***Prop. §1.301­2 Application to basis.***

(a) *Application to basis*. That portion of a distribution which is not a dividend shall be applied *pro rata*, on a share­by­share basis, to reduce the adjusted basis of each share of stock held by the shareholder within the class of stock upon which the distribution is made. The following example illustrates this paragraph (a):

*Example*. (i) *Facts*. Corporation X, a calendar year taxpayer, has only common stock outstanding. A, an individual, owns all 100 shares; 25 were acquired on Date 1 for $25 (Block 1) and 75 were acquired on Date 2 for $175 (Block 2). On December 31, when Corporation X had earnings and profits of $100, it made a $3 distribution on each share of common stock.

(ii) *Analysis*. A is treated as receiving $75 of the distribution on block 1 and $225 on block 2. On Block 1, A will have a $25 dividend under section 301(c)(1), a $25 return of capital under section 301(c)(2) and a $25 gain under section 301(c)(3). On Block 2, A will have a $75 dividend under section 301(c)(1), a $150 a return of capital under section 301(c)(2) and will have a remaining basis of $25 in the shares of block 2.

***Prop. §1.302­5 Redemptions under section 302(d)*.**

(a) *In general*—(1) *Share­by­share basis reduction*. In any case in which an amount received in redemption of stock (as defined in section 317(b)) is treated as a distribution to which section 301 applies, that portion of a distribution that is not a dividend shall be applied to reduce the adjusted basis of each share held by the redeemed shareholder (as defined in paragraph (b) of this section) in the redeemed class (as defined in paragraph (b) of this section). Such reduction shall be applied *pro rata*, on a share­by­share basis, to all shares of the redeemed class held by the redeemed shareholder. Gain, if any, on a share shall be determined under section 301(c)(3).

(2) *Deemed recapitalization*. Except as provided in paragraph (a)(3) of this section, immediately following the reduction of basis as provided in section 301(c)(2) and paragraph (a)(1) of this section, all shares of the redeemed class, including the redeemed shares, held by the redeemed shareholder will be treated as surrendered in a reorganization described in section 368(a)(1)(E) in exchange for the number of shares of the redeemed class directly held by the redeemed shareholder after the redemption. The basis of the shares deemed received in the reorganization described in section 368(a)(1)(E) will be determined under the rules of section 358 and §1.358­2.

(3) *Redemption of all shares of redeemed class*—(i) *Remaining basis treated as loss*. If all the shares of the redeemed class held by the redeemed shareholder are redeemed, an amount equal to the basis of the redeemed stock, after adjusting such basis to reflect the application of section 301(c)(2) as provided in paragraph (a)(1) of this section, will be treated as a loss on a disposition of the redeemed stock on the date of the redemption. Such loss is taken into account on the inclusion date as defined in paragraph (b) of this section.

*Example 1*. (i) *Facts*. A and B, husband and wife, each own 100 shares (50 percent) of the common stock of Corporation X which they hold as a capital asset. On Date 1, A acquired 50 shares for $100 (block 1) and 50 shares on Date 2 for $200 (block 2). On December 31, Corporation X, which has no current or accumulated earnings and profits, redeems all of A’s block 2 shares for $300. Under section 302(d), the redemption proceeds are treated under section 301 as a recovery of basis.

(ii) *Analysis*. Under this section, immediately before the redemption, the distribution of property is applied on a *pro rata*, share­by­share basis with respect to each of the shares in the redeemed class held directly by A, the redeemed shareholder. Accordingly, A will have a $50 capital gain on block 1 ($150­100) under section 301(c)(3) and $50 of basis remaining on block 2 ($150­200). To reflect the actual number of shares held by A after the redemption, A’s shares in the redeemed class, including the shares actually surrendered, will be

treated as exchanged in a recapitalization under section 368(a)(1)(E). The basis in A’s recapitalized shares will be determined under §1.358­2. Accordingly, A will have 25 shares with a zero basis (attributable to block 1) and 25 shares with a basis of $50 (attributable to block 2).