

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 redemption 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 distribu-

tions 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 (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

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(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 corporate 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