Dividend-Equivalent Redemption Avoids Repurchase Excise Tax

by Robert Willens

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In this article, Willens uses Coca-Cola Consolidated Inc.'s recent stock purchase to explain how some redemptions can qualify for exchange treatment and the available safe harbors that shareholders might consider.

Coca-Cola Consolidated Inc. (COKE) is the largest U.S. bottler of Coca-Cola products. It can be described as closely held but only in the sense that one family owns high-vote stock in COKE, which represents about 71 percent of the total combined voting power of all classes of COKE stock entitled to vote. COKE's market capitalization is about $8 billion.

COKE is offering to purchase shares of its common stock (its high-vote stock is its class B common stock) "pursuant to auction tenders at prices specified by its shareholders of not less than $850 per share nor more than $925 per share."[1] COKE has placed a ceiling on the amount it is willing to spend; it is offering to purchase shares with an aggregate purchase price of no more than $2 billion (the offer). Much of the funding for the offer will be provided by third-party lenders. Thus, it is replacing equity with debt in its capital structure.

Carolina Coca-Cola Bottling Investments Inc. (Carolina) today owns about 26.5 percent of COKE's common stock. COKE, shortly before the announcement of the offer, had entered into an agreement to repurchase shares of its common stock from Carolina, subject to conditions. The consummation of the purchase and sale of Carolina's COKE stock is to take place on the 11th business day after the expiration date of the offer. The obligations of COKE to purchase Carolina's shares are subject to this condition: "The Tender Offer shall have expired and [COKE] shall have purchased shares of Common Stock in the Tender Offer in accordance with the terms thereof."[2]

However, the obligation of Carolina to sell common stock to COKE is conditioned not only on the offer having expired but also on a finding that the purchase price per share "shall be not less than $925." For this purpose, the purchase price is defined as "the per share purchase price of common stock for the shares of common stock purchased by COKE in the tender offer." If the latter condition is not complied with, Carolina is not obligated to sell any of its COKE shares to COKE. If, in fact, COKE purchases common stock from Carolina because this purchase price condition has either been satisfied or waived, it is expected that Carolina will sell and that COKE will "purchase, acquire, and accept [the] number of seller-owned shares that will cause the seller to beneficially own 21.5 percent (of COKE's common

[1] COKE, "Coca-Cola Consolidated Announces Commencement of Tender Offer to Purchase up to $2.0 Billion in Value of its Common Stock" (May 20, 2024).

[2] Coca-Cola Consolidated Inc., SEC Form 8-K (May 6, 2024).

stock) (taking into account shares purchased in the Offer)."

Thus, if all goes according to plan, COKE will be repurchasing about $1.1 billion in value of its common stock from Carolina that — when added to the $2 billion it is expending in the offer — would enable it to retire nearly 40 percent of its issued and outstanding stock.

Essentially Equivalent to a Dividend

As a domestic corporation with stock that is traded on an established securities market, COKE is a covered corporation whose stock repurchases attract an excise tax amounting to 1 percent of the value of the stock that is repurchased (and not reissued) during the tax year. However, some repurchases will be excluded from the covered corporation's repurchase excise tax base. Notice 2023-2, 2023-3 IRB 374, states: "The fair market value of stock repurchased by the covered corporation in a repurchase described in this section 3.07 is a reduction for purposes of computing the covered corporation's stock repurchase excise tax base" to the extent the repurchase is treated as the distribution of a dividend under section 301(c)(1).

It is expected that the repurchase of Carolina's shares will be essentially equivalent to a dividend. "To the extent eligible and permitted to do so under applicable law . . . Carolina shall provide to COKE the certification required pursuant to proposed regulation section 58.4501-3(g)(2)(iii)(A) and in accordance with section 58.4501-3(g)(3), certifying that the sale 'constitutes a redemption treated as a distribution to which section 301 applies by reason of section 302(d).'"

While it is presumed that all redemptions of a covered corporation's stock are treated as distributions in part or full payment in exchange for the redeemed stock, that presumption can be overcome if the redeemed shareholder certifies to the redeeming corporation that it is treating the redemption as a distribution and there are sufficient earnings and profits to render the distribution a dividend in its entirety.

A redemption will qualify as "a distribution in part or full payment in exchange for the stock" under section 302(a) only if the redemption falls within one of the categories enumerated in section 302(b). Here, section 302(b)(3) is inapplicable because Carolina is not undergoing a complete redemption of all the stock it owns in COKE.

A redemption is substantially disproportionate, within the meaning of section 302(b)(2), if (1) the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote immediately after the redemption and (2) the ratio of voting stock and common stock owned by the shareholder to all voting stock and common stock immediately after the redemption is less than 80 percent of that same ratio determined immediately before the redemption. Here, however, Carolina's post-redemption ratio is about 81 percent of its pre-redemption ratio (of ownership of voting stock and common stock) and therefore, undoubtedly intentionally, its redemption will not be considered substantially disproportionate.

Even when those safe harbors are not satisfied, under section 302(b)(1) a redemption can qualify for exchange treatment if it is "not essentially equivalent to a dividend." The fact that a redemption fails to meet the requirements of paragraphs (2) and (3) of section 302(b) "shall not be taken into account in determining whether the redemption is not essentially equivalent to a dividend."[3]

In *Davis*, the Supreme Court held that the business purpose, if any, for the redemption is wholly irrelevant in determining dividend equivalency. To avoid such dividend equivalency, the Court said, the redemption must result in "a meaningful reduction of the shareholder's proportionate interest in the corporation."[4] In Rev. Rul. 76-364, 1976-2 C.B. 91, the redeemed shareholder's proportionate interest in the corporation was reduced from 27 percent to 22.27 percent, insufficient to bring the case under section 302(b)(2).

However, the IRS ruled that the shareholder experienced a meaningful reduction of his proportionate interest because the redemption caused him to go from a position of holding a block of stock that afforded him control of the corporation if he acted in concert with one other shareholder (each of whom owned before the

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[3] *See* reg. section 1.302-2(a).

[4] *United States v. Davis*, 397 U.S. 301 (1970).

redemption 24.3 percent of the outstanding stock) to a position in which such action was not possible (each of the other shareholders, immediately after the redemption, owned slightly more than 26 percent of the pro forma stock).

It does not appear that we have such a dislocation here. In fact, Carolina will own enough stock in COKE to account for its investment on the "equity method." To do so, the investor must be able to exercise significant influence over the affairs of the investee. Thus, arguably, there will be no meaningful reduction of Carolina's proportionate interest in COKE because — before and after the redemption — it is positioned to exercise significant influence over the affairs of the redeeming corporation.

As noted, Carolina has conceded that its redemption will not pass muster under section 302(b) and has agreed to attest to that so that COKE will avoid having to include the redeemed shares in its repurchase excise tax base. Treating the redemption as a distribution, rather than as an exchange, also benefits Carolina. It will be eligible for a dividends received deduction for the redemption dividend, and because Carolina COKE is a so-called 20 percent owned corporation, the dividends received deduction percentage will increase from its default level of 50 percent to 65 percent.

The dividend will be a *per se* extraordinary dividend because it results from a redemption that "is not pro rata as to all shareholders," and therefore Carolina's basis in its COKE stock will be reduced by the nontaxed portion of the extraordinary dividend. That said, such basis reduction will not translate into additional tax liabilities until the truncated basis stock is sold or otherwise disposed of. Corporate shareholders generally prefer their redemptions be characterized as distributions to which section 301 applies, rather than as an exchange, because of the availability of the dividends received deduction.

Firm and Fixed Plan

How will those shareholders who participate in the offer measure their compliance (or lack thereof) with section 302(b)? More specifically, in determining whether the shareholders have experienced the requisite meaningful reduction of their proportionate interests, it is not entirely clear how each shareholder should determine its pre- and post-redemption proportionate interest. More specifically, is the post-redemption interest determined immediately after the offer and without taking into account the effect on such proportionate interest of Carolina's redemption, or is the offer and the Carolina redemption sufficiently integrated so that one's post-redemption interest is properly measured only when Carolina's redemption has been completed?

There is much to be said for the proposition that the offer and the Carolina redemption are separate and independent transactions. After all, the offer depends on the completion of the Carolina redemption. In fact, if the purchase price arising from the offer falls short of the upper limit set by the company — that is, $925 per share — Carolina will not be bound to surrender shares for redemption, although apparently it may choose to do so at the lower clearing price set in the auction.

When one transaction can occur regardless of whether a putatively related transaction takes place, the two transactions arguably should not be seen as a single, integrated transaction because the transactions are not mutually interdependent. In short, the offer and the Carolina redemption do not seem to be the subject of a "firm and fixed plan" to achieve a series of redemptions.[5]

However, the sheer temporal proximity of the two events — the second transaction occurs only 11 days after the first one — makes it highly likely that the two transactions will be seen as single transaction. Thus, with discretion being the better part of valor, a tendering shareholder, we believe, should assume that he will be constrained to compare his pre-redemption proportionate interest with the proportionate interest he emerges with after taking into account the decrease in outstanding shares caused by Carolina's redemption.[6]

Unlike Carolina, however, the shareholders participating in the offer should find it easier to fit within the recesses of section 302(b)(1). In fact, the IRS has famously ruled that any reduction of

[5] *See Merrill Lynch & Co. and Subsidiaries v. Commissioner*, 386 F.3d 464 (2d Cir. 2004).

[6] *See* Rev. Rul. 75-447, 1975-2 C.B. 113.

proportionate interest will be seen as meaningful if the shareholder can be properly described as a small minority shareholder whose relative stock interest is minimal and who exercises no control over the affairs of the corporation.[7]

However, if section 302(b)(1) is to be availed of, there must be some reduction of proportionate interest — the meaningful reduction standard demands it. Absent some reduction of proportionate interest, the redemption will certainly be viewed as a distribution of property to which section 301 applies, no matter how small the redeeming shareholder's absolute proportionate interest happens to be.[8] ■

[7] *See* Rev. Rul. 76-385, 1976-2 C.B. 92.

[8] *See* Rev. Rul. 81-289, 1981-2 C.B. 82.