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I.R.C. § 302(b)(1): Dividend Equivalency after United States v. Davis

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NOTES

I.R.C. § 302(b)(1): DIVIDEND EQUIVALENCY AFTER UNITED STATES V. DAVIS

RONALD L. NELSON

I. INTRODUCTION

When Justice Marshall delivered the opinion of the Court in *United States v. Davis*[1] he probably thought he was bringing clarity and certainty to an area of tax law that had been surrounded by forty years of confusion.[2] In spite of *Davis* and all subsequent case law which has examined the dividend equivalency issue, however, the precise implications of section 302(b)(1) of the Internal Revenue Code (the Code)[3] have remained unclear, and consequently it has served only a limited role as a tax planning vehicle. Indeed, several commentators have suggested that *Davis* effectively eliminated section 302(b)(1) from the Code.[4]

However, in spite of *Davis* and the efforts of the Internal Revenue Service (the Service) to increase the impact of *Davis*, section 302(b)(1) remains very much alive. The section's availability to the contemporary corporate tax planner is the subject matter of this note. It will attempt to ascertain the more significant particulars of current section 302(b)(1) law by tracing the historical development of this section of the Code and by analyzing those recent cases and revenue rulings which give indications of the probable perimeters of the *Davis* dividend equivalency test.

II. BACKGROUND: SECTION 302(b)(1)'S RELATIONSHIP WITH THE CODE

Normally a shareholder is required to report the receipt of corporate distributions as ordinary dividend income to the extent of the corporation's earnings and profits.[5] However, the Code provides for

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1. 397 U.S. 301 (1970).
2. *See* Crawford, *The Section 302(b)(1) Redemption: Bringing Order to the Confusion*, 28 J. TAX. 346 (1968); 43 TEX. L. REV. 755 (1965).
3. I.R.C. § 302 provides in pertinent part:

> (a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.
>
> (b) REDEMPTIONS TREATED AS EXCHANGES.—
>
> (1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.— Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

4. *See, e.g.*, 22 BAYLOR L. REV. 429 (1970); 25 OKLA. L. REV. 301 (1972).
5. I.R.C. §§ 301 and 316 set forth the basic rules which govern the treatment of corporate

exchange treatment under section 302(a) for stock redemptions that satisfy the requirements of section 302(b).[6] The Code thus treats a section 302(b) redemption as a return of capital to the extent of the shareholder's basis in the stock, and provides for capital gain or loss treatment for any excess or deficit under sections 1221 and 1222. Redemptions which fail to satisfy the requirements of section 302(b) are taxed as ordinary dividend income to the shareholder under section 302(d).[7]

Usually a taxpayer will prefer exchange treatment over dividend treatment because of the tax-free return of capital, as well as the potential for long-term capital gain and the effective lower tax rate on such gain provided by section 1202.[8] Thus, a taxpayer will want his redemption to fall under the provisions of section 302(b). Unless the redemption comes within one of the "safe harbor" provisions of this section, either as a complete termination of the shareholder's interest under section 302(b)(3) or as a substantially disproportionate redemption under section 302(b)(2),[9] it will be tested for exchange treatment under section 302(b)(1).[10]

Section 302(b)(1) simply provides that exchange treatment is extended to a stock redemption if the redemption is "not essentially equivalent to a dividend." The Treasury Regulations (the Regulations) further stipulate that the determination of whether a redemp-

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distributions to shareholders. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.01, at 7-2 (3d ed. 1971).

6. A redemption is defined in the Code as an acquisition by a corporation of "its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b). Property is defined in the Code as "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." I.R.C. § 317(a). Both definitions apply technically only to Part I of Subchapter C of the Code (§§ 301-318). *See* I.R.C. § 317; Treas. Reg. § 1.317-1 (1960).

7. Such distributions in redemptions of stock are taxed as ordinary dividend income to the distributee only to the extent that the distributing corporation has current or accumulated earnings and profits. I.R.C. §§ 301(c)(1), 316. If the distributing corporation has no current or accumulated earnings and profits, such a distribution is treated as a return of basis, and in this situation any excess is taxed as gain from the sale or exchange of property. I.R.C. § 301(c)(2)-(3).

8. *See* B. BITTKER & J. EUSTICE, *supra* note 5, ¶ 9.20, at 9-9. Note, however, that a corporate shareholder usually will prefer dividend treatment because of the 85% dividends received deduction generally allowed corporations by I.R.C. § 243.

9. Note that the provisions of I.R.C. § 302(b)(2) are applicable only to voting stock. Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962). It is obvious that without § 302(b)(1) a substantially disproportionate redemption of nonvoting stock could never qualify for capital gain treatment, as § 302(b)(2) is keyed only to changes in voting power. *See* Cornwall v. Commissioner, 48 T.C. 736 (1967).

10. It should be noted that I.R.C. § 302(b)(4) also treats redemptions of stock as exchanges. The stock must have been issued by railroad corporations in certain reorganizations, however, and thus this section is not relevant to the present discussion.

tion is essentially equivalent to a dividend must be made according to the facts and circumstances of each case.[11]

III. Historical Development of Section 302(b)(1)

In 1921, Congress enacted a statute imposing a tax on a shareholder when the redemption of stock which was previously issued to him as a dividend was deemed "essentially equivalent to the distribution of a taxable dividend . . . ."[12] Following amendments in 1924[13] and 1926,[14] Congress codified the statute as section 115(g) in the Internal Revenue Code of 1939.[15] In determining whether a stock redemption was equivalent to a dividend under this Code section, the courts applied the test of whether the net effect of the transaction resembled more closely a dividend or a stock sale.[16] (A significant factor generally taken into account was whether the corporation had an authentic business reason for redeeming the stock.)[17] Considerable confusion followed from this subjective test, however, as it necessarily entailed a predominantly factual determination by the court.

In drafting the Internal Revenue Code of 1954, the House of Representatives sought to eliminate this confusion by striking the "essentially equivalent to a dividend" language from the Code and proposing the more objective guidelines that now compose sections 302(b)(2)-(4).[18] The Senate Finance Committee, however, reinstated the dividend equivalency language, which became section 302(b)(1) of the 1954 Code, with the following explanation:

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11. Treas. Reg. § 1.302-2(b) (1960). The Regulations also state that as a general rule pro rata redemptions of part of the stock probably will be construed to be essentially equivalent to a dividend if the corporation has only one class of stock outstanding, as will redemptions of all of one class of stock (except § 306 stock) if all classes of outstanding stock are held in the same proportion. Treas. Reg. § 1.302-2(a) (1960). Note that when confronted with a series of apparently related redemptions the courts in effect have viewed the redemptions as if they had occurred at the same time and compared the stock ownership before the first redemption with that after the last redemption. Bullock v. Commissioner, 26 T.C. 276 (1956), *aff'd per curiam*, 253 F.2d 715 (2d Cir. 1958); Boyle v. Commissioner, 14 T.C. 1382 (1950), *aff'd*, 187 F.2d 557 (3d Cir.), *cert. denied*, 342 U.S. 817 (1951).

12. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 229 (current version at I.R.C. § 302(b)(1)).

13. Revenue Act of 1924, ch. 234, § 201(f), 43 Stat. 255 (current version at I.R.C. § 302(b)(1)).

14. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11 (current version at I.R.C. § 302(b)(1)).

15. Int. Rev. Code of 1939, ch. 1, § 115(g), 53 Stat. 48 (now I.R.C. § 302(b)(1)).

16. *See, e.g.*, Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940); McGuire v. Commissioner, 84 F.2d 431 (7th Cir.), *cert. denied*, 299 U.S. 591 (1936).

17. *See* Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 Tax L. Rev. 437, 468 (1950).

18. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 302, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4017, 4060-62.

> While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend.[19]

The Senate Report also stated that "[t]he test intended to be incorporated in the interpretation of [section 302(b)(1)] is in general that currently employed under section 115(g)(1) of the 1939 Code," but did not otherwise indicate the intended scope of section 302(b)(1).[20]

The courts struggled with delineating the perimeters of section 302(b)(1)'s application. Eventually two separate lines of authority arose from the cases. The more prevalent of these, prior to the year 1970, centered around the flexible net effect test, which held that all of the various effects of the redemption should be examined in ascertaining dividend equivalence. Included among these effects were: (1) the presence or absence of a legitimate corporate business purpose; (2) whether the distribution was in substance pro rata among the shareholders; (3) whether a dividend distribution would have given substantially the same result as the redemption; (4) the prior dividend history of the corporation; (5) whether or not the redemption resulted in a contraction of the corporate business; and (6) whether the transaction resulted in a significant change in the rights of the shareholder. The redeemed shareholder attempted to prove that these and similar factors supported exchange treatment for the redemption.[21]

The other line of authority, which governed a minority of the pre-1970 cases, adhered to the strict net effect test. The Second Circuit outlined this test in *Himmel v. Commissioner.*[22] The circuit court therein defined a shareholder's interest to include: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation.[23] The court then held that a

19. S. REP. No. 1622, 83d Cong., 2d Sess. 44-45, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4675.

20. *Id.* at 233-34, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4870.

21. *See* Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962).

22. 338 F.2d 815 (2d Cir. 1964).

23. *Id.* at 817. "Ownership of common stock generally involves all of these [rights, while]

redemption is to be given exchange treatment if a substantial alteration in these rights follows from the corporate distribution, but is to be treated as a dividend distribution if it produces no significant reduction of such rights.[24] No other factors, particularly the existence of a legitimate corporate business purpose for the redemption, have any relevance under the strict net effect test.

The Second Circuit's *Himmel* decision, based upon the application of the strict net effect test, contrasted sharply with the decisions of those circuits which, in applying the flexible net effect test, held that the business purpose justification for the redemption was a critical factor under the 1954 Code.[25] To resolve the uncertainty and confusion surrounding the issue, the Supreme Court, in 1970, granted certiorari in *United States v. Davis*.

IV. The *Davis* Case

The taxpayer in *Davis* redeemed preferred stock for a price identical to the stock's basis and treated the corporate distribution as not essentially equivalent to a dividend under the flexible net effect test. The Sixth Circuit agreed, holding that the legitimate business purpose underlying the entire transaction permitted the redemption to be taxed as an exchange.[26] The Supreme Court reversed. The Court recognized the strict net effect test as the proper standard and asserted that the existence of a business purpose for the distribution was irrelevant.[27] The Court then established the rule that, to qualify for exchange treatment under section 302(b)(1), "a redemption *must* result in a *meaningful reduction of the shareholder's proportionate interest* in the corporation."[28] The Court did not proceed to declare exactly what would normally constitute such a "meaningful reduction," however, but instead left this task for the lower courts.[29]

Various cases and revenue rulings have subsequently addressed

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ownership of preferred stock generally involves the last two, but only to limited extents, unless otherwise provided." *Id.*

24. *Id.* Note that a distribution can be essentially equivalent to a dividend even though the corporation has no earnings or profits. Treas. Reg. § 1.302-2(a) (1960).

25. *See* Lewis v. Commissioner, 47 T.C. 129 (1966); Sorem v. Commissioner, 40 T.C. 206 (1963), *rev'd and remanded on other grounds*, 334 F.2d 275 (10th Cir. 1964). A listing of the alignment of the circuits is provided in United States v. Davis, 397 U.S. 301, 303 n.2 (1970).

26. Davis v. United States, 408 F.2d 1139 (6th Cir. 1969), *rev'd*, 397 U.S. 301 (1970).

27. 397 U.S. at 312.

28. *Id.* at 313 (emphasis added).

29. The Court did say that a partial redemption from a shareholder owning 100% of the stock, whether owned directly or by attribution, does not constitute a meaningful reduction, but is rather "always 'essentially equivalent to a dividend' within the meaning of that phrase in § 302(b)(1) . . . ." *Id.* at 307. Later cases have strictly adhered to this rule. *See* Johnson v. United States, 434 F.2d 340 (8th Cir. 1970); Fireoved v. United States, 318 F. Supp. 133 (E.D. Pa. 1970), *aff'd in part & rev'd in part & remanded*, 462 F.2d 1281 (3d Cir. 1972).

the issue. These cases and rulings are quite helpful from a tax planning standpoint. They can be accurately discussed, however, only in light of the role played here by the attribution rules of Code section 318.

V. Attribution Rules of Section 318

The Supreme Court stated in *Davis* that the attribution rules of section 318(a) are to be applied to dividend equivalency determinations under section 302(b)(1).[30] Thus a "meaningful reduction" is often virtually impossible, particularly in close corporations when family members whose stock would be attributed to the redeemed shareholder continue to own a significant percentage of the corporate stock after the redemption, such that the redeemed shareholder continues to own their stock constructively.[31]

Treasury Regulations section 1.302-2(b),[32] promulgated prior to *Davis,* provides that the constructive stock ownership of a shareholder is merely "one of the facts to be considered" in making the determination of dividend equivalence. Also before *Davis, Squier v. Commissioner*[33] and *Parker v. Commissioner*[34] both held that the attribution rules would not be applied in a "family fight" situation wherein there was no economic commonality of interest between, or among, the related taxpayers.

After the *Davis* decision, the Tax Court held in *Haft Trust v. Commissioner* that under *Davis,* the family attribution rules are to operate "mechanically" in testing a redemption under section 302(b)(1).[35] However, the First Circuit reversed and remanded *Haft Trust* to the Tax Court to determine whether family discord actually existed.[36]

The Ninth Circuit has also characterized as unfair the application

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30. 397 U.S. at 307. The Court stated that "the attribution rules of § 318(a) do apply . . . for the purposes of deciding whether a distribution is 'not essentially equivalent to a dividend' under § 302(b)(1) . . . ." *Id.* The Court also believed "that Congress intended that they [the rules of attribution] be taken into account wherever ownership of stock was relevant." *Id.*

31. *See* I.R.C. § 318(a)(1). The attribution rules of § 318 are also referred to as constructive ownership rules. *See* B. Bittker & J. Eustice, *supra* note 5, § 9.21, at 9-10. These rules provide that stock owned by certain family members is considered to be owned by the taxpayer.

32. Treas. Reg. § 1.302-2(b) (1955).

33. 35 T.C. 950 (1961), *acq.* 1961-2 C.B. 5.

34. 20 T.C.M. (CCH) 893 (1961).

35. 61 T.C. 398, 403 (1973), *vacated & remanded,* 510 F.2d 43 (1st Cir. 1975). *See also* Niedermeyer v. United States, 62 T.C. 280 (1974); Jones v. United States, 72-1 U.S. Tax Cas. ¶ 9349 (D.C.N.J. 1972).

36. 510 F.2d at 48. The First Circuit noted that *Davis* "seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction . . . ." *Id.*

of the attribution rules in instances of disharmony between family members,[37] as has at least one judge in the Eighth Circuit.[38] The other circuits will likely follow suit and allow flexibility in the application of the attribution rules to discordant families involved in section 302(b)(1) redemptions.[39] It must be understood, however, that the constructive ownership rules of section 318 fully apply to all other section 302(b)(1) stock redemptions.

VI. POST-*Davis* CASES AND RULINGS

The Supreme Court in *Davis* left unresolved two issues: (1) what is a corporate interest; and (2) what is a meaningful reduction of a shareholder's corporate interest? The first of these was later resolved when the Commissioner of Internal Revenue (the Commissioner) recognized the stock ownership rights delineated by the Second Circuit in *Himmel* and construed a shareholder's corporate interest to include the following: (1) the right to vote, and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation.[40]

The relative significance given to each of these rights in the determination of whether a redemption qualifies as a meaningful reduction is partially dependent upon the capital structure of any particular corporation, and partially dependent upon the individual shareholder's percentage of the total outstanding issue of each class of corporate stock.[41] It is thus helpful to classify section 302(b)(1) redemptions according to the interrelationship of these two variables.

A. *Single-Issue Corporations (Redemptions of Common Stock)*

1. *Taxpayer has Complete Ownership*

The Court stated in *Davis* that "a redemption [of shares from a 100% shareholder] is always 'essentially equivalent to a dividend' within the meaning of that phrase in § 302(b)(1) . . . ."[42] This rule eliminates any possibility of meaningful reduction for a sole share-

37. Title Ins. & Trust Co. v. United States, 484 F.2d 462, 465 (9th Cir. 1973).

38. Wright v. United States, 482 F.2d 600, 612 (8th Cir. 1973) (Bright, J., dissenting).

39. Several commentators have supported this point of view. *See, e.g.*, 55 B.U.L. REV. 667 (1975); 7 TEX. TECH. L. REV. 195 (1975).

40. Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964). *See also* Rev. Rul. 75-502, 1975-2 C.B. 111.

41. In speaking of the number or percentage of shares owned by a shareholder, it is hereafter presumed that the attribution rules of § 318 have been applied.

42. 397 U.S. at 307 (footnote omitted).

holder. The courts have followed it consistently.[43]

The Service has even used the *Davis* sole shareholder rule to declare section 302(b)(1) inapplicable to estates selling all of decedent's stock if the estate constructively owns all of the remaining stock.[44] This Service position is difficult to accept, considering that the Supreme Court's intent was to prevent a shareholder from retaining effective control of a corporation (through stock owned by relatives) after redeeming his shares at capital gains rates. Obviously neither a deceased person nor his estate can retain effective control.

2. *Taxpayer Has Majority Ownership*

In a single-issue corporation, all the rights which constitute a shareholder's corporate interest must necessarily exist in proportion to the percentage of shares held. Thus, the courts have almost invariably held reduction of voting power[45] to be the determinative factor in meaningful reduction, majority ownership cases.[46] The only relevant issue of controversy is the precise *amount of control* over the corporation which the majority shareholder must lose.

In *Fehrs Finance Co. v. Commissioner*[47] taxpayer suffered a 10% reduction in voting control, from 98% ownership, directly and constructively, to 88%, solely by attribution. The Tax Court determined that no meaningful reduction had occurred, as the taxpayer's control of the corporation remained essentially unaltered.[48] The court clearly stated, however, that a 10% reduction may constitute a meaningful alteration if the initial percentage of control were not so high.[49] The Eighth Circuit affirmed on appeal.[50]

In *Title Insurance & Trust Co. v. United States,*[51] the corporation redeemed all of the shares held by three separate trusts, but each trust continued to constructively own 100% of the corporate stock.

43. *See* Johnson v. United States, 434 F.2d 340 (8th Cir. 1970); Maher v. Commissioner, 55 T.C. 441 (1970), *modified,* 469 F.2d 225 (8th Cir. 1972); Estate of Runnels v. Commissioner, 54 T.C. 762 (1970).

44. Rev. Rul. 71-261, 1971-1 C.B. 108.

45. In a corporation with only one class of stock outstanding, voting power, of course, always correlates directly with the percentage of shares held.

46. *See* Moloney v. United States, 521 F.2d 491 (6th Cir.), *cert. denied,* 423 U.S. 1017 (1975); Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Title Ins. & Trust Co. v. United States, 326 F. Supp. 617 (C.D. Cal. 1971), *aff'd,* 484 F.2d 462 (9th Cir. 1973); Sawelson v. Commissioner, 61 T.C. 109 (1973).

47. 58 T.C. 174 (1972), *aff'd,* 487 F.2d 184 (8th Cir. 1973), *cert. denied,* 416 U.S. 938 (1974).

48. 58 T.C. at 185. *See also* 487 F.2d at 187.

49. 58 T.C. at 185.

50. 487 F.2d 184 (8th Cir. 1973).

51. 326 F. Supp. 617 (C.D. Cal. 1971), *aff'd,* 484 F.2d 462 (9th Cir. 1973).

The district court and the Ninth Circuit both determined that the redemption did not result in a meaningful reduction. The Tax Court has also held that a redemption can never qualify for exchange treatment under section 302(b)(1) if it results in an increase in the redeeming shareholder's proportionate interest, even if such increase is attributable solely to the application of the rules of constructive ownership.[52]

The taxpayer in *Jones v. United States*[53] again constructively retained full control when the stock redemption reduced his interest from 98% to 96%. The court found that "ownership of such a vast majority of corporate stock precludes a finding that plaintiffs' attributed interest had been meaningfully reduced . . . ."[54] Likewise, in *Niedermeyer v. Commissioner,*[55] the Tax Court held that a reduction from 90% to 83% was not meaningful, as taxpayer's control over the corporation was essentially unaltered.[56] A similar rationale was applied in *Estate of Runnels v. Commissioner* when taxpayers constructively owned 100% of the corporation's stock following the redemption.[57]

Not all of the majority shareholder single-issue corporation cases have been decided against the taxpayer. The Eighth Circuit held in *Wright v. United States*[58] that a redemption which reduced taxpayer's stock ownership interest from 85% to 62% constituted a meaningful reduction. Although taxpayer was still in a majority position, he could no longer effect certain changes, such as corporate liquidation, consolidation, merger, or amendment of the articles of incorporation. Under Arkansas law all of these changes required a two-thirds vote, which taxpayer had relinquished.[59] The court concluded that he had thus lost a meaningful portion of his corporate control.[60]

The district court in *Shimberg v. United States*[61] closely followed the reasoning of the *Wright* court. A statutory merger, involving an

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52. Sawelson v. Commissioner, 61 T.C. 109 (1973).
53. 72-1 U.S. Tax Cas. ¶ 9349 (D.N.J. 1972).
54. *Id.* at 84,212.
55. 62 T.C. 280 (1974).
56. *Id.* at 287-88. The court asserted that "[A]n 82.96-percent interest clearly is sufficient to dominate and control the policies of the corporation." *Id.*
57. 54 T.C. 762 (1970).
58. 482 F.2d 600 (8th Cir. 1973); *accord,* Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976).
59. Wright v. United States, 482 F.2d 600, 609-10 (8th Cir. 1973).
60. *Id.* The dissenting judge believed the redemption only reduced taxpayer's ownership interest to 72%, which would have no practical effect on his control over the corporation. *Id.* at 611.
61. 415 F. Supp. 832 (M.D. Fla. 1976); *rev'd,* 577 F.2d 283 (5th Cir. 1978), *cert. denied,* 99 S. Ct. 1019 (1979).

exchange of stock for stock and cash, reduced taxpayer's ownership interest from 66% to less than 1%. The court held that a meaningful reduction had occurred, as the transaction had virtually extinguished taxpayer's voting control.[62]

The Commissioner's position regarding redemptions of majority stockholders is similar to that of the courts. In Revenue Ruling 75-502[63] a reduction of stock ownership from 57% to 50% was held to be meaningful. Taxpayer's loss of control over the corporation was the factor which most significantly affected the Commissioner's determination.[64]

3. Taxpayer Has a Minority Interest

Reduction in shareholder control remains a very relevant issue in redemptions of stock held by minority shareholders who exercise significant voting control over the affairs of the corporation. In Revenue Ruling 76-364[65] taxpayer owned 27% of the common stock of the corporation and three unrelated individuals owned the remaining 73%. The Commissioner held that a redemption which reduced taxpayer's portion to 22% constituted a meaningful reduction. The ruling noted the substantial reduction in the taxpayer's right to vote, right to earnings, and right to share in net assets on liquidation. The Commissioner considered especially significant the fact that the redemption "caused [taxpayer] to go from a position of holding a block of [the corporation's] stock that afforded [taxpayer] control of [the corporation] if [taxpayer] acted in concert with only one other stockholder, to a position where such action was not possible."[66] Revenue Ruling 76-364 strongly suggests that a minority shareholder with a significant voting interest can qualify for a 302(b)(1) redemption only if he sustains a practical reduction in his voting control as a result of the redemption.

A minority shareholder who has never exercised any significant amount of control over the corporation stands a much better chance of being accorded section 302(b)(1) treatment. In Revenue Ruling 75-512[67] a redemption reduced a trust's ownership interest in the

62. 415 F. Supp. at 836.

63. 1975-2 C.B. 111.

64. The last paragraph of the ruling states:

> If in the instant case, the stock of *X* held by the estate was reduced by less than 7 percentage points the redemption would not qualify under section 302(b)(1) because the estate would continue to have dominant voting rights in *X* by virtue of its ownership of more than 50 percent of the *X* stock.

Id. at 112.

65. 1976-2 C.B. 91.

66. *Id.* at 92.

67. 1975-2 C.B. 112.

corporation's outstanding stock from 30% to 24%. The Commissioner noted that the trust was a minority shareholder that took no part in the management of the corporation, and ruled that the trust's 19% reduction in "its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in net assets on liquidation" was significant enough to be regarded as meaningful.[68] The Commissioner failed to discuss, however, the extent to which a reduction would qualify as meaningful if the taxpayer's previous ownership interest is reduced by less than 19%.

The Service readdressed that issue a year later in Revenue Ruling 76-385.[69] In this ruling a redemption reduced taxpayer's ownership interest from .0001118% of the corporation's outstanding stock to .0001081%. The Commissioner ruled that this 3.3% decrease constituted a meaningful reduction.

Revenue Ruling 76-385 noted that the taxpayer had experienced a reduction of its voting rights, its rights to earnings, and its rights to share in assets upon liquidation.[70] Furthermore, it had held *minimal* stockholdings and had exercised no control over the corporate affairs. The Commissioner emphasized that in enacting section 302(b)(1) Congress intended to provide capital gains treatment for redemptions which involve "a minority shareholder whose relative stock interest in [the corporation] is minimal and who exercises no control over the affairs of [the corporation]."[71] Revenue Ruling 76-385 may be interpreted as holding, although it does not specifically take this position, that the Service is willing to always allow exchange treatment for redemptions of stock held by shareholders who exercise no meaningful control over the corporate affairs, so long as the shareholder's percentage ownership is reduced.

B. *Multiple-Issue Corporations (Redemptions of Preferred Stock)*

The issuance of both common and preferred stock compounds the difficulties of determining what constitutes a shareholder's interest in a corporation and what qualifies as a meaningful reduction of an interest. The "interest equals voting power" equation no longer suffices, as voting and economic rights are generally distributed unevenly among the various classes of stock.

A redemption of a shareholder's common stock in a multi-class corporation is generally treated as though it were from a single-issue corporation, *i.e.*, such a redemption satisfies the *Davis* test if it

68. *Id.* at 113.
69. 1976-2 C.B. 92.
70. *Id.* at 93.
71. *Id.*

would have resulted in a meaningful reduction had only the common stock been outstanding. The treatment extended to a redemption of preferred stock is almost invariably dependent upon the shareholder's common stock ownership position.[72] Thus preferred stock redemptions are classified according to the shareholder's percentage ownership of the corporation's common stock outstanding just as common stock redemptions are classified.

1. *Taxpayer Has Complete Ownership of Corporation's Common Stock*

A taxpayer who owns 100% of a corporation's common stock suffers no loss of corporate control in the partial or total redemption of his nonvoting preferred stock. Thus the Supreme Court ruled in *Davis* that when a shareholder owns all of the voting stock outstanding, a redemption of any amount of preferred stock can *never* result in a meaningful reduction of his corporate interest.[73] The lower courts have followed this rule without deviation.[74]

2. *Taxpayer Has Majority Ownership of Corporation's Common Stock*

The Supreme Court in *Davis* clearly did not adopt the Second Circuit's two-part definition of a dividend, *i.e.*, a pro rata distribution and no change in the basic shareholder relationships, found in *Himmel.* Rather, the Court ignored the pro rata aspect of a dividend distribution, and instead defined a distribution as being essentially equivalent to a dividend whenever it does not effect a meaningful reduction in the shareholder's proportionate corporate interest.

The Tax Court has since held that, under this *Davis* meaningful reduction test, the redemption of some or all of a majority shareholder's preferred stock must result in an alteration in the basic shareholder relationships, particularly a reduction in the redeemed shareholder's voting control, in order to escape dividend treatment. Consequently, a redemption of a controlling shareholder's nonvoting preferred stock can never qualify for exchange treatment under section 302(b)(1), even if it is a non-pro-rata redemption, since it would not affect taxpayer's control over business decisions.

72. The only situations in which the shareholder's common stock ownership position does not necessarily control are those where the corporation's capital structure includes *voting* preferred stock. In such instances, redemptions of preferred stock can reduce the shareholder's voting control even though his common stock ownership position remains the same.

73. 397 U.S. at 307. The Supreme Court held in *Davis* that "such a redemption is always 'essentially equivalent to a dividend' within the meaning of that phrase in § 302(b)(1) . . . ." *Id.*

74. *See* Benjamin v. Commissioner, 66 T.C. 1084 (1976). "[T]he retention of absolute voting control in the present case outweighs any other consideration." *Id.* at 1111.

Thus, in *Hays v. Commissioner*[75] the Tax Court found a non-pro-rata redemption of 10% of a majority shareholder's preferred stock as essentially equivalent to a dividend. Since the redeeming shareholder continually owned 80% of the common stock, he suffered no loss of voting rights, and thus there was no meaningful reduction of his proportionate interest in the corporation.

Likewise, in *Brown v. United States*[76] the non-pro-rata redemption of preferred stock did not result in a meaningful reduction of the redeemed shareholder's proportionate interest (even though the redemption did result in a change in rights to current earnings), since the shareholder retained ownership of 99% of the voting common stock and thus lost no corporate control. The district court here expressly rejected *Himmel* if under the rule of that case a different result would have ensued.

Similarly, in *Grabowski Trust v. Commissioner*[77] the Tax Court stated that compliance with the *Himmel* formula does not mean the facts would necessarily satisfy the meaningful reduction test of *Davis*. The court held that a redemption of preferred stock which completely terminated the shareholder's direct interest in the corporation, without a significant decrease in the shareholder's constructive majority in the common stock, did not qualify as a meaningful reduction of taxpayer's corporate interest.[78] It is quite apparent that, when testing redemptions of preferred stock held by majority common stock shareholders for section 302(b)(1) exchange treatment, the courts regard continued control of the corporation through ownership of the common stock as the controlling factor.

3. Taxpayer Has Minority Ownership of Corporation's Common Stock

The rule governing redemptions of preferred stock held by majority shareholders also applies to redemptions of such stock owned by minority shareholders who exercise substantial control over the corporate affairs. A redemption of preferred stock, therefore, qualifies as a meaningful reduction of a controlling minority shareholder's corporate interest only if it results in a practical reduction in his control over the corporation. A redemption of a controlling minority shareholder's nonvoting preferred stock thus can never qualify for section 302(b)(1) exchange treatment, since such a redemption in

75. 30 T.C.M. (CCH) 378 (1971).
76. 345 F. Supp. 241 (S.D. Ohio 1972), *aff'd mem.*, 477 F.2d 599 (6th Cir.), *cert. denied*, 414 U.S. 1011 (1973).
77. 58 T.C. 650 (1972).
78. *Id.* at 659.

no way diminishes the shareholder's voting control. Several cases exemplify this point.

In *Miele v. Commissioner*[79] five taxpayers, each with "substantial control," owned preferred stock and virtually all of the common stock in a corporation. The Third Circuit affirmed the Tax Court's determination that a redemption of the preferred stock was essentially equivalent to a dividend, as it failed to change the relative rights or interests of each of the five taxpayers.

The Tax Court reached a similar conclusion in *Furr v. Commissioner,*[80] when taxpayer owned 24.19% of the common stock before a preferred stock redemption and 23.86% afterward. Likewise, the Tax Court extended dividend treatment in *Furr v. Commissioner*[81] to a taxpayer who owned 41.2% of the common stock before a preferred stock redemption and 39.5% following the redemption.

Minority shareholders who hold no controlling interest have fared much better in redemptions of preferred stock. The more favorable treatment is appropriate. As the Supreme Court noted in *Davis,* Congress enacted section 302(b)(1) in order to extend exchange treatment to "redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place."[82] Furthermore, since voting control cannot be meaningfully reduced, the *Davis* test is necessarily satisfied if the redemption reduces the shareholder's rights to earnings and to net assets on liquidation.

The Service partially indicated its position with regard to redemptions of preferred stock held by minority shareholders who exercise no control over the corporation in Revenue Ruling 74-515.[83] This ruling involved a non-pro-rata redemption of preferred stock held by a group of shareholders who each owned less than 1% of the corporation's common stock. The Commissioner ruled that the redemption resulted in a meaningful reduction of the shareholder's corporate interest and thus qualified for section 302(b)(1) treatment under *Davis,* since none of the redeemed shareholders had exercised any form of control over the corporation. The legislative history of section 302(b)(1), as noted directly above and as cited in *Davis,*[84]

79. 56 T.C. 556 (1971), *aff'd mem.*, 474 F.2d 1338 (3d Cir.), *cert. denied sub nom.* Albers v. Commissioner, 414 U.S. 982 (1973).

80. 34 T.C.M. (CCH) 433 (1975).

81. 34 T.C.M. (CCH) 426 (1975).

82. 397 U.S. at 310 (quoting S. Rep. No. 1622, 83d Cong., 2d Sess. 44, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 4675).

83. 1974-2 C.B. 118.

84. *See* note 82 *supra.*

indicates that the Commissioner should rule the same way even in cases where the redemption of preferred stock is pro rata with respect to common ownership.

In *Agway, Inc. v. United States,*[85] the taxpayer owned 6% of the voting stock and 18% of the nonvoting preferred stock of a corporation. He exercised no significant control over the business. The court treated a partial redemption of his preferred as an exchange, noting that the transaction had reduced taxpayer's rights to earnings and to net assets on liquidation.

The holding of *Agway* is essentially the rule which governs redemptions of preferred stock owned by taxpayers who exercise no control over the business of the corporation. A decrease in voting power or corporate control is never required. A reduction in proportionate rights to earnings and rights to net assets on liquidation is helpful, but not essential as long as the Service adheres to the congressional intent behind section 302(b)(1). The Service has not thus far challenged exchange treatment for proceeds from these redemptions.

4. *Taxpayer Owns None of the Corporation's Common Stock*

Revenue Ruling 74-515[86] suggests that the Commissioner is willing to extend exchange treatment under section 302(b)(1) to the complete redemption of a shareholder who owns only preferred stock. In *Cummins Diesel Sales Corp. v. United States*[87] the Seventh Circuit affirmed the district court's determination that a redemption of a taxpayer who holds only preferred stock qualifies for section 302(b)(1) exchange treatment even if it does not completely terminate the taxpayer's interest.

In Revenue Ruling 77-426[88] the Commissioner essentially adopted the holding of *Cummins Diesel,* stating "the redemption of *any* amount of stock that is nonvoting, nonconvertible, and limited and preferred as to dividends and in liquidation represents a meaningful reduction of the shareholder's proportionate interest in the corporation if the shareholder does not own stock of any other class, either directly or indirectly."[89] The rulings and cases clearly indicate that a redemption from a shareholder owning only nonvoting preferred stock will virtually always constitute a meaningful reduction of the shareholder's proportionate interest, and thus qualify for exchange treatment under section 302(b)(1).

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85. 524 F.2d 1194 (Ct. Cl. 1975).
86. 1974-2 C.B. 118.
87. 323 F. Supp. 1114 (S.D. Ind. 1971), *aff'd,* 459 F.2d 668 (7th Cir. 1972).
88. 1977-2 C.B. 87.
89. *Id.* at 88 (emphasis added).

VII. SUMMARY OF POST-*Davis* CASES AND RULINGS

The Supreme Court stated in *Davis* that dividend equivalency exists unless the redeemed shareholder has incurred a meaningful reduction in his proportionate corporate interest. According to *Davis,* the courts must apply a strict net effect test to determine if such a meaningful reduction has taken place. This test, by subsequent order of the Commissioner and the courts, is concerned almost exclusively with reductions in the redeemed shareholder's voting rights (particularly if the shareholder exercises any form of control over the corporation), rights to earnings and accumulated surplus, and rights to net assets on liquidation. The courts also take into account the congressional intent underlying section 302(b)(1) in those situations in which the redeemed shareholder has exercised no corporate control. The constructive ownership rules of section 318 fully apply, except in family hostility situations.

Two prevailing rules have evolved from the post-*Davis* meaningful reduction cases and rulings. The first is that if a shareholder exercises any form of control over the affairs of the redeeming corporation, a redemption of his stock will qualify for section 302(b)(1) exchange treatment if, and only if, it results in his experiencing a significant reduction in his corporate control.[90] This rule applies whether the shareholder holds a majority or minority interest,[91] and whether the corporation redeems common or preferred stock.[92]

The second rule is that if the shareholder exercises no practical control over the corporation, a redemption of his stock will qualify for section 302(b)(1) treatment regardless of any other factors.[93] This rule as well applies whether the corporation redeems common or preferred stock.[94]

VIII. CIRCUMVENTION OF *Davis:* THE ESOP

Tax planners have found a way by which, in certain circumstances, the construction of *Davis* may be avoided. The scheme involves the use of an Employee Stock Ownership Plan (ESOP).

The ESOP, which is used as an employee retirement income security device, is a defined contribution[95] type of stock bonus plan.[96] It

90. *See* section VI.*A.2. supra.*
91. *See* section VI.*A.3. supra.*
92. *See* sections VI.*B.2., 3. supra.*
93. *See* sections VI.*A.3., B.3., 4. supra.*
94. *See* section VI.*B.4. supra.*
95. I.R.C. § 414(i) defines a defined contribution plan as follows:

(i) Defined contribution plan.—For purposes of this part, the term "defined contribution plan" means a plan which provides for an individual account for each

is designed to invest primarily in employer securities.[97] The most advantageous characteristic of an ESOP is that the attribution rules of section 318, which can so easily trigger dividend equivalency under *Davis,* do not apply to such a stock bonus plan.[98]

A corporation may wish to set up an ESOP trust and fund it with deductible contributions of cash. So long as the corporation's stock is not publicly traded, the plan can provide that none of the corporation's stock held by the trust will be voted. Stockholders of the corporation could then sell any amounts of the corporation's stock to the trust and realize capital gains upon the sales rather than ordinary income. Section 302 would not enter the picture.

The value of an ESOP in circumventing *Davis* may best be explained with an example. Suppose *A* owns 100% of the common stock of *X* Corporation, a single-issue corporation with a going concern value of $2,000,000, and that *X* Corporation has $250,000 cash on hand. *A* could have *X* Corporation redeem 10% of his stock for $200,000, but he would then realize ordinary income under *Davis* and section 302(b)(1). On the other hand, *X* Corporation, at *A*'s direction, could set up an ESOP, have the plan provide that none of the corporation's stock held by the ESOP trust will be voted, and fund the trust with deductible contributions totaling $200,000. *A* could then sell 10% of his stock to the trust for $200,000, either all at one time or in installments over a span of years. The sale would be treated as a normal sale of stock, such that *A* would realize capital gain rather than ordinary income. At the same time, *A* would retain 100% control of the corporation. The trust would hold the stock until the time came for it to make payments to employees, which it would do in such fashion as would be provided in the plan.

> participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

96. *See* I.R.C. § 401.

97. I.R.C. § 409A(a).

98. An ESOP falls within the category of an employee's trust described in § 401(a) which is exempt from tax under § 501(a). *See* I.R.C. §§ 401(a) and 501(a). I.R.C. § 318(a)(2)(B)(i) provides that: "Stock owned, directly or indirectly, by or for a trust (other than an employee's trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust."

I.R.C. § 318(a)(3)(B)(i) provides in part that:

> Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employee's trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest.

IX. Conclusion

When *Davis* came before the Supreme Court in 1970 most courts regarded the existence of a legitimate business purpose underlying a stock redemption as a very important, if not the most important, consideration in the determination of whether the redemption was essentially equivalent to a dividend under section 302(b)(1). The Supreme Court held that business purpose was an irrelevant factor, and asserted that to qualify for section 302(b)(1) exchange treatment a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. The lower courts and the Commissioner then struggled to define what constituted a "meaningful reduction" and a "proportionate interest," as the Supreme Court had given little indication of the implications of these expressions.

Several justices dissenting in the denial of certiorari in *Albers v. Commissioner*[99] expressed doubt as to whether *Davis* was correctly decided. The three dissenting *Albers* justices, similarly to the three dissenters in *Davis,* viewed *Davis* as eliminating section 302(b)(1) from the Code under the mechanical approach of never examining the business purpose of the transaction.[100] The Service subsequently issued a number of revenue rulings in which redemptions did qualify for exchange treatment under section 302(b)(1).[101]

At present, the taxpayer can derive several general rules from the post-*Davis* cases and rulings, and thus utilize section 302(b)(1) as an effective tax planning tool in some situations. Significant controversy and uncertainty continue to cloud this section of the Code, however, and the entire dividend equivalency issue may still require ultimate settlement by the Supreme Court.

In spite of all that may be said about section 302(b)(1) and dividend equivalency, the contemporary corporate tax planner does have the option to avoid the far-reaching effects of *Davis* altogether. Congress has enabled him to do so by specifically providing that stock held by qualified stock bonus plans, such as ESOP's, may not

99. 414 U.S. 982 (1973).

100. Ironically, the *Albers* bench probably would have approved the business purpose approach if the issue were one of first impression. Chief Justice Burger and Justice Brennan, who both dissented in *Davis,* apparently regarded stare decisis as now controlling, and thus failed to dissent in *Albers.* Had they stood by their *Davis* convictions, they would have joined *Albers* dissenting Justices Powell and Blackmun, who were not on the Supreme Court when *Davis* was decided, and Douglas. The five of them would have constituted a majority.

101. *See* Rev. Rul. 76-385, 1976-2 C.B. 92; Rev. Rul. 76-364, 1976-2 C.B. 91; Rev. Rul. 75-512, 1975-2 C.B. 112; Rev. Rul. 75-502, 1975-2 C.B. 111. These post-*Albers* rulings suggest that the Service decided to relax its strict application of section 302(b)(1)'s "not essentially equivalent to a dividend" language to appease the *Albers* dissenters rather than run the risk that the Supreme Court would modify *Davis.*

be constructively owned by anyone under the attribution rules of section 318. Thus, the purchase of stock by an ESOP will never trigger dividend equivalency. The taxpayer facing *Davis* should consider the value of an ESOP, as sales of stock to such a plan are sure to yield capital gains rather than ordinary income.