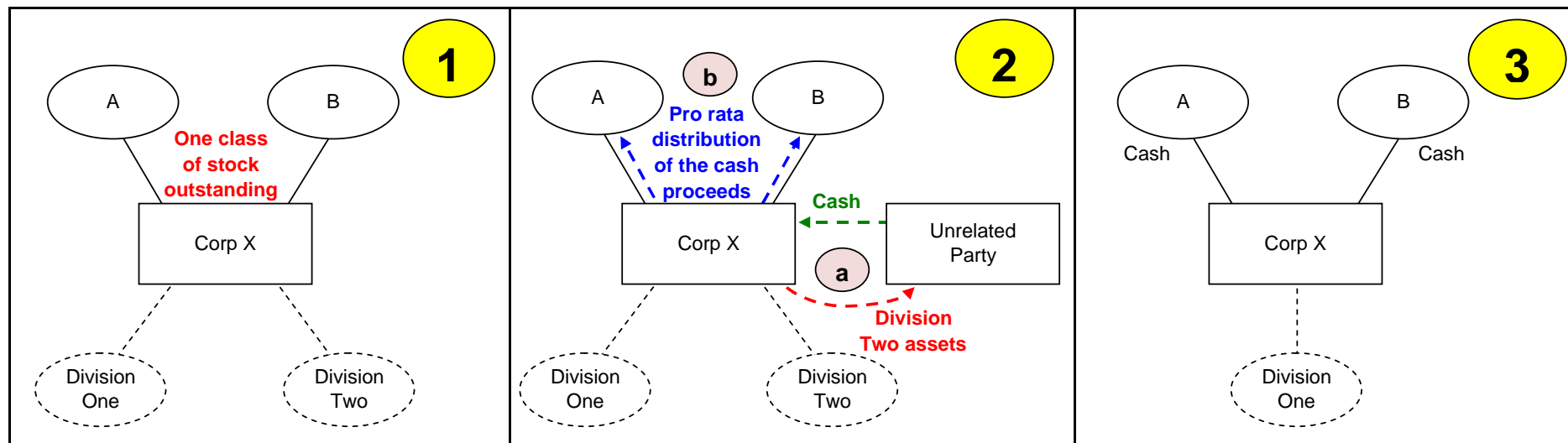


**No Surrender of Stock in Pro Rata Partial Liquidation**

**Initial Structure**

**Partial Liquidation**

**Ending Point**



Corporation X operated two divisions of equal size and had one class of stock outstanding, which was owned by individuals A and B. There were no outstanding rights, such as warrants, options, convertible securities, shareholder agreements or rights of first refusal, affecting the stock of X. Pursuant to a plan of partial liquidation, X sold one of its divisions to an unrelated party for cash and distributed the cash proceeds of the sale to A and B pro rata. A and B did not surrender any stock in exchange for the cash distributed by X.

Except for the question as to whether there must be a surrender of stock by the shareholders, the transaction qualifies as a partial liquidation under section 302(b)(4) and (e). Under section 302(b)(4)(A) and (B) respectively, two requirements for partial liquidation treatment are that (1) stock be redeemed and (2) the redemption be in partial liquidation within the meaning of section 302(e). The second requirement can be satisfied (as the facts here indicate it has been satisfied) irrespective of an actual stock surrender because under section 302(b)(4)(B) and (e) this requirement is tested at the corporate level, not the shareholder level, and is not concerned with stock ownership. However, the first requirement--that stock be redeemed--is tested at the shareholder level. Moreover, the reference to section 317(b) in section 302(a) raises the question whether an actual surrender of stock is required for a transaction to be treated as a partial liquidation under section 302(b)(4). Rev. Rul. 79-257, concerning facts similar to the facts here, held that an actual surrender of stock by a sole shareholder was not required in partial liquidation under pre-TEFRA section 346. A surrender of stock was seen as a meaningless gesture because the sole shareholder's interest in the corporation would have remained unchanged. In Rev. Rul. 81-3, the Internal Revenue Service extended this holding to include all pro rata distributions in connection with partial liquidations under former section 346. But see Rev. Proc. 89-3, Section 5.07. The pro rata distribution by X to its shareholders, individuals A and B, qualifies as a distribution in redemption of stock held by A and B in partial liquidation of X under section 302(b)(4) and (e), even though the shareholders did not surrender any of their stock.