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The Interaction Between Family Attribution Rules and Corporate Redemptions

*Francis B. Brogan, Jr.**

The application of stock attribution rules to corporate redemptions presents some difficult issues in corporate tax law. This Article analyzes two significant areas of controversy—the relevance of family hostility in mitigating the application of family attribution rules and the extension of the statutory waiver of attribution to estates. The author advocates judicial inquiry in the above situations where the rationale for application of the attribution rules no longer exists. The Article concludes with proposals for change in judicial and legislative response based on policy considerations.

INTRODUCTION

THE INTERPLAY of attribution rules of Internal Revenue Code[1] section 318 with corporate redemptions under section 302 is a troublesome area of corporate tax law. One area of controversy is the relevance of family hostility in mitigating the constructive ownership rules of section 318 while determining dividend equivalence under section 302(b)(1). Another issue is whether the statutory waiver of family attribution under section 302(c)(2) should be extended to estates.

The problem of family hostility has been brought to the forefront by the issuance of Revenue Ruling 80–26[2] in which the Service reiterated its position that the family attribution rules of section 318 must be mechanically applied in ascertaining dividend equivalence under section 302(b)(1). This position is contrary to the First Circuit decision in *Haft Trust v. Commissioner*[3] which allowed the attribution rules to be disregarded where the family relationship had deteriorated.

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1. Hereinafter the Internal Revenue Code will be referred to as the "Code," the Commissioner of Internal Revenue as the "Commissioner," and the Internal Revenue Service as the "Service."

2. Rev. Rul. 80–26, 1980–1 C.B. 67. *See* notes 111–13 *infra* and accompanying text.

3. 510 F.2d 43 (1st Cir. 1975), *rev'g and remanding*, 61 T.C. 398 (1973), *supplemented*, 62 T.C. 145 (1974).

The issue of allowing estates to file a waiver of the entity attribution rules of section 318(a)(3) has been presented in *Rickey v. United States*.[4] The court in *Rickey* allowed an estate to file a waiver of the entity attribution rules of section 318(a)(3). Commentators have been critical of this decision because such a waiver is not provided for by section 302(c)(2).

Both the issues of the relevance of family hostility and the statutory waiver of attribution by entities were raised in the recent case of *Metzger Trust*.[5] This position supports the stance of Revenue Ruling 80-26 and conflicts with the decision of the First Circuit in *Haft Trust*. Additionally, the Tax Court refused to follow the Fifth Circuit's decision in *Rickey*—a case seemingly on point[6]—and rejected the taxpayer's attempted waiver of the attribution rules of section 318(a)(3).[7] The Tax Court's opinion threatens further judicial development of family hostility and entity waiver concepts. The policy rationales supporting family hostility and entity waiver, however, merit affirmative action by Congress.[8]

The purpose of this Article is to outline the relevant provisions of the Code and regulations, to examine the legislative history of these provisions, and to analyze the case law which has focused on the application of attribution rules in corporate redemptions. The established practice regarding waiver of these rules will then be examined and proposals for changes will be explored and analyzed.

I. FAMILY ATTRIBUTION RULES AND SECTION 302 CORPORATE REDEMPTIONS

A. *Code Provisions and Regulations*

A corporate redemption of stock may be characterized as either an exchange or distribution. Section 302 provides a general rule that if a corporation redeems its stock and one of the four exceptions[9] in section 302(b) applies, the redemption shall be

4. 592 F.2d 1251 (5th Cir. 1979). *See* notes 92–108 *infra* and accompanying text.

5. [1981] TAX CT. REP. (CCH) Dec. 37,614. *See* notes 115–17 *infra* and accompanying text.

6. After final decision is rendered in *Metzger Trust*, it is appealable to the Fifth Circuit Court of Appeals.

7. *See* notes 146–48 *infra* and accompanying text.

8. *See* notes 149–72 *infra* and accompanying text.

9. Only three of the four sections have general applicability. The fourth exception, § 302(b)(4), applies only to stock issued by railroad corporations in certain reorganizations.

treated as part or full payment in exchange for the stock.[10] A redemption within section 302(b) is an acquisition by a corporation of its stock from a shareholder in exchange for property.[11] If the corporate redemption of stock does not qualify under one of these exceptions, section 301 applies and the redemption is treated as a distribution of property.[12] Under section 301(c), the distribution is treated as a dividend to the extent of earnings and profits, with any excess over the dividend amount reducing the shareholder's basis in the stock. Any amount in excess of basis would be entitled to exchange treatment.

The benefits in qualifying for exchange treatment are enormous. The shareholder's gain would be recognized under section 1001. If the stock is a capital asset[13] in the hands of the shareholder and has been held for the requisite one-year period,[14] the gain would qualify for the sixty percent long term capital gains deduction.[15] Only the remaining forty percent would be subject to taxation at normal income tax rates.[16] Alternatively, dividend treatment[17] requires full inclusion of the dividend amount into income at marginal rates of up to seventy percent.[18]

The first exception in section 302 is for a redemption "not essentially equivalent to a dividend."[19] The regulations under this section state that the question of whether a distribution in redemption of a shareholder's stock is not essentially equivalent to a dividend depends upon the facts and circumstances of each case.[20] The Code provides that in determining whether this test has been met, the failure to satisfy the other exceptions of section 302 shall not be taken into account.[21]

The second exception is for a substantially disproportionate

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10. I.R.C. § 302(a).

11. I.R.C. § 317(b). As a general rule, a corporation recognizes no gain or loss on a distribution in redemption of its own stock; however, § 311(d) mitigates this effect to some extent.

12. I.R.C. § 302(d).

13. I.R.C. § 1221.

14. I.R.C. §§ 1222(3), 1223.

15. I.R.C. § 1202.

16. The highest marginal tax rate for capital gains income in most cases is 28% (100% gain – 60% deduction × 70% highest marginal rate). However, the alternative minimum tax of § 55 may raise this percentage in some cases.

17. I.R.C. § 3019(c). A dividend is defined by § 316(a) as a distribution of property made by a corporation to its shareholders out of earnings and profits accumulated since February 28, 1913, or out of earnings and profits for the current taxable year.

18. I.R.C. § 1.

19. I.R.C. § 302(b)(1).

20. Treas. Reg. § 1.302–2(b) (1955).

21. I.R.C. § 302(b)(5).

redemption of stock.[22] To qualify for this exception, the following conditions must be met: (1) the shareholder must own, immediately after the redemption, less than fifty percent of the total combined voting power of all classes of stock entitled to vote;[23] (2) the shareholder's percentage ownership of the outstanding voting stock must be reduced immediately after the redemption to less than eighty percent of the shareholder's percentage interest in the stock immediately before the redemption;[24] and (3) the shareholder's percentage ownership of the outstanding common stock (both voting and nonvoting) must be reduced immediately after the redemption to less than eighty percent of the percentage ownership immediately before the redemption.[25]

The third exception involves a complete redemption of all the stock in the corporation that is owned by the shareholder.[26] This section is the most useful from a practical standpoint and will be examined in slightly more detail later in the Article.[27]

Section 302(c) makes the attribution rules of section 318 specifically applicable in determining ownership of stock for purposes of section 302.[28] In the context of family hostility, the effect of section 302 in determining whether a redemption is essentially equivalent to a dividend has been questioned. This effect is the focal point of one of the issues discussed in detail in this Article.[29] It is interesting to note at this point that the Treasury Regulations state that the attribution rules are merely one factor to be considered in determining dividend equivalence.[30]

There is one statutory exception to the imposition of the attribution rules in the context of corporate redemptions. Section 302(c)(2)(A) provides that in determining whether a complete termination of a shareholder's interest under section 302(b)(3) has occurred, the family attribution rules of section 318(a)(1) shall not apply if: (1) immediately after the distribution, the distributee has no interest in the corporation other than an interest as a creditor;[31] (2) the distributee does not acquire any other interest within

22. I.R.C. § 302(b)(2).
23. I.R.C. § 302(b)(2)(B).
24. I.R.C. § 302(b)(2)(C).
25. *Id.*
26. I.R.C. § 302(b)(3).
27. *See* notes 118–21 *infra* and accompanying text.
28. I.R.C. § 302(c)(1).
29. *See* notes 64–113 & 155–65 *infra* and accompanying text.
30. Treas. Reg. § 1.302.2(b) (1955).
31. I.R.C. § 302(c)(2)(A)(i).

ten years of the date of distribution, other than by bequest or inheritance;[32] and (3) the distributee files an agreement with the Service agreeing to notify the Service upon acquiring any interest prohibited by (2).[33]

To prevent an abuse of the family attribution waiver rule, Congress enacted section 302(c)(2)(B) which denies a waiver in the following situations: first, where one family member has transferred stock to another family member so the corporation can later redeem all such stock from the transferee and second, where one family member has transferred some stock to another family member to qualify the redemption of the transferor's remaining stock as a complete termination of interest. The Code accomplishes this goal by providing that the waiver rule will not apply if any portion of the stock redeemed was acquired within a ten-year period from a person whose ownership of the stock would have been attributable to the redeeming stockholder under section 318(a).[34] The waiver benefits are also denied if stock is held by any other person whose ownership would be attributable to the redeeming stockholder and was acquired from the redeeming stockholder within the ten-year period prior to the date of the transaction, unless that stock is also redeemed.[35] There is, however, an escape hatch which allows the family attribution rules to be waived, despite a stock transfer during the preceding ten years, if the transfer did not have as one of its principal purposes the avoidance of federal income tax.[36]

The attribution rules of section 318 which affect corporate redemptions are quite complex. An individual is considered to own stock owned, directly or indirectly, by his or her spouse (absent a legal separation), children, grandchildren and parents.[37] Only these family attribution rules can be waived in a complete termination of interest redemption.[38] There are, however, other categories of attribution. For example, an individual is considered constructively to own stock held by certain entities. Stock owned

32. I.R.C. § 302(c)(2)(A)(ii).

33. I.R.C. § 302(c)(2)(A)(iii).

34. I.R.C. § 302(c)(2)(B)(i).

35. I.R.C. § 302(c)(2)(B)(ii).

36. I.R.C. § 302(c)(2)(B) (last paragraph). The Service has liberalized the requirements to obtain the benefits of this relief provision. *See* Rev. Rul. 77-293, 1977-2 C.B. 91; Rev. Rul. 77-455, 1977-2 C.B. 93. *See also* Brogan, *Rulings on Tax Motivated Transfers Expand Planning Possibilities for Redemptions*, 51 J. TAX. 292 (1979).

37. I.R.C. § 318(a)(1)(A).

38. I.R.C. § 302(c)(2)(A).

by a partnership or estate is deemed to be owned proportionately by the partners or beneficiaries of the entity.[39] Stock owned by a trust is considered to be owned by its beneficiaries in proportion to the actuarial interest of the beneficiaries in the trust.[40] Grantor trusts, however, under sections 671–678 are deemed to have their stock owned by the owner of the trust under these rules.[41] Stockholders who hold fifty percent or more of a corporation's stock are viewed as owners of their proportionate share, determined by the value of their stock holdings as a percentage of all stock held by the corporation.[42]

Conversely, stock owned by individuals is also attributable to entities in which they have an interest. A partnership or estate is considered to own stock owned by a partner or beneficiary.[43] A trust is deemed to own stock owned by a beneficiary of the trust, unless the beneficiary has a remotely contingent interest, computed actuarially, of less than five percent.[44] A corporation is treated as owning all the stock owned by a person holding fifty percent or more of the value of its stock.[45]

The overall complexity of the attribution rules is heightened by the concept of re-attribution. It is in this area that many taxpayers find they cannot meet the mechanical "safe harbor" provisions of section 302 and consequently must fall back on the "not essentially equivalent to a dividend" facts and circumstances test.[46] As a general rule, stock attributed to a person on the basis of the provisions outlined above is deemed to be actually owned by that person and may be re-attributed to another person.[47] The exceptions to this rule are limited. First, there can be no double inclusion of stock owned by any person.[48] Second, stock that is

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39. I.R.C. § 318(a)(2)(A).
40. I.R.C. § 318(a)(2)(B)(i).
41. I.R.C. § 318(a)(2)(B)(ii).
42. I.R.C. § 318(a)(2)(C).
43. I.R.C. § 318(a)(3)(A).
44. I.R.C. § 318(a)(3)(B).
45. I.R.C. § 318(a)(3)(C). In addition, § 318(a)(4) provides that if a person has an option to acquire stock, such stock shall be considered as owned by that person.
46. *See* notes 19–20 *supra* and accompanying text.
47. I.R.C. § 318(9)(5)(A).
48. Treas. Reg. § 1.318-1(b)(2) (1968).

The operation of the rule prohibiting double inclusion can be demonstrated with the following example.

Father (F) and Son (S) each have a 50% actuarial interest in a trust. The trust owns 100 shares of X Corp. directly. F also owns 100 shares of X Corp. directly. (Applying the attribution rule of § 318(a)(2)(B), F would own 150 shares; 100 shares directly and 50 shares constructively through the trust). There are two possibilities for determining S's holdings: (1) F's 100 shares could be attributed to S through the trust resulting in S own-

considered to be owned by an individual because of the constructive ownership rules is not treated as owned by that person for the purposes of again applying the family attribution rules to make another person the constructive owner of the stock.[49] Finally, stock owned constructively, but not actually, by a partnership, trust, corporation, or estate shall not be considered as stock owned by such entities for the purpose of applying the attribution rules *from* those entities so as to make yet another entity the constructive owner of the stock.[50]

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ing 100 shares constructively; and (2) F's 100 shares could be attributed directly to S under § 318(a)(1)(A) in addition to 50 shares attributed to S through the trust. Thus, S would own 150 shares constructively.

In applying the double inclusion rule, the stock owned by F may be used in the computation of S's holdings only once. Finally, F's stock must be attributed to S in the manner that will maximize S's total stock ownership. Thus, F's holdings must be attributed directly to S under § 318(a)(1)(A) and not through the trust under § 318(A)(2)(B).

49. I.R.C. § 318(9)(5)(B). This exception is not applicable if constructive ownership is caused by the option attribution rules of § 318(9)(5)(D).

50. I.R.C. § 318(9)(5)(C).

The following examples illustrate the application of the attribution rules:

Example (a)

> A, an individual, owns 50 percent of X Corporation's stock. The other 50 percent is owned by [an estate] in which A has a 20 percent interest. The [estate] is considered as owning 100 percent of X, and A is considered as owning 60 percent.

B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 9.15 (4th ed. 1979).

A originally owned 50% of the total stock. A also owned a 20% residual interest in an estate which owned the remaining 50%. Thus, A constructively owned 10% (20% of 50%) of the estate's stock in addition to the original 50% interest. Therefore, A was considered to own a total of 60%. Under § 318(a)(3)(A) the estate is considered to own all stock "owned, directly or indirectly, by or for a . . . beneficiary of [the] estate." Therefore, the estate owns 50% directly and 50% constructively for a total interest of 100%.

Example (b)

> X Corporation's 100 shares of stock are owned as follows: 20 shares each by A, B, and C, who are brothers, and 40 shares by a trust, in which the interests of A, B, and C, computed actuarially, are 50 percent, 20 percent, and 30 percent, respectively. The trust is considered to own all of the stock in X, whereas A, B, and C, in addition to the 20 shares each owns directly, own 20, 8, and 12 shares constructively, respectively.
>
> If C's interest in the trust was both "remote" (i.e., worth 5 percent or less) and contingent, his stock would not be attributed to the trust, but its stock would be attributed proportionately to him.

B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 9.15 (4th ed. 1979).

Under § 318(a)(3)(B) all stock "owned, directly or indirectly, by or for a beneficiary of [the] trust, . . . shall be considered as owned by the trust," unless the value of the beneficiary's interest, computed actuarially, is worth "5% or less of the value of the trust property." A, B, and C each constructively own 50%, 20%, and 30% respectively of the trust's original holdings (40 shares) in addition to their individual direct holdings.

B. *Legislative History*

The "essentially equivalent" language contained in section 302(b)(1) first appeared in section 201(d) of the Revenue Act of 1921[51] which provided:

> A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend. . . .[52]

This legislation was a response to the Supreme Court decision in *Eisner v. Macomber*,[53] which held that pro rata stock distributions represent a gain accruing to capital as opposed to a gain derived from capital. As such, pro rata stock distributions do not constitute taxable income within the meaning of the sixteenth amendment. Section 201(d) was designed to combat taxpayers who, even then, were attempting to have corporate earnings distributed at capital gains rates. Several refinements to this provision were made, and this concept was ultimately codified as section 115(g)(1) of the Internal Revenue Code of 1939.[54]

Section 115(g)(1) was the sole statutory expression in the 1939 Code governing the qualification of a transaction as a redemption. This language forced a factual determination in every case, result-

Brother	A	B	C
(a) Individual Direct Holdings	20 shares	20 shares	20 shares
(b) Actuarial Interest in Trust	50%	20%	30%
(c) Trust's Original Holdings	40 shares	40 shares	40 shares
(d) Constructive Holdings ((b) × (c))	20 shares	8 shares	12 shares
(e) Total Holdings ((a) + (d))	40 shares	28 shares	32 shares

51. Revenue Act of 1921, ch. 136, 42 Stat. 228 (amended and codified at I.R.C. § 115(g)(1) (1939)).

52. *Id.*

53. 252 U.S. 189 (1920).

54. *See* Revenue Act of 1924, ch. 234, 43 Stat. 253, and Revenue Act of 1926, ch. 27, 44 Stat. 9. Section 115(g)(1) of the Internal Revenue Code of 1939 provides:

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

ing in an examination of a variety of factors, such as whether there was business purpose and whether the transaction was a tax avoidance scheme, to determine if a redemption or dividend had occurred. There was general disagreement among the courts as to what types of factual determination met these guidelines.[55] These inconsistent decisions naturally created uncertainty, which provided the background for the legislative enactment of section 302 of the 1954 Code.[56]

The House report on the 1954 Code clearly indicates that these changes were designed to implement specific conditions regarding whether a redemption resulted in capital gains treatment. The House bill was intended to eliminate the widespread confusion in the area[57] by enacting certain objective tests to determine the tax consequences of stock dividends.[58] As a result, the revision of the tax bill passed by the House contained no "essentially equivalent" language.[59] Rather, the House enactment only contained provisions which were similar to those now contained in section 302(b)(2), (3), and (4). The Senate added section 302(b)(1) and the current "not essentially equivalent to a dividend" language. The Senate committee, in adding this language, took the position that "the definite rules of the House bill appear unduly restrictive . . . ."[60] The Senate report also indicates that it was following existing law by inserting this language and it intended that a factual test apply.[61]

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55. *See* United States v. Davis, 397 U.S. 301, 309 (1970). In *Davis* the Court noted that ambiguous wording of the policies embodied in § 115(g)(1) created much confusion in the tax law. Justice Marshall stated that § 115(g)(1) was initially perceived to be aimed only at tax avoidance schemes and thus courts sought to determine only if such a scheme existed. Later the emphasis shifted to a consideration of the effect of the distribution. Many courts held that if the distribution was motivated by a "sufficiently strong non-tax business purpose," then it was deemed not to be essentially equivalent to a dividend. There was a general disagreement, however, as to what would constitute a sufficiently strong non-tax business purpose. The result was that courts proceeded on a case-by-case basis looking to the particular facts involved in the transaction in question.

56. *See id.*

57. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 35, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025, 4060.

58. *Id.*

59. *Id.* at 309–10.

60. S. REP. NO. 1622, 83d Cong., 2d Sess. 44, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4629, 4675.

61. *Id.* at 233–34, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4629, 4870. The Senate report states:

> In lieu of the approach in the House bill, your committee intends to revert in part to existing law thereby making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates

Neither report mentions the intended effect of the interplay of the attribution rules with the provision added by the Senate. The House report states that the Code "makes clear that the rules of attribution of ownership provided in section 311 [now section 318] will be applicable in determining ownership of stock for the purpose of section 302."[62] The House report further indicates an intention to provide precise rules for attribution. The Senate version, which was ultimately adopted, seems tacitly to accept the House position that the attribution rules of section 318 will apply to determinations of ownership for purposes of section 302(b)(1).[63]

II. Family Hostility Exception to Application of Attribution Rules

The statutory and legislative framework discussed in the previous section provides conflicting authority concerning the interplay of the corporate redemption and attribution rules where family hostility is involved. These rules provide no definite guidelines on whether there should be a family disharmony exception to the attribution rules. On the one hand, the provisions of section 302 apply the attribution rules without mitigation.[64] On the other hand, the "essentially equivalent to a dividend" language of the Code and the legislative history of section 302 require a factual determination.[65]

The Tax Court first recognized this controversy in *Estate of Squier v. Commissioner*.[66] This proceeding involved a redemption from an estate where family disharmony existed regarding who should be the president of the corporation. The Tax Court recognized a "sharp cleavage" between the executor and members of the Squier family.[67] This fact, coupled with the existence of a substantial nonfamily minority interest and the court's finding of a significant change in control, led the court to conclude that the redemption was not essentially equivalent to a dividend. This re-

dependent, except where it is specifically provided otherwise, upon a factual inquiry.

62. H.R. Rep. No. 1337, *supra* note 57, at A75 *reprinted in* [1954] U.S. Code Cong. & Ad. News 4025, 4212.

63. S. Rep. No. 1622, *supra* note 60, at 43 *reprinted in* [1954] U.S. Code Cong. & Ad. News 4629, 4674–75.

64. I.R.C. § 302(c)(1). *See* notes 28–50 *supra* and accompanying text.

65. I.R.C. § 302(b)(1) and S. Rep. No. 1622, *supra* note 60, at 233–34 *reprinted in* [1954] U.S. Code Cong. & Ad. News 4629, 4870.

66. 35 T.C. 950 (1961), *acq.*, 1961-2 C.B. 5, *acq. withdrawn and nonacq. substituted*, 1978-2 C.B. 5.

67. *Id.* at 955.

sult was reached despite the court's apparent application of the attribution rules, which resulted in the taxpayer owning eighty percent of the corporation's stock, both before and after the redemption.[68]

In 1961, the Tax Court decided another case that contained the family disharmony issue. In *Parker v. Commissioner*[69] evidence was presented of a history of family disputes over control of the corporation involved. To resolve these problems, the father had the corporation redeem a portion of his stock to give control of the corporation to his son. The court held that this redemption was not essentially equivalent to a dividend because of the significant change in control.[70] While not clearly stated in the opinion, the court appears not to have considered the attribution rules because of the family disharmony present.[71]

The following year, the First Circuit passed in dicta on the family disharmony issue.[72] The court noted that while the attribution rules are generally applicable to redemptions, their imposition is not inflexible. The rules need not be applied if it is demonstrated that discord exists in a family relationship which would make attribution unwarranted.[73] There appears to have been no further case law development on this issue until the Supreme Court decision in *United States v. Davis*.[74] While *Davis* did not deal directly with the family disharmony issue, it unquestionably altered the law by which redemptions qualified as not essentially equivalent to a dividend. Consequently, *Davis* has a

68. *Id.* at 956–57.

69. 20 T.C.M. (CCH) 893 (1961).

70. *Id.* at 900–01.

71. *Id.* In holding the attribution rules inapplicable, the Tax Court cited two of its earlier opinions: Lewis v. Commissioner, 35 T.C. 71 (1960), and Estate of Squier v. Commissioner, 35 T.C. 950 (1961).

In *Lewis* the court applied the attribution rules of § 318. The *Parker* court distinguished *Parker* from that precedent: "In [*Lewis*], however, the findings are devoid of any reference to controversy or adversity of interest among the various shareholder interests." 20 T.C.M. (CCH) at 900.

The court explained how it had reached an opposite result in *Squier*, recognizing that in *Lewis* "we did not consider [the attribution rules] to be conclusive in all events. . . ." *Id.* Further, "the issue of essential equivalence to a dividend is to be resolved in the light of all the facts and circumstances involved." *Id.* Therefore, the family disharmony present in *Parker*, as in *Squier*, caused the court to disregard the attribution rules of § 318. *Id.* at 900–01.

72. Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).

73. 298 F.2d 111, 116 n.7. The Bradbury court distinguished both *Squier* and *Parker*, commenting, "Here the record is clear that complete harmony and community of purpose existed between petitioner and her daughter and consequently section 318 applies." *Id.*

74. 397 U.S. 301, *reh. denied*, 397 U.S. 1071 (1970).

great, although perhaps not clear, effect on the family disharmony exception.

The taxpayer in *Davis*, along with his wife and children, owned all of the common stock of a corporation. To allow the corporation to have sufficient working capital to obtain a loan through the Reconstruction Finance Corporation, the taxpayer purchased $25,000 worth of the corporation's preferred stock. The parties intended that this preferred stock be redeemed when the loan was paid. When the load was repaid, the taxpayer claimed that the transaction was a redemption not essentially equivalent to a dividend and that he realized no gain from the transaction since his tax basis in the preferred stock was equal to the amount he received. The Commissioner viewed the transaction as a redemption essentially equivalent to, and thus taxable as, a dividend. After paying the resulting deficiency, the taxpayer sued for a refund and was successful in the district court[75] and court of appeals.[76]

The two basic issues in *Davis* were whether the stock attribution rules of section 318(a) applied to stock redemptions under section 302(b)(1)[77] and whether the redemption qualified as not essentially equivalent to a dividend under section 302(b)(1).[78] In considering the first issue, the Supreme Court looked to the "plain language of the statute" to reject the taxpayer's argument that the attribution rules did not apply to section 302(b)(1) redemptions.[79] In support of its position, the Court also pointed to the views of the courts of appeals which had considered the issue,[80] the opin-

75. Davis v. United States, 274 F. Supp. 466 (M.D. Tenn. 1967). The district court held that the preferred stock was issued "solely in order to provide the additional security required by the RFC as a precondition to making the initial $95,000 loan." *Id.* at 471. Consequently, the amount received by Davis in exchange for his 1,000 shares of preferred stock was not essentially equivalent to a dividend, but was treated as a distribution in payment for the stock redeemed. *Id.*

76. Davis v. United States, 408 F.2d 1139 (6th Cir. 1969). In affirming the district court, the Sixth Circuit commented, "Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme." *Id.* at 1143–44. The Sixth Circuit concluded that the amount received by Davis was not essentially equivalent to a dividend because the redemption was the final step in a course of action that had a legitimate business (as opposed to a tax avoidance) purpose. *Id.*

77. 397 U.S. at 304.

78. *Id.* at 307.

79. *Id.* at 306.

80. *Id.* at 306. *See* Levin v. Commissioner, 285 F.2d 521, 526–27 (2d Cir. 1967); Commissioner v. Berenbaum, 369 F.2d 337, 342 (10th Cir. 1966); Ballenger v. United States, 301 F.2d 192, 199 (4th Cir. 1962); Bradbury v. Commissioner, 298 F.2d 111, 116–17 (1st Cir. 1962).

ions of leading commentators,[81] and the legislative history of the attribution and redemption rules.[82] The Court clearly concluded that the attribution rules did apply to redemptions under section 302(b)(1).[83] The Court then went on to decide the second issue against the taxpayer.[84] In so doing, the Court rejected any business purpose exception to the essentially equivalent to a dividend rules. The Court held that the motivation for the redemption was to be disregarded in determining dividend equivalence. Thus, for a redemption to qualify under section 302(b)(1), "a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."[85]

The effects of *Davis* on the family disharmony exception to the attribution rules were unclear following the decision and continue to be so. While the Court did not cite *Squier* or specifically overrule it, some commentators argued that its findings seemed to undercut the rationale for that decision.[86] Other commentators, however, argued that the family disharmony exception still existed.[87] The Service in several post-*Davis* revenue rulings opined that the attribution rules fully applied in testing redemptions under section 302(b)(1),[88] indicating a determination that the fam-

81. 397 U.S. at 306. See Treas. Reg. 1.302-2(b); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 292 n.32 (2d ed. 1966).

82. 397 U.S. at 306-07. *See* notes 80-81 *supra*.

83. *Id.* at 307.

84. *Id.* at 307-13.

85. *Id.* at 313. The Court did not elaborate on what would constitute a meaningful reduction, but held that Davis clearly (after application of the attribution rules) "was the sole shareholder of the corporation both before and after the redemption," and therefore, did not qualify under this test. *Id.*

86. *See, e.g.*, 23 U. FLA. L. REV. 188, 192 n.38 (1970).

87. *See, e.g.*, B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 9.24 at 26 n.43 (3d ed. 1971); D. KAHN, BASIC CORPORATE TAXATION 32-33 n.80 (1973); Cathcart, *Section 302 Redemptions: Family Fights and Attribution*, 61 A.B.A.J. 1272 (1975); Sweenes, *"Not Essentially Equivalent to a Dividend" Exception Still Viable Despite* Davis, 41 J. TAX. 78, 82 (1974); Comment, *Defining Dividend Equivalency Under Section 302(b)(1)*, 16 VILL. L. REV. 88 (1970).

88. Rev. Rul. 77-218, 1977-2 C.B. 81; Rev. Rul. 75-512, 1975-2 C.B. 112.

The facts in Rev. Rul. 77-218 involve two corporations (X and Y) in which W as the beneficiary of a trust in each corporation directly owns 20% of the stock of X and 10% of the stock of Y. Application of the attribution rules increases W's shares by constructive ownership to 60% of X and 75% of Y. Similarly, by virtue of attribution, the trust is deemed owner of the same percentage of shares. Y then acquires the trust-owned stock of X for cash. The transaction qualifies as a redemption of the stock of Y since the trust was in control of both the issuing corporation (X) and the acquiring corporation (Y) (§ 304(a)(1)). Applying § 318(a)(2)(C), the trust owns 55% of X after the transaction and fails to come under §§ 302(b)(2) and 302(b)(3). The Service concludes that the redemption also fails to meet the "not essentially equivalent to a dividend" test under § 302(b)(1) since

ily hostility exception was no longer cognizable. The courts did not directly address this issue, although some glimmer of support for the continued vitality of the *Squier* concept was found by the Ninth Circuit. In *Title Insurance & Trust Co. v. United States*,[89] the court noted that assumptions of family harmony inherent in the attribution rules "may prove indeed, awkward or unfair in cases where families do not behave as the rules assume they will, and intra-family disputes exist as to who should control and how."[90] This observation was dicta, however, because there was no evidence of family hostility before the court.[91] The stage was thus set for a definite holding on this topic, and the case of *Haft Trust v. Commissioner*[92] provided the perfect vehicle for this determination.

In *Haft Trust* certain redemptions of stock owned by four trusts in Haft-Gaines Company were involved. The trusts had been created by Marcia Haft's father for her four children, two from her marriage to Burt Haft and two from her previous marriage who were adopted by Burt Haft. These trusts were established in January 1962, and each held 25,000 shares of stock in the company. In November 1966, Marcia Haft commenced divorce proceedings against Burt Haft and each made "serious and bitter charges and countercharges against the other."[93] A series of negotiations ensued between the parties and their representatives. These negotiations culminated in a redemption in June 1967 of all of the stock held by the trusts and the subsequent divorce of the

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it does not constitute a "meaningful reduction of the shareholder's proportionate interest in the corporation" (60% to 55% as required by *Davis*). Consequently, under § 302(d), the redemption is regarded as a distribution of property to which § 301 applies.

In Rev. Rul. 75-512, the Service applied the attribution rules to find a redemption not essentially equivalent to a dividend within § 302(b)(1). A family corporation redeemed 75 trust-owned shares from its 1,000 outstanding shares of common stock. After the redemption, the trust still owned 225 shares of 24.3% of the total stock through attribution. However, the percentage of stock owned by the trust after the redemption was 81% of the stock owned prior to the redemption. Although the redemption did not qualify for exchange treatment under §§ 302(b)(2) or 302(b)(3), the Service concluded that there was a meaningful reduction of the shareholder's proportionate interest in the corporation under *Davis*. Factors considered were the trust's status as a minority shareholder taking no part in the management of the corporation, a reduction of voting rights, the reduction of the right to participate in current earnings and accumulated surplus and the reduced right to share in net assets on liquidation.

89. 484 F.2d 462 (9th Cir. 1973).

90. *Id.* at 465, n.4.

91. *Id.* at 462.

92. 510 F.2d 43 (1st Cir. 1975).

93. *Id.* at 45.

Hafts.[94]

Immediately prior to the redemption, the company had 500,000 shares of stock outstanding, which was owned as follows:

Shareholders	Shares
Burt Haft	100,000
Richard Haft (Burt's brother)	100,000
Jack Gaines	100,000
Abraham Haft Trust for the benefit of Burt Haft, Richard Haft and Norma Gaines (Burt's sister)	100,000
Robin Haft Trust	25,000
Wendy Laura Haft Trust	25,000
Lisa Ann Haft Trust	25,000
Daniel Foster Haft Trust	25,000
TOTAL	500,000[95]

After the redemption only 400,000 shares remained outstanding.

The issue before the court was "the relevance after *United States v. Davis* of family hostility in mitigation of the constructive ownership rules of Code section 318 in determining dividend equivalence under section 302(b)(1)."[96] It should be noted that because of the application of the attribution rules, the four trusts were considered to own a greater percentage of stock in the corporation after the redemption than before it. This fact is demonstrated by the following table:

PERCENTAGE OF SHARES OWNED BY TRUST[97]

Actual Owner	Shares Attributed to Trust Before Redemption	Shares Attributed to Trust After Redemption
Each Child's Trust	25,000	-0-
Abraham Haft Trust[98]	33,333	33,333
Burt Haft[99]	100,000	100,000
Total Owned	158,333	133,333
Total Outstanding	500,000	400,000
Percentage Owned	31.67%	33.33%

94. *Id.*
95. *Id.* at 46.
96. *Id.* at 44–45.
97. *Id.* at 46, n.2.
98. *See* I.R.C. §§ 318(a)(2)(B)(ii), (1)(A)(ii).
99. *See* I.R.C. § 318(a)(1)(A)(ii).

It was clear that if the attribution rules were applied as the sole guideline in this case, the redemption would be considered as essentially equivalent to a dividend under the *Davis* rationale.[100]

Initially, the First Circuit considered the principle from *Squier* that family discord could call into question the community of interest rationale of the attribution rules and therefore was a relevant circumstance to be considered in determining dividend equivalence under section 302(b)(1).[101] The court noted its endorsement of this principle in *Bradbury v. Commissioner*,[102] and in the Tax Court's opinion below which reasoned that *Squier* had been implicitly overruled by *Davis*.[103]

According to the First Circuit, *Davis* held that the attribution rules must be taken into account in analyzing dividend equivalence under section 302(b)(1), but are not determinative of whether a redemption is essentially equivalent to a dividend.[104] The court adopted the position that *Davis* permitted, if not mandated, an examination of the facts and circumstances of a particular situation to determine the effect of the transaction, rather than a mere mechanical application of the attribution rules.[105]

In support of its findings, the Court pointed to the Service's regulations which provided that the issue is to be decided by examining the facts and circumstances of each case and that constructive stock ownership under section 318(a) is merely one of the facts to be considered.[106] The court also concluded, on the basis of *Davis*, that the effect of the transaction, rather than its motivation, is determinative.[107]

Thus, for the first time under the 1954 Code, a court held that the family attribution rules of section 318(a)(1) could be disregarded or minimized under section 302(b)(1), depending on the facts of the particular situation. The First Circuit remanded *Haft Trust* to the Tax Court to consider the effect of family discord in this particular situation. There was no further Tax Court opinion on this issue, however, since the case was subsequently settled.[108]

100. *Id.* at 46.
101. 510 F.2d at 46.
102. *See* notes 72–73 *supra* and accompanying text for a discussion of *Bradbury*.
103. *Id.* at 47.
104. *Id.*
105. *Id.* at 48.
106. *Id.* at 47. *See* Treas. Reg. § 1.302-2(b) (1955).
107. 510 F.2d at 48.
108. *See* Note, *Family Hostility as a Factor in Determining Constructive Stock Ownership in Corporate Redemptions*, 29 TAX LAW. 386, 392 (1976).

As a result, no case directly holds that the attribution rules should be mitigated by family hostility. Issues such as how significant the family dispute must be, who must be affected by it, and what facts are needed to prove the disharmony are left open for discussion in future cases. In this regard, the facts of *Haft Trust* indicate a dispute between Mr. and Mrs. Haft rather than any dispute between the trustees of the four trusts and family members as officers of the corporation. Consideration of these issues also awaits further case law development.

The commentators on *Haft Trust* have been mostly favorable in their review of the court's decision and the legal status of family hostility with respect to section 318(a)(1).[109] Commentators generally agreed with the court's interpretation of *Davis* that the attribution rules were merely one factor to be considered in determining dividend equivalence under section 302(b)(1). Other factors, such as family disharmony, may be considered in reaching this determination, and these additional factors may overcome the effects of the constructive ownership. This position is supported by *Davis*, which fully applied the attribution rules, but also developed a separate guideline for testing dividend equivalence. The consideration of whether there was a meaningful reduction of the shareholder's interest would have been unnecessary if the attribution rules were determinative. The policy implications involved in acknowledging factors that might mitigate the attribution rules will be discussed in greater detail in the last section of this Article.[110]

The Service has recently issued Revenue Ruling 80-26[111] directly related to the family hostility issue. This ruling involved a factual situation exactly like that of *Haft Trust*. The Service held that the attribution rules are applicable in determining whether a distribution in redemption qualifies under section 302(a). In so doing, the Service announced it would follow neither the *Haft Trust* decision nor the *Squier* decision.[112]

In Revenue Ruling 80-26, a corporation, whose outstanding stock was owned by three individuals and five trusts, redeemed

109. *See, e.g.*, Bacon, *Corporate Stock Redemptions—Definitions; Basic Categories*, 343 TAX MNGM'T (BNA) (1978); Englebredht & deCelles, *Family Discord and Section 302 Stock Redemptions: A Review and Analysis*, 58 TAXES 43 (1980); Note, *supra* note 108; Note, *Family Hostility as Mitigating the Constructive Ownership of Section 318 When Applied to the Dividend Equivalency Provision of Section 302(b)(1)*, 55 B.U.L. REV. 667 (1975).

110. *See* notes 155-65 *infra* and accompanying text.

111. Rev. Rul. 80-26, 1980-1 C.B. 67.

112. *Id.*

the stock held by four of the trusts, which had been established for the benefit of an individual shareholder's children. Before the redemption each trust owned, actually and constructively, thirty-one percent of the stock. Afterwards each owned thirty-three percent solely by attribution under section 318. Because of family hostility over a bitter divorce, the four trusts were prevented from exercising actual control over the stock attributed to them. Notwithstanding the family hostility, section 318 was applied and the redemption was deemed not to qualify under section 302(b)(1). The Service based its decision on an analysis of *Davis* and the legislative history of section 318.

The Service interpreted *Davis* to mean that in determining dividend equivalence under section 302(b)(1), the section 318 attribution rules were directly applicable. The Service found that "the purpose of the attribution rules under section 318 was to replace the confusion of prior law [pre-1954 Code] with clear and objective standards for attribution of stock ownership among related shareholders."[113]

According to the Service, "the facts and circumstances of a particular case cannot contradict the mechanical determination under section 318 of how much stock a shareholder owns."[114] The Service expressly rejected the holdings in *Haft Trust* and *Squier* on the grounds that the clearly defined rules of section 318 should not be ignored, since the result would be an ad hoc utilization of the family attribution rules.

In January of 1981, the Tax Court restated its position that family hostility does not mitigate the application of family attribution rules. The opinion in *Metzger Trust v. Commissioner*[115] is a major setback in the judicial development of a family hostility exception to the application of section 318.

In *Metzger Trust*, David Metzger formed Metzger Dairies, Inc. (MDI) to operate a private dairy business. Earlier he had created a trust with his wife, Nora, as life income beneficiary and his three children, Jacob, Catherine, and Cecelia, each as one-third holders of remainder interests. The trust then became a shareholder of the MDI corporation. When David Metzger died, his son Jacob assumed managerial control over MDI. His sisters, Catherine and Cecelia, were installed as directors of the corporation.

113. *Id.*

114. *Id.*

115. [1981] TAX CT. REP. (CCH) Dec. 37, 614.

For a while, the corporation operated profitably. As MDI's performance and earnings fell, however, disagreements arose among Jacob and his sisters over the proper management of MDI. Over the next few years, numerous personal battles and general family discord bred deep-seated animosities between Jacob and his two sisters. Eventually as a result of this family hostility, Jacob and his sisters decided to cause MDI to redeem the stock owned by the trust and the two sisters so that Jacob would acquire full control over MDI. In return, Jacob relinquished his interests in the other family businesses in favor of his two sisters.

The primary issue which the Tax Court faced in *Metzger Trust* was whether family hostility nullified the attribution rules under section 318 so as to entitle the trust to exchange treatment under section 302.[116] The trust, relying on *Haft Trust*, argued that the existence of family hostility should be a factor considered in mitigating the constructive ownership rules of section 318. The Tax Court, however, specifically rejected the *Haft Trust* rationale and concluded that family hostility would not mitigate the operation of the constructive ownership rules in this case.[117]

Clearly, if the decision stands, *Metzger Trust* represents a disruption in the judicial development of a family hostility exception to the section 318 constructive ownership rules. However, only further judicial examination of the constructive ownership rules and family hostility will reveal the significance of *Metzger Trust*.

III. STATUTORY WAIVER OF FAMILY ATTRIBUTION RULES

There is one statutory exception to the application of the attribution rules in a corporate redemption. This exclusion can provide significant benefits in family hostility situations, and a recent case law expansion[118] of the scope of this statutory waiver could further enhance its effectiveness.

A. *Waiver by Individuals*

Section 302(b)(3) provides that a redemption that completely terminates a shareholder's interest in the redeeming corporation is eligible for the more favorable exchange treatment. The attribution rules of section 318, however, are specifically made applicable by section 302(c)(1) in determining whether the shareholder's in-

116. *Id.* at 2637.
117. *Id.* at 2647.
118. *See* notes 124–43 *infra* and accompanying text.

terest has been completely terminated. As noted previously, a waiver of the family attribution rules of section 318(a)(1) is provided in section 302(c)(2) where: 1) distributee actually terminates stock ownership and has no interest in the corporation other than as a creditor; 2) distributee does not acquire any such interest (other than acquired by bequest or inheritance) within a ten-year period; and 3) distributee files an agreement to notify the Service of any such acquisition. This statutory waiver, however, is inapplicable in two situations. First, the waiver of attribution is not allowed if any portion of the stock redeemed was acquired within a ten-year period from a person whose ownership of the stock would be attributable to the redeeming stockholder under section 318(a). Second, the statutory waiver may not be claimed if any person owns stock which would be attributable to the redeeming stockholder and which was acquired from such stockholder within the ten-year period prior to the date of the transaction, unless that stock is also redeemed. These two exceptions to the statutory waiver may be avoided if the prohibited transfer did not have as one of its principal purposes the avoidance of federal income tax.[119] If the requirements for waiver can be met, then a family dispute can be settled by the redemption of a family member's stock. Where all of the stockholders are individuals, this settlement does not prove to be very difficult.

B. *Waiver by Entities*

Where one or more of the stockholders are entities, statutory waiver of the family attribution rules may be difficult to achieve. In *Haft Trust*, the trustee attempted to avail the trusts of the benefits of the complete termination of interest redemption under section 302(b)(3). The attempt was made by filing the agreement required by section 302(c)(2)(A)(iii),[120] thereby waiving the family attribution rules. Both the Tax Court and the First Circuit held that the agreement was not filed in a timely fashion, and therefore did not consider the merits of whether a trust could obtain statutory waiver of family attribution rules.[121]

The Service maintained that section 302(c)(2)(A)(iii) does not allow an entity to obtain statutory waiver of the family attribution

119. *See* § 302(c)(2)(B) and the prior discussion of this issue at notes 28–56 *supra* and accompanying text.

120. This agreement is hereinafter referred to as "triple eye" (iii) agreement.

121. 62 T.C. 145 (1974) (supplemental opinion); 510 F.2d 43, 45 n.1 (1st Cir. 1975).

rules. In Revenue Ruling 59-233,[122] the Service found that a trust could not avail itself of the waiver privilege. It argued that an examination of the legislative history of section 302(c)(2)(A) clearly revealed that only individuals could qualify to file a waiver agreement. This position was reiterated concerning estates in Revenue Ruling 68-388.[123] At the same time, the Service stated that it would not recognize a transfer from entity to individual beneficiaries to facilitate the waiver of the attribution rules.

In *Crawford v. Commissioner*[124] the Tax Court rejected the Service's interpretation of the word "distributee" to mean individuals and not entities. The only shareholders of the corporation were the decedent's estate, his surviving spouse, and his two sons.[125] The sole beneficiary of the estate was the mother of the sons.[126] The mother constructively owned all the stock owned by her sons, through operation of section 318(a)(1)(A). The estate, both before and after the redemptions, constructively owned all of the stock that was actually and constructively owned by the mother, through operation of section 318(a)(3)(A). Both the mother and the estate filed "triple eye" agreements.[127] The Service claimed that the estate could not waive the series of attributions under sections 318(a)(1) and 318(a)(3) from the sons, to the mother, to the estate. Relying on the legislative history of section 302(c)(2), the Service argued that the family attribution rules could be waived only by individuals.[128] The court, however, disagreed and noted that congressional use of the term "distributee" rather than individual avoided any limitation of the attribution rules to individuals.[129]

The second argument made by the Service was that waiver of the attribution rules by the estate would not bind the beneficiaries and, therefore, would not prevent them from reacquiring an interest in the corporation within the succeeding ten-year period. While the court acknowledged this potential for abuse, it noted that the particular remedy proposed by the Service would lead to a nonsensical result. Since the statutory waiver applies only to the family attribution rules, the Service's concern appears unfounded.

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122. Rev. Rul. 59-233, 1959-2 C.B. 106.
123. Rev. Rul. 68-388, 1968-2 C.B. 122.
124. 59 T.C. 830 (1972), *nonacq*. 1974-2 C.B. 5.
125. 59 T.C. at 833.
126. *Id*. at 832.
127. *Id*. at 833.
128. *Id*. at 835.
129. *Id*. at 835-37.

Any reacquisition by the beneficiary would constitute a prohibited reacquisition by the entity under the entity attribution rules and thus defeat the effectiveness of the waiver. In Revenue Ruling 71-562,[130] the Service implicitly recognized this point. This ruling held that a reacquisition by a member of the redeeming stockholder's family would not violate the ten-year acquisition rule.[131]

The *Crawford* rationale was extended to trusts in *Johnson Trust v. Commissioner*.[132] In *Johnson Trust*, a testamentary trust owned roughly five percent of the corporation's stock.[133] The primary beneficiary of the trust was the decedent's son, who individually owned no stock in the corporation.[134] His mother, whose actuarial interest in the trust was not sufficient to require attribution to the trust under section 318(a)(3)(B)(i), owned approximately forty percent of the stock in her own name.[135] Under sections 318(a)(1)(A)(ii) and (B)(ii) her stock was attributable through her son to the trust. The Tax Court rejected the Service's attempts to limit the use of "triple eye" agreements to individuals and to limit the *Crawford* decision to situations where the beneficiary also filed a "triple eye" agreement.[136] The court also noted that if the son acquired stock in the corporation, this would be attributed to the trust under section 318(a)(3)(B)(i) and thus defeat the trust's waiver.[137]

The *Johnson Trust* and *Crawford* decisions were further extended by *Rickey v. Commissioner*.[138] This decision involved a corporation whose stock was owned fifty-seven percent by an estate and thirty-five percent by the decedent's two sons and daughter. The remaining eight percent was owned by other shareholders unrelated to the decedent's family. The will of the decedent left all of his property to his children. The estate's shares

130. Rev. Rul. 71-562, 1971-2 C.B. 173. For a discussion of this issue, see Willens, *Recent Decisions Open the Way for Trusts and Estates to Waive Stock Attribution*, 51 J. TAX. 208 (1979).

131. The ruling held that an acquisition by A's son is not an acquisition of an interest by A [father] within the meaning of § 302(c)(2)(A)(ii). Therefore, any interest in the corporation acquired during the 10-year period following redemption of A's stock, which would be attributable to A solely by reason of family attribution rules, would be disregarded for purposes of § 302(c)(2)(A)(ii). Rev. Rul. 71-562, 1971-2 C.B. 173, 174.

132. 71 T.C. 941 (1979).

133. *Id.* at 943.

134. *Id.*

135. *Id.* at 943.

136. *Id.* at 950.

137. *Id.* at 948.

138. 592 F.2d 1251 (5th Cir. 1979).

were redeemed, pursuant to a buy-sell agreement. The shares of the children, however, were not redeemed.[139] This fact pattern is substantially different from those in *Johnson Trust* and *Crawford* since beneficiaries of the redeeming entity remained shareholders of the corporation. The entity attribution rules of section 318(a)(3)(A) dictate that the stock owned by the decedent's children, as beneficiaries of his estate, would be considered as owned by the estate. The filing of the "triple eye" agreement would not effectively waive this attribution since that agreement is applicable only to the waiver of family attribution under section 318(a)(1). After the redemption, the estate would be considered to own shares in the corporation and would not have completely terminated its interest in the corporation.

Recognizing this situation, the court in *Rickey* attempted to apply the principles of *Squier* and *Haft Trust* to its facts,[140] even though no family disharmony was present. The Fifth Circuit joined those courts in rejecting "a crabbed reading of the Code when the rationale for applying a rule is absent, and where application of the rule leads to inappropriately harsh results."[141] The court noted that the estate's actual interest in the corporation had terminated, and that the decedent's death could not be viewed as a "device to bleed out corporate profits at capital gains rates."[142] Although not provided for in the statute, the court allowed the estate to file a waiver of the entity attribution rules of section 318(a)(3).[143]

Commentators have been critical of the result reached in the *Rickey* case.[144] Their comments have been primarily directed to the decision allowing the estate to file a waiver of the entity attribution rules, a result clearly not provided for by section 302(c)(2). Limited to that narrow ground, this criticism is well taken; the court's reliance on the statutory waiver was misguided. To the extent *Rickey* rested on the principles enunciated in *Squier* and *Haft Trust*, however, it was a logical extension of the concept that

139. *Id.* at 1255.

140. *Id.* at 1257.

141. *Id.* at 1258.

142. *Id.*

143. The *Rickey* court held that this transaction also qualified as not essentially equivalent to a dividend under § 302(b)(1). *See* 592 F.2d 1251, 1258 n.7 (5th Cir. 1979). Since the Rickey family actually owned over 80% of the corporation's stock both before and after the redemption, it is questionable whether a meaningful reduction in ownership occurred. See Rev. Rul. 78-401, 1978-2 C.B. 127.

144. *See, e.g.*, Bacon, *supra* note 92; Willens, *supra* note 130.

the obseqious application of the attribution rules is improper where, under the facts of a particular case, a mechanical application of this rule would result in a harsh and unjustified decision. *Rickey* can thus be read as part of a growing judicial trend to examine the congressional intent in enacting the attribution rules and to disregard these rules where the rationale for their existence is not present in a particular case. *Rickey* also applies to a section 302(b)(3) redemption and the principles expressed in *Haft Trust* for section 302(b)(1) redemptions. It is unclear whether the *Rickey* result is limited solely to shareholders that are estates or whether individuals can also benefit from it. The rationale underlying the decision, however, seems to limit its application to estates.

The Service has provided taxpayers a method of avoiding the entity waiver issue in factual circumstances similar to those found in *Crawford*. In Revenue Ruling 79-67,[145] the Service retreated from its position in Revenue Ruling 68-388 and held that an estate could transfer stock in a corporation to its beneficiary and then have the corporation redeem the stock held by the beneficiary where the stock received from the estate is the only stock held by the beneficiary. The Service reiterated its position in *Crawford* and Revenue Ruling 68-388 that the estate could not waive the attribution rules. It noted, however, that the beneficiary could file the "triple eye" agreement. The ruling pointed out that the distribution from the estate to the beneficiary would be covered by the ten-year prior acquisition rules of section 302(c)(2)(B). Yet, it also indicated that the avoidance of federal income tax was not one of the principal purposes of the distribution from the estate and, therefore, the exception to the prior acquisition rules had been met.

Revenue Ruling 79-67 appears to be a logical solution to the entity waiver problem. The finding of no tax avoidance motive in the distribution from the estate is of particular importance. The position of this revenue ruling could also be extended to trusts, but probably would be limited only to those situations where the distributions from the trust are mandated by the trust instrument. Discretionary distributions would probably be suspect under the tax avoidance test. This ruling probably provides no help in a *Rickey*-type fact pattern, where the beneficiaries of the estate also continue as stockholders in their own right after the redemption.

145. Rev. Rul. 79-67, 1979-1 C.B. 128.

The revenue ruling highlights the effect of the ten-year acquisition rules of section 302(c)(2)(B), which should also be applied to acquisitions by estates and trusts. The transfer of stock to an estate can hardly be considered a tax avoidance maneuver. An acquisition has greater significance in a trust situation, however, and will in many cases prevent the filing of the "triple eye" agreement. It can be legitimately argued that if an entity can satisfy the statutory rules, it should be allowed to waive the family attribution requirements. Congress has provided a statutory mechanism in section 302(c)(2) for testing tax avoidance in this situation; if these guidelines are met, no legitimate grounds exist for denying waiver treatment. The two Service contentions in this area—that there should be individual waiver only and that the potential for abuse is inherent in entity waivers—are adequately answered by the Code language. Thus, in the *Crawford* and *Johnson Trust* factual situations, no reason exists to deny waiver benefits.

It should be noted that a recent decision by the Tax Court in *Metzger Trust*[146] has again attacked the rationale and holding of *Rickey*. In *Metzger Trust*, the trust argued that the agreement it filed under section 302(c)(2)(A)(iii) was effective to waive the trust-beneficiary attribution rules of section 318(a)(3). In support of its position the trust relied upon *Rickey*. The Tax Court discussed *Rickey* at length, but after exploring its rationale, stated that it disagreed with the court's reasoning.[147] The Tax Court then proceeded to distinguish *Rickey* on the facts stating that *Rickey* involved a redemption that was required by the decedent's will, while in the instant case the redemption was effectuated solely to avoid further family discord in the operation of the family businesses.[148] On these grounds, the Tax Court found the agreement filed by the trust ineffective to waive the attribution rules of section 318(a)(3).

Thus, in view of *Metzger Trust*, the operation of a *Rickey*-type waiver of attribution rules may occur less frequently. Nevertheless, *Rickey* continues to represent a possible method of waiving family attribution under certain circumstances. The next section of the Article examines the policy considerations underlying the waiver of attribution rules in family hostility and *Rickey*-type fact situations.

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146. [1981] TAX CT. REP. (CCH) Dec. 37, 614. *See* notes 114–16 *supra* and accompanying text.

147. *Id.* at 2649.

148. *Id.* at 2651.

IV. Proposal for Changes in Corporate Redemption Rules

The analysis presented above portrays the existing legal guidelines regarding the effect of family attribution rules on corporate redemptions. The language of the Code appears to require the use of the attribution rules, an interpretation supported by the *Davis* decision.[149] In addition, certain language of the legislative history indicates an intention to apply the attribution rules completely to this type of transaction.[150] Other language in the same legislative history, however, indicates that a facts and circumstances test is the appropriate method for determining dividend equivalence.[151] This view has been accepted by the Service in its regulations, and the courts have tended to support the reasoning.[152]

An analysis of the various authorities on this point has led this commentator to suggest two changes to the redemption rules to reflect more accurately current policy considerations and to provide for more effective administration of tax policy. First, a facts and circumstances test should be adopted with regard to a "not essentially equivalent to a dividend" redemption under section 302(b)(1). This test would allow sufficient evidence of family hostility to overcome the effects of the attribution rules of section 318. Second, the existing statutory waiver of the family attribution rules of section 302(c)(2) should be extended, in the case of estates, to a waiver of all attribution rules. Current statutory rules, however, should be maintained for redemption by individuals or other entities.

A. *Facts and Circumstances Test for Section 302(b)(1) Redemptions*

The first recommended change would establish a facts and circumstances test for determining dividend equivalence under section 302(b)(1). This proposed guideline would allow sufficient evidence of family hostility to overcome the family ownership provisions of the attribution rules. The rationale behind the attribution rules is that certain relationships bespeak an economic identity of interest and common control. The attribution rules are based on the assumption that entities benefiting certain individu-

149. 397 U.S. 301 (1970).

150. *See* note 51 *supra*.

151. *See* note 54 *supra* and accompanying text.

152. *See* notes 65 & 105 *supra* and accompanying text.

als will act in concert with these individuals and likewise that individuals will react similarly toward entities which they control or from which they receive benefits. This recommended change is based on the principle that if the reason for the existence of the attribution rules is no longer present, then the attribution rules should not be utilized as a mechanism to deny a tax treatment which would otherwise be available. For example, if a father and son have legitimate policy disputes which caused hostility between them, a redemption under section 302 should be permitted even if the ten-year prior transfers rule has not been met.

Haft Trust recognized that, notwithstanding *Davis*, common sense and fairness dictate that the attribution rules should not be strictly applied where family disharmony exists. *Haft Trust* also recognized the potential for abuse through family disputes specially manufactured in an attempt to remove corporate earnings at capital gains rates.[153] The First Circuit indicated in *Haft Trust* that courts should view such claims skeptically and require strong evidence of the existence and nature of the dispute.[154] Furthermore, that opinion clearly indicated that the burden of proving this family hostility would be on the taxpayer.[155] *Haft Trust*, however, left unanswered the question of who the disputing parties must be. Presumably this question will be answered by requiring a direct dispute between the parties whose stock is being redeemed or a controversy between a party who holds a beneficial ownership in the entity whose stock is being redeemed and the other stockholders of the entity. This requirement did not exist in *Haft Trust*, however, and further judicial interpretation of the issue will be necessary.

The policy recommendation goes further than *Haft Trust* because it allows a waiver of all the attribution rules where the showing of family hostility has been made. If legitimate disharmony exists, it would appear irrelevant whether the stock is owned by individuals or entities. Of course, the court should review closely the situation where an individual whose stock is being redeemed is benefited by or controls an entity which is remaining a stockholder. Courts should also consider whether such an individual recently created the entity for the benefit of family members. This type of inquiry would provide a mechanism to prevent tax abuse under the suggested policy.

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153. 510 F.2d at 48.
154. *Id.*
155. *Id.*

Under the policy recommendation, the taxpayer would still need to meet the meaningful reduction test of *Davis*[156] to qualify for favorable redemption treatment. This standard is needed to prevent the abuses which may occur where a taxpayer redeems a small percentage of the stock and claims that the family hostility rule applies, but still exercises significant control over the affairs of the corporation through his or her remaining stock ownership.[157] Where all the stock of the taxpayer has been redeemed, this provision should not create any difficulty.

Further support for the policy change is found in the nature of the closely held corporation. Normally, such an entity is owned and controlled by a few individuals who all belong to one or two family units. In most cases the imposition of nonfamily ownership would be an unwelcome and unacceptable solution to a family dispute. In such circumstances, a sale of stock back to the corporation may be the only effective means for the disputing party to terminate ownership interest in the corporation.[158] The effect of the current redemption rules is to create a disincentive to the only practical solution to the problem. This result undoubtedly has the effect of prolonging many disputes and increasing the bitterness and animosity involved.

Potential Supreme Court acceptance of these policy guidelines has been foreshadowed by its decision in *Trammel v. United States*.[159] In *Trammel* the Supreme Court modified the longstanding common law rule barring the testimony of one spouse against the other in a criminal proceeding unless both consent. The Court substituted a guideline that the witness spouse alone has a privilege to refuse to testify adversely, and thus may be neither compelled nor foreclosed from testifying. The Court noted that the modern justification for the privilege against adverse spousal testimony is its perceived role in fostering the harmony and sanctity of the marriage relationship.[160] Nevertheless, the Court devised a guideline which, in its view, "furthers the important public interest in marital harmony without unduly bur-

156. *See* text accompanying note 85 *supra*.

157. While a detailed discussion of the meaningful reduction test is beyond the scope of this Article, the key point reviewed is the effect of the redemption of the taxpayer's control of the corporation. *See* Fehrs Finance Co. v. Commissioner, 58 T.C. 174 (1972) *aff'd* 487 F.2d 184 (8th Cir. 1973), *cert. denied* 416 U.S. 938 (1974), and Rev. Rul. 76-364, 1976-2 C.B. 91.

158. *See* Note, *supra* note 108, at 393.

159. 445 U.S. 40 (1980).

160. *Id.* at 44.

dening legitimate law enforcement needs."[161] In reaching this conclusion, the Court noted that if one spouse was willing to testify against the other in a criminal proceeding, then there was little in the way of family harmony to preserve.[162]

The Court in *Trammel* was willing to modify a longstanding evidentiary rule where social policy had changed over time. The Court recognized the practical aspects of the situation before it. Similarly, the longstanding attribution rules might be disregarded if the Court were convinced that its application was irrational because of social change. The *Trammel* decision may indicate a willingness to support a family hostility exception to the attribution rules. Current evidence of social change which affects the rationale of the family attribution rules includes the increasingly high divorce rate and the general trend toward family relationships which are not so intertwined as those in the past. The *Trammel* decision involves support to those courts which are willing to follow *Haft Trust* and *Rickey* and provides support for the policy recommendation suggested.

The suggested policy change could be criticized because it might create less certain tax results and might overburden the courts with an additional workload. Neither of these contentions, however, should be allowed to outweigh legitimate policy considerations. After a few court decisions and the issuance of a few revenue rulings, taxpayers should have a fairly certain idea of what would qualify under this provision. Additional criticism of this proposed change may focus on the absence of a waiver of the family attribution rules because of disharmony under other Code sections. This fact alone, however, should not be determinative.[163] It must be pointed out that this recommendation has been made previously in a somewhat different format without success. In 1958, the Commissioner's advisory group recommended that section 302 be amended to provide specifically that in determining whether a redemption is essentially equivalent to a dividend, the attribution rules of section 318 should not be applicable, but the relationships described therein might be taken into account along

161. *Id.* at 53.

162. *Id.* at 52.

163. *See* Randall & Benson, *Family Dissension and the Attribution Rules of Sections 267, 318 and 544*, 53 TAXES 534 (1975); Miller v. Comm'r, [1980] Tax Ct. Rep. (CCH) Dec. 37,376.

with all other facts and circumstances.[164] This recommendation, modified to reflect current developments, should be renewed at this time.

B. *Extension of Statutory Waiver to Estates*

The second proposed change, the extension of the statutory waiver to estates, is supported by the nature of the stockholder involved. By definition, an estate is not created for a tax avoidance purpose.[165] In many instances under current law, the decedent could have redeemed the stock prior to death by merely waiving the family attribution rules. Nevertheless, the event of the stockholder's death prohibits the estate, which is merely a legal extension of the stockholder's existence, from obtaining these benefits. The effect of the current statutory rules is to thwart a capital gains redemption because of the unplanned event of death. While there are situations where a decedent could not redeem stock on a capital gains basis prior to death because of the entity attribution rules, the family circumstances of the stock ownership have permanently changed upon the death, and there seems to be little policy justification for preventing a section 302 redemption at that point.

The *Rickey* case recognized the special characteristics of estates by allowing the estate to waive the entity attribution rules of section 318(a)(3). The court was cognizant of the status of an estate as an extension of the individual and placed particular reliance on the termination of the estate's actual stock ownership.[166] While the *Rickey* court may have overstepped the current language, the decision appears sound from a policy standpoint.[167] A legislative change to reflect its rationale is a desirable step.

Congress has partially reacted to this problem by enacting section 303.[168] This provision allows estates to redeem stock in corporations under the sale or exchange rules to obtain the funds to pay estate and inheritance taxes and funeral and administrative expenses. To qualify under section 303, the value of stock owned by the estate must be greater than fifty percent of the decedent's adjusted gross estate. Furthermore, the amount which can be re-

164. SUBCHAPTER C ADVISORY GROUP, REV. REP. ON CORP. DISTRIBUTIONS & ADJUSTMENTS P5 (1958).

165. A probate estate is created only on the death of an individual.

166. 592 F.2d 1251, 1258 (5th Cir. 1979).

167. *Id.*

168. I.R.C. § 303.

deemed is limited to the sum of the taxes and funeral and administrative costs. The attribution rules are not applied to this type of redemption. The limitations of section 303 leave substantial gaps which should be filled by the recommended changes to section 302.

The proposed change regarding estates is in accordance with reality in many situations. Often the estate needs to obtain funds to pay administrative expenses, taxes, and perhaps debts of the decedent. If the guidelines of section 303 cannot be met, the estate is faced with the dilemma of redeeming the stock at dividend rates or selling the stock at what may be a depressed price. Furthermore, the estate may be obligated under a buy-sell agreement to sell the decedent's stock to the corporation at a prearranged price. Such an arrangement is common in most closely held businesses to insure that stock ownership is not transferred to nonfamily owners. This situation occurred in *Rickey*, and undoubtedly the court was influenced in its decision by the obligations on the estate to make the redemption.[169]

No change is suggested to the current statutory waiver rules for individuals and other entities. These rules provide a reasonable guideline to taxpayers that has proved workable. As noted earlier, the Service has recently issued favorable rulings which extend these guidelines.[170] This recommendation of the status quo, however, is conditional on further judicial acceptance of the principles of *Johnson Trust* which allowed trusts to waive the family attribution rules.[171] There appears to be no logical policy reason for not allowing entities to take advantage of these statutory guidelines if they fulfill the other requirements, particularly the ten-year prior transfer rules.

V. CONCLUSION

The issue of the interplay of the stock attribution rules of section 318 with corporate redemptions under section 302 remains a thorny one. At the present time, case law does not present a fully developed response to the issue. The Service has taken a position clearly opposed to the judicial trend in the area, although the *Metzger Trust* decision may signal a change in the direction of the trend. Therefore, the issue awaits further legislative and judicial

169. 592 F.2d at 1258.
170. *See* note 36 *supra*.
171. 71 T.C. at 954-55.

thinking. From a policy standpoint, however, the rationale behind the *Haft Trust* and *Rickey* decisions should be accepted as the guidelines for future developments. The proposals for policy changes set forth in this Article are based on these cases and present a fair and equitable solution to this problem.[172]

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172. *See* notes 132–36 *supra* and accompanying text.