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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Bettie N. Ricca
Associate District Counsel
CC:SER:EEM:WAS

FROM: Filiz A. Serbes
Branch Chief
CC:CORP:B03

SUBJECT:

This Field Service Advice responds to your memorandum dated September 21, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Target =

Buyer =

Seller =

Agent and Lender =

Collateral Agent =

Other Holders =

State X =

State Y =

Date 1 =

Date 2 =

a =

b =

$c =

$d =

$e =

$f =

$g =

$h =

$i =

ISSUE

Is Buyer entitled to include in its basis the amounts paid by Target to Seller for Seller's Target stock?

CONCLUSION

The Buyer's basis in the Target stock initially will equal the amount paid to Seller by Buyer and by Target (as Buyer's designee) for the stock of Target. Section 1012. Buyer's basis then will be reduced by the amount of the deemed distribution from Target to Buyer, less the amount treated as a dividend under § 316. Section 301(c).

FACTS

Seller is an independent agency of State X. Target is a State X corporation that operates as a real estate investment trust. Target has a shares of issued and outstanding common stock, all of which are owned by Seller. Target also has b shares of issued and outstanding preferred stock, all of which are owned by Other Holders.

Buyer is a State Y limited partnership. On Date 1, Buyer and Seller entered into a Stock Purchase Agreement pursuant to which Buyer would purchase all of the outstanding shares of Target common stock from Seller no later than Date 2. The terms of the Stock Purchase Agreement specify that Seller would sell all of its shares of common stock in Target to Buyer or its designee(s) free and clear of any encumbrances. The aggregate consideration for the Target common stock, subject to certain adjustments, was to consist of (i) $d in cash and (ii) a promissory note in an aggregate principal amount of $e.

Upon execution and delivery of the Stock Purchase Agreement, Buyer agreed to deliver to Seller an irrevocable letter of credit in the amount of $f. At the closing of the transaction, Seller would return the letter of credit to Buyer for cancellation and Buyer would deposit $g with a mutually-agreed-upon escrow agent pending payment of the remaining consideration after adjustment.

On Date 2, an amendment was entered into by the parties which specifies that "[A]fter the Closing, the Purchaser may assign to any third party or parties any and all of its rights (but not its obligations) contained in this agreement and the other agreements relating to this agreement or to the acquisition of the Common Stock, including, without limitation, the Post-Closing Escrow Agreement."

In addition, on Date 2, the Board of Directors of Target held a special meeting in which it decided that it was "advisable or appropriate to cause [Target] to purchase the Designated Shares for an aggregate purchase price of [$d plus e less adjustments[1]] on the terms specified in the Stock Purchase Agreement....” The Board further resolved to authorize and empower Target to borrow up to $c, “which amount shall be used to, among other things, purchase the Designated Shares as [Buyer’s] designee under the Stock Purchase Agreement[.]” Further, the Board authorized the granting of a lien on substantially all of the assets of Target as collateral security for the loan.

Accordingly, On Date 2, Target entered into a Loan Agreement with Lender for an amount up to $c, which included “the amount to be paid by [Target] at Closing to redeem its common stock....” The Loan Agreement specifically indicates that the proceeds of the loan were to be used to make payments to Seller as consideration for Target’s common stock on the closing date in connection with the acquisition by Buyer and its affiliates of the remainder of Target’s common stock under the Stock Purchase Agreement. The Loan Agreement provides that, as one of the conditions precedent to the loan, the Collateral Agent shall have received the executed and effective “Interest Guaranty and Pledge,” in which Buyer pledges to the Collateral Agent, acting on behalf of the Lender, all outstanding common stock of Target and enters into a guaranty of the timely payment in full of all interest owed by Target to Lender.

Thus, on Date 2, the following transactions occurred: (1) Target received the approximately $c in loan proceeds from Lender; (2) Target transferred that amount to Seller in exchange for a certain designated amount of Seller’s Target stock; (3) Buyer paid the remaining portion of cash to Seller for Seller’s remaining Target common stock; and (4) Seller ceased to be a shareholder of Target.

You state that, on its federal income tax return for the taxable year in which these transactions occurred, Target treated the payment of the loan proceeds to Seller as a distribution in redemption of Seller’s Target stock, to which § 302 of the Internal Revenue Code applies. Target reduced its earnings and profits (E&P) by the part of the amount so distributed chargeable to E&P and treated that part as a dividend for purposes of computing the dividends paid deduction.

LAW AND ANALYSIS

District Counsel seeks guidance on whether a shareholder in receipt of a constructive distribution may include in its stock basis the amount of the shareholder obligation satisfied by the corporation.

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[1] For analytical purposes herein, we will ignore subsequent adjustments that were made to the initial purchase price of $d plus $e designated in the Stock Purchase Agreement.

However, it is unclear under the facts presented whether Buyer is in receipt of a constructive distribution because it is unclear whether Buyer was subject to an unconditional obligation to purchase all of the shares indicated in the original Stock Purchase Agreement at the time it caused the corporation to redeem part of Seller's shares. If, under state law, Buyer is subject to an unconditional obligation to purchase all the shares and any designee of Buyer would be merely acting as its agent in satisfying this unconditional obligation, then we agree that the redemption could be viewed as a constructive distribution to Buyer.

Section 1012 states that the basis of property shall be the cost of the property.

Section 301(a) provides that a distribution of property (as defined in § 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated as provided in § 301(c). Section 301(c) provides that that portion of the distribution which is a dividend (which § 316 defines as any distribution made out of the corporation's accumulated or current earnings and profits) shall be included in gross income. The remaining portion of the distribution that is not a dividend shall be applied against and reduce the adjusted basis of the stock. Any amount which is not a dividend and which exceeds the adjusted basis of the stock shall be treated as gain from the sale or exchange of property.

We assume for purposes of this discussion that: (i) there existed at the time of the transfer of the loan proceeds by Target to Seller in exchange for part of Seller's shares an unconditional obligation on the part of Buyer to purchase those shares, and (ii) under state law, the ability to designate a substitute buyer does not render the terms conditional.

In this case, Buyer contracted to purchase the Target stock of Seller for an aggregate consideration of $d in cash plus a promissory note in the amount of $e. Thus, Buyer's initial basis would be that amount, $d plus $e. However, Buyer designated Target to satisfy a portion of its unconditional obligation to purchase Seller's stock and pledged all of its Target stock as security for the loan of $c to Target. Thus, Target's borrowing and payment of $c to Seller on Buyer's behalf constitutes a constructive distribution to Buyer.

Under § 301(c), that portion of the $c paid by Target to Seller that is made out of Target's accumulated or current E&P constitutes a dividend to Buyer and shall be included in Buyer's gross income for the taxable year in which the stock purchase was made. You have indicated that, although Target had no accumulated E&P, it had approximately $h in undistributed current E&P for the taxable year at issue.

After determination of the portion of the distribution that constitutes a dividend (in this case, $h), the remaining portion of the distribution will reduce Buyer's initial adjusted basis in the Target stock under § 302(c)(2). Accordingly, Buyer's basis in the stock of Target is equal to the purchase price ($d plus $e) reduced by the amount treated under § 301(c)(2) as a reduction in the adjusted stock basis ($c less $h, which is the amount treated as a dividend).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We are not expressing an opinion regarding the validity of the constructive dividend characterization. The facts we received with the request for field service advice are not sufficiently developed for us to concur with the field's characterization. The following discussion is an analysis of the hazards associated with the dividend characterization and a possible alternative analysis

In order for the dividend characterization to be supported, it must be clear that Buyer had an unconditional obligation to purchase Seller's stock of Target and that Target's redemption of part of Seller's Target stock actually is "the same as if the money had been paid to the taxpayer and transmitted by him to the creditor; and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt." Wall v. United States, 164 F.2d 462, 464 (4th Cir. 1947).

In Wall, Wall was one of two shareholders in a corporation, and he agreed to purchase the other shareholder's shares for $57,000. Wall paid $6,700 cash and agreed to pay $5,000 annually for nine years and $20,000 in the tenth year. To cover the deferred payments, he executed and delivered to the other shareholder 13 promissory notes, each for $5,000. Wall made the initial payment and the first payment under the first note and then reached an agreement with the corporation whereby the corporation agreed to pay the remaining notes as they matured. Wall, in turn, transferred to the corporation his equity in the stock, and the corporation entered that stock on its books as treasury stock.

The Commissioner of Internal Revenue considered the corporation's payment of Wall's debt as income for tax purposes, and the district court upheld the Commissioner's determination. The appellate court affirmed, holding that the corporation's payment of appellant's debt was taxable because such a payment by a third party pursuant to an agreement between them was income to Wall. The court found that the controlling fact in this situation was that Wall was under an obligation to pay the other shareholder $5,000 in the tax year at issue and that the corporation paid this indebtedness for Wall out of its surplus. The court held that the use by Wall of the corporation to redeem out the other selling shareholder after execution of the sale was treated as a discharge of his personal purchase money obligation to the seller by the corporation and as a constructive dividend to Wall. The “redemption” was viewed as equivalent to a payment by the corporation of a personal debt of the stockholder.

Some guidance also might be found in Rev. Rul. 69-608, 1969-1 C.B. 42, which addresses the treatment of a redemption by a corporation of a retiring shareholder’s stock where the remaining shareholder of the corporation has entered into a contract to purchase such stock. But, as with Wall, the situations in the revenue ruling address agreements between two existing shareholders of a corporation for one to acquire the stock of the other and the shifting by the remaining shareholder of that obligation to the corporation for satisfaction.

In the case at hand, however, Buyer actually does not become a shareholder of Target until Date 2, and it might be hard to argue under § 301 that, on Date 2, Target’s redemption of part of Seller’s shares is actually a distribution of property made by Target to Buyer with respect to Buyer’s stock when Buyer is not yet a shareholder (or is becoming a shareholder as a result of the transaction). In other words, unlike the assumptions in analysis made above, there may not have existed an unconditional obligation on the part of Buyer to purchase those Target shares at the time of the execution of the original contract on Date 1 or at the time of the transfer of the loan proceeds by Target to Seller on Date 2 in exchange for part of Seller’s shares, and/or, under state law, the ability to designate a substitute buyer may have rendered conditional the terms of the contract executed on Date 1.

In all practicalities, the two analyses do not yield very different numerical outcomes in this case with respect to Buyer’s ultimate basis in the Target stock since Target does not have any accumulated E&P and only $h in current E&P. Under your dividend analysis, Buyer’s basis is ($d plus $e) minus ($c less $h). Under a redemption-sale analysis, Buyer’s basis is what it paid for the remaining stock after redemption, or $i (which is $d plus $e minus $c).

Please call Paula Hu-Pitzer at 202-622-7550 if you have any further questions.

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