

TDS's Repurchases Are Not Distributions in Partial Liquidation

by Robert Willens



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In this article, Willens examines the tax consequences of Telephone and Data Systems' planned stock buyback, and he explains why the repurchases cannot be considered distributions in partial liquidation.

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Array Digital Infrastructure Inc., formerly known as United States Cellular Corp., has been selling off its spectrum assets at a furious clip, mostly to T-Mobile, but recently over \$1 billion worth to AT&T. Array has been distributing the net sale proceeds to its shareholders. In fact, after closing the AT&T sale, it declared a special dividend of \$10.25 per share that was payable in the first week of February.¹ About 82 percent of the stock in Array is owned by Telephone and Data Systems Inc. (TDS), which owns an even larger percentage of the total combined voting power of all classes of Array stock entitled to vote. TDS has vowed to use some of the proceeds of its share of the special dividend to repurchase its own stock. In fact, it recently increased its repurchase authorization by \$500 million. At issue is whether those repurchases can be considered distributions in partial liquidation. If so, the repurchases will be

treated (even if a redeemed shareholder does not experience a reduction in its proportionate interest in TDS) as distributions "in part or full payment in exchange for stock."²

Genuine Contraction

A distribution in partial liquidation is one that is "not essentially equivalent to a dividend" in the redemption of stock in accordance with a plan, and occurs in the tax year in which (or immediately after which) the plan is adopted.³ Whether a distribution is not essentially equivalent to a dividend is determined solely at the corporate level.⁴ Thus, even a pro rata distribution — the prototypical dividend — can be "not essentially equivalent to a dividend." For purposes of section 302(e), a distribution is not essentially equivalent to a dividend if it results from a genuine contraction of the corporate business.

For advance ruling purposes, the IRS will concede that a contraction has occurred if the distribution reduces the distributing corporation's gross revenues, net fair value of assets, and employees by at least 20 percent. Moreover, under a statutory safe harbor in section 302(e)(2), a distribution is automatically not a dividend equivalent if it is attributable to the corporation's ceasing to conduct (or consists of the assets of) a qualified trade or business, provided that immediately after the distribution the distributing corporation is engaged in the active conduct of at least one other qualified trade or business. A qualified trade or business is one that has been

² See section 302(a) and (b)(4).

³ See section 302(e)(1).

⁴ See Rev. Rul. 82-187, 1982-2 C.B. 80 ("The legislative history of section 346(a)(2) [the predecessor of section 302(e)] confirms that only what occurs at the corporate level is relevant in determining whether a transaction qualifies for partial liquidation treatment.")

¹ See Array release announcing completion of asset sale to AT&T (Jan. 13, 2026).

actively conducted by the corporation throughout the five-year period ending on the date of distribution and that was not acquired in that period in a transaction in which gain or loss was recognized in whole or in part.⁵ The size of the discontinued trade or business is immaterial for purposes of determining whether a distribution meets the requirements of section 302(e)(2).⁶ Compare this munificence with the IRS's refusal to rule on a contraction unless there has been at least a 20 percent reduction in gross revenues, net fair value of assets, and employees.⁷

In the case of the TDS-Array family, a business is certainly being genuinely contracted — that is, Array's wireless business. Remember, however, that the business terminated (or contracted) must have been operated directly (not merely indirectly) by the distributing corporation. Here, that requirement is not satisfied. TDS has not operated the wireless business — Array has — and generally, the business of a subsidiary is not considered the business of its parent. There is, however, one scenario in which a parent can be viewed as having operated (and later contracted or terminated) a business conducted by its controlled subsidiary.

Rev. Rul. 75-223, 1975-1 C.B. 109, says a partial liquidation of a parent occurs when a subsidiary

sells its operating assets to an unrelated party and distributes the sales proceeds to its parent in a complete liquidation to which sections 332 and 381 apply, and the parent then distributes those proceeds to its shareholders in exchange for a portion of their stock in accordance with a plan.

The ruling bases the partial liquidation treatment of the parent on the eminently reasonable theory that if the parent had conducted the business of the subsidiary, a distribution of the proceeds from the sale of that business would have qualified for partial liquidation treatment. When a parent liquidates a subsidiary in a liquidation to which section 332 applies, the parent, under section 381, inherits the subsidiary's various tax attributes, including its earnings and profits and its net operating loss carryovers. Section 381, therefore, integrates past business results so that, for most practical purposes, the parent is viewed as if it had always operated the business of the liquidated subsidiary.

What if the subsidiary is indebted to the parent, and the debt owed by the subsidiary to the parent is cancelled in the section 332 liquidation? Despite the permissive language of Rev. Rul. 75-223, the IRS takes the position in Rev. Rul. 77-375, 1977-2 C.B. 106, that "Rev. Rul. 75-223 is not precedent for ignoring the subsidiary's corporate existence and treating its business activities as if they had always been conducted as a division of the parent so that the inter-company indebtedness would be disregarded."

Thus, in these cases, the assets that will be subject to partial liquidation treatment of the parent as a result of the complete liquidation of its subsidiary are:

limited to the assets of the subsidiary received by the parent with respect solely to its stock (equity) interest in the subsidiary. The proceeds of liquidation do not include those assets received in satisfaction of the subsidiary's indebtedness to the parent. . . . The amount of the distribution in partial liquidation of [the parent, P] is limited to the amount distributed by [the subsidiary, S] to P in exchange for P's stock interest in S in complete liquidation of S and does not include that part of the distribution

⁵ See section 302(e)(3). Section 302(e)(2) and (3) borrow liberally from their better-known counterpart, section 355(b)(2). Note the similarity in the definitions of qualified trade or business for partial liquidation purposes, and active trade or business for spinoff purposes. There are, however, some important differences. For example, section 355(b)(2)(C) and (D) prohibit not only the acquisition of a trade or business within the five-year period preceding an attempted spinoff in a transaction in which gain or loss was recognized in whole or in part, but also the acquisition of control of a corporation conducting that trade or business. For reasons that are not readily apparent, the partial liquidation rules do not prohibit the latter. Thus, a corporation can accumulate surplus funds, purchase the stock of a corporation that has actively conducted a trade or business throughout the past five years, liquidate that corporation, sell its assets, and distribute the net sale proceeds in partial liquidation. In that case, the business terminated will have been actively conducted for the requisite period, and although it was acquired within that period, it was acquired in a permissible manner — that is, through a tax-free section 332 liquidation. The fact that control of the corporation conducting the business was acquired within the five-year period preceding the distribution in a transaction in which gain or loss was recognized is of no moment because section 302(e)(2), unlike its doppelgänger, section 355(b)(2), does not explicitly proscribe acquisitions of control of corporations conducting qualified trades or businesses.

⁶ See Rev. Rul. 77-376, 1977-2 C.B. 107.

⁷ Presumably, Rev. Rul. 77-376 overrules Rev. Rul. 57-333, 1957-2 C.B. 239, which suggests, to the contrary, that the size of a discontinued business is highly relevant in determining whether its discontinuance passes muster as either a genuine contraction or a termination of a qualified trade or business.

attributable to the indebtedness of S to P that was cancelled upon the liquidation.⁸

The IRS has thus acknowledged that there is no meaningful distinction, for partial liquidation purposes, between a corporation that distributes the assets of a division (or the proceeds of the sale) and a parent that distributes the assets of a subsidiary, or the proceeds from the sale of those assets, received from the subsidiary in a liquidation to which section 332 applies.

No Complete Liquidation

Here, however, there is no reason to believe that TDS will be liquidating Array. As far as we can tell, Array will remain a controlled subsidiary of TDS for the foreseeable future, and the 18 percent of Array's stock not owned by TDS will remain widely held and publicly traded. The proceeds from the sale of Array's assets will not be received by TDS under the auspices of section 332; those proceeds will be received by TDS as an intercompany dividend. Section 381 does not apply here to attribute Array's business history to TDS. Thus, the distribution by TDS in redemption of its stock cannot qualify as a distribution in partial liquidation because there is no mechanism for treating the contracted and terminated

business as if it were conducted by TDS. Thus, TDS's distribution cannot be seen as not essentially equivalent to a dividend (within the meaning of section 302(e)) because it does not result from a genuine contraction of a business conducted (or deemed conducted) by it.

Whether a distributee shareholder of TDS is eligible for sale or exchange treatment for the redemption of its shares will depend on whether that shareholder sustains a sufficient reduction of its proportionate interest in TDS — that is, a reduction of interest that satisfies the standards laid out in section 302(b)(1)-(3).⁹ The fact that the genesis or origin of TDS's redemption distributions is the contraction of a business conducted by an affiliate of TDS is of no help because for section 302(e) nondividend equivalence to arise, the business contracted must be conducted by the distributing corporation, and here, in the absence of a section 381 transaction, TDS cannot be viewed, despite its controlling interest in Array, as having conducted the latter's business. ■

⁸ Rev. Rul. 77-375.

⁹ Because the distribution is scheduled to be made on a pro rata basis, there is little likelihood, absent the adoption by the distributee shareholder of a *Zenz* plan (see *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954)) in connection with which a portion of their nonredeemed shares are otherwise disposed of as part of the plan that includes the redemption, that the redemption will be eligible under any of those subsections for treatment as a sale or exchange.