302(d) provides that if section 302(a) does not apply, the redemption will be treated as a distribution of property to which section 301 applies.

***2** In the instant case, neither section 302(b)(1) of the Code nor section 302(b)(2) applies since *A*, through the constructive ownership rules of section 318(a), owned 100 percent of the stock of *X* both before and after the redemption.

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Therefore, there was no meaningful reduction under section 302(b)(1) or a substantially disproportionate reduction under section 302(b)(2) of *A*'s stock ownership.

Section 302(c)(2)(A) of the Code provides that for purposes of section 302(b)(3), 318(a)(1) will not apply if (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as an officer, director, or employee), other than an interest as a creditor, (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution, and (iii) the distributee files an agreement to notify the district director of any acquisition of any such interest in the corporation. However, pursuant to section 302(c)(2)(B)(ii), the provisions of section 302(c)(2)(A) are not applicable if any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the ten-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction. However, section 302(c)(2)(B)(ii) will not apply if the disposition by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

The structure and legislative history of section 302 of the Code make it clear that the purpose of section 302(c)(2)(B) is not to prevent the reduction of capital gains through gifts of appreciated stock prior to the redemption of the remaining stock of the transferor, but to prevent the withdrawal of earnings at capital gains rates by a shareholder of a family controlled corporation who seeks continued control and/or economic interest in the corporation through the stock given to a related person or the stock he retains. Application of this provision thus prevents a taxpayer from bailing out earnings by transferring part of the taxpayer's stock to such a related person and then qualifying the redemption of either the taxpayer's stock or the transferee's stock as a complete termination of interest by virtue of the division of ownership thus created and the availability of the attribution waiver provisions.

Tax avoidance within the meaning of section 302(c)(2)(B) of the Code would occur, for example, if a taxpayer transfers stock of a corporation to a spouse in contemplation of the redemption of the remaining stock of the corporation and terminates all direct interest in the corporation in compliance with section 302(c)(2)(A), but with the intention of retaining effective control of the corporation indirectly through the stock held by the spouse. Another example, which would generally constitute tax avoidance within the meaning of this provision, is the transfer by a taxpayer of part of the stock of a corporation to a spouse in contemplation of the subsequent redemption of the transferred stock from the spouse. *See H. R. Rep. No. 1337*, 83d Cong., 2d Sess. 36, A76 (1954); *S. Rep. No. 1622*, 83d Cong., 2d Sess. 236-37 (1954).

*3 Whether one of the principal purposes of an acquisition or disposition of stock is tax avoidance within the meaning of section 302(c)(2)(b) of the Code can be determined only by an analysis of all of the facts and circumstances of a particular situation. Here, the gift of *X* stock by *A* was to *B* who is active and knowledgeable in the affairs of the business of *x* and who intends to control and manage the corporation in the future. The gift of stock was intended solely for the purpose of enabling *A* to retire while leaving the business to *B*. Therefore, the avoidance of Federal income tax will not be deemed to have been one of the principal purposes of the gift of stock from *A* to *B*, notwithstanding the reduction of the capital gains tax payable by *A* as a result of the gift of appreciated stock prior to the redemption.

Accordingly, if *A* files the agreement specified in section 302(c)(2)(A)(iii) of the Code, the redemption by *X* of its stock from *A* qualifies as a termination of interest under section 302(b)(3).

Rev. Rul. 57-387, 1957-2 C.B. 225, is modified to the extent that it contains implications to the contrary concerning the reduction of the capital gains tax.

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