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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR RICHARD S. BLOOM, ASSOCIATE AREA COUNSEL (LMSB)

FROM: Jasper L. Cummings, Jr.
Associate Chief Counsel CC:CORP

SUBJECT:

This Field Service Advice responds to your memorandum dated August 18, 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

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

ISSUES:

(1) Whether the language of the 1997 amendment to § 304(a)(1) indicates a Congressional intent 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).

(2) What is the proper tax treatment of cash received by A and J and what is the proper determination of the bases of A's and J's stock of Acquiring in a transaction considered a redemption under I.R.C. § 304(a)(1).

CONCLUSIONS:

(1) The language of the 1997 amendment to § 304(a)(1) does not indicate a Congressional intent 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 amended language does not impact the *spillover rule* of §§ 1367 and 1368, and does not circumscribe the extent of the taxpayer's basis recovery to only the basis of the hypothetical shares of Acquiring.

(2) Under the scheme of § 1368(c), A and J must 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*. A and J must treat any excess distribution, to the extent of Acquiring's accumulated adjustment account, as gain from the sale or exchange of property. The portion of the distribution in excess of Acquiring's accumulated adjustment account, if any, is treated as a dividend to the extent it does not exceed the accumulated E&P of both Acquiring and Issuing. The remainder of the distribution, if any, is taxed as a return of capital and/or gain from the sale or exchange, as the case may be.

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.

LAW AND ANALYSIS: 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. § 1368[1], the 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

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[1] 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 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).

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*[2] 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 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

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[2]The "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).

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.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS: None.

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

Please call if you have any further questions.

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