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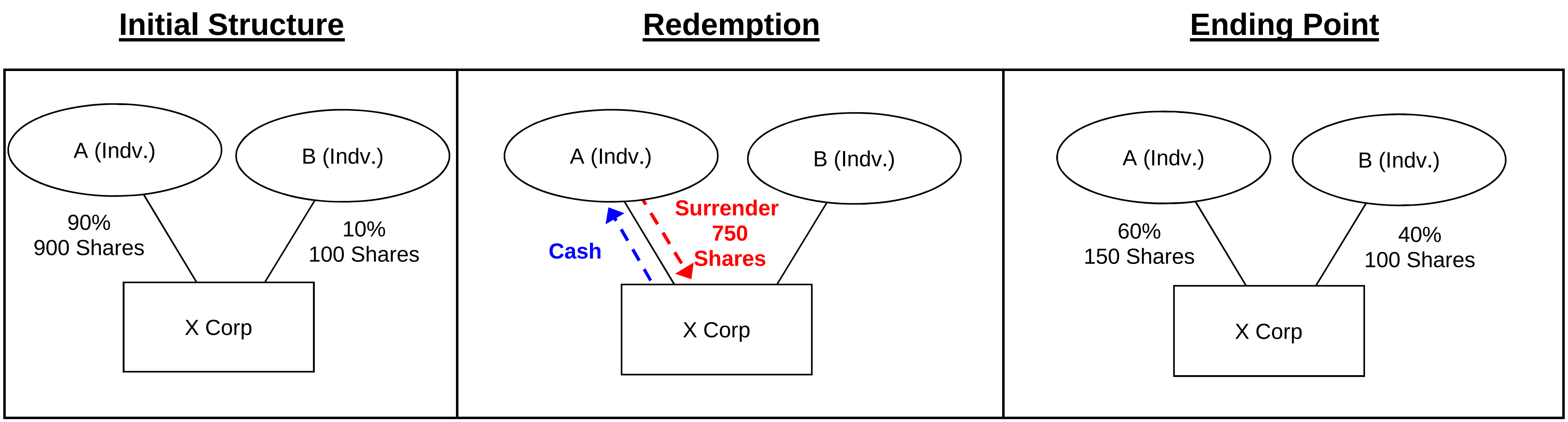
Revenue Ruling 78-401

Stock Redemption: No Meaningful Reduction of Proportionate Interest



A and B owned all of the stock of X Corp, with A owning 900 shares and B owning 100. X Corp redeemed 750 shares of its stock held by A, reducing A's voting rights from 90% to 60%. Pursuant to the articles of incorporation of X Corp and the laws of its state, a holder of over 50 percent of the X stock controlled X's day to day affairs through the board of directors, and a holder of 66.67 percent of the X stock controlled broader corporate decisions such as those regarding corporate liquidation, merger, or disposition of substantial amounts of operating assets.

A redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation in order to qualify as not essentially equivalent to a dividend within the meaning of section 302(b)(1) of the Code. *United States v. Davis*, 397 U.S. 301 (1970). It is most significant that the redemption did not reduce A's voting rights in X to 50 percent or less. Although A has surrendered the ability to individually control those corporate decisions requiring a 66.67 percent vote, A has retained control of the day to day affairs of X. Since A is in control of the day to day affairs of X and because there is no indication that the type of corporate action requiring a 66.67 percent shareholder vote is imminent, the retention by A of 60 percent of the voting rights in X becomes a predominant factor in determining whether the redemption results in a meaningful reduction of A's interest in X.

Under the facts and circumstances, the redemption by X of A's stock did not constitute a meaningful reduction in A's interest in X within the meaning of *Davis* despite the fact that A's voting rights were reduced below 66.67 percent. Accordingly, the redemption does not qualify as a distribution not essentially equivalent to a dividend under section 302(b)(1) of the Code and, therefore, is not a distribution in part or full payment in exchange for the X stock under section 302(a). Thus, under section 302(d), the redemption is a distribution of property to which section 301 applies.