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NOTE

STOCK REDEMPTIONS UNDER THE PENNSYLVANIA BUSINESS CORPORATION LAW AND THE INTERNAL REVENUE CODE OF 1954

Modern tax legislation has improved the status and encouraged the formation of the small "close corporation."[1] While this favorable treatment encourages the transaction of business in the corporate form, the selection of an effective method of disposing of an interest, and possibly thereby control, presents formidable problems for the unwary shareholders.[2] It is the purpose of this note to consider the effects of one method of disposition whereby the corporation itself buys the shares from the shareholder, that is, the "stock redemption." "Stock redemption" is a term which has received an enlarged meaning from the tax law.[3] Briefly, it is defined by the Internal Revenue Code of 1954 as a corporation acquiring "its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."[4] Pennsylvania law appears to restrict the meaning of the term somewhat, as "redemption" in Pennsylvania involves an acquisition by the corporation of its shares which are subject

1. See Polisher and Aaron, *The 1958 Technical Amendments Act—Estate and Gift Tax Changes and Small Business Tax Revision*, 63 DICK. L. REV. 185 (1959). In SARNER (Rev. by Mette), ORGANIZATIONAL PROBLEMS OF SMALL BUSINESSES (1956), the author states at p. 54: "The differences in tax treatment between the proprietorship on the one hand, and the corporation on the other, result in the main from two basic factors. The one is the question of rates, the other is the nature of the taxable entity." This difference in nature of the taxable entity (and thereby the rates) has been removed in the case of certain corporations electing to be taxed as partnerships. INT. REV. CODE of 1954 §§ 1371-7. See also Polisher and Aaron, *supra* at p. 202. The "double taxation" feature of the corporation has proved to be the primary drawback in selecting the corporation as a business form: SARNER, *supra* at p. 58. The tax changes would therefore seem to favor the corporation over the other business forms today where the corporation meets the qualifications of the INT. REV. CODE of 1954 §§ 1371-7. But see Jardine, *Tax and Estate Planning for Owners of Small Corporations*, 7 UTAH L. REV. 48-50 (1960) and Caplan, *Partnership or S. Corporation?*, 13 J. TAXATION 32 (1960) for problems contained in such election.

2. See Hull, *Tax Planning to Avoid the Dividend Hazard in Stock-Purchase Agreements*, 13 J. TAXATION 337 (1960); Jardine, *Tax and Estate Planning for Owners of Small Corporations*, *supra* note 1. Greene, *Tax Traps for Company and Owner Lie Hidden in Many Stock Redemption Plans*, 14 J. TAXATION 12 (1961); Casey, *Hazards Which Today Threaten Harsh Tax Consequences of Redemptions*, 12 J. TAXATION 325 (1960); and Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961). For an exposition of problems in insurance funding, see Newhoff, *Life Insurance Funding of Business Buy Out Agreements*, 25 Mo. L. REV. 3 (1960).

3. Herwitz, *supra* note 2 at 886-899.

4. INT. REV. CODE of 1954 § 317(b).

to redemption by classification.[5] The term "redemption" used hereafter will be that meaning ascribed under the tax laws and will not be restricted to acquisitions involving "redeemable" shares.

This note will emphasize the stock redemption from two viewpoints which are considered of great importance: (1) The ability of the corporation to redeem its shares under Pennsylvania law; and (2) The tax ramifications under the Internal Revenue Code of 1954 arising from a stock redemption.

Much has been written about the purpose of the stock redemption—especially in the case of a small "close corporation"[6]—and the reasons given could be summarized generally as follows: (1) The corporation must be able to control who the future shareholders will be if it is to continue as an effective business unit; (2) while being somewhat collateral to the above, the shareholder will want to provide a reasonable sale for the surviving family in the event they are unskilled in corporate matters; (3) if the interest of the shareholder forms a large portion of his estate, the need for liquidity to handle immediate expenses will require a "quick sale" for an adequate consideration of at least some of the shares; (4) the shareholder may wish to sever his interest with the corporation, *while living*, so as to enter other businesses or to retire; and (5) the shareholder may wish to reduce his interests in the corporation so as to effect a transfer of control while he retains an interest in the corporation. The underlying problem of valuation is present throughout all five rationales.

In ascertaining the possibility of the stock redemption, the initial problem lies with the corporation's power to redeem stock.[7] Suffice it to say that

5. The Business Corporations Act of 1955, 15 PA. STAT. ANN. tit. 15, § 2852-701 (1959) distinguishes between a "purchase" and a "redemption." The term "redemption" is used in reference to repurchasing shares "subject to redemption." It should be pointed out that while shares "subject to redemption" may be purchased by the corporation, redemption involves unilateral action by the corporation pursuant to the power contained in the articles. The Act does not appear to require that the redeemed shares be cancelled, but it distinguishes between those shares subject to redemption and those not subject to redemption in outlining corporate action necessary for such cancellation: PA. STAT. ANN. tit. 15, § 2852-708(A) (Nov. 1959). See also PA. STAT. ANN. tit. 15, § 2852-709 (1959). There is one instance where cancellation would result—where shares are redeemed and the corporation has neither capital surplus nor earned surplus. This, however, would stem from accounting and not a mandate of the statute.

6. See *e.g.*, Pennish, *Tax Effect of Buy-Sell Agreement Now Clearer*: *Many Types Are Practical*, 11 J. TAXATION 270 (1959); Hall, *supra* note 2 at 337; Jardine, *supra* note 1 at 53-69; and Comment, 44 MARQ. L. REV. 96 (1960).

7. In Mountain State Steel Foundries, Inc., 18 T.C.M. 306 (1959), the Commissioner attacked the redemption plan as being outside the scope of corporate power due to state law. He argued that there was no genuine indebtedness arising from a note given in consideration for the shares hence no interest deduction should be allowed. Further, any accumulations to meet the payments of the note were not required for the "reasonable needs of the business," thus the corporation was subject to the accumulated earnings tax. The Court of Appeals of the Fourth Circuit rejected this argument and emphasized the fact that the corporation had gone to the state court for a determination that the redemption agreement was valid: 284 F.2d 737, 740 (4th Cir. 1960). Finally,

where the corporation lacks the power to redeem the shares in question, the agreement could be attacked as not merely ultra vires, but also illegal,[8] and liabilities could attach to the shareholders and directors.[9] The Business Corporation Law of Pennsylvania generally defines the power of the corporation to buy its shares by reference to "redeemable shares" and "non-redeemable shares."[10] The inquiry here will be restricted to the assumption of a corporation which has but one class of shares issued, *viz.* voting common shares.[11]

The corporation has the right to purchase its "non-redeemable" shares upon resolution of the board of directors to the extent of its unrestricted and unreserved earned surplus.[12] Upon a majority vote of its shareholders (within one year prior thereto) the corporation may purchase its shares to the extent of its unrestricted capital surplus.[13] However, this is the limit

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the court said in dictum that the statute "prohibits use by a corporation of its funds to purchase its own stock if such use will impair capital. It says nothing of executory agreements *which create no rights in competition with creditors.*" (Emphasis added.) However, this statement would have the effect of treating the agreement as nugatory, for the redeeming shareholder would lose his status as a creditor. This could ultimately impair, if not extinguish, the corporate power to perform the redemption contract. *Contra*: Topken, Toring and Swartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 765 (1928), criticized in Comment, 42 HARV. L. REV. 829 (1929). This case was not literally followed in Steinburger v. William C. Atwater and Co., 28 N.Y.S.2d 613 (1941). The corporate power to redeem is covered by statute in Pennsylvania. See PA. STAT. ANN. tit. 15, § 2852-701 (1959).

8. An illegal contract is "void" where it violates a statute or public policy. See FLETCHER, CORPORATIONS § 3400 (1931). "[Unlike an ultra vires contract] it may be defended against and avoided by any of the parties thereto. The underlining equities or real intent of those who choose to repudiate the contract cannot be considered": Shaw v. Circle Fisheries Co., 37 Erie L. J. 351 at 354 (Pa. 1954). *Cf.* Acker v. Girard Trust, 42 F.2d 37 (3d Cir. 1930); In re Matthews Construction Co., 120 F. Supp. 818 (S.D. Cal. 1954); United Thacker Coal Co. v. Peyton Lumber Co., 15 Fed. Supp. 40 (S.D. W. Va. 1936). Any redemption contract which will "impair capital" contravenes PA. STAT. ANN. tit. 15, § 2852-701 (1959) and would seem to be illegal. The defense of impossibility of performance could be successfully asserted on grounds of illegality. See Restatement, Contracts §§ 456-58 (1932). This must be distinguished from ultra vires contracts where the defense is restricted by statute: See PA. STAT. ANN. tit. 15, § 2852-303 (1959).

9. PA. STAT. ANN. tit. 15, § 2852-707 (1959) places joint and several liability upon directors, unless they dissent in writing or have their dissent placed upon the minutes, for any unlawful distribution. A shareholder is also liable for the amount he received but must be sued within two years thereafter. While there is a different rule applying to shareholders taking without knowledge, it would seem unlikely that a shareholder would take without knowledge in a small corporation. Since a corporation might experience difficulties in operation during this transitional period, the directors and shareholders are on precarious ground.

10. See note 5, *supra.*

11. A corporation, to qualify for taxation as a partnership may only have one class of stock: INT. REV. CODE of 1954 § 1371(a)(4). This means that the corporation may have more than one class of stock authorized, so long as only one class is *issued*: Treas. Regs. 1.1371(g).

12. PA. STAT. ANN. tit. 15, § 2852-701(B)(1)(i) (1959). See also PA. STAT. ANN. tit. 15, § 2852-2 (1959). But *cf.* Mountain State Steel Co., 284 F.2d 737, 741 (4th Cir. 1960).

13. PA. STAT. ANN. tit. 15, § 2852-701(B)(1)(ii) (1959).

of the corporate ability to purchase "non-redeemable" shares.[14] It can be seen that a corporation may not be able to buy the controlling shareholder's interest in the typical situation without the help of outside financing, *i.e.*, insurance.[15]

Nevertheless, another alternative is open to the corporation by use of the "redeemable" share. The Business Corporation Act provides that the corporation may purchase, upon resolution of the board of directors, those shares subject to redemption.[16] But, it also provides that these shares may be purchased only to the extent of: (a) its unrestricted and unreserved earned surplus, or (b) to the extent of its unrestricted capital surplus, or (c) to the extent of stated capital represented by the shares. There are no restrictions placed on "redeemable" stock as exist upon purchase of "non-redeemable" stock, hence it is evident that this type of share would probably place no obstacle in the corporate power to reacquire the shares.[17]

Shares may be made redeemable by the articles upon incorporation.[18] (As we are assuming that there is to be one class, voting common stock, perhaps redemption should be restricted by placing a standard in the articles denoting the situations in which directors may redeem.[19]) But, assume that the corporation has already been formed and capitalized by non-redeemable shares. In this case, the corporation may amend its articles to reclassify the "non-redeemable" shares as "redeemable."[20] While there appears to be no

14. There are some circumstances under which a corporation may purchase its shares, which are not deemed relevant here: See PA. STAT. ANN. tit. 15, § 2852-701(B)(1)(iii) (1959).

15. Note that even though insurance is used to create a special surplus account for the purpose of stock redemption, should a corporate deficit exist at the time scheduled for such redemption, there would be no corporate surplus sufficient to pay for the full purchase price of the stock. See Greater New York Carpet House, Inc. v. Herschmann, 258 App. Div. 649, 17 N.Y.S.2d 483 (1940).

It would seem that outside financing, other than insurance, should be restricted to the case where the corporation has the necessary surplus, for otherwise it would circumvent the statute. One alternative is left open to the corporation and that is to redeem the shares by a corporate note. The initial question arises whether the note constitutes an impairment of capital. One court has answered in the negative by engrafting a condition on the contract and the note that the corporation be able to legally perform the contract, *i.e.*, that performance of the contract will not impair the capital: Mountain State Foundaries, *supra* note 12 at 743. This reasoning could be extended to making the decision of whether the contract, and thereby the note, is enforceable depend upon the status of the corporate surplus at each payment of the note thereby rendering the device legal in most situations.

16. PA. STAT. ANN. tit. 15, § 2852-701(A) and (B)(2) (1959).

17. This would have the effect of allowing the corporation to transfer its assets in payment thereof or give a note which would be valid under any test for the note would not "impair capital." See note 15, *supra*.

18. PA. STAT. ANN. tit. 15, § 2852-204(6) (1959).

19. This would provide for protection in that the majority could not engulf the minority, hence would make the redemption feature attractive to subscribers.

20. PA. STAT. ANN. tit. 15, § 2852-204(6) (1959). See Comment, 1954 ILL. LAW FORUM 688 and Annot., 48 A.L.R.2d 392 for a discussion of the right to create common shares subject to redemption. While the point is made that other state statutes forbid

Pennsylvania litigation on this point, cases dealing with a comparable reclassification tend to demonstrate that such an amendment is valid so long as it is fair to the minority stockholders.[21] Should the contrary appear, it is possible that the amendment might be set aside.[22]

In addition to the inclusion of a standard for redemption as mentioned above, the amendment must also provide for the type and amount of consideration to be given in exchange for the shares. Most likely, a cash or property payment term is essential to its validity.[23] However, it may be wise to insert a provision expressly providing that the redemption contract may contain, at the shareholder's option, any other consideration deemed satisfactory to the shareholders and corporation.[24] If such a provision was used, the corporation would be able to execute a note in payment, and thus spread the financial impact over a period of time. In so doing, the immediate heavy drain on capital would be eliminated and continued development would be possible. The amount of the consideration could be based upon a formula, similiar to those used in business "buy-outs," which is agreeable to the shareholders.[25] It would seem that once a price or formula is fixed in the

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creation of common shares subject to redemption, no such restriction is found in the Pennsylvania Business Corporation Law.

21. *Cf.* Cowan v. Salt Lake Hardware Co., 118 Utah 300, 221 P.2d 625 (1950); Clarke v. Gold Dust Corp., 106 F.2d 598, *cert. den.*, 309 U.S. 671 (1940); Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E.2d 127, *aff'd*, 30 N.E.2d 1019 (1937). See also FLETCHER, CORPORATIONS § 3696 (1931) and discussion following p. 858 n.16 in Supp. (1960). While these cases deal with preferred stock, and involve the problem of dividend rights, they illustrate that the reclassification amendment may be reviewed to determine its fairness.

The reclassification can be accomplished without tax consequences. The corporation has power by virtue of PA. STAT. ANN. tit. 15, §§ 2852-204(6), 602, 603, and 801-6 (1959) to amend the articles, and reclassify the shares as redeemable. This reclassification would be considered a tax free reorganization by virtue of INT. REV. CODE of 1954 §§ 368(a)(1)(E) and 354(a)(1) unless the stockholder receives "boot" on the exchange.

22. *Cf.* Weisbecker v. Hosiery Patents, 356 Pa. 244, 51 A.2d 811 (1947) where a corporation, although it had statutory power to dissolve, was enjoined because of the unfairness to the minority shareholder.

23. It would seem payment by other means, such as notes, could be attacked by the minority shareholders, if any, by asserting that the amendment will constitute them "quasi-creditors," who should have the right to demand payment in lawful currency or that deemed valid under the Business Corporation Law. See PA. STAT. ANN. tit. 15, § 2582-701 (1960) ("cash or property," *i.e.*, a corporation must pay a redeeming shareholder in cash or property). Hence, it would be arguable that any other consideration would be such a fundamental change as to constitute divestment of a contract or property right. While the amendment, because of the minority shareholder's objection, could not be enjoined unless it was unfair, it would seem the shareholder would have the common law remedy of appraisal. See note 26, *infra*.

24. When the shareholder and the corporation enter into the contract for the buy-sell agreement, the contract could specify a certain type of consideration—perhaps a note. This would provide for an annuity type receipt by the shareholder and may prove attractive to a retiring shareholder.

25. See note 31, *infra*. See Halkias v. Liberty Laundry Co., 361 Pa. 475, 64 A.2d 800 (1949) illustrating the dangers of a mere purchase agreement not based on shares subject to redemption.

articles, changing it would give minority shareholders the right to the appraisal remedy: If the suggested change was unfair, the proposed amendment to the article or the "redemptions" amendment could be enjoined.[26]

One important objection to any payment over a period of time stems from the corporation's accumulation of surplus to meet the obligation which may take the form of a reserve fund to compensate for contingencies. As there are tax restrictions on corporate accumulations, care must be used so as not to run afoul of these provisions.[27] The effect of the accumulated earnings tax will be discussed under tax ramifications.

Assuming that the corporation has the statutory power to purchase the shares, whether "redeemable" or "non-redeemable," the next step lies in the type of agreement to be selected and the terms thereto.[28] Agreements are of three basic types: (1) option agreement whereby the corporation has the option in the first instance to buy the shares before an offer is made to "outsiders"; (2) restricted "buy-sell" agreement whereby the shareholder agrees to sell and the corporation agrees to buy the shares at a stated price; and (3) an agreement akin to a "restricted buy-sell" contract, except that the corporation guarantees a buyer, *i.e.*, either itself or another buyer at the stated price. It can be seen that an option agreement would not serve the purposes of the stockholder and may be discarded. It would seem to make little difference whether (2) or (3) is selected. However, their divergence can be illustrated by assuming that "non-redeemable" shares have been issued. If there is not sufficient earned and capital surplus (assuming a favorable election), the corporation would be powerless to redeem the stock.[29]

26. Once a price is set, any change could be attacked by asserting that the redemption price and mode of payment are contract rights existing between the shareholders. The supreme court has stated that these rights may not be affected by amendments because they are akin to property rights, which may only be taken where fair consideration is given in exchange therefor. Schaad v. Hotel Easton, 369 Pa. 486, 87 A.2d 227 (1952); *cf.* Lauman v. Lebanon Valley R.R. Co., 30 Pa. 42 (1858). It is an open question whether this rule would apply in a situation where incorporation occurred after the enactment of the Business Corporation Law of 1933 which *apparently* gives the corporation unlimited power to amend the articles. However, in Metzger v. George Washington Memorial Park, Inc., 380 Pa. 350, 110 A.2d 425 (1955), the supreme court indicated that the above rule applies to an amendment by a corporation even under the Business Corporation Law of 1933.

It would seem that the shareholders, while they may not stop the amendment, have a common law right of appraisal which may not be effected by legislative action. See Lauman v. Lebanon Valley R.R. Co., *supra* at 49.

Where the amendment does not merely affect the minority shareholder's rights but constitutes unfairness, it may be enjoined. See note 22, *supra*.

27. INT. REV. CODE of 1954 §§ 531-537.

28. See *e.g.*, Jardine, *supra* note 1 at 59-66; Hull, *supra* note 2 at 337; and Pennish, *Tax Effect of Buy-Sell Agreement Now Clear*; *Many Types Are Practical*, 11 J. TAXATION 270 (1959).

29. This assumes a court would not enforce part of the agreement nor would it apply a test to determine validity of the contract by referring the power of the corporation to each payment in reference to the surplus at that time. See note 7, *supra*.

By inserting the alternative provision, the agreement is enforceable to the end that the corporation must endeavor to find a buyer. If it does not, the agreement is merely unenforceable due to impossibility of performance. Nevertheless, there exists the additional duty on the part of the corporation to seek out a buyer. On this basis, the third type may be more desirable when dealing with "non-redeemable" shares.

One of the most important elements of the contract is, of course, valuation of the shareholder's interest.[30] Since many of the small "close corporations" do not list their stock on any exchange, the shares being unmarketed, no objective means of valuation is available. Thus, a problem is presented in arriving at a fair and satisfactory price. For this reason, the value attached in the agreement will need to reflect the inherent value of the shares. Valuation also becomes important for estate and inheritance tax purposes.[31] (There could also be gift tax ramifications where the amount received is inadequate for the interest sold.) The problem of valuation is deemed too broad for consideration in this note, and hence will be excluded. Its importance in this area, however, cannot be over-emphasized.

Assuming that the type of agreement has been selected and the valuation has been effected, the next consideration and perhaps the most far reaching is the income tax ramifications of the redemption agreement. Basically, the redemption which involves an exchange of shares for property or money is an event having tax consequences upon the shareholder and corporation.

The exchange of shares for money or property is generally categorized as a corporate distribution.[32] The treatment of any distribution to the shareholder is divided into two categories: dividends[33] and a return of capital.[34] That part of the distribution which is considered as a dividend is treated as ordinary income[35] while that part which is treated as a return of capital is offset against the basis of the stock and the gain or remainder is accorded

30. Willcox, *Valuation of Close Held Business Interest*, 35 TRUSTS BULL. 36 (1955); Rockefeller, *Valuation of Closely Held Stock for Estate and Gift Tax Purposes*, 36 TAXES 259 (1958); Maney, *Money Valuation of Common Stock of Unlisted Corporations*, 33 TAXES 584 (1955); Page, *Setting the Price in a Close Corporation Buy-Sell Agreement*, 57 MICH. L. REV. 655 (1959).

31. See note 30, *supra*. It should be noted, however, that while Treas. Reg. 20.2031-2(h) gives effect to the valuation in "buy and sell" agreements for estate tax purposes, it will not give that corresponding effect to the option agreement. The courts do not follow the valuation agreements in the realm of the gift tax, however. See 1 C.C.H. Fed. Est. and Gift Tax Rep. ¶ 1202.08. Pennsylvania does not follow the federal view and will not accept this valuation for inheritance tax purposes: See McLure Appeal, 347 Pa. 481, 32 A.2d 885 (1943).

32. See INT. REV. CODE of 1954 §§ 301-307.

33. INT. REV. CODE of 1954 § 301(c)(1).

34. INT. REV. CODE of 1954 § 301(c)(2) and (3).

35. INT. REV. CODE of 1954 § 301(c)(1) provides that: "That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income."

the treatment as a sale of a capital asset.[36] To the extent that a corporation has current or accumulated earnings and profits, the entire amount received will be treated as a dividend.[37] Therefore, the corporation may not arbitrarily distribute funds from capital in order to gain the favorable tax treatment unless it is involved in a reorganization or liquidation.[38] Having the entire amount received treated as ordinary income will result in disaster as can be seen by a mere reference to the tax rates. In fact, a shareholder who has spent his energies to build up equity in the corporation can witness its rapid dissipation by the application of the normal individual tax rates.

However, the Internal Revenue Code of 1954 has afforded relief to the redeeming shareholder under limited circumstances.[39] It provides that if the requirements are met, the amount received will be treated as a return of capital regardless of the source of payment.[40] The requirements for this redemption depend upon the amount of stock redeemed, the amount of stock owned after the redemption, and other circumstances surrounding the redemption.[41]

There are five situations in which the shareholder may receive favorable treatment: *The first situation is the redemption which is "not essentially equivalent to a dividend."*[42] This test depends upon the circumstances surrounding the distribution but does not depend necessarily upon the earnings or surplus existing at that time. In the case of a small "close corporation," the test would probably be the same as that accorded under the general treatment of corporate distributions.[43] As a practical matter, this situation adds little to the general scheme, and would not seem to be an "exception" to the small "close corporation." However, this test may become a relief provision for redemptions not meeting the other tests.[44]

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36. INT. REV. CODE of 1954 §§ 301(c)(2) and (3).

37. INT. REV. CODE of 1954 §§ 316(a)(1) and (2), 301(c) and 312(a).

38. Dividends must be distinguished from liquidations and reorganizations. See INT. REV. CODE of 1954 §§ 331-368. In those situations, distributions may receive the treatment accorded to returns of capital assuming the tests are met even though the corporation has earnings and profits.

39. See Grather, *How to Redeem a Shareholders Stock*, 39 TAXES 169 (1961); Casey, *Hazards Which Today Threaten Harsh Tax Consequence of Redemption*, 12 J. TAXATION 325 (1960); Hull, *Tax Planning to Avoid the Dividend Hazard in Stock Purchase Agreements*, 13 J. TAXATION 337 (1960); Greene, *Tax Traps for Company and Owner Lie Hidden in Many Stock-Redemption Plans*, 14 J. TAXATION 12 (1961).

40. INT. REV. CODE of 1954 § 302(a).

41. For an excellent discussion of the rules relating to ownership, see Winton and Hoffman, *A Case Study of Stock Redemption Under Sections 302 and 318 Under the New Code*, 10 TAX L. REV. 362 (1955).

42. INT. REV. CODE of 1954 § 302(b)(1). See also Merten, TAXATION (Code Commentary) § 302(b)(1) wherein it lists prior factors used by the courts in arriving at decisions under the Int. Rev. Code of 1939. See also page 380, *infra*.

43. Treas. Reg. 1.302-2(b). This is to be distinguished from situations involving reorganizations and liquidations. See INT. REV. CODE of 1954 §§ 331-368. But see note 50, *infra*.

44. See *e.g.*, Decker v. Commissioner, 32 T.C. 326, *aff'd*, 286 F.2d 427 (1960).

The second situation is a redemption by which the amount of shares redeemed is "substantially disproportionate" to the stockholder's ownership.[45] This test is more specific. It has two requirements: The shareholder, after the redemption, must own less than fifty per cent of the voting stock;[46] and the stockholder must have redeemed a sufficient number of shares so that his shares, in relation to the total outstanding shares after redemption, constitute less than eighty per cent of his shares in relation to the outstanding shares prior to redemption.[47] In other words, his relative position after redemption must be less than eighty per cent of his relative position before redemption. Since this test involves the redemption of voting stock (alone or with other stock), it has as its basis the relinquishment of control in most cases. This test, unlike the "not equivalent to a dividend method," is more mechanical and specific in application.

The third redemption recognized is that which completely terminates the interest of a shareholder.[48] This test is self-explanatory: A stockholder must surrender all shares (of all classes of stock) that he holds in the corporation. If the "termination" test is not met by the stockholder, but the redemption of all his shares would meet another test, then it may qualify under that test.[49] Redemptions need only qualify under one of the five tests—if they qualify under any one, then they receive the "capital gains" treatment.[50]

The two remaining redemptions depend upon special circumstances. They are restricted in application and are not governed generally by the rules relating to the other redemptions. *The fourth type is one which results*

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45. INT. REV. CODE of 1954 § 302(b)(2).

46. INT. REV. CODE of 1954 § 302(b)(2)(B). If there are more than one class of voting stock, the fifty per cent requirement extends to the "total combined voting power of all classes. . . ."

47. INT. REV. CODE of 1954 § 302(b)(2)(C). If the shareholder owns other classes of shares, the common stock must nevertheless meet the test of the eighty per cent figure. If there is more than one class of stock, § 302(b)(2)(C) provides that the test will be determined "by references to fair market value."

48. INT. REV. CODE of 1954 § 302(b)(3).

49. INT. REV. CODE of 1954 § 302(b)(5).

50. It should be noted that in a recent case, Decker v. Commissioner, 32 T.C. 326, *aff'd*, 286 F.2d 427 (1960), five stockholders agreed upon death to sell their stock to the surviving shareholders. A second shareholder died shortly thereafter, and the surviving shareholders purchased his shares. The shareholders in turn resold these shares to the corporation. The redemption by the shareholders did not meet the "entire termination" or the "substantial disproportionate" test of the 1954 Code. Nevertheless, the court found that the redemption was not equivalent to a dividend. Its main reason was: "In applying these criteria to the facts in this case, we find that tax avoidance does not appear to have been a major consideration of this case. The corporation had a good dividend record, having for a number of years paid out in dividends a large part of its earnings after taxes. *The object of both the stockholder and the corporation was to prevent the stock of the company from falling into the hands of widows, minors, or outsiders and this was of benefit to the corporation as well as the stockholders.*" (Emphasis added.) 32 T.C. at 330. This perhaps illustrates a prediction that termination agreements, although not qualifying under that test, may qualify under the "not equivalent to a dividend" test.

from an exchange, by an administrator or another, of stock which is included in the gross estate of a decedent for estate tax purposes.[51] The only qualifications are that the stock comprise either thirty-five per cent of the gross estate or fifty per cent of the taxable estate;[52] and that the distribution occur after the death of the decedent and before the statute of limitations bars assessment of the estate tax.[53] If the conditions are met, the stock of a corporation may be redeemed in an amount equal to the estate tax assessed, administration expenses allowable under the federal estate tax, and state succession taxes.[54] The amount received does not have to be actually expended for the above-mentioned taxes or administration expenses. It should be noted that in determining whether the shares of a corporation fall within the percentage tests only the shares of one corporation may be totalled to qualify. However, where shares comprise more than seventy-five per cent in value of a corporation, they may be added to shares comprising seventy-five per cent in value of other corporations.[55] Thus, they are treated as if they were shares of one corporation in determining whether the stock qualifies for the redemption. If the redemption qualifies with the above condition the exchange is treated as a return of capital. It is important to note that this redemption is determined without regard to rules of ownership to be discussed later. Because of this, it could be stated that the "303 redemption" is further relief when death occurs, and where the other type of redemptions may not afford relief.[56]

The fifth situation in which a redemption qualifies under the relief provisions is an exchange "of stock issued by a railroad corporation (as defined in section 77(m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act."[57] This situation is of limited interest and is mentioned to complete the statutory outline. It should also be noted that a redemption may be treated as a gain or loss from the sale or exchange of a capital asset if the redemption occurs in the course of a contraction of corporate activity followed by a partial liquidation.[58]

The Code also has the further requirement that these tests, with the

51. INT. REV. CODE of 1954 § 303.

52. INT. REV. CODE of 1954 § 303(b)(2)(A). Since shares need only be included in the gross estate, donees in contemplation of death, beneficiaries receiving their stock prior to the time the statute bars the assessment of estate tax, or other situations in which the donee's shares are included in the gross estate could redeem shares under this provision: Treas. Reg. 1-303-2(f).

53. INT. REV. CODE of 1954 § 303(b)(1).

54. INT. REV. CODE of 1954 §§ 303(a)(1) and (2).

55. INT. REV. CODE of 1954 § 303(b)(2)(B).

56. See page 382, *infra* for a situation in which the "303 redemption" could be employed.

57. INT. REV. CODE of 1954 § 302(b)(4).

58. INT. REV. CODE of 1954 §§ 331(a)(2) and 346.

exception of the last two mentioned, are not to be measured merely by the shares actually owned by the shareholder, but certain types of constructive ownership must also be considered.[59] There are four areas of constructive ownership: members of a family, partnerships and estates, trusts, and corporations.[60] These rules are commonly known as "attribution rules." The "family" rule ascribes to the person all stock owned by his spouse, parents, children, and grandchildren.[61] While it applies to adopted children, it is restricted to those members listed within the rule. "In-laws," for example, are not considered as "members of the family." The partnership and estate rules are similar in that the stock is considered as owned by each individual in proportion to his interest in the partnership and the estate.[62] The ownership of the individual is also ascribed to the estate or trust.[63] In the case of an estate, note that the stock is deemed to be constructively owned in proportion to the beneficiary's interest in the estate regardless of whether the stock would be considered as descending to him. The "trust" rule is analogous to the "estate" rule, except that the interests of the beneficiaries in the res are calculated on an actuarial basis.[64] The trust, like the estate and partnership, has attributed to it the ownership of its beneficiaries' shares. Any contingent interest which constitutes less than five per cent of the value of trust property will not be considered within the trust for purposes of this rule.[65] This must be distinguished from the "estate" rule which has no such limitation. The "corporation" rule ascribes the ownership of the corporation to its shareholder in proportion to his interest if he owns fifty per cent or more, in value, of the corporate shares.[66] The corporation, in such a case, would also be considered as owning the individual's shares. Whenever the individual is no longer a member of a corporation or partnership, or receives his share of the trust or estate, his individual ownership is no longer attributed to the corporation, *etc.*, nor is the ownership of the corporation, *etc.*, attributed to him.

In applying the "attribution" rules, the situation may arise for their consecutive application: *e.g.*, If a father and son actually own shares, and the son is also the beneficiary of a trust, the shares of the trust would be attributed proportionately to the son, and these, coupled with the shares he actually owns, would be reattributed to the father. However, the "family"

59. See note 41, *supra*.

60. INT. REV. CODE of 1954 § 318.

61. INT. REV. CODE of 1954 § 318(a)(1)(A). Adopted children are treated as blood children under this rule. *Id.* § 318(1)(B).

62. INT. REV. CODE of 1954 § 318(a)(2)(A).

63. *Ibid.*

64. INT. REV. CODE of 1954 § 318(a)(2)(B).

65. *Ibid.*

66. INT. REV. CODE of 1954 § 318(a)(1)(C).

rule will only be applied once.[67] The constructive ownership may not again be applied: *e.g.*, A daughter-in-law's shares could be attributed to her husband, but not from the husband to his father, as this would result in reattribution by virtue of the "family" rule. Note also that the daughter-in-law's ownership could not be attributed to the father in the first instance.

In correlating the two tests, the ownership rules apply to all the tests although it would seem that they have no relevance in determining whether a redemption is "not essential to a dividend."[68] The interrelation between the "family" rule and the "not essential to a dividend" test has been applied in two recent cases. In *Lewis v. Commissioner*,[69] the tax court applied these concepts in a situation where a majority shareholder, upon her death, bequeathed such holdings to her daughters. While the husbands of the latter were already shareholders, only one of the daughters had an interest in the corporation prior to the mother's death. The daughters, acting in the capacity of executrices, could not satisfy the indebtedness of the estate without a sale of the stock, and thus proposed a stock redemption which was accepted. Upon the redemption, the daughters and their husbands owned 100 per cent of the corporation: The Commissioner asserted this distribution was essentially equivalent to a dividend. The tax court agreed. It applied the "family" rule to attribute the husbands' stock to their wives and the "estate" rule to reattribute the husbands' stock, along with the one wife's shares, to the estate of which the three wives were beneficiaries. Thus, the estate was deemed to "own" 100 per cent after the redemption. And, stated the court:

> [W]ith that assumption in mind, we conclude that the redemption herein was essentially equivalent to a dividend. For, the picture thus presented is one of corporate withdrawals [mother's indebtedness] from time to time by a dominant stockholder for her needs, where the corporation has never declared a dividend although having sufficient accumulated earnings and profits to do so, followed finally by a cancellation of indebtedness in exchange for stock upon the death of the stockholder where such cancellation and redemption could not possibly have any economic effect upon the stockholder-corporation relationship, and when there was no plan either to contract the corporate enterprise or to use the redeemed shares in any manner for a corporate purpose.[70]

In *Squier Estate*,[71] which was decided subsequent to the *Lewis* case, the facts were similar. Here, a majority shareholder died leaving stock to his wife, daughter, and grandson. However, there was a minority share-

67. INT. REV. CODE of 1954 § 318(a)(3)(B).
68. See Treas. Regs. 1-302-2(b), and Sinrich, *Family and Estate Attribution Made in First 1954—Code Dividend Equivalence Case*, 14 J. TAXATION 136 (1961).
69. 35 T.C. 71 (1960).
70. *Id.* at 78.
71. 35 T.C. 691 (1961).

holder, unrelated to the above family. This minority shareholder and the decedent entered into a purchase agreement with the corporation, giving their estates the option to redeem thirty per cent of their interest at death. The estate of the father exercised the option, and the Commissioner attacked part of the distribution (not falling within the purview of a "303 redemption") as being essentially equivalent to a dividend. In this case the tax court disagreed and distinguished the *Lewis* case, stating:

> In this case [*Squier Estate*], a substantial minority interest, not covered by the attribution rules, was held by Otto Shilling . . . . [A]nd, in spite of the attribution rules as to stock "ownership," the redemptions herein in fact resulted in a crucial reduction of the estates *control* over the corporation. Accordingly, notwithstanding the attribution rules, the redemptions in this case did result in a substantial dislocation of relative stockholdings in the corporation and also in fact brought about a significant change of control. . . . Thus unlike the Lewis Case where there was a history of failure to pay dividends over a long period, the corporation in the present case had declared a dividend (albeit a conservative one) for a number of years prior to the redemptions.[72]

Thus, the attribution rules appear to be relevant in formulating the "ownership structure" from which other factors may be weighed in the "not essential to a dividend" test. It would appear that the tax court will employ circumstances deemed relevant under the 1939 Code, but only after the stock has been arranged pursuant to the attribution rules under the 1954 code. In the "complete termination" test, the "family" rule applies only where the shareholder does not meet specific requirements set out in Section 302(c).[73] This is the only exception in the complete correlation of the rules.

To illustrate the above, consider first a small family corporation in which the father, F, owns seventy of one hundred outstanding common voting shares. His son, S, owns twenty shares and S's wife, D, owns the remaining ten shares. If F desired to completely terminate his interest he would be successful if the "family" rule is not applied. He would not "own" any shares in the corporation after redemption, and thus would comply with the complete termination test.

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72. *Id.* at 695.

73. This in essence provides that the distributee cannot maintain an interest in the corporation as an officer, director, or employer other than as a creditor. It further provides that the distributee will not acquire an interest within ten years from date of distribution. This exception is also restricted in that there cannot have been any stock redeemed which was acquired within ten years prior to redemption and whose ownership from persons can be attributed to the distributee; nor can other persons whose ownership can be attributed to the distributee hold stock acquired within ten years from the distributee, after his stock is redeemed. This is qualified in that if the distributee did not have as his purpose the avoidance of federal income tax by the transfer, then the prior ownership of either the distributee's shares or those whose ownership can be attributed to the distributee will not exclude the operation of the exception.

However, assuming application of the "family" rule, he would be considered as owning the twenty shares of S, and thus would not qualify under the "complete termination" test. In applying the "substantially disproportionate" test, F's redemption will not qualify because S's twenty shares, which will be attributed to F, constitute more than fifty per cent of the voting shares after redemption.[74]

F probably cannot successfully plan to redeem his stock upon death. If he includes S and D as beneficiaries, their thirty shares would be attributed to the estate via the "estate" rule. This would disqualify the estate for either the "entire termination" test or the "substantial disproportionate" test.[75] If he were to exclude both S and D from his estate and select his wife, W, and S and D's children, the redemption would not qualify under Revenue Ruling 59-233.[76] Even though the "complete termination" test precludes, in certain situations, the application of the "family" rule, the Commissioner has ruled that this exception applies only to individuals.[77] Thus, S's shares would be attributed to W or the children, D's shares would be attributed to the children, and those shares would then be reattributed to the estate. Thus, unless F would go beyond this natural group, a redemption would be ill-advised. In such a situation, a "303 redemption" would be a partial relief.

Suppose that F transferred thirty shares to a trust with his wife W as income beneficiary and S and S's brother, B, as vested remaindermen. (Assume further that W's interest constituted forty per cent of the trust and the interests of the two brothers were each thirty per cent.) If the "family" rule is applied, the redemption of F's remaining forty shares would not qualify under either the "entire termination" or "substantial disproportionate" test. S's twenty shares would be attributed to F as above. The trust's thirty shares would be attributed as twelve to W, and nine shares each to S and B. These thirty shares would then be reattributed to F, and he would be considered as owning fifty shares.[78] Since, after the redemption, there are only sixty outstanding shares, F is considered as

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74. After the redemption, there will be thirty voting shares as the treasury shares may not be voted: PA. STAT. ANN. tit. 15, § 2852-508 (1957). The thirty shares represent 100 per cent ownership. Hence, the twenty shares instead of being 20 per cent as before redemption now become 66 2/3 per cent. But see note 50 for the possibility that the redemption would qualify under the "not essential to a dividend" test.

75. The estate would be deemed as owning the thirty shares which constitutes 100 per cent ownership. See note 74, *supra*.

76. 1959-2 Cum. Bull. 106. See also Gleason and Jones, *Recent Ruling Creates Double Attribution in Redemptions*; *Perils Buy-out Plans*; *Error Seen*, 12 J. TAXATION 268 (1960).

77. *Ibid.*

78. After the redemption, there will be sixty voting shares. Since fifty of the sixty voting shares would be attributed to him he will be deemed to have 83 1/3 per cent ownership. See note 74, *supra*.

owning more than fifty per cent of the combined voting power—a fatal defect to the "substantial disproportionate" test.

If S were to wait until death, his chances of success would not be increased. Were he to exclude S, B, D (assuming F has no other children) and even the grandchildren, inclusion of W in his estate would be fatal. S's twenty shares owned outright, his nine shares from the trust, and B's nine shares from the trust would be attributed to W. Along with her twelve shares from the trust, the above mentioned thirty-eight shares would be attributed to the estate after its redemption.[79] The estate would be deemed to own fifty of the sixty outstanding shares, thereby disqualifying it for either the "complete termination" or "substantial disproportionate" tests.

The above illustrations are simple in their basic facts, but they show the drastic effect of the constructive ownership rules to any redemption in a family corporation. They also illustrate the importance of the "303 redemption" in the statutory scheme of taxing redemptions.

Turning away from the strict family corporation, suppose A, who is not related to B or C, owns sixty of one-hundred outstanding shares of Corporation X. B, who is also unrelated to C, owns thirty shares and C owns the remaining ten shares.

If A wishes to terminate his interest, his redemption will qualify as he will be deemed to own none of the shares of Corporation X after redemption. If he wishes to qualify for the "substantial disproportionate" test, he would have to redeem at least twenty-four shares. After the redemption, there would be seventy-six outstanding shares, hence A would own less than fifty per cent of the outstanding shares. A would also qualify in that his relative ownership after redemption is less than eighty per cent of his relative ownership prior to redemption.

(Expressed algebraically:

$\frac{36}{76}$ — A's shares after redemption / Total outstanding shares after redemption

is less than eighty per cent of

$\frac{60}{100}$ — A's shares before redemption / Total outstanding shares before redemption.

$$\frac{36}{76} = 47.4 \text{ per cent}$$

$$\frac{60}{100} = 60 \text{ per cent}$$

47.4 per cent is less than 80 per cent [79 per cent] of 60 per cent.)

79. This attribution is made on the assumption of Rev. Rul. 59-233, 1959-2 Cum. Bull. 106. See note 76, *supra*.

Hence, A's redemption would qualify at this point for the "substantial disproportionate" test.

Suppose that Corporation Y owns thirty shares of Corporation X, instead of B, and A owns thirty shares as above; A also owns sixty shares of an outstanding one-hundred shares of Corporation Y. If A were to redeem his sixty shares in Corporation X he could not qualify under the "entire termination" test. The reason is that eighteen of thirty shares held by Corporation Y of Corporation X would be attributed to A after the redemption.[80] However, A would qualify in this case under the "substantial disproportionate" test as he would be deemed to own eighteen of the forty outstanding shares which is less than eighty per cent of the relative ownership before the redemption (sixty per cent).[81]

Some general statements may be helpful in planning a redemption: (1) The attribution rules applicable, whether it be a family trust, estate, or corporation, should be carefully listed for the various resulting ownership possibilities. (2) The change of the relative status of shares after redemption should be listed as they will encompass a greater interest than before the redemption. (3) Estate planning in other areas, such as the provisions of the will and of any trust, should be carefully coordinated so as to outline the results of death on the inter vivos transfer. (4) The shareholders should be cautioned as to future changes in the estate plan which might change existing formulas. (5) Due to the technical rules, stock redemption plans must be reviewed constantly to insure that revision of another plan does not effect the status of the redemption.

The remaining tax ramification lies in the domain of corporate income tax. The problem may arise where a "reserve fund" is created for future redemptions or in those situations where the corporation must accumulate its surplus to meet the payments on notes given pursuant to a redemption agreement. While a corporation may accumulate surplus, certain dangers are present.[82]

The Internal Revenue Code of 1954 provides that where the corporation accumulates surplus for the purpose of avoiding income tax with respect to its shareholders, a penalty tax will be placed upon the corporation in addition to its corporate income tax.[83] The penalty tax is imposed upon

80. Since A owns 60 per cent of the shares of Corporation Y, the 60 per cent is projected to Corporation X and 60 per cent of Y's holding in X is 18 shares. See INT. REV. CODE of 1954 § 318(a)(1)(C)(i).

81. The ownership in X Corporation is confined to forty shares after redemption. The shares which A has attributed to him by virtue of his ownership in Y Corporation (18) constitute forty-five per cent. Forty-five per cent is seventy-five per cent of sixty per cent, hence it meets the "eighty per cent" rule of INT. REV. CODE of 1954 § 302(b)(2)(C).

82. See Herwitz, *supra* note 2; and Note, 59 DICK L. REV. 146 (1955).

83. INT. REV. CODE of 1954 § 532(a).

accumulated taxable income at the rate of 27½ per cent for the first 100,000 dollars and 38½ per cent of the balance.[84] The "accumulated taxable income" is determined by making certain adjustments to the taxable income of the corporation for the current year.[85] From the adjustment, the dividends paid,[86] the accumulated earnings credit and all income and excess profits tax accrued during the current year are deducted.[87] It can be readily seen that this tax coupled with the income tax make the over-all tax on current income nearly confiscatory.

To escape the penalty tax, the accumulation must not have been made for the purpose of avoiding income tax by the shareholders. In approaching this area, note that the motive not to avoid taxes is subjective and must be proved by circumstances surrounding the redemption. It may be sustained by showing that the accumulation is "for the reasonable needs of the business."[88] If such be the dominant purpose of the accumulation, whether definite or anticipated, it would appear the corporation should not be subject to the tax.[89] *Generally speaking, the burden of proving that the accumulation is beyond the reasonable needs of the business rests with the Commissioner.*[90] But if the Commissioner is able to show that the accumulation is "beyond the reasonable needs of the business," then it is presumed that the purpose of the accumulation was for the purpose of avoiding the income tax.[91] To rebut this presumption, the corporation must prove by a preponderance of the evidence that the purpose of the accumulation was not to avoid income tax on behalf of the shareholders.

The only relief given the corporations in this area is a credit of 100,000 dollars in addition to accumulations needed for the business.[92] Thus, before the Commissioner can attack the accumulations, they must total at least 100,000 dollars. It has been stated that this will "save" most small corporations from liability for the tax.[93] Two recent cases, *Pelton Steel Casting Co.*[94] and *Mountain State Steel Foundaries, Inc.*[95] indicate the potential tax problems in this area.

In the *Pelton Steel* case, the earnings were accumulated *in contemplation of* a redemption agreement. Three individuals had originally incorporated in 1925 and their interests were 900 shares, 300 shares, and 300

84. INT. REV. CODE of 1954 § 531.
85. *Ibid.*
86. INT. REV. CODE of 1954 § 563(a).
87. INT. REV. CODE of 1954 § 531(b)(1).
88. Herwitz, *supra* note 2 at 870.
89. *Id.* at 874-878.
90. INT. REV. CODE of 1954 § 534.
91. INT. REV. CODE of 1954 § 533(a).
92. INT. REV. CODE of 1954 §§ 535(c)(1) and (2).
93. Comment, 44 MARQ. L. REV. at 104.
94. 28 T.C. 153, *aff'd*, 251 F.2d 278 (7th Cir. 1958).
95. 18 T.C.M. 306, *rev'd*, 284 F.2d 737 (4th Cir. 1960).

shares respectively. About 1945, two of the three (one of whom had acquired his 300 shares from one of the original incorporators) owning 1200 shares decided to withdraw from the business. The third party, desiring to keep the corporation in operation, set up a redemption plan for those shareholders wishing to retire. The formulation of the plan occurred in 1945 and surplus was accumulated from that time until 1947 when the redemption plan was executed. The Commissioner sought to impose the accumulated earnings tax on the corporation for the accumulations during 1946. The tax court sustained the assessment stating: "The very substantial and obvious anticipated tax savings to the controlling shareholders accruing from the Ehne-Faurich transaction . . . makes it impossible under the attending circumstances to accept the view that the interdicted purpose did not to some degree permeate the plan."[96] Another reason given was that "A significant factor in the present record is that the [redemption] could have been achieved notwithstanding the declaration of a dividend." Since the controlling shareholders redeemed their stock after accumulations the court felt that a dividend should have been declared regularly, within sound business judgment, until the redemption was actually executed. It appeared to base any accumulation prior to this redemption as not serving a business purpose because it viewed this redemption by controlling shareholders as beyond the "reasonable needs of the business."[97] However, the most objectionable feature of the case appeared in the opinion affirming the tax court. The Circuit Court of Appeals of the Seventh Circuit implied that the redemption by a majority of the shareholders could never serve a business purpose and any accumulations would seem therefore to be for the purpose of avoiding income tax.[98] Thus, estate planners were faced with the possibility that such redemptions would never be possible in the absence of insurance.[99]

In the *Mountain State* case, shareholders, owning fifty per cent of the business, sought to redeem their shares. One reason for the redemption was that the group took no active part in the conduct of the business, hence their share of the profits was restricted to dividends. In addition, the other group, which conducted the business, wished to expand the enterprise and curtail dividends. A typical impasse arose. As a result, the group which was not active in the business were advised to redeem their stock. The corporation agreed to pay 50,000 dollars and to give a long term note for 400,000 dollars. Relying on the *Pelton Steel* case, the Commissioner asserted that this redemption, by a "majority," did not serve a business purpose. The tax court accepted his argument and found no corporate purpose was served

96. 28 T.C. 153 at 179.
97. *Ibid.*
98. 251 F.2d 278 at 281.
99. Greene, *supra* note 2 at pp. 12 and 13.

by the redemption. Consequently, it ruled that accumulations for the purpose of funding the redemption agreement were not for a valid business purpose.[100] The Court of Appeals of the Fourth Circuit reversed the tax court holding that a true conflict existed between the shareholders and was one reason for the redemption agreement.[101] It found, however, that the redemption agreement as a share disposition device was within "the reasonable needs of the business":

> Many business men now anticipate such problems [the court here was referring to the situation of a decedent leaving heirs unskilled in the business] and provide solutions through agreements. . . . It has been held that corporate disbursement to pay insurance premiums to provide a fund with which to purchase stock from the estate of the person whose life is insured do serve a corporate, business purpose [footnote omitted]. If disbursements to create a fund with which to purchase stock serve a corporate purpose, *surely the disbursement of the created fund in purchasing the stock serves the same purpose.* (Emphasis added.)[102]

This decision was lauded as restoring balance to the redemption agreement in the accumulated penalty tax area after the somewhat stilted view taken in the *Pelton Steel* case.[103]

Professor Herwitz in his article, *Stock Redemptions and the Accumulated Earnings Tax*,[104] has approached the problem by categorizing the accumulation in relation (time-wise) to the redemption. He distinguishes the *Pelton* and *Mountain State* cases by pointing to the time at which the surplus was accumulated in each case. In the *Pelton Steel* case, it was accumulated subsequent to the performance of the agreement. It would seem plausible that an accumulation, to serve "a business purpose," should not merely be a means for providing the shareholder with "a treasure chest" upon a redemption. Could it not be asserted that the stockholder contemplated redemption from organization of the corporation and that the accumulated earnings tax has no application to such a corporation?

Perhaps a few general statements may at least lend direction to the possibilities in this area. Accumulations prior to redemption should not be attempted unless the contemplated redemption is pursuant to true corporate needs. It is doubtful that a controlling shareholder should be able to escape tax on the earnings by asserting a future redemption and thereby render the accumulated earnings tax inapplicable to any accumulation by stating it was for the reasonably anticipated needs of the business. Certainly, dis-

100. 18 T.C.M. 306 (1958).
101. 284 F.2d 737 (4th Cir. 1960).
102. *Id.* at 745.
103. Greene, *CA-4 Rejects Section 102 Penalty in Stock Redemption*; *Pelton Steel Collapsed*, 14 J. TAXATION 68 (1961).
104. 74 HARV. L. REV. 866 (1961).

agreement among the shareholders should be considered a valid purpose for redemption in this situation—especially in the case of the minority dissident stockholder. Earnings accumulated during the year of the redemption would appear to be beyond the scope of the tax as there would be no income tax avoided that year.[105] The shareholders would receive the accumulations in consideration for the shares (whether it be cash or the payment of a note), and therefore there would seem to be no attempt to avoid taxes by such an accumulation.

Earnings accumulated subsequent to the redemption would probably be needed to pay a note issued by the corporation. On the basis of the *Mountain State* case, it would seem that this accumulation should be outside the purview of the penalty tax. The corporation has an obligation and, if valid under Pennsylvania Law, it would amount to an accumulation to satisfy a bonafide obligation which should be deemed to be within the "reasonable needs of the business." It would seem, therefore, that the accumulation should be found to be within the "reasonable needs of the business." While these statements indicate an emphasis on timing, it should be understood that the law is still crystallizing in this area and these statements are based on the few cases which have been litigated.

Redemption of a shareholder's stock may only be accomplished through careful planning. It would seem that the most difficult area is moving the redemption within the purview of "capital gains" treatment. Perhaps, the remainder of the problems depend largely on procedure and timing, but they emphasize the need for over-all coordination between the corporation and its shareholders for the successful execution of the stock redemption.

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105. Herwitz, *supra* note 2 at 933. Since the distributions to the shareholders are taxed as income from the sale of capital assets, which is "income tax," there could be no avoidance of the income tax in such a situation.