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Stock Redemptions Under IRC Sections 302, 303, and 304

Michael Ira Levin*

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I. Introduction

A. General Considerations

Of special interest to attorneys counseling owners and managers of closely held corporations are the redemption provisions of the Internal Revenue Code.[1] Without proper planning a stock redemption can have disastrous tax consequences. For example, if a corporation distributes $100,000 to its sole shareholder in redemption of stock having a basis of the same amount, instead of realizing no gain or loss as would be expected, the shareholder will have dividend income to the full extent of the distribution.[2] It is essential, therefore, for attorneys to master the redemption provisions.

The fundamental issues addressed by the redemption provisions is whether a distribution in redemption of stock will be taxed as a dividend or as an exchange of a capital asset, as ordinary income or capital gains. Section 302[3] provides that property distributed in redemption of stock[4] will be treated as a dividend[5] unless it meets one

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1. INT. REV. CODE OF 1954, §§ 302-04.
2. *See id.* § 302(a).
3. *Id.*
4. For purposes of the Internal Revenue Code, "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." *Id.* § 317(b).
5. The Internal Revenue Code defines a dividend as follows:

> (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, or
>
> (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.

Id. § 316(a). By way of comparison, for nontax purposes the word "dividend" has been defined as stockholders' withdrawals from accumulated profits, Lewis v.

of the following conditions: (1) The distribution is not essentially equivalent to a dividend; (2) it is substantially disproportionate; (3) it is in complete redemption of all the shareholder's stock of the corporation; or (4) it is of stock issued by railroad corporations in certain reorganizations.[6] Section 303[7] excludes redemptions "to pay death taxes" from the general rule. Section 304[8] governs tax consequences of redemptions through use of related corporations. These three sections attempt to tax properly transactions possessing characteristics of both exchanges of capital assets and dividends.

The hybrid nature of a corporate distribution in redemption of stock can be easily illustrated. When an individual sells stock, the transaction normally is a sale of a capital asset. Assuming the stock was held for more than six months and that a gain was realized on the sale, the taxpayer will be taxed at the favorable capital gains rate.[9] When a shareholder sells his stock to the issuing corporation, however, the transaction may resemble a dividend distribution. For example, suppose the sole shareholder of a corporation initially owns 1,000 shares of stock. Each year the corporation redeems ten shares of stock without distributing a dividend. Although the shareholder owns fewer shares after each redemption, he still retains one hundred percent ownership and the redemption was a mere disguise to get money out of the corporation at favorable tax rates. In effect, it was a distribution by the corporation resembling a dividend. When a redemption resembles a dividend, it should be taxed as such. Otherwise the unfavorable tax consequences related to dividends could be

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O'Malley, 49 F. Supp. 173, 179 (D. Neb. 1943), distributions of profits and earnings, *In re* Carlson's Estate, 16 App. Div. 2d 28, 31, 224 N.Y.S.2d 985, 989 (1962), corporate profits set aside, declared or ordered by the corporate directors to be paid to the stockholders upon demand or at a fixed time, *In re* Mortimer's Will, 12 Misc. 2d 744, 747, 171 N.Y.S.2d 635, 638 (Sup. Ct. 1958). Contrasted to this is the fact that not every corporate distribution is a dividend. Commercial benefits to a stockholder who buys the corporation's product at a discount is not a dividend. Northwest Eng'r Corp. v. Wisconsin Dep't of Tax., 241 Wis. 324, 4 N.W.2d 198 (1942).

6. INT. REV. CODE OF 1954, § 302(b). This exception is not of general interest and will not be discussed further.

7. *Id.* § 303.

8. *Id.* § 304.

9. The special treatment accorded gains on the sale or exchange of capital assets is based on social policy. In Burnet v. Harmel, 287 U.S. 103 (1932), the Court held that favorable capital gains treatment was enacted to "relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." *Id.* at 106. *See also, e.g.*, Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Sherlock v. Commissioner, 294 F.2d 863 (5th Cir.), *cert. denied*, 369 U.S. 802 (1961). The relief was motivated by the realization that there is a difference between gain realized from activities of a single year, such as compensation for services, receipt of dividends, interest, or the sale of stock in trade, and gain realized from the sale or exchange of property that represents the appreciation of several years. Rollingwood Corp. v. Commissioner, 190 F.2d 263 (9th Cir. 1951); Rieger v. Commissioner, 139 F.2d 618 (6th Cir. 1943). Also, favorable capital gains treatment serves to protect investment property. Rollingwood Corp. v. Commissioner, *supra*; Martin v. United States, 119 F. Supp. 468 (N.D. Ga. 1954).

avoided by having a corporation embark upon a program of stock redemptions. When a redemption resembles a sale, on the other hand, tax consequences should reflect this fact.

The redemption provisions of the 1954 Code have proved only partially effective in their primary function of properly taxing transactions resembling both exchanges and dividends. Some obstacles to effective application of these provisions arise from the wording of the sections themselves. For example, the phrase "not essentially equivalent to a dividend" that appears in section 302(b)(1) is imprecise and has caused questionable interpretations by the courts. The United States Supreme Court has stated that the phrase contemplates a meaningful reduction in the redeeming shareholder's interest.[10] Such an interpretation, however, frequently precludes examination of relevant considerations that would negate a finding of dividend equivalence. With regard to section 302(b)(3) the effect of distributing a debt instrument in exchange for stock is often litigated.[11] Furthermore, special provisions for waiver of family attribution rules make the effect of a redeemed shareholder's continued employment by the corporation uncertain. Another important application of section 302(b)(3)—the sale of a corporation's stock to a third party as part of a sale of the corporation—is also burdened with problems of interpretation.

This article will survey sections 302, 303, and 304 of the Code, examine the interpretations given them, and explore some of the problems involved in their use. The article also will recommend procedures that will allow practitioners to avoid some of the pitfalls in stock redemptions.

B. *Historical Treatment*

The law of stock redemptions began with the Bureau of Internal Revenue's administrative practice of treating stock dividends as income.[12] Codified in 1916,[13] this practice was declared unconstitutional in *Eisner v. Macomber*.[14] As a result a corporation could issue a stock dividend with no tax consequences to its shareholders and then redeem the shares of stock for cash. Since stock redemptions

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10. *See* notes 55-61 and accompanying text *infra*.
11. *See* notes 96-99 and accompanying text *infra*.
12. *See* Towne v. Eisner, 245 U.S. 418 (1918).
13. Int. Rev. Code of 1916, ch. 463, § 2(a), 39 Stat. 756, 757.
14. 252 U.S. 189 (1920).

were nontaxable, accumulated earnings and profits could be distributed without producing taxable dividend income to the shareholders. Congress reacted quickly by enacting section 201(d) of the Revenue Act of 1921, which instead of taxing the receipt of a stock dividend, taxed the subsequent cancellation or redemption of the distributed stock if made "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."[15] Congress broadened this provision in 1924 to include corporate redemptions of stock followed by a stock dividend.[16] Finally, in 1926 Congress altered the emphasis of the redemption provision by eliminating any reference to shares issued as a dividend. Dividend treatment of a redemption, thus, was appropriate whenever cancellation or redemption in reality was a disguised dividend.[17] No further changes were made until 1954.

Although the statutory language changed significantly from 1916 to 1926, many courts ignored the changes. Several courts refused to treat a redemption of stock as a dividend if the taxpayer proved that it was made in good faith[18] or that there was no relationship between the redemption and a prior or subsequent stock issue.[19] Most courts looked to the net effect of the redemption, however, to determine whether it was a disguised dividend.[20] These courts considered circumstances surrounding the redemption, placing special emphasis on legitimate business purpose and resemblance to pro rata distribution. Nevertheless, the haphazard manner in which courts applied the net effect test led one court to observe that

> the courts generally have not applied the 'net effect' test with strict logic but have broadened its scope to include inquiry into the possible existence of some 'legitimate business purpose,' for the redemption, that is to say, a legitimate corporate purpose as distinguished from a purpose to benefit the stockholder by a distribution of accumulated earnings and profits exempt from the imposition of income tax, . . . thus adding a question of motive to the question of ultimate result.[21]

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15. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 228.

16. Revenue Act of 1924, ch. 234, § 201(f), 43 Stat. 253, 255.

17. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11.

18. *E.g.*, Patty v. Helvering, 98 F.2d 717 (2d Cir. 1938). *See also, e.g.*, Commissioner v. Quackenbos, 78 F.2d 156 (2d Cir. 1935); Commissioner v. Cordingley, 78 F.2d 118 (1st Cir. 1935); Commissioner v. Babson, 70 F.2d 304 (7th Cir. 1934).

19. *See, e.g.*, Commissioner v. Rockwood, 83 F.2d 359 (7th Cir. 1936); H.F. Asmussen, 36 B.T.A. 878 (1937); Alfred E. Fuhlage, 32 B.T.A. 222 (1935).

20. *E.g.*, Smith v. United States, 121 F.2d 692 (3d Cir. 1941); Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940); Fostoria Glass Co. v. Yoke, 45 F. Supp. 962 (N.D. W. Va. 1942).

21. Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954). For a discussion of the history of § 115(g) see Adams, *Some Tax Aspects of the Complete and Partial Liquidation of Corporations*, 28 N.C.L. REV. 36 (1949); Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437 (1950); Danzig, *Distributions in Liquidations and Reorganizations*, 26 TAXES 645 (1948); Darrell, *Corporate*

The Internal Revenue Code of 1954 modified the stock redemption provisions: stock redemptions were distinguished from partial liquidations;[22] three new provisions allowing automatic capital gains treatment of certain redemptions were added;[23] and elaborate rules on constructive ownership of stock were made applicable to stock redemptions.[24] These modifications made the analysis of whether a stock redemption should be treated as a sale or as a dividend more

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Liquidations and the Federal Income Tax, 89 U. PA. L. REV. 907 (1941); Gutkin & Bech, *Stock Redemptions as Taxable Events Under Section 115(g): The Impressionistic Test*, 80 J. ACCOUNTANCY 285 (1945); *The Tax Clinic*, 78 J. ACCOUNTANCY 59, 60-61 (Lasser ed. 1944).

22. *Compare* INT. REV. CODE OF 1954, § 302 *with id.* § 346. The draftsmen of the 1954 Code made the following observations in this respect:

> Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.
>
> Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in part I of this subchapter. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation.

S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954). Although the format of the Internal Revenue Code distinguished redemptions from partial liquidations, commentators have not seen any clear distinction. Chiefly, the criticism has been that § 346(a) is written in terms of stock redemptions that are not essentially equivalent to dividends and that there is no requirement in § 346(a) that there be a contraction of corporate business. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.6-.8 (1971); Moore, *Dividend Equivalency—Taxation of Distributions in Redemption of Stock*, 19 TAX L. REV. 249 (1964).

23. *See* notes 91-138 and accompanying text *infra*.

24. INT. REV. CODE OF 1954, §§ 302(c)(1), 318. The rules relating to the constructive ownership of stock can be divided into four basic categories: (a) attribution from one family member to another; (b) attribution from a partnership, trust, estate or corporation to an owner or beneficiary thereof or from such owner or beneficiary to the related entity; (c) attribution from one of the aforementioned entities to an individual and then from that individual to a family member, or from one family member to another and then to one of the aforementioned entities; and (d) attribution by reason of owning an option to acquire stock. The third type of attribution is a combination of the first two types and has been called "sidewise" attribution. Although this form of sidewise attribution is permissible, there are some limitations. For instance, it is impermissible to attribute stock actually owned by one family member to another family member and then reattribute that constructively owned stock to a third family member. Similarly, stock owned constructively by a corporation, trust, estate or partnership cannot be reattributed to another entity. Of note is the fact that the attribution rules apply only to those sections that expressly incorporate them. *Id.* § 318.

exact in some respects[25] and more extensive in others.[26] To a certain extent, however, the problems existing before 1954 remained because the phrase "essentially equivalent to a dividend" was not deleted from the Code.

II. Redemptions Not Equivalent to Dividends

A. Background

Section 302(b)(1) provides that a redemption will be treated as a distribution in partial or full payment in exchange for stock if it "is not essentially equivalent to a dividend."[27] Because this language had been difficult for courts to apply with consistency,[28] the original House bill omitted the provision.[29] The Senate, however, felt compelled to reinstate it:

> While the House bill set forth definite conditions under which stock may be redeeemed at capital-gain rates, these rules appeared *unnecessarily restrictive*, particularly in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control when the redemption may take place. Accordingly, your committee follows existing law by reinstating 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.[30]

Although the motive underlying the Senate action seems to have been protection of minority shareholders,[31] this fact has received little attention in subsequent interpretations of the phrase by the courts. The net effect test continued to determine whether a distribution in redemption of stock was essentially equivalent to a dividend.[32]

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25. For example, when the corporation has redeemed all the stock of a shareholder, a redemption will be treated as a sale. *Id.* § 302(b)(3).

26. This is primarily because of the attribution rules found in *id.* § 318.

27. *Id.* § 302(b)(1).

28. Courts have described the application of the equivalence test as a "morass," Ballenger v. United States, 301 F.2d 192, 196 (4th Cir. 1962), a "most exasperating task," Thomas Lewis, 35 T.C. 71, 78 (1960), a "nightmarish problem," Wilson v. United States, 154 F. Supp. 341, 342 (N.D.N.Y. 1957), and a "vexing question," Bradbury v. Commissioner, 298 F.2d 111, 114 (1st Cir. 1962).

29. *See* U.S. CODE CONG. & AD. NEWS, 83d Cong., 2d Sess., No. 3, 4209-14 (1954).

30. S. REP. No. 1622, 83d Cong., 2d Sess. 44-45 (1954) (emphasis added).

31. *See* Brown v. United States, 345 F. Supp. 241 (S.D. Ohio), *aff'd*, 477 F.2d 599 (6th Cir.), *cert. denied*, 414 U.S. 1011 (1972), in which the court said that § 302(b)(1) "must be construed narrowly since 'its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock.' " *Id.* at 246-47.

32. The income tax regulations provide the following guidance in determining whether a distribution in redemption of stock is not essentially equivalent to a dividend:

> The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). All distributions in pro rata re-

1. *Flexible Net Effect Test.*—Until 1970 most circuit courts employed the so-called flexible net effect test.[33] This analysis of dividend equivalence was a factual one.

> Whether or not a particular transaction involves the essential equivalent of a taxable dividend is a question of fact [citations omitted]. There is *no sole decisive test,* [citation omitted], but a number of judicial criteria or guideposts have been determinative . . . .
>
> Among these criteria are: the presence or absence of a bona fide corporate business purpose; whether the action was initiated by the corporation or by the shareholders; did the corporation adopt any plan or policy of contraction, or did the transaction result in a contraction of the corporation's business; did the corporation continue to operate at a profit; whether the transaction resulted in any substantial change in the proportionate ownership of stock held by the shareholders; what were the amounts, frequency, and significance of dividends paid in the past; was there a sufficient accumulation of earned surplus to cover the distribution, or was it partly from capital [citation omitted].[34]

The phrase "legitimate business purpose" has encompassed a broad range of corporate objectives. One of these objectives has been the redemption of stock to make it available for purchase by others.[35] In *Neff v. United States*[36] a corporation in need of additional capital for diversification redeemed stock of the controlling shareholder for resale at a profit. The court first recognized that a redemption for the ultimate purpose of raising capital is a legitimate business purpose. The redemption at issue, however, was found to be essentially equivalent to a dividend because the shareholder's position remained substantially unchanged and the objective could have been achieved in a more appropriate manner.[37] Therefore, the court effectively

> demptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding.

Treas. Reg. § 1.302-2(b), T.D. 6152, 1955-2 CUM. BULL. 61, 74.

33. *See, e.g.,* Commissioner v. Berenbaum, 369 F.2d 337 (10th Cir. 1966); Kerr v. Commissioner, 326 F.2d 225 (9th Cir. 1964); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); Heman v. Commissioner, 283 F.2d 227 (8th Cir. 1960); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958).

34. Heman v. Commissioner, 32 T.C. 479, 486-87 (1959), *aff'd,* 283 F.2d 227 (8th Cir. 1960) (emphasis added).

35. Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949) (redeemed stock placed in treasury); Decker v. Commissioner, 32 T.C. 326 (1959), *aff'd per curiam,* 286 F.2d 427 (6th Cir. 1960) (redemption to provide stock for proposed employee stock purchase plan); H.F. Asmussen v. Commissioner, 36 B.T.A. 878 (1937) (corporate purchase for contribution to an employee's association).

36. 305 F.2d 455 (Ct. Cl. 1962).

37. *Id.* at 457-58. In this case the corporation could have issued authorized but unissued stock rather than rely on a stock redemption.

required that the asserted objective be closely related to the redemption and that more appropriate methods of reaching the objective be unavailable.

In *United States v. Carey*[38] the owner of fifty percent of a growing automobile dealership desired to sell his shares because he could not devote sufficient time to the business. When no buyer could be found at his high asking price, the corporation redeemed a percentage of each stockholder's shares, which contracted the corporation's capital structure and effectively reduced the selling shareholder's asking price. At the reduced price a buyer was found. Looking at the entire transaction the court found that the redemption was part of a legitimate corporate purpose—eliminating one shareholder and obtaining another. The court noted that the redemption and sale completely terminated the selling shareholder's interest in the corporation. Therefore, the redemption was not essentially equivalent to a dividend.[39]

Neff and *Carey* involved the same basic transaction—a stock redemption by a corporation in contemplation of a sale of stock to a third party.[40] Yet the tax consequences were different. The *Carey* court was willing to examine the redemption *and* the subsequent sale of stock,[41] but the *Neff* court viewed only the redemption.[42] Furthermore, the required levels of proof of legitimate business purpose differed greatly. *Neff* looked beyond the transaction to find private benefit.[43] In *Carey*, however, the entire transaction was initiated to benefit a single stockholder.[44]

Improvement of a corporation's credit position is another business purpose often cited as the reason for stock redemptions.[45] Not all courts have found this motive persuasive. In *Bradbury v. Commissioner*[46] a corporation seeking a loan was told informally to improve its credit by collecting the principal shareholder's debt. The corporation redeemed a portion of the shareholder's stock in cancellation of his debt. This redemption was held essentially equivalent to a divi-

38. 289 F.2d 531 (8th Cir. 1961).
39. *Id.* at 538-39.
40. These cases are readily distinguishable, but for purposes of this discussion are sufficiently analogous.
41. 289 F.2d at 538-39.
42. 305 F.2d at 458.
43. *Id.* at 457-58.
44. *See* 289 F.2d at 539.
45. This purpose is alleged to have been the motivating factor behind redemptions in several different contexts. In Koch v. Commissioner, 26 B.T.A. 1025 (1932), a redemption was made at the behest of a bank to reduce the number of the corporation's outstanding shares as a prerequisite for a loan. In Allen v. Commissioner, 41 B.T.A. 206 (1940), credit conditions required that debts of shareholders to the corporation be eliminated by redemption of portions of their stock.
46. 298 F.2d 111 (1st Cir. 1962).

dend for two reasons. First, no meaningful change in the position of the shareholder vis-a-vis the corporation and minority shareholders had been effected by the redemption. Second, the evidence was insufficient to prove that credit considerations actuated the redemption.[47] In addition, the court stated that a sole or dominating shareholder is but a "shadow of the corporation" itself and that in such situations it is very difficult for a taxpayer to prove a corporate business purpose entirely separate and distinct from his own purpose.[48]

Another determinant of dividend equivalence under the flexible net effect test was whether the redemption was initiated by the corporation or the shareholder.[49] Analysis of this element was substantially the same as that given legitimate business purpose. For example, in *Kerr v. Commissioner*[50] a corporation redeemed some of the stock of its sole shareholder allegedly at the suggestion of the corporation's accountants and tax advisers. Disregarding the evidence offered to prove this allegation, the court said, "It is hard to believe that in a solely owned corporation, initiative can come from the corporation as an entity rather than from the sole shareholder. Any other belief would fly in the face of reality."[51]

In summary, although courts using the flexible net effect test paid verbal homage to many considerations, these generally were disregarded after a finding that the redemption had caused no substantial reduction in the shareholder's interest in the corporation.[52]

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47. *Id.* at 116.

48. In this regard the court said,

> However, we believe that for business purpose to be of really meaningful import the dichotomy between shareholder and corporation must be more sharply drawn than is the case here. In a case such as the instant one, while, on the verbal level, there may be a conceptually distinct corporate and shareholder purpose, as a matter of economic import, it is unrealistic to attempt to segregate them. The separateness of the shareholders in a widely held corporation or the minority position of a particular shareholder in a closely held corporation make considerations of legitimate corporate business purpose a more eminently vital consideration than here where the shareholder is but the shadow of the corporation.

Id. at 118. *See also* Kerr v. Commissioner, 326 F.2d 225 (9th Cir. 1964); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958).

49. *See* note 34 and accompanying text *supra.*

50. 326 F.2d 225 (9th Cir. 1964).

51. *Id.* at 231.

52. *See, e.g.,* Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964); Pacific Veg. Oil Corp. v. Commissioner, 251 F.2d 682 (9th Cir. 1957); Earle v. Woodlaw, 245 F.2d 119 (9th Cir.), *cert. denied,* 354 U.S. 942 (1957); Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957); Wilson v. United States, 154 F. Supp. 341 (N.D.N.Y. 1951), *aff'd,* 257 F.2d 534 (2d Cir. 1958); Stolz v. Commissioner, 30 T.C. 530, *aff'd per curiam,* 267 F.2d 482 (5th Cir. 1959).

This was especially true in cases involving a sole or controlling shareholder.[53]

2. *Strict Net Effect Test.*—The strict net effect test was more limited in its scope of inquiry. Courts applying it did not consider the various criteria used by courts applying the flexible test. Instead these courts viewed only the consequences of the redemption. If a dividend distribution would have produced the same results, the redemption was held to be essentially equivalent to a dividend.[54]

To determine dividend equivalence, many courts assumed a hypothetical dividend in the same amount as the redemption and compared the results. Another analytical tool was the pro rata distribution, which many courts felt was an undeniable characteristic of a dividend.[55] In *Northup v. United States*[56] a corporation attempting to revitalize its business implemented a plan to issue a preferred stock dividend and have the existing shareholders give a substantial portion of their common stock to their sons to induce them to stay in the business. The corporation later redeemed the preferred stock. The court combined the hypothetical dividend and pro rata distribution analyses and found as follows:

> [T]he percentage of preferred stock payments that went to persons who owned no common stock was 36% in 1945, 42.2% in 1946 and 74.7% in 1947. Had dividends on common stock been paid, these persons would have received nothing . . . .
>
> Nor would the 'same effect' have followed with respect to appellants Northup, Hine and Usher. These taxpayers owned respectively in 1945, 24.8% of the common stock and 20% of the outstanding preferred, 20.7% of the common and 8.5% preferred, and 21.1% common and 13.1% preferred. Had the funds expended to retire the preferred stock been applied instead to dividends on the common, each would have received larger payments than he did . . . .[57]

The court, therefore, failed to find dividend equivalence.[58]

B. *United States v. Davis*[59]

In this landmark case the Supreme Court resolved a conflict among the circuits and adopted the strict net effect test.[60] Davis

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53. *See* Kerr v. Commissioner, 326 F.2d 225 (9th Cir. 1964); Neff v. United States, 305 F.2d 455 (Ct. Cl. 1962).

54. *See* Kerr v. Commissioner, 326 F.2d 225, 230 (9th Cir. 1964).

55. *See* Hasbrook v. United States, 343 F.2d 811, 813 (2d Cir. 1965); Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964).

56. 240 F.2d 304 (2d Cir. 1957).

57. *Id.* at 306.

58. *Id.* at 307.

59. 397 U.S. 301 (1970).

60. Previously, there had been a conflict among the circuits over whether the strict net effect test or the flexible net effect test should be applied. *Compare* Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967) *and* Hasbrook v. United States, 343 F.2d 811 (2d Cir. 1965), *with* Commissioner v. Berenbaum, 369 F.2d 337 (10th Cir.

owned twenty-five percent of a corporation's common stock and his wife owned another twenty-five percent. Soon after the original issue he made a capital contribution in exchange for preferred stock to enable the corporation to obtain a loan. The preferred stock was to be redeemed after the loan had been repaid. During the interim Davis bought the remaining fifty percent of the common stock and distributed it to his children. When the corporation redeemed the preferred stock the Service argued that the redemption was essentially equivalent to a dividend. The lower courts disagreed, finding the redemption to be a sale of a capital asset because it was the final step in a course of action that had a legitimate business purpose.[61]

On appeal, the Supreme Court first applied the constructive ownership rules of section 318[62] to section 302(b)(1).[63] Because all the corporation's stock was held by Davis and his immediate family, the Court viewed the case as one in which a sole shareholder had a portion of his stock redeemed. After reviewing the legislative history of section 302(b)(1) and noting that its meaning was not free from doubt, the Court held that consideration of a redemption's business purpose was erroneous:

> If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative *economic* interests or rights of the stockholders. Where a redemption has that same effect, it cannot be said to have satisfied the 'not essentially equivalent to a dividend' requirement of § 302(b)(1). Rather, to qualify for preferred treatment under that section, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. Clearly, taxpayer here, who (after application of the attribution rules) was the sole shareholder of the corporation both before and after the redemption, did not qualify under this test.[64]

1966); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); Heman v. Commissioner, 283 F.2d 227 (8th Cir. 1960).

61. Davis v. United States, 274 F. Supp. 466 (M.D. Tenn. 1967), *aff'd*, 408 F.2d 1139 (6th Cir. 1969).

62. *See* note 24 *supra*.

63. The court held that the attribution rules were applicable to § 302(b)(1) for the following reasons:

> In subsection (c) of § 302, the attribution rules are made specifically applicable 'in determining the ownership of stock for purposes of this section.' Applying this language, both courts below held that § 318(a) applies to all of § 302, including § 302(b)(1)—a view in accord with the decisions of the other courts of appeals, a longstanding treasury regulation, and the opinion of the leading commentators.

397 U.S. at 306 (footnotes omitted).

64. *Id.* at 313 (emphasis added). Justices Douglas and Brennan and Chief Justice Burger dissented, arguing that a redemption for a legitimate business purpose

The Supreme Court focused on only one attribute of a dividend in *Davis*—its failure to affect the economic interests of the shareholders *inter se* and vis-a-vis the corporate—and held that a redemption with the same characteristic is essentially equivalent to a dividend. By narrowing the scope of inquiry in this manner, the Court not only struck down the flexible net effect test, but also altered the application of the strict net effect test. This action certainly exceeded the limited question of whether the strict or flexible test should be used to determine dividend equivalence, which had led the Court to grant certiorari in the first place.[65] It is not clear why the Court rejected the hypothetical dividend and pro rata distribution devices in favor of an analysis couched in terms of a meaningful reduction of a shareholder's proportionate interest in the corporation. One possibility may be that in a corporation with a complex capital structure, a hypothetical dividend often will not have the same consequences as a redemption, especially when the redemption is of preferred stock held disproportionately.[66] Another reason may be that a meaningful reduction in a shareholder's interest may not occur even when a distribution is not pro rata. Indeed, following *Davis* the court in *Brown v. United States*[67] found that a distribution was not pro rata, but held the redemption equivalent to a dividend because there was no meaningful reduction of the taxpayer's proportionate interest in the corporation.

One question caused by the *Davis* decision relates to its use of the phrase "relative economic interests or rights of the stockholders."[68] Does it address only economic interests and rights? In *Grabowski Trust*[69] this language was interpreted to mean that the strict net effect test "measures whether the distribution has altered the shareholder's control over the corporation or the shareholder's rights to future earnings."[70] On the other hand, the court in *Wright v. United States*[71] said, "We . . . think that it is improper to refer to the 'net effect' standard as the 'net economic test', . . . since a meaningful change in shareholders' voting power is a relevant inquiry."[72]

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is not essentially equivalent to a dividend and that to hold otherwise would effectively cancel § 302(b)(1) from the Code. *Id.* at 314 (dissenting opinion).

65. *Id.* at 303.

66. *See* Brown v. United States, 345 F. Supp. 241 (S.D. Ohio), *aff'd*, 477 F.2d 599 (6th Cir.), *cert. denied*, 414 U.S. 1011 (1971).

67. *Id.* The Tax Court in Grabowski Trust v. Commissioner, 58 T.C. 650 (1972), expressed uncertainty over whether a non-pro-rata redemption would "necessarily satisfy the 'meaningful reduction of the shareholders' proportionate interest' requirement of Davis." *Id.* at 659.

68. 397 U.S. at 313.

69. 58 T.C. 650 (1972).

70. *Id.* at 656.

71. 482 F.2d 600 (8th Cir. 1973).

72. *Id.* at 609. An opposite result was reached in Brown v. United States, 345 F. Supp. 241 (S.D. Ohio), *aff'd*, 477 F.2d 599 (6th Cir.), *cert. denied*, 414 U.S. 1011

The Service has continued to follow its pre-*Davis* position that analysis of redemptions should include changes in both economic and voting rights.[73] In *Himmel v. Commissioner*[74] a corporation had a capital structure composed of one class of common stock and two classes of preferred. The complexity of the capital structure forced the court, in an analysis of the possible dividend equivalence of a preferred stock redemption, to focus on the redemption's effect on the shareholders' rights. These rights were said to include the rights "(1) to vote and thereby exercise control, (2) to participate in current earnings and accumulated surplus, and (3) to share in net assets on liquidation."[75] There is no reason to believe that the word "economic" modifying "interest" in the *Davis* formulation was also intended to modify the word "rights." The two words are separated by a disjunctive and, therefore, do not share a common modifier.

Another uncertain phrase in *Davis* is "meaningful reduction."[76] The term does not lend itself readily to mathematical equations and uniform results: reductions of fifteen percent[77] and two percent[78] have been held meaningful, while reductions of nine percent[79] and seven percent[80] have not. In a post-*Davis* ruling the IRS concluded that reducing a shareholder's voting power from fifty-seven to fifty percent constituted a meaningful reduction.[81]

(1972). There is thus a split as to whether courts should only analyze changes in economic interests or changes in both economic and voting interest. In Wright v. United States, 482 F.2d 600 (8th Cir. 1973), the court held that " 'voting power' may indeed eventually have an economic effect." *Id.* at 609 n.18. The weight of authority supports this view.

73. Rev. Rul. 75-502, 1975 INT. REV. BULL. No. 47, at 10.

74. 338 F.2d 815 (2d Cir. 1964).

75. *Id.* at 817. Discussing the complexity of determining dividend equivalence when a complex corporate structure exists, the court said,

> [D]ifficult problems are raised when a corporation has more than one class of stock. The additional class will often be a preferred, which typically has no voting rights, has preferential though limited rights to participate in earnings, and has rights to share in liquidation only to the extent of capital contributed, and perhaps accrued but unpaid dividends. Redemption of some preferred stock consequently may cause different changes in a shareholder's total rights than would redemption of common. Even more is this so when the preferred and common are not held in the same proportions by the same shareholders. Shares of different classes should therefore not casually be lumped together.

Id. at 818.

76. 397 U.S. at 313.

77. Smith v. United States, 130 F. Supp. 586 (Ct. Cl. 1955).

78. Rev. Rul. 56-183, 1956-1 CUM. BULL. 161.

79. Fehrs Fin. Co. v. Commissioner, 487 F.2d 184 (8th Cir. 1973).

80. Friend v. United States, 345 F.2d 761 (1st Cir. 1965).

81. Rev. Rul. 75-502, 1975 INT. REV. BULL. No. 47, at 10.

C. Criticism of the Davis Approach

The *Davis* test can be weighed most logically by considering its effect on the underlying purposes of the statutory provision. Section 302 was enacted to prevent tax avoidance by shareholders who would disguise dividends as stock redemptions.[82] Subsection (b)(1) was included in the 1954 Code to add flexibility to an otherwise "unnecessarily restrictive" section 302.[83] The purposes of section 302(b)(1), then, are flexibility and prevention of tax avoidance. *Davis,* on the other hand, has ruled out the question of tax avoidance as a relevant issue and has locked the courts into an analysis that considers only one factor—whether a meaningful reduction of the shareholder's proportionate interest in the corporation has been effected by the redemption.

Because of its failure to meet the statutory objective of flexibility, *Davis* has been judicially criticized. The dissenting Justices in *Davis* chided the majority for effectively destroying the viability of the subsection.[84] Three years later in a dissent to a certiorari denial, Justices Powell, Douglas, and Blackmun argued that the Supreme Court should reconsider its holding in *Davis.*[85] In that case a closely held corporation desperately needed a loan for a new barge. Funds proved to be unavailable, however, without a repayment guarantee from the Federal Maritime Commission. The Commission ordered the corporation to increase its capital base, which was done by issuing a class of nonvoting, nondividend-paying, noncumulative preferred stock that could not be redeemed until the loan was fully repaid. When the corporation was able to redeem this new class of stock, the Service, pursuant to the rule in *Davis,* taxed the distribution as ordinary income. The dissenting Justices presented three arguments against this result: (1) the ease of administration provided by the *Davis* test is contrary to the subsection's goal of flexibility; (2) when tax avoidance is not a motive for a redemption, it is improper to tax the distribution as a dividend; and (3) when a redemption is a mere return of capital, it is unduly harsh to tax it at ordinary income rates.[86] The last point is significant because it recognizes that there are more attributes of a dividend than the one expressed in *Davis.* For instance, a dividend does not reduce stated capital. In fact, state

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82. *See* notes 12-24 and accompanying text *supra.*

83. *See* note 30 and accompanying text *supra.*

84. 397 U.S. at 314 (dissenting opinion). The dissent overreacts; situations exist that are still covered by § 302(b)(1). *See* Treas. Reg. § 1.302-2(a)-(b) (1955); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.26 (1971); McAndrews, *Supreme Court's Davis Decision: Does It Do Away With the 302(b)(1) Redemption?,* 32 J. TAX. 328 (1970).

85. Albers v. Commissioner, 414 U.S. 982, *denying cert. to* Miele v. Commissioner, No. 72-1031 (3d Cir., Jan. 30, 1972).

86. *Id.* at 985.

corporate codes generally prohibit the payment of dividends from stated capital.[87] Logically, dividend equivalence should involve an examination of all attributes of dividends, except those contrived by the taxpayer to effect tax avoidance.

Although the difficulty of gaining acceptance of an approach broader than *Davis* is obvious, several cogent arguments can be raised. First, several Justices do not believe that *Davis* is correct.[88] Second, *Davis* was a limited decision. The only issue presented was whether a legitimate business purpose will destroy the dividend equivalence of a redemption. Whether the only dividend attribute to be considered in applying section 302(b)(1) is its failure to affect shareholder rights was not at issue.[89] Third, a comparison of all the legitimate attributes of a redemption and all the attributes of a dividend is a proper examination in a test of equivalence. Furthermore, it complies with treasury regulations providing that equivalence depends on the facts and circumstances of each case.[90] Last, a broad-based examination need not focus on the redemption's business purpose. On the contrary, as illustrated by the dissenting Justices in *Albers*,[91] it looks to the substance of the transaction. If the redemption constitutes the return of a capital contribution, the business motivation is irrelevant. The tax motivation is very important, however, because the form may be a return of capital, but the substance a distribution of earnings and profits.

In addition to these substantive arguments, equitable administration of taxation statutes should be considered. The overriding purpose of section 302 is prevention of tax avoidance.[92] Therefore, distributions that are not so motivated should remain untouched by

87. *E.g.*, CAL. CORP. CODE § 1500 (West 1955 & Supp. 1975); DEL. CODE ANN. tit. 8, § 170 (1974); PA. STAT. ANN. tit. 15, § 1701 (1967 & Supp. 1975).

88. Justices Powell, Douglas, and Blackmun dissented in Albers v. Commissioner, 414 U.S. 982 (1973). Justices Douglas, Brennan, and Chief Justice Burger dissented in Davis v. United States, 397 U.S. 301 (1970).

89. The Court's holding in this regard must be considered as dictum:

> We conclude that the Court of Appeals was therefore wrong in looking for a business purpose and considering it in deciding whether the redemption was equivalent to a dividend. Rather, we agree with the Court of Appeals for the Second Circuit that 'the business purpose of a transaction is irrelevant in determining dividend equivalence,' under 302(b)(1).

397 U.S. at 312.

90. Treas. Reg. § 1.302-2(b) (1955).

91. Albers v. Commissioner, 414 U.S. 982, *denying cert. to* Miele v. Commissioner, No. 72-1031 (3d Cir., Jan. 30, 1972).

92. *See* notes 12-24 and accompanying text *supra*.

the section. This is true even though the IRS will be required to examine taxpayers' motives. This examination will not interfere unduly with the Service's functions and is a relevant inquiry in several other areas of taxation.[93]

III. Substantially Disproportionate Redemptions

Section 302(b)(1) provides that if a redemption is substantially disproportionate and after the redemption the shareholder owns less than fifty percent of the total voting stock, the distribution will be treated as partial or full payment for the stock. The rationale of the fifty percent rule is that a shareholder's reduction is not significant if he continues to control the corporation through ownership of more than half the stock.[94] A redemption is deemed to be substantially disproportionate when the shareholders' percentage of ownership of outstanding voting stock after the redemption is less than eighty percent of his percentage of ownership prior to the redemption. If there is more than one class of stock, the percentage ratios are computed with reference to the fair market value of the stock.[95] This section cannot be circumvented by redeeming stock of separate shareholders at different times. If the net effect of a series of redemptions is the same as a substantially proportionate redemption, favorable tax treatment will not result.[96] The attribution of ownership may also cause problems in applying this section.[97]

In applying this explicit provision the only questions are how to determine the amount of stock outstanding and the amount owned by the shareholder. These determinations normally are made by a brief examination of the corporate balance sheet and stock transfer records, but are not always obvious. As an illustration, assume that *X* corporation had outstanding 1,000 shares of common stock and that

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93. *E.g.*, Int. Rev. Code of 1954, §§ 302(c)(2)(B), 357(b).

94. The original House version of the Internal Revenue Code of 1943 did not include this fifty percent requirement. As a result the provision was criticized in the minority report and corrected when it went to the Senate.

> Another mechanical rule, which should be critically appraised, is the 'substantially disproportionate redemption' rule . . . . The test provided is whether, after the redemption, the shareholders' percentage of participating stock ownership is less than 80% of his percentage prior to distribution. Assume that stockholder X owns 9,000 out of 10,000 (90%) outstanding shares of common stock . . . . Stockholder X is in control of the corporation and wishes to realize in part upon its earnings and profits without ordinary income tax consequences and without substantially relinquishing control of the enterprise. Under the bill, he may cause redemption of 721 shares, retain 71% of control, and obtain capital-gain treatment of his gain upon the redeemed stock. The adequacy of this provision is open to question.

U.S. Code Cong. & Ad. News, 83d Cong., 2d Sess., No. 3, 4615-16 (1954) (H.R. minority view).

95. Int. Rev. Code of 1954, § 302(b)(2)(C).

96. *Id.* § 302(b)(2)(D).

97. *E.g., id.* § 318(a)(4).

A and *B* each owned 100 shares. Suppose further that the corporation redeemed fifty shares from each in exchange for a debenture convertible into forty shares of common and a warrant to purchase twenty shares of common. The outstanding stock prior to the redemption is easy to calculate—1,000 shares. After the redemption, however, a more difficult question arises: Is the outstanding stock composed of those shares actually outstanding or those outstanding plus the shares represented by the convertible debentures and warrants? The IRS has indicated that the latter alternative is the correct one and that *A* and *B* would fail to satisfy section 302(b)(2).[98] The computation is as follows:

Percentage of ownership prior to redemption: 10% (100/1000)

Stock owned by A or B		Stock outstanding
actually	100	1,000 shares
constructively	0	
total	100	

Percentage of ownership after the redemption: 11.46% (110/960)

Stock owned by each shareholder	
actually	50
constructively	60
total	110

Stock outstanding	
actually	900
shares representing warrants and debentures	60
total	960

Finally, it should be noted that a twenty percent reduction in the number of shares owned will not satisfy the test because the redemption will also decrease the number of shares outstanding.[99]

98. Rev. Rul. 68-601, 1968-2 CUM. BULL. 124. Note that in the formula in text, 960 shares of stock are considered outstanding, not 1020.

> Since the warrants and convertible debentures in this case constitute options under section 318(a)(4) of the Code, it is held that under section 302(b)(2) of the Code there should be considered as issued and outstanding, on a shareholder by shareholder basis without regard to the rights of unrelated shareholders to acquire unissued stock, those shares which a given shareholder may acquire by exercising his warrants and converting his debentures and those shares which that shareholder would constructively own by reason of other shareholders exercising their warrants and converting their debentures.

Id. Contra, Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964).

99. A simple formula to determine the number of shares to be redeemed when one shareholder is involved is as follows:

IV. Termination of Shareholder's Interest

A. Statutory Scheme

Section 302(b)(3) of the 1954 Code directs that a redemption shall be treated as a distribution in part or full payment in exchange for the stock "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."[100] Although this provision did not appear in the Code prior to 1954, the Service for several years had treated a redemption in complete termination of a shareholder's interest as not essentially equivalent to a dividend.

> A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend . . . . On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend.[101]

1. Effect of Debt Instrument.—If in exchange for all a shareholder's stock the corporation pays cash, the transaction falls within the literal requirements of the provision. Problems may arise, however, when a corporation pays for the stock with a debt instrument. The IRS may disregard the form of the note and hold that it is essentially an equity security that will not comply with the statutory requirements.[102] Warning that these transactions will be closely

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$$S = \frac{N}{5 - 4r}$$

S = minimum number of shares to be redeemed;
N = number of voting shares owned by the redeeming shareholder prior to the redemption; and
r = the ratio of the redeeming shareholder's voting stock to the outstanding stock prior to the redemption.

If there are multiple redemptions, three additional computations are required: (1) Determine the aggregate number of shares held by all of the redeeming shareholders and use this figure for "N"; (2) determine the ratio of their combined holdings to the total outstanding stock and use this figure for "r"; (3) the above two computations will give you "S", which is apportioned among the shareholders according to their proportionate interest in the corporation. *See* Freret, *A Simplified Computation for Substantially Disproportionate Stock Redemptions*, 37 TAXES 767, 772 (1959).

100. INT. REV. CODE OF 1954, § 302(b)(3).

101. Treas. Reg. 118, § 39.115(g)-1(a)(2). *See also* Howell v. Commissioner, 26 T.C. 846 (1956); Tiffany v. Commissioner, 16 T.C. 1443 (1951); Rev. Rul. 54-408,1954-2 CUM. BULL. 165.

102. To qualify an instrument as debt for income tax purposes requires (1) an unconditional obligation to pay a sum certain, (2) a fixed maturity date (not unreasonably far in the future), (3) interest payable in all events, (4) rights equal to all general creditors, and (5) no voting rights. *See generally, e.g.*, Harlan v. United States, 409 F.2d 904 (5th Cir. 1969); United States v. Snyder Bros., 367 F.2d 980 (5th Cir. 1966); Fellinger v. United States, 363 F.2d 826 (6th Cir. 1966). In addition to the formal terms of the instrument, the courts will often go beyond the four corners of the instrument. The following factors have been considered in this respect: (1) excessive debt-equity ratio; (2) intent to create a creditor-debtor relationship; and (3) pro rata holding of stock and debt. *See generally, e.g.*, A.R. Lantz Co. v. United States, 424 F.2d 1330 (9th Cir. 1970); P.M. Fin. Corp. v. Commissioner, 302 F.2d 786 (3d Cir. 1962); Gilbert v. Commissioner, 248 F.2d 399

scrutinized, the Service in 1972 issued a revenue procedure declaring that no revenue ruling or determination ordinarily will be given when notes payable over a period in excess of fifteen years are used or when the stock is held in escrow or by the shareholder as security for the notes and there is a possibility that the stock will be returned to the shareholder upon the corporation's default.[103] The courts have not always accepted the implicit argument in the Service's position. In *Estate of Mathis*[104] a corporation redeemed all a shareholder's stock with a down payment of $26,130 and monthly payments of $500 until a total of $100,000 was reached. The stock was held by an escrow agent until the corporation's final payment. The Service argued that because the shareholder did not have his stock redeemed until the final payment was received, the down payment and monthly installments were dividends taxable to the shareholder. Rejecting this argument, the Tax Court held that a redemption is complete once there is a binding redemption contract and that passage of title only upon final payment will not invalidate such a contract.[105]

2. *Attribution of Ownership Rules.*—The constructive ownership rules of section 318 apply to section 302(b)(3). Thus, if a husband and wife each own fifty percent of a corporation and the corporation redeems all the husband's stock, he will continue to be deemed to hold all the outstanding stock of the corporation because of the attribution rules.[106] Section 302(c)(2) provides, however, that for purposes of section 302 (b)(3) the family attribution rules can be waived if three conditions are met: (1) All the shareholder's interest in the corporation (other than his interest as a creditor) is terminated; (2) the redeeming shareholder does not reacquire any interest within ten years from the date of the redemption; and (3) the

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(2d Cir. 1957); Gooding Amus. Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957).

In addition, the Tax Reform Act of 1969, Pub. L. No. 91-172, § 415, 83 Stat. 487, incorporated § 385 into the Internal Revenue Code, giving the Commissioner broad authority to distinguish corporate stock and debt. For general discussions in this area see Plumb, *The Federal Income Tax Significance of Corporate Debt*, 26 TAX L. REV. 369 (1971); Eustice, *Corporations and Corporate Investors,* 25 TAX L. REV. 509 (1970).

103. Rev. Proc. 72-9, 1972-1 CUM. BULL. 719; Rev. Rul. 57-295, 1957-2 CUM. BULL. 227, which held that a redemption for cash plus promissory notes payable over a ten-year period falls within § 302(b)(3).

104. 47 T.C. 248 (1966).

105. *See* Hoffman v. Commissioner, 47 T.C. 218 (1966); Lewis v. Commissioner, 47 T.C. 129 (1966).

106. *See* note 24 *supra.*

redeeming shareholder files the necessary agreements with the Secretary.[107]

(a) Termination of all interest.—A valid waiver of family attribution can occur only if the shareholder terminates all interest in the corporation, including his interest as an officer, director, or employee. The only exception is that the redeeming shareholder may retain an interest as a creditor.

Beyond these obvious categories of interests, decisions of the Service and the courts must be consulted to avoid losing the benefits of section 302(c)(2). Revenue Ruling 70-104 dealt with a corporation owned entirely by a father and his children. The corporation redeemed all the father's stock and immediately thereafter entered into an agreement for the father's services as a consultant. The IRS held that these services were an interest in the corporation within the meaning of section 302(c)(2)(A)(i) and, therefore, the family attribution rules could not be waived.[108]

In *Estate of Lennard v. Commissioner*[109] the Tax Court considered whether performance of accounting services for a corporation precluded a redeeming shareholder from meeting the termination of interest requirement. The taxpayer and his son each had a one-third interest in the corporation. Prior to acquiring his interest, taxpayer was a certified public accountant and he continued until his death to be associated with accounting firms, some of which did work for the corporation. After taxpayer's stock was redeemed and he resigned as an officer and director, his accounting firm continued to render services to the corporation. The IRS argued that these services precluded taxpayer from waiving the family attribution rules, but the court disagreed. Referring to Revenue Ruling 70-104 it held that accounting services were more "circumscribed" than consultation services and that in enacting section 302(c)(2)(A)(i) Congress was concerned with redeeming shareholders who retained a "financial stake" or some "corporate involvement." An independent contractor was found to be outside this category. Because the taxpayer was an independent contractor when he rendered services to the corporation, he was held to have met the requirements of section 302(c)(2)(A)(i).[110] Similarly, a landlord-tenant relationship retained by a redeeming shareholder has been held free from attack.[111]

In Revenue Ruling 70-426 the Service determined that a shareholder who continued to be a trustee of a voting trust was precluded

107. INT. REV. CODE OF 1954, § 302(c)(2).
108. Rev. Rul. 70-104, 1970-1 CUM. BULL. 66.
109. 61 T.C. 554 (1974).
110. *Id.* at 561.
111. When a corporation distributes real estate to a shareholder who then leases it back to the corporation, no prohibited relation exists under § 302(c)(2)(A)(i). Rev. Rul. 70-639, 1970-2 CUM. BULL. 74.

from waiving the family attribution rules. "By remaining as a voting trustee, the taxpayer will continue to have an interest in the corporation by having the right to vote the stock which is held by the trust."[112] The shareholder's right to vote illustrated the type of corporate involvement alluded to in *Lennard* that will preclude a finding of a complete termination of interest.[113] Corporate involvement also can arise when a redeeming shareholder accepts a debt obligation for his stock and retains too many protective devices. In one case a corporation agreed to allow taxpayer's nominee to sit on the board of directors as long as the debt remained outstanding. Although the corporation was required to pay the nominated director, the agreement was made solely to protect the redeeming shareholder's interest. The Service held, therefore, that the nominee was taxpayer's agent and that the conditions of the termination of interest rule had not been met.[114] The ruling continued, however, by stating that a creditor may attend board meetings without adverse effect on his ability to waive family attribution.[115]

In summary, shareholders of family-owned corporations must be wary of retaining too close an interest in the corporation after a section 302(b)(3) redemption. Although some ties are permissible, a finding of corporate involvement or financial dependence on the corporation will render waiver of family attribution rules unavailable.

(b) Reacquisition of interest within ten years.—With the exception of reacquisition of stock by bequest or inheritance, it is generally impermissible, at the cost of losing waiver of family attribution, for an individual to reacquire any interest in the corporation within

112. Rev. Rul. 71-426, 1971-2 CUM. BULL. 173.
113. *See* Estate of Lennard v. Commissioner, 61 T.C. 554, 562 (1974).
114. Rev. Rul. 59-119, 1959-1 CUM. BULL. 68.
115. With regard to retention of rights by a creditor the regulations provide the following:

> For the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

Treas. Reg. § 1.302-4(d), T.D. 6152, *as amended*, T.D. 6969, 1968-2 CUM. BULL. 126.

ten years from the date of the redemption.[116] One uncertain area is whether an acquisition within ten years by an individual from whom stock is attributable to the redeeming shareholder complies with section 302(c)(2). In Revenue Ruling 71-562[117] a father and son each owned one-half of a corporation's stock. The corporation redeemed all the father's stock and he filed the agreement necessary to waive the family attribution rules. Within ten years a second son acquired shares of the corporation. The Service held the waiver applicable to the reacquisition provision as well as to the redemption provision of section 302(b)(3). Therefore, the father continued to comply with the requirements of section 302(c)(2)(A)(ii). Although the ruling is logical—since attribution from family members is waived at the time of redemption, it is logical to waive attribution from family members who subsequently become stockholders—its validity is questionable. The express words of the statute allow waiver of family attribution only for the purpose of the redemption described in section 302(b)(3).[118] Waiver for other purposes, such as reacquisition, is unauthorized by the Code.

Another ruling involved the reacquisition of stock by two brothers as executors in a state that allows executors to vote the estate's stock. The IRS viewed this as merely a reacquisition by bequest and held it in compliance with section 302(c)(2)(A)(ii).[119]

(c) Filing of agreement.—The redeeming shareholder must file an agreement to notify the Secretary of any reacquisition of interest and to keep necessary records.[120] The agreement must be timely filed with the income tax return for the year in which the redemption took place.[121] Courts have been lenient, however, in applying this time limit. In *United States v. Van Keppel*[122] the redeeming share-

116. INT. REV. CODE OF 1954, § 302(c)(2)(A)(ii).
117. Rev. Rul. 71-562, 1971-2 CUM. BULL. 173.
118. INT. REV. CODE OF 1954, § 302(c)(2)(A).
119. Rev. Rul. 72-380, 1972-2 CUM. BULL. 201.
120. INT. REV. CODE OF 1954, § 302(c)(2)(A)(iii). The regulations provide,

> (a) The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to his return timely filed for the year in which the distribution described in section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired any interest in the corporation (as described in section 302(c)(2)(A)(i)) since such distribution, and that he agrees to notify the district director of internal revenue for the district in which such return is filed of any acquisition of such an interest in the corporation within 30 days after such acquisition if such acquisition occurs within 10 years from the date of such distribution.
>
> (b) The distributee who files an agreement under section 302(c)(2)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.

Treas. Reg. § 1.302-4(a)-(b), T.D. 6152, *as amended,* T.D. 6969, 1968-2 CUM. BULL. 126.

121. Treas. Reg. § 1.302-4(a)-(b), T.D. 6152, *as amended,* T.D. 6969, 1968-2 CUM. BULL. 126.
122. 321 F.2d 717 (10th Cir. 1963).

holder inadvertently failed to file the agreement on time. The court cautioned that taxpayer had no absolute right to file the agreement late, but held the late filing valid, noting that it was the produce of mistake not a change in an election, that the government's interests were not prejudiced, and that the IRS was not misled or inconvenienced. The court described its decision as analogous to the Service's administrative practice of accepting amended returns.[123]

A contrary decision was reached in *Fehrs Finance Co. v. Commissioner*.[124] The redeeming shareholder in that case argued that the redemption was not essentially equivalent to a dividend. On appeal taxpayer also alleged a complete termination of his interest in the corporation. The circuit court rejected this argument, however, because stock owned by his wife and children was attributed to him. Taxpayer then argued that his filing of a section 302(c)(2)(A)(iii) agreement after the trial was substantial compliance with the provision. The court disagreed, holding that to wait until after trial is too long.[125]

In general, the owner of a beneficial interest in stock must file the required agreement. Thus, if stock held by a voting trust is redeemed, the holder of the voting trust certificate, rather than the voting trustee, must file.[126] Similarly, a beneficiary of an ordinary trust is the proper party to file the agreement.[127] In addition, redemptions in community property states require both the shareholder and his spouse to file agreements to waive family attribution. In these states each spouse is deemed to receive one-half of the redemption price.[128]

When an estate desires to waive family attribution, on the other hand, it has been held proper for the estate, rather than the beneficiaries, to file the nonreacquisition agreement.[129] The Tax Court in *Crawford* based its decision on the estate's status as a "distributee," the party statutorily required to file.[130] The court, however, may have misconstrued the term "distributee." Waiver of family attribution is an exception to the general rule and should be interpreted

123. *Accord*, Pearce v. United States, 226 F. Supp. 702 (W.D.N.Y. 1964).
124. 487 F.2d 184 (8th Cir. 1973).
125. *Id.* at 189.
126. Rev. Rul. 71-262, 1971-1 CUM. BULL. 110.
127. Rev. Rul. 72-471, 1972-2 CUM. BULL. 201.
128. Rev. Rul. 71-138, 1971-1 CUM. BULL. 109.
129. Crawford v. Commissioner, 59 T.C. 830 (1973).
130. *Id.* at 835.

narrowly. Additionally, the language of the waiver provisions illustrates congressional intent to disallow their availability when a possibility of tax avoidance exists.[131] By considering the decedent's estate as the distributee of the redemption price, the decedent's family members and beneficiaries are insulated from the limitations of section 302(c)(2) dealing with termination and acquisition of interest. Therefore, *Crawford*'s characterization of the estate as distributee is suspect and of dubious precedential value.[132]

(d) Limitations on waiver of attribution.—Waiver of attribution is expressly limited to ownership attributable to and from family members.[133] Neither a trust nor an individual can waive attribution from a corporation.[134] Furthermore, the waiver is only for the purpose of determining an individual's stock ownership in the redemption of his own stock and does not eliminate family attribution for other purposes.[135] Thus, when a corporation's stock is owned by a father, his son, and a trust of which the son is the sole beneficiary and the corporation redeems all the stock actually owned by the son and the trust, two consequences will follow. On filing of a section 302(c)(2)(A)(iii) agreement, the son will not be considered as owning his father's stock for purposes of section 302(b)(3). The father's stock, however, will be attributed to the son for the purpose of reattributing it to the trust.[136]

(e) The "look-back" rule.—A limitation on waiver of family attribution is provided in section 302(c)(2)(B). If the redeemed stock was acquired within ten years prior to the redemption from a family member or if a family member acquired any stock from the redeeming shareholder within ten years prior to the redemption, the waiver of attribution allowed by section 302(c)(2)(A) will not be available.[137] Relief from this limitation can be obtained by showing that the redeeming shareholder's acquisition or disposition of stock was not made for the principal purpose of federal tax avoidance.[138] For an illustration of this provision's rationale, assume that Husband wanted to give $100,000 to Wife, but had no cash because all his assets were tied up in his solely owned corporation. He considered redeeming some of his stock, but realized that this would result in a dividend to him. Instead, he transferred stock to Wife and had the

131. INT. REV. CODE OF 1954, § 302(c)(2).

132. The Commissioner nonacquiesced in *Crawford* at 1974-2 CUM. BULL. 5. *See* Rev. Rul. 68-388, 1968-2 CUM. BULL. 122; Rev. Rul. 59-233, 1959-2 CUM. BULL. 106. The Tax Court has refused to extend *Crawford* to trusts. Haft Trust v. Commissioner, 61 T.C. 398 (1973); 62 T.C. (1974); *see* note 136 and accompanying text *infra*.

133. INT. REV. CODE OF 1954, § 302(c)(2)(A).

134. Rev. Rul. 59-233, 1959-2 CUM. BULL. 106.

135. *Id.*

136. Rev. Rul. 72-472, 1972-2 CUM. BULL. 202.

137. INT. REV. CODE OF 1954, § 302(c)(2)(B).

138. *Id.*

corporation redeem it. If family attribution rules were validly waived, Husband would avoid taxes by having the redemption taxed at capital gains rates to Wife. This type of tax avoidance is thwarted by section 302(c)(2)(B), the so-called ten-year "look back" rule. This subjective provision focuses on a single motive and is normally of little concern. Reasonable business objectives will prevent the operation of the section. For example, when a father gave his son stock in his corporation to interest the son in corporate operations and the son had his stock redeemed within ten years, the Service allowed the son to waive family attribution.[139]

B. *Use of Buy-Sell Agreements To Reduce a Corporation's Price*

Frequently in the sale of a closely held or solely owned corporation, the purchaser (assuming that he agrees to purchase stock instead of assets) may be unwilling or unable to buy all the stock and the corporation may have excess cash on its books. A distribution by the corporation to the selling shareholder, therefore, will be necessary to lower the price of the stock to be purchased.

1. *From the Seller's Viewpoint.*—Under the 1954 Code the selling shareholder or shareholders can lower the stock price, dispose of their entire interest in the corporation, and avoid dividend consequences by engaging in a two-step transaction. First, the purchaser should be sold a portion of the stock. Second, the corporation should redeem the remaining stock from the sellers. Because this redemption is in complete termination of the seller's interest, it will qualify for capital gain treatment.[140]

Under the 1939 Code selling shareholders could achieve the same result. In *Zenz v. Quinlivan*[141] a woman owned all the stock of a corporation. A prospective buyer, worried about tax liabilities inherent in the accumulated earnings and profits, bought a portion of the stock and three weeks later the corporation redeemed the seller's remaining stock, completely exhausting the accumulated earnings and profits. The Sixth Circuit upheld the transaction:

> We cannot concur with the legal proposition enunciated by the District Court that a corporate distribution can be essentially equivalent to a taxable dividend even though that distribution extinguishes the shareholder's interest in the corporation. To

139. Rev. Rul. 56-584, 1956-2 CUM. BULL. 179.
140. INT. REV. CODE OF 1954, § 302(b)(3).
141. 213 F.2d 914 (6th Cir. 1954).

> the contrary, we are satisfied that where the taxpayer effects a redemption which completely extinguishes the taxpayer's interest in the corporation, and does not retain any beneficial interest whatever, that such transaction is not the equivalent of the distribution of a taxable dividend . . . .[142]

Although a sale-redemption transaction should begin with the sale, it has been held that a redemption before the sale will not result in dividend treatment.[143] The court in *United States v. Carey*[144] found that because the related transactions were meant to effect a transfer of stock ownership, the distribution in redemption of stock was not a taxable dividend. It must be observed, however, that the court viewed the redemption as one step in an integrated plan. If a redemption and the termination of a shareholder's interest appear disjointed, the redemption may be treated as a dividend.[145]

The apparent rationale of *Carey* is that when the substance of a transaction is the same as if the sale had preceded the redemption, the same tax consequences should result. An extension of this reasoning would allow capital gains treatment when a corporation, as part of an integrated plan to transfer stock ownership, distributes property to selling shareholders without a redemption to reduce the value of their stock. The only difference between this transaction and the *Carey* transaction is a transfer of paper. The Fifth Circuit reached this exact conclusion in *Casner v. Commissioner*,[146] noting that the distribution was but one step in a "pre-conceived multi-step plan" and that it would not have occurred "but for the contemplated stock sale."[147]

While a stock sale and redemption transaction need not follow the technically correct course for the seller to get favorable capital gains treatment, the buyer should carefully construct the transaction to avoid having a constructive dividend attributed to him.

2. *From the Buyer's Viewpoint.*—If a buyer contracts to purchase all the stock of a corporation and after buying it attempts to recoup part of the purchase price by redeeming stock, clearly this redemption will be treated as a dividend because none of the requirements of section 302(b) have been met. Furthermore, most attempts to avoid this result are likely to fail. If the buyer attempts to restructure the deal, it is likely that courts or the Service will see through the new form of the transaction, similar to the Supreme Court's reaction in *Commissioner v. Court Holding Co.*[148] In that case

142. *Id.* at 917.
143. United States v. Carey, 289 F.2d 531 (8th Cir. 1961).
144. *Id.*
145. *See id.* at 538. *Contra,* Friend v. United States, 345 F.2d 761 (1st Cir. 1965).
146. 450 F.2d 379 (5th Cir. 1971).
147. *Id.* at 397.
148. 324 U.S. 331 (1945).

the Court frustrated the selling shareholder's attempt to restructure the transaction and avoid income tax at the corporate level.[149] Even though there was no written agreement between the corporation and the prospective buyer, the Court felt that negotiations had progressed to such a point that any change was merely to avoid taxes. Using this same analysis, courts and the Service are likely to impute a dividend to the buyer when he restructures a deal, having the seller redeem some stock and lowering the price, to avoid a dividend to himself.

The buyer may also try to purchase a stock by paying a portion of or the entire purchase price with a debt instrument. If the buyer repays his debt by having the corporation make the payments, the buyer is receiving a constructive dividend and will be taxed as such. Revenue Ruling 58-614 stated, "[I]f the stock is in reality purchased by a shareholder and paid for by the corporation, then, regardless of the form of the transaction, the payment will be considered a dividend to the shareholder who made the purchase."[150] Similarly, if an individual shareholder has a binding commitment to purchase stock from another individual and he causes the corporation to buy a portion of it, a dividend will result.[151] In this situation, however, there is always the issue of whether the buyer had a binding obligation. If he did not, the corporation's payments will not be treated as a constructive dividend to him.

Both *Carey*[152] and *Casner*[153] illustrated that a redemption or dividend distribution in an integrated plan to transfer stock ownership will not be treated as a dividend to the selling shareholder.[154] The distributions are considered part of the stock purchase price paid by the buyer.[155] On the other hand, treating the distribution as part of the purchase price does benefit the buyer. Indeed, *Casner* found distributions to the selling shareholders to be properly taxable as constructive dividends to the buying shareholders.[156] Although the court did not expressly attach signficance to the buyers' involvement

149. *Id.* at 334.
150. Rev. Rul. 58-614, 1958-2 CUM. BULL. 920. *See also* McGinty v. Commissioner, 325 F.2d 820 (2d Cir. 1963); Television Indus., Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960).
151. *See generally* Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Stephens v. Commissioner, 60 T.C. 1004 (1973); Rev. Rul. 69-608, 1969-2 CUM. BULL. 43.
152. United States v. Carey, 289 F.2d 531 (8th Cir. 1961).
153. Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971).
154. *See* notes 145-47 and accompanying text *supra*.
155. *See* Casner v. Commissioner, 450 F.2d 379, 395 (5th Cir. 1971).
156. *Id.* at 399.

in formulating the mode of purchase, implicitly this involvement was determinative. Logically, if a buyer makes an offer to a corporation's shareholders and they accept it only after distributing some of its assets to themselves (or the sellers make an acceptable counteroffer), how can the buyer be deemed to receive a constructive dividend? The lesson to be learned from *Casner* is that the buyer should disassociate himself from the corporate distribution. Mere knowledge that the corporation is not discharging his obligation may not be enough to preclude the finding of a constructive dividend.

When a buyer cannot afford the entire stock of a corporation, the solution is to reduce the corporation's value through a distribution of assets. This is the essence of each of the following transactions: (1) The seller has some of his stock redeemed and sells the remainder to the buyer; (2) the seller sells a portion of his stock to the buyer and has the remaining stock redeemed; (3) the buyer pays for all the stock with a debt instrument and has the corporation make the payments; and (4) the buyer agrees to buy all the stock, but at closing pays for only a portion, causing the corporation to redeem the remaining stock. As illustrated above, however, these similar transactions result in different tax consequences: the first two will not be deemed constructive dividends to the buyer, while the last two will.

Logically, the same tax treatment should be given to substantially similar transactions. A corporation's accumulated earnings and profits are withdrawn at favorable capital gains rates by a terminating shareholder. A purchasing shareholder should receive the same tax benefits. A possible solution would allow corporate distributions, in redemption of stock or otherwise, made for the sole purpose of effecting a change in stock ownership to receive capital gain treatment. In the case of a redemption, the shareholder would be taxed at the favorable rates in the year of distribution. Other distributions would decrease the basis of the shareholder's stock, resulting in capital gain treatment when the stock is eventually sold. The requisite purpose would be easily determinable in this solution. Furthermore, attribution of stock ownership and a requirement of complete termination of interest could be used to prevent tax avoidance.

V. Redemptions To Pay Death Taxes

A. In General

If a corporation redeems stock that comprises a substantial portion of a decedent's estate, to the extent the distribution does not exceed estate, inheritance, legacy and succession taxes, and funeral and administration expenses, it will be treated as payment in exchange for the stock redeemed.[157] The primary purpose of section

157. INT. REV. CODE OF 1954, § 303.

303 is to give liquidity to estates whose value is swollen by stock of closely held corporations. Also, by excepting such redemptions from the family attribution rules, it discourages dissolution of family-owned corporations by stock sales to outsiders. The drafters of the provision elaborated,

> It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country . . . .
>
> Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free private enterprise.[158]

Although the stated purpose of the provision is to provide estates with liquidity to pay death taxes, it will apply even though an estate is already liquid[159] and even though the redemption proceeds are not used to pay taxes or expenses.[160]

B. Statutory Scheme

1. Relationship of Stock to Decedent's Estate.—For section 303 to apply, the value of the stock held by the estate must equal thirty-five percent of the gross estate or fifty percent of the taxable estate.[161] In meeting the percentage requirements, all stock included in the decedent's gross estate may be counted. Thus, stock transferred by the decdent in contemplation of death or over which he had a general power of appointment is counted.[162] On the other hand, because constructive ownership rules of section 318 are not applicable to section 303, stock constructively owned by the decedent for other purposes may not be counted in determining the percentage requirements.[163]

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158. H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), *reprinted in* 1950-2 CUM. BULL. 380, 427-28.
159. United States v. Lake, 406 F.2d 941, 948 (5th Cir. 1969).
160. *Id.* at 948. *See also* Rev. Rul. 56-449, 1956-2 CUM. BULL. 180.
161. INT. REV. CODE OF 1954, § 303(b)(2)(A).
162. Rev. Rul. 69-616, 1969-2 CUM. BULL. 45.
163. Byrd v. Commissioner, 388 F.2d 223 (5th Cir. 1967).

If stock of two or more corporations is included in a decedent's gross estate, the aggregate amount of stock will be considered the stock of one corporation for purposes of the thirty-five and fifty percent requirements, providing the estate holds more than seventy-five percent of the value of the outstanding stock of each corporation.[164] This relieves an estate that has a substantial interest in more than one corporation, no one of which meets the percentage requirements and prevents an estate with interests in two or more corporations from meeting the thirty-five or fifty percent requirements through post-mortem manipulation. Suppose a decedent owned forty percent of corporation *X* and forty-five percent of corporation *Y*, neither corporation satisfying the percentage requirements. Assume further that *Y* agrees to exchange its own stock for *X* stock held by the estate, that after the exchange the *Y* stock equals more than thirty-five percent of the gross estate, and that the alternate valuation date is elected and follows the exchange. This subterfuge will be unavailing because the estate will be deemed to hold two blocks of *Y* stock for purposes of section 303(b)(2).[165]

The decedent's personal representative has a limited ability to aid the estate in meeting the percentage requirements of section 303. First, the requirements speak in terms of "value." Therefore, it may be wise to value the stock at its highest arguable value. Second, because an alternate valuation date six months after death can be elected, the personal representative may seek to encourage the corporation to take steps to increase its stock's value. For example, the corporation could forego the payment of dividends to increase its book value. Last, the personal representative has authority to deduct administration and funeral expenses of the estate tax return or on the estate's income tax return. If he deducts these expenses on the estate tax return, the taxable estate will be lowered, thus making it easier to reach the fifty percent requirements.[166]

2. *Time Limitation for Redemption.*—Section 303 states alternative tests to determine when a redemption must occur to receive favorable tax treatment. The basic rule is that the redemption has to occur within the period of limitations provided in section 6501(a) (three years) for the assessment of federal estate taxes or within ninety days thereafter.[167] In practice, this limitation can be eliminated by distributing a long-term note in redemption of the stock.[168] In

164. INT. REV. CODE OF 1954, § 303(b)(2)(B).
165. Rev. Rul. 69-594, 1969-2 CUM. BULL. 44.
166. *See generally* Kadish, *Section 303—Redemptions To Pay Death Taxes and Administrative Expenses*, 18 W. RES. L. REV. 895 (1967); Tiger, *How To Plan Stock Redemptions To Pay Estate Taxes—The Problem of Section 303*, 24 J. TAX. 92 (1966).
167. INT. REV. CODE OF 1954, § 303(b)(1)(A).
168. Rev. Rul. 67-427, 1967-2 CUM. BULL. 156.

addition, because the three-year period for assessment of taxes does not run until the return is filed, a late filing will extend the period of time in which a section 303 redemption can be made.[169] Furthermore, a filing within the statutory period is deemed to have been made on the last day of the period. Thus, a redemption more than three years and ninety days after the actual filing of the estate tax return, but less than three years and ninety days from the last day of the filing period will qualify for section 303 treatment.[170]

The second time limit for a section 303 redemption is narrow in scope. If a petition for redetermination of an estate tax deficiency has been timely filed with the Tax Court, the redemption must be made within sixty days after the court's decision becomes final.[171]

3. *Persons Who May Use Section 303.*—The language of section 303 does not limit the persons entitled to its favorable treatment. There is no requirement that distributions received be used to pay estate taxes and expenses. It is only necessary that the stock redeemed under this section be included in the decedent's gross estate. The treasury regulations provide, however, that

> section 303 is not applicable to the case where stock is redeemed from a stockholder who has acquired the stock by gift or purchase from any person to whom such stock has passed from the decedent. Nor is section 303 applicable to the case where stock is redeemed from a stockholder who has acquired the stock from the executor in satisfaction of a specific monetary bequest.[172]

United States v. Lake[173] involved a shareholder who purchased stock from a beneficiary of the decedent and allegedly paid the death taxes. The court held the regulations inapplicable to this taxpayer.[174] On the other hand, the Service has ruled that when a personal representative has no discretionary power to distribute assets in kind, a distribution of stock will be considered in satisfaction of a specific monetary bequest and the distributee will be unable to make a section 303 redemption.[175]

4. *Stock with Substituted Basis.*—Section 303(c) provides that if a shareholder owns stock whose basis is determined by refer-

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169. Rev. Rul. 72-204, 1972-1 CUM. BULL. 422.
170. Rev. Rul. 69-47, 1969-1 CUM. BULL. 94.
171. INT. REV. CODE OF 1954, § 303(b)(1)(B).
172. Treas. Reg. § 1.303-2(f), T.D. 6152, *as amended*, T.D. 6724, 1964-1 CUM. BULL. 128.
173. 406 F.2d 941 (5th Cir. 1969).
174. *Id.* at 950.
175. Rev. Rul. 70-297, 1970-1 CUM. BULL. 66.

ence to stock that would meet the requirements of section 303(a), this stock will qualify for the benefits of section 303.[176]

VI. Redemptions Through Related Corporations

A. Background

Section 302 states that "[i]f a corporation redeems *its* stock"[177] certain tax consequences will result. The section has no application, therefore, to a shareholder who sells stock of one corporation to another corporation. In *Wanamaker v. Commissioner*,[178] John Wanamaker established a trust and transferred to it stock in a corporation named John Wanamaker, Philadelphia. Later, lacking liquidity the trustees transferred the stock to John Wanamaker, New York, a wholly owned subsidiary corporation of John Wanamaker, Philadelphia. The trustees and the court treated the transaction as an exchange of a capital asset because it was not a redemption by John Wanamaker, New York of *its* stock.

Recognizing that sales of stock of a parent corporation to its subsidiaries by controlling shareholders could circumvent the provisions relating to redemptions, Congress enacted section 115(g)(2) of the Internal Revenue Code of 1939 in 1950. Under section 115(g)(2) a transaction cast in the form of the *Wanamaker* transaction was treated as though the subsidiary had first distributed assets to the parent corporation and the parent had then redeemed its own stock.[179] This section, however, did not completely close the loophole. A shareholder who owned stock of two corporations could still sell stock of one to the other.[180] The effect of this transaction was the same as if the acquiring corporation distributed assets to the shareholder and the shareholder made a capital contribution of the stock. With the enactment of the 1954 Code, section 304 closed this loophole.[181]

B. Statutory Framework

1. Brother-Sister Corporations.—If one or more persons control two corporations and in exchange for property one of the corporations acquires stock in the other, the following consequences will

176. INT. REV. CODE OF 1954, § 303(c).

177. *Id.* § 302(a) (emphasis added).

178. 11 T.C. 365 (1948), *aff'd per curiam*, 178 F.2d 10 (3d Cir. 1949) (interpreting § 115(g) of the Internal Revenue Code of 1939).

179. Revenue Act of 1950, ch. 994, § 209(a), 64 Stat. 932.

180. Commissioner v. Pope, 239 F.2d 881 (1st Cir. 1957); Trianon Hotel Co. v. Commissioner, 30 T.C. 156 (1958); Rev. Rul. 55-15, 1955-1 CUM. BULL. 361, *revoked by* Rev. Rul. 59-97, 1959-1 CUM. BULL. 684.

181. INT. REV. CODE OF 1954, § 304(a); *see* United States v. Collins, 300 F.2d 821 (1st Cir. 1962).

result: (1) The property distributed will be treated as a distribution in redemption of the stock of the acquiring corporation; (2) the stock acquired will be treated as a contribution to the capital of the corporation; (3) the determination of whether the redemption will be treated as an exchange or as a dividend pursuant to section 302 will be made with reference to the stock of the issuing corporation; and (4) if the redemption is afforded dividend treatment, the amount of the dividend will be based on the earnings and profits of the acquiring corporation.[182]

2. *Parent-Subsidiary Corporations.*—If one corporation controls another and the subsidiary purchases stock from a shareholder of the parent, the property distributed will be treated as a redemption by the issuing corporation. In addition, the determination of dividend treatment under section 302 will be made with reference to the stock of the issuing corporation. Finally, if the redemption is treated as a dividend, the determination of its amount will be made as if the property had been distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed to the shareholder by the issuing corporation.[183]

3. *Control.*—Section 304 is dependent on control. For example, in the brother-sister transaction the section requires the shareholder to be in control of the two corporations. In this context control means ownership of stock possessing at least fifty percent of the total combined voting power of all classes of stock entitled to vote or at least fifty percent of the total value of all shares.[184] In addition, for purposes of determining control the constructive ownership rules of section 318 are applicable. Furthermore, the fifty percent requirement for attribution to and from corporations is waived for purposes of section 304.[185]

As a result of the attribution of ownership rules, it has been suggested that the distinction between brother-sister corporations and parent-subsidiary corporations has vanished.[186] When a person controls two corporations, his stock in each is attributed to the other so that each corporation is a parent of the other. Depending on the

182. INT. REV. CODE OF 1954, § 304.
183. *Id.*
184. *Id.* § 304(c)(1).
185. *Id.* § 304(c)(2). *See also* Coyle v. United States, 415 F.2d 488 (4th Cir. 1968); Rev. Rul. 71-563, 1971-2 CUM. BULL. 175.
186. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.39 (1971); Morans, *Section 304*, 22 TAX L. REV. 161 (1967).

Service's selection of the brother-sister or parent-subsidiary rules, different substantive effects on the amount of dividend and the basis of the transferred stock can result. Others have suggested, however, that the constructive ownership rules do not have this effect. Section 304(b)(2)(B) states that "the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation."[187] The argument is that the hypothetical distribution by the acquiring corporation to the issuer can occur "only if the latter [is] an actual parent."[188]

4. *Scope of Section 304.*—Even though section 304 was enacted to prevent tax avoidance, it nevertheless applies in the absence of this motive.[189] Moreover, the acquiring corporation's receipt of property equal in value to the property it distributed is of no consequence. In *United States v. Collins*[190] the district court held that because there was no reduction of the accumulated earnings and profits of the acquiring corporation and the selling shareholder gave up property of equal value to the amount distributed, section 304 would not apply. The circuit court[191] reversed, explaining that the consolidated assets of the two corporations were reduced and the shareholder retained the same proportionate interest in the two corporations.[192]

C. *Relationship to Other Code Sections*

1. *Section 351.*—Basically, section 351 provides that if property is transferred to a corporation solely in exchange for stock or securities and immediately after the exchange the transferor is in control of the corporation, no gain or loss will be recognized. If the shareholder receives property or money, however, gain will be recognized to the extent of its value.[193] Control for purposes of section 351 exists when the shareholder owns eighty percent of the total combined voting power of all classes of stock entitled to vote and at least eighty percent of the total number of shares of all other classes of stock.[194] Thus, if a shareholder owns all the stock of two corporations and exchanges the stock of one for property of the other, the

187. INT. REV. CODE OF 1954, § 304(b)(2)(B).
188. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.39 (1971).
189. Radnitz v. United States, 294 F.2d 577 (2d Cir. 1961).
190. 193 F. Supp. 602 (D. Mass. 1961).
191. Collins v. United States, 300 F.2d 821 (1st Cir.), *rev'g* 193 F. Supp. 602 (D. Mass. 1961).
192. *Id.* at 824.
193. INT. REV. CODE OF 1954, § 351.
194. *Id.* § 368(c).

transaction falls within the purview of both sections 304 and 351. The IRS treats section 304 as controlling.[195]

> Section 304 of the Code is specifically directed at *distributions in redemptions* of stock through use of related corporations meeting the 50% stock control requirement of section 304(c) of the Code. Section 351 of the Code, on the other hand, generally applies to the *formation* of corporations in transactions where assets are transferred by a person or persons who, after the transfer, meet the 80% stock control requirement.
>
> If section 351 of the Code were construed to apply to transactions described in section 304 of the Code, an individual owning between 80% and 100% of the acquiring corporation would fall under the mantle of section 351 of the Code, whereas an individual owning as much as 50% but less than 80% of the acquiring corporation's stock would come within the scope of section 304 of the Code, thereby raising the possibility of dividend treatment. Such an interpretation of section 351 of the Code would permit an 80% to 100% shareholder who has the greater ability to shape the affairs of the corporation to his own ends, to be free of the effects of section 304 of the Code, but would subject the person with a lesser interest and, therefore, a lesser ability to control the policies of the corporation, to the more stringent requirement of section 304 of the Code.[196]

The Service's view, however, does not enjoy unanimous support. The Sixth Circuit has held that section 351 is controlling,[197] basing its decision on the words "except as otherwise provided in this chapter" that appear in section 301.[198] Holding that sections 301 and 304 are *in pari materia*, the court found section 351 to be an exception to both sections. On the other hand, the Court of Appeals for the Ninth Circuit disagreed.[199] That court declared that by holding section 304 controlling it was effectuating the legislative intent and policy of the two sections.[200] Congress could easily rectify this ambiguity through legislation.

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195. Rev. Rul. 73-2, 1973-1 CUM. BULL. 171.
196. *Id.* at 172.
197. Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968).
198. INT. REV. CODE OF 1954, § 301(a).
199. Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir. 1973).
200. The court in *Coates* illustrated why it felt it was effectuating the intent of Congress:

> Our case reveals the ultimate inconsistency that would result if we followed *Stickney* and held that the 'except as otherwise provided' provisos of §§ 302(d) and 301(a) precluded § 304 applicability to these taxpayers. Other parties to this transaction were taxed at the capital gains rate by virtue of §§ 304(a) and 302(b)(2). . . . That result would not be altered were we to follow *Stickney*'s interpretation of the provisos. Thus *Stickney*'s rationale would lead us to hold that those specifically excluded by Congress from dividend treatment (by virtue of § 302(b)(2)) would be taxed at the capital gains rate, while those Congress intended to be taxed at ordinary in-

2. *Sections 317 and 306.*—Section 304 is expressly applicable only to exchanges of property of one corporation for stock of a related corporation. Section 317(a), on the other hand, defines "property" as excluding stock in the corporation making the distribution. Therefore, if the sole owner of two corporations gives stock of one corporation to the other in exchange for a distribution of stock of that corporation, section 304 is inapplicable. Furthermore, this transaction is a taxable event in the nature of an exchange of a capital assets. Thus, the stock received by the shareholder will not constitute section 306 stock and its subsequent sale or redemption will be free from the adverse effects of that section.[201]

VII. A Final Note

One matter applicable to all three Code sections discussed in this article is basis. When stock is sold, the gain or loss on the transaction normally will be determined by the difference between the amount received and the basis of the stock given up. If a shareholder redeems stock and receives dividend treatment, however, a question arises about the effect of the basis of the redeemed stock.[202] The Code provides no answer to this question and the treasury regulations say only that "[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed."[203] The Service offered this illustration:

> A, an individual, purchases all of the stock of Corporation X for $100,000. In 1955 the corporation redeems half of the stock for $150,000, and it is determined that this amount constitutes a dividend. The remaining stock of Corporation X held by A has a basis of 100,000 dollars.[204]

Apparently, the proper adjustment is to allow the shareholder to retain his original basis.

Although the general rules of taxation of stock redemptions are easily stated, in practice they become strained by the pressures of the multifarious situations they govern. As a result, applications of the rules are often inconsistent or imprecise. Those rules that are inconsistent include waiver of family attribution[205] and corporate buy-sell arrangements.[206] Those that are imprecise include the standard for

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come rates (by virtue of §§ 304(a), 302(d) and 301(a)) would escape taxation altogether . . . .

Id. at 473 n.9.

201. *See* INT. REV. CODE OF 1954, § 306.

202. Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949); Katcher, *The Case of the Forgotten Basis*, 48 MICH. L. REV. 465 (1950).

203. Treas. Reg. § 1.302-2(c) (1955).

204. *Id.*

205. *See* notes 126-29 and accompanying text *supra*.

206. *See* notes 156-57 and acconpanying text *supra*.

determining dividend equivalency,[207] the application of stock ownership attribution rules to redemptions through related corporations,[208] and the relationship between sections 351 and 304 of the Code.[209] Nevertheless, these imprecisions and inconsistencies are traps only for the unwary. Careful planning and communication with the Service will allow the tax counselor to advise his clients properly.

207. *See* notes 52-84 and accompanying text *supra*.
208. *See* notes 180-88 and accompanying text *supra*.
209. *See* notes 193-200 and accompanying text *supra*.