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INCOME TAX: STOCK REDEMPTION AND THE TEST
FOR DIVIDEND EQUIVALENCY UNDER SECTION
302 (b) (1) OF THE INTERNAL REVENUE CODE OF 1954*

United States v. Davis, 397 U.S. 301 (1970)

In 1945 respondent and another party organized a corporation, respondent and his wife each receiving 250 shares for their initial contribution to capital. Respondent purchased an additional 1,000 shares of preferred stock at par value of twenty-five dollars to increase the corporation's capital necessary to qualify for a previously negotiated loan. The corporation would redeem the preferred shares when the loan was repaid. Subsequently, respondent purchased the other party's common stock and divided it equally between his own son and daughter. After repayment of the loan, in 1963, the corporation redeemed the preferred stock and respondent reported the 25,000 dollars as a sale. Although there were accumulated earnings and profits in excess of 25,000 dollars at the time of redemption, the corporation had not paid a dividend. The Internal Revenue Service disapproved treatment of the redemption as a sale and found the 25,000 dollars to be a distribution out of earnings and profits¹ and therefore a dividend² includible in respondent's gross income. Respondent paid the deficiency and sued for refund. The trial court found the 25,000 dollars was not essentially equivalent to a dividend because the redemption had a legitimate business purpose³ and the court of appeals affirmed.⁴ On certiorari, the Supreme Court reversed and HELD, the business purpose of the transaction is irrelevant and to qualify for preferred treatment under section 302 (b) (1) of the 1954 Internal Revenue Code, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation.

Redemption of stock by a corporation⁵ and its characterization as a sale

*EDITOR'S NOTE: This case comment was awarded the *George W. Milam Award* as the outstanding case comment submitted by a Junior Candidate in the spring 1970 quarter.

1. INT. REV. CODE OF 1954, §302 (d) [hereinafter cited as CODE].

2. CODE §316 (a) (1).

3. 274 F. Supp. 466 (M.D. Tenn. 1967). CODE §302 provides in part: "DISTRIBUTIONS IN REDEMPTION OF STOCK. (a) GENERAL RULE.— If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock. (b) REDEMPTIONS TREATED AS EXCHANGES.— (1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.— Subsection (a) shall apply if the redemption is *not essentially equivalent to a dividend.*" (Emphasis added.)

4. 408 F.2d 1139 (6th Cir. 1969).

5. CODE §317 provides in part: "OTHER DEFINITIONS. (b) REDEMPTIONS OF STOCK.— For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."

or exchange⁶ or distribution as a dividend⁷ has been a constant source of litigation.⁸ In the instant case the Court attempts to meet the problems posed by section 302(b) (1) and to provide some objectivity in an area beset by uncertainty in defining that which is not essentially equivalent to a dividend.

The source of the problem is an ambiguous statute and conflicting interpretations of congressional intent in adopting section 302 of the 1954 Code.⁹ The House designed section 302 with specific safe harbor provisions for guaranteed capital gain treatment of redemptions.¹⁰ The Senate found the House proposal "unnecessarily restrictive"¹¹ and incorporated into section 302(b) (1) the language of its predecessor, section 115 (g) (1) of the 1939 Code, which offered capital gain treatment to any stock redemption "not essentially equivalent to a dividend."¹² The test for dividend equivalency employed by the courts under section 115(g) (1) was intended to be used under section 302(b) (1).¹³

Although this test for dividend equivalency was carried forward, the Senate also intended that the transaction would be afforded favorable treatment only if it could be characterized as a sale of stock to the corporation by the redeeming shareholder.¹⁴ This further limitation implied an even more restrictive meaning for section 302(b) (1) than under the 1939 Code.¹⁵ The conflict between incorporation of the language of section 115(g) (1) and its previous judicial interpretation with the Senate restriction that the transaction must constitute a sale precipitated conflicting interpretations of the applicable test.¹⁶ The "strict net effects test" and the "flexible net effects test" emerged from this conflict.¹⁷

The strict net effects test is couched in terms of whether the redemption may properly be characterized as a sale. It asks: (1) Was the redemption

6. CODE §302(a).

7. CODE §§302(d), 301(c)(1), 316(a)(1).

8. Wolfberg, *Stock Redemptions Under Section 302 of the 1954 Code*, 48 TAXES 27 (1970). The author notes the unsettled area surrounding the proper test to be employed under §302(b)(1) and the chaos that has resulted from conflicting court decisions.

9. *Id.*

10. H.R. REP. NO. 1377, 83d Cong., 2d Sess. 35-36 (1954). The House originally designed §302 to provide favorable capital gain treatment only if the shareholder could meet the formula prescribed under §§302(b)(2) or (3) without including §302(b)(1) for redemptions "not essentially equivalent to a dividend."

11. S. REP. NO. 1622, 83d Cong., 2d Sess., 44-45 (1954).

12. Int. Rev. Code of 1939, §115(g)(1), provided that if a corporation cancelled or redeemed its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part *essentially equivalent to the distribution of a taxable dividend*, the amounts so distributed in redemption or cancellation of the stock, to the extent that they represented a distribution of earnings or profits, were taxable as a dividend.

13. S. REP. NO. 1622, 83d Cong., 2d Sess. 234 (1954).

14. *Id.*

15. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 291 (2d ed. 1966).

16. *Commissioner v. Berenbaum*, 369 F.2d 337, 340 (10th Cir. 1966).

17. *Id.*

pro rata to a large percentage of the shareholders? (2) Was there any substantial change in the relative control of the corporation as a result of the redemption?¹⁸ A redemption that is not pro rata and that results in a substantial change in the control of the corporation will be within the scope of section 302 (b) (1), and thus will be afforded capital gain treatment.¹⁹ This test requires the taxpayer to show that, after the transaction, he has less control in the corporation as a shareholder than before.

The flexible net effects test incorporates the twofold inquiry of the strict net effects test but also considers additional factors.²⁰ Under this test courts have looked to past decisions construing section 115 (g) (1)²¹ and considered all relevant factors surrounding the redemption,²² including whether there was a legitimate business purpose rather than merely an intent to benefit the stockholder by distributing accumulated earnings and profits exempt from income taxes.²³ This test emphasized the substance of the transaction.²⁴ Moreover, the inquiry was peculiarly a factual one into the motives of the taxpayer²⁵ and the redeeming corporation.²⁶ The majority of courts²⁷ and the Tax Court²⁸ adopted this less restrictive view.

In the instant case the Supreme Court initially considered the proper interpretation of section 302 (b) (1) and found inapplicable the standards established under section 115 (g) (1) of the 1939 Code.²⁹ The opinion relied heavily upon a finding of congressional intent that future inquiry under

18. Wolfberg, *supra* note 8, at 36. These criteria for determining dividend equivalency, implied from Rev. Rul. 56-103, 1956-1 CUM. BULL. 157, are essentially those adopted by the courts utilizing the strict net effects test. See *Hasbrook v. United States*, 343 F.2d 811 (2d Cir. 1965).

19. *Kerr v. Commissioner*, 326 F.2d 225, 228-29 (9th Cir. 1964).

20. The other factors include: "Did the corporation adopt any plan of contraction of its business activities; did the transaction actually result in a contraction of the corporation [*sic*] business; did the initiative for the corporate distribution come from the corporation or the shareholder; what were the amounts, frequency, and significance of dividends in the past; was there a sufficient accumulation of earned surplus to cover distribution or was it partly from capital; was there a bona fide corporate business purpose for the distribution?" *Id.* at 230, quoting from *Earle v. Woodlaw*, 245 F.2d 119, 126 (6th Cir. 1957).

21. Most courts adopted the flexible net effects test in one form or another giving at least some weight to the business purpose for a distribution redemption. See *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); *United States v. Fewell*, 255 F.2d 496 (5th Cir. 1958); *Neff v. United States*, 301 F.2d 330 (Ct. Cl. 1962); *Lewis v. Commissioner*, 47 T.C. 129 (1966).

22. See note 20 *supra*.

23. *Keefe v. Cote*, 213 F.2d 651, 657 (1st Cir. 1954).

24. See 397 U.S. 301, 303 n.2 (1970). The Court noted that the courts of appeals have treated the business purpose concept in different ways. *Id.*

25. *Keefe v. Cote*, 213 F.2d 651, 657 (1st Cir. 1954).

26. *Id.*

27. See cases cited note 21 *supra*.

28. *Lewis v. Commissioner*, 47 T.C. 129 (1966). The court's decision indicates that this court adopts the flexible net effects test and considers legitimate business purpose to be a determinative factor in dividend equivalency under §302 (b) (1).

29. 397 U.S. 301, 310 (1970).

section 302 (b) (1) should be limited to whether the redemption could properly be characterized as a sale.³⁰

The instant decision sets out three guidelines that are to govern future inquiries into whether a redemption may be classified as a sale or distribution:

- (1) section 318 of the 1954 Code³¹ is to be strictly applied to section 302 (b) (1);
- (2) the only proper test for determining dividend equivalency is whether there has been a meaningful reduction in the shareholder's proportionate interest in the corporation;³² and
- (3) the existence of legitimate business purpose is irrelevant in determining whether the redemption amounts to dividend equivalency.³³

To qualify for preferred treatment under section 302 (b) (1), the taxpayer must now show that his proportionate interest in the corporation has been meaningfully reduced. The term "proportionate interest" suggests that section 302 (b) (1) has been interpreted consistently with the elements of section 302 (b) (2), which offers capital gains treatment for a substantially disproportionate redemption.³⁴ Section 302 (b) (2) offers capital gains treat-

30. *Id.* at 311.

31. CODE §318 (a) (1) (A) provides that a taxpayer will be attributed with constructive ownership of stock owned directly or indirectly by his spouse, "children, grandchildren, and parents." This section is made specifically applicable to §302 by subsection 302 (c) (1).

32. In the instant decision respondent asserted he owned only 25% of the stock because his wife and children together owned 75%. However, §318 gave respondent constructive ownership of 100% of the stock. In attempting to argue that §318 was inapplicable, respondent sought to cast himself in the role of a minority shareholder having little control over the redemption of his preferred stock. This was a situation that the Senate specifically provided would fall within the scope of §302 (b) (1). S. REP. No. 1622, 83d Cong., 2d Sess. 44-45 (1954). The Court emphasized that, in substance, the instant decision dealt with a corporation redeeming preferred stock of its sole shareholder out of accumulated earnings and profits. The redemption was pro rata because respondent constructively owned 100% of the outstanding common stock, and there was no meaningful reduction in his proportionate interest because after the redemption he constructively remained the sole shareholder.

33. Justice Douglas, joined by the Chief Justice and Justice Brennan, dissented, alining himself with the circuit court. He argued that characterizing the transaction as a distribution emphasized form over substance and allowed the mechanical attribution rules to convert a legitimate transaction taxable as a capital gain into a dividend taxable as income. The dissent concluded that the Court's interpretation of §302 (b) (1) rendered it meaningless. The implication is that the Court abrogated the factual nature of the inquiry for dividend equivalency by bringing §302 (b) (1) under the guise of an objective test for dividend equivalency. 391 U.S. 313-14 (1970) (dissenting opinion).

34. CODE §302 (b) (2) provides a substantially disproportionate redemption of stock will be treated as a distribution in exchange for the stock and taxed as a capital gain. To qualify under §302 (b) (2) the taxpayer must have reduced his voting power in all classes of voting stock to less than 50%. Moreover, subsequent to the redemption the ratio of voting stock owned to voting stock outstanding must be less than 80% of the ratio of voting stock owned to voting stock outstanding prior to redemption. This means that the reduction in the shareholder's proportionate interest subsequent to the redemption must be 20% or greater.

ment for a taxpayer who can show that immediately after the redemption he holds less than fifty per cent of the voting control in the corporation and has reduced his voting control by twenty per cent or more.³⁵ If the shareholder reduces his voting control so that he relinquishes majority control and becomes a minority shareholder, this may be a meaningful reduction. Likewise, if the shareholder reduces his voting control by twenty per cent or more, though immediately after redemption he still controls the corporation, this may qualify as a meaningful reduction in proportionate interest in the corporation. It is difficult to determine if "a meaningful reduction in proportionate interest" could be effected by other than a reduction in voting control.

Some decisions under section 302 (b) (1) indicate that the Supreme Court interprets a meaningful reduction in proportionate interest to mean a loss of voting control as defined in section 302 (b) (2). In *Squier v. Commissioner*³⁶ an estate reduced its constructive ownership of outstanding common stock in a corporation from 63.30 per cent to 56.62 per cent, obviously failing to meet the test of section 302 (b) (2).³⁷ However, since actual ownership was reduced to below fifty per cent, the court disregarded the attribution rules of section 318 and held the redemption was not essentially equivalent to a dividend.³⁸ The decision demonstrates that a reduction in voting control to less than fifty per cent of the outstanding common stock without meeting the section 302 (b) (2) test may nevertheless qualify for capital gain treatment under section 302 (b) (1) as not essentially equivalent to a dividend. *Sorem v. Commissioner*³⁹ suggests that when two shareholders have negative control, each shareholder owning fifty per cent of the outstanding stock, changing to a minority position may constitute a meaningful reduction.⁴⁰ Here, the shareholders' interests had been reduced to 43.77 and 37.91 per cent respectively so they could only control the corporation by cooperative effort between themselves or with other new shareholders.⁴¹ The court found a significant reduction in the shareholder's proportionate interest and that the redemption was not essentially equivalent to a dividend.⁴² A shareholder initially in a minority position may be unable to meaningfully reduce his

35. *Id.*

36. 35 T.C. 950 (1961), *acquiesced in* 1961-2 CUM. BULL. 5.

37. The estate still constructively owned more than 50% of outstanding voting stock and the reduction in proportionate interest was not greater than 20%. This placed the redemption outside the safe harbor of capital gains afforded by §302 (b) (2). 35 T.C. 950, 955 (1961).

38. Because the instant decision holds that the attribution rules of §318 will be strictly applied to §302 (b) (1), *Squier* is now of questionable validity with regard to its application of §318. The Tax Court construed §318 as permissive rather than mandatory, but the Supreme Court subsequently rejected this construction. 397 U.S. 301, 307 (1970).

39. 334 F.2d 275 (10th Cir. 1964).

40. *Id.* at 280. In a situation where each shareholder owns 50% of the outstanding voting stock, each exerts negative control because only by unanimity between them can any effective action be taken.

41. *Id.*

42. *Id.*

proportionate interest in a corporation.⁴³ After redemption he retains a minority position, and there is no meaningful change in his proportionate interest in the corporation.⁴⁴

These cases suggest that, for a taxpayer to qualify under the strict net effects test, he must relinquish some significant interest. The primary concern is not with the quantity of the interest the shareholder gives up, but with the effect this has upon his control in the corporation. A shift from majority to minority position or a loss of negative control in the corporation suggests a meaningful reduction in the shareholder's interest.⁴⁵ In the instant case the preferred shareholder who constructively owned all the common stock of the corporation parted with nothing meaningful when he redeemed the preferred shares.⁴⁶ His proportionate interest remained the same and he did not release any control.⁴⁷

A second definition of meaningful reduction is suggested by *Himmel v. Commissioner*.⁴⁸ *Himmel* indicates that stock ownership includes not only voting control but also the right to participate in current earnings and accumulated surplus and share in net assets upon liquidation.⁴⁹ Section 302(b)(2) interprets a reduction of proportionate interest in terms of voting control. There is seemingly no reason to limit the interpretation of section 302(b)(1) to a meaningful reduction in voting control when the reduction of a proportionate interest substantially reduces the shareholder's right to share in earnings and assets on liquidation.⁵⁰ Upon a substantial reduction in the shareholder's proportionate interest while still retaining majority control, the taxpayer may forcefully argue that the reduction is meaningful within the scope of section 302(b)(1).

The rejection of the relevancy of legitimate business purpose in determining dividend equivalency renders most decisions under the flexible net effects test questionable precedent. The function of business purpose is unclear under prior case law,⁵¹ however, some courts considered it to have

43. *Bloch v. United States*, 261 F. Supp. 597 (S.D. Texas 1966), *aff'd*, 386 F.2d 839 (5th Cir. 1967).

44. *Id.*

45. *Sorem v. Commissioner*, 334 F.2d 275, 280 (10th Cir. 1964).

46. 397 U.S. 301, 313 (1970).

47. *Id.*

48. 338 F.2d 815 (2d Cir. 1964).

49. *Id.*

50. CODE §302(b)(5) provides that failure to meet the provisions of subsections (2), (3), or (4) shall not preclude capital gain treatment of a redemption not essentially equivalent to a dividend under subsection (1). Because §§302(2), (3), and (4) offer a safe harbor for redemptions that meet definite reductions in voting control, §302(b)(5) implies that reductions may be meaningful within the scope of the instant decision when there is a significant reduction in the right to participate in earnings and assets on liquidation.

51. In *Lewis v. Commissioner*, 47 T.C. 129, 135 (1966), the Tax Court emphasized the significance of business purpose and the discretionary nature of the attribution rules of §18. In the Tax Court, business purpose seems to have been more predominate than in the circuit courts for determining dividend equivalency. For a history of the varied application of business purpose under §302, see Wolfberg, *supra* note 8, at 42.

only limited application.⁵² Business purpose was determinative only when the significance of the reduction in the shareholder's proportionate interest was questionable.⁵³ The instant decision removes a method used by the courts to deal with the redemption between the extremes of sale and distribution. The inquiry is now less factual,⁵⁴ and the taxpayer is governed by a yet undetermined objective standard of meaningful reduction in his proportionate interest in the corporation.

The impact of the instant decision will weigh most heavily on the close corporation. The Court offered no quantitative guidelines of what it considers sufficient to warrant protection under section 302 (b) (1), but it is clear that, as in the instant case, a taxpayer must give up something more than an equitable interest in the form of nonvoting preferred stock. Without guidelines concerning what qualifies as a meaningful reduction in a shareholder's proportionate interest, redemptions by a closely held family corporation should be carefully planned, noting strict adherence to the mechanical attribution rules, to take advantage of the safe harbor provisions of section 302.

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52. *Commissioner v. Berenbaum*, 369 F.2d 337, 341 (10th Cir. 1966); *Bradburry v. Commissioner*, 298 F.2d 111, 118 (1st Cir. 1962).

53. *Commissioner v. Berenbaum*, 369 F.2d 337, 341 (10th Cir. 1966); *Bradburry v. Commissioner*, 298 F.2d 111, 118 (1st Cir. 1962).

54. *Treas. Reg. §1.302-2(b)* (1954). The Internal Revenue Service has emphasized that the determination of dividend equivalency depends upon the facts and circumstances of each case. *E.g.*, *Coyle v. United States*, 415 F.2d 488, 492 (4th Cir. 1968). The court recognized that the determination of dividend equivalency requires a factual inquiry into the circumstances of each case.