

INFORMAL FIELD ASSISTANCE (TELEPHONE CALL)

Number: **200110004**
Release Date: 3/9/2001
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Call Received By: George R. Johnson
Date: November 14, 2000

Symbols:CC:CORP:B06
Time:

Call Received From: XXXXXXXXXX
Phone:
District/Region:

Office:

Taxpayer Name and TIN:

Tax Years:

Case In Audit	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>	Appeals	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>
Case In Litigation	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>	ISP Case	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>
Date Of Trial			CEP Taxpayer	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>

Prior Counsel Advice:

None District Region Nat. Office
Given By: Karlene Lesho Symbols:CC:PSI:B09
Phone: (202) 622-7830

Legend:

A =
J =
Acquiring =
Issuing =
Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =

Issue/Questions: (1) The impact, if any, of the 1997 amendment to § 304(a)(1)¹

¹As amended, I.R.C. § 304(a)(1) provides:

If two or more persons are in control of each of two corporations, and in return for property (other than stock in

on the basis-recovery rule of I.R.C. § 1368; and (2) the proper tax treatment of cash received and the proper determination of the basis of stock of Acquiring in a transaction considered a redemption under I.R.C. § 304(a)(1).

Facts: A and J, two brothers, each own by attribution 50 percent of the stock of both Issuing and Acquiring. They each have a basis of Amount 1 in Issuing and a basis in excess of Amount 2 in Acquiring. Both corporations have E&P. At the beginning of the year of sale, Acquiring had an accumulated earnings and profits of Amount 3 and an accumulated adjustment account (AAA) balance of approximately Amount 4. In late 1997, A and J sold all of their stock in Issuing to Acquiring in exchange for Amount 5, which they split equally. This amount is twice Amount 2 and exceeds Acquiring's accumulated earnings and profits, but it does not exceed Acquiring's AAA. After the transaction, A and J each own by attribution 50 percent of the stock of both Issuing and Acquiring.

Telephone Response: In our earlier Field Service Advice, dated June 30, 2000, we advised you that the acquisition of Issuing by related Acquiring qualified as a redemption transaction under I.R.C. § 304(a)(1), as amended by Tax Reform Act of 1997. We also advised you that the redemption failed to meet the tests of § 302(b), and therefore it should be treated as a distribution of property to which § 301 (the general distribution provision of Subchapter C) applies. Here, Acquiring is a Subchapter S corporation and, therefore, I.R.C. § 1368², the

the Acquiring corporation), one of the corporations acquire stock in the other corporation from the person (or persons) so in control, then such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. *To the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.*

(Amended language in italics).

² I.R.C. § 1368 governs the tax effect of a distribution made by an S corporation to its shareholders. This section distinguishes S corporations by whether or not they have any accumulated earnings and profits. Distributions by S corporations having no accumulated earnings and profits are governed by § 1368(b). This provision provides that the distribution is excluded from the shareholder's gross

general distribution provision of Subchapter S, preempts § 301.

In our earlier advice, we were uncertain of the impact, if any, of the amended language of § 304(a)(1) on the “basis” available for reduction under § 1368 and, therefore, we did not analyze all tax aspects of the underlying transaction. The “amended language” recasts a “brother-sister” stock acquisition transaction as a deemed § 351 transfer of Issuing stock to Acquiring in exchange for hypothetical Acquiring stock, followed by an immediate redemption of “*the stock it was treated as issuing in such transaction.*” I.R.C. § 304(a)(1), flush language. (Emphasis added).

Initially, we were concerned that the above italicized language, which shows Congress’ intent to specifically identify the shares redeemed, may also indicate Congress’ intention to limit the shareholder’s basis recovery to *only* the basis of the shares actually redeemed (*i.e.*, the basis of the hypothetical Acquiring stock). Thus, the issue, as we saw it, was whether the amended language indicates a Congressional intent to substitute a segregated basis rule in place of the *spillover rule*³ of §§ 1367 and 1368, and thereby circumscribe the extent of the taxpayer’s basis recovery to only the basis of the hypothetical shares of Acquiring.

After considering the issue, we now conclude that the answer is “No.” The amended language of I.R.C. § 304(a)(1) does not intimate a Congressional intention to limit the shareholder’s basis recovery under I.R.C. § 1368 to *only* the

income up to the adjusted basis of the stock, reducing the basis *pro tanto*. The excess is treated as gain from the sale or exchange of property. Distributions by S corporations having no accumulated earnings and profits are governed by § 1368(c). This section assigns distributions by corporations with accumulated earnings and profits to three tiers, depending on the existence and extent of the accumulated adjustments account. Under the first tier, the distribution is treated as prescribed by § 1368(b) up to the amount of the corporation’s AAA. Under the second tier, the balance of the distribution, if any, is treated as a dividend up to the amount of the distributing corporation’s accumulated earnings and profits. Under the third tier, the remainder of the distribution, if any, qualifies for § 1368(b) treatment and is taxed as a return of capital and/or gain from the sale or exchange, as the case may be. B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 6.08 (7th ed. 2000).

³The “spillover” rule allows a shareholder of an S corporation to apply losses and deductions in excess of the basis of a share of stock to which such items are attributable against the remaining bases of all other shares of stock in the S corporation owned by the same shareholder. T.D. 8508, 1994-1 C.B. 219 (1993); Treas. Reg. § 1.1367-1(a)(c)(3).

shares actually redeemed. Nor does the legislative history of I.R.C. § 304(a)(1) suggest a Congressional intent to substitute a segregated basis rule in place of the spillover rule of §§ 1367 and 1368.

Accordingly, the “bases” to be reduced under § 1368 are A’s and J’s entire bases in their S Corporation stock. Under § 1368(c), A and J apply the distribution in excess of their bases in the hypothetical S Corporation stock against the remaining bases of all other Acquiring Corporation shares of stock they own *pro tanto*. Any excess distribution, to the extent of Acquiring’s accumulated adjustment account, is treated as gain from the sale or exchange of property. That portion of the distribution in excess of Acquiring’s accumulated adjustment account is treated as a dividend to the extent it does not exceed the accumulated earnings and profits of both Acquiring and Issuing. The remainder of the distribution, if any, qualifies for § 1368(b) treatment and is taxed as a return of capital and/or gain from the sale or exchange, as the case may be.

Applying the above law and analysis to the facts of this case, A and J each have a basis of Amount 1 in Issuing. A and J acquire “hypothetical” Acquired stock in a deemed § 351 transaction and each takes a substituted basis of Amount 1 in such stock (*i.e.*, the same basis as they held in the stock of Issuing). A and J each received a distribution of Amount 2 in exchange for their stock in Issuing. Neither one of them recognizes any gain from this distribution because the first Amount 1 of the Amount 2 each received reduces their hypothetical stock basis to zero and the remaining amount (*i.e.*, Amount 2 minus Amount 1) is applied to reduce (“spills over”) to the remaining basis each has in the stock of Acquiring stock (*i.e.*, Amount 2). Each is left with a basis of Amount 1 in their S corporation shares.

If you have any questions regarding this response, please call George Johnson at (202) 622-7930.

Further Action Needed: Yes [] No [X]
Describe:

Call Returned By: George R. Johnson
Date Call Returned: 11/14/00
Reviewed By: Steven J. Hankin
Office: CC:CORP:B06
Date: 11/14/00

Symbols: CC:CORP:B06
Time Spent: 20 hours

Phone: (202) 622-7930