The following comments (the “Comments”) constitute the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation (the “Committee”). Principal responsibility was exercised by Rose Williams. Substantive contributions were made by Jasper Cummings, Chris Nelson, and David Wheat. These Comments were reviewed by Wayne Strasbaugh and Joe Pari.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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These Comments respond to the request for comments regarding the regulations proposed by the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") in the Federal Register on October 18, 2002 (the "Proposed Regulations") providing guidance regarding the treatment of the basis of redeemed stock when a distribution in redemption of such stock is treated as a dividend, and guidance regarding certain acquisitions of stock by related corporations that are treated as distributions in redemption of stock.

I. EXECUTIVE SUMMARY

The Proposed Regulations respond to a limited basis shifting technique by making sweeping changes in the basis rules applicable to dividend-equivalent redemptions. These changes deny the transfer of basis to a shareholder’s remaining shares of stock or to stock held by a related shareholder. The Proposed Regulations extend these changes to intragroup transactions under the consolidated return rules. We urge that the Proposed Regulations not be adopted in their current form because we believe that they are not needed, lead to inappropriate results, and create more problems than they solve.

We believe that basis transfers resulting from dividend-equivalent redemptions are entirely appropriate and should be allowed in most instances. In our view, however, dividend-equivalent redemption transactions have the potential to create inappropriate results where the transactions involve shareholders not subject to (or indifferent to) U.S. taxation. Therefore, we believe that basis transfers generally should be prevented only where basis is being shifted from a shareholder not subject to (or indifferent to) U.S. federal income taxation to a party that is subject to (or is not indifferent to) U.S. taxation. Preventing basis transfers in other cases is

generally unnecessary, particularly for transactions involving members of a consolidated group that are treated as a single taxpayer and for which existing basis adjustment mechanisms already prevent the avoidance of tax.

Under the Proposed Regulations, if a redemption is characterized as a dividend-equivalent redemption, the basis of the redeemed shares is not transferred to other shares. Rather, the basis is treated as a loss recognized by the redeemed shareholder on the date of the redemption. The redeemed shareholder is not permitted to take the loss into account except upon the occurrence of certain events. We believe these new rules will produce economic distortions, because they elevate form over substance, and generate new tax avoidance opportunities. Moreover, in the consolidated return context, where only one level of tax exists under the current consolidated return rules, the Proposed Regulations inappropriately create the potential for two levels of tax (one level with respect to an excess loss account on the stock redeemed and a second level with respect to the underlying assets of the corporation whose stock is redeemed).

Rather than the sweeping approach of the Proposed Regulations, we believe that existing authorities allow the Service to prevent the basis shifting techniques in abusive transactions without disrupting the current, long-accepted basis rules applicable to dividend-equivalent redemptions for both separate return and consolidated return taxpayers. Nevertheless, we include in these Comments (i) a narrowly-tailored anti-avoidance rule that could be adopted to enhance the Service’s ability to address abusive basis-shifting transactions involving dividend-equivalent redemptions and (ii) an example clarifying where basis transfers are “proper” under Treas. Reg. § 1.302-2(c). The anti-avoidance rule generally would address dividend-equivalent redemptions where basis is shifted from stock held by a “tax-indifferent person” to stock held by a person who is not a “tax-indifferent person.” For these purposes, we would define “tax
indifferent person” to include (i) any tax-exempt entity and (ii) any person not subject to U.S. Federal income taxation on such a dividend-equivalent redemption at a rate at least equal to the tax rate generally applicable to dividends received by such person from a domestic corporation. The example would clarify that basis shifts are not “proper” where, as a result of the complete redemption of shares owned by a person not subject to (or indifferent to) U.S. taxation, basis otherwise would be shifted from stock owned by such person to stock owned by a person subject to (or not indifferent to) U.S. taxation.

Accordingly, we urge that the Proposed Regulations be withdrawn.

II. GENERAL BACKGROUND

A. Section 302

Section 302\(^2\) governs the tax treatment of stock redemptions. Section 302(a) provides that “[i]f a corporation redeems its stock . . . and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.” Section 302(a). If none of sections 302(b)(1)-(4) applies to a redemption, however, then section 302(a) does not apply. In that event, section 302(d) provides that “such redemption shall be treated as a distribution of property to which section 301 applies.” Section 302(d). In other words, the redemption is treated as a distribution with respect to stock.

Section 302(b) provides that a redemption is treated as a distribution in part or full payment in exchange for the redeemed stock (i.e., a sale of stock) if the redemption is: (1) not essentially equivalent to a dividend (i.e., the redemption does not meet any of the other three tests in section 302(b), yet it is not economically equivalent to a dividend); (2) a substantially

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\(^2\) References to “section” are to the Internal Revenue Code of 1986, as amended (the “Code”).
disproportionate redemption of stock (i.e., the redemption is sufficiently non-pro rata to avoid being classified as a disguised dividend); (3) a termination of the shareholder’s interest; or (4) a redemption from a noncorporate shareholder in partial liquidation (i.e., the redemption is not essentially equivalent to a dividend and, by virtue of the assets distributed to the redeeming shareholder, represents a contraction of the redeeming corporation’s business).

The constructive ownership rules of section 318(a) apply to determine if a redemption falls into one of the first three categories enumerated above. Section 302(c)(1). As a result of the section 318 constructive ownership rules, a non-pro rata redemption may be treated as a pro rata redemption (and hence a distribution with respect to stock) if the redeeming corporation and shareholders are related for purposes of the section 318 attribution rules. Similarly, if a corporation redeems all of the shares held directly by one of its shareholders, such a redemption nevertheless may be treated as a distribution with respect to stock due to the section 318 attribution rules. For example, Husband and Wife own all of the outstanding shares of Corporation X. X redeems all of Husband’s shares of X stock. Although the redemption is a complete termination of Husband’s direct ownership of X shares, section 318 treats the shares owned by Wife as owned by Husband. Section 318(a)(1).\(^3\) Thus, after the redemption of Husband’s shares, Husband’s ownership of X shares, on a percentage basis, has not decreased. Before the redemption, section 318 treated Husband as owning 100 percent of the outstanding X shares. After the redemption, section 318 treats Husband as owning 100 percent of the outstanding X shares actually owned by Wife. The redemption of Husband’s shares meets none of the constructive ownership rules of section 318(a) that may treat the redemption as a distribution with respect to stock.

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\(^3\) For purposes of this example, it is presumed that Husband does not file the agreement described in section 302(c)(2)(A)(iii) and thus does not satisfy the requirements of section 302(c)(2)(A). See also Treas. Reg. § 1.302-4. If Husband had filed such agreement and otherwise satisfied the requirements of section 302(c)(2)(A) and Treas. Reg. § 1.302-4, section 318 would not cause Husband to be treated as owning the X shares owned by Wife.
of the tests under section 302(b). Therefore, the redemption is treated as a distribution with respect to stock. Section 302(d). As a distribution with respect to stock, the redemption is treated as the distribution of a dividend to the extent of X’s earnings and profits. Sections 301 and 316.

B. Current Basis-Shifting Regulations

In the case of a redemption that is treated as the distribution of a dividend (a “dividend-equivalent redemption”), the Code does not address what happens to the basis that the shareholder had in his redeemed shares. Since 1955, however, Treasury Regulations have provided that “[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.” Treas. Reg. § 1.302-2(c) (emphasis added). Examples in Treas. Reg. § 1.302-2(c) clarify what constitutes a “proper adjustment.” See Treas. Reg. § 1.302-2(c), exs. 1-3.

Examples 1 and 3 provide that if a shareholder continues to own stock directly in the redeeming corporation after a dividend-equivalent redemption, his basis in the redeemed stock is transferred to the stock that he continues to own directly.4 Example 2 provides that if a

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4 Example 1 states:

A, an individual, purchased all of the stock of Corporation X for $100,000. In 1955 the corporation redeems half of the stock for $150,000, and it is determined that this amount constitutes a dividend. The remaining stock of Corporation X held by A has a basis of $100,000.

Treas. Reg. § 1.302-2(c), ex. 1.

Example 3 states:

The facts are the same as in Example (2) [see fn. 5 below] with the additional facts that the outstanding stock of Corporation X
redemption completely terminates a shareholder’s direct ownership interest in a corporation, but the redeemed shareholder continues to own shares in the redeeming corporation pursuant to section 318, then the redeemed shareholder’s basis in his redeemed shares shifts to the stock that the shareholder owns constructively, even though such stock is owned by a different person.\(^5\)

C. Notice 2001-45: Abusive Basis-Shifting Transactions

As described above, Treas. Reg. § 1.302-2(c) preserves a shareholder’s basis in his redeemed shares in a dividend-equivalent redemption. In Notice 2001-45, the Service identified a type of transaction in which taxpayers purportedly could utilize this basis preservation rule, in a pre-arranged redemption of a tax-indifferent party’s stock, to create an immediately utilizable loss. These transactions generally are structured in the manner described in Example 1, below.

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Example 1 consists of 1,000 shares and all but 10 shares of the stock of H is redeemed. Immediately after the transaction, H holds 10 shares of the stock of Corporation X with a basis of $50,000, and W holds 500 shares with a basis of $50,000.

Treas. Reg. § 1.302-2(c), ex. 3.

\(^5\) Example 2 states:

H and W, husband and wife, each own half of the stock of Corporation X. All of the stock was purchased by H for $100,000 cash. In 1950 H gave one-half of the stock to W, the stock transferred having a value in excess of $50,000. In 1955 all of the stock of H is redeemed for $150,000, and it is determined that the distribution to H in redemption of his shares constitutes the distribution of a dividend. Immediately after the transaction, W holds the remaining stock of Corporation X with a basis of $100,000.

Treas. Reg. § 1.302-2(c), ex. 2.
Example 1.

Facts. A and B are shareholders of Corporation Y. A and B employ a variety of devices, including options, to treat A as owning the Corporation Y stock owned by B under section 318. Corporation Y has accumulated earnings and profits. A is not subject to U.S. federal income tax or is otherwise indifferent to the U.S. federal income tax consequences of the dividend-equivalent redemption. Corporation Y redeems all of A’s Corporation Y stock.

Analysis. The section 318 constructive ownership rules cause the redemption of A’s stock to be treated as a dividend-equivalent redemption to the extent of Corporation Y’s earnings and profits. Prior to the redemption, A owned, directly and constructively, 100 percent of Corporation Y’s stock. After the redemption, A continues to own constructively 100 percent of Corporation Y’s stock. Thus, the redemption is a dividend-equivalent redemption under sections 302(d), 301, and 316 to the extent of Corporation Y’s earnings and profits. However, A pays no federal income tax with respect to the dividend. B takes the position, under Treas. Reg. § 1.302-2(c), that the basis of A’s redeemed stock is added to the basis of the Corporation Y stock held by B. B subsequently sells its Corporation Y stock and claims a loss due to the use of the transferred basis.

In Notice 2001-45, the Service stated that it does not believe that the loss created by such a transaction is properly allowable for federal income tax purposes. See Notice 2001-45, 2001-2 C.B. 129. The Service announced in Notice 2001-45 that it will disallow losses claimed by taxpayers from such transactions using several theories, including, but not limited to, the following: (i) the integrated redemption and sale steps result in a complete termination of A’s interest in Corporation Y (citing Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954)); (ii) the shifting of A’s basis to B is not a “proper adjustment” for purposes of Treas. Reg. § 1.302-2(c), ex. 2; and (iii) there is no attribution of stock ownership or basis shift because the steps taken to cause B’s loss are transitory and serve no purpose other than tax avoidance.
D. The Proposed Regulations

1. In General

In addition to issuing Notice 2001-45, Treasury and the Service also stated their belief that “it [was] desirable to revise the rules that govern accounting for unutilized basis attributable to redeemed stock” in order to prevent taxpayers from utilizing basis shifting transactions like the kind described in Notice 2001-45 to generate losses. See preamble to the Proposed Regulations, 67 Fed. Reg. 64331 (Oct. 18, 2002). Thus, Treasury and the Service issued the Proposed Regulations in October of 2002.

The Proposed Regulations revoke Treas. Reg. § 1.302-2(c) and substitute a completely new approach to basis in connection with dividend-equivalent redemptions. Under the Proposed Regulations, if a redemption is characterized as a dividend-equivalent redemption, the basis of the redeemed shares remains with the redeeming shareholder. See Prop. Treas. Reg. § 1.302-5(a). The basis in the redeemed shares is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption. Id. The character, source, and amount of the loss are fixed on the date of the redemption. Id. However, the redeemed shareholder is not permitted to take such loss into account except upon the earlier of two dates: the “final inclusion date” or the “accelerated loss inclusion date.” Prop. Treas. Reg. § 1.302-5(c). The “final inclusion date” is the date on which (i) the redeemed shareholder would satisfy the provisions of section 302(b)(1), (2), or (3) if the facts and circumstances that exist on such date had existed immediately after the redemption or (ii) there is no later date on which the redeemed shareholder could take the loss into account. Prop. Treas. Reg. § 1.302-5(b)(3). The “accelerated loss inclusion date” is the date, other than the final inclusion date, on which the redeemed shareholder must take into account gain from an actual or deemed sale or exchange of some or all of his or her remaining shares in the redeeming corporation. Prop. Treas. Reg. § 1.302-5(b)(4).
The Proposed Regulations prevent taxpayers from shifting basis in order to generate losses in the type of transactions described in Notice 2001-45, as illustrated in Example 2.

**Example 2.**

**Facts.** Same facts as Example 1.

**Analysis.** The constructive ownership rules of section 318 cause the redemption of A’s stock to be treated as a dividend-equivalent redemption to the extent of Corporation Y’s earnings and profits.

Prior to the redemption, A owned, directly and constructively, 100 percent of Corporation Y’s stock. After the redemption, A continues to own constructively 100 percent of Corporation Y’s stock. Thus, the redemption is treated as a dividend-equivalent redemption under sections 302(d), 301, and 316 to the extent of Corporation Y’s earnings and profits. However, A pays no federal income tax with respect to the dividend. Under Prop. Treas. Reg. § 1.302-5(a), no part of A’s basis in its Corporation Y shares is transferred to B. Instead, A has a recognized loss equal to the basis A had in its Corporation Y shares. A cannot take its loss into account until B sells a sufficient number of Corporation Y shares to trigger either A’s final inclusion date or accelerated loss inclusion date.

2. **Application of the Proposed Regulations to Consolidated Groups**

The Proposed Regulations incorporate these concepts into the consolidated return regulations applicable to inter-company stock transfers and redemptions. Currently, Treas. Reg. § 1.1502-13(f)(7), ex. 3 (“Example 3”) reads as follows:

**Facts.** P forms S and B by contributing $200 to the capital of each. During Years 1 through 4, S and B each earn $50, and under § 1.1502-32 P adjusts its basis in the stock of each to $250. (See § 1.1502-33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S's assets and its stock is $500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of $350 and $150 of cash.

**Treatment as a section 301 distribution.** The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of $500 and, under section 358, a basis of $250. Immediately after
the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the $150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, $100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under § 1.1502-32. The remaining $50 of the distribution reduces P's basis in the B stock. Section 301(c)(2) and § 1.1502-32. Under paragraph (f)(2)(ii) of this section, P's $100 of dividend income is not included in gross income. Under §1.302-2(c), proper adjustments are made to P's basis in its B stock to reflect its basis in the B stock redeemed, with the result that P's basis in the B stock is reduced by the entire $150 distribution.

Treas. Reg. § 1.1502-13(f)(7), ex. 3 (emphasis added).

Although the Proposed Regulations do not modify the facts of Example 3, the Proposed Regulations do modify the analysis in Example 3 by deleting the last sentence and inserting two new sentences.

Treatment as a section 301 distribution. The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of $500 and, under section 358, a basis of $250. Immediately after the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the $150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, $100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under § 1.1502-32. Under paragraph (f)(2)(ii) of this section, P's $100 of dividend income is not included in gross income. Accordingly, P has a $75 excess loss account in the redeemed stock. That excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption and is taken into account under the rules of §1.1502-19(b)(5).

Apparently, under the Proposed Regulations, the basis adjustment rules of Treas. Reg. § 1.1502-32 would reduce only the basis in those shares that are redeemed by a group member from another group member rather than the redeemed member shareholder’s basis in all of its shares of the redeeming group member’s stock. If the value of the redeemed shares exceeds the redeemed shareholder’s basis therein, this basis reduction creates an excess loss account (an “ELA”) in the redeemed shares. This ELA is treated as income recognized on a disposition of the redeemed stock on the date of the redemption. See Prop. Treas. Reg. § 1.1502-19(b)(5)(i). However, such income is not immediately taken into account by the redeemed shareholder. Instead, such income is, in effect, suspended until the occurrence of either the “final inclusion date” or the “accelerated income inclusion date.” See Prop. Treas. Reg. § 1.1502-19(b)(5)(ii) (defining “final inclusion date” by reference to Prop. Treas. Reg. § 1.302-5(b)(3) and defining “accelerated income inclusion date” as “a date on which P is permitted to take into account a loss recognized on a disposition of S stock without regard to the application of Temp. Treas. Reg. § 1.337(d)-2T”). See also id. at § 1.1502-19(b)(5)(iii). The character, source, and amount of this suspended income are fixed as of the date of the redemption. Prop. Treas. Reg. § 1.1502-19(b)(5)(i). Importantly, the suspended income cannot be eliminated.

6 Note that suspended gain (or loss) under Prop. Treas. Reg. § 1.1502-19(b)(5) is different from deferred gain (or loss) from intercompany transactions subject to the rules of Treas. Reg. § 1.1502-13. The events causing such suspended income to be taken into account by the redeemed shareholder under Prop. Treas. Reg. § 1.1502-19(b)(5) are different from the events causing a consolidated group member to take deferred gain from intercompany transactions into account under Treas. Reg. § 1.1502-13. Compare Prop. Treas. Reg. § 1.1502-19(b)(5) with Treas. Reg. §§ 1.1502-13(c) and (d). Similarly, the events causing such suspended income to be taken into account by the redeemed shareholder under Prop. Treas. Reg. § 1.1502-19(b)(5) are different from the events causing a consolidated group member to take into account an ELA that was not created or increased by the receipt of a dividend-equivalent redemption. Compare Prop. Treas. Reg. § 1.1502-19(b)(5) with Treas. Reg. § 1.1502-19(b)-(e).
III. PROBLEMS CREATED BY THE PROPOSED REGULATIONS

Although the Proposed Regulations may prevent taxpayers from using the type of transactions described in Notice 2001-45 to shift basis in order to generate capital losses, they do far more. As discussed below, the Proposed Regulations may allow taxpayers to obtain favorable tax results that currently are not possible under Treas. Reg. § 1.302-2(c). The Proposed Regulations contain rules for creating suspended losses in dividend-equivalent redemptions and rules for taking these suspended losses into account that, in effect, elevate form over substance. Thus, taxpayers may have opportunities to manipulate a dividend-equivalent redemption and a subsequent stock sale to obtain favorable tax consequences that differ significantly from the tax consequences of an actual dividend even where a dividend-equivalent redemption and a cash dividend create economically identical consequences. Moreover, as discussed below, the application of the Proposed Regulations to redemptions within a consolidated group may cause previously tax-free intragroup transactions to become taxable, leading to potential double taxation of the consolidated group in contravention of the single entity theory of consolidated groups. These Comments illustrate and analyze these consequences through the following Examples.

A. Elevation of Form Over Substance

Under section 302, a cash distribution and a dividend-equivalent redemption are economically identical transactions. However, as Examples 3, 4, and 5 demonstrate, the Proposed Regulations cause the form of the transaction, rather than its economic result, to control a shareholder’s tax consequences.

Example 3. Actual Dividend

Facts. X is a public corporation with 1000 shareholders, each holding 100 shares (100,000 total shares outstanding). Y corporation is a public shareholder of X. Y’s ownership of X
shares satisfies the requirements of section 1059(d)(6). Each of Y's X shares has a fair market value and basis of $1. X has a value of $100,000. In Year 1, X earns income of $100,000 (after tax) and the value of X increases to $200,000. In Year 1, X pays a pro-rata dividend of $1 per share ($100,000 total). In Year 2, Y sells 2 shares of X stock (2% of Y’s interest in X) for $1 each ($2 total).

Analysis. In Year 1, Y has dividend income of $100 and a dividend received deduction of $70 (70% of $100). See Sections 301, 316, and 243. Because Y’s ownership of X shares satisfies the requirements of section 1059(d)(6), section 1059 does not apply to the dividend that Y received from X. Y’s basis in each of its 100 shares of X stock remains at $1. In Year 2, Y recognizes no gain or loss on the sale of two shares of X stock. Section 1001.

Example 4. Dividend-Equivalent Redemption Under Current Regulations

Facts. The facts are the same as in Example 3, except that in Year 1, X redeems, on a pro rata basis, 50 shares of X stock from each shareholder for $2 per share ($100,000 total). In Year 2, Y sells 1 share of X stock (2% of Y’s interest in X) for $2.

Analysis. In Year 1, Y has dividend income of $100 and a dividend received deduction of $70. See Sections 302, 301, 316, and 243. Section 1059(e) does not apply to the redemption because the redemption is pro rata to all X shareholders. Y’s basis in its remaining X shares increases by $1 each ($50 total). Treas. Reg. § 1.302-2(c), ex. 1. In Year 2, Y recognizes no gain or loss on the sale of one share of X stock. Section 1001.

Example 5. Dividend-Equivalent Redemption Under Proposed Regulations

Facts. The facts are the same as in Example 4.

Analysis. In Year 1, Y has dividend income of $100 and a dividend received deduction of $70. See Sections 302, 301, 316, and 243. Section 1059(e) does not apply to the redemption because the redemption is pro rata to all X shareholders. Under Prop. Treas. Reg. § 1.302-5(a) and (c), Y recognizes a loss in the amount of $50 (equal to the basis of the redeemed shares), which is suspended; Y’s basis in each of its remaining 50 shares of X stock is $1 (total basis of $50).

In Year 2, Y recognizes a $1 gain on the sale of the one share of X stock. Section 1001. Moreover, the sale of one share of X stock in Year 2 creates a final inclusion date for Y. If the facts and circumstances that exist at the end of the day in Year 2 when Y sold the share of X stock had existed immediately after the
redemption, the redemption would not have been a pro rata redemption. Thus, the redemption would not have been essentially equivalent to a dividend under section 302(b)(1). See Rev. Rul. 76-385, 1976-2 C.B. 92. As a result, Y may take into account its entire $50 suspended loss in Year 2. See Prop. Treas. Reg. § 1.302-5(b)(3), (c)(1), and (f), ex. 2.

Examples 3, 4, and 5 demonstrate that the Proposed Regulations inappropriately elevate form over substance. In Example 3, the cash distribution is treated as a dividend and ordinary income to Y. Y cannot claim a loss in Year 2 for the sale of two X shares. In Example 4, Y’s proportional ownership in X does not change as a result of the redemption. Thus, section 302 characterizes the redemption as economically equivalent to the cash distribution in Example 3. As a result, Y’s tax consequences in Example 4 are identical to those of the cash distribution in Example 3. Y recognizes ordinary income with respect to the redemption. Y cannot claim a loss in Year 2 for the sale of one X share.

Under the Proposed Regulations, the tax consequences of a cash distribution and a dividend-equivalent redemption are drastically different. The economic consequences of the dividend-equivalent redemption in Example 5 are identical to those of the cash distribution in Example 3. Y’s proportional ownership in X does not change as a result of the redemption. Thus, section 302 characterizes the redemption as economically equivalent to the cash distribution in Example 3. However, Y’s tax consequences are not identical to those in Example 3. Y recognizes ordinary income with respect to the redemption; but, rather than recognizing neither gain nor loss on the sale of an X share in Year 2, Y recognizes gain and loss on the sale of an X share in Year 2. Note that, under the Proposed Regulations, Y takes into account all of its suspended loss in Year 2 as a result of selling only one share of X stock. By contrast, under the current regulations (see Example 4), Y would shift its basis in the redeemed shares to the basis of the retained shares. On the sale of one share in Year 2, Y would recognize only a portion of the loss resulting from such shifted basis. In our view, there is no apparent policy rationale for the
appropriate because both the gain and the loss flow from the form of the transaction, not its substance. This is the very consequence that Treasury and the Service intended to prevent by issuing Notice 2001-45 and the Proposed Regulations.

B. Consolidated Groups: Duplication of Income for Intragroup Redemptions

As demonstrated by Example 6, the Proposed Regulations override the single taxpayer principles underlying the taxation of consolidated groups in order to affix the location of gain or loss within the group. Thus, where only one level of tax exists under the current consolidated return rules, the Proposed Regulations create the potential for two levels of tax. The Proposed Regulations create a potential second level of tax by applying the basis adjustment rules of Treas. Reg. § 1.1502-32 to reduce only the basis in those shares that are redeemed by a group member from another group member rather than the redeemed member shareholder’s basis in all of its shares of the redeeming group member’s stock. This narrow application of the Treas. Reg. § 1.1502-32 basis adjustment rules can create deferred gain for the redeemed shareholder that is, in effect, suspended under the Proposed Regulations. Further, this deferred gain cannot be eliminated and is generally taken into account by the redeemed shareholder when it or the redeeming corporation leaves the consolidated group.

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8 The Proposed Regulations create one level of tax with respect to an ELA on the stock redeemed and a second level with respect to the underlying assets of the corporation whose stock is redeemed.

9 This deferred gain may also create immediate state tax consequences.
Example 6.

Facts. Acquiring contributes $500 to a newly formed, wholly owned subsidiary, Newco. S2 transfers all of its assets to Newco in exchange for $500 and then liquidates (distributing the $500 sale proceeds to S1).

Analysis. Under Treas. Reg. §§ 1.1502-13(f)(3) and (f)(7), ex. 3, the asset transfer and liquidation would be treated as follows: (i) Newco is treated as issuing Newco stock worth $500 to S2 in exchange for S2’s assets in a “D” reorganization; (ii) S2 is treated as distributing Newco’s stock to S1 in a liquidating distribution pursuant to section 354; and (iii) Newco is treated as redeeming its stock from S1 in exchange for a $500 cash payment.

1. Current Basis Adjustment Rules

Under the current regulations, the following basis adjustments occur as a result of the transaction described in Example 6.

- **Newco Stock.** S1’s basis in the Newco stock deemed redeemed is reduced by the amount of the distribution ($500). See Treas. Reg. § 1.1502-32(b)(2). This reduction creates a $300 “theoretical ELA” for S1. However, under Treas. Reg. § 1.302-2(c) this ELA is shifted to Acquiring’s basis in its Newco stock. As a result, Acquiring’s basis in its Newco stock is reduced by $300 (from $500 to $200). Thus, Acquiring would have a built-in gain of $300 in its Newco stock after the merger and liquidation.

- **S1 Stock.** P’s basis in its S1 stock is adjusted as follows: (i) decreased by $500 to reflect a tier-up of S1’s reduction in basis in its redeemed Newco stock (see Treas. Reg. § 1.1502-32(a)(3)(iii)); (ii) increased by $500 to reflect S1’s receipt of $500 from Newco (see Treas. Reg. § 1.1502-32(b)(2)(i)); and...
(iii) increased by $300 to take into account S₁’s ELA shifted to Acquiring (see Treas. Reg. § 1.1502-32(b)(2)).

- **Acquiring Stock.** P’s basis in its Acquiring stock is reduced by $300 to reflect the tier-up of Acquiring’s reduction to its basis in its Newco Stock. See Treas. Reg. § 1.1502-32(a)(3)(iii).

- **S₂’s Assets.** Newco’s basis in S₂’s assets is $200.

- **Gain Recognition.** Under the current regulations, no gain is recognized in the transaction. Newco succeeds to S₂’s $200 basis in its assets. Thus, the $300 built-in gain in S₂’s assets continues to exist in Newco. The adjusted bases of the P group members following the transaction are illustrated as follows.¹⁰

2. **Basis Adjustment Rules in the Proposed Regulations**

   Under the Proposed Regulations, by contrast, the following basis adjustments and income recognition would occur as a result of the transaction described in Example 6.

   - **Newco Stock.** S₁’s basis in the Newco stock deemed redeemed is reduced by the amount of the distribution ($500). This reduction creates a $300 ELA, which results in S₁’s immediate recognition of $300 of income. Prop. Treas. Reg. § 1.1502-19(b)(5)(i). Such income is not taken into account by S₁ until a final inclusion date or an accelerated income inclusion date. Prop. Treas. Reg. § 1.1502-19(b)(5)(i) & (ii). Therefore the

   ¹⁰See PLR 9815050 (April 10, 1998) (addressing similar basis adjustments in an intragroup stock redemption that involved two consolidated group member shareholders).
income is suspended. See Prop. Treas. Reg. § 1.1502-13(f)(7), ex. 3. Acquiring’s basis in its Newco stock is unchanged.\footnote{11}

- **S\(_1\)** Stock. P’s basis in its S\(_1\) stock is decreased by $500 to reflect a tier-up of S\(_1\)’s reduction in basis in its redeemed Newco stock (see Treas. Reg. § 1.1502-32(a)(3)(iii)) and increased by $500 to reflect S\(_1\)’s receipt of $500 from Newco. Treas. Reg. § 1.1502-32(b)(2). When S\(_1\) takes its suspended $300 of income into account, P’s basis in its S\(_1\) stock will increase by $300 to $600. See Treas. Reg. § 1.1502-32(a)(3)(iii).\footnote{12}

- **Acquiring Stock.** P’s basis in its Acquiring stock is unchanged.

- **S\(_2\)**’s Assets. S\(_2\)’s basis in its assets remains $200.

- **Income Recognition.** Under the Proposed Regulations, Newco succeeds to S\(_2\)’s $200 basis in its assets. Thus, the $300 built-in gain in S\(_2\)’s assets continues to exist in Newco. However, S\(_1\)’s ELA does not shift from S\(_1\) to Acquiring’s basis in its Newco stock. Instead, as described above, S\(_1\) is treated as immediately recognizing the amount of its ELA as income. S\(_1\) does not take such income into account immediately; instead, such income is suspended. Nevertheless, this suspended income cannot be eliminated. As demonstrated below, this suspended income can result in two levels of tax for the P consolidated group. The adjusted bases of the P group members following the transaction are illustrated below.

\footnote{11}{It appears that S\(_1\)’s recognition of income that is suspended generally should not result in taxable income for state tax purposes for those states that conform to the Internal Revenue Code and federal tax treatment until S\(_1\) is required to take such income into account. Such suspended income should not be reflected in S\(_1\)’s separate taxable income determined under Treas. Reg. § 1.1502-12 or the group’s consolidated taxable income determined under Treas. Reg. § 1.1502-11 until such later time. See Treas. Reg. § 1.1502-12(f). Thus, the state tax implications of S\(_1\)’s suspended income appear to be the same as the state tax implications of intercompany gain that is deferred under Treas. Reg. § 1.1502-13.}

\footnote{12}{Note that P will have a $600 basis in its S\(_1\) stock with a fair market value of $500. P may or may not be able to recognize this loss at some future time. For example, this built-in loss may be eliminated in S\(_1\) liquidates under section 332. In addition, if P recognizes this built-in loss on a disposition of its S\(_1\) stock, the loss may be subject to loss disallowance provisions. See, e.g., Temp. Treas. Reg. §§ 1.337(d)-2T and 1.1502-35T.}
3. **Post-Transaction Sale of Newco**

a. **Current Regulations**

Under the current regulations, Newco succeeds to $S_2$’s basis in $S_2$’s assets. Treas. Reg. §§ 1.1502-13(f)(3) and (f)(7), ex. 3. If, after completing the transaction described in Example 6, Acquiring were to sell Newco in an unrelated transaction and the purchaser and Acquiring elected under section 338(h)(10) to treat the transaction as a sale of Newco’s assets, Newco would be treated as recognizing $300 of gain on its deemed asset sale and then liquidating upstream into Acquiring in a tax-free section 332 liquidation. See Treas. Reg. § 1.338(h)(10)-1(d)(3) & (4).\(^{13}\)

These deemed transactions would cause the following basis adjustments. Acquiring’s basis in its Newco stock would be increased by $300 (from $200 to $500) to reflect Newco’s gain from its deemed asset sale. See Treas. Reg. § 1.1502-32(b)(2). Because Newco would be deemed to liquidate, Acquiring’s increased basis in the Newco stock itself would not matter. However, Acquiring’s momentary basis increase in its Newco stock would tier up and cause P’s basis in its Acquiring stock to be increased by $300 (from $300 to $600). See Treas. Reg. § 1.1502-32(a)(3)(iii). In total, the P consolidated group would recognize $300 of gain as the

\(^{13}\) This assumes that there was no change in value between the time of the reorganization and the sale of Newco. Acquiring would recognize no gain on the sale of the Newco stock to the unrelated purchaser. Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).
result of the sale (i.e., a single level of tax), and P’s basis in its Acquiring stock would increase by that amount.

b. **Proposed Regulations**

Under the Proposed Regulations, like the current regulations, Newco succeeds to S₂’s basis in S₂’s assets. See Prop. Treas. Reg. § 1.1502-13(f)(7) \textit{ex 3}. If, after completing the transaction described in Example 6, Acquiring were to sell Newco in an unrelated transaction and the purchaser and Acquiring elected under section 338(h)(10) to treat the transaction as a sale of Newco’s assets, two members of the P group (rather than one) would recognize and be required to take into account income. As under the current regulations, Newco would recognize $300 of gain. In addition, the sale of Newco would trigger a final inclusion date for S₁ because there would be no later date on which S₁ could take its suspended income into account. See Prop. Treas. Reg. § 1.1502-19(b)(5) (citing Prop. Treas. Reg. § 1.302-5(b)(3)). As a result, S₁ would take its $300 of suspended income into account in the year of the Newco sale. This income inclusion would, in effect, duplicate Newco’s recognized gain from Newco’s deemed asset sale.\textsuperscript{14} In total, the P consolidated group would recognize and take into account $600 of income.

Admittedly, the basis adjustment resulting from the income duplication may, at some point, result in a loss to offset this duplicated income. Acquiring’s basis in its Newco stock would be increased by $300 (from $500 to $800) to reflect a tier-up of Newco’s recognized gain. See Treas. Reg. § 1.1502-32(b)(2). P’s basis in its Acquiring stock would be increased by $300 (from $600 to $900) to reflect a tier-up of Acquiring’s increase to its basis in its Newco stock.\textsuperscript{14} If Acquiring sold Newco to an unrelated party at a loss, it appears that the P group could not elect under Treas. Reg. § 1.1502-13(f)(5) to offset S1’s suspended income (taken into account due to Acquiring’s sale of Newco to the unrelated party) with such loss. See Treas. Reg. § 1.1502-13(f)(5).
See Treas. Reg. § 1.1502-32(a)(3)(iii). After the sale of Newco, P’s basis in its Acquiring stock would be $300 higher than under the current regulations. P would increase its basis in its S₁ stock by $300 to reflect S₁’s income inclusion. Treas. Reg. § 1.1502-32(b)(2). Thus, after the sale of Newco, P’s basis in its shares of S₁ stock would be $600 although S₁ presumably has a fair market value of $300. Thus, the P group may be able to offset some of the P group’s duplicated income upon a sale of S₁ stock. But the P group may not want to dispose of any of its S₁ shares.

Moreover, under Temp. Treas. Reg. §§ 1.337(d)-2T and 1.1502-35T, the P group may not be able to recoup any of its duplicated income from the sale of Newco by selling S₁ shares. For example, under Temp. Treas. Reg. § 1.1502-35T(b), if the P group were to dispose of less than all of its S₁ shares in a single taxable year, P would be required to redetermine its basis in its S₁ shares to account for the difference between its basis in its shares of S₁ stock and the fair market value of its shares of S₁ stock. See Temp. Treas. Reg. § 1.1502-35T(b)(1)-(4) and (e), exs. 2, 3. The redetermination would increase P’s basis in its S₁ shares immediately prior to their disposition by an amount equal to the amount of loss that P would otherwise incur upon the sale of its S₁ shares thereby eliminating P’s built-in loss. In addition, if for other reasons S₁ liquidates, the built-in loss in P’s shares of S₁ stock would be eliminated, causing the income duplication to become permanent. Finally, under Temp. Treas. Reg. § 1.1502-35T, in order to be entitled to a loss from the sale of its shares of S₁ stock, P would be required to demonstrate that the loss is not a duplicate loss. To prove that the loss is not a duplicate loss, P would have to trace its losses and deductions within its group. In recent discussions, the Service has stated that if P cannot trace its losses and deductions to document that its S₁ stock loss is not duplicative,

The income duplication caused by the Proposed Regulations is clearly inconsistent with the most basic principle of recent consolidated regulations that a consolidated group should be treated as a single entity for purposes of determining amounts of taxable income. See Treas. Reg. § 1.1502-13(a)(1) (stating “[t]he purpose of this section is to provide rules to clearly reflect the taxable income . . . of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income. . .”); Treas. Reg. § 1.1502-32(a)(1) (stating “[t]he purpose of the adjustments is to treat P and S as a single entity so that consolidated taxable income reflects the group’s income”). In addition, the adoption of rules creating such double taxation is unwarranted in this case. Preventing basis transfers resulting from dividend-equivalent redemptions is likely warranted where one of the “related parties” in a transaction is not subject to (or is indifferent to) U.S. federal income taxation (e.g., the types of transactions described in Notice 2001-45). However, preventing basis transfers is unnecessary in other cases, particularly for transactions between members of a consolidated group, which is treated as a single taxpayer and for which existing basis adjustment mechanisms already exist to prevent the avoidance of tax.

IV. **EXISTING AUTHORITIES THAT ADDRESS ABUSIVE BASIS SHIFTING TRANSACTIONS**

The government’s proposed abandonment of basis adjustments in dividend-equivalent redemptions represents a significant and unwarranted departure from existing rules. As previously described, the policy decision to treat a dividend-equivalent redemption differently than a dividend causes similarly situated taxpayers (in this case shareholders receiving dividend-type distributions) to be treated differently depending on the form of the distribution. In our
view this differing treatment is inappropriate and not justified by the abuse the government is seeking to address. In addition, such differing treatment creates new planning opportunities that may result in more abusive transactions.\(^{15}\)

We recognize, as the preamble to the Proposed Regulations illustrates, that some taxpayers have engaged in dividend-equivalent redemption transactions that have purportedly resulted in inappropriate, artificial tax benefits to the participants. However, as the government has itself asserted in the preamble to the Proposed Regulations,\(^{16}\) Notice 2001-45,\(^{17}\) and other releases,\(^{18}\) there are existing authorities that should prevent participants from enjoying the tax benefits sought in such abusive transactions.

A brief description of some of the existing authorities that address such abusive transactions is provided in this part of the Comments.

A. \textit{“Proper Adjustment” under Treas. Reg. § 1.302-2(c)}

The existing regulations that would be replaced by the Proposed Regulations already provide the Service with ample authority to prevent taxpayers from using dividend-equivalent redemptions to obtain inappropriate tax benefits. In fact, Treas. Reg. § 1.302-2(c) is arguably

\(^{15}\) We note that the concept of basis shifting also continues to be endorsed by the government in other areas of tax law. For example, the government recently proposed a new regime endorsing wide ranging basis shifting adjustments among members in a consolidated group. \textit{See} Prop. Treas. Reg. § 1.1502-35. REG-131478-02, 2002-47 I.R.B. 892.

\(^{16}\) The preamble to the Proposed Regulations states that “…the IRS intends to challenge the [basis shifting] adjustments claimed in such [abusive] transactions….”

\(^{17}\) In the context of describing the identified abusive transaction, the Service stated that it “…intends to disallow losses claimed (or to increase taxable income or gains) in the transactions described in this Notice to the extent a taxpayer derives a tax benefit that is attributable to stock basis purportedly shifted from the redeemed shares.” Notice 2001-45, 2001-2 C.B. 129 at 5.

\(^{18}\) \textit{See, e.g.,} F.S.A.s 200218004 (January 11, 2002); 200202057 (October 11, 2001); 200201012 (October 1, 2001); 200009003 (October 20, 1999); and 1998-1042 (September 25, 1992).
more effective than the Proposed Regulations as a weapon against abusive basis shifting transactions because it applies a fact-driven, flexible inquiry into the purposes underlying a basis shifting dividend-equivalent redemption rather than a bright-line rule that prohibits basis shifts in all dividend-equivalent redemptions. Unlike the bright-line rule of the Proposed Regulations, the fact-driven, flexible inquiry of Treas. Reg. § 1.302-2(c) cannot easily be manipulated by taxpayers seeking to obtain inappropriate tax benefits based solely on the form of a transaction.\footnote{As discussed in Part V of these Comments, we recommend that no basis adjustments be allowed under Treas. Reg. § 1.302-2(c) for dividend-equivalent, complete redemptions of “tax-indifferent persons”.}

Treas. Reg. § 1.302-2(c) provides that “[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, \textit{proper adjustment} of the basis of the remaining stock will be made with respect to the stock redeemed.” Treas. Reg. § 1.302-2(c) \footnote{This basis shifting transaction is illustrated and discussed further in Part II(D)(1), Example 2 of the Comments.} (emphasis added). The government has already taken the position and put taxpayers on notice that a basis shift is not “proper,” for purposes of Treas. Reg. § 1.302-2(c), in every case in which the redeemed shareholder retains no stock in the redeeming corporation. See, e.g., Notice 2001-45 (where the Service announced that it would disallow any purported tax benefits from a basis shifting tax shelter that essentially involves a complete redemption of the stock of a shareholder that is not subject or indifferent to U.S. tax and a shifting of the tax basis of the redeemed stock to a U.S. taxpayer because of the attribution of ownership rules of section 318).\footnote{This basis shifting transaction is illustrated and discussed further in Part II(D)(1), Example 2 of the Comments.}

The inquiry that Treas. Reg. § 1.302-2(c) requires into the underlying facts of a transaction to determine whether a basis shift is proper provides the government with a powerful tool against abusive basis shifting transactions. As demonstrated in Examples 3 and 4 of these Comments, all basis shifts arising out of dividend-equivalent redemptions are not improper.
Example 4, the basis shift caused by Treas. Reg. § 1.302-2(c) ensures that the economic and tax consequences of the dividend-equivalent redemption in Example 4 and the dividend in Example 3 are identical. Thus, shifting the basis from the shareholder’s redeemed shares to the shareholder’s remaining shares in Example 4 is certainly a “proper” adjustment. The basis shift treats the redeeming shareholder as such shareholder would have been treated in an actual dividend distribution consistent with the intent of section 302.

However, basis shifts arising from a dividend-equivalent redemption may not be “proper” for purposes of Treas. Reg. § 1.302-2(c) where the redeemed shareholder is not subject to (or is indifferent to) U.S. taxation. It is appropriate for the Service to evaluate the facts underlying these types of dividend-equivalent redemptions. If a basis shift results from such a transaction, and the principal purposes of such transaction are to generate capital losses and avoid the inclusion of dividend income, such a basis shift could be considered not to be “proper” because the transaction would not mirror the tax effects that would have been created had the transaction merely involved the distribution of a dividend. Therefore, any basis shifts arising in such a transaction correctly could be disallowed under Treas. Reg. § 1.302-2(c).  

Example 7, below, illustrates and analyzes the application of the “proper adjustment” rule to a dividend-equivalent redemption where the redeemed shareholder is not subject to (or is indifferent to) U.S. taxation.

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21 In those rare instances where a purportedly abusive basis shift created by an intragroup stock transfer in an affiliated (but not consolidated) group withstands the “proper adjustment” inquiry of Treas. Reg. § 1.302-2(c), section 304(b)(4) may be relied on to prevent taxpayers from artificially increasing or shifting basis within the affiliated group. See F.S.A. 1998-1042 (September 25, 1992).
Example 7. Basis Shift From a Foreign Corporation to a U.S. Resident Individual

Facts. A and B are the sole shareholders of Corporation Y, which is not a domestic corporation. A is a corporation organized and resident in Country C, which does not have an income tax treaty with the United States. A does not have a U.S. trade or business. B is a U.S. resident individual. A holds an option to acquire the Y stock held by B. Y redeems all of the Y stock held by A. The section 318 constructive ownership rules cause the redemption to be treated as a dividend-equivalent redemption to the extent of Y’s earnings and profits. The principal purposes of the transaction are to generate capital losses and avoid the inclusion of dividend income. B takes the position, under Treas. Reg. § 1.302-2(c), that A’s basis in the redeemed Y stock is properly added to the basis of the Y stock held by B.

Analysis. A pays no federal income tax with respect to the dividend-equivalent redemption because the redemption is a transaction between a foreign shareholder and a foreign corporation. B would be subject to U.S. Federal income taxation on a dividend-equivalent redemption. The transfer of A’s basis in the redeemed Y stock to the basis of the Y stock held by B is not proper.

Granted, Treas. Reg. § 1.302-2(c) does not provide the certainty to taxpayers that is provided by the Proposed Regulations. However, unlike the Proposed Regulations, Treas. Reg. § 1.302-2(c) does not elevate form over substance and create the distortions and potential abuses described in Example 5 of these Comments. Therefore, Treas. Reg. § 1.302-2(c) is a superior alternative to the Proposed Regulations.

B. Step Transaction Doctrine

In the past, courts and the Service have applied the step transaction doctrine to re-cast purported dividend-equivalent redemptions as sales or exchanges or stock. See, e.g., Zenz v. Quinlivan, supra; Merrill Lynch & Co. & Subsidiaries v. Commissioner, 120 T.C. 12 (2003); Rev. Rul. 55-745, 1955-2 C.B. 223; Rev. Rul. 75-447, 1975-2 C.B. 113. These cases and rulings have found that a purported dividend-equivalent redemption is properly recharacterized as a sale or exchange of stock if the redemption is part of an overall plan by the shareholder to dispose of
his or her interest in the corporation (the “fixed-plan rule”). We are unaware of any adverse
decision that would prevent courts and the Service from applying the fixed-plan rule to prevent
taxpayers from using abusive dividend-equivalent redemptions to shift basis in inappropriate
ways (i.e., the transactions described in Examples 1 and 2, above, where the redeemed
shareholder is not subject to (or is indifferent to) U.S. taxation).

The fixed-plan rule is based on the principles of the step transaction doctrine. It is a basic
principle of tax law that substance should prevail over form. The step transaction doctrine is one
of several tools created and used by the courts to implement the goal that the tax consequences
should flow from its substance rather than its form. The doctrine is intended to insure that “a
given result at the end of a straight path is not made a different result because reached by
following a devious path.” Minnesota Tea v. Helvering, 302 U.S. 609, 613 (1938). In general,
under the step-transaction doctrine, a series of formally separate steps are treated as a single
transaction “if such steps are in substance integrated, interdependent, and focused toward a
Commissioner, 57 T.C.M. 1231 (1989).22

The step transaction doctrine has been applied on more than one occasion by the
government to determine the appropriate tax treatment of stock redemptions. For example, in the
lending case of Zenz v. Quinlivan, a sole shareholder disposed of all of her interest in a two-step
transaction.23 First, the shareholder sold part of her shares to a competitor. Second, shortly after
the sale, the corporation redeemed the shareholder’s remaining shares. The redeemed

22 See generally B. Bittker and J. Eustice, Federal Income Taxation of Corporations and
Shareholders, 14-131 (6th Ed. 1994); Mintz and Plumb, “Step Transactions in Corporate

23 See Zenz v. Quinlivan, supra.
shareholder took the position on her tax return that the payment by the corporation for all of her remaining shares constituted a complete cancellation or redemption of her interests, rather than a taxable distribution. The government argued that the redemption was essentially equivalent to a dividend and should not escape dividend treatment solely because the taxpayer had cleverly ordered the sequence of the steps in the overall transaction. The Sixth Circuit rejected the government's contention and held that the redemption was not essentially equivalent to a dividend under section 302(b); accordingly, the former shareholder was entitled to exchange treatment on the redemption. The Zenz Court reasoned that, when determining whether a particular transaction satisfies the “essentially equivalent to a dividend” test of section 302(b), the sequence of a transaction’s events is disregarded as long as the events are clearly part of the same overall plan.

Similar rules have been applied to a cross-chain stock sale between members of a consolidated group, which was undertaken in anticipation of selling a consolidated group member to an unrelated third party. See Merrill Lynch & Co., Inc. & Subsidiaries v. Commissioner, 120 T.C. 12 (2003). In that case, Merrill Lynch & Company, Inc. (“Merrill”) was the parent of a consolidated group. Merlease Leasing Corp. (“Merlease”), Merrill Lynch Leasing, Inc. (“Leasing”) and Merrill Lynch Asset Management, Inc. (“Asset Management”) were subsidiaries of Merrill and members of Merrill’s consolidated group. Leasing owned all of the stock of Merlease. In 1986, Leasing sold its Merlease stock to Asset Management in a cross-chain stock sale. Merrill took the position that Leasing’s cross-chain stock sale was properly characterized as a dividend under the rules of section 304(a)(1). Section 304(a) required a cross-chain stock sale to be treated as a redemption of stock subject to the rules of sections 302 and
301. As a result, Merrill took the position that the cross-chain stock sale should be evaluated under section 302 immediately after the completion of the sale. Immediately after the completion of the sale, Leasing constructively owned, under section 318, a number of Merlease shares that prevented the cross-chain stock sale from qualifying as a sale or exchange under section 302(b). Therefore, Merrill concluded that the cross-chain stock sale resulted in a dividend to Leasing.

Under the consolidated return regulations in effect at the time, the dividend arising from the cross-chain stock sale increased the earnings and profits of Leasing. As a result of this increase in Leasing’s earnings and profits, Leasing’s shareholder (also a member of the Merrill consolidated group) increased its basis in its Leasing shares prior to an anticipated sale of Leasing to an unrelated third party. Treas. Reg. § 1.1502-33; Treas. Reg. § 1.1502-32. Thus, when the Merrill consolidated group sold Leasing to the unrelated third party, the seller was able to recognize a loss on the sale.

The Service denied the loss arising from the sale of Leasing. The Service agreed that the cross-chain stock sale should be treated as a redemption under section 304(a). However, the Service, relying heavily on the Zenz decision,25 contended that the redemption created by the cross-chain stock sale must be combined with the subsequent sale of Leasing to a non-member when determining if the redemption was a sale or exchange or a dividend under section 302. According to the Service, the cross-chain stock sale and the subsequent sale of Leasing to a non-member were steps of a fixed, firm plan undertaken to dispose of Leasing to a non-member. Thus, the cross-chain stock sale could only be evaluated under section 302 in conjunction with

24 Merrill actually took this position with respect to nine cross-chain sales. See Merrill Lynch, 120 T.C. at 14.

25 See Zenz v. Quinlivan, supra.
the sale of Leasing to the non-member. When the cross-chain stock sale’s status under section 302(b) was evaluated in this manner, the deemed redemption arising from the cross-chain stock sale was a sale or exchange under section 302(b)(3) because the cross-chain stock sale and subsequent sale of Leasing resulted in the complete termination of Leasing’s actual and constructive ownership interest in Merlease.

The Tax Court agreed with the Service. Judge Marvel noted that a “firm and fixed plan does not exist for purposes of section 302 when there is only a ‘vague anticipation’ that a particular step in an alleged plan will occur.” Id. at 56. However, Judge Marvel believed that, in Merrill’s case, “the facts establish the existence of much more than a vague anticipation that the sale of Leasing would occur.” Id. Judge Marvel noted:

The principal, and most compelling, evidence on which we rely is the formal presentation of the plan to Merrill Parent's board of directors, which took place on July 28, 1986, only 4 days after the cross-chain sale of [stock]. The formal presentation included the distribution of a written summary and slides illustrating the details of the plan to dispose of petitioner's proprietary lease business culminating in the sale of [Leasing]. The written summary laid out each step of the plan. Among the steps identified were (1) the cross-chain sale of [stock], which the summary acknowledged had already occurred ... and (3) the imminent sale of [Leasing] to [an unrelated third party]. The written summary described the tax benefits of the plan, which were predicated on an increase in ... basis in [Leasing] under the consolidated return regulations for the proceeds of the cross-chain sale. The written summary confirmed that the plan included the sale of [Leasing] and unequivocally identified [unrelated third party] as the purchaser.

Id. at 54. In light of these facts, according to the court, “a firm and fixed plan to dispose of Leasing existed on the date of the cross-chain sale.” Id. at 56. Therefore, for purposes of determining if the cross-chain sale should be treated as a dividend or a sale or exchange, the Tax Court held that the cross-chain stock sale and the subsequent sale of Leasing to a non-member must be considered a single transaction. As a single transaction, the cross-chain stock sale and
sale of Leasing constituted a complete termination of Leasing’s interest in Merlease, and, therefore, a sale or exchange under section 302 that did not increase the selling group member’s basis in its Leasing shares.

Like the redemptions described in Zenz v. Quinlivan and Merrill Lynch & Co. & Subsidiaries v. Commissioner, dividend-equivalent redemptions involving persons not subject to (or indifferent to) U.S. taxation may be subject to challenge under the fixed-plan rule. Such transactions, of course, must be evaluated on a case-by-case basis to determine if steps should be combined. If it is determined that a dividend-equivalent redemption involving a person not subject to (or indifferent to) U.S. taxation results in inappropriate tax benefits to a taxpayer, it is also likely that the redemption transaction involves a coordinated redemption and sale of shares sufficient to constitute a fixed plan to terminate the redeemed shareholder’s interest in the corporation. Therefore, the fixed-plan rule of Zenz v. Quinlivan, which has its genesis in the step transaction doctrine and has been used by the courts and the Service on many occasions, should be an effective weapon against inappropriate and abusive basis shifting transactions.  

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26 See also, e.g., McDonald v. Commissioner, 52 T.C. 82, 87 (1969) (where the Tax Court used the step transaction doctrine to determine whether a redemption is essentially equivalent to a dividend under section 302(b)(1)); Rev. Rul. 55-745, 1955-2 C.B. 223 (where the government concluded that, when an overall transaction results in a complete termination of a shareholder’s interests in the corporation as required to satisfy the redemption test of section 302(b)(3), the amount the shareholder receives from the corporation is properly treated as a payment for stock); Rev. Rul. 75-447, 1975-2 C.B. 113 (where the government specified that when (1) there is a plan calling for a stock redemption, (2) the plan is accompanied either by an issuance of new stock or by a shareholder’s sale of stock, and (3) these events are clearly part of an overall plan to reduce a shareholder’s interest, then the Service will disregard the sequence of events and examine only the overall result in determining whether a distribution is "substantially disproportionate."); F.S.A. 1998-1042 (September 25, 1992) (where the government citing Zenz concluded that a member’s basis of stock sold in an intragroup transaction could not be added to the basis of its remaining stock, which was later sold to an unrelated corporation. In reaching its determination, the government treated the intragroup sale and the subsequent third-party sale as one integrated transaction.).
In Examples 1 and 2, above, if the redemptions and subsequent sales of stock by the non-redeemed shareholders were viewed as parts of overall plans, the redemptions of the tax-indifferent shareholders’ stock would be treated as sales or exchanges rather than as redemptions. In either Example 1 or 2 above, after the sale of the non-redeemed shareholder’s stock, neither the tax-indifferent shareholder nor the non-redeemed shareholder would own any stock in the redeeming corporation. As a result, the redemption would qualify as a sale or exchange under section 302(b)(3). If the redemption of the tax-indifferent shareholder’s stock was treated as a sale or exchange, no basis shift from the redeemed shareholder to the non-redeemed shareholder could occur under the rules of Treas. Reg. § 1.302-2(c). Therefore, when the non-redeemed shareholder sold its stock, it could not utilize the tax-indifferent shareholder’s basis in its redeemed shares to create a capital loss.27

C. General Anti-Tax Avoidance Rules

The types of dividend-equivalent redemptions most likely to result in inappropriate tax benefits to taxpayers generally involve economically unrelated parties that are deemed to be related, for tax purposes, through the use of options and similar instruments. The redeemed shareholders in the transactions are persons not subject to (or indifferent to) U.S. taxation and receive no material return on their investment in the stock of the redeeming corporations (except, possibly, an accommodation fee). The government has a number of tools that it can apply against such transactions on a case-by-case basis.

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27 The government may also be able to utilize the fast-pay regulations to recharacterize abusive dividend-equivalent redemption transactions as transactions between shareholders. See Treas. Reg. § 1.7701(l)-3. However, it is not clear that applying the fast-pay regulations to abusive dividend-equivalent redemptions is either practical or appropriate.
1. **Business Purpose and the Sham Transaction Doctrine**

The government can apply the sham transaction doctrine to prevent taxpayers from utilizing dividend-equivalent redemptions to shift basis in inappropriate transactions (i.e., the transactions described in Examples 1 and 2 above). The sham transaction doctrine permits a transaction to be disregarded when it is determined that the transaction’s only significant economic effect is the creation of tax benefits. See, e.g., *Knetsch v. U.S.*, 364 U.S. 361 (1960). Courts have generally looked at two factors when making this determination: (1) the objective indications of the transaction’s non-tax economic substance (e.g., whether the transaction provides the taxpayer a reasonable possibility of profit) and (2) the taxpayer’s non-tax business purpose motivation for consummating the transaction.28

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28 See, e.g., *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998); *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184 (1983), aff'd in relevant part, 752 F.2d 89 (4th Cir. 1985); *ACM Partnership v. Commissioner*, 157 F.3d 231 at 247 (3rd. Cir. 1998). F.S.A 200233016 (May 9, 2002) (A valid business purpose requirement is incorporated into an economic substance analysis. The economic substance analysis examines (1) the subjective business purpose and (2) the objective profit potential of a transaction.).

The courts of appeal have taken varying positions regarding the relative importance of these two factors in determining whether a transaction lacks such economic substance. Compare *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992) (holding that the economic substance of a transaction can be established if the transaction at issue had objective economic substance or if there was a subjective non-tax business purpose (the “disjunctive test” adopted by the Second, Fourth, D.C., and Federal Circuits)) with *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988) (holding that the economic substance of a transaction can be established if the transaction at issue had objective economic substance and if there was a subjective non-tax business purpose (the “conjunctive test” adopted by the First, Seventh, Eighth, and Eleventh Circuits)). The Third, Fifth, Sixth, Ninth, and Tenth Circuits, have adopted a hybrid test. See, e.g., *Internal Revenue Service v. C.M. Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002) (citing *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998)).

Similarly, courts have disallowed tax losses that did not correspond to economic losses. While section 165(a) provides a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise, Treas. Reg. § 1.165-1(b) dictates that only a bona fide loss is deductible, and that the substance and not mere form of a purported loss transaction must be examined when evaluating whether a loss may be deducted. The Third Circuit in *ACM*
The government has already concluded that the sham transaction doctrine applies to certain dividend-equivalent redemptions. As noted by the government, there are generally no non-tax business purposes or economic benefits for an abusive basis shifting transaction other than tax reduction. As a result, if such a basis shifting transaction was disregarded under the sham transaction doctrine, this would have the effect of denying the transaction participants the benefit sought by using the dividend-equivalent redemption characterization.

Like the rules of Treas. Reg. § 1.302-2(c) and the step transaction doctrine, the sham transaction doctrine provides a better method for addressing inappropriate basis shifts than the Proposed Regulations. The sham transaction doctrine provides fact-based, flexible rules that generally will deny the application of the basis shifting rules of Treas. Reg. § 1.302-2(c) only for abusive dividend-equivalent redemptions arising from tax-motivated transactions. In addition, the sham transaction doctrine will not provide taxpayers with new basis shifting rules that can be manipulated in new, abusive ways by taxpayers (see Example 5, above).

Partnership v. Commissioner, supra, discusses the need for tax losses to correspond to economic losses in order for them to be “bona fide” and thus deductible under the Internal Revenue Code and regulations. See F.S.A. 200202057 (October 11, 2001) (where the government noted that even if the basis adjustment could survive attack, the losses generated by the taxpayer’s using a foreign corporation to achieve a basis shift would not be bona-fide under section 165). See also Smith v. Commissioner, 78 T.C. 350 (1982) and Fox v. Commissioner, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions).

29 For example, in abusive basis shifting transactions that involve the affirmative use of the section 318 attribution rules, the government has asserted that there is no attribution of stock ownership from a U.S. taxpayer to a tax-advantaged taxpayer or basis shift because steps taken to achieve these results are transitory and serve no purpose other than tax avoidance. See Notice 2001-45, supra.

30 Id.
2. **Section 269**

In certain instances, the government could apply section 269 to disallow the tax benefits claimed in abusive basis shifting dividend-equivalent redemptions. Section 269(a)(1) allows the Service to disallow a deduction, credit, or other allowance where a person(s), directly or indirectly, acquires control (at least 50 percent of the vote or value) of a corporation and the principal purpose for the acquisition was the avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance.\(^{31}\) In transactions where a taxpayer forms or gains control of a corporation with the principal purpose of avoiding or evading taxation through a basis shifting transaction, the purported tax benefit (i.e., the stock loss) arising from the subsequent dividend-equivalent transaction may be disallowed under section 269.\(^{32}\)

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\(^{31}\) As the Joint Committee on Taxation has noted, section 269 has a “limited reach as it applies to acquisitions of corporate equity interests for the principal purpose of obtaining tax benefits.” See Joint Committee on Taxation, 108th Cong., “Report on the Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, And Policy Recommendations,” JCS-3-03, Vol. 1 at 163, (Comm. Print 2003). However, the relationships created between the shareholders to facilitate the basis shifts in abusive basis shifting dividend-equivalent redemptions could cause taxpayers to acquire control of the corporation for the principal purpose of obtaining tax benefits if section 269 were amended to explicitly apply the rules of section 318 for purposes of determining if a shareholder has acquired control of a corporation.

\(^{32}\) In two recent field service advices, the Service suggested that section 269 may be used to disallow losses generated from dividend-equivalent redemptions involving “related parties” that were not subject to (or indifferent to) U.S. taxation. See F.S.A. 200202057, supra, and F.S.A. 200201012, supra. In each F.S.A., the transaction at issue involved the following facts. Individual A purchased a warrant for shares of a foreign corporation, FC. If A had exercised the warrants, he would have owned more than 50% of the outstanding voting power of FC. A also purchased shares in a foreign bank, FB. At the same time, FC purchased shares in FB and sold FB a call on such FB shares. FC purchased a put on the FB shares, which when combined with the call, created a collar on the FB shares. When FB exercised its call rights on the FB shares owned by FC, A purchased options to acquire FB shares. A then treated the exercise of FB’s call right as a dividend-equivalent redemption of FB shares from FC. As a result, FC’s basis in its redeemed FB shares was allocated to A’s FB shares and to A’s option to acquire FB shares. A then sold his FB shares and options to acquire FB shares, surrendered his warrant to purchase FC shares, and claimed a loss on all three transactions. A then used the loss to offset gains subject to U.S. federal income tax.
The Service suggested that the loss claimed by A might be denied under section 269. According to the Service’s analysis, A, by virtue of his stock and warrant ownership, had acquired control over FC sufficient to trigger the application of section 269. In addition, based on the documents provided to the Service, A had acquired control over FC for the principal purpose of avoiding or evading Federal income tax. The Service noted that A had “not shown any... valid and substantiated purpose for engaging in the transaction other than for the avoidance or evasion of Federal income tax.” In addition, the Service noted that “the transaction and the various steps of the transaction had no economic substance and had relatively insignificant economic consequences.” As a result, the Service believed that “the loss resulting from the sale of FB stock and options should be disallowed under section 269.”
V. SUGGESTED APPROACH: PROHIBIT BASIS SHIFTING FROM TAX-INDIFFERENT PERSONS

As described above, we believe that the existing basis shift rule provided in Treas. Reg. § 1.302-2(c) produces reasonable results in most dividend-equivalent redemptions. Moreover, in our view, existing regulations and doctrines already provide the government with ample authority to prevent taxpayers from engaging in abusive basis shifting transactions that rely on dividend-equivalent redemptions (i.e., the transactions described in Examples 1 and 2 above).

However, if Treasury and the Service believe that additional authority is needed to prevent taxpayers from entering into the types of dividend-equivalent redemption transactions described in Examples 1 and 2 above, a narrow anti-avoidance rule could be adopted as an amendment to Treas. Reg. § 1.302-2(c). This rule would proscribe basis shifts in dividend-equivalent redemptions where, as a result of the complete redemption of shares owned by a tax-indifferent person (a “TIP”), basis would otherwise be shifted from stock owned by such TIP to stock owned by a person who is not a TIP. For purposes of this anti-avoidance rule, we would define TIPs to include (i) any tax-exempt entity and (ii) any person not subject to U.S. Federal income taxation on such a dividend-equivalent redemption at a rate at least equal to the tax rate generally applicable to dividends received by such person from a domestic corporation.

In the case of a partial redemption of a TIP’s shares, basis would be shifted to other shares of the redeeming corporation owned by the TIP. Thus, we would not apply the anti-avoidance rule proposed above. In the case of a complete redemption of a TIP’s shares where the basis would be shifted to shares held by a different TIP, we also would not apply the anti-

33 For this purpose, members of a consolidated group would be treated as a single shareholder. Thus, if the redeemed shareholder were a member of a consolidated group and another group member owned stock in the redeeming corporation, the rule proposed in this section V would not apply.
avoidance rule proposed above because we do not believe that such a redemption tends to result in U.S. Federal income tax avoidance. Where, however, there is a complete redemption of a TIP’s shares and the basis in the TIP’s redeemed shares would shift to a person who is not a TIP, the anti-avoidance rule would apply to prevent such a basis shift. This would target the transactions most likely to result in tax avoidance.

The application of the anti-avoidance rule is illustrated and analyzed in the following Examples.

**Example 8. Basis Shift From a Tax-Exempt Entity To a Domestic Corporation**

**Facts.** A and B are the sole shareholders of Corporation Y. A is an organization exempt from tax under section 501. B and Y are domestic corporations. A holds an option to acquire the Y stock held by B. Y redeems all of the Y stock held by A. The section 318 constructive ownership rules cause the redemption to be treated as a dividend-equivalent redemption to the extent of Y’s earnings and profits. However, A pays no federal income tax with respect to the dividend because the dividend is not unrelated business taxable income subject to tax under section 511. B takes the position, under Treas. Reg. § 1.302-2(c), that A’s basis in the redeemed stock is properly added to the basis of the Y stock held by B.

**Analysis.** A is a tax-exempt entity and therefore a TIP. B is not a TIP because (i) it is not a tax-exempt entity and (ii) it would be subject to U.S. Federal income taxation on a dividend-equivalent redemption at a rate equal to the tax rate under section 11 generally applicable to dividends received by B from a domestic corporation. Thus, the anti-avoidance rule described above would apply to prevent A’s basis in its Y stock from being transferred to the Y stock held by B.

**Example 9. Basis Shift From a Foreign Corporation to a U.S. Resident Individual**

**Facts.** A and B are the sole shareholders of Corporation Y, which is not a domestic corporation. A is a corporation organized and resident in Country C, which does not have an income tax treaty with the United States. A does not have a U.S. trade or business. B is a U.S. resident individual. A holds an option to acquire the Y
stock held by B. Y redeems all of the Y stock held by A. The section 318 constructive ownership rules cause the redemption to be treated as a dividend-equivalent redemption to the extent of Y’s earnings and profits. B takes the position, under Treas. Reg. § 1.302-2(c), that A’s basis in the redeemed Y stock is properly added to the basis of the Y stock held by B.

**Analysis.** A pays no federal income tax with respect to the dividend-equivalent redemption because the redemption is a transaction between a foreign shareholder and a foreign corporation. A generally would be subject to taxation on a dividend from a domestic corporation at a rate of 30%. See Sections 861(a)(1) and 881(a). Thus, A is a TIP. B is not a TIP because (i) B is not a tax-exempt entity and (ii) B would be subject to U.S. Federal income taxation on a dividend-equivalent redemption at a rate equal to the tax rate under section 1(h)(1) generally applicable to dividends received by B from a domestic corporation. Thus, the anti-avoidance rule described above would apply to prevent A’s basis in its Y stock from being transferred to the Y stock held by B.

**Example 10. Basis Shift From a Domestic Corporation to a U.S. Resident Individual**

**Facts.** A and B are the sole shareholders of Corporation Y, which is a domestic corporation. A is a domestic corporation. B is a U.S. resident individual. A holds an option to acquire the Y stock held by B. Y redeems all of the Y stock held by A. The section 318 constructive ownership rules cause the redemption to be treated as a dividend-equivalent redemption to the extent of Y’s earnings and profits. A has dividend income of $100 and a dividends received deduction of $80 (80% of $100). See Sections 301, 316, and 243. B takes the position, under Treas. Reg. § 1.302-2(c), that A’s basis in the redeemed stock is properly added to the basis of the Y stock held by B.

**Analysis.** A is not a TIP because A is (i) not a tax-exempt entity and (ii) subject to tax on the dividend-equivalent redemption at the rate generally applicable to dividends received by A from a domestic corporation under section 11. The fact that A receives a dividends received deduction is irrelevant for purposes of determining if A is a TIP. Thus, the anti-avoidance rule described above would not apply to prevent A’s basis in its Y stock from being transferred to the Y stock held by B. As noted above, however, the government has other tools to address this transaction.
In lieu of (or perhaps in addition to) the anti-avoidance rule described above, Example 7, set forth above to illustrate an “improper” basis shift under Treas. Reg. § 1.302-2(c), could be adopted as an amendment to Treas. Reg. § 1.302-2(c). Adding such an example could clarify that basis shifts are not “proper” in transactions where, as a result of the complete redemption of shares owned by a person not subject to (or indifferent to) U.S. taxation, basis otherwise would be shifted from stock owned by such person to stock owned by a person subject to (or not indifferent to) U.S. taxation.

As illustrated above, the anti-avoidance rule and Example 7 are intended to proscribe basis shifts in dividend-equivalent redemptions only in cases where basis would be shifted from a shareholder that is a “tax-indifferent person” to a shareholder that is not a “tax-indifferent person.” This is because, in our view, such transactions present the typical fact pattern for abusive basis shifting transactions involving dividend-equivalent redemptions. In general, however, we believe that existing rules and judicial doctrines provide the government with sufficient authority to address transactions it deems abusive. In the end, we believe that the use of such existing authorities, possibly supplemented by the anti-avoidance rule or Example 7 set out above, are preferable to the sweeping changes contained in the Proposed Regulations. For the reasons discussed above, we urge that the Proposed Regulations be withdrawn.