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Davis v. United States: A Victory for Congressional Intent in the Federal Income Laws

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NOTES

DAVIS v. UNITED STATES: A VICTORY FOR CONGRESSIONAL INTENT IN THE FEDERAL INCOME TAX LAWS

The Supreme Court in *Davis v. United States*[1] held that the existence of a bona fide business purpose for a stock redemption was irrelevant in determining dividend equivalency under section 302(b)(1) of the Internal Revenue Code of 1954; such a redemption to a corporation's sole shareholder was always to be deemed essentially equivalent to a dividend for federal income tax purposes. The basic question from *Davis* is whether this holding emasculates section 302(b)(1), or merely reasserts the true import of the section as enacted by Congress in 1954.

The Internal Revenue Code of 1954 provides in section 301(a) and (c)[2] that a distribution of property by a corporation to a shareholder with respect to its stock is includable in the shareholder's gross income, if the distribution is a dividend, as defined in section 316.[3] The term "dividend" is defined in section 316(a) as any distribution of property by a corporation to its shareholders out of the corporation's earnings and profits accumulated after February 28, 1913. In addition,

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1. 397 U.S. 301 (1970).
2. INT. REV. CODE of 1954, § 301:
(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c) . . .
(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—
(1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.
(2) AMOUNT APPLIED AGAINST BASIS.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.
(3) AMOUNT IN EXCESS OF BASIS.—
(A) IN GENERAL.— . . . that portion of the distribution which is not a dividend, to the extent it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property . . . .
3. INT. REV. CODE of 1954, § 316:
(a) GENERAL RULE.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—
(1) out of its earnings and profits accumulated after February 28, 1913 . . . . Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof . . . .

section 316(a) sets forth the rule that every distribution by a corporation is deemed to be out of earnings and profits to the extent thereof. Therefore, whenever a corporation, which has either current or accumulated earnings and profits, makes a distribution of property to its shareholders, the distribution is considered a dividend and is taxable as ordinary income. One exception to this treatment of corporate distributions is found in section 302(b)(1)[4] which provides that if a corporation redeems its stock and "the redemption is not essentially equivalent to a dividend," then the transaction is treated as a sale or exchange of the redeemed stock. If the redeemed stock has been held longer than six months by the shareholder, any gain on the transaction is a capital gain. Thus, the determination of whether a corporate distribution to a shareholder in return for stock shall be subject to treatment as a capital gain is dependent upon a finding that the distribution was "not essentially equivalent to a dividend."

The federal circuit courts of appeals have differed in their approach in the development of a test to determine when a stock redemption is not a dividend under the vague rule in section 302(b)(1). Basically, the split concerned whether a legitimate corporate business purpose was relevant in determining dividend equivalency under section 302(b)(1). The first approach, which has been characterized as the "net effect" test, stated that any business purpose was irrelevant, and the basic question focused upon the net effects of the redemption on the shareholder's stock ownership rights. If there has been no effect on the shareholder's rights to vote or control the corporation, to participate in future distributions of current or accumulated earnings, or to share in the net assets of the corporation upon liquidation, then the redemption is "essentially

4. INT. REV. CODE of 1954, § 302:
(a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1) . . . 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 . . . .
(d) REDEMPTIONS TREATED AS DISTRIBUTIONS OF PROPERTY.— . . . if a corporation redeems its stock . . . , and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.
INT. REV. CODE of 1954, § 317(b):
(b) REDEMPTION OF STOCK.—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

equivalent to a dividend."[5] The second approach, which has been characterized as the "flexible net effect" test, deemed the "net effect" test as a factor to be weighted, but considered a valid business purpose for the redemption as sufficient to overcome its resemblance to a dividend under the "net effect" test.[6]

To understand how the circuit courts' interpretation of the phrase "essentially equivalent to a dividend" came to be so divergent and confusing that the Fourth Circuit Court of Appeals called it a "morass,"[7] a discussion of the legislative and judicial history of the phrase is necessary.

HISTORICAL BACKGROUND TO SECTION 302(b)(1)

In response to the Supreme Court's decision in *Eisner* v. *Macomber*,[8] which held that stock dividends are not taxable income, Congress enacted section 201(d) of the Revenue Act of 1921.[9] This

5. The Second Circuit has been the only circuit to hold that a business purpose is not important in any case involving § 302(b)(1) and to follow strictly the analysis that looks only to the net effects on the incidents of ownership that result from the redemption. *See* Himmel v. Comm'r, 338 F.2d 815 (2d Cir. 1964); McGinty v. Comm'r, 325 F.2d 820 (2d Cir. 1963); Levin v. Comm'r, 385 F.2d 521 (2d Cir. 1967); Hasbrook v. United States, 343 F.2d 811 (2d Cir. 1965); Northup v. United States, 240 F.2d 304 (2d Cir. 1957); Kirschenbaum v. Comm'r, 155 F.2d 23 (2d Cir. 1946).

The First Circuit has gone so far as to say that where the taxpayer is the sole or dominant shareholder of the distributing corporation a business purpose is irrelevant. *See* Wiseman v. United States, 371 F.2d 816 (1st Cir. 1967); Friend v. United States, 345 F.2d 761 (1st Cir. 1965); Bradbury v. Comm'r, 298 F.2d 111 (1st Cir. 1962); United States v. Collins, 300 F.2d 821 (1st Cir. 1962).

The Third Circuit also has said that the terms "essentially equivalent to a dividend" were aimed at results or effects rather than purpose. *See* Kessner v. Comm'r, 248 F.2d 943 (3d Cir. 1957); Boyle v. Comm'r, 187 F.2d 557 (3d Cir. 1951), *cert. denied*, 342 U.S. 817 (1951); Smith v. United States, 121 F.2d 692 (3d Cir. 1941).

6. The Fourth, Fifth, Seventh, Eighth, Ninth, and Tenth Circuits at least give some weight to a business purpose for the redemption. *See* Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958); Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954); Commissioner v. Brown, 69 F.2d 602 (7th Cir. 1934), *cert. denied*, 293 U.S. 570 (1934); Heman v. Comm'r, 283 F.2d 227 (8th Cir. 1960); Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966); Philps v. Comm'r, 247 F.2d 156 (9th Cir. 1957); Pacific Vegetable Oil Corp. v. Comm'r, 251 F.2d 682 (9th Cir. 1957); Commissioner v. Berenbaum, 369 F.2d 337 (10th Cir. 1966); Sorem v. Comm'r, 334 F.2d 275 (10th Cir. 1964); Jones v. Griffin, 216 F.2d 885 (10th Cir. 1954).

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

8. 252 U.S. 189 (1920).

9. REV. ACT of 1921, ch. 136, § 201(d), 42 Stat. 228:

(d) 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

section provided that stock dividends were not subject to taxation; however, if they were later redeemed by the corporation "at such time and in such manner as to make" the redemption "essentially equivalent to the distribution of a taxable dividend," then, to the extent of corporate earnings and profits, the distribution was to be taxed as a dividend. The purpose of section 201(d) was to prevent corporations from issuing stock dividends and later redeeming this stock for cash which, if taxable at all,[10] would be treated as a capital gain.[11]

It was discovered that the same tax avoidance could be accomplished whether the stock dividend was declared before or after the redemption.[12] To remedy this, Congress amended the section in 1926 to include redemptions or cancellations which meet the dividend equivalency test whether or not the stock was originally issued as a stock dividend.[13] Thus, the phrase "essentially equivalent to a dividend" was initially aimed only at preventing tax avoidance. This is emphasized by the fact that section 201(g)[14] used the terms "at such time and in such manner" which would imply that if a corporation redeemed its stock for a valid business purpose and not at the time and in the manner of a normal dividend, then the redemption would not be "essentially equivalent to a taxable dividend." The showing of a business purpose for the redemption would dispell any impression of tax avoidance and make the redemption not "at such time and in such manner" as to be "essentially equivalent

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stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913.

10. A taxpayer could escape taxation entirely. For example, a corporation could declare a 100 per cent stock dividend on stock that had a basis to the shareholder (taxpayer) of 100 dollars per share. After the stock dividend, the shareholder would have twice as many shares. Hence, a proportionate allocation of his basis would give him a basis of 50 dollars per share. If the corporation redeemed part of this stock at a price equal to its basis (50 dollars), the shareholder would have no gain on the transaction and, thus, not be subject to any tax.

11. *See* Commissioner v. Brown, 69 F.2d 602, 603 (7th Cir. 1934), *cert. denied,* 293 U.S. 570 (1934).

12. H.R. REP. No. 356, 69th Cong., 1st Sess. 30 (1926). For example, a corporation could redeem part of its stock and then later declare a stock dividend in order to replenish the shareholder's supply of stock for future redemptions. The end result would be the same type of tax avoidance § 201(d) of the REV. ACT of 1921 had tried to prevent.

13. REV. ACT of 1926, ch. 27, § 201(g), 44 Stat. 11.

14. (g) 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.

Id.

to a taxable dividend." Indeed, this is how the courts originally interpreted section 201(g). In *Commissioner v. Brown*,[15] the court held that the government must show some circumstance in time or manner indicating that the redemption was essentially equivalent to a dividend, and that a cash redemption per se did not come under the dividend equivalency test of section 201(g).[16] With that as the test, the showing of a business purpose for the redemption became highly persuasive in dispelling both indications of tax avoidance and circumstances in time or manner which made the redemption appear essentially equivalent to a taxable dividend.[17]

The Internal Revenue Code of 1939, in section 115(g)[18] reiterated the dividend equivalency test substantially as it had been in section 201(g) of the Revenue Act of 1926. However, in 1940 Associate Justice Vinson in *Flanigan v. Helvering*[19] said that the net effect of the distribution rather than the motives of the taxpayer or his corporation is the fundamental question in administering section 115(g).[20] The Third Circuit Court of Appeals, in *Smith v. United States*,[21] cites *Flanigan* as the originator of the "net effect" test[22] and further holds that section 115(g) of the 1939 Code and section 201(g) of the 1926 Act were aimed at the results of the redemption, not the purpose. In support of this interpretation, the *Smith* court cites a congressional report.[23] This report stated that section 201(g) of the House bill amended the provision of the existing law in order to make clear that a corporation, especially one with only a few shareholders, will not be able to use a redemption, even without resorting to the device of a stock dividend, to get capital gains treatment, when the redemption would have the *same effect* as a taxable dividend.[24] The Second and Third Circuit Courts of Appeals were the only courts to clearly adopt the "net effect"

15. 69 F.2d 602 (7th Cir. 1934), *cert. denied*, 293 U.S. 570 (1934).
16. 69 F.2d at 604.
17. *See* Commissioner v. Quackenbos, 78 F.2d 156 (2d Cir. 1935).
18. INT. REV. CODE of 1939, ch. 1, § 115(g), 53 Stat. 48:
(g) REDEMPTION OF STOCK.—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.
19. 116 F.2d 937 (D.C. Cir. 1940).
20. *Id.* at 939-40.
21. 121 F.2d 692 (3d Cir. 1941).
22. *Id.* at 695.
23. H.R. REP. No. 356, 69th Cong., 1st Sess. 5 (1926).
24. *Id.*

test.[25] The remaining circuits, to varying degrees, continued to hold that a business purpose was relevant.[26]

In an attempt to resolve these conflicting interpretations, the House of Representatives in 1954 proposed a section that established objective tests to determine when a redemption would be excepted from taxation as a dividend and excluded the "essentially equivalent to a dividend" language.[27] The Senate Finance Committee found the House's section too restrictive and stated:

> While the House bill set forth definite conditions under which stock may be redeemed at capital gains rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemption of preferred stock which might be called by the corporation without the shareholder having any control 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.[28]

Hence, section 302(b)(1) as enacted in 1954, contained the vague phrase "essentially equivalent to a dividend" with which the courts had been struggling for 33 years. The court in *Ballenger v. United States*[29] asserted that the law in this area would have been clarified had not this vague, negative test been included in the 1954 Code.

A DISCUSSION OF THE DAVIS CASE

In *United States v. Davis*[30] the taxpayer and another individual,

25. *See* Smith v. United States, 121 F.2d 692 (3d Cir. 1941); Kirschenbaum v. Comm'r, 155 F.2d 23 (2d Cir. 1946). The Supreme Court, foreshadowing its holding in *Davis*, adopted the "net effect" test in construing § 112(c)(2) of the INT. REV. CODE of 1939 which was quite similar to § 115(g) of the INT. REV. CODE of 1939.

26. *See* cases cited note 6 *supra*.

27. H.R. REP. No. 1337, 83rd Cong., 2d Sess. 35 (1954). The objective tests mentioned above were essentially what is now contained in INT. REV. CODE of 1954, § 302(b)(2) and (3). Section 302(b)(2) provides that a substantially disproportionate redemption, as determined by a precise mathematical formula, will not be subject to taxation as a dividend under § 301. Section 302(b)(3) provides that § 301 shall not apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

28. S. REP. No. 1622, 83rd Cong., 2d Sess. 44-45 (1954). B. BITTKER and J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 291 (2d ed. 1966), assert that it is not easy to give § 302(b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock.

29. 301 F.2d 192, 194 (4th Cir. 1962).

30. 397 U.S. 301 (1970). [hereinafter cited as *Davis*].

Mr. Bradley, had organized a corporation with the taxpayer and his wife each owning 250 shares of common stock and Bradley 500 shares. Thereafter, the taxpayer purchased 1,000 shares of preferred stock in the corporation at 25 dollars per share in order to increase the corporation's working capital and thereby qualify for a loan from the Reconstruction Finance Corporation. It was understood that the corporation was to redeem the preferred stock upon repayment of the RFC loan. Subsequently, the taxpayer bought Bradley's 500 shares of common stock and distributed it equally between his son and daughter. After repayment of the RFC loan, the corporation, in accordance with the original agreement, redeemed the taxpayer's preferred stock for 25,000 dollars: its original cost to taxpayer. At the time of the redemption, the taxpayer owned 250 shares of common stock and 1,000 shares of preferred stock; his wife, son, and daughter each owned 250 shares of common stock. There were no other shareholders in the corporation.

The taxpayer argued that the redemption was the culmination of the original plan to qualify for the RFC loan and thus, a legitimate business purpose existed to make the redemption "not essentially equivalent to a dividend." The Commissioner of Internal Revenue disagreed, contending that this redemption had the same net effect as a dividend since it did not cause any decrease in the taxpayer's ownership rights in the corporation. The United States District Court held that a legitimate business purpose for the redemption of the taxpayer's preferred stock made the redemption eligible for treatment as "not essentially equivalent to a dividend" under section 302(b)(1).[31] The Sixth Circuit Court of Appeals affirmed.[32] The Supreme Court granted certiorari[33] in order to resolve the conflict in the circuit courts over whether a valid business purpose for a redemption by a closely held corporation qualifies the redemption for section 302(b)(1) treatment.

One factor playing an important role in the Supreme Court's final resoluton of *Davis* was its holding that for the purposes of analysis under section 302(b)(1) the attribution rules of section 318(a)[34]

31. 274 F. Supp. 466 (M.D. Tenn. 1967).
32. 408 F.2d 1139 (6th Cir. 1969).
33. 396 U.S. 815 (1969).
34. INT. REV. CODE of 1954, § 318(a):
(a) GENERAL RULE.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—
(1) MEMBERS OF FAMILY.—
(A) IN GENERAL.—An individual shall be considered as owning the stock owned, directly, or indirectly, by or for—
(i) his spouse . . . and
(ii) his children . . . .

apply, and therefore, the taxpayer was constructively the sole shareholder of the corporation. The Supreme Court reversed the lower courts and held a business purpose to be irrelevant in determining dividend equivalency under section 302(b)(1). The Court further concluded that a redemption by a closely held corporation was always "essentially equivalent to a dividend."[35] In reaching this result, the Court quoted extensively from the Senate Finance Committee's report on section 302(b)(1). In explaining the addition of the terms "essentially equivalent to a dividend," the Senate Finance Committee announced that the test intended to be incorporated in the interpretation of section 302(b)(1) was the one currently employed under section 115(g) of the 1939 Code.[36] As noted earlier, the test as applied by the circuit courts was in a state of considerable confusion because the courts did not agree as to whether or not a business purpose was relevant. In light of this, the Finance Committee, in an attempt to clarify their conception of the correct test, asserted:

> Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. For this purpose the presence or absence of earnings or profits of the corporation is not material.[37]

The Supreme Court recognized that the legislative history was certainly not free from doubt, but concluded that Congress, by making the sole inquiry the narrow one of whether or not the redemption could be characterized as a sale, was apparently rejecting past court decisions

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INT. REV. CODE of 1954, § 302(c):

(c) CONSTRUCTIVE OWNERSHIP OF STOCK.—

(1) IN GENERAL.—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of his section.

The taxpayer in *Davis* argued that, since only §§ 302(b)(2) and 302(b)(3) expressly mentioned ownership of stock and 302(c) only made 318(a) expressly applicable in determining ownership of stock, the 318(a) rules of attribution did not apply to 302(b)(1). The Supreme Court said that the plain language of the statute compels rejection of the taxpayer's argument. 397 U.S. at 307. The Court held that 318(a) applies to § 302 whenever ownership of stock is relevant. *See* Thomas G. Lewis, 35 T.C. 71 (1960); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); Himmel v. Comm'r, 338 F.2d 815 (2d Cir. 1964); Levin v. Comm'r, 385 F.2d 521 (2d Cir. 1967); Treas. Reg. § 1.302-2(b) (1960); B. BITTKER and J. EUSTICE, *supra* note 28, at 291 n.32.

35. 397 U.S. at 307.

36. S. REP. No. 1622, 83rd Cong., 2d Sess. 44 (1954).

37. *Id.* at 44-45.

holding factors indicating tax avoidance to be relevant.[38]

The Court's conclusion was further supported[39] by the Finance Committee's explanation of why they separated redemptions and partial liquidations into two parts. The Finance Committee announced:

> Those distributions which may have capital gains characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholders level, to the separate tests described in part I of this subchapter [sections 301-18]. On the other hand those distributions characterized by what happens solely at the corporate level . . . , would be included as within the aspect of a partial liquidation [section 346].[40]

It seems clear from the Finance Committee's announcement that section 302 was meant to deal with non-pro rata distributions,[41] and that the test to be applied would concern the effects of the distribution at the shareholder level. Moreover, any corporate justification was to be considered as immaterial for purposes of sections 301-18.[42] Indeed, this is how the Treasury Regulations have interpreted section 302 from its inception.[43] The Supreme Court said that since Congress, under section 301 and 316, treated any distribution by a corporation which has earnings and profits as a taxable dividend, it was clearly proper for Congress to tax any redemption which did not meet the specific "safe harbors" of section 302 as dividends without regard to corporate motivation in order to prevent tax avoidance.[44] Therefore, the Supreme Court concluded that, since the taxpayer in *Davis* was constructively the sole

38. 397 U.S. at 311.

39. *Id.* at 311-12 n. 11.

40. S. REP. No. 1622, 83rd Cong., 2d Sess. 44 (1954).

41. *See* Bittker, *The Taxation of Stock Redemptions and Partial Liquidations*, 44 CORNELL L.Q. 299, 325 (1959).

42. This is further supported by the Finance Committee's statements regarding the correct test under § 346 of the INT. REV. CODE of 1954. Section 346 provides, *inter alia*, that a distribution is a partial liquidation, if the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted. The Finance Committee stated that a valid business purpose for the partial liquidation would qualify the distribution under § 346 and cited Jospeh W. Imler, 11 T.C. 836 (1948), as an example of a valid business purpose case. S. REP. No. 1622, 83rd Cong., 2d Sess. 44 (1954). Since Congress was aware of the business purpose doctrine and endorsed it as it related to § 346, it would seem that their failure to mention or endorse it in discussing § 302(b)(1) would lend weight to the argument that it was not meant to be incorporated in that section.

43. *See* Treas. Reg. § 1.302-1(b), T.D. 6152, 1955-2 CUM. BULL. 61, 73; *see also* Treas. Reg. § 1.302-2(a) and (b) (1960).

44. 397 U.S. at 313.

shareholder of the corporation, the distribution of 25,000 dollars in redemption of his preferred stock was pro rata and resulted in no meaningful reduction in his proportionate interest in the corporation. As a result, the distribution was "essentially equivalent to a dividend" and, by virtue of section 302(d),[45] was treated as a distribution under section 301. Thus, it was includable in the taxpayer's adjusted gross income as a taxable dividend by sections 301(c) and 316.[46]

Justices Douglas and Brennan dissented, claiming that the bona fide business purpose for the redemption prevented characterization of the payment as a dividend.[47] They added that when the Court held this to be a dividend it was effectively cancelling section 302(b)(1) from the Code.[48] This clearly is an overstatement by the dissent, since any redemption that meets the *Davis* test of a meaningful reduction in the taxpayer's ownership rights, will still qualify under section 302(b)(1).[49] The dissent is correct, however, to the extent it implies that *Davis* effectively prevents section 302(b)(1) from applying to stock redemptions to the sole shareholder of a corporation.

IMPLICATIONS OF THE DAVIS DECISION

The Supreme Court's decision in the *Davis* case will bring greater predictability and clarity to an area of the tax law which has plagued Congress, the courts, and the Internal Revenue Service since the introduction of the vague phrase "essentially equivalent to a dividend" in the Code. But the Supreme Court, by focusing upon whether or not a business purpose was relevant and by assuming that a redemption having the same effect as a dividend is necessarily "essentially equivalent to a dividend,"[50] failed to face the central issue of dividend equivalency: under what circumstances may a redemption properly be characterized as a sale of stock?[51] The problem in the area of stock redemptions results from the fact that Congress has seen fit, generally, to tax only the earnings and profits of a domestic corporation upon their distribution to

45. INT. REV. CODE of 1954, § 302(d), quoted in note 4 *supra*. Section 302(d) provides, *inter alia*, that if a redemption is found to be essentially equivalent to a dividend under § 302(b)(1), § 301 is to apply. Hence, even if the redemption is "essentially equivalent to a dividend" under § 302(b)(1), it will only be taxed as a dividend if the redeeming corporation has accumulated earnings or profits. *See* INT. REV. CODE of 1954, §§ 301 and 316, quoted in notes 2 and 3 *supra*.

46. 397 U.S. at 313.

47. *Id.* at 313-14.

48. *Id.* at 314.

49. *See* examples given in note 57 *infra*. *Cf.* Note, *Tax is 'Not Essentially Equivalent to a Dividend' Still There?* 22 BAY. L. REV. 429 (1970).

50. 397 U.S. at 313.

51. S. REP. No. 1622, 83rd Cong., 2d Sess. 44 (1954).

the shareholder, and not when earned.[52] The result is that corporations, to an extent, are permitted to accumulate earnings and profits which are not taxed as income until distributed, if ever, to the owners. Therefore, the basic problem facing Congress in 1954 was how to prevent corporations from distributing these accumulated earnings and profits in the form of a stock redemption, without subjecting a redemption to taxation as ordinary income when the shareholder could have sold his stock to a disinterested third party. Congress, in enacting section 302(b)(1), said that the test was whether the redemption could properly be characterized as a sale.[53] The Supreme Court failed to analyze in the *Davis* case whether there was any change in the incidents of ownership in the corporation resulting from the redemption of the taxpayer's preferred stock. The Second Circuit Court of Appeals in *Himmel v. Commissioner*[54] found that the ownership of stock involved the right to vote, the right to share in the net assets upon liquidation of the corporation, and the right to participate in current profits and accumulated surplus. Of course, since the taxpayer in *Davis* was constructively the sole owner of the corporation, none of these rights were affected by the redemption of his stock. However, the Supreme Court by stating that to qualify for preferred treatment under section 302(b)(1) a redemption must result in a meaningful reduction of the shareholder's proportionate interests in the corporation,[55] without enumerating what were the relevant interests, left unclear what would be the proper treatment of cases in the future involving a number of stockholders holding different classes of stock in various proportions and situations where the redemption is not pro rata.

Even accepting the Supreme Court's conclusions that a business purpose is irrelevant, and the redemption resulted in no meaningful effect on the taxpayer's ownership interests, there are at least three analogous transactions which may cast doubt on the Court's holding that this redemption was "essentially equivalent to a dividend." First,

52. Compare this treatment of domestic corporate distributions with that in INT. REV. CODE of 1954, §§ 551 and 951. Under certain circumstances, these sections tax the earnings and profits of a foreign corporation as dividends to the United States shareholder whether or not the corporation distributes these earnings and profits to the shareholder.

53. S. REP. No. 1622, 83rd Cong., 2d Sess. 44 (1954). As stated in Bradbury v. Comm'r, 298 F.2d 111, 114 (1st Cir. 1962): "Those transactions [when a corporation acquires its own stock] which more closely resemble sales are accorded capital gains treatment while those partaking of the essential attributes of a dividend—however styled—are taxable at ordinary income rates."

54. 338 F.2d 815, 817 (2d Cir. 1964).

55. 397 U.S. at 313.

the taxpayer's purchase of preferred stock coupled with an agreement from the corporation to redeem it when the RFC loan was repaid, is similar to a subordinated loan from the taxpayer to the corporation. The difficulty with this characterization of the *Davis* situation is that, in light of the fact that the RFC would not have given the corporation a loan until more capital had been contributed, the *Davis* corporation was probably too thinly capitalized to permit the Court to reconstruct the transaction as a subordinated loan.[56] There is even less reason to re-cast the transaction as a debt after the taxpayer purchased Bradley's 500 shares since he was then constructively the sole shareholder. Second, the transaction in *Davis* is similiar to the sale by the taxpayer of his preferred stock to a disinterested third party; but, the sale to a disinterested third party would have resulted in a decrease in the taxpayer's incidents of stock ownership which did not occur in *Davis*. Third, the transaction was in some respects similar to a redemption prior to the taxpayer's purchase of Bradley's shares. But this analogy is destroyed because such a redemption would not have been pro rata and would have resulted in a decrease in the taxpayer's incidents of stock ownership, unlike the *Davis* transaction.

The dissimilarities in each of these analogous transactions should preclude any assertion that the Supreme Court placed a premium on form over substance by not characterizing the *Davis* transaction as one of the above. Even though the Supreme Court looked at the substance of the transaction, by focusing on the lack of relevance of a business purpose and failing to articulate what it was that distinguished *Davis* from these types of analogous transactions, it failed to face the basic issue under section 302(b)(1): what prevented the *Davis* redemption from properly being characterized as a sale.

Congress, by making the sole inquiry under section 302(b)(1) whether or not the redemption could properly be characterized as a sale and omitting the terms "at such time and in such manner," gave notice that section 302(b)(1) was no longer solely concerned with preventing tax avoidance schemes. The phrase "essentially equivalent to a dividend" was no longer merely meant to prevent tax avoidance. In addition, it was meant to prevent unfairness in a situation where a shareholder's stock was redeemed (which, without section 302(b)(1), would be taxed as a

56. *See* Jewell Ridge Coal Corp. v. Comm'r, 318 F.2d 695 (4th Cir. 1963), which held that advances by a controlling corporation to its thinly capitalized subsidiary were contributions to capital and not loans for federal income tax purposes. *But cf.* Edwards v. Comm'r, 415 F.2d 578 (10th Cir. 1969). *See also* INT. REV. CODE of 1954, § 385.

dividend by section 301), when he could have sold the stock to a disinterested third party. Thus, the dissent in *Davis* is correct in saying that the majority effectively cancelled section 302(b)(1) from the Code, at least in cases involving closely held corporations. However, by doing so the majority was merely correcting an error in the interpretation of section 302(b)(1) that had developed in the circuit courts. The redemption of stock by a closely held corporation is not like the sale of the same stock to disinterested third parties. In a transaction involving a closely held corporation and a pro rata redemption, the shareholders relinquish no rights to current or accumulated earnings, they relinquish no rights to assets upon liquidation, and they relinquish no control over the corporation. Therefore, such a transaction was never intended by Congress to come under the exception in section 302(b)(1) to section 301.

Clearly, the scope of section 302(b)(1) has been narrowed by the *Davis* case, but it is not cancelled. For example, a redemption that is not pro rata and results in a significant decrease in the shareholder's right to current earnings and accumulated surplus, right to control the corporation, or right to the assets of the corporation on liquidation should still be exempted from dividend treatment by section 302(b)(1) under the *Davis* interpretation.[57]

It can be concluded from the Supreme Court's holding in *Davis* and its previous ruling in *Commissioner v. Estate of Bedford*[58] that, in cases involving dividend equivalency, the existence of a legitimate corporate business purpose for the transaction will not determine the resolution of the problem. Also, for purposes of section 302(b)(1), the redemption of a sole shareholder's stock will always be deemed "essentially equivalent to a dividend." Hence, the *Davis* case will bring greater predictability and security in terms of tax planning in the area of

57. 338 F.2d 815 (2d Cir. 1964); Rev. Rul. 56-183, 1956-1 CUM. BULL. 161; and Rev. Rul. 55-462, 1955-2 CUM. BULL. 221 would seem to meet the *Davis* test and still be valid examples of the scope of § 302(b)(1). A redemption involving more than one class of stock not held proportionately by the same shareholders resulting in a distribution that would be different from a dividend might still come under § 302(b)(1), especially if the shareholder's interests in the corporation were substantially changed. *See* Northup v. United States, 240 F.2d 304 (2d Cir. 1957). Even a pro rata corporation might come under the *Davis* rationale. *See* Rev. Rul. 56-485, 1956-2 CUM. BULL. 176 which held that a pro rata redemption by a corporation of 20 per cent of its preferred stock, where the preferred was not owned by those shareholders in substantially the same proportion as they owned common stock (resulting in a decrease of their ownership interests), was not essentially equivalent to a dividend. *See also* Rev. Rul. 56-540, 1956-2 CUM. BULL. 177. *Cf.* 22 BAY. L. REV. 429 (1970).

58. 325 U.S. 283 (1945).

section 302(b)(1) stock redemptions than has been possible since Congress first introduced the vague phrase "essentially equivalent to a dividend" 59 years ago.

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