**8812. What is an IRC Section 302 stock redemption?**

One of the exceptions to dividend treatment (discussed in Q 8811) is contained in IRC Section 302(b)(3). IRC Section 302(b)(3) provides that if a corporation redeems all of a shareholder’s remaining shares so that a shareholder’s interest in the corporation is terminated, the amount paid by the corporation will be treated as a payment in exchange for the stock, not as a dividend. In other words, the redemption will be treated as a capital transaction (See Q 8543 to Q 8558).[[1]](#footnote-1)

This means that the distribution by the corporation of the purchase price will not be treated as a taxable dividend if a corporation redeems all of its stock owned by an estate. However, in determining what stock is owned by an estate, it is important to keep in mind that the constructive ownership or attribution-of-ownership rules contained in IRC Section 318 must be applied in determining what shares must be sold.

Consequently, to achieve non-dividend treatment under IRC Section 302(b)(3), a corporation must redeem not only all of its shares actually owned by an estate, but also all of its shares constructively owned by the estate.

One of these constructive ownership rules provides that shares owned by a beneficiary of an estate are considered owned by the estate. For example, assume that a decedent owned 250 shares of Corporation X’s stock, so that the decedent’s estate now actually owns 250 shares. Assume further that a beneficiary of the decedent’s estate owns 50 shares. Because the estate constructively owns the beneficiary’s 50 shares, the estate is deemed to own a total of 300 shares. Redemption of the 250 shares actually owned, therefore, will not affect a redemption of all the stock owned by the estate.

Further, stock owned by a close family member of a beneficiary of an estate may be attributed to an estate beneficiary, because of the family constructive ownership rules, and through the estate beneficiary to the estate. An estate beneficiary would be considered to own, by way of family attribution rules, shares owned by the decedent’s spouse, children, grandchildren, and parents.[[2]](#footnote-2) There are two ways in which the family attribution rules can be addressed.

First, the First Circuit has held that where, because of hostility among family members, a redeeming shareholder is prevented from exercising control over stock that the individual would be deemed to own constructively under attribution rules, the attribution rules will not be applied to the individual.[[3]](#footnote-3)

On the other hand, the IRS has indicated it will not follow this decision and has ruled that the existence of family hostility will not affect its application of attribution rules.

If certain conditions are met, however, the IRS will not apply the ruling to taxpayers who have acted in reliance on the IRS’s previously announced position on this issue.[[4]](#footnote-4) The Fifth Circuit also has taken the position that the existence of family hostility does not prevent application of attribution rules, thus creating disagreement between the two circuit courts that have ruled on the question.[[5]](#footnote-5) The Tax Court consistently has held that hostility within a family does not affect application of attribution rules.[[6]](#footnote-6)

The second way in which the family attribution rules can be addressed is if the sale of the departing owner’s interest qualifies as a complete termination of the shareholder’s interest.[[7]](#footnote-7) This is the category which most planners will try to fit within.

Constructive ownership rules are complicated and their application requires expert legal advice. It generally may be said that a danger of dividend tax treatment exists in every case involving a family-owned corporation engaging in a stock redemption. There are, however, means available in some cases to avoid the harsh operation of the rule. A partial redemption may be able to escape dividend tax treatment even in a family-owned corporation.

1. . Rev. Rul. 77-455, 1977-2 CB 93. [↑](#footnote-ref-1)
2. . IRC Sec. 318(a). [↑](#footnote-ref-2)
3. . *Robin Haft Trust v. Comm.*, 75-1 USTC ¶9209 (1st Cir. 1975). [↑](#footnote-ref-3)
4. . Rev. Rul. 80-26, 1980-1 CB 66; IRC Sec. 7805(b). [↑](#footnote-ref-4)
5. . *David Metzger Trust v. Comm.*, 82-2 USTC ¶9718 (5th Cir. 1982), *cert. den*., 463 U.S. 1207 (1983). [↑](#footnote-ref-5)
6. . See *Cerone v. Comm.*, 87 TC 1 (1986). [↑](#footnote-ref-6)
7. . IRC Sec. 302(b)(3); see IRC Sec. 302(c)(2) for situations in which constructive ownership rules of IRC Sec. 318(a)(1) will not apply. [↑](#footnote-ref-7)