Merrill Lynch & Co. , Inc. & Subsidiaries v. Commissioner of Internal Revenue, 131 T. C. 293 (U. S. Tax Court 2008)

In a significant ruling, the U. S. Tax Court clarified the tax treatment of cross-chain stock sales under Section 304 of the Internal Revenue Code. The court held that only the actual transferor of the stock must be considered for determining whether a redemption qualifies as a complete termination under Section 302(b)(3), rejecting Merrill Lynch's argument that the parent company's constructive ownership should be factored in. This decision impacts how corporations structure stock sales within affiliated groups to achieve desired tax outcomes.

Parties

Merrill Lynch & Co. , Inc. & Subsidiaries (Petitioner) filed a petition against the Commissioner of Internal Revenue (Respondent) in the U. S. Tax Court. The case was appealed to the Court of Appeals for the Second Circuit, which affirmed in part and remanded the case back to the Tax Court for further consideration.

Facts

Merrill Lynch & Co. , Inc. (Merrill Parent) was the parent corporation of an affiliated group that filed consolidated federal income tax returns. Merrill Parent owned Merrill Lynch Capital Resources, Inc. (ML Capital Resources), which was engaged in equipment leasing and owned subsidiaries involved in lending and financing. In 1987, Merrill Parent decided to sell ML Capital Resources but wanted to retain certain assets within the affiliated group. Before the sale, ML Capital Resources sold the stock of seven subsidiaries to other corporations within the affiliated group (MLRealty, ML Asset Management, and Merrill, Lynch, Pierce, Fenner & Smith, Inc.) in cross-chain sales. These sales were treated as Section 304 transactions. Subsequently, ML Capital Resources was sold to GATX Leasing Corp. and BCE Development, Inc. (GATX/BCE) for $57,363,817. Merrill Lynch reported a long-term capital loss from this sale, treating the proceeds of the cross-chain sales as dividends that increased ML Capital Resources' earnings and profits, thereby increasing the basis of its stock.

Procedural History

The Commissioner issued a notice of deficiency, decreasing the reported long-term capital loss by $328,826,143, asserting that the cross-chain sales should be treated as redemptions under Section 302(a) and (b)(3), not dividends under Section 301. The Tax Court initially held that the cross-chain sales, integrated with the later sale of ML Capital Resources, resulted in a complete termination of ML Capital Resources' interest in the subsidiaries, thus requiring exchange treatment under Section 302(a). The Court of Appeals for the Second Circuit affirmed this decision but remanded the case for the Tax Court to consider Merrill Lynch's new argument that Merrill Parent's continuing constructive ownership should be considered under

Section 302(b)(3).

Issue(s)

Whether, for purposes of determining if a redemption is in complete termination under Section 302(b)(3) as applied through Section 304(a)(1), the continuing constructive ownership interest of the parent corporation (Merrill Parent) in the issuing corporations must be taken into account?

Rule(s) of Law

Section 304(a)(1) of the Internal Revenue Code treats the proceeds of a stock sale between commonly controlled corporations as a distribution in redemption of the acquiring corporation's stock, to be analyzed under Sections 301 and 302. Section 302(b)(3) provides that a redemption is treated as a distribution in exchange for stock if it is in complete redemption of all the stock of the corporation owned by the shareholder. Section 304(b)(1) specifies that determinations under Section 302(b) must be made by reference to the stock of the issuing corporation.

Holding

The Tax Court held that only the interest of ML Capital Resources, the actual transferor of the stock, must be considered under Section 302(b)(3) as applied through Section 304(a)(1). Since ML Capital Resources' interest in the issuing corporations was completely terminated upon its sale outside the affiliated group, the redemption was properly treated as a distribution in exchange for stock under Section 302(a), rather than as a dividend under Section 301.

Reasoning

The court's reasoning focused on the plain language and structure of Sections 304 and 302. It emphasized that Section 304(a)(1) requires the person in control to actually receive property in exchange for transferring stock to warrant redemption analysis under Section 302. The court rejected Merrill Lynch's argument that the parent company's constructive ownership interest should be considered, finding that such an interpretation would contradict the statutory requirement that only the actual transferor's interest be tested. The court also relied on the regulations under Section 304, which support the application of Section 302(b) tests only to the person transferring stock in exchange for property. The court concluded that the language and structure of the statutes mandate that only ML Capital Resources' interest be considered, and since its interest was completely terminated, the redemption must be treated as an exchange.

Disposition

The Tax Court entered a decision in accordance with the mandate of the Court of Appeals for the Second Circuit, affirming that the cross-chain sales must be treated as a distribution in exchange for stock under Section 302(a).

Significance/Impact

This case clarifies the application of Section 304 in the context of corporate stock redemptions within affiliated groups. It establishes that only the actual transferor's interest is relevant for determining whether a redemption qualifies as a complete termination under Section 302(b)(3). This ruling impacts how corporations structure internal stock sales to achieve desired tax outcomes, emphasizing the importance of considering the actual transferor's ownership interest rather than the constructive ownership of parent entities. The decision also underscores the Tax Court's adherence to statutory language and legislative intent in interpreting tax provisions, setting a precedent for future cases involving similar transactions.