INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-169386-02/CC:CORP:B3

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Company =

Individual =

Holding =

Sub =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Month 1 =

Month 2 =

Month 3 =

Month 4 =

Month 5 =

Date 1 =

Date 2 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

ISSUE:

Whether the distribution of \$ h which takes the form of a § 305(b)(1) dividend and is followed by a recapitalization at a later date should be taxed as a dividend or as capital gain.

CONCLUSION:

The distribution of \$ h is taxable as a dividend because even if the step transaction doctrine applies to treat the distribution and recapitalization as occurring simultaneously,
§ 1.301-1(l) of the Income Tax Regulations applies to treat the distribution as a separate transaction.

FACTS:

The information submitted indicates that Taxpayer is the common parent of a consolidated group. During Year 1 and Year 2, Taxpayer acquired a% of the common stock of Company, a corporation.[1] The remaining b% was owned by an unrelated individual (Individual).

Between Year 1 and Year 3, the relationship between Taxpayer and Individual deteriorated and was contentious. Among the disagreements between the parties was that Taxpayer wanted Company to make annual dividend distributions of a significant portion of its current earnings, while Individual preferred that Company retain any excess cash for expansion and growth. From Year 2 on there were numerous discussions regarding a sale of Taxpayer's interest in Company, Taxpayer's purchase of Individual's interest, or a sale of both interests to a third party. However, the parties could not come to terms.

In early Month 1 of Year 3, Individual proposed two alternatives for purchasing Taxpayer's Company stock. First, Individual proposed to purchase the stock for \$ c pursuant to which Taxpayer would receive net after tax proceeds of \$ d. Second, Individual proposed that Company distribute to Taxpayer a dividend of \$ e and Individual purchase Taxpayer's stock for \$ f. Under the second proposal, Taxpayer would receive net after-tax proceeds of \$ d for its stock and Individual would indemnify Taxpayer for any tax resulting from the characterization of the dividend as proceeds from the sale by Taxpayer of its stock.

[1] Taxpayer subsequently transferred the stock of Company to Sub, a wholly owned subsidiary of Taxpayer and a member of the consolidated group, in a nonrecognition transaction. After that transfer, however, Taxpayer continued to represent Sub in all matters relating to Sub's ownership of the Company common stock. In this memorandum, for purposes of simplicity, Taxpayer will be treated as the owner of the Company common stock owned by Sub.

Negotiations ensued in which variations on the above proposals were discussed, including converting Taxpayer's common stock into preferred stock after a distribution. Taxpayer and Individual finally agreed that Company would declare a dividend in the total amount of $ g that was payable, at the election of the shareholders, either in cash or additional shares of Company common stock. Up until the moment at which each shareholder made its election, each was free to receive its share of the dividend in cash or stock.

On Month 2, Date 1, Year 3, Individual contributed his common stock in Company to a wholly owned corporation (Holding). Four days later, Company declared a pro rata dividend in the amount of $ g that was payable, at the election of its shareholders, in either cash or additional common stock of Company. The following day, Taxpayer elected to receive its share of the dividend in cash which amounted to $ h, and on the next day, Holding elected to receive its share of the dividend in additional shares of Company common stock. Because Holding received additional shares of Company common stock and Taxpayer did not, Holding's percentage of outstanding stock of Company went up to i% while Taxpayer's decreased to j%.

Taxpayer reported the cash received in the amount of $ h as a dividend received from a 20%-owned corporation taxable under § 301(c)(1). Taxpayer takes the position that the cash received in the amount of $ h is a distribution under § 305(b)(1), thus treated as a distribution under § 301. Taxpayer therefore claimed an 80% dividends received deduction (DRD) under § 243(c) (permitting such deductions in the case of dividends received from a 20% or more owned corporation) in the amount of $ k on Taxpayer's Year 3 consolidated Federal income tax return.[2] It is assumed that Company had earnings and profits in excess of $ g.

In connection with the purported dividend and other agreements entered into in late Month 2, Year 3, Taxpayer and Holding amended their shareholders agreement to provide that either Company shareholder could cause Company to pay a pro-rata cash dividend in an aggregate amount equal to the lesser of (i) $ l per month, (ii) the amount permitted to be distributed under the credit agreement to which Company was a party, or (iii) the maximum dividend that Company could pay under state law.

In Month 3, Month 4, and Month 5 of Year 4, Company paid the $ l monthly dividends, until the shareholders agreement was revised in conjunction with the Recapitalization, described below.

During Month 5, Year 4, after certain banks gave Individual their consent, Taxpayer, Holding, and Company agreed to and consummated an exchange by Taxpayer of all of its Company common stock for Company preferred stock (the

[2] Technical Advice was not requested, and this memorandum does not opine, concerning whether the proper DRD is 80% or 70% or whether § 1059 applies.

"Preferred") with an aggregate par value of $ m and a redemption value and liquidation preference in the same amount (the “Recapitalization”). The Preferred had an n% dividend rate which would increase o% each year after p years, to a maximum of q%. It also included certain accelerators if any dividend was not paid timely. It also provided that Company could, but was not required to, redeem the Preferred at par value at any time after Date 2. Taxpayer could not require Company to redeem the Preferred, nor was the Preferred mandatorily redeemable on a certain date.

Taxpayer reported all distributions received from Company with respect to the Preferred as dividends under §§ 316 and 301(c)(1). In four separate transactions in Year 5 and Year 6, the Preferred was redeemed. For purposes of this memorandum, it is assumed that the Preferred is properly treated as preferred stock for Federal tax purposes.

The Examining Agent and Appeals Officer argue that the Year 3 distribution of $ h should not be respected as a dividend. They argue that the distribution and the Recapitalization should be stepped together under the step transaction doctrine and, in effect, should be treated as occurring simultaneously. Accordingly, the $ h should be treated as "other property" received in the Recapitalization under § 356(a)(1) and gain, rather than dividend income, must be recognized.

The Examining Agent raises an additional argument that the $ h payment received by Taxpayer from Company in Year 3 be treated as received in partial redemption of Taxpayer's Company common stock.

Taxpayer argues that the distribution and Recapitalization should not be stepped together, but even if the distribution and the Recapitalization are treated as occurring simultaneously under the step transaction doctrine, § 1.301-1(l) requires that the distribution still be classified as a dividend.

LAW AND ANALYSIS:

In analyzing the Federal tax consequences of the transactions described herein, we will first assume that the distribution of $ h to Taxpayer and the subsequent Recapitalization are steps of a single transaction at the conclusion of which Taxpayer would have no common stock in Company. After analyzing the transaction with this assumption, we will then, if necessary, determine if the step transaction doctrine properly applies to treat the transactions described herein as steps of a single transaction.

Section 305(b)(1) provides that if a distribution is, at the election of any of the shareholders payable either (A) in its stock, or (B) in property then the distribution shall be treated as a distribution of property to which § 301 applies.

Section 356(a)(1) provides that if §§ 354 or 355 would apply to an exchange, but for the fact that boot was also received in the exchange, then gain, if any, shall be recognized, but not in an amount in excess of the boot. Section 356(a)(2) provides that if an exchange described in § 356(a)(1) has the effect of the distribution of a dividend, then the gain recognized therein shall be treated as a dividend, but not in excess of the recipient's ratable share of the distributor's earnings and profits.

Section 1.301-1(l) provides: "A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property. "

Rev. Rul. 69-34, 1969-1 C.B. 105, provides that cash received in a recapitalization in lieu of fractional shares is subject to § 302 if the cash represents a mere mechanical rounding off of fractional share interests and is not separately bargained-for consideration. Otherwise, the distribution will be treated either as the receipt of boot under § 356(a) or as a distribution to which § 301 applies, depending upon all facts and circumstances involved, citing § 1.301-1(l).

Rev. Rul. 72-57, 1972-1 C.B. 103, applied Rev. Rul. 69-34 to the following fact pattern. Corporation X had $ 5 par value common stock outstanding of which Corporation Y owned approximately 99%. The remaining stock was held by various minority shareholders none of whom owned as many as 10 shares. In order to eliminate the minority shareholders, X issued one new share of $ 50 par value common stock in exchange for 10 shares of the existing stock and paid cash in lieu of fractional shares. Rev. Rul. 72-57 held that the cash received by Y is treated under § 302 as having been received in redemption of fractional share interests.

Rev. Rul. 78-351, 1978-2 C.B. 148, modified Rev. Rul. 72-57. Rev. Rul. 78-351 states that Rev. Rul. 69-34 does not apply to Y in the facts of Rev. Rul. 72-57 because the sole business purpose of the reorganization described therein was to eliminate the interest of the minority shareholders. Accordingly, Rev. Rul. 78-351 holds that the cash received by Y must be treated as boot in the recapitalization under § 356(a), taxable under its facts as a dividend under § 356(a)(2). However, the ruling notes that "[i]f the circumstances were such that the transaction was essentially a device by Y to withdraw corporate earnings, the provisions of section 1.301-1(l) of the regulations would apply to the cash received by Y."

In Rev. Rul. 61-156, 1961-2 C.B. 62, a target corporation sold all of its assets to a newly formed acquiring corporation in exchange for acquiring stock, acquiring notes and cash. Acquiring then issued 55% of its stock to the public. Target then liquidated, distributing 45% of Acquiring stock, cash, and notes to its shareholders. The revenue ruling held that the transaction was a reorganization within the meaning of

§§ 368(a)(1)(E) and 368(a)(1)(F). With regard to the cash and other property received by the target shareholders, the revenue ruling focuses on whether the shareholders exchanged part of their target stock for boot in the reorganization under § 356 or whether the shareholders received a separate distribution under § 1.301-1(l).

The ruling, in effect, finds that the transaction was a mere recapitalization and reincorporation coupled with an unrelated withdrawal of funds and accordingly holds that the cash and other property were distributed under § 301 separately from the reorganization. There was no sale because the dominant purpose was to withdraw corporate earnings at capital gains rates while continuing the equity interest in substantial part in a business enterprise conducted in corporate form. "The issuance of stock to new investors was not needed to implement the dominant purpose and, therefore, the rest of the transaction was not fruitless without it and so dependent on it."

Applying the relevant authorities to the facts and circumstances (and assumptions) described above, it must be determined whether the distribution of the $ h is properly taxable as boot in the Recapitalization or is in substance a separate transaction. In either case, the economic result to the Taxpayer is the same, i.e., in the end Taxpayer has Preferred and $ h and no common stock. The fact that Taxpayer is a corporation and would be entitled to a DRD if the distribution is treated as a dividend is not a relevant fact or circumstance.

Among the facts and circumstances to consider is the shareholders' history of disagreement concerning the payment of dividends and of attempting to sever their interests in Company by way of various types of sales. It was while Taxpayer was negotiating to actually sell all its stock that the parties finally agreed to a transaction where Company would declare a dividend payable in additional stock or cash. The parties also discussed Taxpayer's exchange of its common stock for the Preferred, and, for purposes of this memorandum, we are assuming that the distribution and the exchange were definitively agreed upon and that they took place at the same time. In the end, Taxpayer had $ h and Preferred and no common stock while Holding still held its original common stock and the newly issued stock which it received in the distribution. Although the complete separation of Taxpayer's and Holding's interests in Company may have been the best possible result for Taxpayer, the receipt of an $ h dividend with a continuing interest in Company was a much improved position for Taxpayer than where Taxpayer previously stood.

Accordingly, the facts of this case tend to establish that the $ h distribution represents separately bargained-for consideration and that the distribution is in substance a separate transaction from the Recapitalization, notwithstanding that it is assumed that it takes place at the same time as the Recapitalization. Therefore, the $ h distribution is taxable as a dividend.

The Examining Agent also argues that the substance of the transaction is that the $ h payment received by Taxpayer from Company in Year 3 was received in partial redemption of Taxpayer's Company common stock rather than in the Recapitalization. However, in order for there to be a redemption, Taxpayer must actually surrender stock. See Reitz v. Commissioner, 61 T.C. 443, 448 (1974) aff'd without opinion, 507 F.2d 1279 (5th Cir. 1975) and Estate of Durkin v. Commissioner, 99 T.C. 561, 570 (1992). See also Merrill Lynch v. Commissioner, 120 T.C. 12, 43 at n. 34 (2003). Under the actual facts at issue, there was no surrender of stock by Taxpayer for the $ h, thus the $ h payment cannot be treated as being made in redemption of Taxpayer's Company common stock.

On the other hand, if the distribution and Recapitalization are treated as occurring simultaneously, arguably, all of the common exchanged by Taxpayer for cash and Preferred could be bifurcated to treat a portion of the common as exchanged for the Preferred in a recapitalization and a portion as redeemed at the same time for $ h. Nevertheless, the analysis set forth above is equally applicable to the bifurcation argument and therefore the $ h is not taxable as redemption proceeds.

Based on our analysis above that the $ h distribution is taxable as a dividend even if the transactions are stepped together, it is unnecessary to determine whether the step transaction doctrine applies to the facts at issue.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Ken Cohen
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel (Corporate)