

Redemption of Preferred Stock; Substantially..., Rev. Rul. 81-41 (1981)

Rev. Rul. 81-41 (IRS RRU), 1981-6 I.R.B. 5, 1981-1 C.B. 121, 1981 WL 166072

Internal Revenue Service (I.R.S.)

Revenue Ruling

REDEMPTION OF PREFERRED STOCK; SUBSTANTIALLY DISPROPORTIONATE; NO COMMON STOCK

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SECTION 302.— DISTRIBUTIONS IN REDEMPTION OF STOCK, 26 CFR 1.302-3: Substantially disproportionate redemption

***1 Redemption of preferred stock; substantially disproportionate; no common stock.** A redemption of voting preferred stock without a reduction in a 'shareholder's ownership of the common stock' may qualify as a substantially disproportionate redemption under section 302(b)(2) of the Code if the shareholder owns no common stock either directly or constructively. Rev. Rul. 77-426 clarified.

ISSUE

Can a redemption of voting preferred stock qualify as a substantially disproportionate redemption under section 302(b)(2) of the Internal Revenue Code, even though the redeeming shareholder, as a result of not owning any common stock either directly or constructively, is unable to have a reduction in common stock ownership?

FACTS

A domestic corporation, *X*, had outstanding 5,100 shares of voting common stock and 4,900 shares of voting preferred stock. Except for minor limitations of local law, the common and preferred stock have equal voting rights. Each share of common and preferred stock has one vote in electing directors. The preferred stock is entitled to a cumulative nine percent annual dividend and is not a participating stock. All the preferred stock is owned by *A*, who is the founder of *X* and the board chairman. The preferred stock is not section 306 stock within the meaning of section 306(c) of the Code. *A* holds no common stock in *X*, either directly or constructively within the meaning of section 318 of the Code. The common stock in *X* is widely held by persons unrelated to *A*.

In accord with a request from *A*, *X* redeemed 2,000 shares of the preferred stock for cash. Thus, *A*'s vote in *X* was reduced from 49 percent immediately before the redemption to 36.25 percent immediately after the redemption (2,900 shares still held by *A* divided by 8,000 shares then outstanding). There was no plan or intent for *X* to redeem any of the stock held by shareholders other than *A*.

LAW AND ANALYSIS

Section 302(a) of the Code provides that if a corporation redeems its stock and if paragraph (1), (2), (3), or (4) of section 302(b) applies to the redemption, the redemption shall be treated as a distribution in part or full payment in exchange for the stock. Section 302(b)(2) states as a general rule that section 302(a) shall apply to a redemption if the distribution is substantially disproportionate with respect to the shareholder. Under section 302(b)(2)(C) a distribution is substantially disproportionate if:

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(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of-

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

*2 For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. . . .

Section 302(b)(2) does not apply to a redemption unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote. Section 302(b)(2)(B). Finally, section 302(b)(2) does not apply to a redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution that in the aggregate is not substantially disproportionate with respect to the shareholder. Section 302(b)(2)(D).

In the present case, *A* owned 49 percent of the voting stock of *X* prior to the redemption. Eighty percent of 49 percent is 39.2 percent. Because *A* owned 36.25 percent of the voting stock of *X* after the redemption, the first '80 percent test' of section 302(b)(2)(C) is satisfied. In addition, because *A* owned only 36.25 percent of the voting stock of *X* after the redemption, the limitation of section 302(b)(2)(B) is met. Also, because this redemption was not part of a plan to redeem other stock of *X*, the provisions of section 302(b)(2)(D) are not violated. The question remaining is whether the second '80 percent test' of section 302(b)(2)(C), which concerns the ownership of common stock, has to be satisfied even though *A* owned no common stock either directly or constructively.

The Senate Finance Committee Report accompanying the enactment of section 302 states:

Paragraph (2) of subsection (b) sets forth a general rule that if the redemption is substantially disproportionate, it will be treated as a sale under subsection (a), if the other conditions described in the paragraph are met. *It is intended that the general rule shall apply with respect to a redemption of preferred stock (other than section 306 stock) as well as common stock.* S. Rep. No. 1622, 83d Cong., 2d Sess. 234 (1954). (Emphasis added.)

Moreover, section 1.302-3 of the Income Tax Regulations states that section 302(b)(2) of the Code only applies to a redemption of voting stock or to a redemption of both voting stock and other stock, but does not apply to the redemption solely of nonvoting stock. Therefore, both the legislative history and the regulations accompanying section 302(b)(2) indicate that the provision should apply to the redemption of voting preferred stock.

In the same report, the Senate Finance Committee does make two statements that a substantially disproportionate redemption requires a reduction in the redeemed shareholder's ownership of common stock in the redeeming corporation. However, the context of the first of these statements (S. Rep. No. 1622 at 44-45) indicates that this requirement is a safeguard against abuse where the redeeming shareholder holds common stock. Similarly, the second statement (S. Rep. No. 1622 at 234) views this requirement as meaning, 'it is necessary that the shareholder's ownership of voting or nonvoting common stock (that is, his participating interest) in the corporation also be reduced by the percentage required with respect to voting stock.' These statements indicate that in the case of a redeeming shareholder owning two or more classes of stock, one of which is common stock, the shareholder may not retain or improve his or her 'participating'

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interest in the corporation (while having a substantially disproportionate reduction in his or her voting interest) and still claim the protection of the section 302(b)(2) safe-harbor. To conclude otherwise would permit a 'bail-out' of corporate earnings at capital gains rates without a sacrifice of the shareholder's economic interest in the corporation. See *United States v. Davis*, 397 U.S. 301, 313 (1970), Ct. D. 1937, *rehearing denied*, 397 U.S. 1071 (1970), 1970-1 C.B. 62. Thus, these statements (indicating that section 302(b)(2) requires a reduction in common stock ownership) are addressed to situations where the redeeming shareholder owns common stock, and are not addressed to situations where the redeeming shareholder does not own any common stock.

*3 In the present case, *A* owns no common stock either directly or constructively. Therefore, the additional 'safeguard' provided by the second '80 percent test' of section 302(b)(2)(C) is inapplicable to *A*.

HOLDING

A redemption of voting preferred stock can qualify as a substantially disproportionate redemption under section 302(b)(2) even though the redeeming shareholder does not experience a reduction in common stock ownership, if the shareholder owns no common stock either directly or constructively.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 77-426, 1977-2 C.B. 87, holds that for stock that is nonvoting, nonconvertible, and limited and preferred as to dividend and liquidation rights, the redemption of any amount of such stock represents a meaningful reduction of the shareholder's proportionate interest in the corporation if the shareholder does not own stock of any other class, either directly or indirectly. In so holding, the ruling states that such a redemption does not qualify as substantially disproportionate within the meaning of section 302(b)(2) because that provision only relates to redemptions of voting stock and common stock.

Rev. Rul. 77-426 is clarified to remove any implication that in order for a redemption of voting preferred stock to qualify as a substantially disproportionate redemption under section 302(b)(2), the redeeming shareholder must experience a reduction in common stock ownership even if the redeeming shareholder owns no common stock either directly or constructively.

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