

Internal Revenue Service, Treasury

§ 1.301-1

Section 1.367(b)-2(d)(3) also issued under 26 U.S.C. 367(b)(1) and (2).

Section 1.367(b)-3 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)-3T also issued under 26 U.S.C. 367(a) and (b).

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Section 1.367(b)-6 also issued under 26 U.S.C. 367(b).

Section 1.367(b)-7 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904.

Section 1.367(b)-8 also issued under 26 U.S.C. 367(b).

Section 1.367(b)-9 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904.

Section 1.367(b)-10 also issued under 26 U.S.C. 367(b).

Section 1.367(b)-12 also issued under 26 U.S.C. 367(a) and (b).

Section 1.367(b)-13 also issued under 26 U.S.C. 367(b).

Section 1.367(e)-1 also issued under 26 U.S.C. 367(e)(1).

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Section 1.382-2 also issued under 26 U.S.C. 382(k)(1), (1)(3), (m), and 26 U.S.C. 383.

Section 1.382-2T also issued under 26 U.S.C. 382(g)(4)(C), (i), (k)(1) and (6), (1)(3), (m), and 26 U.S.C. 383.

Section 1.382-3 also issued under 26 U.S.C. 382(m).

Section 1.382-4 also issued under 26 U.S.C. 382(1)(3) and 382(m).

Section 1.382-5 also issued under 26 U.S.C. 382(m).

Section 1.382-5T also issued under 26 U.S.C. 382(m).

Section 1.382-6 also issued under 26 U.S.C. 382(b)(3)(A), 26 U.S.C.(d)(1), 26 U.S.C. 382(m), and 26 U.S.C.383(d).

Section 1.382-7 also issued under 26 U.S.C. 382(m).

Section 1.382-7T also issued under 26 U.S.C. 382(m).

Section 1.382-8 also issued under 26 U.S.C. 382(m).

Section 1.382-9 also issued under 26 U.S.C. 382(1)(3) and (m).

Section 1.382-10 also issued under 26 U.S.C. 382(m).

Section 1.382-10T is also issued under 26 U.S.C. 382(m).

Section 1.383-1 also issued under 26 U.S.C. 383.

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CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

DISTRIBUTIONS BY CORPORATIONS

EFFECTS ON RECIPIENTS

§ 1.301-1 Rules applicable with respect to distributions of money and other property.

(a) *General.* Section 301 provides the general rule for treatment of distributions on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock. The term *property* is defined in section 317(a). Such distributions, except as otherwise provided in this chapter, shall be treated as provided in section 301(c). Under section 301(c), distributions may be included in gross income, applied against and reduce the adjusted basis of the stock, treated as gain from the sale or exchange of property, or (in the case of certain distributions out of increase in value accrued before March 1, 1913) may be exempt from tax. The amount of the distributions to which section 301 applies is determined in accordance with the provisions of section 301(b). The basis of property received in a distribution to which section 301 applies is determined in accordance with the provisions of section 301(d). Accordingly, except as otherwise provided in this chapter, a distribution on or after June 22, 1954, of property by a corporation to a shareholder with respect to its stock shall be included in gross income to the extent the amount distributed is considered a dividend under section 316. For examples of distributions treated otherwise, see sections 116, 301(c)(2), 301(c)(3)(B), 301(e), 302(b), 303, and 305. See also part II (relating to distributions in partial or complete liquidation), part III (relating to corporate organizations and reorganizations), and part IV (relating to insolvency reorganizations), subchapter C, chapter 1 of the Code.

(b) *Time of inclusion in gross income and of determination of fair market value.* A distribution made by a corporation

to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. However, if such distribution is a distribution other than in cash, the fair market value of the property shall be determined as of the date of distribution without regard to whether such date is the same as that on which the distribution is includible in gross income. For example, if a corporation distributes a taxable dividend in property (the adjusted basis of which exceeds its fair market value on December 31, 1955) on December 31, 1955, which is received by, or unqualifiedly made subject to the demand of, its shareholders on January 2, 1956, the amount to be included in the gross income of the shareholders will be the fair market value of such property on December 31, 1955, although such amount will not be includible in the gross income of the shareholders until January 2, 1956.

(c) *Application of section to shareholders.* Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.

(d) *Distributions to corporate shareholders.* (1) If the shareholder is a corporation, the amount of any distribution to be taken into account under section 301(c) shall be:

- (i) The amount of money distributed,
- (ii) An amount equal to the fair market value of any property distributed which consists of any obligations of the distributing corporation, stock of the distributing corporation treated as property under section 305(b), or rights to acquire such stock treated as property under section 305(b), plus
- (iii) In the case of a distribution not described in subdivision (iv) of this subparagraph, an amount equal to (a) the fair market value of any other property distributed or, if lesser, (b) the adjusted basis of such other property in the hands of the distributing corporation (determined immediately before the distribution and increased for any gain recognized to the distributing corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a)), or

(iv) In the case of a distribution made after November 8, 1971, to a shareholder which is a foreign corporation, an amount equal to the fair market value of any other property distributed, but only if the distribution received by such shareholder is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such shareholder.

(2) In the case of a distribution the amount of which is determined by reference to the adjusted basis described in subparagraph (1)(iii)(b) of this paragraph:

(i) That portion of the distribution which is a dividend under section 301(c)(1) may not exceed such adjusted basis, or

(ii) If the distribution is not out of earnings and profits, the amount of the reduction in basis of the shareholder's stock, and the amount of any gain resulting from such distribution, are to be determined by reference to such adjusted basis of the property which is distributed.

(3) Notwithstanding paragraph (d)(1)(iii), if a distribution of property described in such paragraph is made after December 31, 1962, by a foreign corporation to a shareholder which is a corporation, the amount of the distribution to be taken into account under section 301(c) shall be determined under section 301(b)(1)(C) and paragraph (n) of this section.

(e) *Adjusted basis.* In determining the adjusted basis of property distributed in the hands of the distributing corporation immediately before the distribution for purposes of section 301(b)(1)(B)(ii), (b)(1)(C)(i), and (d)(2)(B), the basis to be used shall be the basis for determining gain upon a sale or exchange.

(f) *Examples.* The application of this section (except paragraph (n)) may be illustrated by the following examples:

Example 1. On January 1, 1955, A, an individual owned all of the stock of Corporation M with an adjusted basis of \$2,000. During 1955, A received distributions from Corporation M totaling \$30,000, consisting of \$10,000 in cash and listed securities having a basis in the hands of Corporation M and a fair market value on the date distributed of \$20,000. Corporation M's taxable year is the calendar year. As of December 31, 1954, Corporation M had earnings and profits accumulated after

February 28, 1913, in the amount of \$26,000, and it had no earnings and profits and no deficit for 1955. Of the \$30,000 received by A, \$26,000 will be treated as an ordinary dividend; the remaining \$4,000 will be applied against the adjusted basis of his stock; the \$2,000 in excess of the adjusted basis of his stock will either be treated as gain from the sale or exchange of property (under section 301(c)(3)(A)) or, if out of increase in value accrued before March 1, 1913, will (under section 301(c)(3)(B)) be exempt from tax. If A subsequently sells his stock in Corporation M, the basis for determining gain or loss on the sale will be zero.

Example 2. The facts are the same as in Example 1 with the exceptions that the shareholder of Corporation M is Corporation W and that the securities which were distributed had an adjusted basis to Corporation M of \$15,000. The distribution received by Corporation W totals \$25,000 consisting of \$10,000 in cash and securities with an adjusted basis of \$15,000. The total \$25,000 will be treated as a dividend to Corporation W since the earnings and profits of Corporation M (\$26,000) are in excess of the amount of the distribution.

Example 3. Corporation X owns timber land which it acquired prior to March 1, 1913, at a cost of \$50,000 with \$5,000 allocated as the separate cost of the land. On March 1, 1913, this property had a fair market value of \$150,000 of which \$135,000 was attributable to the timber and \$15,000 to the land. All of the timber was cut prior to 1955 and the full appreciation in the value thereof, \$90,000 (\$135,000 - \$45,000), realized through depletion allowances based on March 1, 1913, value. None of this surplus from realized appreciation had been distributed. In 1955, Corporation X sold the land for \$20,000 thereby realizing a gain of \$15,000. Of this gain, \$10,000 is due to realized appreciation in value which accrued before March 1, 1913 (\$15,000 - \$5,000). Of the gain of \$15,000, \$5,000 is taxable. Therefore, at December 31, 1955, Corporation X had a surplus from realized appreciation in the amount of \$100,000. It had no accumulated earnings and profits and no deficit at January 1, 1955. The net earnings for 1955 (including the \$5,000 gain on the sale of the land) were \$20,000. During 1955, Corporation X distributed \$75,000 to its stockholders. Of this amount, \$20,000 will be treated as a dividend. The remaining \$55,000, which is a distribution of realized appreciation, will be applied against and reduce the adjusted basis of the shareholders' stock. If any part of the \$55,000 is in excess of the adjusted basis of a shareholder's stock, such part will be exempt from tax.

(g) *Reduction for liabilities*—(1) *General rule.* For the purpose of section 301, no reduction shall be made for the amount of any liability, unless the liability is

assumed by the shareholder within the meaning of section 357(d).

(2) *No reduction below zero.* Any reduction pursuant to paragraph (g)(1) of this section shall not cause the amount of the distribution to be reduced below zero.

(3) *Effective dates*—(i) *In general.* This paragraph (g) applies to distributions occurring after January 4, 2001.

(ii) *Retroactive application.* This paragraph (g) also applies to distributions made on or before January 4, 2001, if the distribution is made as part of a transaction described in, or substantially similar to, the transaction in Notice 99-59 (1999-2 C.B. 761), including transactions designed to reduce gain (see § 601.601(d)(2) of this chapter). For rules for distributions on or before January 4, 2001 (other than distributions on or before that date to which this paragraph (g) applies), see rules in effect on January 4, 2001 (see § 1.301-1(g) as contained in 26 CFR part 1 revised April 1, 2001).

(h) *Basis.* The basis of property received in the distribution to which section 301 applies shall be—

(1) If the shareholder is not a corporation, the fair market value of such property;

(2) If the shareholder is a corporation—

(i) In the case of a distribution of the obligations of the distributing corporation or of the stock of such corporation or rights to acquire such stock (if such stock or rights are treated as property under section 305(b)), the fair market value of such obligations, stock, or rights;

(ii) In the case of the distribution of any other property, except as provided in subdivision (iii) (relating to certain distributions by a foreign corporation) or subdivision (iv) (relating to certain distributions to foreign corporate distributees) of this subparagraph, whichever of the following is the lesser—

(a) The fair market value of such property; or

(b) The adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property increased in the amount of gain to the distributing corporation which is recognized under section 311(b)

(relating to distributions of LIFO inventory), section 311(c) (relating to distributions of property subject to liabilities in excess of basis), section 311(d) (relating to appreciated property used to redeem stock), section 341(f) (relating to certain sales of stock of consenting corporations), section 617(d) (relating to gain from dispositions of certain mining property), section 1245(a) or 1250(a) (relating to gain from dispositions of certain depreciable property), section 1251(c) (relating to gain from disposition of farm recapture property), section 1252(a) (relating to gain from disposition of farm land), or 1254(a) (relating to gain from disposition of interest in natural resource recapture property);

(iii) In the case of the distribution by a foreign corporation of any other property after December 31, 1962, in a distribution not described in subdivision (iv) of this subparagraph, the amount determined under paragraph (n) of this section;

(iv) In the case of the distribution of any other property made after November 8, 1971, to a shareholder which is a foreign corporation, the fair market value of such property, but only if the distribution received by such shareholder is not effectively connected for the taxable year with the conduct of a trade or business in the United States by such shareholder.

(i) [Reserved]

(j) *Transfers for less than fair market value.* If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. If property is transferred in a sale or exchange by a corporation to a shareholder which is a corporation, for an amount less than its fair market value and also less than its adjusted basis, such shareholder shall be treated as having received a distribution to which section 301 applies, and—

(1) Where the fair market value of the property equals or exceeds its ad-

justed basis in the hands of the distributing corporation the amount of the distribution shall be the excess of the adjusted basis (increased by the amount of gain recognized under section 311 (b), (c), or (d), or under section 341(f), 617(d), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) to the distributing corporation) over the amount paid for the property;

(2) Where the fair market value of the property is less than its adjusted basis in the hands of the distributing corporation, the amount of the distribution shall be the excess of such fair market value over the amount paid for the property. If property is transferred in a sale or exchange after December 31, 1962, by a foreign corporation to a shareholder which is a corporation for an amount less than the amount which would have been computed under paragraph (n) of this section if such property had been received in a distribution to which section 301 applied, such shareholder shall be treated as having received a distribution to which section 301 applies, and the amount of the distribution shall be the excess of the amount which would have been computed under paragraph (n) of this section with respect to such property over the amount paid for the property. In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

If property is transferred in a sale or exchange after December 31, 1962, by a foreign corporation to a shareholder which is a corporation for an amount less than the amount which would have been computed under paragraph (n) of this section if such property had been received in a distribution to which section 301 applied, such shareholder shall be treated as having received a distribution to which section 301 applies, and the amount of the distribution shall be the excess of the amount which would have been computed under

paragraph (n) of this section with respect to such property over the amount paid for the property. Notwithstanding the preceding provisions of this paragraph, if property is transferred in a sale or exchange after November 8, 1971, by a corporation to a shareholder which is a foreign corporation, for an amount less than its fair market value, and if paragraph (d)(1)(iv) of this section would apply if such property were received in a distribution to which section 301 applies, such shareholder shall be treated as having received a distribution to which section 301 applies and the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

(k) *Application of rule respecting transfers for less than fair market value.* The application of paragraph (j) of this section may be illustrated by the following examples:

Example 1. On January 1, 1955, A, an individual shareholder of corporation X, purchased property from that corporation for \$20. The fair market value of such property was \$100, and its basis in the hands of corporation X was \$25. The amount of the distribution determined under section 301(b) is \$80. If A were a corporation, the amount of the distribution would be \$5 (assuming that sections 311 (b) and (c), 1245(a), and 1250(a) do not apply), the excess of the basis of the property in the hands of corporation X over the amount received therefor. The basis of such property to corporation A would be \$25. If the basis of the property in the hands of corporation X were \$10, the corporate shareholder, A, would not receive a distribution. The basis of such property to corporation A would be \$20. Whether or not A is a corporation, the excess of the amount paid over the basis of the property in the hands of corporation X (\$20 over \$10) would be a taxable gain to corporation X.

Example 2. On January 1, 1963, corporation A, which is a shareholder of corporation B (a foreign corporation engaged in business within the United States), purchased one share of corporation X stock from B for \$20.

The fair market value of the share was \$100, and its adjusted basis in the hands of B was \$25. Assume that if the share of corporation X stock had been received by A in a distribution to which section 301 applied, the amount of the distribution under paragraph (n) of this section would have been \$55. The amount of the distribution under section 301 is \$35, i.e., \$55 (amount computed under paragraph (n) of this section) minus \$20 (amount paid for the property). The basis of such property to A is \$55.

(l) *Transactions treated as distributions.* 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. For example, if a corporation having only common stock outstanding, exchanges one share of newly issued common stock and one bond in the principal amount of \$10 for each share of outstanding common stock, the distribution of the bonds will be a distribution of property (to the extent of their fair market value) to which section 301 applies, even though the exchange of common stock for common stock may be pursuant to a plan of reorganization under the terms of section 368(a)(1)(E) (recapitalization) and even though the exchange of common stock for common stock may be tax free by virtue of section 354.

(m) *Cancellation of indebtedness.* The cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property.

(n) [Reserved]

(o) *Distributions of certain property by DISC's to corporate shareholders.* See § 1.997-1 for the rule that if a corporation which is a DISC or former DISC (as defined in section 992(a)(1) or (3) as the case may be) makes a distribution of property (other than money and other than the obligations of the DISC or former DISC) out of accumulated DISC income (as defined in section 996(f)(1)) or previously taxed income (as defined in section 996(f)(2)), such distribution of property shall be treated

as if it were made to an individual and that the basis of the property distributed, in the hands of the recipient corporation, shall be determined as if such property were distributed to an individual.

(p) *Cross references.* For certain rules relating to adjustments to earnings and profits and for determining the extent to which a distribution is a dividend, see sections 312 and 316 and regulations thereunder.

(q) *Split-dollar and other life insurance arrangements—(1) Split-dollar life insurance arrangements—(i) Distribution of economic benefits.* The provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in §1.61-22(b)(1) or (2), of economic benefits described in §1.61-22(d) or of amounts described in §1.61-22(e) is treated as a distribution of property, the amount of which is determined under §1.61-22(d) and (e), respectively.

(ii) *Distribution of entire contract or undivided interest therein.* A transfer (within the meaning of §1.61-22(c)(3)) of the ownership of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement is a distribution of property, the amount of which is determined pursuant to §1.61-22(g)(1) and (2).

(2) *Other life insurance arrangements.* A payment by a corporation on behalf of a shareholder of premiums on a life insurance contract or an undivided interest therein that is owned by the shareholder constitutes a distribution of property, even if such payment is not part of a split-dollar life insurance arrangement under §1.61-22(b).

(3) *When distribution is made—(i) In general.* Except as provided in paragraph (q)(3)(ii) of this section, paragraph (b) of this section shall apply to determine when a distribution described in paragraph (q)(1) or (2) of this section is taken into account by a shareholder.

(ii) *Exception.* Notwithstanding paragraph (b) of this section, a distribution described in paragraph (q)(1)(ii) of this section shall be treated as made by a corporation to its shareholder at the time that the life insurance contract, or an undivided interest therein, is

transferred (within the meaning of §1.61-22(c)(3)) to the shareholder.

(4) *Effective date—(i) General rule.* This paragraph (q) applies to split-dollar and other life insurance arrangements entered into after September 17, 2003. For purposes of this paragraph (q)(4), a split-dollar life insurance arrangement is entered into as determined under §1.61-22(j)(1)(ii).

(ii) *Modified arrangements treated as new arrangements.* If a split-dollar life insurance arrangement entered into on or before September 17, 2003 is materially modified (within the meaning of §1.61-22(j)(2)) after September 17, 2003, the arrangement is treated as a new arrangement entered into on the date of the modification.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.301-1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.fdsys.gov.

§ 1.302-1 General.

(a) Under section 302(d), unless otherwise provided in subchapter C, chapter 1 of the Code, a distribution in redemption of stock shall be treated as a distribution of property to which section 301 applies if the distribution is not within any of the provisions of section 302(b). A distribution in redemption of stock shall be considered a distribution in part or full payment in exchange for the stock under section 302(a) provided paragraph (1), (2), (3), or (4) of section 302(b) applies. Section 318(a) (relating to constructive ownership of stock) applies to all redemptions under section 302 except that in the termination of a shareholder's interest certain limitations are placed on the application of section 318(a)(1) by section 302(c)(2). The term *redemption of stock* is defined in section 317(b). Section 302 does not apply to that portion of any distribution which qualifies as a distribution in partial liquidation under section 346. For special rules relating to redemption of stock to pay death taxes see section 303. For special rules relating to redemption of section 306 stock see section 306. For special rules relating to redemption of stock in partial or complete liquidation see section 331.

(b) If, in connection with a partial liquidation under the terms of section 346, stock is redeemed in an amount in excess of the amount specified by section 331(a)(2), section 302(b) shall first apply as to each shareholder to which it is applicable without limitation because of section 331(a)(2). That portion of the total distribution which is used in all redemptions from specific shareholders which are within the terms of section 302(a) shall be excluded in determining the application of sections 346 and 331(a)(2). For example, Corporation X has \$50,000 which is attributable to the sale of one of two active businesses and which, if distributed in redemption of stock, would qualify as a partial liquidation under the terms of section 346(b). Corporation X distributes \$60,000 to its shareholders in redemption of stock, \$20,000 of which is in redemption of all of the stock of shareholder A within the meaning of section 302(b)(3). The \$20,000 distributed in redemption of the stock of shareholder A will be excluded in determining the application of sections 346 and 331(a)(2). The entire \$60,000 will be treated as in part or full payment for stock (\$20,000 qualifying under section 302(a) and \$40,000 qualifying under sections 346 and 331(a)(2)).

§ 1.302-2 Redemptions not taxable as dividends.

(a) *In general.* The fact that a redemption fails to meet the requirements of paragraph (2), (3) or (4) of section 302(b) shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend under section 302(b)(1). See, however, paragraph (b) of this section. For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraph (2), (3) or (4) of such section. The determination of whether or not a distribution is within the phrase “essentially equivalent to a dividend” (that is, having the same effect as a distribution without any re-

demption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if A owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under section 301 pursuant to section 302(d).

(b) *Redemption not essentially equivalent to a dividend—(1) In general.* The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding. However, for distributions in partial liquidation, see section 302(e). The redemption of all of one class of stock (except section 306 stock) either at one time or in a series of redemptions generally will be considered as a distribution under section 301 if all classes of stock outstanding at the time of the redemption are held in the same proportion. Distributions in redemption of stock may be treated as distributions under section 301 regardless of the provisions of the stock certificate and regardless of whether all stock being redeemed was acquired by the stockholders from whom the stock was redeemed by purchase or otherwise.

(2) *Statement.* Unless § 1.331-1(d) applies, every significant holder that transfers stock to the issuing corporation in exchange for property from such corporation must include on or with such holder's return for the taxable year of such exchange a statement entitled, “STATEMENT PURSUANT TO § 1.302-2(b)(2) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER OF THE STOCK OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER

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(IF ANY) OF ISSUING CORPORATION].” If a significant holder is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The statement must include—

(i) The fair market value and basis of the stock transferred by the significant holder to the issuing corporation; and

(ii) A description of the property received by the significant holder from the issuing corporation.

(3) *Definitions.* For purposes of this section:

(i) *Significant holder* means any person that, immediately before the exchange—

(A) Owned at least five percent (by vote or value) of the total outstanding stock of the issuing corporation if the stock owned by such person is publicly traded; or

(B) Owned at least one percent (by vote or value) of the total outstanding stock of the issuing corporation if the stock owned by such person is not publicly traded.

(ii) *Publicly traded stock* means stock that is listed on—

(A) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(B) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o-3).

(iii) *Issuing corporation* means the corporation that issued the shares of stock, some or all of which were transferred by a significant holder to such corporation in the exchange described in paragraph (b)(2) of this section.

(4) *Cross reference.* See section 6043 of the Internal Revenue Code for requirements relating to a return by a liquidating corporation.

(c) *Basis adjustments.* In 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. (For adjustments to basis required for certain redemptions of cor-

porate shareholders that are treated as extraordinary dividends, see section 1059 and the regulations thereunder.) The following examples illustrate the application of this rule:

Example 1. 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.

Example 2. 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.

Example 3. The facts are the same as in *Example (2)* with the additional facts that the outstanding stock of Corporation X 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.

(d) *Effective/applicability date.* Paragraphs (b)(2), (b)(3) and (b)(4) of this section apply to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply paragraphs (b)(2), (b)(3) and (b)(4) of this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see § 1.302-2 as contained in 26 CFR part 1 in effect on April 1, 2006.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 8724, 62 FR 38028, July 26, 1997; T.D. 9264, 71 FR 30593, May 30, 2006; T.D. 9329, 72 FR 32796, June 14, 2007]

§ 1.302-3 Substantially disproportionate redemption.

(a) Section 302(b)(2) provides for the treatment of an amount received in redemption of stock as an amount received in exchange for such stock if—

(1) Immediately after the redemption the shareholder owns less than 50 percent of the total combined voting

power of all classes of stock as provided in section 302(b)(2)(B).

(2) The redemption is a substantially disproportionate redemption within the meaning of section 302(b)(2)(C), and

(3) The redemption is not pursuant to a plan described in section 302(b)(2)(D). Section 318(a) (relating to constructive ownership of stock) shall apply both in making the disproportionate redemption test and in determining the percentage of stock ownership after the redemption. The requirements under section 302(b)(2) shall be applied to each shareholder separately and shall be applied only with respect to stock which is issued and outstanding in the hands of the shareholders. Section 302(b)(2) only applies to a redemption of voting stock or to a redemption of both voting stock and other stock. Section 302(b)(2) does not apply to the redemption solely of nonvoting stock (common or preferred). However, if a redemption is treated as an exchange to a particular shareholder under the terms of section 302(b)(2), such section will apply to the simultaneous redemption of nonvoting preferred stock (which is not section 306 stock) owned by such shareholder and such redemption will also be treated as an exchange. Generally, for purposes of this section, stock which does not have voting rights until the happening of an event, such as a default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Subsection 302(b)(2)(D) provides that a redemption will not be treated as substantially disproportionate if made pursuant to a plan the purpose or effect of which is a series of redemptions which result in the aggregate in a distribution which is not substantially disproportionate. Whether or not such a plan exists will be determined from all the facts and circumstances.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example. Corporation M has outstanding 400 shares of common stock of which A, B, C and D each own 100 shares or 25 percent. No stock is considered constructively owned by A, B, C or D under section 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C. For the redemption to

be disproportionate as to any shareholder, such shareholder must own after the redemptions less than 20 percent (30 percent of 25 percent) of the 300 shares of stock then outstanding. After the redemptions, A owns 45 shares (15 percent), B owns 75 shares (25 percent), and C owns 80 shares (26⅔ percent). The distribution is disproportionate only with respect to A.

§ 1.302-4 Termination of shareholder's interest.

Section 302(b)(3) provides that a distribution in redemption of all of the stock of the corporation owned by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock of such shareholder. In determining whether all of the stock of the shareholder has been redeemed, the general rule of section 302(c)(1) requires that the rules of constructive ownership provided in section 318(a) shall apply. Section 302(c)(2), however, provides that section 318(a)(1) (relating to constructive ownership of stock owned by members of a family) shall not apply where the specific requirements of section 302(c)(2) are met. The following rules shall be applicable in determining whether the specific requirements of section 302(c)(2) are met:

(a) *Statement.* The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a statement entitled, "STATEMENT PURSUANT TO SECTION 302(c)(2)(A)(iii) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER OR RELATED PERSON, AS THE CASE MAY BE], A DISTRIBUTE (OR RELATED PERSON) OF [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF DISTRIBUTING CORPORATION]." The distributee must include such statement on or with the distributee's first return for the taxable year in which the distribution described in section 302(b)(3) occurs. If the distributee is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The distributee must represent in the statement—

(1) THE DISTRIBUTE (OR RELATED PERSON) HAS NOT ACQUIRED, OTHER THAN BY BEQUEST

OR INHERITANCE, ANY INTEREST IN THE CORPORATION (AS DESCRIBED IN SECTION 302(c)(2)(A)(i)) SINCE THE DISTRIBUTION; and

(2) THE DISTRIBUTEES (OR RELATED PERSON) WILL NOTIFY THE INTERNAL REVENUE SERVICE OF ANY ACQUISITION, OTHER THAN BY BEQUEST OR INHERITANCE, OF SUCH AN INTEREST IN THE CORPORATION WITHIN 30 DAYS AFTER THE ACQUISITION, IF THE ACQUISITION OCCURS WITHIN 10 YEARS FROM THE DATE OF THE DISTRIBUTION.

(b) *Substantiation information.* The distributee who files an agreement under section 302(c)(2)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.

(c) *Stock of parent, subsidiary or successor corporation redeemed.* If stock of a parent corporation is redeemed, section 302(c)(2)(A), relating to acquisition of an interest in the corporation within 10 years after termination shall be applied with reference to an interest both in the parent corporation and any subsidiary of such parent corporation. If stock of a parent corporation is sold to a subsidiary in a transaction described in section 304, section 302(c)(2)(A) shall be applicable to the acquisition of an interest in such subsidiary corporation or in the parent corporation. If stock of a subsidiary corporation is redeemed, section 302(c)(2)(A) shall be applied with reference to an interest both in such subsidiary corporation and its parent. Section 302(c)(2)(A) shall also be applied with respect to an interest in a corporation which is a successor corporation to the corporation the interest in which has been terminated.

(d) *Redeemed shareholder as creditor.* For the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the

form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

(e) *Acquisition of assets pursuant to creditor's rights.* In the case of a distributee to whom section 302(b)(3) is applicable, who is a creditor after such transaction, the acquisition of the assets of the corporation in the enforcement of the rights of such creditor shall not be considered an acquisition of an interest in the corporation for purposes of section 302(c)(2) unless stock of the corporation, its parent corporation, or, in the case of a redemption of stock of a parent corporation, of a subsidiary of such corporation is acquired.

(f) *Constructive ownership rules applicable.* In determining whether an entire interest in the corporation has been terminated under section 302(b)(3), under all circumstances paragraphs (2), (3), (4), and (5) of section 318(a) (relating to constructive ownership of stock) shall be applicable.

(g) *Avoidance of Federal income tax.* Section 302(c)(2)(B) provides that section 302(c)(2)(A) shall not apply—

(1) If any portion of the stock redeemed was acquired directly or indirectly within the 10-year period ending on the date of the distribution by the distributee from a person, the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(2) If any person owns (at the time of the distribution) stock, the ownership of which is attributable to the distributee under section 318(a), such person acquired any stock in the corporation directly or indirectly from the distributee within the 10-year period ending on the date of the distribution, and such stock so acquired from the distributee is not redeemed in the same

transaction, unless the acquisition (described in subparagraph (1) of this paragraph) or the disposition by the distributee (described in subparagraph (2) of this paragraph) did not have as one of its principal purposes the avoidance of Federal income tax. A transfer of stock by the transferor, within the 10-year period ending on the date of the distribution, to a person whose stock would be attributable to the transferor shall not be deemed to have as one of its principal purposes the avoidance of Federal income tax merely because the transferee is in a lower income tax bracket than the transferor.

(h) *Effective/applicability date.* Paragraph (a) of this section applies to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply paragraph (a) of this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see § 1.302-4 as contained in 26 CFR part 1 in effect on April 1, 2006.

(Sec. 302(c)(2)(A)(iii) (68A Stat. 87; 26 U.S.C. 302 (c)(2)(A)(iii)))

[T.D. 7535, 43 FR 10686, Mar. 15, 1978, as amended by T.D. 9264, 71 FR 30594, 30607, May 30, 2006; T.D. 9329, 72 FR 32796, 32808, June 14, 2007]

§ 1.303-1 General.

Section 303 provides that in certain cases a distribution in redemption of stock, the value of which is included in determining the value of the gross estate of a decedent, shall be treated as a distribution in full payment in exchange for the stock so redeemed.

§ 1.303-2 Requirements.

(a) Section 303 applies only where the distribution is with respect to stock of a corporation the value of whose stock in the gross estate of the decedent for Federal estate tax purposes is an amount in excess of (1) 35 percent of the value of the gross estate of such decedent, or (2) 50 percent of the taxable estate of such decedent. For the purposes of such 35 percent and 50 percent requirements, stock of two or more corporations shall be treated as the stock of a single corporation if more

than 75 percent in value of the outstanding stock of each such corporation is included in determining the value of the decedent's gross estate. For the purpose of the 75 percent requirement, stock which, at the decedent's death, represents the surviving spouse's interest in community property shall be considered as having been included in determining the value of the decedent's gross estate.

(b) For the purpose of section 303(b)(2)(A)(i), the term *gross estate* means the gross estate as computed in accordance with section 2031 (or, in the case of the estate of a decedent nonresident not a citizen of the United States, in accordance with section 2103). For the purpose of section 303(b)(2)(A)(ii), the term *taxable estate* means the taxable estate as computed in accordance with section 2051 (or, in the case of the estate of a decedent nonresident not a citizen of the United States, in accordance with section 2106). In case the value of an estate is determined for Federal estate tax purposes under section 2032 (relating to alternate valuation), then, for purposes of section 303(b)(2), the value of the gross estate, the taxable estate, and the stock shall each be determined on the applicable date prescribed in section 2032.

(c)(1) In determining whether the estate of the decedent is comprised of stock of a corporation of sufficient value to satisfy the percentage requirements of section 303(b)(2)(A) and section 303(b)(2)(B), the total value, in the aggregate, of all classes of stock of the corporation includible in determining the value of the gross estate is taken into account. A distribution under section 303(a) may be in redemption of the stock of the corporation includible in determining the value of the gross estate, without regard to the class of such stock.

(2) The above may be illustrated by the following example:

Example. The gross estate of the decedent has a value of \$1,000,000, the taxable estate is \$700,000, and the sum of the death taxes and funeral and administration expenses is \$275,000. Included in determining the gross estate of the decedent is stock of three corporations which, for Federal estate tax purposes, is valued as follows:

§ 1.303-2

Corporation A:	
Common stock	\$100,000
Preferred stock	100,000
Corporation B:	
Common stock	50,000
Preferred stock	350,000
Corporation C: Common stock	200,000

The stock of Corporation A and Corporation C included in the estate of the decedent constitutes all of the outstanding stock of both corporations. The stock of Corporation A and the stock of Corporation C, treated as the stock of a single corporation under section 303(b)(2)(B), has a value in excess of \$350,000 (35 percent of the gross estate or 50 percent of the taxable estate). Likewise, the stock of Corporation B has a value in excess of \$350,000. The distribution by one or more of the above corporations, within the period prescribed in section 303(b)(1), of amounts not exceeding, in the aggregate, \$275,000, in redemption of preferred stock or common stock of such corporation or corporations, will be treated as in full payment in exchange for the stock so redeemed.

(d) If stock includible in determining the value of the gross estate of a decedent is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, the redemption of the new stock will be treated the same under section 303 as the redemption of the old stock would have been. Thus section 303 shall apply with respect to a distribution in redemption of stock received by the estate of a decedent (1) in connection with a reorganization under section 368, (2) in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355), (3) in an exchange under section 1036 or (4) in a distribution to which section 305(a) applies. Similarly, a distribution in redemption of stock will qualify under section 303, notwithstanding the fact that the stock redeemed is section 306 stock to the extent that the conditions of section 303 are met.

(e) Section 303 applies to distributions made after the death of the decedent and (1) before the expiration of the 3-year period of limitations for the assessment of estate tax provided in section 6501(a) (determined without the application of any provisions of law extending or suspending the running of such period of limitations), or within 90 days after the expiration of such period, or (2) if a petition for redetermination of a deficiency in such estate

tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final. The extension of the period of distribution provided in section 303(b)(1)(B) has reference solely to bona fide contests in the Tax Court and will not apply in the case of a petition for redetermination of a deficiency which is initiated solely for the purpose of extending the period within which section 303 would otherwise be applicable.

(f) While section 303 will most frequently have application in the case where stock is redeemed from the executor or administrator of an estate, the section is also applicable to distributions in redemption of stock included in the decedent's gross estate and held at the time of the redemption by any person who acquired the stock by any of the means comprehended by part III, subchapter A, chapter 11 of the Code, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust created by the decedent. Thus section 303 may apply with respect to a distribution in redemption of stock from a donee to whom the decedent has transferred stock in contemplation of death where the value of such stock is included in the decedent's gross estate under section 2035. Similarly, section 303 may apply to the redemption of stock from a beneficiary of the estate to whom an executor has distributed the stock pursuant to the terms of the will of the decedent. However, section 303 is not applicable to the case where stock is redeemed from a stockholder who has acquired the stock by gift or purchase from any person to whom such stock has passed from the decedent. Nor is section 303 applicable to the case where stock is redeemed from a stockholder who has acquired the stock from the executor in satisfaction of a specific monetary bequest.

(g)(1) The total amount of the distributions to which section 303 may apply with respect to redemptions of stock included in the gross estate of a decedent may not exceed the sum of the estate, inheritance, legacy, and

succession taxes (including any interest collected as a part of such taxes) imposed because of the decedent's death and the amount of funeral and administration expenses allowable as deductions to the estate. Where there is more than one distribution in redemption of stock described in section 303(b)(2) during the period of time prescribed in section 303(b)(1), the distributions shall be applied against the total amount which qualifies for treatment under section 303 in the order in which the distributions are made. For this purpose, all distributions in redemption of such stock shall be taken into account, including distributions which under another provision of the Code are treated as in part or full payment in exchange for the stock redeemed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) The gross estate of the decedent has a value of \$800,000, the taxable estate is \$500,000, and the sum of the death taxes and funeral and administrative expenses is \$225,000. Included in determining the gross estate of the decedent is the stock of a corporation which for Federal estate tax purposes is valued at \$450,000. During the first year of administration, one-third of such stock is distributed to a legatee and shortly thereafter this stock is redeemed by the corporation for \$150,000. During the second year of administration, another one-third of such stock includible in the estate is redeemed for \$150,000.

(ii) The first distribution of \$150,000 is applied against the \$225,000 amount that qualifies for treatment under section 303, regardless of whether the first distribution was treated as in payment in exchange for stock under section 302(a). Thus, only \$75,000 of the second distribution may be treated as in full payment in exchange for stock under section 303. The tax treatment of the remaining \$75,000 would be determined under other provisions of the Code.

(h) For the purpose of section 303, the estate tax or any other estate, inheritance, legacy, or succession tax shall be ascertained after the allowance of any credit, relief, discount, refund, remission or reduction of tax.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6724, 29 FR 5343, Apr. 21, 1964; T.D. 7346, 40 FR 10669, Mar. 7, 1975]

§ 1.303-3 Application of other sections.

(a) The sole effect of section 303 is to exempt from tax as a dividend a distribution to which such section is applicable when made in redemption of stock includible in a decedent's gross estate. Such section does not, however, in any other manner affect the principles set forth in sections 302 and 306. Thus, if stock of a corporation is owned equally by A, B, and the C Estate, and the corporation redeems one-half of the stock of each shareholder, the determination of whether the distributions to A and B are essentially equivalent to dividends shall be made without regard to the effect which section 303 may have upon the taxability of the distribution to the C Estate.

(b) See section 304 relative to redemption of stock through the use of related corporations.

§ 1.304-1 General.

(a) Except as provided in paragraph (b) of this section, section 304 is applicable where a shareholder sells stock of one corporation to a related corporation as defined in section 304. Sales to which section 304 is applicable shall be treated as redemptions subject to sections 302 and 303.

(b) In the case of—

(1) Any acquisition of stock described in section 304 which occurred before June 22, 1954, and

(2) Any acquisition of stock described in section 304 which occurred on or after June 22, 1954, and on or before December 31, 1958, pursuant to a contract entered into before June 22, 1954.

The extent to which the property received in return for such acquisition shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if the Internal Revenue Code of 1954 had not been enacted. See section 391. In cases to which this paragraph applies, the basis of the stock received by the acquiring corporation shall be determined as if the Internal Revenue Code of 1939 continued to apply in respect of such acquisition and as if the Internal Revenue Code of 1954 had not been enacted.

[T.D. 6533, 26 FR 401, Jan. 19, 1961]

§ 1.304-2 Acquisition by related corporation (other than subsidiary).

(a) If a corporation, in return for property, acquires stock of another corporation from one or more persons, and the person or persons from whom the stock was acquired were in control of both such corporations before the acquisition, then such property shall be treated as received in redemption of stock of the acquiring corporation. The stock received by the acquiring corporation shall be treated as a contribution to the capital of such corporation. See section 362(a) for determination of the basis of such stock. The transferor's basis for his stock in the acquiring corporation shall be increased by the basis of the stock surrendered by him. (But see below in this paragraph for subsequent reductions of basis in certain cases.) As to each person transferring stock, the amount received shall be treated as a distribution of property under section 302(d), unless as to such person such amount is to be treated as received in exchange for the stock under the terms of section 302(a) or section 303. In applying section 302(b), reference shall be had to the shareholder's ownership of stock in the issuing corporation and not to his ownership of stock in the acquiring corporation (except for purposes of applying section 318(a)). In determining control and applying section 302(b), section 318(a) (relating to the constructive ownership of stock) shall be applied without regard to the 50-percent limitation contained in section 318(a)(2)(C) and (3)(C). A series of redemptions referred to in section 302(b)(2)(D) shall include acquisitions by either of the corporations of stock of the other and stock redemptions by both corporations. If section 302(d) applies to the surrender of stock by a shareholder, his basis for his stock in the acquiring corporation after the transaction (increased as stated above in this paragraph) shall not be decreased except as provided in section 301. If section 302(d) does not apply, the property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under section 302(a), which stock has a basis equal to the amount by which the shareholder's basis for his stock in the

acquiring corporation was increased on account of the contribution to capital as provided for above in this paragraph. Accordingly, such amount shall be applied in reduction of the shareholder's basis for his stock in the acquiring corporation. Thus, the basis of each share of the shareholder's stock in the acquiring corporation will be the same as the basis of such share before the entire transaction. The holding period of the stock which is considered to have been redeemed shall be the same as the holding period of the stock actually surrendered.

(b) In any case in which two or more persons, in the aggregate, control two corporations, section 304(a)(1) will apply to sales by such persons of stock in either corporation to the other (whether or not made simultaneously) provided the sales by each of such persons are related to each other. The determination of whether the sales are related to each other shall be dependent upon the facts and circumstances surrounding all of the sales. For this purpose, the fact that the sales may occur during a period of one or more years (such as in the case of a series of sales by persons who together control each of such corporations immediately prior to the first of such sales and immediately subsequent to the last of such sales) shall be disregarded, provided the other facts and circumstances indicate related transactions.

(c) The application of section 304(a)(1) may be illustrated by the following examples:

Example 1. Corporation X and corporation Y each have outstanding 200 shares of common stock. One-half of the stock of each corporation is owned by an individual, A, and one-half by another individual, B, who is unrelated to A. On or after August 31, 1964, A sells 30 shares of corporation X stock to corporation Y for \$50,000, such stock having an adjusted basis of \$10,000 to A. After the sale, A is considered as owning corporation X stock as follows: (i) 70 shares directly, and (ii) 15 shares constructively, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 30 shares owned directly by Y. Since A's percentage of ownership of X's voting stock after the sale (85 out of 200 shares, or 42.5%) is not less than 80 percent of his percentage of ownership of X's voting stock before the sale (100 out of 200

shares, or 50%), the transfer is not “substantially disproportionate” as to him as provided in section 302(b)(2). Under these facts, and assuming that section 302(b)(1) is not applicable, the entire \$50,000 is treated as a dividend to A to the extent of the earnings and profits of corporation Y. The basis of the corporation X stock to corporation Y is \$10,000, its adjusted basis to A. The amount of \$10,000 is added to the basis of the stock of corporation Y in the hands of A.

Example 2. The facts are the same as in *Example (1)* except that A sells 80 shares of corporation X stock to corporation Y, and the sale occurs before August 31, 1964. After the sale, A is considered as owning corporation X stock as follows: (i) 20 shares directly, and (ii) 90 shares indirectly, since by virtue of his 50-percent ownership of Y he constructively owns 50 percent of the 80 shares owned directly by Y and 50 percent of the 100 shares attributed to Y because they are owned by Y’s stockholder, B. Since after the sale A owns a total of more than 50 percent of the voting power of all of the outstanding stock of X (110 out of 200 shares, or 55%), the transfer is not “substantially disproportionate” as to him as provided in section 302(b)(2).

Example 3. Corporation X and corporation Y each have outstanding 100 shares of common stock. A, an individual, owns one-half the stock of corporation X, and C owns one-half the stock of corporation Y. A, B, and C are unrelated. A sells 30 shares of the stock of corporation X to corporation Y for \$50,000, such stock having an adjusted basis of \$10,000 to him. After the sale, A is considered as owning 35 shares of the stock of corporation X (20 shares directly and 15 constructively because one-half of the 30 shares owned by corporation Y are attributed to him). Since before the sale he owned 50 percent of the stock of corporation X and after the sale he owned directly and constructively only 35 percent of such stock, the redemption is substantially disproportionate as to him pursuant to the provisions of section 302(b)(2). He, therefore, realizes a gain of \$40,000 (\$50,000 minus \$10,000). If the stock surrendered is a capital asset, such gain is long-term or short-term capital gain depending on the period of time that such stock was held. The basis to A for the stock of corporation Y is not changed as a result of the entire transaction. The basis to corporation Y for the stock of corporation X is \$50,000, i.e., the basis of the transferor (\$10,000), increased in the amount of gain recognized to the transferor (\$40,000) on the transfer.

Example 4. Corporation X and corporation Y each have outstanding 100 shares of common stock. H, an individual, W, his wife, S, his son, and G, his grandson, each own 25 shares of stock of each corporation. H sells all of his 25 shares of stock of corporation X to corporation Y. Since both before and after the transaction H owned directly and con-

structively 100 percent of the stock of corporation X, and assuming that section 302(b)(1) is not applicable, the amount received by him for his stock of corporation X is treated as a dividend to him to the extent of the earnings and profits of corporation Y.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11997, Aug. 23, 1968]

§ 1.304-3 Acquisition by a subsidiary.

(a) If a subsidiary acquires stock of its parent corporation from a shareholder of the parent corporation, the acquisition of such stock shall be treated as though the parent corporation had redeemed its own stock. For the purpose of this section, a corporation is a parent corporation if it meets the 50 percent ownership requirements of section 304(c). The determination whether the amount received shall be treated as an amount received in payment in exchange for the stock shall be made by applying section 303, or by applying section 302(b) with reference to the stock of the issuing parent corporation. If such distribution would have been treated as a distribution of property (pursuant to section 302(d)) under section 301, the entire amount of the selling price of the stock shall be treated as a dividend to the seller to the extent of the earnings and profits of the parent corporation determined as if the distribution had been made to it of the property that the subsidiary exchanged for the stock. In such cases, the transferor’s basis for his remaining stock in the parent corporation will be determined by including the amount of the basis of the stock of the parent corporation sold to the subsidiary.

(b) Section 304(a)(2) may be illustrated by the following example:

Example. Corporation M has outstanding 100 shares of common stock which are owned as follows: B, 75 shares, C, son of B, 20 shares, and D, daughter of B, 5 shares. Corporation M owns the stock of Corporation X. B sells his 75 shares of Corporation M stock to Corporation X. Under section 302(b)(3) this is a termination of B’s entire interest in Corporation M and the full amount received from the sale of his stock will be treated as payment in exchange for this stock, provided he fulfills the requirements of section 302(c)(2) (relating to an acquisition of an interest in the corporations).

§ 1.304-4 Special rules for the use of related corporations to avoid the application of section 304.

(a) *Scope and purpose.* This section applies to determine the amount of a property distribution constituting a dividend (and the source thereof) under section 304(b)(2), for certain transactions involving controlled corporations. The purpose of this section is to prevent the avoidance of the application of section 304 to a controlled corporation.

(b) *Amount and source of dividend.* For purposes of determining the amount constituting a dividend (and source thereof) under section 304(b)(2), the following rules shall apply:

(1) *Deemed acquiring corporation.* A corporation (deemed acquiring corporation) shall be treated as acquiring for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if a principal purpose for creating, organizing, or funding the acquiring corporation by any means (including through capital contributions or debt) is to avoid the application of section 304 to the deemed acquiring corporation. See paragraph (c) *Example 1* of this section for an illustration of this paragraph.

(2) *Deemed issuing corporation.* The acquiring corporation shall be treated as acquiring for property the stock of a corporation (deemed issuing corporation) controlled by the issuing corporation if, in connection with the acquisition for property of stock of the issuing corporation by the acquiring corporation, the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of section 304 to the deemed issuing corporation. See paragraph (c) *Example 2* of this section for an illustration of this paragraph.

(c) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. (i) *Facts.* P, a domestic corporation, wholly owns CFC1, a controlled foreign corporation with substantial accumulated earnings and profits. CFC1 is organized in Country X, which imposes a high rate of tax on the income of CFC1. P also wholly owns

CFC2, a controlled foreign corporation with accumulated earnings and profits of \$200x. CFC2 is organized in Country Y, which imposes a low rate of tax on the income of CFC2. P wishes to own all of its foreign corporations in a direct chain and to repatriate the cash of CFC2. In order to avoid having to obtain Country X approval for the acquisition of CFC1 (a Country X corporation) by CFC2 (a Country Y corporation) and to avoid the dividend distribution from CFC2 to P that would result if CFC2 were the acquiring corporation, P causes CFC2 to form CFC3 in Country X and to contribute \$100x to CFC3. CFC3 then acquires all of the stock of CFC1 from P for \$100x.

(ii) *Result.* Because a principal purpose for creating, organizing, or funding CFC3 (acquiring corporation) is to avoid the application of section 304 to CFC2 (deemed acquiring corporation), under paragraph (b)(1) of this section, for purposes of determining the amount of the \$100x distribution constituting a dividend (and source thereof) under section 304(b)(2), CFC2 shall be treated as acquiring the stock of CFC1 (issuing corporation) from P for \$100x. As a result, P receives a \$100x distribution out of the earnings and profits of CFC2 to which section 301(c)(1) applies.

Example 2. (i) *Facts.* P, a domestic corporation, wholly owns CFC1, a controlled foreign corporation with substantial accumulated earnings and profits. The CFC1 stock has a basis of \$100x. CFC1 is organized in Country X. P also wholly owns CFC2, a controlled foreign corporation with zero accumulated earnings and profits. CFC2 is organized in Country Y. P wishes to own all of its foreign corporations in a direct chain and to repatriate the cash of CFC2. In order to avoid having to obtain Country X approval for the acquisition of CFC1 (a Country X corporation) by CFC2 (a Country Y corporation) and to avoid a dividend distribution from CFC1 to P, P forms a new corporation (CFC3) in Country X and transfers the stock of CFC1 to CFC3 in exchange for CFC3 stock. P then transfers the stock of CFC3 to CFC2 in exchange for \$100x.

(ii) *Result.* Because a principal purpose for the transfer of the stock of CFC1 (deemed issuing corporation) by P to CFC3 (issuing corporation) is to avoid the application of section 304 to CFC1, under paragraph (b)(2) of this section, for purposes of determining the amount of the \$100x distribution constituting a dividend (and source thereof) under section 304(b)(2), CFC2 (acquiring corporation) shall be treated as acquiring the stock of CFC1 from P for \$100x. As a result, P receives a \$100x distribution out of the earnings and profits of CFC1 to which section 301(c)(1) applies.

(d) *Effective/applicability date.* This section applies to acquisitions of stock occurring on or after December 29, 2009. [T.D. 9606, 77 FR 75845, Dec. 26, 2012]

§ 1.304-5 Control.

(a) *Control requirement in general.* Section 304(c)(1) provides that, for purposes of section 304, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. Section 304(c)(3) makes section 318(a) (relating to constructive ownership of stock), as modified by section 304(c)(3)(B), applicable to section 304 for purposes of determining control under section 304(c)(1).

(b) *Effect of section 304(c)(2)(B)—(1) In general.* In determining whether the control test with respect to both the issuing and acquiring corporations is satisfied, section 304(a)(1) considers only the person or persons that—

- (i) Control the issuing corporation before the transaction;
- (ii) Transfer issuing corporation stock to the acquiring corporation for property; and
- (iii) Control the acquiring corporation thereafter.

(2) *Application.* Section 317 defines property to include money, securities, and any other property except stock (or stock rights) in the distributing corporation. However, section 304(c)(2)(B) provides a special rule to extend the relevant group of persons to be tested for control of both the issuing and acquiring corporations to include the person or persons that do not acquire property, but rather solely stock from the acquiring corporation in the transaction. Section 304(c)(2)(B) provides that if two or more persons in control of the issuing corporation transfer stock of such corporation to the acquiring corporation, and if the transferors are in control of the acquiring corporation after the transfer, the person or persons in control of each corporation include each of those transferors. Because the purpose of section 304(c)(2)(B) is to include in the relevant control group the person or persons that retain or acquire acquiring corporation stock in the transaction,

only the person or persons transferring stock of the issuing corporation that retain or acquire any proprietary interest in the acquiring corporation are taken into account for purposes of applying section 304(c)(2)(B).

(3) *Example.* This section may be illustrated by the following example.

Example. (a) A, the owner of 20% of T's only class of stock, transfers that stock to P solely in exchange for all of the P stock. Pursuant to the same transaction, P, solely in exchange for cash, acquires the remaining 80% of the T stock from T's other shareholder, B, who is unrelated to A and P.

(b) Although A and B together were in control of T (the issuing corporation) before the transaction and A and B each transferred T stock to P (the acquiring corporation), sections 304(a)(1) and (c)(2)(B) do not apply to B because B did not retain or acquire any proprietary interest in P in the transaction. Section 304(a)(1) also does not apply to A because A (or any control group of which A was a member) did not control T before the transaction and P after the transaction.

(c) *Effective date.* This section is effective on January 20, 1994.

[T.D. 8515, 59 FR 2960, Jan. 20, 1994]

§ 1.305-1 Stock dividends.

(a) *In general.* Under section 305, a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under the authority of section 305(c). A distribution made by a corporation to its shareholders in its stock or rights to acquire its stock which would not otherwise be included in gross income by reason of section 305 shall not be so included merely because such distribution was made out of Treasury stock or consisted of rights to acquire Treasury stock. See section 307 for rules as to basis of stock and stock rights acquired in a distribution.

(b) *Amount of distribution.* (1) In general, where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b), the amount of the distribution, in accordance with section 301(b) and § 1.301-1, is the fair market value of such stock or rights on the date of distribution. See *Example (1)* of § 1.305-2(b).

(2) Where a corporation which regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of the stock received by any shareholder electing to receive stock will be considered to equal the amount of the money which could have been received instead. See *Example (2)* of § 1.305-2(b).

(3) For rules for determining the amount of the distribution where certain transactions, such as changes in conversion ratios or periodic redemptions, are treated as distributions under section 305(c), see *Examples (6), (8), (9), and (15)* of § 1.305-3(e).

(c) *Adjustment in purchase price.* A transfer of stock (or rights to acquire stock) or an increase or decrease in the conversion ratio or redemption price of stock which represents an adjustment of the price to be paid by the distributing corporation in acquiring property (within the meaning of section 317(a)) is not within the purview of section 305 because it is not a distribution with respect to its stock. For example, assume that on January 1, 1970, pursuant to a reorganization, corporation X acquires all the stock of corporation Y solely in exchange for its convertible preferred class B stock. Under the terms of the class B stock, its conversion ratio is to be adjusted in 1976 under a formula based upon the earnings of corporation Y over the 6-year period ending on December 31, 1975. Such an adjustment in 1976 is not covered by section 305.

(d) *Definitions.* (1) For purposes of this section and §§ 1.305-2 through 1.305-7, the term *stock* includes rights or warrants to acquire such stock.

(2) For purposes of §§ 1.305-2 through 1.305-7, the term *shareholder* includes a holder of rights or warrants or a holder of convertible securities.

[T.D. 7281, 38 FR 18532, July 12, 1973; 38 FR 19910, July 25, 1973]

§ 1.305-2 Distributions in lieu of money.

(a) *In general.* Under section 305(b)(1), if any shareholder has the right to an election or option with respect to

whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock is treated as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in the other;

(4) Whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

(5) Whether all or part of the shareholders have the election.

(b) *Examples.* The application of section 305(b)(1) may be illustrated by the following examples:

Example 1. (i) Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus \$12 principal amount of securities of corporation Y owned by corporation X. The fair market value of the stock of corporation X on the distribution date was \$10 per share. The fair market value of \$12 principal amount of securities of corporation Y on the distribution date was \$11 but such securities had a cost basis to corporation X of \$9.

(ii) The distribution to all shareholders of one additional share of stock of corporation X (with respect to which no election applies) for each share outstanding is not a distribution to which section 301 applies.

(iii) The distribution of the second share of stock of corporation X to those shareholders who do not elect to receive securities of corporation Y is a distribution of property to which section 301 applies, whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies is \$10 per share of stock of

corporation X held on the record date (the fair market value of the stock of corporation X on the distribution date).

(iv) The distribution of securities of corporation Y in lieu of the second share of stock of corporation X to the shareholders of corporation X whether individuals or corporations, who elect to receive such securities, is also a distribution of property to which section 301 applies.

(v) In the case of the individual shareholders of corporation X who elects to receive such securities, the amount of the distribution to which section 301 applies is \$11 per share of stock of corporation X held on the record date (the fair market value of the \$12 principal amount of securities of corporation Y on the distribution date).

(vi) In the case of the corporate shareholders of corporation X electing to receive such securities, the amount of the distribution to which section 301 applies is \$9 per share of stock of corporation X held on the record date (the basis of the securities of corporation Y in the hands of corporation X).

Example 2. On January 10, 1970, corporation X, a regulated investment company, declared a dividend of \$1 per share on its common stock payable on February 11, 1970, in cash or in stock of corporation X of equivalent value determined as of January 22, 1970, at the election of the shareholder made on or before January 22, 1970. The amount of the distribution to which section 301 applies is \$1 per share whether the shareholder elects to take cash or stock and whether the shareholder is an individual or a corporation. Such amount will also be used in determining the dividend paid deduction of corporation X and the reduction in earnings and profits of corporation X.

[T.D. 7281, 38 FR 18532, July 12, 1973]

§ 1.305-3 Disproportionate distributions.

(a) *In general.* Under section 305(b)(2), a distribution (including a deemed distribution) by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of (1) the receipt of money or other property by some shareholders, and (2) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Thus, if a corporation has two classes of common stock outstanding and cash dividends are paid on one class and stock dividends are paid on the other class, the stock dividends are

treated as distributions to which section 301 applies.

(b) *Special rules.* (1) As used in section 305(b)(2), the term *a series of distributions* encompasses all distributions of stock made or deemed made by a corporation which have the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders.

(2) In order for a distribution of stock to be considered as one of a series of distributions it is not necessary that such distribution be pursuant to a plan to distribute cash or property to some shareholders and to increase the proportionate interests of other shareholders. It is sufficient if there is an actual or deemed distribution of stock (of which such distribution is one) and as a result of such distribution or distributions some shareholders receive cash or property and other shareholders increase their proportionate interests. For example, if a corporation pays quarterly stock dividends to one class of common shareholders and annual cash dividends to another class of common shareholders the quarterly stock dividends constitute a series of distributions of stock having the result of the receipt of cash or property by some shareholders and an increase in the proportionate interests of other shareholders. This is so whether or not the stock distributions and the cash distributions are steps in an overall plan or are independent and unrelated. Accordingly, all the quarterly stock dividends are distributions to which section 301 applies.

(3) There is no requirement that both elements of section 305(b)(2) (i.e., receipt of cash or property by some shareholders and an increase in proportionate interests of other shareholders) occur in the form of a distribution or series of distributions as long as the result of a distribution or distributions of stock is that some shareholders' proportionate interests increase and other shareholders in fact receive cash or property. Thus, there is no requirement that the shareholders receiving cash or property acquire the cash or property by way of a corporate distribution with respect to their shares, so long as they receive such cash or

property in their capacity as shareholders, if there is a stock distribution which results in a change in the proportionate interests of some shareholders and other shareholders receive cash or property. However, in order for a distribution of property to meet the requirement of section 305(b)(2), such distribution must be made to a shareholder in his capacity as a shareholder, and must be a distribution to which section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) applies. (Under section 305(d)(2), the payment of interest to a holder of a convertible debenture is treated as a distribution of property to a shareholder for purposes of section 305(b)(2).) For example if a corporation makes a stock distribution to its shareholders and, pursuant to a prearranged plan with such corporation, a related corporation purchases such stock from those shareholders who want cash, in a transaction to which section 301 applies by virtue of section 304, the requirements of section 305(b)(2) are satisfied. In addition, a distribution of property incident to an isolated redemption of stock (for example, pursuant to a tender offer) will not cause section 305(b)(2) to apply even though the redemption distribution is treated as a distribution of property to which section 301, 871(a)(1)(A), 881(a)(1), or 356(a)(2) applies.

(4) Where the receipt of cash or property occurs more than 36 months following a distribution or series of distributions of stock, or where a distribution or series of distributions of stock is made more than 36 months following the receipt of cash or property, such distribution or distributions will be presumed not to result in the receipt of cash or property by some shareholders and an increase in the proportionate interest of other shareholders, unless the receipt of cash or property and the distribution or series of distributions of stock are made pursuant to a plan. For example, if, pursuant to a plan, a corporation pays cash dividends to some shareholders on January 1, 1971 and increases the proportionate interests of other shareholders on March 1, 1974, such increases in proportionate interests are distributions to which section 301 applies.

(5) In determining whether a distribution or a series of distributions has the result of a disproportionate distribution, there shall be treated as outstanding stock of the distributing corporation (i) any right to acquire such stock (whether or not exercisable during the taxable year), and (ii) any security convertible into stock of the distributing corporation (whether or not convertible during the taxable year).

(6) In cases where there is more than one class of stock outstanding, each class of stock is to be considered separately in determining whether a shareholder has increased his proportionate interest in the assets or earnings and profits of a corporation. The individual shareholders of a class of stock will be deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation.

(c) *Distributions of cash in lieu of fractional shares.* (1) Section 305(b)(2) will not apply if—

(i) A corporation declares a dividend payable in stock of the corporation and distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled, or

(ii) Upon a conversion of convertible stock or securities a corporation distributes cash in lieu of fractional shares to which shareholders would otherwise be entitled.

Provided the purpose of the distribution of cash is to save the corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation. For purposes of paragraph (c)(1)(i) of this section, if the total amount of cash distributed in lieu of fractional shares is 5 percent or less of the total fair market value of the stock distributed (determined as of the date of declaration), the distribution shall be considered to be for such valid purpose.

(2) In a case to which subparagraph (1) of this paragraph applies, the transaction will be treated as though the fractional shares were distributed as part of the stock distribution and then

were redeemed by the corporation. The treatment of the cash received by a shareholder will be determined under section 302.

(d) *Adjustment in conversion ratio.* (1)(i) Except as provided in subparagraph (2) of this paragraph, if a corporation has convertible stock or convertible securities outstanding (upon which it pays or is deemed to pay dividends or interest in money or other property) and distributes a stock dividend (or rights to acquire such stock) with respect to the stock into which the convertible stock or securities are convertible, an increase in proportionate interest in the assets or earnings and profits of the corporation by reason of such stock dividend shall be considered to have occurred unless a full adjustment in the conversion ratio or conversion price to reflect such stock dividend is made. Under certain circumstances, however, the application of an adjustment formula which in effect provides for a "credit" where stock is issued for consideration in excess of the conversion price may not satisfy the requirement for a "full adjustment." Thus, if under a "conversion price" antidilution formula the formula provides for a "credit" where stock is issued for consideration in excess of the conversion price (in effect as an offset against any decrease in the conversion price which would otherwise be required when stock is subsequently issued for consideration below the conversion price) there may still be an increase in proportionate interest by reason of a stock dividend after application of the formula, since any downward adjustment of the conversion price that would otherwise be required to reflect the stock dividend may be offset, in whole or in part, by the effect of prior sales made at prices above the conversion price. On the other hand, if there were no prior sales of stock above the conversion price then a full adjustment would occur upon the application of such an adjustment formula and there would be no change in proportionate interest. Similarly, if consideration is to be received in connection with the issuance of stock, such as in the case of a rights offering or a distribution of warrants, the fact that such consideration is

taken into account in making the antidilution adjustment will not preclude a full adjustment. See paragraph (b) of the example in this subparagraph for a case where the application of an adjustment formula with a cumulative feature does not result in a full adjustment and where a change in proportionate interest therefore occurs. See paragraph (c) for a case where the application of an adjustment formula with a cumulative feature does result in a full adjustment and where no change in proportionate interest therefore occurs. See paragraph (d) for an application of an antidilution formula in the case of a rights offering. See paragraph (e) for a case where the application of a noncumulative type adjustment formula will in all cases prevent a change in proportionate interest from occurring in the case of a stock dividend, because of the omission of the cumulative feature.

(ii) The principles of this subparagraph may be illustrated by the following example.

Example. (a) Corporation S has two classes of securities outstanding, convertible debentures and common stock. At the time of issuance of the debentures the corporation had 100 shares of common stock outstanding. Each debenture is interest-paying and is convertible into common stock at a conversion price of \$2. The debenture's conversion price is subject to reduction pursuant to the following formula:

(Number of common shares outstanding at date of issue of debentures times initial conversion price) *plus* (Consideration received upon issuance of additional common shares) *divided by* (Number of common shares outstanding at date of issue of debentures) *plus* (Number of additional common shares issued)

Under the formula, common stock dividends are treated as an issue of common stock for zero consideration. If the computation results in a figure which is less than the existing conversion price the conversion price is reduced. However, under the formula, the existing conversion price is never increased. The formula works upon a cumulative basis since the numerator includes the consideration received upon the issuance of all common shares subsequent to the issuance of the debentures, and the reduction effected by the formula because of a sale or issuance of common stock below the existing conversion price is thus limited by any prior sales made above the existing conversion price.

(b) In 1972 corporation S sells 100 common shares at \$3 per share. In 1973 the corporation declares a stock dividend of 20 shares to all holders of common stock. Under the antidilution formula no adjustment will be made to the conversion price of the debentures to reflect the stock dividend to common stockholders since the prior sale of common stock in excess of the conversion price in 1972 offsets the reduction in the conversion price which would otherwise result, as follows:

$$100 \times \$2 + \$300 \div 100 + 120 = \$500 \div 220 = \$2.27$$

Since \$2.27 is greater than the existing conversion price of \$2 no adjustment is required. As a result, there is an increase in proportionate interest of the common stockholders by reason of the stock dividend and the additional shares of common stock will be treated, pursuant to section 305(b)(2), as a distribution of property to which section 301 applies.

(c) Assume the same facts as above, but instead of selling 100 common shares at \$3 per share in 1972, assume corporation S sold no shares. Application of the antidilution formula would give rise to an adjustment in the conversion price as follows:

$$100 \times \$2 + \$0 \div 100 + 20 = \$200 \div 120 = \$1.67$$

The conversion price, being reduced from \$2 to \$1.67, fully reflects the stock dividend distributed to the common stockholders. Hence, the distribution of common stock is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(d) Corporation S distributes to its shareholders rights entitling the shareholders to purchase a total of 20 shares at \$1 per share. Application of the antidilution formula would produce an adjustment in the conversion price as follows:

$$100 \times \$2 + 20 \times \$1 \div 100 + 20 = \$220 \div 120 = \$1.83$$

The conversion price, being reduced from \$2 to \$1.83, fully reflects the distribution of rights to purchase stock at a price lower than the conversion price. Hence, the distribution of the rights is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(e) Assume the same facts as in (b) above, but instead of using a "conversion price" antidilution formula which operates on a cumulative basis, assume corporation S has employed a formula which operates as follows with respect to all stock dividends: The conversion price in effect at the opening of business on the day following the dividend record date is reduced by multiplying such conversion price by a fraction the numerator of which is the number of shares of common

stock outstanding at the close of business on the record date and the denominator of which is the sum of such shares so outstanding and the number of shares constituting the stock dividend. Under such a formula the following adjustment would be made to the conversion price upon the declaration of a stock dividend of 20 shares in 1973:

$$200 \div 200 + 20 = 200 \div 220 \times \$2 = \$1.82$$

The conversion price, being reduced from \$2 to \$1.82, fully reflects the stock dividend distributed to the common stockholders. Hence, the distribution of common stock is not treated under section 305(b)(2) as one to which section 301 applies because the distribution does not increase the proportionate interests of the common shareholders as a class.

(2)(i) A distributing corporation either must make the adjustment required by subparagraph (1) of this paragraph as of the date of the distribution of the stock dividend, or must elect (in the manner provided in subdivision (iii) of this subparagraph) to make such adjustment within the time provided in subdivision (ii) of this subparagraph.

(ii) If the distributing corporation elects to make such adjustment, such adjustment must be made no later than the earlier of (a) 3 years after the date of the stock dividend, or (b) that date as of which the aggregate stock dividends for which adjustment of the conversion ratio has not previously been made total at least 3 percent of the issued and outstanding stock with respect to which such stock dividends were distributed.

(iii) The election provided by subdivision (ii) of this subparagraph shall be made by filing with the income tax return for the taxable year during which the stock dividend is distributed—

(a) A statement that an adjustment will be made as provided by that subdivision, and

(b) A description of the antidilution provisions under which the adjustment will be made.

(3) Notwithstanding the preceding subparagraph, if a distribution has been made before July 12, 1973, and the adjustment required by subparagraph (1) or the election to make such adjustment was not made before such date, the adjustment or the election to make such adjustment, as the case may be, shall be considered valid if made no

later than 15 days following the date of the first annual meeting of the shareholders after July 12, 1973, or July 12, 1974, whichever is earlier. If the election is made within such period, and, if the income tax return has been filed before the time of such election, the statement of adjustment and the description of the antidilution provisions required by subparagraph (2)(iii) shall be filed with the Internal Revenue Service Center with which the income tax return was filed.

(4) See § 1.305-7(b) for a discussion of antidilution adjustments in connection with the application of section 305(c) in conjunction with section 305(b).

(e) *Examples.* The application of section 305(b)(2) to distributions of stock and section 305(c) to deemed distributions of stock may be illustrated by the following examples:

Example 1. Corporation X is organized with two classes of common stock, class A and class B. Each share of stock is entitled to share equally in the assets and earnings and profits of the corporation. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in cash. Since the class A shareholders as a class will have increased their proportionate interests in the assets and earnings and profits of the corporation and the class B shareholders will have received cash, the additional shares of class A stock are distributions of property to which section 301 applies. This is true even with respect to those shareholders who may own class A stock and class B stock in the same proportion.

Example 2. Corporation Y is organized with two classes of stock, class A common, and class B, which is nonconvertible and limited and preferred as to dividends. A dividend is declared upon the class A stock payable in additional shares of class A stock and a dividend is declared on the class B stock payable in cash. The distribution of class A stock is not one to which section 301 applies because the distribution does not increase the proportionate interests of the class A shareholders as a class.

Example 3. Corporation K is organized with two classes of stock, class A common, and class B, which is nonconvertible preferred stock. A dividend is declared upon the class A stock payable in shares of class B stock and a dividend is declared on the class B stock payable in cash. Since the class A shareholders as a class have an increased in-

terest in the assets and earnings and profits of the corporation, the stock distribution is treated as a distribution to which section 301 applies. If, however, a dividend were declared upon the class A stock payable in a new class of preferred stock that is subordinated in all respects to the class B stock, the distribution would not increase the proportionate interests of the class A shareholders in the assets or earnings and profits of the corporation and would not be treated as a distribution to which section 301 applies.

Example 4. (i) Corporation W has one class of stock outstanding, class A common. The corporation also has outstanding interest paying securities convertible into class A common stock which have a fixed conversion ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. Corporation W distributes to the class A shareholders rights to acquire additional shares of class A stock. During the year, interest is paid on the convertible securities.

(ii) The stock rights and convertible securities are considered to be outstanding stock of the corporation and the distribution increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation. Therefore, the distribution is treated as a distribution to which section 301 applies. The same result would follow if, instead of convertible securities, the corporation had outstanding convertible stock. If, however, the conversion ratio of the securities or stock were fully adjusted to reflect the distribution of rights to the class A shareholders, the rights to acquire class A stock would not increase the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation and would not be treated as a distribution to which section 301 applies.

Example 5. (i) Corporation S is organized with two classes of stock, class A common and class B convertible preferred. The class B is fully protected against dilution in the event of a stock dividend or stock split with respect to the class A stock; however, no adjustment in the conversion ratio is required to be made until the stock dividends equal 3 percent of the common stock issued and outstanding on the date of the first such stock dividend except that such adjustment must be made no later than 3 years after the date of the stock dividend. Cash dividends are paid annually on the class B stock.

(ii) Corporation S pays a 1 percent stock dividend on the class A stock in 1970. In 1971, another 1 percent stock dividend is paid and in 1972 another 1 percent stock dividend is paid. The conversion ratio of the class B stock is increased in 1972 to reflect the three stock dividends paid on the class A stock. The distributions of class A stock are not

distributions to which section 301 applies because they do not increase the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation.

Example 6. (i) Corporation M is organized with two classes of stock outstanding, class A and class B. Each class B share may be converted, at the option of the holder, into class A shares. During the first year, the conversion ratio is one share of class A stock for each share of class B stock. At the beginning of each subsequent year, the conversion ratio is increased by 0.05 share of class A stock for each share of class B stock. Thus, during the second year, the conversion ratio would be 1.05 shares of class A stock for each share of class B stock, during the third year, the ratio would be 1.10 shares, etc.

(ii) M pays an annual cash dividend on the class A stock. At the beginning of the second year, when the conversion ratio is increased to 1.05 shares of class A stock for each share of class B stock, a distribution of 0.05 shares of class A stock is deemed made under section 305(c) with respect to each share of class B stock, since the proportionate interests of the class B shareholders in the assets or earnings and profits of M are increased and the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

Example 7. (i) Corporation N has two classes of stock outstanding, class A and class B. Each class B share is convertible into class A stock. However, in accordance with a specified formula, the conversion ratio is decreased each time a cash dividend is paid on the class B stock to reflect the amount of the cash dividend. The conversion ratio is also adjusted in the event that cash dividends are paid on the class A stock to increase the number of class A shares into which the class B shares are convertible to compensate the class B shareholders for the cash dividend paid on the class A stock.

(ii) In 1972, a \$1 cash dividend per share is declared and paid on the class B stock. On the date of payment, the conversion ratio of the class B stock is decreased. A distribution of stock is deemed made under section 305(c) to the class A shareholders, since the proportionate interest of the class A shareholders in the assets or earnings and profits of the corporation is increased and the transaction has the effect described in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

(iii) In the following year a cash dividend is paid on the class A stock and none is paid on the class B stock. The increase in conversion rights of the class B shares is deemed to be a distribution under section 305(c) to the class B shareholders since their proportionate interest in the assets or earnings and profits of the corporation is increased and since the transaction has the effect described

in section 305(b)(2). Accordingly, sections 305(b)(2) and 301 apply to the transaction.

Example 8. Corporation T has 1,000 shares of stock outstanding. C owns 100 shares. Nine other shareholders each owns 100 shares. Pursuant to a plan for periodic redemptions, T redeems up to 5 percent of each shareholder's stock each year. During the year, each of the nine other shareholders has 5 shares of his stock redeemed for cash. Thus, C's proportionate interest in the assets and earnings and profits of T is increased. Assuming that the cash received by the nine other shareholders is taxable under section 301, C is deemed under section 305(c) to have received a distribution under section 305(b)(2) of 5.25 shares of T stock to which section 301 applies. The amount of C's distribution is measured by the fair market value of the number of shares which would have been distributed to C had the corporation sought to increase his interest by 0.47 percentage points (C owned 10 percent of the T stock immediately before the redemption and 10.47 percent immediately thereafter) and the other shareholders continued to hold 900 shares (i.e.,

(a) $100 \div 955 = 10.47\%$ (percent of C's ownership after redemption)

(b) $100 + x \div 1000 + x = 10.47\%$; $x = 5.25$ (additional shares considered to be distributed to C).

Since in computing the amount of additional shares deemed to be distributed to C the redemption of shares is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of the corporation which is deemed to be distributed. Thus, in the example, 1,005.25 shares of stock are considered as outstanding after the redemption. The value of each share deemed to be distributed to C is then determined by dividing the 1,005.25 shares into the aggregate fair market value of the actual shares outstanding (955) after the redemption.

Example 9. (i) Corporation O has a stock redemption program under which, instead of paying out earnings and profits to its shareholders in the form of dividends, it redeems the stock of its shareholders up to a stated amount which is determined by the earnings and profits of the corporation. If the stock tendered for redemption exceeds the stated amount, the corporation redeems the stock on a pro rata basis up to the stated amount.

(ii) During the year corporation O offers to distribute \$10,000 in redemption of its stock. At the time of the offering, corporation O has 1,000 shares outstanding of which E and F each owns 150 shares and G and H each owns 350 shares. The corporation redeems 15 shares from E and 35 shares from G. F and H continue to hold all of their stock.

(iii) F and H have increased their proportionate interests in the assets and earnings and profits of the corporation. Assuming that the cash E and G receive is taxable

under section 301, F will be deemed under section 305(c) to have received a distribution under section 305(b)(2) of 16.66 shares of stock to which section 301 applies and H will be deemed under section 305(c) to have received a distribution under section 305(b)(2) of 38.86 shares of stock to which section 301 applies. The amount of the distribution to F and H is measured by the number of shares which would have been distributed to F and H had the corporation sought to increase the interest of F by 0.79 percentage points (F owned 15 percent of the stock immediately before the redemption and 15.79 percent immediately thereafter) and the interest of H by 1.84 percentage points (H owned 35 percent of the stock immediately before the redemption and 36.84 percent immediately thereafter) and E and G had continued to hold 150 shares and 350 shares, respectively (i.e.,

(a) $150+950+350-950=52.63\%$ (percent of F and H's ownership after redemption)

(b) $500+y+1000+y=52.63\%$; $y=55.52$ (additional shares considered to be distributed to F and H)

(c)(1) $150+500 \times 55.52=16.66$ (shares considered to be distributed to F)

(2) $350+500 \times 55.52=38.86$ (shares considered to be distributed to H)).

Since in computing the amount of additional shares deemed to be distributed to F and H the redemption of shares is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of the corporation which is deemed to be distributed. Thus, in the example, 1,055.52 shares of stock are considered as outstanding after the redemption. The value of each share deemed to be distributed to F and H is then determined by dividing the 1,055.52 shares into the aggregate fair market value of the actual shares outstanding (950) after the redemption.

Example 10. Corporation P has 1,000 shares of stock outstanding. T owns 700 shares of the P stock and G owns 300 shares of the P stock. In a single and isolated redemption to which section 301 applies, the corporation redeems 150 shares of T's stock. Since this is an isolated redemption and is not a part of a periodic redemption plan, G is not treated as having received a deemed distribution under section 305(c) to which sections 305(b)(2) and 301 apply even though he has an increased proportionate interest in the assets and earnings and profits of the corporation.

Example 11. Corporation Q is a large corporation whose sole class of stock is widely held. However, the four largest shareholders are officers of the corporation and each owns 8 percent of the outstanding stock. In 1974, in a distribution to which section 301 applies, the corporation redeems 1.5 percent of the stock from each of the four largest shareholders in preparation for their retirement. From 1970 through 1974, the corporation distributes annual stock dividends to its share-

holders. No other distributions were made to these shareholders. Since the 1974 redemptions are isolated and are not part of a plan for periodically redeeming the stock of the corporation, the shareholders receiving stock dividends will not be treated as having received a distribution under section 305(b)(2) even though they have an increased proportionate interest in the assets and earnings and profits of the corporation and whether or not the redemptions are treated as distributions to which section 301 applies.

Example 12. Corporation R has 2,000 shares of class A stock outstanding. Five shareholders own 300 shares each and five shareholders own 100 shares each. In preparation for the retirement of the five major shareholders, corporation R, in a single and isolated transaction, has a recapitalization in which each share of class A stock may be exchanged either for five shares of new class B nonconvertible preferred stock plus 0.4 share of new class C common stock, or for two shares of new class C common stock. As a result of the exchanges, each of the five major shareholders receives 1,500 shares of class B nonconvertible preferred stock and 120 shares of class C common stock. The remaining shareholders each receives 200 shares of class C common stock. None of the exchanges are within the purview of section 305.

Example 13. Corporation P is a widely-held company whose shares are listed for trading on a stock exchange. P distributes annual cash dividends to its shareholders. P purchases shares of its common stock directly from small stockholders (holders of record of 100 shares or less) or through brokers where the holders may not be known at the time of purchase. Where such purchases are made through brokers, they are pursuant to the rules and regulations of the Securities and Exchange Commission. The shares are purchased for the purpose of issuance to employee stock investment plans, to holders of convertible stock or debt, to holders of stock options, or for future acquisitions. Provided the purchases are not pursuant to a plan to increase the proportionate interest of some shareholders and distribute property to other shareholders, the remaining shareholders of P are not treated as having received a deemed distribution under section 305(c) to which section 305(b)(2) and 301 apply, even though they have an increased proportionate interest in the assets and earnings and profits of the corporation.

Example 14. Corporation U is a large manufacturing company whose products are sold through independent dealers. In order to assist individuals who lack capital to become dealers, the corporation has an established investment plan under which it provides 75 percent of the capital necessary to form a dealership corporation and the individual dealer provides the remaining 25 percent.

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Corporation U receives class A stock and a note representing its 75 percent interest. The individual dealer receives class B stock representing his 25 percent interest. The class B stock is nonvoting until all the class A shares are redeemed. At least 70 percent of the earnings and profits of the dealership corporation must be used each year to retire the note and to redeem the class A stock. The class A stock is redeemed at a fixed price. The individual dealer has no control over the redemption of stock and has no right to have his stock redeemed during the period the plan is in existence. U's investment is thus systematically eliminated and the individual becomes the sole owner of the dealership corporation. Since this type of plan is akin to a security arrangement, the redemptions of the class A stock will not be deemed under section 305(c) as distributions taxable under sections 305(b)(2) and 301 during the years in which the class A stock is redeemed.

Example 15. (i) *Facts.* Corporation V is organized with two classes of stock, class A common and class B convertible preferred. The class B stock is issued for \$100 per share and is convertible at the holder's option into class A at a fixed ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. The class B stock pays no dividends but it is mandatorily redeemable in 10 years for \$200. Under sections 305(c) and 305(b)(4), the entire redemption premium (i.e., the excess of the redemption price over the issue price) is deemed to be a distribution of preferred stock on preferred stock which is taxable as a distribution of property under section 301. This amount is considered to be distributed over the 10-year period under principles similar to the principles of section 1272(a). During the year, the corporation declares a dividend on the class A stock payable in additional shares of class A stock.

(ii) *Analysis.* The distribution on the class A stock is a distribution to which sections 305(b)(2) and 301 apply since it increases the proportionate interests of the class A shareholders in the assets and earnings and profits of the corporation and the class B shareholders have received property (i.e., the constructive distribution described above). If, however, the conversion ratio of the class B stock were subject to full adjustment to reflect the distribution of stock to class A shareholders, the distribution of stock dividends on the class A stock would not increase the proportionate interest of the class A shareholders in the assets and earnings and profits of the corporation and such distribution would not be a distribution to which section 301 applies.

(iii) *Effective date.* This *Example 15* applies to stock issued on or after December 20, 1995. For previously issued stock, see § 1.305-3(e)

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Example (15) (as contained in the 26 CFR part 1 edition revised April 1, 1995).

[T.D. 7281, 38 FR 18532, July 12, 1973; 38 FR 19910, 19911, July 25, 1973; as amended by T.D. 7329, 39 FR 36860, Oct. 15, 1974; T.D. 8643, 60 FR 66136, Dec. 21, 1995]

§ 1.305-4 Distributions of common and preferred stock.

(a) *In general.* Under section 305(b)(3), a distribution (or a series of distributions) by a corporation which results in the receipt of preferred stock whether or not convertible into common stock) by some common shareholders and the receipt of common stock by other common shareholders is treated as a distribution of property to which section 301 applies. For the meaning of the term *a series of distribution*, see subparagraphs (1) through (6) of § 1.305-3(b).

(b) *Examples.* The application of section 305(b)(3) may be illustrated by the following examples:

Example 1. Corporation X is organized with two classes of common stock, class A and class B. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in newly authorized class C stock which is nonconvertible and limited and preferred as to dividends. Both the distribution of class A shares and the distribution of new class C shares are distributions to which section 301 applies.

Example 2. Corporation Y is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized class B preferred stock which is convertible into class A stock no later than 6 months from the date of distribution at a price that is only slightly higher than the market price of class A stock on the date of distribution. Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period of time some shareholders will exercise their conversion rights and some will not. Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which section 301 applies.

[T.D. 7281, 38 FR 18536, July 12, 1973]

§ 1.305-5 Distributions on preferred stock.

(a) *In general.* Under section 305(b)(4), a distribution by a corporation of its stock (or rights to acquire its stock) made (or deemed made under section 305(c)) with respect to its preferred stock is treated as a distribution of property to which section 301 applies unless the distribution is made with respect to convertible preferred stock to take into account a stock dividend, stock split, or any similar event (such as the sale of stock at less than the fair market value pursuant to a rights offering) which would otherwise result in the dilution of the conversion right. For purposes of the preceding sentence, an adjustment in the conversion ratio of convertible preferred stock made solely to take into account the distribution by a closed end regulated investment company of a capital gain dividend with respect to the stock into which such stock is convertible shall not be considered a "similar event." The term *preferred stock* generally refers to stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of *preferred stock* for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited, and that such stock does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and antici-

pated earnings and upon liquidation beyond its preferred interest. Among the facts and circumstances to be considered are the prior and anticipated earnings per share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. The determination of whether stock is preferred for purposes of section 305 shall be made without regard to any right to convert such stock into another class of stock of the corporation. The term *preferred stock*, however, does not include convertible debentures.

(b) *Redemption premium*—(1) *In general.* If a corporation issues preferred stock that may be redeemed under the circumstances described in this paragraph (b) at a price higher than the issue price, the difference (the redemption premium) is treated under section 305(c) as a constructive distribution (or series of constructive distributions) of additional stock on preferred stock that is taken into account under principles similar to the principles of section 1272(a). However, constructive distribution treatment does not result under this paragraph (b) if the redemption premium does not exceed a de minimis amount, as determined under the principles of section 1273(a)(3). For purposes of this paragraph (b), preferred stock that may be acquired by a person other than the issuer (the third person) is deemed to be redeemable under the circumstances described in this paragraph (b), and references to the issuer include the third person, if—

(i) This paragraph (b) would apply to the stock if the third person were the issuer; and

(ii) Either—

(A) The acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes (under section 304 or otherwise); or

(B) The third person and the issuer are members of the same affiliated group (having the meaning for this purpose given the term by section 1504(a),

except that section 1504(b) shall not apply) and a principal purpose of the arrangement for the third person to acquire the stock is to avoid the application of section 305 and paragraph (b)(1) of this section.

(2) *Mandatory redemption or holder put.* Paragraph (b)(1) of this section applies to stock if the issuer is required to redeem the stock at a specified time or the holder has the option (whether or not currently exercisable) to require the issuer to redeem the stock. However, paragraph (b)(1) of this section will not apply if the issuer's obligation to redeem or the holder's ability to require the issuer to redeem is subject to a contingency that is beyond the legal or practical control of either the holder or the holders as a group (or through a related party within the meaning of section 267(b) or 707(b)), and that, based on all of the facts and circumstances as of the issue date, renders remote the likelihood of redemption. For purposes of this paragraph, a contingency does not include the possibility of default, insolvency, or similar circumstances, or that a redemption may be precluded by applicable law which requires that the issuer have a particular level of capital, surplus, or similar items. A contingency also does not include an issuer's option to require earlier redemption of the stock. For rules applicable if stock may be redeemed at more than one time, see paragraph (b)(4) of this section.

(3) *Issuer call*—(i) *In general.* Paragraph (b)(1) of this section applies to stock by reason of the issuer's right to redeem the stock (even if the right is immediately exercisable), but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur. However, even if redemption is more likely than not to occur, paragraph (b)(1) of this section does not apply if the redemption premium is solely in the nature of a penalty for premature redemption. A redemption premium is not a penalty for premature redemption unless it is a premium paid as a result of changes in economic or market conditions over which neither the issuer nor the holder has legal or practical control.

(ii) *Safe harbor.* For purposes of this paragraph (b)(3), redemption pursuant to an issuer's right to redeem is not treated as more likely than not to occur if—

(A) The issuer and the holder are not related within the meaning of section 267(b) or 707(b) (for purposes of applying sections 267(b) and 707(b) (including section 267(f)(1)), the phrase "20 percent" shall be substituted for the phrase "50 percent");

(B) There are no plans, arrangements, or agreements that effectively require or are intended to compel the issuer to redeem the stock (disregarding, for this purpose, a separate mandatory redemption obligation described in paragraph (b)(2) of this section); and

(C) Exercise of the right to redeem would not reduce the yield of the stock, as determined under principles similar to the principles of section 1272(a) and the regulations under sections 1271 through 1275.

(iii) *Effect of not satisfying safe harbor.* The fact that a redemption right is not described in paragraph (b)(3)(ii) of this section does not affect the determination of whether a redemption pursuant to the right to redeem is more likely than not to occur.

(4) *Coordination of multiple redemption provisions.* If stock may be redeemed at more than one time, the time and price at which redemption is most likely to occur must be determined based on all of the facts and circumstances as of the issue date. Any constructive distribution under paragraph (b)(1) of this section will result only with respect to the time and price identified in the preceding sentence. However, if redemption does not occur at that identified time, the amount of any additional premium payable on any later redemption date, to the extent not previously treated as distributed, is treated as a constructive distribution over the period from the missed call or put date to that later date, to the extent required under the principles of this paragraph (b).

(5) *Consistency.* The issuer's determination as to whether there is a constructive distribution under this paragraph (b) is binding on all holders of

the stock, other than a holder that explicitly discloses that its determination as to whether there is a constructive distribution under this paragraph (b) differs from that of the issuer. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the date the holder acquired the stock. The issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will make available to holders upon request the information required for holders to comply with this provision of this paragraph (b).

(c) *Cross reference.* For rules for applying sections 305(b)(4) and 305(c) to recapitalizations, see § 1.305-7(c).

(d) *Examples.* The application of sections 305(b)(4) and 305(c) may be illustrated by the following examples:

Example 1. (i) Corporation T has outstanding 1,000 shares of \$100 par 5-percent cumulative preferred stock and 10,000 shares of no-par common stock. The corporation is 4 years in arrears on dividends to the preferred shareholders. The issue price of the preferred stock is \$100 per share. Pursuant to a recapitalization under section 368(a)(1)(E), the preferred shareholders exchange their preferred stock, including the right to dividend arrearages, on the basis of one old preferred share for 1.20 newly authorized class A preferred shares. Immediately following the recapitalization, the new class A shares are traded at \$100 per share. The class A shares are entitled to a liquidation preference of \$100. The preferred shareholders have increased their proportionate interest in the assets or earnings and profits of corporation T since the fair market value of 1.20 shares of class A preferred stock (\$120) exceeds the issue price of the old preferred stock (\$100). Accordingly, the preferred shareholders are deemed under section 305(c) to receive a distribution in the amount of \$20 on each share of old preferred stock and the distribution is one to which sections 305(b)(4) and 301 apply.

(ii) The same result would occur if the fair market value of the common stock immediately following the recapitalization were \$20 per share and each share of preferred stock were exchanged for one share of the new class A preferred stock and one share of common stock.

Example 2. Corporation A, a publicly held company whose stock is traded on a securi-

ties exchange (or in the over-the-counter market) has two classes of stock outstanding, common and cumulative preferred. Each share of preferred stock is convertible into .75 shares of common stock. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. The issue price of the preferred stock is \$100 per share. In order to retire the preferred stock, corporation A recapitalizes in a transaction to which section 368(a)(1)(E) applies and each share of preferred stock is exchanged for one share of common stock. Immediately after the recapitalization the common stock has a fair market value of \$110 per share. Notwithstanding the fact that the fair market value of the common stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, the recapitalization is not deemed under section 305(c) to result in a distribution to which sections 305(b)(4) and 301 apply since the recapitalization is not pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits and does not involve dividend arrearages.

Example 3. Corporation V is organized with two classes of stock, 1,000 shares of class A common and 1,000 shares of class B convertible preferred. Each share of class B stock may be converted into two shares of class A stock. Pursuant to a recapitalization under section 368(a)(1)(E), the 1,000 shares of class A stock are surrendered in exchange for 500 shares of new class A common and 500 shares of newly authorized class C common. The conversion right of class B stock is changed to one share of class A stock and one share of class C stock for each share of class B stock. The change in the conversion right is not deemed under section 305(c) to be a distribution on preferred stock to which sections 305(b)(4) and 301 apply.

Example 4. (i) *Facts.* Corporation X is a domestic corporation with only common stock outstanding. In connection with its acquisition of Corporation T, X issues 100 shares of its 4% preferred stock to the shareholders of T, who are unrelated to X both before and after the transaction. The issue price of the preferred stock is \$40 per share. Each share of preferred stock is convertible at the shareholder's election into three shares of X common stock. At the time the preferred stock is issued, the X common stock has a value of \$10 per share. The preferred stock does not provide for its mandatory redemption or for redemption at the option of the holder. It is callable at the option of X at any time beginning three years from the date of issuance for \$100 per share. There are no other plans,

arrangements, or agreements that effectively require or are intended to compel X to redeem the stock.

(ii) *Analysis.* The preferred stock is described in the safe harbor rule of paragraph (b)(3)(ii) of this section because X and the former shareholders of T are unrelated, there are no plans, arrangements, or agreements that effectively require or are intended to compel X to redeem the stock, and calling the stock for \$100 per share would not reduce the yield of the preferred stock. Therefore, the \$60 per share call premium is not treated as a constructive distribution to the shareholders of the preferred stock under paragraph (b) of this section.

Example 5. (i) *Facts*—(A) Corporation Y is a domestic corporation with only common stock outstanding. On January 1, 1996, Y issues 100 shares of its 10% preferred stock to a holder. The holder is unrelated to Y both before and after the stock issuance. The issue price of the preferred stock is \$100 per share. The preferred stock is—

(1) Callable at the option of Y on or before January 1, 2001, at a price of \$105 per share plus any accrued but unpaid dividends; and

(2) Mandatorily redeemable on January 1, 2006, at a price of \$100 per share plus any accrued but unpaid dividends.

(B) The preferred stock provides that if Y fails to exercise its option to call the preferred stock on or before January 1, 2001, the holder will be entitled to appoint a majority of Y's directors. Based on all of the facts and circumstances as of the issue date, Y is likely to have the legal and financial capacity to exercise its right to redeem. There are no other facts and circumstances as of the issue date that would affect whether Y will call the preferred stock on or before January 1, 2001.

(ii) *Analysis.* Under paragraph (b)(3)(i) of this section, paragraph (b)(1) of this section applies because, by virtue of the change of control provision and the absence of any contrary facts, it is more likely than not that Y will exercise its option to call the preferred stock on or before January 1, 2001. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply because the provision that failure to call will cause the holder to gain control of the corporation is a plan, arrangement, or agreement that effectively requires or is intended to compel Y to redeem the preferred stock. Under paragraph (b)(4) of this section, the constructive distribution occurs over the period ending on January 1, 2001. Redemption is most likely to occur on that date, because that is the date on which the corporation minimizes the rate of return to the holder while preventing the holder from gaining control. The de minimis exception of paragraph (b)(1) of this section does not apply because the \$5 per share difference between the redemption price and the issue price exceeds the amount determined under

the principles of section 1273(a)(3) ($5 \times .0025 \times \$105 = \1.31). Accordingly, \$5 per share, the difference between the redemption price and the issue price, is treated as a constructive distribution received by the holder on an economic accrual basis over the five-year period ending on January 1, 2001, under principles similar to the principles of section 1272(a).

Example 6. Corporation A, a publicly held company whose stock is traded on a securities exchange (or in the over-the-counter market) has two classes of stock outstanding, common and preferred. The preferred stock is nonvoting and nonconvertible, limited and preferred as to dividends, and has a fixed liquidation preference. There are no dividend arrearages. At the time of issue of the preferred stock, there was no plan or prearrangement by which it was to be exchanged for common stock. In order to retire the preferred stock, corporation A recapitalizes in a transaction to which section 368(a)(1)(E) applies and the preferred stock is exchanged for common stock. The transaction is not deemed to be a distribution under section 305(c) and sections 305(b) and 301 do not apply to the transaction. The same result would follow if the preferred stock was exchanged in any reorganization described in section 368(a)(1) for a new preferred stock having substantially the same market value and having no greater call price or liquidation preference than the old preferred stock, whether the new preferred stock has voting rights or is convertible into common stock of corporation A at a fixed ratio subject to change solely to take account of stock dividends, stock splits, or similar transactions with respect to the stock into which the preferred stock is convertible.

Example 7. (i) *Facts*—(A) Corporation Z is a domestic corporation with only common stock outstanding. On January 1, 1996, Z issues 100 shares of its 10% preferred stock to C, an individual unrelated to Z both before and after the stock issuance. The issue price of the preferred stock is \$100 per share. The preferred stock is—

(1) Not callable for a period of 5 years from the issue date;

(2) Callable at the option of Z on January 1, 2001, at a price of \$110 per share plus any accrued but unpaid dividends;

(3) Callable at the option of Z on July 1, 2002, at a price of \$120 per share plus any accrued but unpaid dividends; and

(4) Mandatorily redeemable on January 1, 2004, at a price of \$150 per share plus any accrued but unpaid dividends.

(B) There are no other plans, arrangements, or agreements between Z and C concerning redemption of the stock. Moreover, there are no other facts and circumstances

as of the issue date that would affect whether Z will call the preferred stock on either January 1, 2001, or July 1, 2002.

(ii) *Analysis.* This stock is described in paragraph (b)(2) of this section because it is mandatorily redeemable. It is also potentially described in paragraph (b)(3)(i) of this section because it is callable at the option of the issuer. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on January 1, 2001, because the call would reduce the yield of the stock when compared to the yield produced by the January 1, 2004, mandatory redemption feature. Moreover, absent any other facts indicating a contrary result, the fact that redemption on January 1, 2001, would produce the lowest yield indicates that redemption is most likely to occur on that date. Under paragraph (b)(4) of this section, paragraph (b)(1) of this section applies with respect to the issuer's right to call on January 1, 2001, because redemption is most likely to occur on January 1, 2001, for \$110 per share. The de minimis exception of paragraph (b)(1) of this section does not apply because the \$10 per share difference between the redemption price payable in 2001 and the issue price exceeds the amount determined under the principles of section 1273(a)(3) ($5 \times .0025 \times \$110 = \1.38). Accordingly, \$10 per share, the difference between the redemption price and the issue price, is treated as a constructive distribution received by the holder on an economic accrual basis over the five-year period ending January 1, 2001, under principles similar to the principles of section 1272(a).

(iii) *Coordination rules—(A)* If Z does not exercise its option to call the preferred stock on January 1, 2001, paragraph (b)(4) of this section provides that the principles of paragraph (b) of this section must be applied to determine if any remaining constructive distribution occurs. Under paragraphs (b)(3)(i) and (b)(4) of this section, paragraph (b)(1) of this section applies because, absent any other facts indicating a contrary result, the fact that redemption on July 1, 2002, would produce a lower yield than the yield produced by the mandatory redemption feature indicates that redemption on that date is most likely to occur. The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on July 1, 2002, because, as of January 1, 2001, a call by Z on July 1, 2002, for \$120 would reduce the yield of the stock. The de minimis exception of paragraph (b)(1) of this section does not apply because the \$10 per share difference between the redemption price and the issue price (revised as of the missed call date as provided by paragraph (b)(4) of this section) exceeds the amount determined under the principles of section 1273(a)(3) ($1 \times .0025 \times \$120 = \$.30$). Accordingly, the \$10 per share of additional redemption premium that is payable on July 1, 2002, is treated as a constructive distribution

received by the holder on an economic accrual basis over the period between January 1, 2001, and July 1, 2002, under principles similar to the principles of section 1272(a).

(B) If Z does not exercise its second option to call the preferred stock on July 1, 2002, then the \$30 additional redemption premium that is payable on January 1, 2004, is treated as a constructive distribution under paragraphs (b)(2) and (b)(1) of this section. The de minimis exception of paragraph (b)(1) of this section does not apply because the \$30 per share difference between the redemption price and the issue price (revised as of the second missed call date) exceeds the amount determined under the principles of section 1273(a)(3) ($1 \times .0025 \times \$150 = \3.75). The holder is treated as receiving the constructive distribution on an economic accrual basis over the period between July 1, 2002, and January 1, 2004, under principles similar to the principles of section 1272(a).

Example 8. (i) *Facts.* The facts are the same as in paragraph (i) of Example 7, except that, based on all of the facts and circumstances as of the issue date (including an expected lack of funds on the part of Z), it is unlikely that Z will exercise the right to redeem on either January 1, 2001, or July 1, 2002.

(ii) *Analysis.* The safe harbor rule of paragraph (b)(3)(ii) of this section does not apply to the option to call on either January 1, 2001, or July 1, 2002, because each call would reduce the yield of the stock. Under paragraph (b)(3)(i) of this section, neither option to call is more likely than not to occur, because, based on all of the facts and circumstances as of the issue date (including an expected lack of funds on the part of Z), it is not more likely than not that Z will exercise either option. However, the \$50 per share redemption premium that is payable on January 1, 2004, is treated as a constructive distribution under paragraphs (b)(1) and (2) of this section, regardless of whether Z is anticipated to have sufficient funds to redeem on that date, because Z is required to redeem the stock on that date. The de minimis exception of paragraph (b)(1) of this section does not apply because the \$50 per share difference between the redemption price and the issue price exceeds the amount determined under the principles of section 1273(a)(3) ($8 \times .0025 \times \$150 = \3).

Example 9. Corporation Q is organized with 10,000 shares of class A stock and 1,000 shares of class B stock. The terms of the class B stock require that the class B have a preference of \$5 per share with respect to dividends and \$100 per share with respect to liquidation. In addition, upon a distribution of \$10 per share to the class A stock, class B participates equally in any additional dividends. The terms also provide that upon liquidation the class B stock participates equally after the class A stock receives \$100 per share. Corporation Q has no accumulated

earnings and profits. In 1971 it earned \$10,000, the highest earnings in its history. The corporation is in an industry in which it is reasonable to anticipate a growth in earnings of 5 percent per year. In 1971 the book value of corporation Q's assets totalled \$100,000. In that year the corporation paid a dividend of \$5 per share to the class B stock and \$.50 per share to the class A. In 1972 the corporation had no earnings and in lieu of a \$5 dividend distributed one share of class B stock for each outstanding share of class B. No distribution was made to the class A stock. Since, in 1972, it was not reasonable to anticipate that the class B stock would participate in the current and anticipated earnings and growth of the corporation beyond its preferred interest, the class B stock is preferred stock and the distribution of class B shares to the class B shareholders is a distribution to which sections 305(b)(4) and 301 apply.

Example 10. Corporation P is organized with 10,000 shares of class A stock and 1,000 shares of class B stock. The terms of the class B stock require that the class B have a preference of \$5 per share with respect to dividends and \$100 per share with respect to liquidation. In addition, upon a distribution of \$5 per share to the class A stock, class B participates equally in any additional dividends. The terms also provide that upon liquidation the class B stock participates equally after the class A receives \$100 per share. Corporation P has accumulated earnings and profits of \$100,000. In 1971 it earned \$75,000. The corporation is in an industry in which it is reasonable to anticipate a growth in earnings of 10 percent per year. In 1971 the book value of corporation P's assets totalled \$5 million. In that year the corporation paid a dividend of \$5 per share to the class B stock, \$5 per share to the class A stock, and it distributed an additional \$1 per share to both class A and class B stock. In 1972 the corporation had earnings of \$82,500. In that year it paid a dividend of \$5 per share to the class B stock and \$5 per share to the class A stock. In addition, the corporation declared stock dividends of one share of class B stock for every 10 outstanding shares of class B and one share of class A stock for every 10 outstanding shares of class A. Since, in 1972, it was reasonable to anticipate that both the class B stock and the class A stock would participate in the current and anticipated earnings and growth of the corporation beyond their preferred interests, neither class is preferred stock and the stock dividends are not distributions to which section 305(b)(4) applies.

(e) *Effective date.* The rules of paragraph (b) of this section and *Examples 4, 5, 7, and 8* of paragraph (d) of this section apply to stock issued on or after December 20, 1995. For rules applicable

to previously issued stock, see § 1.305-5 (b) and (d) *Examples (4), (5), and (7)* (as contained in the 26 CFR part 1 edition revised April 1, 1995). Although the rules of paragraph (b) of this section and the revised examples do not apply to stock issued before December 20, 1995, the rules of sections 305(c)(1), (2), and (3) apply to stock described therein issued on or after October 10, 1990, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Public Law 101-508 Stat.). Moreover, except as provided in section 11322(b)(2) of the Revenue Reconciliation Act of 1990 (Public Law 101-508 Stat.), with respect to stock issued on or after October 10, 1990, and issued before December 20, 1995, the economic accrual rule of section 305(c)(3) will apply to the entire call premium on stock that is not described in paragraph (b)(2) of this section if the premium is considered to be unreasonable under the principles of § 1.305-5(b) (as contained in the 26 CFR part 1 edition revised April 1, 1995). A call premium described in the preceding sentence will be accrued over the period of time during which the preferred stock cannot be called for redemption.

[T.D. 7281, 38 FR 18536, July 12, 1973, as amended by T.D. 7329, 39 FR 36860, Oct. 15, 1974; T.D. 8643, 60 FR 66136, Dec. 21, 1995]

§ 1.305-6 Distributions of convertible preferred.

(a) *In general.* (1) Under section 305(b)(5), a distribution by a corporation of its convertible preferred stock or rights to acquire such stock made or considered as made with respect to its stock is treated as a distribution of property to which section 301 applies unless the corporation establishes that such distribution will not result in a disproportionate distribution as described in § 1.305-3.

(2) The distribution of convertible preferred stock is likely to result in a disproportionate distribution when both of the following conditions exist: (i) The conversion right must be exercised within a relatively short period of time after the date of distribution of the stock; and (ii) taking into account such factors as the dividend rate, the redemption provisions, the marketability of the convertible stock, and

the conversion price, it may be anticipated that some shareholders will exercise their conversion rights and some will not. On the other hand, where the conversion right may be exercised over a period of many years and the dividend rate is consistent with market conditions at the time of distribution of the stock, there is no basis for predicting at what time and the extent to which the stock will be converted and it is unlikely that a disproportionate distribution will result.

(b) *Examples.* The application of section 305(b)(5) may be illustrated by the following examples:

Example 1. Corporation Z is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized class B preferred stock which is convertible into class A stock for a period of 20 years from the date of issuance. Assuming dividend rates are normal in light of existing conditions so that there is no basis for predicting the extent to which the stock will be converted, the circumstances will ordinarily be sufficient to establish that a disproportionate distribution will not result since it is impossible to predict the extent to which the class B stock will be converted into class A stock. Accordingly, the distribution of class B stock is not one to which section 301 applies.

Example 2. Corporation X is organized with one class of stock, class A common. During the year the corporation declares a dividend on the class A stock payable in newly authorized redeemable class C preferred stock which is convertible into class A common stock no later than 4 months from the date of distribution at a price slightly higher than the market price of class A stock on the date of distribution. By prearrangement with corporation X, corporation Y, an insurance company, agrees to purchase class C stock from any shareholder who does not wish to convert. By reason of this prearrangement, it is anticipated that the shareholders will either sell the class C stock to the insurance company (which expects to retain the shares for investment purposes) or will convert. As a result, some of the shareholders exercise their conversion privilege and receive additional shares of class A stock, while other shareholders sell their class C stock to corporation Y and receive cash. The distribution is a distribution to which section 301 applies since it results in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders.

[T.D. 7281, 38 FR 18538, July 12, 1973]

§ 1.305-7 Certain transactions treated as distributions.

(a) *In general.* Under section 305(c), a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder may be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction. In general, such change, difference, redemption, or similar transaction will be treated as a distribution to which sections 305(b) and 301 apply where—

(1) The proportionate interest of any shareholder in the earnings and profits or assets of the corporation deemed to have made such distribution is increased by such change, difference, redemption, or similar transaction; and

(2) Such distribution has the result described in paragraph (2), (3), (4), or (5) of section 305(b).

Where such change, difference, redemption, or similar transaction is treated as a distribution under the provisions of this section, such distribution will be deemed made with respect to any shareholder whose interest in the earnings and profits or assets of the distributing corporation is increased thereby. Such distribution will be deemed to be a distribution of the stock of such corporation made by the corporation to such shareholder with respect to his stock. Depending upon the facts presented, the distribution may be deemed to be made in common or preferred stock. For example, where a redemption premium exists with respect to a class of preferred stock under the circumstances described in § 1.305-5(b) and the other requirements of this section are also met, the distribution will be deemed made with respect to such preferred stock, in stock of the same class. Accordingly, the preferred shareholders are considered under sections 305(b)(4) and 305(c) to have received a distribution of preferred stock to which section 301 applies. See the examples in §§ 1.305-

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3(e) and 1.305-5(d) for further illustrations of the application of section 305(c).

(b) *Antidilution provisions.* (1) For purposes of applying section 305(c) in conjunction with section 305(b), a change in the conversion ratio or conversion price of convertible preferred stock (or securities), or in the exercise price of rights or warrants, made pursuant to a bona fide, reasonable, adjustment formula (including, but not limited to, either the so-called “market price” or “conversion price” type of formulas) which has the effect of preventing dilution of the interest of the holders of such stock (or securities) will not be considered to result in a deemed distribution of stock. An adjustment in the conversion ratio or price to compensate for cash or property distributions to other shareholders that are taxable under section 301, 356(a)(2), 871(a)(1)(A), 881(a)(1), 852(b), or 857(b) will not be considered as made pursuant to a bona fide adjustment formula.

(2) The principles of this paragraph may be illustrated by the following example:

Example. (i) Corporation U has two classes of stock outstanding, class A and class B. Each class B share is convertible into class A stock. In accordance with a bonafide, reasonable, antidilution provision, the conversion price is adjusted if the corporation transfers class A stock to anyone for a consideration that is below the conversion price.

(ii) The corporation sells class A stock to the public at the current market price but below the conversion price. Pursuant to the antidilution provision, the conversion price is adjusted downward. Such a change in conversion price will not be deemed to be a distribution under section 305(c) for the purposes of section 305(b).

(c) *Recapitalizations.* (1) A recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which section 305(c) and this section apply if—

(i) It is pursuant to a plan to periodically increase a shareholder’s proportionate interest in the assets or earnings and profits of the corporation, or

(ii) A shareholder owning preferred stock with dividends in arrears exchanges his stock for other stock and, as a result, increases his proportionate interest in the assets or earnings and profits of the corporation. An increase

in a preferred shareholder’s proportionate interest occurs in any case where the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization), exceeds the issue price of the preferred stock surrendered.

(2) In a case to which subparagraph (1)(ii) of this paragraph applies, the amount of the distribution deemed under section 305(c) to result from the recapitalization is the lesser of (i) the amount by which the fair market value or the liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or (ii) the amount of the dividends in arrears.

(3) For purposes of applying subparagraphs (1) and (2) of this paragraph with respect to stock issued before July 12, 1973, the term *issue price of the preferred stock surrendered* shall mean the greater of the issue price or the liquidation preference (not including dividends in arrears) of the stock surrendered.

(4) For an illustration of the application of this paragraph, see *Example (12)* of § 1.305-3(e) and *Examples (1), (2), (3), and (6)* of § 1.305-5(d).

(5) For rules relating to redemption premiums on preferred stock, see § 1.305-5(b).

[T.D. 7281, 38 FR 18538, July 12, 1973, as amended by T.D. 8643, 60 FR 66138, Dec. 21, 1995]

§ 1.305-8 Effective dates.

(a) *In general.* Section 421(b) of the Tax Reform Act of 1969 (83 Stat. 615) provides as follows:

(b) *Effective dates.* (1) Except as otherwise provided in this subsection, the amendment made by subsection (a) shall apply with respect to distributions (or deemed distributions) made after January 10, 1969, in taxable years ending after such date.

(2)(A) Section 305(b)(2) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall not apply to a distribution (or deemed distribution) of stock made before January 1, 1991, with respect to stock (i) outstanding on January 10, 1969, (ii) issued pursuant to a contract binding on January 10, 1969, on the

distributing corporation, (iii) which is additional stock of that class of stock which (as of January 10, 1969) had the largest fair market value of all classes of stock of the corporation (taking into account only stock outstanding on January 10, 1969, or issued pursuant to a contract binding on January 10, 1969), (iv) described in subparagraph (c)(iii), or (v) issued in a prior distribution described in clause (i), (ii), (iii), or (iv).

(B) Subparagraph (A) shall apply only if—

(i) The stock as to which there is a receipt of property was outstanding on January 10, 1969 (or was issued pursuant to a contract binding on January 10, 1969, on the distributing corporation), and

(ii) If such stock and any stock described in subparagraph (A)(i) were also outstanding on January 10, 1968, a distribution of property was made on or before January 10, 1969, with respect to such stock, and a distribution of stock was made on or before January 10, 1969, with respect to such stock described in subparagraph (A)(i).

(C) Subparagraph (A) shall cease to apply when at any time after October 9, 1969, the distributing corporation issues any of its stock (other than in a distribution of stock with respect to stock of the same class) which is not—

(i) Nonconvertible preferred stock,

(ii) Additional stock of that class of stock which meets the requirements of subparagraph (A)(iii), or

(iii) Preferred stock which is convertible into stock which meets the requirements of subparagraph (A)(iii) at a fixed conversion ratio which takes account of all stock dividends and stock splits with respect to the stock into which such convertible stock is convertible.

(D) For purposes of this paragraph, the term *stock* includes rights to acquire such stock.

(3) In cases to which Treasury Decision 6990 (promulgated January 10, 1969) would not have applied, in applying paragraphs (1) and (2) April 22, 1969, shall be substituted for January 10, 1969.

(4) Section 305(b)(4) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall not apply to any distribution (or deemed distribution) with respect to preferred stock (including any increase in the conversion ratio of convertible stock) made before January 1, 1991, pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.

(5) With respect to distributions made or considered as made after January 10, 1969, in taxable years ending after such date, to the extent that the amendment made by subsection (a) does not apply by reason of paragraph (2), (3), or (4) of this subsection, section 305 of the Internal Revenue Code of 1954 (as in effect before the amendment made by subsection (a)) shall continue to apply.

(b) *Rules of application.* (1) The rules contained in section 421(b)(2) of the Tax Reform Act of 1969 (83 Stat. 615), hereinafter called “the Act”, shall apply with respect to the application of section 305(b)(2), section 305(b)(3), and section 305(b)(5). Thus, for example, section 305(b)(5) of the Code will not apply to a distribution of convertible preferred stock made before January 1, 1991, with respect to stock outstanding on January 10, 1969 (or which was issued pursuant to a contract binding on the distributing corporation on January 10, 1969), provided the distribution is pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.

(2)(i) For purposes of section 421(b)(2)(A), (B)(i), and (C) of the Act, stock is considered as outstanding on January 10, 1969, if it could be acquired on such date or some future date by the exercise of a right or conversion privilege in existence on such date (including a right or conversion privilege with respect to stock issued pursuant to a contract binding, on January 10, 1969, on the distributing corporation). Thus, if on January 10, 1969, corporation X has outstanding 1,000 shares of class A common stock and 3,000 shares of class B common stock which are convertible on a one-to-one basis into class A stock, corporation X is considered for purposes of section 421(b)(2)(A), (B)(i), and (C) of the Act to have outstanding on January 10, 1969, 4,000 shares of class A stock (1,000 shares actually outstanding and 3,000 shares that could be acquired by the exercise of the conversion privilege contained in the class B stock) and 3,000 shares of class B stock.

(ii) For the purposes of section 421(b)(2)(A) (other than for the purpose of determining under section 421(b)(2)(A)(iii) that class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation), (B)(i), and (C) of the Act, stock will be considered as outstanding on January 10, 1969, if it is issued pursuant to a conversion privilege contained in stock issued, mediately or immediately, as a stock dividend with respect to stock outstanding on January 10, 1969.

(3) If, after applying subparagraph (2) of this paragraph, the class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation is a class of stock which is convertible into another class of nonconvertible stock, then for purposes of section 421(b)(2)(C)(ii) of the Act stock issued upon conversion of any such convertible stock (whether or not outstanding on January 10, 1969) into stock of such other class shall be deemed to be stock which meets the requirements of section 421(b)(2)(A)(iii) of the Act.

(4) For purposes of section 421(b) of the Act, stock of a corporation held in its treasury will not be considered as outstanding and a distribution of such stock will be considered to be an issuance of such stock on the date of distribution. Stock of a parent corporation held by its subsidiary is not considered treasury stock.

(5) The following stock shall not be taken into account for purposes of applying section 421(b)(2)(B)(i) of the Act: (i) Stock issued after January 10, 1969, and before October 10, 1969 (other than stock which was issued pursuant to a contract binding on January 10, 1969, on the distributing corporation); (ii) stock described in section 421(b)(2)(C)(i), (ii), or (iii) of the Act; and (iii) stock issued, mediately or immediately, as a stock dividend with respect to stock of the same class outstanding on January 10, 1969. For example, if on June 1, 1970, corporation Y issues additional stock of that class of stock which as of January 10, 1969, had the largest fair market value of all classes of stock of the corporation, such additional stock will not be taken into account for the purpose of meeting the requirement under section 421(b)(2)(B)(i) of the Act that the stock as to which there is a receipt of property must have been outstanding on January 10, 1969, and thus subparagraph (A) of section 421(b)(2) of the Act will not, where otherwise applicable, cease to apply.

(6) Section 421(b)(2)(A) of the Act, if otherwise applicable, will not cease to apply if the distributing corporation issues after October 9, 1969, securities which are convertible into stock that meets the requirements of section

421(b)(2)(A)(iii) of the Act at a fixed conversion ratio which takes account of all stock dividends and stock splits with respect to the stock into which the securities are convertible.

(7) Under section 421(b)(4) of the Act, section 305(b)(4) does not apply to any distribution (or deemed distribution) by a corporation with respect to preferred stock made before January 1, 1991, if such distribution is pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969. For example, if as of January 10, 1969, a corporation had followed the practice of paying stock dividends on preferred stock (or of periodically increasing the conversion ratio of convertible preferred stock) or if the preferred stock provided for a redemption price in excess of the issue price, then section 305(b)(4) would not apply to any distribution of stock made (or which would be considered made if section 305(b)(4) applied) before January 1, 1991, pursuant to such practice.

(8) If section 421(b)(2) is not applicable and, for that reason, a distribution (or deemed distribution) is treated as a distribution to which section 301 applies by virtue of the application of section 305(b)(2), (b)(3), or (b)(5), it is irrelevant that, by reason of the application of section 421(b)(4) of such Act, section 305(b)(4) is not applicable to the distribution.

[T.D. 7281, 38 FR 18539, July 12, 1973]

§ 1.306-1 General.

(a) Section 306 provides, in general, that the proceeds from the sale or redemption of certain stock (referred to as "section 306 stock") shall be treated either as ordinary income or as a distribution of property to which section 301 applies. Section 306 stock is defined in section 306(c) and is usually preferred stock received either as a non-taxable dividend or in a transaction in which no gain or loss is recognized. Section 306(b) lists certain circumstances in which the special rules of section 306(a) shall not apply.

(b)(1) If a shareholder sells or otherwise disposes of section 306 stock (other than by redemption or within the exceptions listed in section 306(b)), the entire proceeds received from such disposition shall be treated as ordinary

income to the extent that the fair market value of the stock sold, on the date distributed to the shareholder, would have been a dividend to such shareholder had the distributing corporation distributed cash in lieu of stock. Any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock disposed of, shall be treated as gain from the sale of a capital asset or noncapital asset as the case may be. No loss shall be recognized. No reduction of earnings and profits results from any disposition of stock other than a redemption. The term *disposition* under section 306(a)(1) includes, among other things, pledges of stock under certain circumstances, particularly where the pledgee can look only to the stock itself as its security.

(2) Section 306(a)(1) may be illustrated by the following examples:

Example 1. On December 15, 1954, A and B owned equally all of the stock of Corporation X which files its income tax return on a calendar year basis. On that date Corporation X distributed pro rata 100 shares of preferred stock as a dividend on its outstanding common stock. On December 15, 1954, the preferred stock had a fair market value of \$10,000. On December 31, 1954, the earnings and profits of Corporation X were \$20,000. The 50 shares of preferred stock so distributed to A had an allocated basis to him of \$10 per share or a total of \$500 for the 50 shares. Such shares had a fair market value of \$5,000 when issued. A sold the 50 shares of preferred stock on July 1, 1955, for \$6,000. Of this amount \$5,000 will be treated as ordinary income; \$500 (\$6,000 minus \$5,500) will be treated as gain from the sale of a capital or non-capital asset as the case may be.

Example 2. The facts are the same as in *Example 1* except that A sold his 50 shares of preferred stock for \$5,100. Of this amount \$5,000 will be treated as ordinary income. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, \$400, the allocated basis of \$500 reduced by the \$100 received.

Example 3. The facts are the same as in *Example 1* except that A sold 25 of his shares of preferred stock for \$2,600. Of this amount \$2,500 will be treated as ordinary income. No loss will be allowed. There will be added back to the basis of the common stock of Corporation X with respect to which the preferred stock was distributed, \$150, the allocated basis of \$250 reduced by the \$100 received.

(c) The entire amount received by a shareholder from the redemption of section 306 stock shall be treated as a distribution of property under section 301. See also section 303 (relating to distribution in redemption of stock to pay death taxes).

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7556, 43 FR 34128, Aug. 3, 1978]

§ 1.306-2 Exception.

(a) If a shareholder terminates his entire stock interest in a corporation—

(1) By a sale or other disposition within the requirements of section 306(b)(1)(A), or

(2) By redemption under section 302(b)(3) (through the application of section 306(b)(1)(B)),

the amount received from such disposition shall be treated as an amount received in part or full payment for the stock sold or redeemed. In the case of a sale, only the stock interest need be terminated. In determining whether an entire stock interest has been terminated under section 306(b)(1)(A), all of the provisions of section 318(a) (relating to constructive ownership of stock) shall be applicable. In determining whether a shareholder has terminated his entire interest in a corporation by a redemption of his stock under section 302(b)(3), all of the provisions of section 318(a) shall be applicable unless the shareholder meets the requirements of section 302(c)(2) (relating to termination of all interest in the corporation). If the requirements of section 302(c)(2) are met, section 318(a)(1) (relating to members of a family) shall be inapplicable. Under all circumstances paragraphs (2), (3), (4), and (5) of section 318(a) shall be applicable.

(b) Section 306(a) does not apply to—

(1) Redemptions of section 306 stock pursuant to a partial or complete liquidation of a corporation to which part II (section 331 and following), subchapter C, chapter 1 of the Code applies,

(2) Exchanges of section 306 stock solely for stock in connection with a reorganization or in an exchange under section 351, 355, or section 1036 (relating to exchanges of stock for stock in the same corporation) to the extent that gain or loss is not recognized to

the shareholder as the result of the exchange of the stock (see paragraph (d) of §1.306-3 relative to the receipt of other property), and

(3) A disposition or redemption, if it is established to the satisfaction of the Commissioner that the distribution, and the disposition or redemption, was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. However, in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, it is not necessary to establish that the distribution was not in pursuance of such a plan. For example, in the absence of such a plan and of any other facts the first sentence of this subparagraph would be applicable to the case of dividends and isolated dispositions of section 306 stock by minority shareholders. Similarly, in the absence of such a plan and of any other facts, if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a disposition one of the principal purposes of which is the avoidance of Federal income tax.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11998, Aug. 23, 1968]

§ 1.306-3 Section 306 stock defined.

(a) For the purpose of subchapter C, chapter 1 of the code, the term *section 306 stock* means stock which meets the requirements of section 306(c)(1). Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, if a distribution of money by the distributing corporation in lieu of such stock would have been a dividend in whole or in part. However, except as provided in section 306(g), if no part of a distribution of money by the distributing corporation in lieu of such stock would have been a dividend, the stock distrib-

uted will not constitute section 306 stock.

(b) For the purpose of section 306, rights to acquire stock shall be treated as stock. Such rights shall not be section 306 stock if no part of the distribution would have been a dividend if money had been distributed in lieu of the rights. When stock is acquired by the exercise of rights which are treated at section 306 stock, the stock acquired is section 306 stock. Upon the disposition of such stock (other than by redemption or within the exceptions listed in section 306(b)), the proceeds received from the disposition shall be treated as ordinary income to the extent that the fair market value of the stock rights, on the date distributed to the shareholder, would have been a dividend to the shareholder had the distributing corporation distributed cash in lieu of stock rights. Any excess of the amount realized over the sum of the amount treated as ordinary income plus the adjusted basis of the stock, shall be treated as gain from the sale of the stock.

(c) Section 306(c)(1)(A) provides that section 306 stock is any stock (other than common issued with respect to common) distributed to the shareholder selling or otherwise disposing thereof if, under section 305(a) (relating to distributions of stock and stock rights) any part of the distribution was not included in the gross income of the distributee.

(d) Section 306(c)(1)(B) includes in the definition of section 306 stock any stock except common stock, which is received by a shareholder in connection with a reorganization under section 368 or in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355) provided the effect of the transaction is substantially the same as the receipt of a stock dividend, or the stock is received in exchange for section 306 stock. If, in a transaction to which section 356 is applicable, a shareholder exchanges section 306 stock for stock and money or other property, the entire amount of such money and of the fair market value of the other property (not limited to the gain recognized) shall be treated as a distribution of property to which section 301 applies. Common

stock received in exchange for section 306 stock in a recapitalization shall not be considered section 306 stock. Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of section 356(b) or section 302(d). The application of the preceding sentence is illustrated by the following examples:

Example 1. Corporation A, having only common stock outstanding, is merged in a statutory merger (qualifying as a reorganization under section 368(a)) with Corporation B. Pursuant to such merger, the shareholders of Corporation A received both common and preferred stock in Corporation B. The preferred stock received by such shareholders is section 306 stock.

Example 2. X and Y each own one-half of the 2,000 outstanding shares of preferred stock and one-half of the 2,000 outstanding shares of common stock of Corporation C. Pursuant to a reorganization within the meaning of section 368(a)(1)(E) (recapitalization) each shareholder exchanges his preferred stock for preferred stock of a new issue which is not substantially different from the preferred stock previously held. Unless the preferred stock exchanged was itself section 306 stock the preferred stock received is not section 306 stock.

(e) Section 306(c)(1)(C) includes in the definition of section 306 stock any stock (except as provided in section 306(c)(1)(B)) the basis of which in the hands of the person disposing of such stock, is determined by reference to section 306 stock held by such shareholder or any other person. Under this paragraph common stock can be section 306 stock. Thus, if a person owning section 306 stock in Corporation A transfers it to Corporation B which is controlled by him in exchange for common stock of Corporation B in a transaction to which section 351 is applicable, the common stock so received by him would be section 306 stock and subject to the provisions of section 306(a) on its disposition. In addition, the section 306 stock transferred is section 306

stock in the hands of Corporation B, the transferee. Section 306 stock transferred by gift remains section 306 stock in the hands of the donee. Stock received in exchange for section 306 stock under section 1036(a) (relating to exchange of stock for stock in the same corporation) or under so much of section 1031(b) as relates to section 1036(a) becomes section 306 stock and acquires, for purposes of section 306, the characteristics of the section 306 stock exchanged. The entire amount of the fair market value of the other property received in such transaction shall be considered as received upon a disposition (other than a redemption) to which section 306(a) applies. Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death or the optional valuation date under section 1014.

(f) If section 306 stock which was distributed with respect to common stock is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in section 306 stock), such common stock shall not be section 306 stock. This paragraph applies to exchanges not coming within the purview of section 306(c)(1)(B). Common stock which is convertible into stock other than common stock or into property, shall not be considered common stock. It is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.

(g) If there is a substantial change in the terms and conditions of any stock, then, for the purpose of this section—

(1) The fair market value of such stock shall be the fair market value at the time of distribution or the fair market value at the time of such change, whichever is higher;

(2) Such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined by reference to the time of distribution or by reference to the time of such change, whichever ratable share is higher; and

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(3) Section 306(c)(2) shall be inapplicable if there would have been a dividend to any extent if money had been distributed in lieu of the stock either at the time of the distribution or at the time of such change.

(h) When section 306 stock is disposed of, the amount treated under section 306(a)(1)(A) as ordinary income, for the purposes of part I, subchapter N, chapter 1 of the Code, be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If the amount is determined to be derived from sources within the United States, the amount shall be considered to be fixed or determinable annual or periodic gains, profits, and income within the meaning of section 871(a) or section 881(a), relating, respectively, to the tax on non-resident alien individuals and on foreign corporations not engaged in business in the United States.

(i) Section 306 shall be inapplicable to stock received before June 22, 1954, and to stock received on or after June 22, 1954, in transactions subject to the provisions of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 7556, 43 FR 34128, Aug. 3, 1978]

§ 1.307-1 General.

(a) If a shareholder receives stock or stock rights as a distribution on stock previously held and under section 305 such distribution is not includible in gross income then, except as provided in section 307(b) and § 1.307-2, the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and pursuant to section 305 part of the distribution is not includible in gross income, then (except as provided in section 307(b) and § 1.307-2) the basis of the stock with respect to which the distribution is made shall be allocated between (1) the old stock and (2) that part of the new stock or rights which is not includible

in gross income, in proportion to the fair market values of each on the date of distribution. The date of distribution in each case shall be the date the stock or the rights are distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example. A taxpayer in 1947 purchased 100 shares of common stock at \$100 per share and in 1954 by reason of the ownership of such stock acquired 100 rights entitling him to subscribe to 100 additional shares of such stock at \$90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of \$110 and the rights had a fair market value of \$19 each. The basis of the rights and the common stock for the purpose of determining the basis for gain or loss on a subsequent sale or exercise of the rights or a sale of the old stock is computed as follows:

100 (shares) × \$100 = \$10,000, cost of old stock (stock in respect of which the rights were acquired).
100 (shares) × \$110 = \$11,000, market value of old stock.
100 (rights) × \$19 = \$1,900, market value of rights.
11,000/12,900 of \$10,000 = \$8,527.13, cost of old stock apportioned to such stock.
1,900/12,900 of \$10,000 = \$1,472.87, cost of old stock apportioned to rights.

If the rights are sold, the basis for determining gain or loss will be \$14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor (\$90) plus the basis of the rights exercised (\$14.7287 each) or \$104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be \$85.2713 per share.

§ 1.307-2 Exception.

The basis of rights to buy stock which are excluded from gross income under section 305(a), shall be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided in paragraph (a) of § 1.307-1.

The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.

EFFECTS ON CORPORATION

§ 1.312-1 Adjustment to earnings and profits reflecting distributions by corporations.

(a) In general, on the distribution of property by a corporation with respect to its stock, its earnings, and profits (to the extent thereof) shall be decreased by—

(1) The amount of money,

(2) The principal amount of the obligations of such corporation issued in such distribution, and

(3) The adjusted basis of other property.

For special rule with respect to distributions to which section 312(e) applies, see § 1.312-5.

(b) The adjustment provided in section 312(a)(3) and paragraph (a)(3) of this section with respect to a distribution of property (other than money or its own obligations) shall be made notwithstanding the fact that such property has appreciated or depreciated in value since acquisition.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. Corporation A distributes to its sole shareholder property with a value of \$10,000 and a basis of \$5,000. It has \$12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is \$5,000. Such is the reduction even though the amount of \$10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.

Example 2. The facts are the same as in *Example 1* above except that the property has a basis of \$15,000 and the earnings and profits of the corporation are \$20,000. The reduction in earnings and profits is \$15,000. Such is the reduction even though only the amount of \$10,000 is includible in the income of the shareholder as a dividend.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305(b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§ 1.312-2 Distribution of inventory assets.

Section 312(b) provides for the increase and the decrease of the earnings and profits of a corporation which distributes, with respect to its stock, inventory assets as defined in section 312(b)(2), where the fair market value of such assets exceeds their adjusted basis. The rules provided in section 312(b) (relating to distributions of certain inventory assets) shall be applicable without regard to the method used in computing inventories for the purpose of the computation of taxable income. Section 312(b) does not apply to distributions described in section 312(e).

§ 1.312-3 Liabilities.

The amount of any reductions in earnings and profits described in section 312 (a) or (b) shall be (a) reduced by the amount of any liability to which the property distributed was subject and by the amount of any other liability of the corporation assumed by the shareholder in connection with such distribution, and (b) increased by the amount of gain recognized to the corporation under section 311 (b), (c), or (d), or under section 341(f), 617(d),