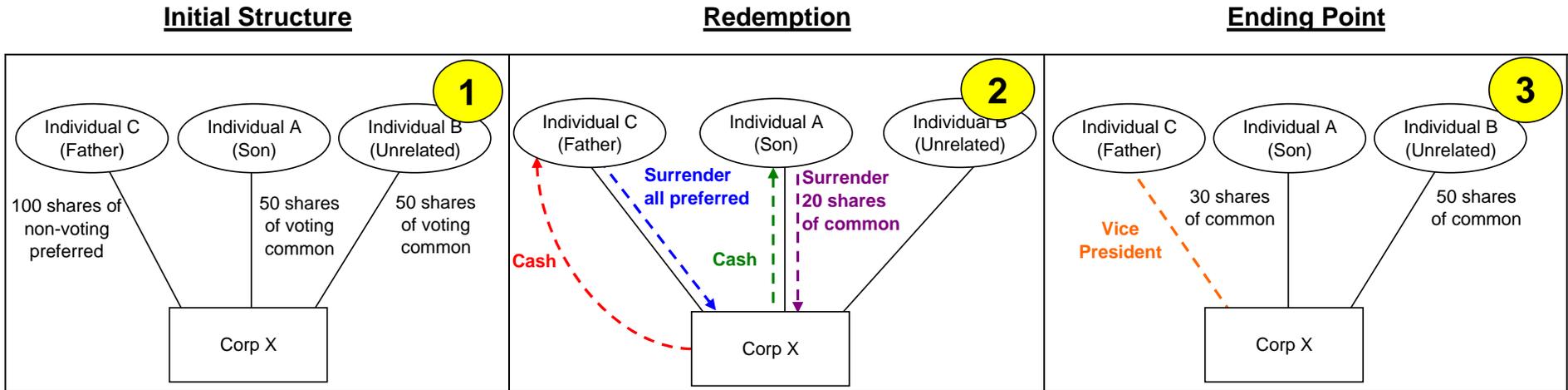


Substantially Disproportionate Redemption of Both Father & Son



X corporation had outstanding 100 shares of voting common stock and 100 shares of nonvoting preferred stock, which were not section 306 stock. The 100 shares of X voting common stock were owned in equal parts by individuals A and B, who were not related. The 100 shares of X nonvoting preferred stock were owned by C, who is the father of A. C held positions as vice-president and a member of the board of directors of X, which positions he maintained subsequent to the redemption of the nonvoting preferred stock. X redeemed for cash all 100 shares of the X nonvoting preferred stock held by C and 20 shares of the X voting common stock held by A.

Section 302(a) provides that if a corporation redeems its stock, and if section 302(b)(1), (2), or (3) applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock instead of a distribution of a dividend as provided for in section 302(d) and section 301. Section 302(b)(2) provides that section 302(a) will apply if the redemption substantially reduces the voting power of the shareholder, but that section 302(b)(2) will not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of section 302(b)(2), the distribution is substantially disproportionate if the ratio that the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of the ratio that the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time. Also for purposes of section 302(b)(2), no distribution will be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before the redemption also meets the 80 percent requirement of the preceding paragraph.

Reg. 1.302-3 states that section 302(b)(2) does not apply to the redemption solely of nonvoting stock. However, the redemption of nonvoting stock actually owned by C and of voting common stock constructively owned by C is a redemption of both voting and nonvoting stock for purposes of these regulations. The redemption of C's preferred stock will therefore be treated as a payment in exchange for the stock if the requirements of section 302(b)(2) are satisfied.

In applying the provisions of section 302(b)(2) to the redemption of C's nonvoting stock, C is deemed to have owned 50 percent of X's voting common stock prior to the redemption and approximately 38 percent of X's voting common stock subsequent to the redemption (such stock ownership being attributed to C from A under section 318(a)(1)(A)(ii)). Thus, C's percentage ownership in X's voting common stock after the redemption is less than 80 percent (78 percent) of what such percentage ownership was prior to the redemption. Therefore, the 80 percent requirement in section 302(b)(2) defining substantially disproportionate is met. Also, as required in section 302(b)(2)(B), after the redemption C owns less than 50 percent of the total combined voting power of X. Since the terms of section 302(b)(2) are met with regard to the voting common stock constructively owned by C, that section applies to the redemption of C's nonvoting preferred stock. The distribution by X to C in redemption of the 100 shares of X nonvoting preferred stock is substantially disproportionate within the meaning of section 302(b)(2) and, therefore, the redemption qualifies under section 302(a) as a distribution in full payment in exchange for the stock. The redemption of A's voting common stock likewise meets the requirements of section 302(b)(2).