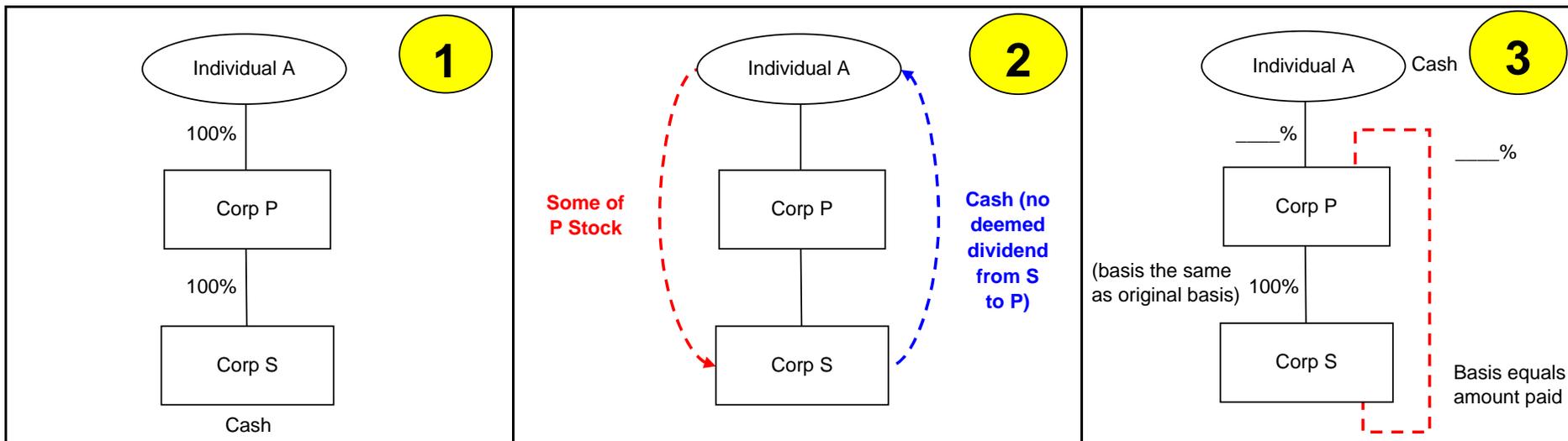


Section 304 - Subsidiary Purchase of Parent Stock

Initial Structure

Stock Purchase

Ending Point



In Rev. Rul. 69-261, S corporation purchased for cash some of the stock of P corporation, its sole shareholder, from A, the sole shareholder of P. Section 304(a)(2) provides that, for purposes of sections 302 and 303, if in return for property, a subsidiary acquires stock of its parent from a shareholder of the parent, such property will be treated as a distribution in redemption of the stock of the parent. Section 304(b)(2)(B) provides that in such a case, the determination of the amount that is a dividend will be made as if the property were distributed by the subsidiary to the parent and immediately thereafter distributed by the parent. Rev. Rul. 69-261 held that the amount received by A is a constructive dividend to A.

Rev. Rul. 69-261 further held that the amount deemed distributed by S to P, by operation of section 304(b)(2)(B), is a constructive dividend to P under section 301. This position was sustained by the United States Tax Court in *Union Bankers Insurance Co. v. Commissioner*, 64 T.C. 807 (1975), and by the United States District Court in *Broadview Lumber Co. v. United States*, Civil Nos. 73 F 104, 105 (N.D. Ind., Oct. 15, 1975). However, the Tax Court reversed its position in the case of *Webb v. Commissioner*, 67 T.C. 293 (1976), *aff'd per curiam*, 572 F.2d 135 (5th Cir. 1978), reasoning that section 304(b)(2)(B) is directed only toward adjusting the earning and profits of the parent for the purpose of determining the amount that is a dividend to the shareholder, and has nothing to do with determining the parent corporation's income. Later, the Tax Court in *Virginia Materials Corp. v. Commissioner*, 67 T.C. 372 (1976), *aff'd without opinion* (4th Cir., June 20, 1978) reached a similar decision. Further, the District Court in *Broadview Lumber* was reversed on this issue on appeal, 561 F.2d 698 (7th Cir., 1977).

The Internal Revenue Service will follow the decisions in *Webb*, *Broadview Lumber*, and *Virginia Materials* on this issue. Consequently, P is not in receipt of a constructive distribution from S when S purchases P's stock from a third party. P's adjusted basis in S's stock will remain the same as it was prior to the transaction, and S, under section 1012, will have a basis in P's stock acquired in the transaction equal to the amount paid therefor. Rev. Rul. 69-261 is modified to the extent that it holds that P is in receipt of a constructive dividend by operation of section 304(b)(2)(B).