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VII

The Effect of Stock Redemptions Upon Tax Avoidance and the Reasonable Needs of the Business

Harlan Pomeroy

THE INTERPLAY of stock redemptions with the penalty tax on improper accumulations of earnings is a subject of considerable current interest. The problems encountered are in some respects quite different from those arising in the typical section 531

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case. An analysis of the issues raised by stock redemptions in situations where there is also a section 531 problem usually requires consideration of the impact and relation of

other provisions of the Internal Revenue Code in addition to the provisions directly pertinent to the penalty tax on improper accumulations of earnings.

Historically, there has been a substantial amount of litigation involving the effect of stock redemptions upon the penalty tax. Present indications are that the recurrence of similar litigation will continue unabated until the United States Supreme Court deals with the issue or until Congress takes steps to clarify or outline the solutions to some of the problems.¹

A stock redemption may have an effect on one or more of three aspects of the section 531 penalty: (1) the determination of the corporation's accumulated taxable income; (2) the question of

¹ One of the problems arises from the fact that the Internal Revenue Code provides favored capital gain treatment to shareholders (but not to corporations) for the proceeds of certain stock redemptions. INT. REV. CODE OF 1954, §§ 302(a), 303(a), 331(a) [hereinafter cited as CODE §]. CODE § 317(b) contains a broad definition of stock redemption. It has been argued that by enacting § 531 Congress did not intend to penalize corporations which were merely carrying out a tax-favored redemption to raise funds to pay federal taxes. See text accompanying notes 26-27 *infra*. This is particularly true with respect to stock redemptions effected under § 303 in order to pay death taxes and administration and funeral expenses.

whether the corporation's earnings had in fact been accumulated during a particular year; and (3) the twin determinations of whether the corporation had a purpose to avoid the income tax on its shareholders and whether its earnings were permitted to accumulate beyond the reasonable needs of the business.

I. EFFECT OF STOCK REDEMPTION UPON ACCUMULATED TAXABLE INCOME

The tax base for the section 531 penalty tax is the corporation's accumulated taxable income which generally is equal to the corporation's taxable income for the year in question less applicable income taxes and dividend distributions.² Dividends qualifying for the dividends-paid deduction, which reduces the penalty tax base, include ordinary dividends as defined in section 316 and liquidation distributions whether made as part of a complete or partial liquidation or pursuant to a stock redemption.³ However, in any case, in order to qualify for the dividends-paid deduction, the distribution must not be *preferential* either among shareholders of the same class of stock or among shareholders of different classes of stock, except to the extent that a particular class might be entitled to a preference.⁴

Because of these conditions, many stock redemptions will not qualify for the dividends-paid deduction and hence will not reduce accumulated taxable income, the base upon which the tax is imposed. Of course, in those limited situations where a preferred class, or the only class, of stock is entirely redeemed or redeemed pro rata among the shareholders of the class, the distribution would have the effect of reducing the tax base and hence the amount of the penalty. Moreover, where a redemption or other distribution in fact results in a dis-

² See Pomeroy, *The Statutory Pattern*, 17 W. RES. L. REV. 704 n.2 (1966).

³ CODE § 535 (a) provides that taxable income shall be reduced by the dividends-paid deduction, as defined in § 561. Section 561, in providing for the dividends-paid deduction, refers in turn to § 562 which includes within the meaning of the dividends-paid deduction amounts distributed in liquidation which are properly chargeable to post-1913 earnings and profits. The distribution may be in complete or partial liquidation of the corporation, or it may include a stock redemption under § 302 (Treas. Reg. § 1.562-1 (b) (1958), as amended, T.D. 6795, 1965-1 CUM. BULL. 287, 288 [hereinafter cited as Reg. §]), and it may be made within two-and-one-half months after the close of the tax year. Reg. § 1.563-1 (1958). See Sullivan, *Planning To Avoid the Section 531 Tax*, 17 W. RES. L. REV. 763 (1966).

⁴ CODE § 562 (c); Reg. § 1.562-1 (a) (1958), as amended, T.D. 6795, 1965-1 CUM. BULL. 287, 288. A preference will destroy the dividends paid-deduction "if any rights to preference inherent in any class of stock are violated." Reg. § 1.562-2 (1958). Moreover, the entire distribution is disallowed as a deduction if there is a preference as to any part of it.

persing of all of the current year's earnings, the proscribed accumulation of earnings may be absent without regard to whether the distribution may have been preferential.⁵

II. EFFECT OF A STOCK REDEMPTION UPON THE DETERMINATION OF WHETHER EARNINGS HAVE ACCUMULATED

It should be recalled that the penalty tax is imposed upon corporations which commit the *act* of permitting their earnings to accumulate instead of being divided or distributed in a particular year.⁶ It appears that the penalty cannot be imposed in a year when a stock redemption has the effect of distributing all of the corporation's current earnings and profits since the penalty, like the income tax, is imposed on an annual basis. Therefore, in a year when all current earnings have been paid out, there has been *no increase* in the earnings and profits and hence no accumulation.⁷

III. EFFECT OF A STOCK REDEMPTION UPON THE DETERMINATION OF TAX AVOIDANCE AND REASONABLE BUSINESS NEEDS

The authorities dealing with the effect of a stock redemption on the assertion of the penalty tax are concerned principally with the impact of the redemption upon two factual questions — the presence of a purpose to avoid the shareholders' income taxes and the validity of the claimed needs of the business. Since the authorities generally deal with both of these questions together, and since the questions themselves are necessarily interdependent, the discussion which follows will be directed to an analysis of both problems.

While the law in this area is not firmly established, certain general principles have emerged from the cases. One of these principles is that the redemption of stock, standing alone, does not warrant imposition of the penalty tax.⁸ However, the stock redemption rarely

⁵ See text accompanying note 7 *infra*.

⁶ See CODE § 351.

⁷ See Pomeroy, *Accumulations and Distributions of Earnings and Profits*, 17 W. RES. L. REV. 717 (1966).

⁸ *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737, 745 (4th Cir. 1960), *reversing* 28 P-H Tax Ct. Mem. 269 (1959); *Fenco, Inc. v. United States*, 234 F. Supp. 317, 325 (D. Md. 1964), *aff'd per curiam*, 348 F.2d 456 (4th Cir. 1965). *Contra*, Office Decision 360, 2 CUM. BULL. 25 (1920). For jury charges on the effect of a stock redemption on the penalty tax, see *Donruss Co. v. United States*, 65-1 U.S. Tax Cas. 95094 (W.D. Tenn. 1965), appeal pending, 6th Cir.; *Mobile Stove & Pulley Mfg. Co. v. United States*, 62-2 U.S. Tax Cas. 85563 (S.D. Ala. 1962).

stands alone, since the typical section 531 case involves a kaleidoscope of facts bearing upon the needs of the business, the presence or absence of a tax avoidance purpose, and the circumstances under which the redemption occurred.

A. *Redemption of a Minority of Voting Shares*

Where less than a majority of the voting shares are redeemed, the effect of the redemption upon the substantive factual aspects of the penalty tax will probably depend upon the purpose of the redemption. If the redemption is made to preserve corporate harmony by removing dissident shareholders, to resolve a deadlock among shareholder factions,⁹ to permit officers and employees to become shareholders, or to increase the holdings of officers and employees,¹⁰ the redemption generally will not be treated as evidence that the earnings used to effect the redemption were not needed in the business. Moreover, the redemption itself may possibly carry out a proper business purpose so that the amount of corporate funds needed to redeem the stock may constitute one of the capital needs of the business for which earnings may properly be accumulated.¹¹

Where a fifty per cent interest is being redeemed, the same principles appear to be relevant.¹² However, in one case the result, which was unfavorable to the taxpayer, turned upon the fact that the dissident shareholder whose stock was redeemed had opposed the payment of dividends upon which the other fifty per cent shareholder was insisting.¹³

Certainly, where the dispute involves whether to pay out earnings as dividends or to use the earnings to expand the business, the

⁹ *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952) (twenty-five per cent share interest redeemed); *Penn Needle Art Co.*, 27 P-H Tax Ct. Mem. 435 (1958) (fifty per cent share interest redeemed); *Dill Mfg. Co.*, 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 CUM. BULL. 47 (forty-nine per cent share interest redeemed). *Contra*, *Hedberg-Freidheim Contracting Co. v. Commissioner*, 25 P-H Tax Ct. Mem. 1171 (1956), *aff'd*, 251 F.2d 839 (8th Cir. 1958) (affirmed without discussion of this point) (fifty per cent share interest redeemed).

¹⁰ *Ted Bates & Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251, at 1497 (Sept. 17, 1965).

¹¹ *Ibid.*

¹² *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960); *Penn Needle Art Co.*, 27 P-H Tax Ct. Mem. 435 (1958).

¹³ *Hedberg-Freidheim Contracting Co. v. Commissioner*, 25 P-H Tax Ct. Mem. 1171 (1956), *aff'd*, 251 F.2d 839 (8th Cir. 1958) (affirmed without discussion of this point). It is ironical that the continuing shareholder was penalized, because the shareholder whose shares were redeemed, presumably at capital gain rates, had opposed action which might have avoided the penalty tax.

requisite statutory tax avoidance purpose would seem to be absent.¹⁴ In this connection, it has recently been held that a corporation may deduct for income tax purposes the cost of purchasing the stock of its fifty per cent shareholder where the stock purchase was made to permit the business to continue by satisfying creditors who would not permit it to continue unless the withdrawing shareholder's interest in the corporation was terminated.¹⁵

B. Redemption of a Majority of Voting Shares

The redemption of a sufficient number of the controlling shareholders' shares, even though this number constitutes more than fifty per cent of one class of shares, in order to shift control to others active in the business, has recently been held to serve a valid corporate purpose.¹⁶ However, in earlier cases the accumulation of earnings for the purpose of future redemption of a majority of the voting shares had been held to justify the imposition of the penalty tax on the rather confusing theory that the corporate purpose is the same as the purpose of the controlling shareholders.¹⁷ This theory is not necessarily factually correct in every situation and ignores the fact that the redemption of a majority of the shares may prevent the controlling shareholders from liquidating the corporation; thus the corporate life and the business may be prolonged. Without question, this appears to be a valid business purpose.

A second apparent weakness in the previously used theory appears from the judicial recognition that carrying key-man insurance to provide funds for acquiring a shareholder's stock upon his death is a proper business purpose for a corporation.¹⁸ The rationale normally used by the courts is that such an arrangement constitutes an inducement to the employee-shareholder to remain with the business and tends to preserve harmony by permitting the business to be continued by the other owners following the death of one shareholder. If such insurance serves a proper corporate purpose, then

¹⁴ *Casey v. Commissioner*, 267 F.2d 26 (2d Cir. 1959) (deadlock between two fifty per cent shareholders prevented expansion).

¹⁵ *Five Star Mfg. Co. v. Commissioner*, 355 F.2d 724 (5th Cir. 1966), *reversing* 40 T.C. 379 (1963).

¹⁶ *Ted Bates & Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251, at 1497 (Sept. 17, 1965).

¹⁷ *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278, 281 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958), *affirming* 28 T.C. 153 (1957).

¹⁸ See *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951).

it would seem to follow that a similar arrangement in which the corporation acts as its own insurer should be deemed to serve an equally valid business purpose.¹⁹

C. Redemption of Nonvoting Shares

When nonvoting stock is being redeemed, justification for the redemption in terms of business needs may be more difficult.²⁰ However, even nonvoting shareholders have rights in the corporation, including limited voting rights, so that it is possible that a redemption of such shares may serve one or more of the business purposes outlined above. But since the disruptive power of the shareholder who holds nonvoting stock is considerably less than that of a voting shareholder, a higher degree of proof may be required to justify this redemption as serving a corporate business purpose.²¹

Where shares are subject to sinking-fund requirements or mandatory retirement, it has been held that use of corporate funds for their redemption serves a business need.²² Similarly, the use of corporate funds to redeem shares pursuant to a moral or informal commitment to do so over a period of years or upon the happening of an event or upon the shareholder's request, may also serve a proper business purpose. Thus, where a valid business purpose exists²³ for the exchange of nonvoting preferred shares for voting common shares rather than for the immediate redemption of the voting common shares, it has been held that redemption of the preferred shares served a business purpose.²⁴

Where a corporation accumulated funds to redeem a part of its stock in order to help finance the sale of all or a majority of the shares of the corporation to new interests, it was held that such a redemption would not serve a corporate business purpose and the

¹⁹ *Bradford-Robinson Printing Co. v. United States*, 58-1 U.S. Tax. Cas. 67631 (D. C. 1957). See also *Harry A. Koch Co. v. Vinal*, 228 F. Supp. 782 (D. Neb. 1964); *John P. Scripps Newspapers*, 44 T.C. 453 (1965).

²⁰ *KOMA, Inc.*, 18 P-H Tax Ct. Mem. 919 (1949), *aff'd*, 189 F.2d 390 (10th Cir. 1951); *W. H. Gunlocke Chair Co. v. Commissioner*, 12 P-H Tax Ct. Mem. 1424 (1943), *aff'd*, 145 F.2d 791 (2d Cir. 1944).

²¹ *Dill Mfg. Co.*, 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 CUM. BULL. 47.

²² *Metal Office Furniture Co.*, 21 P-H Tax Ct. Mem. 952 (1952); *Walkup Drayage & Warehouse Co.*, 14 P-H Tax Ct. Mem. 801 (1945). See *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960); *Harry A. Koch Co. v. Vinal*, 228 F. Supp. 782 (D. Neb. 1964).

²³ See text accompanying notes 9-21 *supra*.

²⁴ *Dill Mfg. Co.*, 39 B.T.A. 1023 (1939), *nonacq.*, 1939-2 CUM. BULL. 47.

penalty was imposed.²⁵ Presumably, the same result would not necessarily obtain if the redemption were made to permit the sale of a minority share interest for purposes which could reasonably be expected to help the business or to reduce the controlling shareholder's interest by the redemption of a majority of his stock and the sale of the stock to others active in the business.²⁶

D. *Stock Redemptions To Pay Death Taxes and Expenses*

Under section 303 of the Internal Revenue Code, favored capital gain treatment is accorded at the shareholder level to certain share redemptions made to raise funds to pay death taxes and funeral and administration expenses of the shareholder's estate.²⁷ It appears that unless the redemption can be justified in terms of a business purpose or need, the mere fact that the proceeds of the redemption qualify for capital gain treatment, whether under section 303, section 302, or section 331, should not ensure that the corporate funds used to redeem the shares were needed in the business.²⁸ However, a section 303 redemption, which avoids a sale of the shares to outsiders or liquidation of the corporation, may well serve a business purpose. Moreover, it may be argued that a showing that a redemption effected under section 303 was made to permit payment of death taxes and administration and funeral expenses negates the presence of a *purpose* to avoid the shareholder's income taxes.

E. *Timing of the Redemption*

The time at which the redemption occurs may have an important impact upon the section 531 status of the capital needs for the corporate funds used to make the redemption.

²⁵ J. Gordon Turnbull, Inc., 41 T.C. 358, 373-74 (1963). This result seems questionable, at least where it can be shown that the purchasers could not afford to pay an amount equal to the full value of the shares which it is proposed to transfer to them and where the alternative is dissolution of the corporation. Compare *Ted Bates & Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) § 65251, at 1497 (Sept. 17, 1965).

²⁶ *Ted Bates & Co.*, *supra* note 25.

²⁷ See Reg. § 1.303-1 (1955); Reg. § 1.303-2 (1955), as amended, T.D. 6724, 1964-1 CUM. BULL. 128; Reg. § 1.303-3 (1955).

²⁸ *Dickman Lumber Co. v. United States*, 65-1 U.S. Tax Cas. 94603 (W.D. Mich. 1964), *aff'd*, 355 F.2d 670 (9th Cir. 1966); *Kirlin Co.*, 33 P-H Tax Ct. Mem. 1730, 1742-43 (1964), appeal pending, 6th Cir. For a contrary suggestion, see *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960). See *Youngs Rubber Corp.*, 31 P-H Tax Ct. Mem. 1766, 1774-76 (1962), *aff'd per curiam*, 331 F.2d 12 (2d Cir. 1964), indicating that the penalty tax might not be imposed where the redemption of an estate's stock is made in the interest of corporate harmony. See also *Washington, Can Earnings Still be Accumulated To Finance Section 303 Redemptions?*, 44 TAXES 43 (1966).

Where funds are being accumulated to effect a stock redemption at some future time, the cases generally conclude that the accumulation is not for a reasonable need of the business unless there is an obligation of some kind to redeem the shares, other business needs for the funds are shown, or there is some other business purpose for the planned redemption.²⁹ However, where the redemption is first effected and thereafter funds are accumulated to pay off indebtedness incurred pursuant to the redemption, the courts have recognized that even though funds paid out in the year of redemption were not needed in the business, funds accumulated in subsequent years to pay off the indebtedness are being accumulated for a business purpose.³⁰ The rationale normally relied upon is that the accumulation of funds to meet corporate indebtedness preserves the solvency and credit standing of the corporation and thereby serves a reasonable business need regardless of the circumstances surrounding the indebtedness and the reasons for which it was incurred.³¹

This result suggests an approach in planning which may be helpful in avoiding the penalty tax. If the amount charged to earnings and profits in the year of the redemption exceeds that year's earnings and profits, it is arguable³² that the proscribed accumulation of earnings for that year has not been committed and that the penalty cannot be imposed for that year as a matter of law. Then, in subsequent years, earnings may be accumulated in order to pay off the indebtedness incurred in the redemption.³³

F. *Unanticipated Redemption*

Where earnings are accumulated over the years for the reasonable needs of the business and a situation subsequently arises which makes it desirable from the corporation's viewpoint for a portion of its stock to be redeemed, the use of corporate funds to effect the re-

²⁹ See, e.g., *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278 (7th Cir.), cert. denied, 356 U.S. 958 (1958), affirming 28 T.C. 153 (1957); *Fenco, Inc. v. United States*, 234 F. Supp. 317, 325 (D. Md. 1964), *aff'd per curiam*, 348 F.2d 456 (4th Cir. 1965).

³⁰ *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737, 745 (4th Cir. 1960).

³¹ *General Smelting Co.*, 4 T.C. 313, 324 (1944), *acq.*, 1945 CUM. BULL. 3.

³² See text accompanying note 7 *supra*.

³³ *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737, 745 (4th Cir. 1960).

demption should not cause imposition of the penalty tax.³⁴ This rule underscores the importance of annually marshaling whatever support is available to substantiate the other needs of the business for additional capital, since whether or not the redemption itself serves a business purpose, the redemption alone should not cause the penalty to be invoked.

IV. CONCLUSION

The teaching of the judicial authorities on the effect of stock redemptions upon the penalty tax on improper earnings accumulation suggests the following: (1) If possible, a stock redemption should be justified primarily in terms of corporate purpose and business needs, rather than shareholder wishes; (2) Other current business needs for capital usually take on added importance where stock is redeemed during, shortly before, or after the particular tax year; (3) It is better to redeem the stock as soon as it becomes evident that a redemption is to be effected and it becomes feasible to make the redemption, rather than to accumulate earnings over a period of years for an eventual stock redemption; (4) A stock purchase agreement between the shareholder and the corporation or an option on the part of the shareholder to require the corporation to purchase his shares or an informal understanding that the corporation will purchase his shares at his request, may be helpful in substantiating a business need for accumulating corporate funds and in justifying the redemption; (5) A redemption of a minority interest in voting stock is more likely to qualify as a business need than is a redemption of a majority of the voting shares; (6) If a stock redemption will not distribute all of the corporation's earnings for the year of the redemption, an additional distribution or the incurrence of other corporate liabilities large enough to eliminate the balance of the current year's earnings will permit an additional argument that the penalty cannot be imposed as a matter of law for lack of the proscribed act; and (7) In situations where the penalty tax might be imposed, consideration should be given to an agreement by the shareholder whose stock is redeemed to indemnify the corporation for his share of any section 531 penalty imposed against the corporation either as a result of the redemption or for any period prior to the redemption.

³⁴ *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952); *Ted Bates & Co.*, P-H 1965 TAX CT. REP. & MEM. DEC. (34 P-H Tax Ct. Mem.) ¶ 65251, at 1497 (Sept. 17, 1965); *Penn. Needle Art. Co.*, 27 P-H Tax Ct. Mem. 435 (1958). This result assumes, of course, that there is no corporate purpose to avoid its shareholder's income taxes.