

Rev. Rul. 81-289 (IRS RRU), 1981-50 I.R.B. 9, 1981-2 C.B. 82, 1981 WL 165952

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

REDEMPTION OF STOCK; TENDER OFFER ACCEPTANCE
DOES NOT REDUCE PERCENT OF STOCK HELD

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26 CFR 1.302-2: Redemptions not taxable as dividends

***1 Redemption of stock; tender offer acceptance does not reduce percent of stock held.** When a shareholder who holds less than one percent of a publicly traded corporation's outstanding stock has a portion of the stock redeemed pursuant to a tender offer that also reduces the number of shares held by other shareholders, the redemption does not qualify as an exchange within the meaning of section 302(a) and (b)(1) of the Code if the pro rata stock interest of the shareholder is not reduced.

ISSUE

Whether a redemption of stock pursuant to an isolated tender offer is taxable as an exchange under section 302(a) and (b)(1) of the Internal Revenue Code.

FACTS

X corporation has outstanding 1,000,000 x shares of voting common stock which are widely held and publicly traded. *X* has approximately 1,000 x shareholders, none of whom owns a significant amount of the *X* common stock. In an isolated transaction and not as part of a periodic redemption plan, *X* offered to purchase from its shareholders 25,000 x shares of its common stock at the rate of \$20 x per share. Approximately 10 percent of *X*'s shareholders tendered stock for redemption. *X* redeemed a total of 20,000 x shares of its stock pursuant to the tender offer. Individual *A*, who owned 2,000 x shares of *X* stock at the time of the tender offer, surrendered 40 x shares for redemption. Accordingly, *A*'s proportionate interest in *X* was .2 percent (2,000 x shares divided by 1,000,000 x shares) before the tender offer and remained .2 percent (1,960 x shares divided by 980,000 x shares) after the tender offer. *A* was not related to any other shareholder of *X* within the meaning of section 318.

LAW AND ANALYSIS

Section 302(a) of the Code provides, in part, that a redemption of stock will be treated as a distribution in part or full payment in exchange for the stock redeemed if section 302(b)(1), (2), or (3) applies. Section 302(b)(1) will apply if the redemption is 'not essentially equivalent to a dividend'. Section 302(b)(2) will apply if the distribution is 'substantially disproportionate' with respect, to the shareholder. Section 302(b)(3) will apply if all of the shareholder's stock of the corporation is redeemed. Section 302(c)(1) provides that the constructive ownership of stock rules of section 318 will apply in determining ownership of stock for purposes of section 302.

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Section 302(b)(2) of the Code does not apply because *A* did not experience a more than 20 percent reduction in proportionate interest in *X*, as required by section 302(b)(2)(C). Section 302(b)(3) does not apply because *A* continues to own stock of *X*. The question, therefore, is whether *A*'s redemption was 'not essentially equivalent to a dividend' under section 302(b)(1).

*2 Section 1.302-2(b) of the Income Tax Regulations provides, with respect to section 302(b)(1) of the Code, that the question of whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend depends on the facts and circumstances of each case, and that all distributions in pro rata redemptions generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding.

In *United States v. Davis*, 397 U.S. 301 (1970), *rehearing denied*, 397 U.S. 1071 (1970), Ct. D. 1937, 1970-1 C.B. 62, the Supreme Court of the United States held that (1) the constructive ownership of stock rules of section 318(a) of the Code apply to redemptions under section 302(b)(1); (2) the business purpose of a redemption is irrelevant under section 302(b)(1); and (3) a redemption of stock from a sole shareholder (which is necessarily pro rata) will always have the effect of a dividend. In so holding, the Court stated, at page 313, that in order for a redemption to qualify under section 302(b)(1), it must result in a 'meaningful reduction in the shareholder's proportionate interest in the corporation.' The Court, by using singular possessive language, indicated that a shareholder-by-shareholder analysis is the requisite procedure for determining dividend equivalence.

The existence and size of a reduction in proportionate interest that results from a redemption is important because the relationships of the shareholders and the continued exercise of control and participation in the earnings and assets by those shareholders whose stock is redeemed may render essentially meaningless any differences between the redemption and an ordinary dividend distribution. For example, after applying the constructive ownership of stock rules of section 318 of the Code in *Davis*, the taxpayer owned all of the redeeming corporation's stock both before and after the redemption with the result that the distribution was precisely pro rata and, thus, essentially equivalent to a dividend.

Subsequent to the *Davis* decision in 1970, lower courts have established a pattern of applying the meaningful reduction standard to the facts of the case, focusing on the criteria set forth earlier in *Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964). In *Himmel*, the Second Circuit emphasized that stock ownership involves these important rights: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation. In Rev. Rul. 75-502, 1975-2 C.B. 111, and Rev. Rul. 75-512, 1975-2 C.B. 112, the *Davis* meaningful reduction standard was applied to these three criteria on a shareholder-by-shareholder basis in situations involving closely held corporations.

The United States Tax Court applied the meaningful reduction standard in a situation involving a publicly held corporation, stating that 'the 'meaningful reduction' test deserves wider application since the reasoning behind the [*Davis*] decision transcends the narrow facts of the case'. *Sawelson v. Commissioner*, 61 T.C. 109, 117 (1973). See also *Brown v. United States*, 345 F. Supp. 241 (S.D. Ohio 1972), *aff'd without opinion*, 477 F.2d 599 (6th Cir.), *cert. denied*, 414 U.S. 1011 (1973), in which it was held that the meaningful reduction standard applied, notwithstanding that some of the corporation's stock was held by the public. Moreover, the meaningful reduction standard was applied to a redemption by a publicly traded corporation in Rev. Rul. 76-385, 1976-2 C.B. 92. In that revenue ruling, the Internal Revenue Service took the position that a redemption that resulted in a reduction of a minority shareholder's proportionate interest from .0001118 percent to .0001081 percent was not essentially equivalent to a dividend, since the minority shareholder experienced a reduction of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in net assets on liquidation.

HOLDING

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*3 In the present situation the redemption did not result in any reduction of *A*'s right to vote, to participate in current earnings and accumulated surplus, or to share in the corporation's net assets on liquidation. Thus, this redemption with regard to *A* does not satisfy the meaningful reduction standard and does not qualify as an exchange within the meaning of section 302(a) and (b)(1) of the Code.

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