

Basis Shifting Tax Shelter

Notice 2001-45

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is being used by taxpayers for the purpose of generating losses or reducing income or gains. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by such transactions are not properly allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of such transactions of certain responsibilities that may arise from participating in such transactions.

FACTS

The transaction involves the use of the attribution rules of § 318 of the Internal Revenue Code and § 1.302-2(c) of the Income Tax Regulations to increase the basis of stock owned by a taxpayer (the “Taxpayer”) that claims a loss upon disposition of that stock. In the transaction, there is a redemption of stock that is owned by a person (other than the Taxpayer) that is not subject to U.S. tax or is otherwise indifferent to the Federal income tax consequences of the redemption. Purportedly as a result of the application of the attribution rules of § 318, the redemption of stock is claimed to be a dividend under § 301 rather than a payment in exchange for stock under § 302(a). A variety of devices, often including options, is employed to treat the redeemed shareholder as owning stock in the redeeming corporation owned or treated as owned by the Taxpayer under the attribution rules of § 318. The attribution of ownership of such shares purportedly prevents the redemption of stock from reducing the redeemed shareholder’s ownership interest in the redeeming corporation, thereby causing the redemption to be treated as a dividend.

As a result of the redemption, the Taxpayer takes the position that under § 1.302-2(c) all or a portion of the basis of the redeemed stock is added to the basis of stock in the redeeming corporation that the Taxpayer owns. The Taxpayer then sells the stock and claims a loss.

Variations on the transaction include (1) the use of the transaction to reduce income or gain (rather than generate loss) and (2) the transfer of the stock (the basis of which was purportedly increased by reason of the redemption) to an entity in a carryover basis exchange, followed by either a sale of the entity interest or a sale of the stock by the entity.

ANALYSIS

Section 302(a) provides that if a corporation redeems its stock and § 302(b)(1), (2), (3), or (4) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the redeemed stock. Under § 302(b)(1), a redemption distribution will be subject to § 302(a) if, based on the facts and circumstances, the redemption distribution is not essentially equivalent to a dividend. *See* § 1.302-2(b). Section 302(b)(2) provides that a distribution in redemption of stock will be subject to § 302(a) if the distribution is substantially disproportionate with respect to the redeeming shareholder. Under § 302(b)(3), § 302(a) will apply to a distribution in redemption of stock if the redemption is in complete redemption of all of the stock of the corporation owned by the redeeming shareholder.

For purposes of determining whether a distribution in redemption of stock is treated as a sale or exchange of stock, all steps that are part of a single, pre-arranged plan are taken into account. *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). Section 302(d) provides that if § 302(a) does not apply, the distribution will be treated as a distribution subject to § 301. Section 302(c)(1) provides that, in determining whether the provisions of § 302(b) are satisfied, the attribution rules of § 318 shall apply. Section 301(c)(1) provides that the portion of the distribution that is a dividend shall be included in the redeemed shareholder’s gross income.

Section 1.302-2(c) provides that when an amount received in a 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. *Example 2* of § 1.302-2(c) illustrates a proper adjustment where the entire amount received in

redemption of the stock held by one spouse is treated as a dividend because the redeemed spouse is treated as owning stock held by the other spouse. In that example, the basis of the stock of the nonredeemed spouse is properly increased by the basis of the stock of the redeemed spouse.

It is the position of the Service and the Treasury that such an adjustment is not proper in every case in which the redeemed shareholder retains no stock in the redeeming corporation. The example in the regulations is premised on the concept that an adjustment is appropriate where the redeemed spouse is required to include the full redemption proceeds as a dividend in gross income that is subject to U.S. tax and such spouse retains no stock to which the basis of the redeemed stock could attach.

The Service 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. Depending on the facts of the particular case, reasons for disallowance may include, but are not limited to, the following: (1) the redemption does not result in a dividend (and consequently there is no basis shift) because, viewing the transaction as a whole, the redemption results in a reduction of interest in the redeeming corporation to which § 302(b) applies; (2) the basis shift is not a “proper adjustment” as contemplated by § 1.302-2(c); and (3) there is no attribution of stock ownership or basis shift because the steps taken to achieve those results are transitory and serve no purpose other than tax avoidance.

In addition, the Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

Transactions that are the same as, or substantially similar to, those described in this Notice are identified as “listed transactions” for purposes of § 1.6011-4T

(b)(2) of the Temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the Temporary Procedure and Administration Regulations. *See also* § 301.6112-1T, A-4. It should be noted that, independent of their classification as “listed transactions” for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under § 6707(a), and to the penalty under § 6708(a) if the requirements of § 6112 are not satisfied.

The Service and Treasury recognize that some taxpayers may have filed tax re-

turns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this Notice. We advise these taxpayers to take prompt action to file amended returns.

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