CHAPTER 5

REDEMPTIONS AND PARTIAL LIQUIDATIONS

A. INTRODUCTION

Code: §§ 302; 317(b).

The Logic of Section 302. Shareholders generally recognize a capital gain or loss on the sale of all or part of their stock. Assume, for example, that A purchased 100 shares of X Corporation stock two years ago for $1,000. If A sells 50 of those shares to B, an unrelated outsider, for $750, he will recognize a $250 long-term capital gain. But what if A made the same sale to the corporation? Should that transaction, known as a redemption, also generate a $250 long-term capital gain? We need more facts to answer the question. If A is one of several X shareholders and owns a small percentage of the corporation's stock, a sale of stock to the corporation may be similar (for tax purposes) to a sale to B. But if X has few shareholders and ample earnings and profits and A is a major shareholder, the transaction begins to resemble a dividend.

To illustrate, assume that A's 100 shares constitute all of X Corporation's outstanding stock. In that event, A's "sale" of 50 shares to the corporation in exchange for $750 cash is indistinguishable from a nonliquidating distribution of $750. Although A has surrendered a stock certificate for 50 shares, his proportionate interest in the corporation remains unchanged. When the smoke clears, A continues to control all corporate decisions and he remains the sole shareholder, entitled to 100 percent of X's net assets upon a liquidation. Yet without altering his interest in the business, A has extracted $750 from the corporate coffers. This is the essence of a dividend! But if the "sale" to X were respected, A would be permitted to use a proportionate amount of his stock basis ($500) to offset an equivalent amount of income, and any resulting gain will be taxed at capital gains rates. If A were permitted to avoid dividend characterization with such ease, proportionate redemption programs by shareholders of closely held corporations quickly would become a national sport whenever dividends are taxed at higher rates than capital gains or shareholders have a substantial basis in their stock.

These simple examples identify the fundamental problem in determining the shareholder level tax consequences of a redemption. A line must be drawn between redemptions having the effect of a dividend—that is, transactions that enable shareholders to withdraw cash or other property while leaving their proportionate interest intact—and redemptions that resemble sales because they result in a meaningful reduction in the shareholder's proportionate interest. In the now distant

Exchange = Sale
vs.
dividend

past, the Code had only one vague standard to resolve this question. A redemption was treated as an operating distribution and taxed as a dividend to the extent of the corporation's current and accumulated earnings and profits unless it was not "essentially equivalent to a taxable dividend."[1] Cases were resolved by looking to all the facts and circumstances, including the corporation's "business purpose" and the "net effect" of the transaction.[2]

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The enactment of Section 302 introduced a commendable degree of certainty in an area where predictions had been precarious. Section 302(a) provides that a redemption will be treated as an "exchange" if it satisfies one of five statutory tests in Section 302(b). "Exchange" status means that the shareholder generally will recognize capital gain or loss to the extent of the difference between the amount of the distribution and the shareholder's basis in the redeemed stock. A redemption falling outside of Section 302(b) is treated under Section 302(d) as a "distribution to which Section 301 applies." Under the rules studied in the preceding chapter, the distribution will be a dividend to the extent of the corporation's current and accumulated earnings and profits, then a return of capital to the extent of the shareholder's basis in the redeemed stock, and finally gain from the sale or exchange of the stock to the extent of any balance.

Section 302(b) is thus the nerve center for determining the shareholder-level tax consequences of a redemption and the principal focus of this chapter. Three of the five statutory tests (Sections 302(b)(1)–(3)) examine whether there has been a sufficient reduction in the shareholder's ownership interest in the corporation to justify treating the redemption as an exchange. To obtain a more accurate measure, the shareholder's interest before and after the redemption is determined after application of the constructive ownership rules in Section 318.[3] Section 302(b)(4) shifts the focus to the corporate level and provides exchange treatment for any distribution that qualifies as a "partial liquidation" under Section 302(e) because it involves a genuine contraction of the distributing corporation's business. Finally, Section 302(b)(5) provides that redemptions by a mutual fund or real estate investment trust generally will be treated as an exchange.

Basis Consequences. If a redemption is treated as a sale, the basis of the redeemed stock is taken into account in determining the shareholder's gain or loss. If a redemption is treated as a Section 301 distribution, it is a dividend to the extent of the corporation's earnings

[1] Internal Revenue Code of 1939, § 115(g).

[2] See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 9.01. Another line of authority treated a redemption as not "essentially equivalent to a taxable dividend" if it involved a contraction in the corporation's business activities. This test focused on events at the corporate rather than the shareholder level and gave birth to the tax concept known as a "partial liquidation." The remnants of this concept are considered in Section D of this chapter, infra.

[3] I.R.C. § 302(c)(1).

and profits, next recovery of basis, and finally a gain from the sale or exchange of property.[4] The conceptual difficulty is that an actual corporate distribution generally is made pro rata with respect to all shares in a class of stock. In contrast, in a redemption the corporation may buy back only specific shares of stock. Thus, questions may arise about stock basis when some but not all shares are redeemed and the redemption is treated as a Section 301 distribution. Those questions are: (1) how is basis recovered, and (2) what happens to the basis of redeemed stock? The regulations historically have not provided a great deal of guidance except for reassuring shareholders that their remaining basis in the redeemed stock does not disappear but may be added to the basis of the shareholder's retained stock.[5]

In 2009, the Service issued proposed regulations that applied broadly to distributions throughout Subchapter C and would have helped clarify these questions. Those regulations applied to the portion of the distribution that is not a dividend (i.e., the amount in excess of corporate earnings and profits) and adopted the view that a distribution in redemption, like a regular distribution where no stock is surrendered, is attributable to all of the shareholder's stock in the class of shares being redeemed. Thus, the portion of the distribution that is not a dividend would be applied to reduce the adjusted basis of each share held by the redeemed shareholder. This reduction would be pro rata, share-by-share to all shares in the class of stock to be redeemed, not just to the shares actually surrendered in the redemption.[6] Under this approach, amounts distributed in excess of the basis of particular shares result in gain under Section 301(c)(3). Eventually, the proposed regulations were withdrawn because the Treasury determined that they could not be implemented comprehensively without significant modifications. The Treasury will continue to study the issue, but it indicated that the results of a Section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise.[7] Related stock basis issues are discussed as they arise in the relevant redemption fact patterns.

Tax Consequences to Distributing Corporation. Whether a redemption is treated as an exchange or a Section 301 distribution at the shareholder level, the tax consequences to the distributing corporation of a distribution of property in a redemption are governed by Section 311. The distributing corporation recognizes gain on a distribution of

[4] I.R.C. § 301(c).

[5] See Reg. § 1.302–2(c), providing for "proper adjustment of the remaining stock."

[6] Prop. Reg. § 1.302–5(a)(1). This is preferable to limiting basis recovery to the shares actually surrendered in the redemption.

[7] REG–143686–07 (March 28, 2019). The Treasury also indicated that it will focus on redemptions treated as Section 301 distributions that result in inappropriate shifts in stock basis. These transactions include redemptions of stock that shift basis from a taxpayer who is not subject to tax or who is tax indifferent to another taxpayer who is related under Section 318 to permit the related taxpayer to recognize a loss. See I.R.S. Notice 2001–45, 2001–2 C.B. 129.

appreciated property, but it may not recognize loss on a distribution of property that has declined in value.[8]

Changing Stakes. The tax stakes on a redemption have changed considerably over the years. They are influenced by several variables, such as the type of shareholder (individual or corporate), the shareholder's basis in the redeemed stock, and the applicable tax rates for dividends and capital gains. For most of our tax history, noncorporate shareholders preferred a redemption to be treated as a sale of stock resulting in recovery of the shareholder's basis and recognition of more lightly taxed capital gain. Corporate shareholders prefer dividend treatment because they can shelter most of the distribution if they qualify for the dividends received deduction or completely exclude dividends received from other members of an affiliated group of corporations that file a consolidated tax return.

The introduction of reduced tax rates on qualified dividends altered the stakes for individual shareholders. As long as the dividend and long-term capital gains tax rates remain the same, the major advantage to treating a redemption as an exchange is the shareholder's ability to recover the basis of the redeemed stock in determining gain or loss. In some cases, this still provides an incentive to qualify a redemption as an exchange, but not as much as when exchange treatment offered both recovery of basis and a significant capital gains rate preference (as compared to dividends) and hardly at all where a noncorporate shareholder's stock basis is nominal. In special situations, such as where a shareholder has excess capital losses that will offset capital gains but not qualified dividends, on a deferred payment redemption where installment sale reporting under Section 453 would benefit the shareholder, or for foreign shareholders who may incur a withholding tax on U.S. dividends but not on capital gains, exchange treatment also will be preferable.

The Nontax Context. Redemptions are used to accomplish a variety of corporate and shareholder planning objectives. In the case of closely held corporations, a redemption may be the vehicle for a shift of corporate control, the buyout of a dissatisfied or deceased shareholder, or to provide a liquidity opportunity for those shareholders who desire to diversify their holdings. Stock redemptions by publicly traded companies also have become popular transactions for corporations with excess cash, especially when the company believes the market has undervalued its shares relative to their intrinsic value and no better investment opportunities are available. Keep these contexts in mind in studying the somewhat mechanical aspects of Section 302 at the beginning of this chapter. Later sections explore some of the planning opportunities provided by Section 302.

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[8] I.R.C. § 311(a), (b). For the details and the effect of a redemption on the distributing corporation's earnings and profits, see Section E of this chapter, infra.

B. CONSTRUCTIVE OWNERSHIP OF STOCK

Code: §§ 302(c)(1); 318.

Regulations: §§ 1.318–1(a), (b), –2, –3(a), (b), –4.

Any system that purports to measure the change in a shareholder's proportionate interest in a corporation would be ineffective if it failed to consider the holdings of closely related shareholders. Returning to our introductory example, assume that A and his daughter, D, each own 50 of the 100 outstanding shares of X Corporation and A sells 30 of his shares to the corporation for $450. A's actual percentage ownership drops from 50 percent (50 out of 100 shares) to 29 percent (20 out of 70 shares). Has he substantially reduced his proportionate interest? Looking only to A's *actual* ownership, the reduction is substantial, but the remaining shares are owned by a close relative. With appropriate skepticism, the drafters of the Code concluded that in determining stock ownership for purposes of the Section 302(b) tests for exchange treatment, an individual taxpayer or entity should be considered as owning stock owned by certain family members and related entities under elaborate attribution rules set forth in Section 318.[9]

Section 318 is one of several sets of constructive ownership rules in the Internal Revenue Code[10] and applies only when it is expressly made applicable by another provision of the Code.[11] Its principal role is in the redemption area, where it treats a taxpayer as "owning" stock that is actually owned by various related parties. The attribution rules in Section 318 fall into the following four categories.

1. *Family Attribution.* An individual is considered as owning stock owned by his spouse, children, grandchildren and parents. Siblings and in-laws are not part of the "family" for this purpose, and there is no attribution from a grandparent to a grandchild.[12]

2. *Entity to Beneficiary Attribution.* Stock owned by or for a partnership or estate is considered as owned by the partners or beneficiaries in proportion to their beneficial interests.[13] A person ceases to be a "beneficiary" of an estate for this purpose when she receives all property to which she is entitled (e.g., a specific bequest) and the possibility that she must return the property to satisfy claims is remote.[14] Stock owned by a trust (other than a qualified employees' trust) is considered as owned by the beneficiaries in proportion to their actuarial interests in the trust. In the case of grantor trusts, stock is considered owned by the grantor or other person who is taxable on the trust

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9 I.R.C. § 302(c)(1).

10 Other constructive ownership provisions include Sections 267(c), 341(e)(8), and 544.

11 Section 318(b) contains a partial list of cross references to sections applying Section 318.

12 I.R.C. § 318(a)(1). Cf. I.R.C. § 318(a)(5)(B).

13 I.R.C. § 318(a)(2)(A).

14 Reg. § 1.318–3(a).

income.[15] Stock owned by a corporation is considered owned proportionately (comparing the value of the shareholder's stock to the value of all stock) by a shareholder who owns, directly or through the attribution rules, 50 percent or more in value of that corporation's stock.[16]

3. *Beneficiary to Entity Attribution.* Stock owned by partners or beneficiaries of an estate is considered as owned by the partnership or estate.[17] All stock owned by a trust beneficiary is attributed to the trust except where the beneficiary's interest is "remote" and "contingent." Grantor trusts are considered to own stock owned by the grantor or other person taxable on the income of the trust.[18] All the stock owned by a 50 percent or more shareholder of a corporation is attributed to the corporation.[19]

4. *Option Attribution.* A person holding an option to acquire stock is considered as owning that stock.[20]

These general rules are supplemented by a set of "operating rules" in Section 318(a)(5), which generally authorize chain attribution (e.g., parent to child to child's trust) except that there can be no double family attribution (e.g., no attribution from parent to child to child's spouse) or "sidewise" attribution (e.g., stock attributed to an entity from a partner, beneficiary or shareholder may not be reattributed from that entity to another partner, beneficiary or shareholder).[21] In addition, option attribution takes precedence over family attribution where both apply.[22] For Section 318 purposes, an S corporation is treated as a partnership, and S corporation shareholders are treated like partners.[23]

The problems below test your ability to apply the attribution rules in some typical factual contexts.

PROBLEMS

1. Wham Corporation has 100 shares of common stock outstanding. Twenty-five shares are owned by Grandfather, 20 shares are owned by Mother (Grandfather's Daughter), 15 shares are owned by Mother's

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15 I.R.C. § 318(a)(2)(B).

16 I.R.C. § 318(a)(2)(C).

17 I.R.C. § 318(a)(3)(A).

18 I.R.C. § 318(a)(3)(B). Contingent interests are considered remote if the actuarial value of the interest is 5 percent or less of the value of the trust property, assuming the trustee exercises maximum discretion in favor of the beneficiary.

19 I.R.C. § 318(a)(3)(C).

20 I.R.C. § 318(a)(4). "Options" have been interpreted to include warrants and convertible debentures. Rev. Rul. 68–601, 1968–2 C.B. 124. Even options that are exercisable after the lapse of a fixed period of time are considered as options from the time they are granted. Rev. Rul. 89–64, 1989–1 C.B. 91.

21 I.R.C. § 318(a)(5)(A), (B), (C).

22 I.R.C. § 318(a)(5)(D).

23 I.R.C. § 318(a)(5)(E). This rule applies for purposes of attributing stock to and from the S corporation, but not for determining constructive ownership of stock in the S corporation. Id.

Daughter, 10 shares are owned by Mother's adopted Son, and the remaining 30 shares are owned by Grandmother's estate, of which Mother is a 50% beneficiary. One of Mother's cousins is the other beneficiary of the estate. Mother also has an option to purchase 5 of Son's shares. How much Wham stock do Grandfather, Mother's Daughter and Grandmother's estate own after application of § 318?

2. All the 100 shares of Xerxes Corporation are owned by Partnership, in which A, B, C and D (all unrelated to each other) are equal partners. W, A's wife, owns all of the 100 shares of Yancy Corporation.

(a) How many shares, if any, of Xerxes Corporation are owned by A, W and M (W's mother)?

(b) How many shares, if any, of Xerxes are owned by Yancy? Would Yancy constructively own any shares of Xerxes if W owned only 10 percent of Yancy?

(c) How many shares, if any, of Yancy are owned by Partnership, B, C, D and Xerxes?

C. REDEMPTIONS TESTED AT THE SHAREHOLDER LEVEL

1. SUBSTANTIALLY DISPROPORTIONATE REDEMPTIONS

Code: § 302(b)(2).

Regulations: § 1.302–3.

The virtue of Section 302(b)(2) is its certainty. If a shareholder's reduction in voting stock as a result of a redemption satisfies three mechanical requirements, the redemption will be treated as an exchange. To qualify as "substantially disproportionate," a redemption must satisfy the following requirements:

(1) Immediately after the redemption, the shareholder must own (actually and constructively) less than 50 percent of the total combined voting power of all classes of stock entitled to vote,[24]

(2) The percentage of total outstanding voting stock owned by the shareholder immediately after the redemption must be less than 80 percent of the percentage of total voting stock owned by the shareholder immediately before the redemption,[25] and

(3) The shareholder's percentage ownership of common stock (whether voting or nonvoting) after the redemption also

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24 I.R.C. § 302(b)(2)(B).

25 I.R.C. § 302(b)(2)(C). This requirement may be expressed by the following formula:

$$\frac{\text{Voting shares owned after redemption}}{\text{Total voting shares outstanding after redemption}} \text{ must be less than: } .80 \times \frac{\text{Voting shares owned before redemption}}{\text{Total voting shares outstanding before redemption}}$$

must be less than 80 percent of the percentage of common stock owned before the redemption.[26] If there is more than one class of common stock, the 80 percent test is applied by reference to fair market value.[27]

The attribution rules of Section 318 are applicable in measuring stock ownership for purposes of all these percentage tests.

To illustrate, assume Redeemer owns 60 percent of the common stock of a corporation which has only one class of stock outstanding. A redemption which reduces Redeemer's stock interest to a percentage below 48 percent would satisfy Section 302(b)(2). Below that level, Redeemer would own less than 50 percent of the corporation's total combined voting power, and his percentage of voting stock after the redemption (below 48 percent) would be less than 80 percent of his percentage of voting stock before the redemption (60 percent).

The regulations elaborate on the operation of Section 302(b)(2). Stock with voting rights only upon the happening of a specific event (e.g., a default in a payment of dividends on preferred stock) is not considered voting stock until the event occurs.[28] A redemption of solely nonvoting stock will never satisfy Section 302(b)(2) because there will not be a sufficient reduction in the shareholder's interest in voting stock. But if a redemption qualifies as substantially disproportionate under Section 302(b)(2), a simultaneous redemption of nonvoting preferred stock (which is not Section 306 stock)[29] will be treated as an exchange.[30] The Service also has ruled that a redemption of voting preferred stock from a shareholder owning no common stock (either directly or by way of attribution) may qualify under Section 302(b)(2), even though the shareholder cannot satisfy the 80 percent test relating to common stock.[31]

The substantially disproportionate redemption safe harbor does not apply to any redemption made pursuant to a plan which has the purpose or effect of a series of redemptions that, taken together, result in a distribution that is not substantially disproportionate with respect to the shareholder.[32] This statutory application of the step transaction doctrine is the subject of the ruling that follows.

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26 I.R.C. § 302(b)(2)(C).

27 The common stock cutback test is applied on an aggregate rather than a class-by-class basis. Thus, if a shareholder's aggregate reduction in all classes of common stock (measured by value) meets the percentage tests in Section 302(b)(2)(C), the redemption will be treated as an exchange even if the shareholder continues to own 100 percent of one class of outstanding common stock. Rev. Rul. 87–88, 1987–2 C.B. 81.

28 Reg. § 1.302–3(a).

29 See Chapter 6C, infra.

30 Reg. § 1.302–3(a).

31 Rev. Rul. 81–41, 1981–1 C.B. 121.

32 I.R.C. § 302(b)(2)(D).

Revenue Ruling 85–14

Step transaction

1985–1 Cum. Bull. 92.

ISSUE

Should qualification under section 302(b)(2) of the Internal Revenue Code of a redemption of one shareholder be measured immediately after that redemption, or after a second redemption of another shareholder that followed soon after the first redemption, under the following facts?

FACTS

X, a corporation founded by *A*, is engaged in an ongoing business. As of January 1, 1983, *X*'s sole class of stock, voting common stock, was held by *A, B, C,* and *D*, who are unrelated to each other. *A* owned 1,466 shares, *B* owned 210 shares, *C* owned 200 shares, and *D* owned 155 shares of *X* stock. *A* was president and *B* was vice-president of *X*.

X has a repurchase agreement with all *X* shareholders, except *A*. This agreement provides that if any such shareholder ceases to be actively connected with the business operations of *X*, such shareholder must promptly tender to *X* the then-held *X* shares for an amount equal to the book value of such stock. *X* has a reciprocal obligation to purchase such shares at book value within 6 months of such shareholder's ceasing to be actively connected with *X*'s business operations.

On January 1, 1983, *B* informed *A* of *B*'s intention to resign as of March 22, 1983. Based on this information, *A* caused *X* to adopt a plan of redemption and to redeem 902 shares of *A*'s *X* stock, on March 15, 1983, for which *A* received 700*x* dollars. Thus, *A* then held 564 shares of the 1129 shares (49.96 percent) of the *X* stock still outstanding, temporarily yielding majority control over the affairs of *X* until *B* ceased to be a shareholder. On March 22, 1983, *B* resigned from *X* and, in accordance with the *X* stock purchase agreement, *X* redeemed for cash all of *B*'s shares within the next 6 months, thus leaving 919 shares of *X* stock outstanding, restoring majority control to *A*.

LAW AND ANALYSIS

Section 302(a) of the Code provides that if a corporation redeems its stock and if one of the paragraphs of subsection (b) applies, then such redemption will be treated as a distribution in part or full payment in exchange for the stock.

Section 302(b)(2) of the Code provides that a redemption will be treated as an exchange pursuant to section 302(a) if the redemption is substantially disproportionate with respect to the shareholder, but that this paragraph will not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Under section 302(b)(2)(C) of the Code, one of the requirements for the distribution to be substantially disproportionate is that the ratio that the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all the voting stock of the corporation at such time, is less than 80 percent of the ratio that the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all the voting stock of the corporation at such time.

Section 302(b)(2)(D) of the Code, in dealing with a series of redemptions, provides that section 302(b)(2) is not applicable to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

The percentage provisions contained in sections 302(b)(2)(B) and 302(b)(2)(C) of the Code provide "safe harbor" exchange treatment. Examined separately, the transaction that occurred on March 15, 1983, would qualify as a substantially disproportionate redemption because (i) *A*'s ownership of *X*'s voting stock immediately after the redemption was less than 50 percent of the total combined voting power of all the *X* stock and (ii) *A*'s ownership of *X*'s voting stock was reduced from 72.18 percent to 49.96 percent, which meets the 80 percent requirement of section 302(b)(2)(C). However, if *A*'s redemption is considered to be part of a section 302(b)(2)(D) series of redemptions which included *X*'s redemption of *B*'s shares, then *A*'s redemption would not constitute a substantially disproportionate redemption because (i) *A*'s ownership of *X*'s voting stock after the redemptions exceeded 50 percent of the total combined voting power of *X* and (ii) *A*'s ownership of *X*'s voting stock after the redemptions was reduced from 72.18 percent to 61.37 percent, which does not meet the 80 percent requirement of section 302(b)(2)(C).

Section 1.302–3(a) of the Income Tax Regulations states that whether or not a plan described in section 302(b)(2)(D) of the Code exists will be determined from all the facts and circumstances.

In the present situation, although *A* and *B* had no joint plan, arrangement, or agreement for a series of redemptions, the redemption of *A*'s shares was causally related to the redemption of *B*'s shares in that *A* saw an apparent opportunity to secure exchange treatment under section 302(b)(2) of the Code by temporarily yielding majority control over the affairs of *X*.

Nothing in section 302(b)(2)(D) of the Code or in the legislative history of this section * * * indicates that the existence of a plan depends upon an agreement between two or more shareholders. Thus, a "plan" for purposes of section 302(b)(2)(D) need be nothing more than a design by a single redeemed shareholder to arrange a redemption as part of a sequence of events that ultimately restores to such shareholder the control that was apparently reduced in the redemption.

Under the facts and circumstances here, section 302(b)(2)(D) of the Code requires that the redemptions of *A* and *B* be considered in the aggregate. Accordingly, *A*'s redemption meets neither the 50 percent limitation of section 302(b)(2)(B) nor the 80 percent test of section

302(b)(2)(C). Thus, the redemption of *A*'s shares was not substantially disproportionate within the meaning of section 302(b)(2).

HOLDING

Under the facts of this ruling, qualification under section 302(b)(2) of the Code of *A*'s redemption should not be measured immediately after that redemption, but, instead, should be measured after *B*'s redemption that followed soon after *A*'s redemption.

PROBLEMS

1. Y Corporation has 100 shares of common stock and 200 shares of nonvoting preferred stock outstanding. Alice owns 80 shares of Y common stock and 100 shares of its preferred stock. Cathy owns the remaining 20 shares of Y common and 100 shares of Y preferred stock. Alice and Cathy are not related. In each of the following alternative situations, determine whether the redemption satisfies the requirements of § 302(b)(2):

(a) On January 15, Y Corporation redeems 75 of Alice's preferred shares.

(b) Same as (a), above, except that Y also redeems 60 shares of Alice's common stock.

(c) Same as (a), above, except that Y also redeems 70 shares of Alice's common stock.

(d) What difference would it make in (c), above, if, on December 1 of the same year, Y redeems 10 shares of Cathy's common stock?

it not part of plan, Q3 answer remains the same. It part of plan, have to redo calculation.

2. Z Corporation has 100 shares of voting common stock and 200 shares of nonvoting common stock outstanding. Every share of Z common stock has a fair market value of $100. Don owns 60 shares of Z voting common stock and 100 shares of Z nonvoting common stock. Jerry owns all of the remaining Z stock. Don and Jerry are not related to one another. If Z redeems 30 of Don's voting common shares, will the redemption qualify for exchange treatment under § 302(b)(2)?

2. COMPLETE TERMINATION OF A SHAREHOLDER'S INTEREST

a. WAIVER OF FAMILY ATTRIBUTION

Code: § 302(b)(3), (c).

Regulations: § 1.302–4.

The theory of the substantially disproportionate safe harbor is that exchange rather than dividend treatment is appropriate when a distribution in redemption causes a significant reduction in the shareholder's interest in the corporation's voting stock. This policy applies with even greater force in the case of a complete termination of a shareholder's interest, which qualifies for exchange treatment under

Section 302(b)(3). For shareholders of a closely held family corporation, however, the attribution rules present a substantial roadblock to a complete termination. Even if all of the stock of a retiring shareholder is redeemed, she will continue to be treated as a 100 percent owner if her children or other related parties hold the remaining shares.

To provide relief where the redeemed shareholder is willing to cut the corporate cord, Section 302(c)(2) eases the path toward a complete termination by waiving the family attribution rules if certain conditions are met. This attribution amnesty is a useful planning tool for shareholders of family corporations, permitting a shareholder to achieve a complete termination even though the remaining shares are held by close relatives. The waiver applies, however, only to *family* attribution; the entity and option attribution rules remain fully applicable.

Waiver of the family attribution rules is available only if immediately after the distribution the redeemed shareholder retains no "interest" in the corporation (other than as a creditor). The ban extends to interests as an officer, director or employee. Section 302(c)(2)(A) also includes a "ten year look forward" rule, under which the shareholder may not retain or acquire (other than by bequest or inheritance) any of the forbidden interests in the corporation "other than an interest as a creditor."[33] To prevent anticipatory bailouts, Section 302(c)(2)(B) provides a "ten year look back" rule, under which the family attribution rules may not be waived if during the ten years preceding the redemption either: (1) the redeemed shareholder acquired any of the redeemed stock from a "Section 318" relative or (2) any such close relative acquired stock from the redeemed shareholder. Neither of these exceptions applies, however, if "tax avoidance" was not one of the principal purposes of the otherwise tainted transfer.

The materials that follow illustrate how the Service and the courts have interpreted these intricate requirements.

Lynch v. Commissioner

United States Court of Appeals, Ninth Circuit, 1986.
801 F.2d 1176.

■ CYNTHIA HOLCOMB HALL, CIRCUIT JUDGE:

The Commissioner of the Internal Revenue Service (Commissioner) petitions for review of a Tax Court decision holding that a corporate redemption of a taxpayer's stock was a sale or exchange subject to capital gains treatment. The Commissioner argues that the taxpayer held a

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[33] This rule is enforced by requiring the redeemed shareholder to file a form with his tax return in which the shareholder agrees to notify the Service of any acquisition of a forbidden interest within ten years from the redemption and to retain such records as may be necessary to permit enforcement of this rule by the Service. The normal three year statute of limitations is extended to one year after the shareholder gives notice of acquisition of a forbidden interest in order to permit the Service to make a retroactive assessment of a deficiency. I.R.C. § 302(c)(2)(A).

prohibited interest in the corporation after the redemption and therefore the transaction should be characterized as a dividend distribution taxable as ordinary income. We agree with the Commissioner and reverse the Tax Court.

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Taxpayers, William and Mima Lynch, formed the W.M. Lynch Co. on April 1, 1960. The corporation issued all of its outstanding stock to William Lynch (taxpayer). The taxpayer specialized in leasing cast-in-place concrete pipe machines. He owned the machines individually but leased them to the corporation which in turn subleased the equipment to independent contractors.

On December 17, 1975 the taxpayer sold 50 shares of the corporation's stock to his son, Gilbert Lynch (Gilbert), for $17,170. Gilbert paid for the stock with a $16,000 check given to him by the taxpayer and $1,170 from his own savings. The taxpayer and his wife also resigned as directors and officers of the corporation on the same day.

On December 31, 1975 the corporation redeemed all 2300 shares of the taxpayer's stock. In exchange for his stock, the taxpayer received $17,900 of property and a promissory note for $771,920. Gilbert, as the sole remaining shareholder, pledged his 50 shares as a guarantee for the note. In the event that the corporation defaulted on any of the note payments, the taxpayer would have the right to vote or sell Gilbert's 50 shares.

In the years immediately preceding the redemption, Gilbert had assumed greater managerial responsibility in the corporation. He wished, however, to retain the taxpayer's technical expertise with cast-in-place concrete pipe machines. On the date of the redemption, the taxpayer also entered into a consulting agreement with the corporation. The consulting agreement provided the taxpayer with payments of $500 per month for five years, plus reimbursement for business related travel, entertainment, and automobile expenses.[2] In February 1977, the corporation and the taxpayer mutually agreed to reduce the monthly payments to $250. The corporation never withheld payroll taxes from payments made to the taxpayer.

After the redemption, the taxpayer shared his former office with Gilbert. The taxpayer came to the office daily for approximately one year; thereafter his appearances dwindled to about once or twice per week. When the corporation moved to a new building in 1979, the taxpayer received a private office.

In addition to the consulting agreement, the taxpayer had other ties to the corporation. He remained covered by the corporation's group medical insurance policy until 1980. When his coverage ended, the taxpayer had received the benefit of $4,487.54 in premiums paid by the

[2] The corporation leased or purchased a pickup truck for the taxpayer's use in 1977. If someone at the corporation needed the truck, the taxpayer would make it available to him.

corporation. He was also covered by a medical reimbursement plan, created the day of the redemption, which provided a maximum annual payment of $1,000 per member. Payments to the taxpayer under the plan totaled $96.05.

II

We must decide whether the redemption of the taxpayer's stock in this case is taxable as a dividend distribution under 26 U.S.C. § 301 or as long-term capital gain under 26 U.S.C. § 302(a). Section 302(a) provides that a corporate distribution of property in redemption of a shareholder's stock is treated as a sale or exchange of such stock if the redemption falls within one of four categories described in section 302(b). If the redemption falls outside of these categories, then it is treated as a dividend distribution under section 301 to the extent of the corporation's earnings and profits.[4]

Section 302(b)(3) provides that a shareholder is entitled to sale or exchange treatment if the corporation redeems all of the shareholder's stock. In order to determine whether there is a complete redemption for purposes of section 302(b)(3), the family attribution rules of section 318(a) must be applied unless the requirements of section 302(c)(2) are satisfied. Here, if the family attribution rules apply, the taxpayer will be deemed to own constructively the 50 shares held by Gilbert (100% of the corporation's stock) and the transaction would not qualify as a complete redemption within the meaning of section 302(b)(3).

Section 302(c)(2)(A) states in relevant part:

> In the case of a distribution described in subsection (b)(3), [the family attribution rules in] section 318(a)(1) shall not apply if—
>
> (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor * * * .

The Commissioner argues that in every case the performance of post-redemption services is a prohibited interest under section 302(c)(2)(A)(i), regardless of whether the taxpayer is an officer, director, employee, or independent contractor.

The Tax Court rejected the Commissioner's argument, finding that the services rendered by the taxpayer did not amount to a prohibited interest in the corporation. In reaching this conclusion, the Tax Court relied on a test derived from Lewis v. Commissioner, 47 T.C. 129, 136 (1966) (Simpson, J., concurring):

> Immediately after the enactment of the 1954 Code, it was recognized that section 302(c)(2)(A)(i) did not prohibit office

[4] On the date of the redemption, W.M. Lynch Co. had accumulated earnings and profits of $315,863, and had never paid a dividend.

> holding per se, but was concerned with a retained financial stake in the corporation, such as a profit-sharing plan, or in the creation of an ostensible sale that really changed nothing so far as corporate management was concerned. Thus, in determining whether a prohibited interest has been retained under section 302(c)(2)(A)(i), we must look to whether the former stockholder has either retained a financial stake in the corporation or continued to control the corporation and benefit by its operations. In particular, where the interest retained is not that of an officer, director, or employee, we must examine the facts and circumstances to determine whether a prohibited interest has been retained under section 302(c)(2)(A)(i).

Lynch v. Commissioner, 83 T.C. 597, 605 (1984) (citations omitted).

After citing the "control or financial stake" standard, the Tax Court engaged in a two-step analysis. First, the court concluded that the taxpayer was an independent contractor rather than an employee because the corporation had no right under the consulting agreement to control his actions.[5] Second, the court undertook a "facts and circumstances" analysis to determine whether the taxpayer had a financial stake in the corporation or managerial control after the redemption. Because the consulting agreement was not linked to the future profitability of the corporation, the court found that the taxpayer had no financial stake. The court also found no evidence that the taxpayer exerted control over the corporation. Thus, the Tax Court determined that the taxpayer held no interest prohibited by section 302(c)(2)(A)(i).

III

* * *

We reject the Tax Court's interpretation of section 302(c)(2)(A)(i). An individualized determination of whether a taxpayer has retained a financial stake or continued to control the corporation after the redemption is inconsistent with Congress' desire to bring a measure of certainty to the tax consequences of a corporate redemption. We hold that a taxpayer who provides post-redemption services, either as an employee or an independent contractor, holds a prohibited interest in the corporation because he is not a creditor.

The legislative history of section 302 states that Congress intended to provide "definite standards in order to provide certainty in specific instances." S.Rep. No. 1622, 83d Cong., 2d Sess. 233, reprinted in 1954 U.S.Code Cong. & Ad.News 4017, 4621, 4870. "In lieu of a factual inquiry in every case, [section 302] is intended to prescribe specific conditions

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[5] Finding that the taxpayer was not an employee obviated the need to decide whether the parenthetical language in section 302(c)(2)(A)(i) prohibited employment relationships per se. See Seda v. Commissioner, 82 T.C. 484, 488 (1984) (court stated that "section 302(c)(2)(A)(i) may not prohibit the retention of all employment relationships").

from which the taxpayer may ascertain whether a given redemption" will qualify as a sale or be treated as a dividend distribution. H.R.Rep.No. 1337, 83d Cong.2d Sess. 35, reprinted in 1954 U.S.Cong. & Ad.News 4017, 4210. The facts and circumstances approach created by the Tax Court undermines the ability of taxpayers to execute a redemption and know the tax consequences with certainty.

The taxpayer's claim that the Senate rejected the mechanical operation of the House's version of section 302 is misleading. The Senate did reject the House bill because the "definitive conditions" were "unnecessarily restrictive." S.Rep.No.1622, 83d Cong., 2d Sess. 44, reprinted in 1954 U.S.Code Cong. & Ad.News 4621, 4675. However, the Senate's response was to add paragraph (b)(1) to section 302, which reestablished the flexible, but notoriously vague, "not essentially equivalent to a dividend" test. This test provided that all payments from a corporation that were not essentially equivalent to a dividend should be taxed as capital gains. The confusion that stemmed from a case-by-case inquiry into "dividend equivalence" prompted the Congress to enact definite standards for the safe harbors in section 302(b)(2) and (b)(3). The Tax Court's refusal to recognize that section 302(c)(2)(A)(i) prohibits *all* noncreditor interests in the corporation creates the same uncertainty as the "dividend equivalence" test.

The problem with the Tax Court's approach is apparent when this case is compared with Seda v. Commissioner, 82 T.C. 484 (1984). In *Seda*, a former shareholder, at his son's insistence, continued working for the corporation for two years after the redemption. He received a salary of $1,000 per month. The Tax Court refused to hold that section 302(c)(2)(A)(i) prohibits the retention of employment relations per se, despite the unequivocal language in the statute.[6] Id. at 488. Instead, the court applied the facts and circumstances approach to determine whether the former shareholder retained a financial stake or continued to control the corporation. The Tax Court found that the monthly payments of $1,000 constituted a financial stake in the corporation. Id. This result is at odds with the holding in *Lynch* that payments of $500 per month do *not* constitute a financial stake in the corporation. Compare Lynch, 83 T.C. at 606–07 with Seda, 82 T.C. at 488. The court also found in *Seda* no evidence that the former shareholder had ceased to manage the corporation. 82 T.C. at 488. Again, this finding is contrary to the holding in *Lynch* that the taxpayer exercised no control over the corporation after the redemption, even though he worked daily for a year and shared his old office with his son. Compare Lynch, 83 T.C. at 607 with Seda, 82 T.C. at 488. *Seda* and *Lynch* thus vividly demonstrate the perils of making an ad hoc determination of "control" or "financial stake."

[6] Eight of the seventeen Tax Court judges who reviewed *Seda* concurred in the result but would have classified all officer, director, or employee relationships as prohibited interests under section 302(c)(2)(A)(i).

A recent Tax Court opinion further illustrates the imprecision of the facts and circumstances approach. In Cerone v. Commissioner, 87 T.C. 1 (1986), a father and son owned all the shares of a corporation formed to operate their restaurant. The corporation agreed to redeem all of the father's shares in order to resolve certain disagreements between the father and son concerning the management of the business. However, the father remained an employee of the corporation for at least five years after the redemption, drawing a salary of $14,400 for the first three years and less thereafter. The father claimed that he was entitled to capital gains treatment on the redemption because he had terminated his interest in the corporation within the meaning of section 302(b)(3).

Even on the facts of *Cerone,* the Tax Court refused to find that the father held a prohibited employment interest per se. * * * Instead, the Tax Court engaged in a lengthy analysis, citing both *Seda* and *Lynch.* The court proclaimed that *Lynch* reaffirmed the rationale of *Seda,* even though *Lynch* involved an independent contractor rather than an employee. After comparing the facts of *Seda* and *Cerone,* the Tax Court eventually concluded that the father in *Cerone* held a financial stake in the corporation because he had drawn a salary that was $2,400 per year more than the taxpayer in *Seda* and had been employed by the corporation for a longer period after the redemption. *Cerone,* slip op. at 53. However, the Tax Court was still concerned that prohibited interest in *Seda* might have been based on the finding in that case that the taxpayer had both a financial stake *and* continued control of the corporation. The Tax Court, citing *Lynch,* held that the "test is whether he retained a financial stake *or* continued to control the corporation." * * * Thus, the Tax Court found that the father in *Cerone* held a prohibited interest because he had a financial stake as defined by *Seda.*

Although the Tax Court reached the correct result in *Cerone,* its approach undermines the definite contours of the safe harbor Congress intended to create with sections 302(b)(3) and 302(c)(2)(A)(i). Whether a taxpayer has a financial stake according to the Tax Court seems to depend on two factors, length of employment and the amount of salary. Length of employment after the redemption is irrelevant because Congress wanted taxpayers to know whether they were entitled to capital gains treatment on the date their shares were redeemed. * * * As for the amount of annual salary, the Tax Court's present benchmark appears to be the $12,000 figure in *Seda.* Salary at or above this level will be deemed to be a financial stake in the enterprise, though the $6,000 annual payments in this case were held not to be a financial stake. There is no support in the legislative history of section 302 for the idea that Congress meant only to prohibit service contracts of a certain worth, and taxpayers should not be left to speculate as to what income level will give rise to a financial stake.

In this case, the taxpayer points to the fact that the taxpayers in *Seda* and *Cerone* were employees, while he was an independent contractor. On appeal, the Commissioner concedes the taxpayer's independent contractor status. We fail to see, however, any meaningful way to distinguish *Seda* and *Cerone* from *Lynch* by differentiating between employees and independent contractors. All of the taxpayers performed services for their corporations following the redemption. To hold that only the employee taxpayers held a prohibited interest would elevate form over substance. The parenthetical language in section 302(c)(2)(A)(i) merely provides a subset of prohibited interests from the universe of such interests, and in no way limits us from finding that an independent contractor retains a prohibited interest. Furthermore, the Tax Court has in effect come to ignore the parenthetical language. If employment relationships are not prohibited interests per se, then the taxpayer's status as an employee or independent contractor is irrelevant. What really matters under the Tax Court's approach is how the taxpayer fares under a facts and circumstances review of whether he has a financial stake in the corporation or managerial control.[7] Tax planners are left to guess where along the continuum of monthly payments from $500 to $1000 capital gains treatment ends and ordinary income tax begins.

Our holding today that taxpayers who provide post-redemption services have a prohibited interest under section 302(c)(2)(A)(i) is inconsistent with the Tax Court's decision in Estate of Lennard v. Commissioner, 61 T.C. 554 (1974). That case held that a former shareholder who, as an independent contractor, provided post-redemption accounting services for a corporation did not have a prohibited interest. The Tax Court found that "Congress did not intend to include independent contractors possessing no financial stake in the corporation among those who are considered as retaining an interest in the corporation for purposes of the attribution waiver rules." Id. at 561. We disagree. In the context of *Lennard,* the Tax Court appears to be using financial stake in the sense of having an equity interest or some other claim linked to the future profit of the corporation. Yet, in cases such as *Seda* and *Cerone,* the Tax Court has found that fixed salaries of $12,000 and $14,400, respectively, constitute a financial stake. Fees for accounting services could easily exceed these amounts, and it would be irrational to argue that the definition of financial stake varies depending on whether the taxpayer is an employee or an independent contractor. In

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[7] The Tax Court's focus on managerial control or a financial stake originated with Judge Simpson's concurrence in *Lewis,* 47 T.C. at 136–38. His interpretation of section 302(c)(2)(A) is supported by Bittker, Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954, 9 Stan. L. Rev. 13, 33 n. 72 (1956). Professor Bittker argues that Congress' goal was to ensure that taxpayers who transferred only ostensible control or maintained a financial stake in the corporation did not receive the benefit of capital gains treatment. He is no doubt correct. However, the means selected by Congress to achieve this goal do not allow for an individualized determination of control and financial stakes. Instead, section 302(c)(2)(A)(i) operates mechanically: the taxpayer must sever all but a creditor's interest to avoid the family attribution rules and thereby receive capital gains treatment. Nowhere in the legislative history of section 302(c) does Congress intimate that courts may use a flexible facts and circumstances test to determine the existence of managerial control or a financial stake.

order to avoid these inconsistencies, we conclude that those who provide post-redemption services, whether as independent contractors or employees, hold an interest prohibited by section 302(c)(2)(A)(i) because they are more than merely creditors.

In addition, both the Tax Court and the Commissioner have agreed that taxpayers who enter into management consulting contracts after the redemption possess prohibited interests. Chertkof v. Commissioner, 72 T.C. 1113, 1124–25 (1979), *aff'd,* 649 F.2d 264 (4th Cir.1981); Rev.Ruling 70–104, 1970–1 C.B. 66 (1970). Taxpayers who provide such services are, of course, independent contractors. However, unlike the Commissioner's opinion in Rev. Ruling 70–104 that all management consulting agreements are prohibited interests, the Tax Court applies the financial stake or managerial control test. In *Chertkof,* the court found that because the services provided under the contract "went to the essence" of the corporation's existence, the taxpayer had not effectively ceded control. 72 T.C. at 1124. Here, the Tax Court distinguished *Chertkof* on the ground that the taxpayer did not retain control of the corporation, but instead provided only limited consulting services. *Lynch,* 83 T.C. at 608. We believe that any attempt to define prohibited interests based on the level of control leads to the same difficulties inherent in making a case-by-case determination of what constitutes a financial stake.[8]

IV

Our decision today comports with the plain language of section 302 and its legislative history. See Gardner & Randall, Distributions in Redemption of Stock: Changing Definitions for a Termination of Interest, 8 J. Corp. Tax'n 240, 247–48 (1981); Marusic, The Prohibited Interest of I.R.C. Section 302(c)(2)(A)(i) After Seda and Lynch, 65 Neb. L. Rev. 486, 502, 518–19 (1986); Rose, The Prohibited Interest of Section 302(c)(2)(A), 36 Tax L. Rev. 131, 145–49 (1981). Taxpayers who wish to receive capital gains treatment upon the redemption of their shares must completely sever all noncreditor interests in the corporation.[9] We hold that the

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[8] Determining the existence of control is particularly difficult in the context of a family-held corporation. The exercise of control often will not be obvious because a parent may influence a child, and hence corporate decisionmaking, in myriad ways. Our rule that the provision of services is a prohibited interest eliminates the need to make a speculative inquiry into whether the parent still controls the corporation after the redemption. Of course, no rule could or should prohibit post-redemption parent-child communication concerning the management of the corporation.

[9] Our definition of a prohibited interest still leaves an open question as to the permissible scope of a creditor's interest under section 302(c)(2)(A)(i). See, e.g., Treas. Reg. § 1.302–4(d) (a creditor's claim must not be subordinate to the claims of general creditors or in any other sense proprietary, i.e., principal payments or interest rates must not be contingent on the earnings of the corporation).

The taxpayer argues that some creditor relationships might result in an "opportunity to influence" as great or greater than any officer, director, or employee relationship. He cites Rev. Ruling 77–467, 1977–2 C.B. 92 which concluded that a taxpayer who leased real property to a corporation, after the corporation redeemed his shares, held a creditor's interest under section 302(c)(2)(A)(i). While the taxpayer here may be correct in his assessment of a creditor's "opportunity to influence" a corporation, he overlooks the fact that Congress specifically allowed the right to retain such an interest.

taxpayer, as an independent contractor, held such a noncreditor interest, and so cannot find shelter in the safe harbor of section 302(c)(2)(A)(i). Accordingly, the family attribution rules of section 318 apply and the taxpayer fails to qualify for a complete redemption under section 302(b)(3). The payments from the corporation in redemption of the taxpayer's shares must be characterized as a dividend distribution taxable as ordinary income under section 301.

Reversed.

Revenue Ruling 59–119

1959–1 Cum. Bull. 68.

A stock redemption agreement between the corporation and the instant shareholder provides that a total of 350*x* dollars will be paid to such shareholder for all his stock interest in the corporation, 100*x* dollars to be paid on the closing date and 250*x* dollars to be paid by the corporation within eight years, payable in quarter-annual installments. The corporation executed an installment judgment note to the shareholder and the judgment note and shares of stock of the corporation to be redeemed are retained by an escrow holder as security for installment payments due. In the event the installment and interest payments are in default, then pursuant to the agreement the escrow holder, upon notice from the taxpayer, may sell the stock of the corporation held by him at public or private sale to satisfy such obligations, however, in no event will the taxpayer become the purchaser of said stock at such sale.

The stock redemption agreement also states that so long as the corporation owes funds to such shareholder it will not, without first receiving the written consent of the shareholder, declare dividends; pay salaries in excess of a certain amount to officers; sell its assets except in the ordinary course of business; or engage in a reorganization, recapitalization, merger, consolidation or liquidation.

Because of the substantial sums due the shareholder, because he plans to reside permanently in another state and will be far removed from the base of operations of the corporation, and pursuant to the advice of persons skilled in creditor protection matters, he considers it advisable to have a member of the law firm representing him serve on the board of directors of the corporation. Therefore, the instant shareholder and the remaining shareholders, all related, entered into a second agreement whereby a nominee of his law firm will serve on the board of directors as long as the corporation is indebted to the shareholder. Such nominee will be paid *x* dollars by the corporation for each meeting he attends and such additional sums as determined in the sole discretion of the instant shareholder for other services which may be reasonably necessary to determine that his interests as a creditor are being protected in accordance with the agreements.

The sole purpose of this arrangement is to protect the shareholder as a creditor by determining that the aforementioned conditions are being met rather than running the risk of having to engage in extended litigation at some future date if it is then determined that the conditions of the stock redemption agreement were violated.

* * *

According to the agreement in question, the remaining shareholders and the instant shareholder will appoint, indirectly through the law firm representing such shareholder, a member of that law firm to serve on the board of directors of the corporation. Such a nominee director will be acting solely on the taxpayer's behalf and, therefore, will in effect be his agent. The fact that the nominee director will receive remuneration for his service from someone other than the taxpayer does not make him any less the taxpayer's agent, for the source of remuneration to an agent is only one factor to be considered in determining whether an agency exists between two parties. Such an appointment of an agent to the board of directors is contrary to the condition prescribed in section 302(c)(2) of the Code. For the purposes of section 302(c)(2), it is immaterial whether an interest in the corporation is asserted directly or through an agent.

The fact that the director is a "limited" director in that his only duty will be to determine whether the conditions set forth in the stock redemption agreement are being observed is not material, for section 302(c)(2) of the Code does not make any exception for such directors. Furthermore, that section of the Code does not make an exception for a director whose power is limited because he is a minority member of a board.

In view of the foregoing, it is held that the agreement between the instant shareholder and the remaining shareholders of the corporation, under which a nominee is appointed to serve on the board of directors of the corporation, violates the condition prescribed in section 302(c)(2)(A)(i) of the Code. Accordingly, in the event of such an agreement, the redemption of the taxpayer's stock of the corporation shall be treated as a distribution of property to which section 301 of the Code applies.

However, if the taxpayer-shareholder designates a representative of his law firm to attend the board of director's meetings of the corporation solely for the purposes of determining whether the provisions of the agreement described above have been complied with, and not in the capacity of a director, officer or employee, or advisor, such action will not adversely affect section 302(c)(2) of the Code.

Revenue Ruling 77–293

1977–2 Cum. Bull. 91.

Corporation *X* had 120 shares of common stock outstanding, all of which were owned by *A*, its president. *A*'s son, *B*, had been employed by

X for many years as its vice-president and general assistant to the president. Realizing that the future successful operation of *X* required a thorough knowledge of its operation, products lines, and customer needs, *A* had trained and supervised *B* in all phases of the business so that upon *A*'s retirement *B* would be able to assume responsibility for managing the business.

As part of *A*'s plan to retire from the business and to give ownership of the business to *B*, *A* gave 60 shares of *X* stock to *B* as a gift, and not as consideration for past, present, or future services. Shortly thereafter, *A* resigned and *B* assumed the position of chairman of the board and president of *X*. *X* redeemed the remaining 60 shares of stock owned by *A* in exchange for property. Immediately after the redemption, *A* was not an officer, director, or employee of *X* and no longer had any interest in *X*. *A*'s gift of stock to *B* was for the purpose of giving *B* complete ownership and control of *X*. The earnings and profits of *X* exceeded the amount of the distribution in redemption of the *X* stock.

* * *

In the instant case, neither section 302(b)(1) of the Code nor section 302(b)(2) applies since *A*, through the constructive ownership rules of section 318(a), owned 100 percent of the stock of *X* both before and after the redemption. Therefore, there was no meaningful reduction under section 302(b)(1) or a substantially disproportionate reduction under section 302(b)(2) of *A*'s stock ownership.

Section 302(c)(2)(A) of the Code provides that for purposes of section 302(b)(3), 318(a)(1) will not apply if (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as an officer, director, or employee), other than an interest as a creditor, (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution, and (iii) the distributee files an agreement to notify the district director of any acquisition of any such interest in the corporation. However, pursuant to section 302(c)(2)(B)(ii), the provisions of section 302(c)(2)(A) are not applicable if any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the ten-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction. However, section 302(c)(2)(B)(ii) will not apply if the disposition by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

The structure and legislative history of section 302 of the Code make it clear that the purpose of section 302(c)(2)(B) is not to prevent the reduction of capital gains through gifts of appreciated stock prior to the redemption of the remaining stock of the transferor, but to prevent the withdrawal of earnings at capital gains rates by a shareholder of a family controlled corporation who seeks continued control and/or economic interest in the corporation through the stock given to a related person or the stock he retains. Application of this provision thus prevents a taxpayer from bailing out earnings by transferring part of the taxpayer's stock to such a related person and then qualifying the redemption of either the taxpayer's stock or the transferee's stock as a complete termination of interest by virtue of the division of ownership thus created and the availability of the attribution waiver provisions.

Tax avoidance within the meaning of section 302(c)(2)(B) of the Code would occur, for example, if a taxpayer transfers stock of a corporation to a spouse in contemplation of the redemption of the remaining stock of the corporation and terminates all direct interest in the corporation in compliance with section 302(c)(2)(A), but with the intention of retaining effective control of the corporation indirectly through the stock held by the spouse. Another example, which would generally constitute tax avoidance within the meaning of this provision, is the transfer by a taxpayer of part of the stock of a corporation to a spouse in contemplation of the subsequent redemption of the transferred stock from the spouse. * * *

Whether one of the principal purposes of an acquisition or disposition of stock is tax avoidance within the meaning of section 302(c)(2)(B) of the Code can be determined only by an analysis of all of the facts and circumstances of a particular situation. Here, the gift of *X* stock by *A* was to *B* who is active and knowledgeable in the affairs of the business of *X* and who intends to control and manage the corporation in the future. The gift of stock was intended solely for the purpose of enabling *A* to retire while leaving the business to *B*. Therefore, the avoidance of Federal income tax will not be deemed to have been one of the principal purposes of the gift of stock from *A* to *B*, notwithstanding the reduction of the capital gains tax payable by *A* as a result of the gift of appreciated stock prior to the redemption.

Accordingly, if *A* files the agreement specified in section 302(c)(2)(A)(iii) of the Code, the redemption by *X* of its stock from *A* qualifies as a termination of interest under section 302(b)(3).

Rev. Rul. 57–387, 1957–2 C.B. 225, is modified to the extent that it contains implications to the contrary concerning the reduction of the capital gains tax.

NOTE

Ten-Year-Look-Forward Rule. The prohibition on retaining or acquiring any post-redemption "interest" (other than as a creditor or by bequest or inheritance) in the corporation is one of the major hurdles to utilizing Section

302(c)(2).[34] Until the Ninth Circuit's decision in *Lynch*, however, the courts often rejected the Service's strict view that *any* performances of services, with or without compensation, constitutes a forbidden corporate interest.[35]

The results are mixed in the many other factual contexts arising under the ten-year look-forward rule. The Service has ruled that a prohibited interest is obtained if the redeemed shareholder becomes a custodian under the Uniform Gifts to Minors Act or a voting trustee of corporate stock during the restricted ten year period.[36] But if the shareholder becomes executor of a deceased shareholder's estate and can vote the stock held by the estate, the protection of Section 302(c)(2) is still available by virtue of the exception for stock acquired by bequest or inheritance.[37] In Revenue Ruling 72–380,[38] the Service ruled that since a redeemed shareholder may reacquire a direct stock interest by bequest or inheritance, it was reasonable to permit "acquisition under identical circumstances of the significantly lesser interest embodied in the * * * right of an executor to vote stock in an estate * * * ."[39] In Revenue Ruling 79–334[40] the same reasoning was applied to an appointment by will of a previously redeemed shareholder as a trustee of a trust. The ruling concludes that a redeemed shareholder may waive family attribution even though, as trustee, he can vote stock of the corporation in which he once had an interest.

Deferred Payment Redemptions. In the area of deferred payment redemptions, the Service and the courts have disagreed over what constitutes a complete termination of a shareholder's interest or the acquisition of a forbidden proprietary interest for purposes of the waiver of family attribution exception. The regulations provide that to be considered a creditor, the rights of the redeemed shareholder must not be greater than necessary to enforce the claim. An obligation may be treated as proprietary if it is subordinated to claims of general creditors, if payments of principal depend upon corporate earnings, or if the interest rate fluctuates with the corporation's success.[41] Acquisition of corporate property as a result of enforcement of rights as a creditor does not run afoul of Section 302(c)(2)

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34 See generally Rose, "The Prohibited Interest of Section 302(c)(2)(A)," 36 Tax L. Rev. 131 (1981).

35 Compare Rev. Rul. 56–556, 1956–2 C.B. 177 and Rev. Rul. 59–119, 1959–1 C.B. 68 with Estate of Lennard v. Commissioner, 61 T.C. 554 (1974), nonacq. 1978–2 C.B. 1, and Lewis v. Commissioner, 47 T.C. 129 (1966).

36 Rev. Rul. 81–233, 1981–2 C.B. 83; Rev. Rul. 71–426, 1971–2 C.B. 173.

37 I.R.C. § 302(c)(2)(A)(ii).

38 1972–2 C.B. 201.

39 An executor who also becomes an officer of the corporation acquires a prohibited interest and loses Section 302(c)(2)'s protection. Rev. Rul. 75–2, 1975–1 C.B. 99.

40 1979–2 C.B. 127.

41 Reg. § 1.302–4(d). A shareholder's ability to defer gain on a credit redemption under the installment method is a separate issue. First, the redemption must be treated as an exchange rather than a dividend. In addition, Section 453(k)(2)(A) denies use of the installment method for sales of stock or securities which are traded on an established securities market. This provision thus limits the tax advantage of deferral on a credit redemption to redemptions of stock in closely held corporations.

unless the redeemed shareholder acquires stock in the corporation, its parent corporation, or a subsidiary.[42]

The standards applied by the courts to credit redemptions are not as rigid. In Dunn v. Commissioner,[43] a redemption agreement provided for postponement of principal and interest payments on corporate notes given in payment for the shareholder's stock if such payments would violate financial requirements in the corporation's franchise agreement with General Motors. The court concluded that the postponement provision did not require the notes to be classified as equity or give the shareholder an interest in the corporation other than as a creditor. In Estate of Lennard v. Commissioner,[44] the court found that a subordinated demand note, which was paid approximately three months after issuance, did not represent a proprietary interest in the corporation.

The Service has specific guidelines for granting a favorable ruling under Section 302. For example, it ordinarily will not rule on the tax consequences of a redemption of stock for notes when the note payment period extends beyond 15 years.[45] Nor will a ruling be issued under Section 302(b) if: (1) the shareholder's stock is held in escrow or as security for payments on corporate notes given as consideration for the redeemed stock, or (2) the consideration given to the shareholder is entirely or partly contingent on either future corporate earnings or maintenance of levels of corporate working capital, or any other similar contingency.[46] In these situations, the Service's concern is that the redeemed shareholder either may reacquire stock in the corporation or has retained a proprietary stake in its possible future success.

Once again, however, the courts have been far more lenient than the I.R.S.'s ruling position. For example, in Lisle v. Commissioner[47] the Tax Court found a Section 302(b)(3) complete termination where the redeemed shareholders were to be paid for their stock over a 20 year period, the shareholders retained their voting rights pursuant to a security agreement, the stock was held in escrow and could be returned to the shareholders and the shareholders continued to serve as corporate directors and officers. The court concluded that the shareholders were directors and officers in name only and that, based upon the facts present in the case, the security provisions were not inconsistent with a finding that the transaction qualified as a complete redemption.

Other Post-Redemption Interests. The Service will permit a redeemed shareholder to lease property to the corporation on an arms length basis provided that the rental payments are not dependent on corporate earnings or subordinated to the claims of the corporation's general creditors.[48]

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[42] Reg. § 1.302–4(e).

[43] 615 F.2d 578 (2d Cir.1980).

[44] Note 35, supra.

[45] Rev. Proc. 2019–3, § 4.01(24), 2019–1 I.R.B. 139.

[46] Id. at § 3.01(46)–(47), 2019–1 I.R.B. 133.

[47] 35 T.C.M. 627 (1976). The issue in *Lisle* was whether there was a complete termination of the shareholder's interest. The case did not involve a waiver of family attribution issue.

[48] Rev. Rul. 77–467, 1977–2 C.B. 92. The IRS's position is that it will not issue a ruling if, after the redemption, the distributing corporation uses property that is owned by the

Retention of Multiple Interests. A shareholder of a closely held corporation often will retain several different types of interests after a redemption. This raises the question of whether, in determining if the shareholder has retained a prohibited financial stake, we look to each separate economic relationship, or to the totality of continuing interests? In Hurst v. Commissioner,[49] the Tax Court rejected the Service's argument that multiple interests taken together can constitute a prohibited interest and concluded that each interest must be analyzed separately. The taxpayers in *Hurst* were a husband and wife who owned stock in two corporations ("A" and "B").[50] Mr. and Mrs. Hurst each were stockholders of A but only Mr. Hurst owned stock of B. To implement retirement and succession planning, they first sold their A stock to B. B then redeemed 90 percent of Mr. Hurst's B stock, and he sold the remaining 10 percent to his son and two unrelated parties. Both the redemption and sale provided for a 15-year payment term and the corporation's payment obligation was secured by the redeemed or sold B stock. The Hursts continued to own B's corporate headquarters, which they leased back to B; and Mrs. Hurst (remember, she was not a B shareholder) continued as a B employee. All the various agreements (stock purchase, redemption, lease, and employment contract) were cross-collateralized by Mr. Hurst's B stock.

The principal issue was whether the redemption of Mr. Hurst's B stock qualified as a complete termination under Section 302(b)(3) after application of the waiver of family attribution rules in Section 302(c). The Tax Court rejected the Service's arguments that the "total number of related obligations resulting from the transaction gave the [taxpayers] a prohibited interest" that was tantamount to a financial stake in the company's continued success. It held that Mr. Hurst did not retain any prohibited interests by virtue of the 15-year promissory notes (they were not tied to the corporation's financial performance, and using the stock as collateral was consistent with common practice), the lease (it had a fixed rent that was reasonable), or his wife's employment agreement (she owned no B stock, her compensation was not related to the corporation's financial performance, and there was no evidence that she was acting as a surrogate manager for her husband).

Although it involved taxable years before the effective date of the dividend rate reduction, *Hurst* is a good example of why, even apart from basis recovery, characterization still can matter under the current rate regime. Redemptions of closely held stock in the typical "family business" setting are frequently funded with installment notes. If the redemption is treated as an exchange under Section 302, installment sale reporting under Section 453 is available, but there is immediate gain recognition if the distribution is a dividend.

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redeemed shareholder and the payments for the use of the property are dependent upon the corporation's future earnings (other than a fixed percentage of receipts or sales) or are subordinate to the claims of the corporation's general creditors. Rev. Proc. 2019–3, § 3.01(48), 2019–1 I.R.B. 133.

[49] 124 T.C. 16 (2005).

[50] The corporations were S corporations that formerly had been C corporations and, because they had accumulated earnings and profits from their C corporation days, the dividend vs. exchange issue was significant for tax purposes. See Chapter 15G, infra.

b. WAIVER OF ATTRIBUTION BY ENTITIES

Section 302(c)(2) only permits waiver of the *family* attribution rules and requires the "distributee" to file an agreement promising to notify the Service of the acquisition of a forbidden interest within the ten year period following the redemption. What if the redeemed shareholder is a trust, estate or other entity that completely terminates its *actual* interest in the corporation but continues to own shares attributed to a beneficiary from a related family member which then are reattributed from the beneficiary to the entity?[51] May the entity waive family attribution or is the waiver opportunity limited to individual shareholders?

At one time, the Service contended that only individuals could waive family attribution.[52] The Tax Court disagreed, however, holding that an estate or trust that completely terminated its actual interest in a redemption could waive family attribution from a family member to a beneficiary.[53] One appellate court, rejecting what it called a "crabbed reading" of the Code, even held that an entity could waive attribution from a beneficiary to the entity.[54] The problem with these decisions was that they did not prevent the beneficiary from acquiring an interest in the corporation during the ten years after the redemption or require an agreement from the beneficiary to notify the Service if such a forbidden interest were acquired.

Technical as it may seem, this issue was of considerable interest to shareholders of closely held corporations and their estate planners. The Service's rigid position often was an impediment to a redemption of the stock of an estate or trust where family members of the beneficiaries continued to own shares of the company. In the midst of continuing litigation, Congress enacted a special rule for waiver by entities, incorporating appropriate safeguards to preclude the beneficiaries from reacquiring an interest.[55] The Joint Committee on Taxation explained the rule as follows:[56]

> The Act permits an entity to waive the family attribution rules if those through whom ownership is attributed to the

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51 For example, assume Mother's Estate, of which Father is the sole beneficiary, owns 50 of the 100 outstanding shares of X Corporation stock. The other 50 shares are owned by Child. If X redeems Estate's 50 shares, Estate continues to constructively own Child's 50 shares, which are attributed from Child to Father via family attribution and then reattributed from Father to Estate. May Estate break the family attribution chain in order to qualify the redemption as a complete termination?

52 Rev. Rul. 59–233, 1959–2 C.B. 106, Rev. Rul. 68–388, 1968–2 C.B. 122.

53 See Crawford v. Commissioner, 59 T.C. 830 (1973); Johnson Trust v. Commissioner, 71 T.C. 941 (1979); but see Metzger Trust v. Commissioner, 76 T.C. 42 (1981), affirmed, 693 F.2d 459 (5th Cir.1982).

54 Rickey v. United States, 592 F.2d 1251 (5th Cir.1979). This remarkable example of "flexible" statutory construction was sharply criticized. See Andrews, "Comment: Estate Waiver of the Estate-Beneficiary Attribution Rules in Nonliquidating Redemptions Under Section 302 and Related Matters: The *Rickey* Case in the Fifth Circuit," 35 Tax L. Rev. 147 (1979).

55 I.R.C. § 302(c)(2)(C).

56 Staff of Joint Committee on Taxation, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, 98th Cong.2d Sess. 146–47 (1982).

entity join in the waiver. Thus, a trust and its beneficiaries may waive family attribution to the beneficiaries if, after the redemption, neither the trust nor the beneficiaries hold an interest in the corporation, do not acquire such an interest within the 10-year period, and join in the agreement to notify the IRS of any acquisition. The entity and beneficiaries are jointly and severally liable in the event of an acquisition by any of them within the 10-year period and the statute of limitations remains open to assess any deficiency. The tax increase is a deficiency in the entity's tax but may be asserted as a deficiency against any beneficiary liable under the rules. Congress intended that the tax will be collected from a beneficiary only when it cannot be assessed against or collected from the entity, such as when the entity no longer exists or has insufficient funds. Further, it was intended that the tax will be assessed and collected from the beneficiary whose acquisition causes the deficiency before it is asserted against any other beneficiary.

Under the Act, only family attribution under Section 318(a)(1) may be waived by an entity and its beneficiaries. The waiver rules are not extended to waivers of attribution to and from entities and their beneficiaries (secs. 318(a)(2) and 318(a)(3)). The Act thus is intended to overrule Rickey v. United States, 592 F.2d 1251 (5th Cir.1979). Congress intended that the Act should not be construed to provide any inference as to whether the *Rickey* decision adopts a proper construction of prior law. Nor was any inference intended as to whether the other cases extending the waiver rules for family attribution to entities adopt a proper construction of prior law.

Certain anti-avoidance rules applicable where the redeemed stock was acquired by the distributee from a related party or a related party at the time of the redemption owns stock acquired from the distributee are extended to the entity and affected beneficiaries.

PROBLEMS

1. Randall Corporation is owned by John, John's daughter Alison and Alison's son Chuck. John owns 100 shares of Randall stock, Alison owns 50 shares and Chuck owns 25 shares. Consider whether the following redemptions (in year one) qualify as an exchange under 302(b)(3):

(a) Randall redeems Alison's entire 50 shares for cash.

(b) Same as (a), above, except that Alison fails to file the agreement required in § 302(c)(2)(A)(iii)? What is the purpose of this requirement?

(c) Same as (a), above, except the price paid for Alison's shares is contingent upon Randall's future profits?

(d) Randall redeems 20 of Alison's shares for cash on January 1 of year one and the remaining 30 shares for cash on January 1 of year two.

(e) Same as (a), above, except Alison remains as a director of Randall?

(f) Same as (a), above, except that, two years after the redemption, Randall forms a new subsidiary and Alison becomes an employee of the subsidiary?

(g) Same as (a), above, except that two years after the redemption Chuck dies and leaves his Randall shares to Alison?

2. The B & B Windshield Wiper Corporation ("B & B") was organized ten years ago by Betty and Billy, who are wife and husband. Betty and Billy formed B & B by transferring cash and other property to the corporation in exchange for 150 shares of the corporation's common stock. Betty and Billy own B & B's manufacturing plant and lease the plant to the corporation for an annual rental fee. B & B has been very successful and has a large amount of accumulated earnings and profits.

Five years ago, Betty and Billy's youngest Son, Junior, began working for B & B as a clerk in the domestic subcompact wiper division. Junior's managerial talents were quickly recognized and he has risen rapidly in B & B's corporate structure. Today, Junior is B & B's Vice President in charge of operations and has overall responsibility for production at B & B's manufacturing plant.

Shortly after Junior came to B & B, his parents agreed that he would eventually take over control and management of the company. Betty and Billy have now decided that the time has come to retire. To implement this decision, their accountant has suggested the following plan:

- Betty and Billy will give 30 of their 150 B & B shares to Junior to provide him with an ownership interest in the corporation.
- B & B will redeem Betty and Billy's remaining 120 shares for $50,000 plus a $400,000 B & B note paying market rate interest. The note will be payable monthly over a 20-year term and will be secured by an interest in the corporation's assets. Additionally, B & B will agree to restrict dividend payments, limit new indebtedness, and refrain from taking certain extraordinary corporate action (e.g., merger or liquidation) during the term of the note.
- Betty and Billy will continue to lease the manufacturing plant to B & B under a lease which has a rent escalation clause dependent upon the consumer price index. They also will grant B & B a five year option to purchase the plant at its appraised fair market value.

  (a) Will Betty and Billy's redemption be classified as an exchange under Section 302(a)?

  (b) Suppose Betty establishes a management consulting firm after leaving B & B. What would be the tax impact on the redemption if B & B hired Betty's firm to perform an analysis of its proposed entry into the Australian windshield wiper market?

3. Cinelab Corporation has 100 shares of common stock outstanding. John owns 50 shares and Mary, John's sister, owns 30 shares. The other 20 shares are owned by the Estate of Sam; Sam was John and Mary's father. Their mother, Bella, is the sole beneficiary of the estate. Consider the tax consequences of the following redemptions of Cinelab stock:

(a) Cinelab redeems Estate's 20 shares.

(b) Same as (a), above, except that Bella is the residuary beneficiary of the estate and John and Mary each receive specific legacies.

(c) Same as (a), above, except that John and Mary are the residuary beneficiaries of the estate.

(d) Same as (a), above, except the 20 shares were owned and redeemed from a trust established under Sam's will providing income to Bella for her life and the remainder to Nancy, another child of Sam and Bella. The life estate and remainder have equal actuarial values.

(e) Any change in the result in (d), above, if Nancy acquires stock in Cinelab three years after the redemption by the trust?

3. REDEMPTIONS NOT ESSENTIALLY EQUIVALENT TO A DIVIDEND

Code: § 302(b)(1).

Regulations: § 1.302–2.

United States v. Davis

Supreme Court of the United States, 1970.
397 U.S. 301, 90 S.Ct. 1041, rehearing denied, 397 U.S. 1071, 90 S.Ct. 1495 (1970).

■ MR. JUSTICE MARSHALL delivered the opinion of the Court.

In 1945, taxpayer and E.B. Bradley organized a corporation. In exchange for property transferred to the new company, Bradley received 500 shares of common stock, and taxpayer and his wife similarly each received 250 such shares. Shortly thereafter, taxpayer made an additional contribution to the corporation, purchasing 1,000 shares of preferred stock at a par value of $25 per share.

The purpose of this latter transaction was to increase the company's working capital and thereby to qualify for a loan previously negotiated through the Reconstruction Finance Corporation. It was understood that the corporation would redeem the preferred stock when the RFC loan had been repaid. Although in the interim taxpayer bought Bradley's 500 shares and divided them between his son and daughter, the total capitalization of the company remained the same until 1963. That year, after the loan was fully repaid and in accordance with the original understanding, the company redeemed taxpayer's preferred stock.

In his 1963 personal income tax return taxpayer did not report the $25,000 received by him upon the redemption of his preferred stock as income. Rather, taxpayer considered the redemption as a sale of his preferred stock to the company—a capital gains transaction under § 302 of the Internal Revenue Code of 1954 resulting in no tax since taxpayer's basis in the stock equaled the amount he received for it. The Commissioner of Internal Revenue, however, did not approve this tax treatment. According to the Commissioner, the redemption of taxpayer's stock was essentially equivalent to a dividend and was thus taxable as ordinary income under §§ 301 and 316 of the Code. Taxpayer paid the resulting deficiency and brought this suit for a refund. The District Court ruled in his favor, 274 F.Supp. 466 (M.D.Tenn.1967), and on appeal the Court of Appeals affirmed. 408 F.2d 1139 (C.A.6th Cir.1969).

The Court of Appeals held that the $25,000 received by taxpayer was "not essentially equivalent to a dividend" within the meaning of that phrase in § 302(b)(1) of the Code because the redemption was the final step in a course of action that had a legitimate business (as opposed to a tax avoidance) purpose. That holding represents only one of a variety of treatments accorded similar transactions under § 302(b)(1) in the circuit courts of appeals. We granted certiorari, 396 U.S. 815 (1969), in order to resolve this recurring tax question involving stock redemptions by closely held corporations. We reverse.

I

The Internal Revenue Code of 1954 provides generally in §§ 301 and 316 for the tax treatment of distributions by a corporation to its shareholders; under those provisions, a distribution is includable in a taxpayer's gross income as a dividend out of earnings and profits to the extent such earnings exist. There are exceptions to the application of these general provisions, however, and among them are those found in § 302 involving certain distributions for redeemed stock. The basic question in this case is whether the $25,000 distribution by the corporation to taxpayer falls under that section—more specifically, whether its legitimate business motivation qualifies the distribution under § 302(b)(1) of the Code. Preliminarily, however, we must consider the relationship between § 302(b)(1) and the rules regarding the attribution of stock ownership found in § 318(a) of the Code.

Under subsection (a) of § 302, a distribution is treated as "payment in exchange for the stock," thus qualifying for capital gains rather than ordinary income treatment, if the conditions contained in any one of the four paragraphs of subsection (b) are met. In addition to paragraph (1)'s "not essentially equivalent to a dividend" test, capital gains treatment is available where (2) the taxpayer's voting strength is substantially diminished, [or] (3) his interest in the company is completely terminated. * * * [T]axpayer admits that paragraphs (2) and (3) do not apply.

Moreover, taxpayer agrees that for the purposes of §§ 302(b)(2) and (3) the attribution rules of § 318(a) apply and he is considered to own the 750 outstanding shares of common stock held by his wife and children in addition to the 250 shares in his own name.

Taxpayer, however, argues that the attribution rules do not apply in considering whether a distribution is essentially equivalent to a dividend under § 302(b)(1). According to taxpayer, he should thus be considered to own only 25 percent of the corporation's common stock, and the distribution would then qualify under § 302(b)(1) since it was not pro rata or proportionate to his stock interest, the fundamental test of dividend equivalency. See Treas.Reg. 1.302–2(b). However, the plain language of the statute compels rejection of the argument. 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,[6] and the opinion of the leading commentators.[7]

Against this weight of authority, taxpayer argues that the result under paragraph (1) should be different because there is no explicit reference to stock ownership as there is in paragraphs (2) and (3). Neither that fact, however, nor the purpose and history of § 302(b)(1) support taxpayer's argument. The attribution rules—designed to provide a clear answer to what would otherwise be a difficult tax question—formed part of the tax bill that was subsequently enacted as the 1954 Code. As is discussed further, infra, the bill as passed by the House of Representatives contained no provision comparable to § 302(b)(1). When that provision was added in the Senate, no purpose was evidenced to restrict the applicability of § 318(a). Rather, the attribution rules continued to be made specifically applicable to the entire section, and we believe that Congress intended that they be taken into account wherever ownership of stock was relevant.

Indeed, it was necessary that the attribution rules apply to § 302(b)(1) unless they were to be effectively eliminated from consideration with regard to §§ 302(b)(2) and (3) also. For if a transaction failed to qualify under one of those sections solely because of the attribution rules, it would according to taxpayer's argument nonetheless qualify under § 302(b)(1). We cannot agree that Congress intended so to nullify its explicit directive. We conclude, therefore, that the attribution rules of § 318(a) do apply; and, for the purposes of deciding whether a distribution is "not essentially equivalent to a dividend" under § 302(b)(1), taxpayer must be deemed the owner of all 1,000 shares of the company's common stock.

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6 See Treas.Reg. 1.302–2(b).

7 See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 292 n. 32 (2d ed. 1966).

II

After application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation. We conclude that such a redemption is always "essentially equivalent to a dividend" within the meaning of that phrase in § 302(b)(1)[8] and therefore do not reach the Government's alternative argument that in any event the distribution should not on the facts of this case qualify for capital gains treatment.[9]

The predecessor of § 302(b)(1) came into the tax law as § 201(d) of the Revenue Act of 1921, 42 Stat. 228:

> "A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend * * * ."

Enacted in response to this Court's decision that pro rata stock dividends do not constitute taxable income, Eisner v. Macomber, 252 U.S. 189 (1920), the provision had the obvious purpose of preventing a corporation from avoiding dividend tax treatment by distributing earnings to its shareholders in two transactions—a pro rata stock dividend followed by a pro rata redemption—that would have the same economic consequences as a simple dividend. Congress, however, soon recognized that even without a prior stock dividend essentially the same result could be effected whereby any corporation, "especially one which has only a few stockholders, might be able to make a distribution to its stockholders which would have the same effect as a taxable dividend." H.R.Rep. No. 1, 69th Cong., 1st Sess., 5. In order to cover this situation, the law was amended to apply "(whether or not such stock was issued as a stock dividend)" whenever a distribution in redemption of stock was made "at such time and in such manner" that it was essentially equivalent to a taxable dividend. Revenue Act of 1926, § 201(g), 44 Stat. 11.

This provision of the 1926 Act was carried forward in each subsequent revenue act and finally became § 115(g)(1) of the Internal Revenue Code of 1939. Unfortunately, however, the policies encompassed within the general language of § 115(g)(1) and its predecessors were not clear, and there resulted much confusion in the tax law. At first, courts

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[8] Of course, this just means that a distribution in redemption to a sole shareholder will be treated under the general provisions of § 301, and it will only be taxed as a dividend under § 316 to the extent that there are earnings and profits.

[9] The Government argues that even if business purpose were relevant under § 302(b)(1), the business purpose present here related only to the original investment and not at all to the necessity for redemption. Under either view, taxpayer does not lose his basis in the preferred stock. Under Treas.Reg. 1.302–2(c) that basis is applied to taxpayer's common stock.

assumed that the provision was aimed at tax avoidance schemes and sought only to determine whether such a scheme existed. * * * Although later the emphasis changed and the focus was more on the effect of the distribution, many courts continued to find that distributions otherwise like a dividend were not "essentially equivalent" if, for example, they were motivated by a sufficiently strong nontax business purpose. See cases cited n. 2, supra. There was general disagreement, however, about what would qualify as such a purpose, and the result was a case-by-case determination with each case decided "on the basis of the particular facts of the transaction in question." Bains v. United States, 289 F.2d 644, 646, 153 Ct.Cl. 599, 603 (1961).

By the time of the general revision resulting in the Internal Revenue Code of 1954, the draftsmen were faced with what has aptly been described as "the morass created by the decisions." Ballenger v. United States, 301 F.2d 192, 196 (C.A.4th Cir.1962). In an effort to eliminate "the considerable confusion which exists in this area" and thereby to facilitate tax planning, H.R.Rep. No. 1337, 83d Cong., 2d Sess., 35, the authors of the new Code sought to provide objective tests to govern the tax consequences of stock redemptions. Thus, the tax bill passed by the House of Representatives contained no "essentially equivalent" language. Rather, it provided for "safe harbors" where capital gains treatment would be accorded to corporate redemptions that met the conditions now found in §§ 302(b)(2) and (3) of the Code.

It was in the Senate Finance Committee's consideration of the tax bill that § 302(b)(1) was added, and Congress thereby provided that capital gains treatment should be available "if the redemption is not essentially equivalent to a dividend." Taxpayer argues that the purpose was to continue "existing law," and there is support in the legislative history that § 302(b)(1) reverted "in part" or "in general" to the "essentially equivalent" provision of § 115(g)(1) of the 1939 Code. According to the Government, even under the old law it would have been improper for the Court of Appeals to rely on "a business purpose for the redemption" and "an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates." * * * However, we need not decide that question, for we find from the history of the 1954 revisions and the purpose of § 302(b)(1) that Congress intended more than merely to re-enact the prior law.

In explaining the reason for adding the "essentially equivalent" test, the Senate Committee stated that the House provisions "appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place." S.Rep. No. 1622, 83d Cong., 2d Sess., 44. This explanation gives no indication that the purpose behind the redemption should affect the result. Rather, in its more detailed technical evaluation of § 302(b)(1), the Senate Committee reported as follows:

> "The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future * * * the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. For this purpose the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absence of earnings and profits." S.Rep. No. 1622, supra, at 234.

The intended scope of § 302(b)(1) as revealed by this legislative history is certainly not free from doubt. However, we agree with the Government that by making the sole inquiry relevant for the future the narrow one whether the redemption could be characterized as a sale, Congress was apparently rejecting past court decisions that had also considered factors indicating the presence or absence of a tax-avoidance motive. At least that is the implication of the example given. Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316 rather than under § 302, and nothing suggests that there should be a different result if there were a "business purpose" for the redemption. Indeed, just the opposite inference must be drawn since there would not likely be a tax-avoidance purpose in a situation where there were no earnings or profits. 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). Hasbrook v. United States, 343 F.2d 811, 814 (1965).

Taxpayer strongly argues that to treat the redemption involved here as essentially equivalent to a dividend is to elevate form over substance. Thus, taxpayer argues, had he not bought Bradley's shares or had he made a subordinated loan to the company instead of buying preferred stock, he could have gotten back his $25,000 with favorable tax treatment. However, the difference between form and substance in the tax law is largely problematical, and taxpayer's complaints have little to do with whether a business purpose is relevant under § 302(b)(1). It was clearly proper for Congress to treat distributions generally as taxable dividends when made out of earnings and profits and then to prevent avoidance of that result without regard to motivation where the distribution is in exchange for redeemed stock.

We conclude that that is what Congress did when enacting § 302(b)(1). 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. The decision of the Court of Appeals must therefore be reversed and the case remanded to the District Court for dismissal of the complaint.

It is so ordered.

■ MR. JUSTICE DOUGLAS, with whom THE CHIEF JUSTICE and MR. JUSTICE BRENNAN concur, dissenting.

I agree with the District Court, 274 F.Supp. 466, and with the Court of Appeals, 408 F.2d 1139, that respondent's contribution of working capital in the amount of $25,000 in exchange for 1,000 shares of preferred stock with a par value of $25 was made in order for the corporation to obtain a loan from the RFC and that the preferred stock was to be redeemed when the loan was repaid. For the reasons stated by the two lower courts, this redemption was not "essentially equivalent to a dividend," for the bona fide business purpose of the redemption belies the payment of a dividend. As stated by the Court of Appeals:

> "Although closely-held corporations call for close scrutiny under the tax law, we will not, under the facts and circumstances of this case, allow mechanical attribution rules to transform a legitimate corporate transaction into a tax avoidance scheme." 408 F.2d, at 1143–1144.

When the Court holds it was a dividend, it effectively cancels § 302(b)(1) from the Code. This result is not a matter of conjecture, for the Court says that in the case of closely held or one-man corporations a redemption of stock is "always" equivalent to a dividend. I would leave such revision to the Congress.

Revenue Ruling 85–106

1985–2 Cum. Bull. 116.

ISSUE

Is a redemption of nonvoting preferred stock not essentially equivalent to a dividend within the meaning of section 302(b)(1) of the Internal Revenue Code when there is no reduction in the percentage of voting and nonvoting common stock owned by the redeemed shareholder, and when the redeemed shareholder continues to have an undiminished opportunity to act in concert with other shareholders as a control group, under the circumstances described below?

FACTS

Corporation *X* had outstanding three classes of stock consisting of 100 shares of voting common stock, 100 shares of nonvoting common stock, and 50 shares of nonvoting 9 percent cumulative preferred stock. The fair market value of each share of common stock was approximately half the fair market value of each share of preferred stock. The voting common stock was held as follows:

Shareholders	***Shares***
A	19
B	19
C	18
Minority shareholders	44
Total	100

None of the minority shareholders owned more than five shares. None of the holders of the voting common stock were related within the meaning of section 318(a) of the Code. The combined voting power of *A, B,* and *C* was sufficient to elect a majority of the board of directors of *X*.

The nonvoting common stock and the ~~preferred stock~~ were held (directly and indirectly) in approximately the same proportions as the common stock. *C* held no nonvoting common stock or preferred stock directly, but was the sole remaining beneficiary of a trust, *T*, which owned 18 percent of both the nonvoting common stock ~~and the pref~~erred stock.

The trustees of *T* decided that it would be in the best interests of that trust if most of the *X* preferred stock held by *T* could be converted into cash. After negotiation, *X* redeemed six shares of preferred stock for its fair market value of 6*x* dollars. Following this redemption, *T* continued to hold three shares of preferred stock, and 18 percent of the nonvoting common stock. Under section 318(a)(3)(B) of the Code, *T* is also considered to own the voting common stock owned by its sole beneficiary, *C*.

LAW AND ANALYSIS

Section 302(a) of the Code provides, in part, that if a corporation redeems its stock, and if section 302(b)(1), (2), (3), or (4) applies, such redemption will be treated as a distribution in part or full payment in exchange for the stock.

* * *

The lack of any reduction in *T*'s 18 percent vote prevented this redemption from qualifying under section 302(b)(2) of the Code, and the lack of complete termination of interest prevented it from qualifying under section 302(b)(3). The question remains whether the redemption should be considered not essentially equivalent to a dividend so as to qualify under section 302(b)(1). Under section 1.302–2(b) of the Income Tax Regulations, this determination depends upon the facts and circumstances of each case.

In United States v. Davis, 397 U.S. 301 (1970), 1970–1 C.B. 62, the Supreme Court of the United States held that in order to qualify under section 302(b)(1) of the Code, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation, and that, for this purpose, the attribution rules of section 318 apply.

In determining whether a reduction in interest is "meaningful", the rights inherent in a shareholder's interest must be examined. The three elements of a shareholder's interest that are generally considered most significant are: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation. Rev.Rul. 81–289, 1981–2 C.B. 82.

In applying the above principles, it is significant that (as a result of section 318(a)(3)(B) of the Code) the redemption did not reduce *T*'s percentage of the vote in *X*. It is true that *T* reduced its percentage interest in current earnings, accumulated surplus, and net assets upon liquidation, and reduced the fair market value of its ownership in *X*. However, when the redeemed shareholder has a voting interest (either directly or by attribution), a reduction in voting power is a key factor in determining the applicability of section 302(b)(1) of the Code.

It is also true that *T* was not the largest shareholder. *A* and *B* each held slightly larger voting interests, and larger interests measured by fair market value. *T*, however, was not in the position of a minority shareholder isolated from corporate management and control. Compare Rev.Rul. 75–512, where the majority of the redeeming corporation's voting stock was held by a shareholder unrelated (within the meaning of section 318(a)) to the redeemed trust. Also compare Rev.Rul. 76–385, 1976–2 C.B. 92, where the redeemed shareholder's total interest was *de minimis*.

In the present situation, a significant aspect of *T*'s failure to reduce voting power is the fact that the redemption leaves unchanged *T*'s potential (by attribution from *C*) for participating in a control group by acting in concert with *A* and *B*. Compare Rev.Rul. 76–364, 1976–2 C.B. 91, where a reduction in voting interest was found meaningful in itself when it caused the redeemed shareholder to give up a potential for control by acting in concert with one other shareholder. In addition, the Tax Court has indicated significance for this factor of potential group control (*Johnson Trust*, at 947). See also Bloch v. United States, 261 F.Supp. 597, 611–612 (S.D.Tex.1966), aff'd per curiam, 386 F.2d 839 (5th Cir.1967), where, in finding that "the distributions in question were essentially equivalent to a dividend," the court noted that there was no change in the redeemed shareholder's potential for exercising control "by aligning himself with one or more of the other stockholders."

Although there was a reduction of *T*'s economic interest in *X*, such reduction was not sufficiently large to result in a meaningful reduction of *T*'s interest. The absence of any reduction of *T*'s voting interest in *X* (through *C*) and *T*'s potential (through *C*) for control group participation are compelling factors in this situation.

In Himmel v. Commissioner, 338 F.2d 815 (2d Cir.1964), dealing with a similar question, a decision was reached permitting the applicability of section 302(b)(1) of the Code. That case, however, was decided prior to the decision of the Supreme Court in *Davis*. Thus, *Himmel* fails to reflect the development in the law represented by the *Davis* limitation on section 302(b)(1) applicability where there is no meaningful reduction of the shareholder's proportionate interest in the corporation. Thus, pursuant to *Davis,* it is proper to view *Himmel* as incorrect to the extent it conflicts with the position contained in this revenue ruling.

HOLDING

The redemption of nonvoting preferred stock held by *T* does not qualify as a redemption under section 302(b)(1) of the Code, under the facts of this ruling when there is no reduction in the percentage of voting and nonvoting common stock owned by *T*, and when *T* continues to have an undiminished opportunity to act in concert with other shareholders as a control group. Since the redemption does not otherwise qualify under section 302(b), it is not a distribution in part or full payment for the stock under section 302(a). Consequently, under section 302(d), the redemption will be treated as a distribution of property to which section 301 applies.

NOTE

The Meaningful Reduction Standard. In interpreting the "meaningful reduction" standard of *Davis*, the Service's rulings have considered the effect of the redemption on the redeemed shareholder's voting power, rights to participate in current and future corporate earnings, and rights to share in net assets on liquidation.[57] As illustrated by Revenue Ruling 85–106, if the shareholder has a voting interest, the key factor in measuring dividend equivalence is the reduction in the shareholder's voting power as opposed to other important economic rights. Whether such a reduction is "meaningful" is essentially a question of fact, but some guidelines have emerged from published rulings. For example, in Revenue Ruling 75–502,[58] the Service ruled that a shareholder's reduction of voting common stock ownership from 57 percent to 50 percent was meaningful where the remaining stock was held by a single unrelated shareholder. The ruling also states that a lesser

57 See, e.g., Rev. Rul. 81–289, 1981–2 C.B. 82.

58 1975–2 C.B. 111.

reduction would not have qualified under Section 302(b)(1) because the shareholder would have continued to have "dominant voting rights."[59]

Turning to minority shareholders, the Service held in Revenue Ruling 75–512[60] that a reduction of common stock ownership from 30 percent to 24.3 percent—a near-miss under the substantially disproportionate redemption safe harbor—was meaningful because the redeemed shareholder experienced a reduction in three significant rights: voting, earnings, and assets on liquidation. A reduction in common stock ownership from 27 percent to 22 percent also was held to be meaningful where the remaining shares were owned by three unrelated shareholders because the redeemed shareholder lost the ability to control the corporation in concert with only one other shareholder.[61]

The Section 302 regulations also focus upon the effect of the redemption upon the shareholder's control of corporate affairs. Thus, pro rata redemptions of a corporation's single class of stock do not qualify for exchange treatment, and the redemption of all of one class of stock also fails if all outstanding classes of stock are held proportionately.[62] Any redemption of stock from a shareholder owning only nonvoting preferred stock, however, is not essentially equivalent a dividend since the shareholder does not have control over whether the redemption occurs.[63] The Service also has ruled that a redemption of publicly traded common stock that reduces a shareholder's interest from .0001118 percent to .0001081 percent qualifies for exchange treatment since such a shareholder cannot exercise control over corporate affairs.[64] The same reasoning should apply to redemptions by closely held companies of stock held by minority shareholders who reduce their percentage interests, even if the reduction is slight. But a pro rata redemption of stock in a publicly traded corporation will not satisfy the "meaningful reduction" standard even if the shareholder owns only small noncontrolling interest in the corporation.[65]

Suppose that under state law a simple majority of a corporation's outstanding shares can control day-to-day corporate activities through the board of directors but extraordinary corporate action, such as a merger or liquidation, requires approval by two-thirds of the shares. Should a redemption in which a shareholder loses control of extraordinary corporate action but retains control of routine matters (e.g. a reduction to 60% voting control) qualify for exchange treatment under Section 302(b)(1)? In Wright v. United States,[66] the Eighth Circuit determined that such a redemption is not essentially equivalent to a dividend because of the loss of two-thirds

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[59] Id.

[60] 1975–2 C.B. 112.

[61] Rev. Rul. 76–364, 1976–2 C.B. 91.

[62] Reg. § 1.302–2(b).

[63] Reg. § 1.302–2(a). In Rev. Rul. 77–426, 1977–2 C.B. 87, a redemption of five percent of the outstanding preferred stock from a shareholder owning all of the preferred stock (and only preferred stock) qualified for exchange treatment under Section 302(b)(1).

[64] Rev. Rul. 76–385, 1976–2 C.B. 92.

[65] Rev. Rul. 81–289, 1981–2 C.B. 82.

[66] 482 F.2d 600 (8th Cir.1973).

control of the corporation. In Revenue Ruling 78–401,[67] the Service takes a more restrictive view of the application of Section 302(b)(1) to these facts. The ruling concludes that if extraordinary corporate action is not "imminent," the retention of day-to-day control of corporate activities is a "predominant factor" and the redemption does not result in a meaningful reduction in the shareholder's interest. It is unclear what position the Service would take if a merger or similar corporate transaction were contemplated or what evidence would substantiate the likelihood of corporate action.

Family Discord. One of the more titillating issues to arise under Section 302(b)(1) involves whether the Section 318(a)(1) family attribution rules should be ignored when there is evidence of family discord between the redeemed shareholder and related continuing shareholders. A typical factual context in which this "family fight" question arises is well illustrated in the following introduction to a leading Tax Court decision:[68]

> Petitioner Michael N. Cerone * * * and his son Michael L. Cerone * * * owned and operated the Stockade Cafe * * * each owning 50 percent of the stock of the corporation. The father and son had a volatile relationship and frequently disagreed over management decisions. Over the years their disagreements became more serious, and finally they decided one of them should buy the other's interest in the business. Petitioner did not think he could run the business alone, so it was decided that the corporation would redeem all of his stock. After the redemption, petitioner worked at the Stockade Cafe for several years, but he did not exercise any control over the corporation. This case involves the tax treatment of the payments or distributions petitioner received for his stock.

If the family attribution rules applied to the above fact pattern, the redemption of the father's 50 percent stock interest would not qualify under Section 302(b)(1) because he continued to own 100 percent of the company through attribution from his son. If the attribution chain could be broken, however, the father's reduction of his interest from 50 percent to zero would be "meaningful" and the redemption would qualify for exchange treatment under Section 302(b)(1) even if he failed to meet the specific requirements for waiver of family attribution under Section 302(c).[69]

After its victory in United States v. Davis, the Service consistently rejected attempts by taxpayers to break the chain of family attribution by proving family hostility.[70] Most courts to consider the question agree that the

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67 1978–2 C.B. 127.

68 Cerone v. Commissioner, 87 T.C. 1 (1986). See also the colorful introduction to the Fifth Circuit's opinion in David Metzger Trust v. Commissioner, 693 F.2d 459 (5th Cir.1982) ("We decide today a story driven by tensions as old as Genesis but told in the modern lexicon of the tax law. It is the story of David who built a business and left it in the charge of his eldest son Jacob to be shared with Jacob's two sisters Catherine and Cecilia, of their alienation and resulting quarrel with the tax collectors.")

69 See Section C2 of this chapter, supra. Mr. Cerone was unable to waive family attribution under Section 302(c) because he retained a prohibited employment relationship with the corporation after the redemption. 87 T.C. at 29–33.

70 See, e.g., Rev. Rul. 80–26, 1980–1 C.B. 66.

attribution rules apply without regard to family squabbles. Although the First Circuit once held that family discord might "negate the presumption" of the attribution rules,[71] the Tax Court and the Fifth Circuit have refused to allow family discord to nullify the attribution rules in applying Section 302(b)(1).[72]

More recently, the Tax Court has suggested that family discord may be relevant in testing for dividend equivalency under Section 302(b)(1) *after* the attribution rules have been applied. In Cerone v. Commissioner,[73] the court summarized its view of the proper role of family hostility:[74]

> Although we [have] rejected the * * * argument that family discord could preclude application of the attribution rules, we nonetheless noted that family discord does have a role, albeit a limited one, in testing for dividend equivalence under section 302(b)(1). We reasoned that under *United States v. Davis,* supra, the proper analysis is as follows: First, the attribution rules are plainly and straightforwardly applied. Second, a determination is made whether there has been a reduction in the stockholder's proportionate interest in the corporation. If not, the inquiry ends because, if there is no change in the stockholder's interest, dividend equivalency results. If there has been a reduction, then all the facts and circumstances must be examined to see if the reduction was meaningful under *United States v. Davis,* supra. It is at this point, *and only then,* that family hostility becomes an appropriate factor for consideration. * * * .

Basis Issues: The Mystery of the Disappearing Basis. Suppose that after a redemption the shareholder no longer owns any stock in the redeemed class of shares and the redemption is treated as a Section 301 distribution. What happens to the basis of the redeemed shares? For example, suppose there is a redemption of all the shares of one class of stock, but the shareholder is treated as receiving a Section 301 distribution because she continues to own shares in another class of the corporation's stock? Or what if the shareholder actually owns no stock in the corporation after the redemption but is treated as receiving a Section 301 distribution because shares held by a family member are attributed to her and the technical requirements of a waiver of family attribution were not satisfied? What should happen to the basis of the redeemed shares in these fact patterns?

Historically, the regulations resolved this technical teaser—known as the "mystery of the disappearing basis"—by first permitting any remaining basis in the redeemed shares to move to any other shares in the corporation

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71 Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir.1975), vacating and remanding 61 T.C. 398 (1973).

72 Cerone v. Commissioner, supra note 68; Metzger Trust v. Commissioner, 76 T.C. 42 (1981), affirmed, 693 F.2d 459 (5th Cir.1982), cert. denied, 463 U.S. 1207, 103 S.Ct. 3537 (1983); Haft Trust v. Commissioner, 61 T.C. 398 (1973), vacated and remanded, 510 F.2d 43 (1st Cir.1975).

73 Supra note 68.

74 87 T.C. at 22. See also Henry T. Patterson Trust v. United States, 729 F.2d 1089 (6th Cir.1984) (percentage reduction from 97 to 93 percent, after applying attribution rules, is meaningful under *Davis* in view of hostility.)

held by the shareholder.[75] In the situation where the shareholder actually owns no shares in the corporation following a redemption treated as a Section 301 distribution, the regulations permit the basis in the redeemed shares to "levitate" and move to stock held by family members or entities whose stock was attributed to the redeemed shareholder under Section 318.[76]

Regulations proposed in 2009, and later withdrawn, provided a different solution to the mystery of the disappearing basis. The primary goal of those regulations was to combat abusive transactions (well beyond the scope of our coverage) that exploit the current rules by shifting basis from a foreign shareholder not subject to U.S. tax to an affiliated U.S. corporation that can benefit from the additional basis to increase loss or reduce taxable gain. To that end, the proposed regulations prevented a redeemed shareholder from transferring any unrecovered basis to another class of stock or to shares held by a related taxpayer by requiring the unrecovered basis to remain with the redeemed shareholder. The redeemed shareholder was allowed to treat the unrecovered basis as a loss on the disposition of the redeemed stock later on the date when the conditions for exchange treatment under Sections 302(b)(1), (2) or (3) are met (e.g., when a related party no longer owns any stock), or, alternatively, when all shares of the issuing corporation (or its successor) become worthless within the meaning of Section 165(g).[77] As noted, those regulations were withdrawn and the IRS continues to study the issue.[78] When, or if, the Service provides additional guidance, the mystery of the disappearing basis may become less of a mystery.

Z
A 28 B 25 C 23 D 24. <unrelated>

PROBLEMS

1. Z Corporation has 100 shares of common stock outstanding, owned by A (28 shares), B (25 shares), C (23 shares) and D (24 shares.) Unless otherwise indicated, assume the shareholders are not related. In each of the following alternative situations, determine whether the redemption is not essentially equivalent to a dividend under § 302(b)(1): in concert with only 1 other sh. [Rev. Rul 75-5…

   (a) Z redeems 7 shares from A. 28 → 21. ✓ meaningful reduction. × ability to control corp by one…

   (b) Z redeems 5 shares from A, and A and D are mother and daughter. A&D总有 52 → 47 after redemption A control (23+24)/95 = 49.4%

   (c) Z redeems 5 shares from A, and A and B are mother and daughter. A&D 有 53 → 48 (23+25)/95 = 50%+?

   (d) Same as (c), above, except that A has not spoken to B since B married "outside her faith." only if meaningful reduction → consider family hostility in consid… dividend equivalency

2. Y Corporation has 100 shares of common stock and 100 shares of nonvoting preferred stock outstanding. The preferred stock is not convertible into Y common stock and is not Section 306 stock (i.e., not stock treated

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75 Reg. § 1.302–2(c) Examples 1 & 3. The assumption has been that the examples would also permit the basis in the redeemed shares to next move to shares held by the shareholder in a different class of stock.

76 See Reg. § 1.302–2(c) Example 2 where the basis of redeemed shares moves from one spouse to the other spouse.

77 Prop. Reg. § 1.302–5(b)(4).

78 REG–143687–07 (March 28, 2019).

specially in § 306 because of its tax avoidance potential). The Y common and preferred stock are owned by the following unrelated shareholders:

Shareholder	Common Shares	Preferred Shares
A	40	0
B	20	55
C	25	10
D	15	15
E	0	20

∵ pro rata ∴ × §306(c)(1).

Will the following alternative redemptions qualify for exchange treatment under § 302(b)? × 符合(1) ∵ nonvoting × 符合(2) ∵ × substantially disproportionate ∵ nonvoting.

(a) Y redeems 5 preferred shares from E.

for E. ✓ ∵ §306(c)(3) complete termination of E's interest. (b) Y redeems all of its outstanding preferred stock.

3. Suppose an individual shareholder owns ten shares of common stock of X Corporation with a basis of $15,000. What happens to the shareholder's basis if five shares are redeemed in a transaction which is properly classified as a dividend? What if all ten shares are redeemed in a transaction which is properly classified as a dividend because a § 302(c)(2) waiver of family attribution is unavailable? basis move to stock held by family members

if historical reg: $7,500 basis added to remaining 5 sh.
if proposed reg: $7,500 as unrecovered loss.

D. REDEMPTIONS TESTED AT THE CORPORATE LEVEL: PARTIAL LIQUIDATIONS

Code: § 302(b)(4), (e).

Section 302(b)(4) provides exchange treatment for redemptions of stock held by noncorporate shareholders if the distribution qualifies as a "partial liquidation." Under Section 302(e)(1), a distribution is treated as in partial liquidation if it is pursuant to a plan, occurs within the taxable year in which the plan is adopted or the succeeding taxable year, and is "not essentially equivalent to a dividend." Although the "not essentially equivalent to a dividend" standard mirrors the language in Section 302(b)(1), the two provisions have a very different focus. For partial liquidation purposes, dividend equivalency is determined at the corporate rather than the shareholder level. Thus, while a pro rata redemption could never escape dividend classification under Section 302(b)(1), any redemption that results in a genuine contraction of the corporation's business may qualify for exchange treatment as a partial liquidation if the distribution is made to a shareholder other than a C corporation. The legislative history of the predecessor of Section 302(e) explains the corporate contraction standard:[79]

[79] S.Rep. No. 1622, 83d Cong., 2d Sess. 49 (1954). See Imler v. Commissioner, 11 T.C. 836 (1948) (the "contraction-by-fire" case referred to in the Senate Report).

> The general language of the proposed draft would include within the definition of a partial liquidation the type of cases involving the contraction of the corporate business. Such as for example, cases which hold that if the entire floor of a factory is destroyed by fire, the insurance proceeds received may be distributed pro rata to the shareholders without the imposition of a tax at the rates applicable to the distribution of a dividend, if the corporation no longer continues its operations to the same extent maintained by the destroyed facility. Voluntary bona fide contraction of the corporate business may of course also qualify to the same extent as under existing law. In addition to the general definition of what constitutes a partial liquidation, your committee's bill provides a rule to indicate one type of distribution that will in any event constitute a partial liquidation. Under this rule, if a corporation is engaged in two or more active businesses which has [sic] been carried on for at least 5 years, it may distribute the assets of either one of the businesses in kind, or the proceeds of their sale.

The amorphous corporate contraction doctrine is a perilous yardstick for the tax planner. Recognizing the need for greater certainty, Congress has provided a safe harbor in Section 302(e)(2), which assures partial liquidation status if the distribution consists of the assets of a "qualified trade or business" or is attributable to the termination of such a trade or business, and immediately after the distribution the corporation continues to conduct another qualified trade or business. To be "qualified," a trade or business must have been actively conducted throughout the five-year period ending on the date of the distribution and must not have been acquired by the distributing corporation in a taxable transaction during that period.[80] The active trade or business that the corporation continues to conduct must have a similar five-year business history. The "active" business requirement is designed to patrol against the accumulation of earnings in the form of investment assets, such as real estate or securities, followed by prompt bailout distributions masquerading as corporate contractions.[81] If the Section 302(e)(2) safe harbor is not satisfied, the Service ordinarily will not rule that a distribution qualifies as a partial liquidation unless it results in a 20 percent or greater reduction in gross revenue, net fair market value of assets, and employees of the corporation.[82]

A distribution may qualify as a partial liquidation even if the shareholders do not actually surrender any stock.[83] If the other requirements of either the general corporate contraction doctrine or the

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[80] I.R.C. § 302(e)(3).

[81] For the definition of an active trade or business, see Reg. § 1.355–3(b), (c), which govern corporate divisions under Section 355. See Chapter 10B, infra.

[82] Rev. Proc. 2019–3, § 4.01(25), 2019–1 I.R.B. 139.

[83] Fowler Hosiery Co. v. Commissioner, 301 F.2d 394 (7th Cir.1962); Rev. Rul. 90–13, 1990–1 C.B. 65.

statutory safe harbor are met, the transaction will be treated as a constructive redemption of stock.[84]

Distributions to corporate shareholders do not qualify for partial liquidation treatment even if all the other statutory requirements are met.[85] For purposes of determining whether a shareholder is corporate or noncorporate, stock held by a partnership, estate, or trust (but not an S corporation) is treated as if held proportionately by the partners or beneficiaries.[86] S corporations are thus treated as corporate shareholders and do not qualify for exchange treatment on a partial liquidation under Section 302(b)(4).

At first glance, it might seem that C corporation shareholders would welcome their eviction from the partial liquidation safe harbor because distributions that otherwise would give rise to taxable capital gain would become dividends sheltered by the dividends received deduction. But Congress was not acting in a spirit of generosity. Rather, it was attempting to put an end to several widely publicized acquisition techniques that used the partial liquidation as a vehicle for obtaining the best of all tax worlds: a stepped-up basis for selected assets of the acquired corporation along with the preservation of favorable tax attributes (e.g., earnings and profits deficits, loss and credit carryovers, etc.)—all at little or no tax cost.[87]

Congress inflicted further punishment on corporate shareholders when it enacted restrictions to prevent abuse of the dividends received deduction.[88] Any amount treated as a dividend to a corporate shareholder under Section 301 is an "extraordinary dividend" under Section 1059 if it is a distribution in redemption of stock which is part of a partial liquidation of the redeeming corporation, regardless of the shareholder's holding period or the size of the distribution.[89] As a result, a corporate shareholder that receives a dividend in a transaction treated as a partial liquidation must reduce its basis in the stock of the redeeming corporation by the portion of the dividend that was not taxed because of the dividends received deduction.[90]

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84 See Rev. Rul. 77–245, 1977–2 C.B. 105, for the method of computing the tax consequences of a partial liquidation.

85 I.R.C. § 302(b)(4).

86 I.R.C. § 302(e)(5).

87 See, e.g., Henderson, "Federal Tax Techniques for Asset Redeployment Transactions," 37 Tax L. Rev. 325 (1982); Ginsburg, "Taxing Corporate Acquisitions," 38 Tax L. Rev. 171 (1983).

88 See Chapter 4F, supra.

89 I.R.C. § 1059(e)(1).

90 I.R.C. § 1059(a), (b). If the nontaxed portion of the dividend exceeds the shareholder's basis in the redeemed stock, the excess is treated as gain from a sale or exchange of the stock. I.R.C. § 1059(a)(2).

Revenue Ruling 79–184

1979–1 Cum. Bull. 143.

Advice has been requested whether the sale by a parent corporation of all the stock of a wholly owned subsidiary and the distribution of the sales proceeds by the parent to its shareholders qualifies as a distribution in partial liquidation within the meaning of section 346(a)(2) of the Internal Revenue Code of 1954 [now Section 302(e). Ed.].

Corporation *P* owned all of the single class of outstanding stock of Corporation *S* for many years, during which time each had been engaged in the active conduct of a trade or business.

Pursuant to a plan, *P* sold all of the stock of *S* to an unrelated party for cash and distributed the proceeds of the sale pro rata to its shareholders in redemption of part of their *P* stock.

Section [302(e)(1)] of the Code provides, in part, that a distribution will be treated as a partial liquidation of a corporation if it is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year. Section 1.346–1(a)(2) of the Income Tax Regulations provides that a distribution resulting from a genuine contraction of the corporate business is an example of a distribution that will qualify as a partial liquidation under section [302(e)(1)].

Generally, for purposes of section [302(e)] of the Code, the business that is terminated or contracted must be operated directly by the corporation making the distribution. See *H.L. Morgenstern,* 56 T.C. 44 (1971). However, Rev. Rul. 75–223, 1975–1 C.B. 109, provides that when a parent corporation liquidates a wholly owned subsidiary and distributes the subsidiary's assets, or the proceeds from the sale of those assets, to its shareholders, the fact that the distributions were attributable to assets used by the subsidiary rather than directly by the parent will not prevent the distribution from qualifying as a "genuine contraction of the corporate business" to the parent within the meaning of section 1.346–1(a)(2) of the regulations. The basis for this holding is that under section 381 a parent corporation that liquidates a subsidiary under section 332 (when section 334(b)(1) applies) inherits attributes (for example, earnings and profits) of the liquidated subsidiary so that after the liquidation of the subsidiary the parent is viewed as if it had always operated the business of the liquidated subsidiary.

However, when a parent corporation distributes the stock of its subsidiary, as in *Situation 3* of Rev.Rul. 75–223, section 381 of the Code does not apply to integrate the past business results of the subsidiary with those of the parent. Therefore, distribution by the parent of subsidiary's stock does not result in the parent corporation taking into account the past operations of the subsidiary. Thus, there is no analogy between a distribution of stock of the subsidiary and a distribution of the assets of a liquidated subsidiary or the proceeds of a sale of such assets. A distribution of the stock of the subsidiary under such circumstances is a corporate separation, governed by section 355, and not a corporate contraction.

Similarly, as in the present case, where *P* sells all of the stock of its wholly owned subsidiary, *S*, and distributes the proceeds to its shareholders, there is no basis for attributing the business activities of *S* to *P*. It is well established that a corporation is a legal entity separate and distinct from its shareholders. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934), XIII–1 C.B. 194 (1934); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), 1943 C.B. 1011. Although the assets of *P* are reduced by the subsequent distribution of the sale proceeds, the sale by *P* of the *S* stock is not in and of itself sufficient to effect a contraction of the business operations of *P* within the contemplation of section 346(a)(2) of the Code. Rather, the overall transaction has the economic significance of the sale of an investment and distribution of the proceeds.

Accordingly, the distribution by *P* to its shareholders of the proceeds of the sale of the *S* stock does not qualify as a distribution in partial liquidation within the meaning of section [302(e)(1)] of the Code, and the distribution will be treated as a distribution by *P* of property taxable to the *P* shareholders under section 301 by reason of section 302(d). See section 1.302–2(b) of the regulations, which provides that all distributions in pro rata redemption 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.

Michael Pamela Iris corp.

PROBLEM

Alpha (2个business)

own

Beta. sub.

Alpha Corporation operates a book publishing business ("Books") and a bar exam review course ("Cram") as divisions (i.e., not as separately incorporated entities). Alpha's single class of common stock outstanding is owned in equal shares by Michael, Pamela (Michael's wife) and Iris Corporation. Neither Michael nor Pamela owns any stock in Iris. Alpha also owns all of the stock of Beta Corporation, a separately incorporated company which is engaged in the beta processing business, and it directly owns a diversified securities portfolio.

What are the shareholder level tax consequences of the following alternative transactions:

(a) Alpha has operated Books and Cram for more than five years and it distributes the assets of Books to its three equal shareholders in redemption of 50 shares from each shareholder. Any different result if the redemption is made without an actual surrender of shares?

(b) Is there a different result in (a), above, if Alpha had purchased Books three years ago for cash? If so, why should that matter?

What if Alpha acquired Books three years ago in a tax-free reorganization?

(c) What if all the assets of Books were destroyed by fire and Alpha distributes one-half of the insurance proceeds equally to its three shareholders in redemption of an appropriate number of shares of stock and retains the remaining proceeds to carry on its book publishing business on a somewhat smaller scale? ✓ partial liquidation. x Iris

(d) Same as (a), above, except that Alpha distributes the assets of Books to Michael in redemption of all of his stock.

(e) Same as (a), above except that Alpha distributes the assets of Books to Iris in redemption of all of its Alpha stock. X.

(f) Alpha distributes the securities portfolio to its three equal shareholders in redemption of 20 shares from each shareholder. x active business.

(g) Alpha sells all of its Beta stock and distributes the proceeds pro rata to the shareholders in redemption of 20 shares from each. Rev. Rul. 79-184. x sufficient as Alpha contract its business operation.

(h) Same as (g), above, except that Alpha liquidates Beta and then distributes the assets of Beta's business, which Beta has operated for more than five years.

✓ partial liquidation §302(e)(1)

E. CONSEQUENCES TO THE DISTRIBUTING CORPORATION

1. DISTRIBUTIONS OF APPRECIATED PROPERTY IN REDEMPTION

Code: § 311.

In the preceding chapter, the story of the decline of the *General Utilities* doctrine began to unfold.[91] The assault on *General Utilities* in the redemption setting gained momentum when Congress discovered that several insurance companies were redeeming large amounts of their own stock by distributing appreciated securities while avoiding recognition of gain at the corporate level.[92] Congress curtailed this abuse by requiring a corporation to recognize gain on a distribution of appreciated property in a redemption as if the property had been sold for its fair market value. Partial liquidation distributions, however, continued to qualify for nonrecognition at the corporate level, and numerous exceptions demonstrated that Congress was not yet ready to give *General Utilities* a proper burial.[93]

Corporate takeover specialists were quick to exploit these remaining vestiges of the *General Utilities* doctrine. Through carefully orchestrated

91 See Chapter 4D1, supra.

92 See S.Rep. No. 91–552, 91st Cong., 1st Sess. 279, reprinted in 1969–3 C.B. 423, 600.

93 See I.R.C. § 311(d)(2) (pre-1982).

transactions, they sought to convert a direct sale of property by a corporation, normally a taxable event to the seller, into a tax-free distribution.[94] After several of these schemes were publicized, Congress responded by further narrowing the opportunity for nonrecognition on nonliquidating distributions of appreciated property in redemption. The final demise of *General Utilities* in the redemption context came with the Tax Reform Act of 1986. In adopting Section 311(b), which also applies to nonliquidating distributions, Congress repealed all the remaining exceptions that had provided for nonrecognition of gain to the distributing corporation. As a result, a corporation distributing property in redemption of stock (including a partial liquidation) always recognizes gain but may not recognize loss.

2. EFFECT ON EARNINGS AND PROFITS

Code: § 312(n)(7).

The effect of a stock redemption on the distributing corporation's earnings and profits initially depends upon the tax consequences of the redemption at the shareholder level. If the redemption is treated as a distribution to which Section 301 applies, the distributing corporation adjusts its earnings and profits in the same manner as on other nonliquidating distributions—i.e., earnings and profits are decreased by the amount of cash and the principal amount of any obligations, and by the greater of the adjusted basis or the fair market value of any property distributed.[95] In addition, the corporation always recognizes gain and correspondingly increases its current earnings and profits on a distribution of appreciated property, and it reduces current earnings and profits by any taxes paid on that gain.[96]

If a redemption (including a partial liquidation) is treated as an exchange to the redeemed shareholder, the effect on earnings and profits is more complex. In that situation, Section 312(n)(7) provides that the part of the distribution in redemption that is properly chargeable to earnings and profits shall be an amount which does not exceed the ratable share of the corporation's accumulated earnings and profits attributable to the redeemed stock. For purposes of Section 312(n)(7), accumulated earnings and profits include any current earnings and profits available at the time of the redemption. The current earnings and profits available at that time are determined after they first have been applied to characterize as dividends any Section 301 distributions made during the year. If the corporation is unable to show the actual current earnings and profits as of the date of the redemption, then current earnings and profits are allocated to the date of distribution on a pro rata

[94] See Henderson, "Federal Tax Techniques for Asset Redeployment Transactions," 37 Tax L.Rev. 325 (1982). The Service's attack or this strategy was rejected in Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir.1989).

[95] I.R.C. § 312(a), (b).

[96] I.R.C. § 311(b); 312(b).

basis.[97] Congress also expressed its intention that earnings and profits never would be reduced by more than the amount of the redemption.[98]

To illustrate the operation of this rule, assume that X Corporation has 1,000 shares of common stock outstanding, and that A and B each acquire 500 of these shares at issuance at a price of $20 per share. Assume further that X is a profitable business that holds $100,000 of net assets, consisting of $50,000 cash and $50,000 of appreciated real property, and X has $50,000 of accumulated earnings and profits. If X distributes $50,000 cash to A in redemption of A's 500 shares, Section 312(n)(7) reduces X's earnings and profits by $25,000—the ratable share of X's $50,000 earnings and profits attributable to A's 50 percent stock interest that was redeemed. The remaining $25,000 of the distribution is charged to X's capital account and, after the redemption, X has $25,000 of remaining accumulated earnings and profits. The following excerpt from the legislative history of the Tax Reform Act of 1984 explains the operation of this rule in the case of a corporation with a more complex capital structure:[99]

> If a corporation has more than one class of stock outstanding, its earnings and profits generally should be allocated among the different classes in determining the amount by which a redemption of all or a part of one class of stock reduces earnings and profits. However, earnings and profits generally should not be allocated to preferred stock which is not convertible and which does not participate to any significant extent in corporate growth. Therefore, a redemption of such preferred stock should result in a reduction of the capital account only, unless the distribution includes dividend arrearages, which will reduce earnings and profits.
>
> Similarly, priorities legally required as between different classes of stock should be taken into account in allocating earnings and profits between classes. For example, assume that corporation X has 1,000 shares of class A common stock and 1,000 shares of class B common stock. Both classes are $10 par value stock and were issued at the same time at a price of $20. The class A common has a preference as to dividends and liquidating distributions in a 2:1 ratio to the class B common, and only the class B common has voting rights. Assume further that Corporation X holds net assets worth $210,000 and has current and accumulated earnings and profits of $120,000. If X distributes $140,000 in cash in redemption of all of the class A

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97 Rev. Rul. 74–338, 1974–2 C.B. 101; Baker v. United States, 460 F.2d 827 (8th Cir. 1972).

98 S.Rep. No. 98–169, 98th Cong., 2d Sess. 202 (1984).

99 Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1984, 98th Cong., 2d Sess. 181 (1984).

common, earnings and profits should be reduced by \$80,000 and capital account by \$60,000.

PROBLEM

basis: 50K.

A B

X.

X Corporation has 200 shares of common stock outstanding. A and B, who are unrelated, each acquired 100 shares of X upon their issuance at a price of \$500 per share, and they each thus have an adjusted basis of \$50,000 in their X stock. At the beginning of the current year, X has \$120,000 of accumulated earnings and profits and X has \$100,000 of current earnings and profits from operations (after taxes) during the year. What are the tax consequences to X if on July 1 it distributes \$250,000 cash in redemption of A's shares in a redemption that qualifies as an exchange under Section 302(a).

all accumulated E&P & half current E&P attributable to stock

120K Acc E&P
100K current E&P?

3. STOCK REACQUISITION EXPENSES

50K.
+ 120K
170K.
.. 85K
1/2
because redeem half of sh.

Code: § 162(k).

Amounts paid to acquire stock generally must be capitalized as part of the stock's basis.[100] The capitalization requirement applies to the original purchase price of the stock as well as to acquisition expenses, such as brokerage commissions and legal fees.[101] Some older authority held, however, that expenses incurred by a corporation to repurchase its stock, in limited circumstances, might be ordinary and necessary expenses deductible under Section 162.[102] In the midst of the frenzy of hostile corporate takeovers in the 1980s, Congress became concerned that corporate expenditures incurred to fend off unwanted corporate suitors by purchasing their shares—so-called "greenmail" payments—were being characterized as deductible business expenses.[103] Section 162(k)(1) was enacted to make it clear that all expenditures by a corporation incurred in reacquiring its own stock, whether representing amounts paid for the stock, a premium paid in excess of the stock's value, or expenses connected with the purchase, are nondeductible, nonamortizable capital expenditures.[104] Section 162(k)(2) contains exceptions for interest payments deductible under Section 163, and several more specialized situations.

One difficult interpretive problem under the Section 162(k) disallowance rule revolves around the question of what amounts are paid to shareholders "in connection with" a redemption of stock. The legislative history states that while the phrase "in connection with" is to be construed broadly, it is not intended to deny a deduction for "otherwise deductible amounts paid in a transaction which has no nexus with the

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[100] I.R.C. §§ 263(a), 1012.

[101] Reg. § 1.263(a)–4(c), (e). See Woodward v. Commissioner, 397 U.S. 572, 90 S.Ct. 1302 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580, 90 S.Ct. 1307 (1970).

[102] Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir.1966).

[103] S. Rep. No. 99–313, 99th Cong., 2d Sess. 223 (1986).

[104] Id.

redemption other than being proximate in time or arising out of the same circumstances."[105] The Conference Report goes on to expand upon this standard:[106]

> For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision. Payments in discharge of other types of contractual obligations, in settlement of litigation, or pursuant to other actual or potential legal obligations or rights, may also be outside the intended scope of the provision to the extent it is clearly established that the payment does not represent consideration for the stock or expenses related to its acquisition, and is not a payment that is a fundamental part of a "standstill" or similar agreement.
>
> The conferees anticipate that, where a transaction is not directly related to a redemption but is proximate in time, the Internal Revenue Service will scrutinize the transaction to determine whether the amount purportedly paid in the transaction is reasonable. Thus, even where the parties have countervailing tax interests, the parties' stated allocation of the total consideration between the redemption and the unrelated transaction will be respected only if it is supported by all the facts and circumstances.
>
> However, the conferees intend that agreements to refrain from purchasing stock of a corporation or other similar types of "standstill" agreements in all events will be considered related to any redemption of the payee's stock. Accordingly, payments pursuant to such agreements are nondeductible under this provision provided there is an actual purchase of all or part of the payee's stock. The conferees intend no inference regarding the deductibility of payments under standstill or similar agreements that are unrelated to any redemption of stock owned by the payee.

[105] H.R. Rep. No. 841, 99th Cong., 2d Sess. II—168 (1986).

[106] Id. at II—168–69.

F. REDEMPTION PLANNING TECHNIQUES

1. BOOTSTRAP ACQUISITIONS

Revenue Ruling 75–447

1975–2 Cum. Bull. 113.

Advice has been requested as to the Federal income tax consequences, in the situations described below, of the redemption by a corporation of part of its stock.

Situation 1

Corporation *X* had outstanding 100 shares of voting common stock of which *A* and *B* each owned 50 shares. In order to bring *C* into the business with an equal stock interest, and pursuant to an integrated plan, *A* and *B* caused *X* to issue, at fair market value, 25 new shares of voting common stock to *C*. Immediately thereafter, as part of the same plan, *A* and *B* caused *X* to redeem 25 shares of *X* voting common stock from each of them. Neither *A, B,* nor *C* owned any stock of *X* indirectly under section 318 of the Internal Revenue Code of 1954.

Situation 2

Corporation *X* had outstanding 100 shares of voting common stock of which *A* and *B* each owned 50 shares. In order to bring *C* into the business with an equal stock interest, and pursuant to an integrated plan, *A* and *B* each sold 15 shares of *X* voting common stock to *C* at fair market value and then caused *X* to redeem five shares from both *A* and *B*. Neither *A, B,* nor *C* owned any stock of *X* indirectly under section 318 of the Code.

Section 302(b)(2) of the Code states that section 302(a), which provides for treating a redemption of stock as a distribution in part or full payment in exchange for the stock, will apply if the distribution is substantially disproportionate with respect to the shareholder. * * *

In Zenz v. Quinlivan, 213 F.2d 914 (6th Cir.1954), a sole shareholder of a corporation, desiring to dispose of her entire interest therein, sold part of her stock to a competitor and shortly thereafter sold the remainder of her stock to the corporation for an amount of cash and property approximately equal to its earned surplus. The Government contended that the redemption was a dividend on the grounds that the result was the same as if the steps had been reversed, that is, as if the stock had been redeemed first and the sale of stock to the competitor had followed. The United States Court of Appeals rejected the Government's contention and held that the purchase of the stock by the corporation (when coupled with the sale of stock to the competitor) was not a dividend to the selling shareholder and that the proceeds should be treated as payment for the stock surrendered under the provisions of the Internal Revenue Code of 1939.

Rev. Rul. 55–745, 1955–2 C.B. 223, states that in situations similar to that in *Zenz,* the amount received by the shareholder from the corporation will be treated as received in payment for the stock surrendered under section 302(a) of the Code since the transaction when viewed as a whole results in the shareholder terminating his interest in the corporation within the meaning of section 302(b)(3).

In determining whether the "substantially disproportionate" provisions of section 302(b)(2) of the Code have been satisfied in *Situation 1* and in *Situation 2,* it is proper to rely upon the holding in *Zenz* that the sequence in which the events (that is, the redemption and sale) occur is irrelevant as long as both events are clearly part of an overall plan. Therefore, in situations where the redemption is accompanied by an issuance of new stock (as in *Situation 1*), or a sale of stock (as in *Situation 2*), and both steps (the sale, or issuance, of stock, as the case may be, and the redemption) are clearly part of an integrated plan to reduce a shareholder's interest, effect will be given only to the overall result for purposes of section 302(b)(2) and the sequence in which the events occur will be disregarded.

Since the *Zenz* holding requires that effect be given only to the overall result and proscribes the fragmenting of the whole transaction into its component parts, the computation of the voting stock of the corporation owned by the shareholder *immediately before* the redemption for purposes of section 302(b)(2)(C)(ii) of the Code should be made before any part of the transaction occurs. Likewise, the computation of the voting stock of the corporation owned by the shareholder *immediately after* the redemption for purposes of section 302(b)(2)(C)(i) should be made after the whole transaction is consummated. Making the immediately before and the immediately after computations in this manner properly reflects the extent to which the shareholder involved in each situation actually reduces his stock holdings as a result of the whole transaction.

Therefore, for purposes of the computations required by section 302(b)(2)(C) of the Code, *A* and *B,* in *Situation 1,* will each be viewed as having owned 50 percent (50/100 shares) of *X* before the transaction and 33⅓ percent (25/75 shares) immediately thereafter. In *Situation 2, A* and *B* will each be viewed as having owned 50 percent (50/100 shares) of *X* before the transaction and 33⅓ percent (30/90 shares) immediately thereafter. Furthermore, in each situation, the result would be the same if the redemption had preceded the issuance, or sale, of stock.

Accordingly, in both *Situations 1* and *2,* the requirements of section 302(b)(2) of the Code are satisfied. Therefore, the amounts distributed to *A* and *B* in both situations are distributions in full payment in exchange for the stock redeemed pursuant to section 302(a).

NOTE

The classic bootstrap acquisition is a transaction where the buyer purchases all or part of the stock of the target corporation in conjunction with a redemption of some of the selling shareholder's stock. In Zenz v. Quinlivan,[107] which is discussed in Revenue Ruling 75–447, the sole shareholder of a corporation sold part of her stock for cash and, three weeks later, the corporation redeemed her remaining shares. The combined sale and redemption structure was used because the buyer wanted to minimize future dividend exposure by reducing the corporation's earnings and profits. The seller's agenda was to be taxed on both the sale and redemption at then favorable capital gains rates and avoid dividend treatment on the redemption.

The Service argued that the redemption would have been a dividend to the target's shareholder if the distribution had preceded the sale and should not be treated any differently where the parties orchestrated a different order of events. The Sixth Circuit disagreed. Finding that the taxpayer intended from the outset to terminate her entire interest in the corporation, it held that the redemption qualified as an exchange rather than a dividend. The Service subsequently acquiesced to the result in *Zenz* and extended its reasoning to substantially disproportionate redemptions in Revenue Ruling 75–447.

In the case of a noncorporate shareholder, *Zenz* and its progeny have far less significance as long as qualified dividends are taxed at preferential capital gains rates. In a combined sale and redemption transaction, a noncorporate seller ordinarily will suffer no tax disadvantage if the distribution in redemption is characterized as a dividend. The distinction still matters, however, to corporate shareholders. As discussed in Chapter 4,[108] corporate sellers who are seeking to extract liquid assets prior to a sale of stock normally prefer a pre-sale dividend for two reasons: (1) the availability of the dividends received deduction, and (2) corporate capital gains are not taxed at preferential rates.

PROBLEM

Strap is the sole shareholder of Target Corporation. Boot is a prospective buyer and is willing to purchase all of the Target stock, but Boot is unable to pay the $500,000 price demanded by Strap even though he believes it to be fair. Target has more than $100,000 of accumulated earnings and profits and $100,000 cash on hand. Should Strap and Boot structure Boot's acquisition of Target along the lines of the *Zenz* case? Is there a better alternative? What additional facts would you like to know? (Compare to *TSN Liquidating* and the problem on page 200, supra.)

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[107] 213 F.2d 914 (6th Cir. 1954).

[108] See Chapter 4G, supra.

2. BUY-SELL AGREEMENTS

a. IN GENERAL

Code: §§ 101(a); 264(a)(1). Skim § 2703.

Closely held corporations frequently use buy-sell stock purchase agreements to ensure continuity of the business, to satisfy economic and tax goals when a shareholder dies or retires, and to resolve shareholder disputes. There are two basic forms of buy-sell agreements. Under a "cross-purchase" agreement, the departing shareholder or the shareholder's estate sells stock to the continuing shareholders. Under the more commonly employed "entity-purchase" agreement, the corporation redeems the departing shareholder's stock, funding the redemption with available cash, borrowed funds, an installment note, or the proceeds of a corporate-owned life insurance policy. The obligation to buy (or sell) may be mandatory or optional, as the parties agree, and is triggered by certain events specified in the agreement. The most common trigger event is a shareholder's death. Other typical trigger events are retirement or disability.

Buy-sell provisions frequently are part of a more comprehensive shareholders' agreement that includes restrictions on the transfer of stock, rights of first refusal to the corporation in the event a shareholder wishes to sell, and provisions to determine the value of any stock purchased pursuant to the agreement. Some primitive agreements set the price based on "book value," an accounting concept that often bears little or no relationship to the economic value of the company. More sophisticated agreements will use a formula based on earnings or provide for an appraisal mechanism on the occurrence of a trigger event.

A goal of many buy-sell agreements for closely-held family businesses is to establish the federal estate tax valuation of the stock upon a shareholder's death. A decedent's gross estate generally includes all property held by the decedent, valued either at the date of death or six months thereafter (the alternate valuation date).[109] In the case of unlisted stock, which cannot be valued by market quotations, fair market value is determined by taking into account a variety of factors, including the corporation's net worth, its earnings history and dividend-paying capacity, and the value of stock of publicly traded companies in the same line of business.[110] If stock is subject to an option or contract to purchase, such as a buy-sell agreement, the regulations provide that the agreement will establish the value if it represents a bona fide business arrangement and is not a device to pass the stock to the natural objects of the decedent's bounty for less than adequate and full consideration.[111] But if

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[109] I.R.C. §§ 2031; 2032.

[110] I.R.C. § 2031(b); Reg. § 20.2031–2(f)(2). See also Rev. Rul. 59–60, 1959–1 C.B. 237.

[111] Reg. § 20.2031–2(h). For the buy-sell agreement price to be binding, the decedent's estate must be obligated to sell the decedent's stock; the buyer either must be obligated to buy

the decedent was free to dispose of the stock during his lifetime without price restrictions, "little weight" is given to the price set at death by the option or contract.[112] The courts agree that maintaining control of a closely held business constitutes a bona fide business purpose but they require a separate examination of whether a restriction or option constitutes a "testamentary device."[113]

For buy-sell agreements entered into or substantially modified after October 8, 1990, Congress has added some statutory restrictions on the valuation of property subject to an option or contract to purchase. Section 2703(a) provides that the value of any property for estate, gift and generation-skipping tax purposes shall be determined without regard to (1) any option, agreement or other right to acquire or use property at a price less than the fair market value of the property, disregarding the option agreement or right, or (2) any restriction on the right to sell or use such property. Under this general rule, the effect of a buy-sell agreement on valuation would be disregarded. Section 2703(b), however, provides an exception for any option, agreement, right or restriction which satisfies the standards of the regulations (bona fide business arrangement and not a testamentary device) and has terms "comparable to similar arrangements entered into by persons in an arm's length transaction." In adding this comparability standard, Congress intended the taxpayer to show that the agreement was one that could have been obtained in an arm's length bargain with an unrelated party, considering such factors as the term of the agreement, the present value of the affected property, and its expected value at the time of exercise.[114] In noting that this standard would not be met "by showing isolated comparables but requires a demonstration of the general practice of unrelated parties," the Senate Finance Committee stated that expert testimony—e.g., by an appraiser familiar with the industry—would be evidence of such general practice.[115]

Drafters of buy-sell agreements still have some flexibility in their use of valuation methodologies. For example, the legislative history of Section 2703 states that a buy-sell agreement should not be disregarded merely because its terms differ from those used by another similarly situated company.[116] Noting that general business practice may recognize more than one valuation methodology, even within the same industry, the conferees went on to state that "[i]n such situations, one of

the decedent's interest or have an option to do so; and the price specified must have been fair at the time the agreement was made. Id.

[112] Id.

[113] See, e.g., St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir.1982).

[114] Senate Finance Committee Explanation of Revenue Provisions, 1991 Budget Reconciliation Bill (Oct. 13, 1990), 101st Cong., 2d Sess. 68 (1990).

[115] Id. See also Reg. § 25.2703–1.

[116] H.Rep. No. 101–964, 101st Cong., 2d Sess. 157 (1990).

several generally accepted methodologies may satisfy the standard contained in the conference agreement."[117]

Section 2703 has not resulted in the demise of buy-sell agreements to fix estate tax valuation. It merely places a greater premium on an evidentiary showing that the arrangement is bona fide and not merely a tax-avoidance device to transfer a family business to the next generation for less than adequate and full consideration.

As developed in the next section of the text, buy-sell agreements also may raise constructive dividend issues if they are not properly structured and implemented. With most dividends now taxed at 15 or 20 percent, these issues may or may not be important depending on other variables, such as the shareholder's stock basis, the need for capital gains to absorb otherwise unavailable capital losses, and the shareholder's other tax characteristics.

b. CONSTRUCTIVE DIVIDEND ISSUES

Revenue Ruling 69–608

1969–2 Cum. Bull. 42.

Advice has been requested as to the treatment for Federal income tax purposes of the redemption by a corporation of a retiring shareholder's stock where the remaining shareholder of the corporation has entered into a contract to purchase such stock.

Where the stock of a corporation is held by a small group of people, it is often considered necessary to the continuity of the corporation to have the individuals enter into agreements among themselves to provide for the disposition of the stock of the corporation in the event of the resignation, death, or incapacity of one of them. Such agreements are generally reciprocal among the shareholders and usually provide that on the resignation, death, or incapacity of one of the principal shareholders, the remaining shareholders will purchase his stock. Frequently such agreements are assigned to the corporation by the remaining shareholder and the corporation actually redeems its stock from the retiring shareholder.

Where a corporation redeems stock from a retiring shareholder, the fact that the corporation in purchasing the shares satisfies the continuing shareholder's executory contractual obligation to purchase the redeemed shares does not result in a distribution to the continuing shareholder provided that the continuing shareholder is not subject to an existing primary and unconditional obligation to perform the contract and that the corporation pays no more than fair market value for the stock redeemed.

117 Id. See also Reg. § 25.2703–1(b)(4).

On the other hand, if the continuing shareholder, at the time of the assignment to the corporation of his contract to purchase the retiring shareholder's stock, is subject to an unconditional obligation to purchase the retiring shareholder's stock, the satisfaction by the corporation of his obligation results in a constructive distribution to him. The constructive distribution is taxable as a distribution under section 301 of the Internal Revenue Code of 1954.

If the continuing shareholder assigns his stock purchase contract to the redeeming corporation prior to the time when he incurs a primary and unconditional obligation to pay for the shares of stock, no distribution to him will result. If, on the other hand, the assignment takes place after the time when the continuing shareholder is so obligated, a distribution to him will result. While a pre-existing obligation to perform in the future is a necessary element in establishing a distribution in this type of case, it is not until the obligor's duty to perform becomes unconditional that it can be said a primary and unconditional obligation arises.

The application of the above principles may be illustrated by the situations described below.

Situation 1

A and *B* are unrelated individuals who own all of the outstanding stock of corporation *X*. *A* and *B* enter into an agreement that provides in the event *B* leaves the employ of *X*, he will sell his *X* stock to *A* at a price fixed by the agreement. The agreement provides that within a specified number of days of *B*'s offer to sell, *A* will purchase at the price fixed by the agreement all of the *X* stock owned by *B*. *B* terminates his employment and tenders the *X* stock to *A*. Instead of purchasing the stock himself in accordance with the terms of the agreement, *A* causes *X* to assume the contract and to redeem its stock held by *B*. In this case, *A* had a primary and unconditional obligation to perform his contract with *B* at the time the contract was assigned to *X*. Therefore, the redemption by *X* of its stock held by *B* will result in a constructive distribution to *A*. See William J. and Georgia K. Sullivan v. United States of America, 244 F.Supp. 605 (1965), affirmed, 363 F.2d 724 (1966), certiorari denied, 387 U.S. 905, 87 S.Ct. 1683 (1967), rehearing denied, 388 U.S. 924, 87 S.Ct. 2104 (1967).

Situation 2

A and *B* are unrelated individuals who own all of the outstanding stock of corporation *X*. An agreement between them provides unconditionally that within ninety days of the death of either *A* or *B*, the survivor will purchase the decedent's stock of *X* from his estate. Following the death of *B*, *A* causes *X* to assume the contract and redeem the stock from *B*'s estate.

The assignment of the contract to *X* followed by the redemption by *X* of the stock owned by *B*'s estate will result in a constructive distribution to *A* because immediately on the death of *B*, *A* had a primary and unconditional obligation to perform the contract.

Situation 3

All of the stock of *X* corporation was owned by a trust that was to terminate in 1968. Individuals *A* and *B* were the beneficiaries of the trust. Since *B* was the trustee of the trust, he had exclusive management authority over *X* through his control of the board of directors. In 1966, *A* paid to *B* the sum of 25*x* dollars and promised to pay an additional 20*x* dollars to *B* in 1969 for *B*'s interest in the corpus and accumulations of the trust plus *B*'s agreement to resign immediately as supervisor of the trust and release his control over the management of the corporation. The actual transfer of the stock held in trust was to take place on termination of the trust in 1968. In 1969, *X* reimbursed *A* for the 25*x* dollars previously paid to *B*, paid 20*x* dollars to *B*, and received the *X* stock held by *B*.

For all practical purposes, *A* became the owner of *B*'s shares in 1966. Although naked legal title to the shares could not be transferred until the trust terminated in 1968, *B* did transfer all of his beneficial and equitable ownership of the *X* stock to *A* in exchange for an immediate payment by *A* of 25*x* dollars and an unconditional promise to pay an additional 20*x* dollars upon termination of the trust. The payment by *X* of 20*x* dollars to *B* and 25*x* dollars to *A* in 1969 constituted a constructive distribution to *A* in the amount of 45*x* dollars. See Schalk Chemical Company v. Commissioner, 32 T.C. 879 (1959), affirmed 304 F.2d 48 (1962).

Situation 4

A and *B* owned all of the outstanding stock of *X* corporation. *A* and *B* entered into a contract under which, if *B* desired to sell his *X* stock, *A* agreed to purchase the stock or to cause such stock to be purchased. If *B* chose to sell his *X* stock to any person other than *A*, he could do so at any time. In accordance with the terms of the contract, *A* caused *X* to redeem all of *B*'s stock in *X*.

At the time of the redemption, *B* was free to sell his stock to *A* or to any other person, and *A* had no unconditional obligation to purchase the stock and no fixed liability to pay for the stock. Accordingly, the redemption by *X* did not result in a constructive distribution to *A*. See S.K. Ames, Inc. v. Commissioner, 46 B.T.A. 1020 (1942), acquiescence, C.B. 1942–1, 1.

Situation 5

A and *B* owned all of the outstanding stock of *X* corporation. An agreement between *A* and *B* provided that upon the death of either, *X* will redeem all of the *X* stock owned by the decedent at the time of his death. In the event that *X* does not redeem the shares from the estate, the agreement provided that the surviving shareholder would purchase the unredeemed shares from the decedent's estate. *B* died and, in accordance with the agreement, *X* redeemed all of the shares owned by his estate.

In this case *A* was only secondarily liable under the agreement between *A* and *B*. Since *A* was not primarily obligated to purchase the *X* stock from the estate of *B*, he received no constructive distribution when *X* redeemed the stock.

Situation 6

B owned all of the outstanding stock of *X* corporation. *A* and *B* entered into an agreement under which *A* was to purchase all of the *X* stock from *B*. *A* did not contemplate purchasing the *X* stock in his own name. Therefore, the contract between *A* and *B* specifically provided that it could be assigned by *A* to a corporation and that, if the corporation agreed to be bound by the terms, *A* would be released from the contract.

A organized *Y* corporation and assigned the stock purchase contract to it. *Y* borrowed funds and purchased all of the *X* stock from *B* pursuant to the agreement. Subsequently *Y* was merged into *X* and *X* assumed the liabilities that *Y* incurred in connection with the purchase of the *X* stock and subsequently satisfied these liabilities.

The purchase by *Y* of the stock of *X* did not result in a constructive distribution to *A*. Since *A* did not contemplate purchasing the *X* stock in his own name, he provided in the contract that it could be assigned to a corporation prior to the closing date. *A* chose this latter alternative and assigned the contract to *Y*. *A* was not personally subject to an unconditional obligation to purchase the *X* stock from *B*. See Arthur J. Kobacker and Sara Jo Kobacker, et al. v. Commissioner, 37 T.C. 882 (1962), acquiescence, C.B. 1964 2, 6. Compare Ray Edenfield v. Commissioner, 19 T.C. 13 (1952), acquiescence, C.B. 1953–1, 4.

Situation 7

A and *B* owned all of the outstanding stock of *X* corporation. An agreement between the shareholders provided that upon the death of either, the survivor would purchase the decedent's shares from his estate at a price provided in the agreement. Subsequently, the agreement was rescinded and a new agreement entered into which provided that upon the death of either *A* or *B*, *X* would redeem all of the decedent's shares of *X* stock from his estate.

The cancellation of the original contract between the parties in favor of the new contract did not result in a constructive distribution to either *A* or *B*. At the time *X* agreed to purchase the stock pursuant to the terms of the new agreement, neither *A* nor *B* had an unconditional obligation to purchase shares of *X* stock. The subsequent redemption of the stock from the estate of either pursuant to the terms of the new agreement will not constitute a constructive distribution to the surviving shareholder.

PROBLEM

A, B and C, who are unrelated, each own 1,000 shares of common stock (the only class outstanding) of X Corporation with a fair market value of $400 per share. X has $600,000 of accumulated and no current earnings and profits. A and C each have a $50,000 adjusted basis in their X stock. B, who recently received her stock as an inheritance, has a $400,000 adjusted basis. B wishes to retire and dispose of her stock.

What are the tax consequences of the following alternative transactions:

(a) Pursuant to a cross-purchase buy-sell agreement, B sells 500 shares each to A and C for $200,000 each.

(b) Pursuant to an entity-purchase buy-sell agreement, X redeems all of B's stock for $400,000.

(c) Same as (a), above, except the agreement required A and C to buy B's stock over ten years, with appropriate interest, but they did not have sufficient funds to make the payments so they caused X to make them on their behalf.

(d) A and C had options to buy B's stock when B retired but they were short of funds and allowed X to redeem the stock instead.

(e) The parties previously entered into a cross-purchase agreement under which they agreed that the two surviving shareholders would purchase the X stock owned by the estate of the first shareholder to die. X purchased a life insurance policy on the life of each shareholder and paid the annual premiums. X is the beneficiary under the policies. B died this year, and X used the proceeds from the policy on B's life to completely redeem the stock held by B's estate.

c. REDEMPTIONS INCIDENT TO DIVORCE

Regulations: § 1.1041–2(a)–(d).

Arnes v. United States

United States Court of Appeals, Ninth Circuit, 1992.
981 F.2d 456.

■ HUG, CIRCUIT JUDGE:

The issue in this case is whether a taxpayer must recognize for income tax purposes the gain that she realized when, pursuant to a divorce settlement, a corporation redeemed her half of the stock in the corporation, the remaining stock of which was owned by her former husband. The district court, ruling on cross-motions for summary judgment, held that Section 1041 of the Internal Revenue Code of 1986 (I.R.C.) relieved the taxpayer of having to recognize the gain, and awarded the taxpayer a refund of $53,053 for 1988. * * * We affirm.

I.

Joann Arnes, the Taxpayer-Appellee, married John Arnes in 1970. In 1980, they formed a corporation, "Moriah," to operate a McDonald's franchise in Ellensburg, Washington. That corporation issued 5,000 shares of stock in the joint names of John Arnes and Joann Arnes. In 1987, the couple agreed to divorce. McDonald's Corporation required 100% ownership of the equity and profits by the owner/operator, and informed John Arnes that there should be no joint ownership of the restaurant after the divorce.

Joann and John Arnes entered into an agreement to have their corporation redeem Joann Arnes' 50 percent interest in the outstanding stock for $450,000. The corporation would pay that money to Joann Arnes by forgiving a debt of approximately $110,000 that she owed the corporation, by making two payments of $25,000 to her during 1988, and by paying the remainder of approximately $290,000 to her in monthly installments over ten years beginning in February 1988. The agreement was incorporated into the decree of dissolution of the marriage, dated January 7, 1988. Joann Arnes surrendered her 2,500 shares to the corporation on December 31, 1987, and the corporation cancelled her stock certificate on May 4, 1988, then issuing another 2,500 shares to John Arnes.

On her federal income tax return for 1988, Joann Arnes reported that she sold her stock in Moriah on January 2, 1988, for a price of $450,000, and that her basis was $2,500, resulting in a profit of $447,500. She received $178,042 in 1988 as part of the sales price. Using an installment method, she treated $177,045 as long-term capital gain and the remainder as recovery of a portion of her basis.

On December 27, 1989, she filed a timely claim for refund of $53,053 for 1988 on the ground that she was not required to recognize any gain on the transfer of her stock because the transfer was made pursuant to a divorce instrument. The IRS did not allow the claim for refund, and Joann Arnes initiated this suit.

The district court found that the redemption of Joann Arnes' stock in Moriah was required by a divorce instrument, and that John Arnes had benefitted from the transaction because it was part of the marital property settlement, which limited future community property claims that Joann Arnes might have brought against him. The court, in applying the IRS regulations, found that, although Joann transferred her stock directly to Moriah, the transfer was made on behalf of John and should have been treated as having been made to John. Therefore, the transfer qualified for nonrecognition of gain pursuant to the I.R.C. exemption for transfers made to spouses or former spouses incident to a divorce settlement. See 26 U.S.C. § 1041 (1988). Summary judgment was granted in favor of Joann Arnes.

The Government appeals. Meanwhile, in order to insure that the capital gain will be taxed, the Government has asserted a protective income tax deficiency against John Arnes, who has contested the deficiency by filing a petition with the Tax Court. His case is pending but not before this court. The Government maintains that, although Joann Arnes is the appropriate party to be taxed for the gain, John Arnes should be taxed if the district court's ruling is upheld. If neither John nor Joann is taxed, the $450,000 used to redeem Joann's appreciated stock apparently will be taken out of the corporation tax-free.

* * *

III.

The Government contends that the gain resulting from Moriah's redemption of Joann Arnes' stock does not qualify for exemption under section 1041, which is limited to transfers made directly to one's spouse or former spouse, or transfers made into trust for that person. Joann Arnes' transfer to Moriah, the Government contends, is outside the scope of the exemption. Joann Arnes contends that her transfer of stock to Moriah should be considered a transfer to John, resulting in a benefit to John, and absolving her of the obligation to bear the burden of any resulting tax.

* * *

The purpose of [Section 1041] is to defer the tax consequences of transfers between spouses or former spouses. See H.R.Rep. No. 432, Pt. II, 98th Cong., 2d Sess. 1491 (1984), reprinted in 1984 U.S.Code Cong. & Admin.News 697, 1134 ("a husband and wife are a single economic unit"). Property received in such a transfer is excluded from the recipient's gross income. The recipient's basis is then equal to the transferor's basis. 26 U.S.C. § 1041(b)(2) (1988). Later, when the recipient transfers the property to a third party, the gain or loss must be recognized.

After section 1041 was enacted, the Treasury Department published a temporary regulation to implement the statute. Temp. Treas. Reg. § 1.1041–1T (1992). The regulation explains that in certain cases a transfer of property to a third party "on behalf of" a spouse or former spouse should be treated as a transfer to the spouse or former spouse. Id. at Q–9, A–9. One example supplied in the regulation is the case where the transfer to the third party is required by a divorce or separation instrument. Such a transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041. Temp. Treas.Reg. § 1.1041–1T, A–9 (1992).

The example suggests that the tax consequences of any gain or loss arising from the transaction would fall upon the nontransferring spouse for whose benefit the transfer was made, rather than upon the transferring spouse. Consistent with the policy of the statute, which is to defer recognition until the property is conveyed to a party outside the marital unit, the regulation seems to provide for shifting the tax burden from one spouse to the other, where appropriate.

Thus, a transfer by a spouse to a third party can be treated as a transfer to the other spouse when it is "on behalf of" the other spouse. Whether the redemption of Joann's stock can be construed as a transfer to John, pursuant to the regulation example in A–9, depends upon the meaning of "on behalf of." The district court interpreted the regulation as meaning that a transfer was made "on behalf of" John Arnes if he received a benefit from the transfer. The court then concluded that John did receive a benefit, because the transfer was part of the marital property agreement which settled any future community property claims that Joann Arnes could have asserted against John.

Although no case is directly on point, many tax cases concern transfers made on behalf of other persons. Generally, a transfer is considered to have been made "on behalf of" someone if it satisfied an obligation or a liability of that person. If an employer pays an employee's income tax, that payment is income to the employee. See Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729–31, 49 S.Ct. 499, 504, 73 L.Ed. 918 (1929). If a corporation assumes a shareholder's bank note in exchange for stock, the shareholder receives a taxable constructive dividend. Schroeder v. Commissioner, 831 F.2d 856, 859 (9th Cir.1987).

In *Schroeder*, the taxpayer borrowed money from a bank to buy stock in the corporation. The corporation later redeemed part of that stock, assumed the taxpayer's bank note, and forgave a debt owed by the taxpayer to the corporation. At the time that the taxpayer borrowed the money from the bank, he owned no part of the corporation and had no authority to act on behalf of the corporation. See id. at 859–60 & n. 7. The taxpayer had the primary obligation to repay the loan, and the corporation's assumption of the loan relieved the taxpayer of that obligation. We held that the redemption of Schroeder's stock was a taxable constructive dividend. Id. at 859.

The Government argues that the Arnes stock transfer is more properly analogized to Holsey v. Commissioner, 258 F.2d 865 (3d Cir.1958), where the Third Circuit held that a shareholder who owned fifty percent of the stock in a corporation did not receive a taxable benefit when the corporation redeemed the other fifty percent of the stock. The court found that the redemption "did not discharge any obligation of [the taxpayer] and did not benefit him in any direct sense," although the result was that the shareholder gained control of the company. Id. at 868.

John Arnes had an obligation to Joann Arnes that was relieved by Moriah's payment to Joann. That obligation was based in their divorce property settlement, which called for the redemption of Joann's stock. Although John and Joann were the sole stockholders in Moriah, the obligation to purchase Joann's stock was John's, not Moriah's. Furthermore, John personally guaranteed Moriah's note to Joann. Under Washington law, Joann could sue John for payment without suing Moriah. See Wash.Rev.Code Ann. § 62A.3–416(1) (West 1979). Thus, John was liable, with Moriah, for the payments due Joann.

We hold that Joann's transfer to Moriah did relieve John of an obligation, and therefore constituted a benefit to John. Joann's transfer of stock should be treated as a constructive transfer to John, who then transferred the stock to Moriah. The $450,000 was paid to Joann by Moriah on behalf of John. The transfer of $450,000 from the corporate treasury need not escape taxation, if we hold, as we do, that Joann is not required to recognize any gain on the transfer of her stock, because it is subject to section 1041. The tax result for Joann is the same as if she had conveyed the property directly to John.

The Government argues that because Joann transferred her stock to the corporation, rather than to John, the exception in section 1041 should not apply. The corporation cancelled Joann's stock and agreed to pay Joann $450,000. As a result, no asset with a carryover basis exists. John received an additional 2,500 shares from the corporation after Joann's shares were cancelled, but he did not carry over Joann's basis, because the transfer was not made directly to him. Under this literal application of the statute, Joann's gain, from the appreciation of the stock, would not be recognized by John if he were to dispose of his stock. Although John became the sole owner of the corporation as a result of the transfer, the net worth of the corporation was depleted, because the corporation incurred the debt of $450,000 to Joann. As the Government puts it, before the stock redemption, John owned half of a corporation worth $900,000; after the redemption, he owned all of a corporation worth $450,000. John has realized no gain; the value of his stock is still in the corporation, and the redemption did not increase the value of John's stock. In contrast, Joann received cash (and debt forgiveness) for her transfer of stock.

We reject the Government's application of the statute. The regulations, particularly as explained by Question and Answer 9, in Temp. Treas. Reg. § 1.1041–1T, demonstrate that the statute is meant to apply to situations such as this one, where a transfer is made on behalf of one's former spouse.

Finally, the Government points to one other example in the Temporary Treasury Regulations interpreting section 1041. Question 2 describes a situation in which a corporation wholly owned by one spouse sells property to the other spouse. That sale is not subject to the exemption rule of section 1041. See Temp. Treas. Reg. § 1.1041–1T(a), Q–2, A–2, ex. 3 (1992). The example does not apply to the Arnes transaction because Moriah was owned one-half each by John and Joann.

The judgment of the district court is AFFIRMED.

NOTE

Tax Consequences to Nontransferor Spouse. The Ninth Circuit found that the disposition of Mrs. Arnes' stock was not a redemption but rather a sale to Mr. Arnes in a tax-free transaction under Section 1041. What then are the tax consequences to Mr. Arnes, who was not a party to the case? Assuming that Moriah was a C corporation with sufficient earnings and profits, Mr. Arnes would appear to have a $450,000 constructive dividend (taxable, under current law, at a maximum rate of 20 percent but with no recovery of basis) under the Ninth Circuit's characterization of the transaction. But appearances can be deceiving. Mr. Arnes took his controversy to the Tax Court, which held in a reviewed decision that he did not have a constructive dividend because he was not primarily and unconditionally obligated to acquire his wife's stock.[118] The court supported its decision with the following example from Revenue Ruling 69–608:[119]

> A and B owned all the outstanding stock of X corporation. An agreement between A and B provided that upon the death of either, X will redeem all the X stock owned by the decedent at the time of death. In the event that X does not redeem the shares from the estate, the agreement provided that the surviving shareholder would purchase the unredeemed shares from the decedent's estate. B died and, in accordance with the agreement, X redeemed all of the shares owned by his estate.
>
> In this case A was only secondarily liable under the agreement between A and B. Since A was not primarily obligated to purchase the X stock from the estate of B he received no constructive distribution when X redeemed the stock.

As a result, neither Mr. nor Mrs. Arnes was taxable on the transaction—the dreaded "whipsaw" result that the Service was trying to avoid.

Which result was more favorable overall for the taxpayers—the Ninth Circuit's or the Tax Court's? Remember that it is usually desirable in a marital dissolution setting for the parties to plan to reduce their overall tax liability. In a concurring opinion in *Arnes*, Tax Court Judge Beghe offered this observation:[120]

> Hewing to the bright line rules of Rev. Rul. 69–608 * * * in the marital dissolution context will reduce the tax costs of divorce for the owners of small businesses held and operated in corporate form. If the shareholder spouses can negotiate their separation agreement with the assurance that the redemption will be tax free to the remaining shareholder and a capital gain transaction to the

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118 Arnes v. Commissioner, 102 T.C. 522 (1994). See also Blatt v. Commissioner, 102 T.C. 77 (1994) (wife taxable on redemption; no Section 1041 transfer because redemption did not satisfy any legal obligation of husband and wife was not acting "on behalf of" husband at time of acquisition); Hayes v. Commissioner, 101 T.C. 593 (1993) (redemption of wife's stock was a constructive dividend to husband where husband had a primary and unconditional obligation to purchase that stock; no Section 1041 issue before the court).

119 See supra p. 259.

120 102 T.C. at 541.

terminating shareholder, the overall tax costs will ordinarily be less than if the terminating spouse qualifies for nonrecognition under Section 1041, but the remaining spouse suffers a dividend tax. This will leave a bigger pie to be divided in setting the consideration for the share to be redeemed.

Confusion in the Courts: Inconsistent Standards. The Ninth Circuit held that Mrs. Arnes was not taxable under Section 1041 because her transfer was "on behalf of" her husband within the meaning of the Section 1041 regulations. But the Tax Court held that Mr. Arnes did not have a constructive dividend because the corporation did not satisfy his "primary and unconditional" obligation to acquire his wife's stock. So neither spouse was taxed and the Service was whipsawed because different standards were applied to the transferor and nontransferor spouse to determine the tax consequences of the same transaction.

The Tax Court revisited this issue, but its multiple and conflicting opinions in Read v. Commissioner[121] only added to the confusion. The fact pattern in *Read* was fairly typical. Prior to their marital dissolution, Mr. and Mrs. Read owned virtually all the stock of Mulberry Motor Parts, Inc. ("MMP"), a C corporation. Mrs. Read ("W") agreed to sell her MMP stock to Mr. Read ("H") for cash and a promissory note bearing market rate interest unless H elected to cause MMP or its separate employee stock ownership plan to buy the stock on the same terms. H elected to have MMP redeem W's stock. Although W reported the interest paid by MMP on the promissory note as income, neither W nor H reported any taxable gain on the redemption. Fearing a whipsaw, the Service issued deficiency notices to both parties. But it ultimately aligned itself with W by arguing in the Tax Court that H had received a constructive dividend from MMP in the full amount of the principal and interest payments received by W.

The Tax Court majority viewed the central issue to be whether W's transfer of MMP stock to MMP was made "on behalf of H" so that W was entitled to nonrecognition of gain under the Section 1041 regulations.[122] W argued that the regulations squarely applied to her situation, while H, seeking to avoid a constructive dividend, relied on established case law in arguing that he should not be taxed because he never had a "primary and unconditional obligation" to purchase W's stock.

The Tax Court majority sided with W, holding for the first time that application of the venerable "primary and unconditional" standard to the nontransferor spouse was inappropriate in divorce-related redemptions. Instead, the majority based its decision on the Section 1041 regulations in holding that W's transfer of MMP stock to MMP was a transfer made "on behalf of" H. The court found that H's election to have MMP redeem W's stock caused W to be acting as H's representative in connection with the redemption. In light of these holdings, the majority sustained the deficiencies asserted against H, noting that H had "indicated" that he would be taxable if the court found that W was entitled to nonrecognition under Section 1041.

121 114 T.C. 14 (2000)

122 See Reg. § 1.1041–1T(c), Q & A–9.

Because it found H's "indication" as tantamount to a concession, the Tax Court majority offered no analysis of the proper standard to be applied to the nonredeeming spouse. As discussed earlier in this Note, however, the Tax Court previously had applied the "primary and unconditional" standard in holding that a nontransferor spouse does not invariably receive a constructive dividend in a divorce-related redemption.

Nine judges joined the majority opinion in *Read*; six of the nine wrote a concurring opinion with more extensive analysis of the unfavorable tax consequences to H. Seven judges dissented in four separate opinions. Despite differences in emphasis, the essence of the dissents was that the majority should not have discarded the "primary and unconditional" standard in the divorce setting.

Regulations to the Rescue. Reacting to the confusion in the courts, the Service amended the Section 1041 regulations to provide greater certainty in determining the tax consequences of divorce-related redemptions. Unlike the Tax Court majority in *Read*, the regulations seek to harmonize the well recognized "primary and unconditional obligation" standard for constructive dividends with the policy of Section 1041.

The threshold question posed by the regulations is whether a divorce-related redemption results in a constructive distribution to the nontransferor spouse under applicable tax law. For this purpose, "applicable tax law" means the primary and unconditional obligation standard.[123] If the redemption does result in a constructive distribution, the redeemed stock is deemed to have been transferred by the transferor spouse to the nontransferor spouse in a tax-free Section 1041 transaction (provided the requirements of Section 1041 are otherwise met), and then retransferred by the nontransferor spouse to the redeeming corporation.[124] The tax consequences of the deemed redemption are then determined under Section 302.[125] As a result, the transferor spouse has no gain or loss on the deemed transfer of stock to the nontransferor spouse, and the nontransferor spouse most likely has a constructive dividend.[126]

If the redemption does not result in a constructive distribution—e.g., because it does not satisfy a primary and unconditional obligation of the nontransferor spouse—the regulations respect the form of the transaction.[127] That means that the corporation is treated as having redeemed stock directly from the transferor spouse in a transaction in which the nontransferor spouse is not a party. As a result, Section 1041 does not apply, the transferor spouse's tax treatment is determined under Section 302 (likely a capital gain), and the nontransferor spouse is not taxed.[128]

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[123] Reg. § 1.1041–2(a), (d) Examples 1 & 3.

[124] Reg. § 1.1041–2(a)(2), –2(b)(2).

[125] Reg. § 1.1041–2(b)(2).

[126] Whether or not the constructive distribution is a dividend depends on whether the corporation has earnings and profits and whether any of the tests for exchange treatment in Section 302 are met (unlikely in the typical fact pattern).

[127] Reg. § 1.1041–2(a)(1).

[128] Reg. § 1.1041–2(b)(1).

The regulations provide a "special rule" permitting spouses to depart from "applicable tax law" and treat a divorce-related redemption as either taxable to the transferor spouse (even if it would have been a constructive dividend to the nontransferor spouse under applicable tax law) or as a constructive distribution to the nontransferor spouse and a tax-free Section 1041 transfer to the transferor spouse (even in the absence of a primary and unconditional obligation).[129] This rule is consistent with the general policy allowing the parties to a divorce to negotiate and ultimately determine the tax consequences of divorce-related transactions (e.g., spousal and child support payments, property transfers, dependency exemptions) as long as they treat the transactions consistently. To utilize the special rule, the parties must memorialize their intent in a written agreement prior to the date on which the nontransferor spouse files his or her first timely filed federal income tax return for the year that includes the date of the stock redemption but no later than the due date of the return (including extensions).[130]

If the regulations had applied to the redemption in the *Arnes* case and the parties had not elected to utilize the special rule, which spouse would have been taxed?

Planning. In light of these permissive regulations, how should the parties plan a divorce-related redemption? For example, how should a redemption be structured if the parties wish to minimize their overall joint tax liability and preserve more dollars for the family? What is the best advice to a transferor or nontransferor spouse who wishes to avoid tax on the redemption? In what circumstances would the parties wish to invoke the "special rule?" Is it still possible, either through separate or joint planning, to structure a redemption so that neither spouse is taxed? Do the regulations eliminate all legal controversies over the proper tax treatment of divorce-related redemptions?

PROBLEM

H and W, a married couple on the verge of divorce, each own 50 of the 100 outstanding shares of common stock (the only class outstanding) of Family Corp. ("F"), which has a total value of $1 million and $500,000 of accumulated earnings and profits. H and W each have a $100,000 basis in their F stock. H and W have agreed that on the effective date of their divorce, H will own all the stock of F and W will receive $500,000 for her 50 shares. Consider the tax consequences of the following proposals to meet these goals:

(a) H buys W's stock for $500,000 cash.

(b) H and W agree that F will redeem W's stock for $500,000 cash.

(c) How would you advise each of the parties to structure the transaction?

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129 Reg. § 1.1041–2(c).

130 Reg. § 1.1041–2(c)(3).

3. CHARITABLE CONTRIBUTION AND REDEMPTION

Grove v. Commissioner

United States Court of Appeals, Second Circuit, 1973.
490 F.2d 241.

■ KAUFMAN, CHIEF JUDGE:

We are called upon, once again, to wrestle with the tangled web that is the Internal Revenue Code and decipher the often intricate and ingenious strategies devised by taxpayers to minimize their tax burdens. We undertake this effort mindful that taxpayer ingenuity, although channelled into an effort to reduce or eliminate the incidence of taxation, is ground for neither legal nor moral opprobrium. As Learned Hand so eloquently stated, "any one may so arrange his affairs that his taxes shall be as low as possible: he is not bound to choose that pattern which will best pay the Treasury: there is not even a patriotic duty to increase one's taxes * * * ." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir.1934), aff'd 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

* * *

I.

A full recitation of the undisputed facts underlying this controversy will aid in placing the legal issues raised on appeal in their proper context.

Philip Grove received an engineering degree in 1924 from Rensselaer Polytechnic Institute, a private, tax-exempt educational institution. During the Depression, he founded what is now Grove Shepherd Wilson & Kruge, Inc. and at all times since has controlled a majority of its shares. The balance of the Corporation's shares, with the exception of those held by RPI, are owned by officers and employees of the Corporation or their relatives.

The Corporation's business is building airfields, highways, tunnels, canals, and other similar heavy construction projects in both the United States and foreign countries. These projects usually involve the investment of large sums of money over an extended period of time and involve a high degree of risk. Since, in this industry, contract payments normally are made only after specified levels of progress are achieved, a firm must always commit substantial amounts of its own funds, whether borrowed or internally generated, to a project. Moreover, a company can determine an acceptable contract price based only on its best estimate of the cost to complete the project. A bad "guess" or unforeseen contingency may require a firm to complete a project while incurring a loss. Not surprisingly, the mortality rate in this industry is high. To protect against such adverse developments, successful firms seek to maintain liquidity by holding ample cash or other assets easily converted to cash.

One method of conserving cash, adopted by the Corporation, is to retain all earnings and refrain from paying dividends.

As we have noted, RPI, like all universities and colleges, pursued its alumni with a wide variety of contribution plans. One plan employed "life income funds," and its terms were simple. An alumnus would make a gift of securities to RPI and retain a life interest in the income from the donated securities. Whatever dividends and interest were paid during the donor's life would belong to the donor, while any capital appreciation would inure to RPI. Upon the death of the donor, RPI would obtain full title to the securities.

In 1954, Dr. Livingston Houston, RPI's president, suggested to Grove that he make a gift under the "life income funds" plan. Grove explained that his only significant holdings were shares of his own corporation, but expressed a willingness to donate some of these shares under the plan, with certain qualifications. The Corporation, he stated, could not agree to any obligation or understanding to redeem shares held by RPI. This condition, of course, stemmed from a fear that RPI might seek redemption at a time when the Corporation was hard pressed for cash, which, as we have noted, was an asset crucial to a company in the heavy construction business. Moreover, since Grove at that time was unsure of RPI's money-management qualifications, he further conditioned his gift on a requirement that if RPI disposed of the shares, any proceeds would be invested and managed by an established professional firm.

RPI found these terms acceptable and on December 30, 1954, Grove made an initial gift of 200 shares, valued at $25,560. A letter accompanying the donation set forth the conditions we have recited. Moreover, in addition to retaining an interest in the income from the gift for his life, Grove specified that in the event he should predecease his wife Harriet, she would receive the income until her death.

On the same day, the Corporation and RPI signed a minority shareholder agreement. RPI agreed not to "sell, transfer, give, pledge or hypothecate, or in any way dispose of the whole or any part of the common stock of the Corporation now or hereafter owned * * * until [RPI] shall have first offered the Corporation the opportunity to purchase said shares upon the terms and conditions hereinafter provided." The redemption price was established at book value of the shares as noted on the Corporation's most recent certified financial statement prior to the offer. Pursuant to the contract, the Corporation was "entitled (but not obligated) to purchase all or any part of the shares of stock so offered." If the Corporation did not exercise its option to purchase within sixty days, RPI could transfer the shares to any other party and the Corporation's right of first refusal would not subsequently attach to such transferred shares.[3]

The 1954 gift was the first in a series of annual contributions to RPI by Grove. From 1954 to 1968, Grove donated to RPI between 165 and 250 shares of the Corporation each year, reaching a cumulative total of 2,652 shares, subject to terms substantially similar to those noted earlier.

Generally, RPI offered donated shares to the Corporation for redemption, between one and two years after they were donated by Grove. The transactions followed a similar pattern. On each occasion, the Finance Committee of RPI's Board of Trustees first authorized the sale of specific shares of the Corporation. RPI's treasurer or controller would then write to Sidney Houck, the Corporation's treasurer, informing him of RPI's desire to dispose of the shares. Upon receipt of this letter, Houck would call a special meeting of the Corporation's board of directors to consider whether or not to exercise the Corporation's right of first refusal. The Board would adopt a resolution authorizing redemption and Houck would so inform RPI's financial officer, enclosing a company check for the amount due. By return mail, RPI would forward the appropriate stock certificate to the Corporation for cancellation.

At the time of the first redemption, in December, 1955, RPI opened an investment account at the Albany, New York, office of Merrill Lynch, Pierce, Fenner & Beane ("Merrill Lynch"). The account was captioned "Rensselaer Polytechnic Institute (Philip H. Grove Fund) Account." In accordance with Grove's wishes concerning the management of disposition proceeds, RPI authorized Merrill Lynch to act directly upon investment recommendations made by Scudder, Stevens, & Clark, Grove's personal investment adviser. RPI deposited the proceeds of each redemption transaction into this account which, pursuant to Scudder, Stevens & Clark's instructions, were generally invested in securities of large corporations whose shares traded on organized stock exchanges. Merrill Lynch paid the income from these investments to RPI on a monthly basis. RPI, in turn, made quarterly remittances to Grove, accompanied by an analysis of all account transactions.

On his personal income tax return for 1963, Grove reported as taxable income dividends of $4,939.28 and interest of $2,535.73 paid to him by RPI from the Merrill Lynch account. For 1964, Grove reported $6,096.05 in dividends and $3,540.81 in interest. The Commissioner, however, assessed deficiencies in Grove's taxable income for these years, asserting that Grove "realized additional dividends in the amounts of $29,000 and $25,800 in 1963 and 1964, respectively, as the result of the redemption of stock by Grove Shepherd Wilson & Kruge, Inc." Accordingly, the Commissioner increased Grove's taxable income by

[3] Other minority shareholders of the Corporation signed similar agreements, which, in effect put in writing the Corporation's practice of redeeming, when financial conditions permitted, any minority-owner shares offered to it, for example, by a departing employee or a deceased employee's widow.

these amounts and demanded payment of additional taxes—in excess of $13,000 for each year. Grove refused to pay and petitioned the Tax Court for a redetermination of his tax liability. The Court, concluding that Grove had made a bona fide gift to RPI, ruled in favor of the taxpayer and the Commissioner appealed.

II.

The Commissioner's view of this case is relatively simple. In essence, we are urged to disregard the actual form of the Grove-RPI-Corporation donations and redemptions and to rewrite the actual events so that Grove's tax liability is seen in a wholly different light. Support for this position, it is argued, flows from the Supreme Court's decision in Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945), which, in language familiar to law students, cautions that "[t]he incidence of taxation depends upon the substance of a transaction * * *. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Id. at 334, 65 S.Ct. at 708. In an effort to bring the instant case within this language, the Commissioner insists that whatever the appearance of the transactions here under consideration, their "true nature" is quite different. He maintains that Grove, with the cooperation of RPI, withdrew substantial funds from the Corporation and manipulated them in a manner designed to produce income for his benefit. In the Commissioner's view, the transaction is properly characterized as a redemption by the Corporation of Grove's, not RIP's shares, followed by a cash gift to RPI by Grove. This result, it is said, more accurately reflects "economic reality."

The Commissioner's motives for insisting upon this formulation are easily understood once its tax consequences are examined. Although Grove reported taxable dividends and interest received from the Merrill Lynch account on his 1963 and 1964 tax returns, amounts paid by the Corporation to redeem the donated shares from RPI were not taxed upon distribution. If, however, the transactions are viewed in the manner suggested by the Commissioner, the redemption proceeds would be taxable as income to Grove. Moreover, because the redemptions did not in substance alter Grove's relationship to the Corporation—he continued throughout to control a majority of the outstanding shares—the entire proceeds would be taxed as a dividend payment at high, progressive ordinary-income rates, rather than as a sale of shares, at the fixed, and relatively low, capital gains rate. See, 26 U.S.C. § 302; United States v. Davis, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970).

Clearly, then, the stakes involved are high. We do not quarrel with the maxim that substance must prevail over form, but this proposition marks the beginning, not the end, of our inquiry. The court in Sheppard v. United States, 361 F.2d 972, 176 Ct.Cl. 244 (1966) perceptively remarked that "all such 'maxims' should rather be called 'minims' since they convey a minimum of information with a maximum of pretense." Id. at 977 n. 9. Each case requires detailed consideration of its unique facts. Here, our aim is to determine whether Grove's gifts of the Corporation's shares to RPI prior to redemption should be given independent significance or whether they should be regarded as meaningless intervening steps in a single, integrated transaction designed to avoid tax liability by the use of mere formalisms.

The guideposts for our analysis are well marked by earlier judicial encounters with this problem. "The law with respect to gifts of appreciated property is well established. A gift of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title thereto before the property gives rise to income by way of sale." Carrington v. Commissioner of Internal Revenue, 476 F.2d 704, 708 (5th Cir.1973), quoting Humacid Co., 42 T.C. 894, 913 (1964). As noted below by the Tax Court, the Commissioner here "does not contend that the gifts of stock by [Grove] to RPI in 1961 and 1962 were sham transactions, or that they were not completed gifts when made." If Grove made a valid, binding, and irrevocable gift of the Corporation's shares to RPI, it would be the purest fiction to treat the redemption proceeds as having actually been received by Grove. The Tax Court concluded that the gift was complete and irrevocable when made. The Commissioner conceded as much and we so find.[9]

It is argued, however, that notwithstanding the conceded validity of the gifts, other circumstances establish that Grove employed RPI merely as a convenient conduit for withdrawing funds from the Corporation for his personal use without incurring tax liability. The Commissioner would have us infer from the systematic nature of the gift-redemption cycle that Grove and RPI reached a mutually beneficial understanding: RPI would permit Grove to use its tax-exempt status to drain funds from the Corporation in return for a donation of a future interest in such funds.

We are not persuaded by this argument and the totality of the facts and circumstances lead us to a contrary conclusion. Grove testified before the Tax Court concerning the circumstances of these gifts. The court, based on the evidence and the witnesses' credibility, specifically found that "[t]here was no informal agreement between [Grove] and RPI that RPI would offer the stock in question to the corporation for redemption or that, if offered, the corporation would redeem it." Findings of fact by the Tax Court, like those of the district court, are binding upon us unless they are clearly erroneous, 26 U.S.C. § 7482(a); Rule 52, F.R.Civ.P., and "the rule * * * applies also to factual inferences [drawn] from undisputed

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9 The Commissioner might have argued that at least that portion of the redemption proceeds allocable to Grove's retained life income interest was taxable as a dividend. He chose not to do so and the Tax Court "express[ed] no opinion upon the question, if it were properly presented, whether petitioner derived taxable income upon the redemption of stock to the extent of the life estate which he retained * * * ." Since the Commissioner has bypassed this aspect, it would be inappropriate in our discussions of the gifts to attach any special significance to the retained life interest feature.

basic facts." Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278, 291, 80 S.Ct. 1190, 1200, 4 L.Ed.2d 1218 (1960). It cannot seriously be contended that the Tax Court's findings here are "clearly erroneous" and no tax liability can be predicated upon a nonexistent agreement between Grove and RPI or by a fictional one created by the Commissioner.

Grove, of course, owned a substantial majority of the Corporation's shares. His vote alone was sufficient to insure redemption of any shares offered by RPI. But such considerations, without more, are insufficient to permit the Commissioner to ride roughshod over the actual understanding found by the Tax Court to exist between the donor and the donee. Behrend v. United States (4th Cir.1972), 73–1 USTC ¶ 9123, is particularly instructive. There, two brothers donated preferred shares of a corporation jointly controlled by them to a charitable foundation over which they also exercised control. The preferred shares were subsequently redeemed from the foundation by the corporation and the Commissioner sought to tax the redemption as a corporate dividend payment to the brothers. The court, in denying liability, concluded that although "it was understood that the corporation would at intervals take up the preferred according to its financial ability * * * , this factor did not convert into a constructive dividend the proceeds of the redemption * * * [because] the gifts were absolutely perfected before the corporation redeemed the stock." Id.

Nothing in the December, 1954, minority shareholder agreement between the Corporation and RPI serves as a basis for disturbing the conclusion of the Tax Court. Although the Corporation desired a right of first refusal on minority shares—understandably so, in order to reduce the possibility of unrelated, outside ownership interests—it assumed no obligation to redeem any shares so offered. In the absence of such an obligation, the Commissioner's contention that Grove's initial donation was only the first step in a prearranged series of transactions is little more than wishful thinking grounded in a shaky foundation. * * *

We are not so naive as to believe that tax considerations played no role in Grove's planning. But foresight and planning do not transform a non-taxable event into one that is taxable. Were we to adopt the Commissioner's view, we would be required to recast two actual transactions—a gift by Grove to RPI and a redemption from RPI by the Corporation—into two completely fictional transactions—a redemption from Grove by the Corporation and a gift by Grove to RPI. Based upon the facts as found by the Tax Court, we can discover no basis for elevating the Commissioner's "form" over that employed by the taxpayer in good faith. "Useful as the step transaction doctrine may be in the interpretation of equivocal contracts and ambiguous events, it cannot generate events which never took place just so an additional tax liability might be asserted." Sheppard v. United States, supra, at 978. In the absence of any supporting facts in the record we are unable to adopt the

Commissioner's view; to do so would be to engage in a process of decision that is arbitrary, capricious and ultimately destructive of traditional notions of judicial review. We decline to embark on such a course.

Accordingly, the judgment of the Tax Court is affirmed.

■ OAKES, CIRCUIT JUDGE (dissenting):

Review of the tax consequences of a business transaction requires consideration of the economic realities of the entire transaction. See Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); South Bay Corp. v. Commissioner of Internal Revenue, 345 F.2d 698, 703, 705 (2d Cir.1965). Whether a transaction should be viewed as two or more steps or as one integrated transaction may result in entirely different tax consequences. * * *

Here, as I see it, the form of the transaction was two-step: a gift of stock followed by a redemption of the stock by the donor controlled corporation. The substance of the transaction, however, was a payment out of corporate earnings and profits to a charity designated by the donor who retained a life interest in the gift.

The factors which distinguish the RPI-Grove transactions from other charitable donations of securities and which persuade me to treat this as an integrated transaction are two: first, the gifts made by the Groves were of stock in a closed corporation that was inevitably redeemed annually; second, by virtue of retaining a life income from the reinvested proceeds and by retaining a measure of control over how those proceeds should be reinvested (by designating the investment adviser who was also the Groves' personal adviser), the Groves were able to achieve a bail-out from their non-dividend-paying closed corporation.

* * *

The majority opinion relies heavily on two cases which I believe are readily distinguishable from the situation here. One is Carrington v. Commissioner of Internal Revenue, 476 F.2d 704 (5th Cir.1973), relied on for the proposition that "[a] gift of appreciated property does not result in income to the donor so long as he gives the property away absolutely and parts with title before the property gives rise to income by way of sale." Here the Groves did not part with all interest in the construction company stock. The reservation of a life interest in the stock (or its reinvested proceeds), when coupled with taxpayer's right, however indirect, to direct the manner in which proceeds would be invested, gave the Groves a very great continuing interest and control, a fact of not inconsiderable tax significance. Cf. Corliss v. Bowers, 281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916 (1930) (Holmes, J.) ("taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed. * * * "). More importantly, Carrington involved only one contribution of stock and one redemption; there was no pattern of redemption of stock as was clearly established here at least by the time of the tax years in question.

In Behrend v. United States, CCH 1973 Stand.Fed.Tax Rep. ¶ 9123 (4th Cir.1972), also relied upon by the majority, the proceeds of the redemption were used wholly for the benefit of the charitable foundation which was the recipient of the stock; there was no life estate reserved for the personal benefit of the donors. See 1973 Stand.Fed.Tax Rep. ¶ 9123 at 80,067 ("[P]redominant force" in Behrend decision is "indisputable fact" that the taxpayers therein "did not participate whatsoever in the beneficence of the foundation").

Thus, I believe that when, as here, the nature and conditions of the charitable gift and the pattern of donor-charity behavior are such as to make it for all practical purposes inevitable that the stock given will be offered for redemption and accepted by the closely held corporation, resulting in providing the equivalent of a safe pension fund for the donor stockholders, then the transaction must be treated as a distribution of dividends under §§ 301(a), 301(c) and 316(a) of the Internal Revenue Code of 1954. The majority opinion refers to an "absence of any supporting facts in the record" for the Commissioner's position, but omits to rely upon the one most important fact on which the case should turn: the pattern of redemption over years of giving. I accordingly dissent.

NOTE

The *Grove* case illustrates an effective charitable giving technique for the shareholders of a closely held corporation with the financial capacity to repurchase its stock. After losing several similar cases, the Service stopped challenging "charitable bailouts," announcing in Revenue Ruling 78–197[131] that a charitable contribution of stock followed by a redemption would be treated as a dividend to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.[132] Although they may not be legally obligated to do so, most charities will be highly motivated to offer the shares for redemption in order to convert the stock into a more liquid and diversified investment.

One desirable aspect of the transaction in *Grove* was Mr. Grove's ability to retain a life income interest in a diversified portfolio managed by his personal investment advisor. This format is no longer available to the philanthropic shareholder unless certain additional requirements are met. In general, a donor who wishes to retain a life income interest in contributed property will not qualify for charitable income and gift tax deductions unless the gift is made to a qualified charitable remainder annuity trust or unitrust or a pooled income fund.[133]

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131 1978–1 C.B. 83.

132 See also Palmer v. Commissioner, 62 T.C. 684 (1974), affirmed on another issue, 523 F.2d 1308 (8th Cir.1975), where the gift was made to a private foundation controlled by the taxpayer. The Service, however, may continue to challenge transactions where the donated property is later reacquired by the donor, or where the charity uses the redemption proceeds to acquire other property from the donor, pursuant to an informal prearranged understanding. See Blake v. Commissioner, 697 F.2d 473 (2d Cir.1982).

133 See I.R.C. §§ 170(f)(2), (3); 664; 2522(c)(2).

PROBLEM

Philanthropist ("P") owns 25,000 shares of Family Corporation. The fair market value of P's Family stock is $2,500,000 ($100 per share); P's basis is $25,000 ($1 per share). Family has 100,000 shares of common stock (its only class) outstanding; the remaining shares are owned by P's spouse and children. Family has ample accumulated earnings and profits. The Family bylaws require all shareholders to grant the corporation a right of first refusal to buy their stock at fair market value before the shares are offered for sale to an outsider, but the corporation is not required to redeem the stock.

On the occasion of his 25th college reunion, P wishes to make a $100,000 contribution to State University ("SU"). Consider the tax consequences of the following alternative plans:

(a) Family Corporation distributes $100,000 to P in redemption of 1,000 shares of stock. P then contributes $100,000 to SU.

(b) P contributes 1,000 shares of Family stock to SU. Two months later, pursuant to an oral understanding, Family distributes $100,000 to SU in redemption of its 1,000 shares. SU was not legally obligated to surrender the shares for redemption.

(c) Same as (b), above, except that P contributes 250 shares of Family stock to SU in each of the four years following his reunion. (Assume that the value of the stock was $100 per share throughout this period.) Two months after each contribution, Family distributes $25,000 to SU in redemption of the 250 shares.

G. REDEMPTIONS THROUGH RELATED CORPORATIONS

Code: § 304(a); (b)(1), (2), (3)(A) & (B); (c).

Regulations: §§ 1.304–2(a), (c) Examples (1) & (3), –3(a).

Section 304 is an intricate statutory watchdog designed to prevent an end run around Sections 301 and 302. Despite its complexity, the basic purpose of Section 304—to prevent controlling shareholders from claiming basis recovery and capital gain treatment on transactions that result in a "bailout" of corporate earnings without a significant reduction in control—can be illustrated by a simple example. Assume that Shareholder A owns all of the common stock (the only class outstanding) of X Corporation and Y Corporation, and both corporations have ample earnings and profits. Having read the *Davis* case, A knows that a redemption of either her X or Y stock will result in a dividend and no recovery of basis. But what if A sells some of her X shares to Y or vice versa? Because this is a "sale" rather than a redemption or a distribution, A hopes to extract cash while enjoying exchange treatment, but in substance A's "sale" is indistinguishable from a dividend. Section 304 ensures this result by requiring shareholder sales involving "brother-sister" and "parent-subsidiary" corporations to satisfy one of the tests in

Section 302 in order to qualify for capital gain status and recovery of basis.

Section 304 is another area where the tax stakes are less significant as long as dividends and long-term capital gains are taxed at the same preferential rates. As with conventional redemptions and other transactions to be studied later in this text, the importance of dividend classification will depend on variables such as the basis of the stock and the type of shareholder (individual vs. corporate) involved.

Brother-Sister Acquisitions. Section 304(a)(1) applies when one or more persons who are in "control" of each of two corporations transfer stock of one corporation (the "issuing corporation") to the other (the "acquiring corporation") in exchange for cash or other property.[134] "Control" for this purpose is defined as at least 50 percent ownership of either the corporate voting power or of the total value of all classes of stock.[135] In determining control, the Section 318 attribution rules are applicable with certain modifications relating to shareholder-corporation attribution.[136] In the case of a corporation with more than one class of stock, the value prong of the "control" test is applied to the aggregate value of all classes of stock, not class-by-class.[137] Thus, a shareholder who owns 50 percent or more of the value of all the corporation's stock has "control" even if that shareholder owns less than 50 percent of a particular class.

If Section 304(a)(1) applies, Congress devised an intricate method to test the "sale" for dividend equivalence. Returning to the example, when A sells X Corporation stock to Y Corporation for cash, A is treated as having received a distribution of cash in redemption of Y stock (Y being the "acquiring corporation").[138] This hypothetical redemption is then tested under Section 302(b) to determine whether A may treat the transaction as an exchange. Dividend equivalence is determined by reference to A's stock ownership of X (the "issuing corporation"—i.e., the company whose stock is sold) before and after the transaction.[139] To the extent that Y's purchase of X stock from A for cash is characterized as a distribution to which Section 301 applies, A is treated as having transferred the X stock to Y (the acquiring corporation) in exchange for Y stock in a tax-free Section 351(a) transaction, and then Y is treated as having redeemed (from A) the Y stock that it hypothetically issued in the

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134 For this purpose, "property" does not include stock of the acquiring corporation. I.R.C. § 317(a). See Bhada v. Commissioner, 892 F.2d 39 (6th Cir.1989).

135 I.R.C. § 304(c)(1).

136 I.R.C. § 304(c)(3).

137 Rev. Rul. 89–57, 1989–1 C.B. 90.

138 I.R.C. § 304(a)(1).

139 I.R.C. § 304(b)(1). Once again, modified Section 318 corporation-to-shareholder (and vice versa) attribution rules apply in measuring the effect of this hypothetical transaction on A's interest in X. Id.

Section 351 exchange.[140] If the distribution is treated as an exchange under Section 302(a), Y is treated as purchasing the stock of X.[141]

In the example, A owned 100 percent of the X stock before the sale to Y. After the sale, A continued to own 100 percent of the stock directly and constructively by virtue of her ownership of Y. Because the sale does not reduce A's interest in X (the "issuing corporation"), it fails to satisfy any of the Section 302(b) tests for exchange treatment and thus is treated as a Section 301 distribution from Y to A. Section 304(b)(2) requires the distribution to be treated as a dividend received by A from Y (the "acquiring corporation") to the extent of Y's earnings and profits and then from X to the extent of its earnings and profits. Thus, the earnings and profits of both corporations are available to characterize the distribution to A as a dividend.[142]

Parent-Subsidiary Acquisitions. Section 304(a)(2) applies similar principles when a controlled subsidiary acquires stock of its parent from a shareholder of the parent in return for property. The parent-subsidiary relationship is defined by the same 50 percent "control" test described above.[143] The "property" used to make the acquisition is treated as a distribution in redemption of the parent's stock for purposes of testing dividend equivalency under Section 302.[144] If the redemption fails to qualify as an exchange and thus is treated as a Section 301 distribution, the amount and source of any dividend is first determined by reference to the earnings and profits of the acquiring (subsidiary) corporation and then, if necessary, by the earnings and profits of the issuing (parent) corporation.[145] If the constructive redemption is treated as an exchange, the selling shareholders recognize gain or loss under normal tax principles.

If a transaction is both a brother-sister and a parent-subsidiary acquisition, the parent-subsidiary rules take precedence.[146] But because the attribution rules transform most actual brother and sister corporations into a constructive parent and subsidiary, the regulations provide that an actual brother-sister relationship takes precedence over a constructive parent-subsidiary affiliation, causing Section 304(a)(1) to govern acquisitions by related nonsubsidiary corporations.[147]

Collateral Tax Consequences. In the basic Section 304(a)(1) brother-sister acquisition example above, where the amount paid by Y for A's X stock is treated as a Section 301 distribution, A is deemed to have

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140 I.R.C. § 304(a)(1).

141 See S. Rep. No. 99–313, supra note 103, 1048. These deemed transactions are relevant in determining the basis consequences to the parties.

142 I.R.C. § 304(b)(2).

143 I.R.C. § 304(c)(1).

144 I.R.C. § 304(b)(1).

145 I.R.C. § 304(b)(2).

146 I.R.C. § 304(a)(1).

147 Reg. § 1.304–2(c) Example (1).

transferred the X stock to Y in exchange for Y stock in a hypothetical Section 351(a) exchange, and Y is treated as having redeemed the Y stock it hypothetically issued in that exchange. Y thus takes a transferred basis from A in the X stock under Section 362, and A's basis in the Y stock received in the hypothetical Section 351 exchange is equal to A's basis in the X stock that A actually transferred to X.[148] To the extent the distribution is a dividend, the reduction in earnings and profits logically should follow the ordering rules in Section 304(b)(2)—i.e., first reduce the acquiring corporation's earnings and profits insofar as they are the source of the dividend and then, if necessary, reduce the issuing corporation's earnings and profits.

If Section 304(a)(1) applies and A's sale of X Corporation stock to Y Corporation is treated as an exchange under Section 302(a), Y is treated as having acquired the X stock by purchase and it thus takes a cost basis under Section 1012, and A's original basis in his Y stock remains unchanged. The theory, based on various fictional transactions (i.e., A is deemed to receive Y stock in exchange for X stock and then Y is deemed to redeem that Y stock from A for cash or other property) is that A "sold" Y stock (to Y) with a basis equal to the basis of the X stock actually transferred by A to Y. As in any actual sale or exchange, the basis of the (hypothetical) Y stock "sold" by A is fully recovered in determining gain or loss on the sale, and thus A's basis in her remaining Y stock should be the same as it was before the transaction.[149]

In the brother-sister scenario where the redemption is treated as an exchange, any reduction of earnings and profits is limited by Section 312(n)(7) to an amount not in excess of the redeemed stock's ratable share of earnings and profits.[150] The more difficult question is *which* corporation's earnings and profits? The Code and regulations are silent on this technical teaser. Possibilities include the acquiring corporation's (the transaction is treated as a constructive redemption of acquiring corporation stock and the distributed "property" comes from that entity), the issuing corporation's (the redemption is tested by reference to its stock), neither (the transaction is simply a purchase, not a reduction of either corporation's wealth), or both (pro rata?).[151] One defensible answer is that the required reduction should be made first to the acquiring corporation's earnings and profits and, if necessary, then to the issuing corporation's earnings and profits.

In a parent-subsidiary acquisition, if the constructive redemption of the parent's stock is treated as a dividend, the selling shareholder's basis in the parent stock transferred to the subsidiary is added to the basis in

148 I.R.C. § 304(a)(1). Reg. § 1.304–2(c) Example (1) reaches this result using a different approach based on the statute before it was amended in 1997.

149 Reg. § 1.304–2(c) Example 3 reaches this result using the approach that preceded statutory amendments to Section 304 in 1997.

150 See Section E2 of this chapter, supra.

151 See Bittker & Eustice, supra note 2, ¶ 9.24[3].

the shareholder's remaining parent stock.[152] The subsidiary takes a cost basis in the parent stock that it acquires.[153] Tracking Section 304(b)(2), it is logical to first reduce the acquiring subsidiary's earnings and profits to the extent they are the source of the dividend and then move on, if necessary, to reduce the parent's earnings and profits. If the redemption is treated as an exchange, the selling shareholder recovers his basis in the transferred parent stock and recognizes capital gain or loss under normal tax principles. The subsidiary takes a cost basis in the acquired parent stock. If the constructive redemption is treated as an exchange, Section 312(n)(7) again should apply, but it is unclear which corporation's earnings and profits are reduced, leaving taxpayers to apply any reasonable approach.

Coordination with Section 351. Enactment of an intricate statute such as Section 304 inevitably whets the appetite of tax lawyers. Consider the sole shareholder of a profitable company with a desire for cash and a distaste for dividends at a time when dividends were taxed at much higher rates than capital gains. Assume that the shareholder borrows against his stock for valid business reasons and then contributes the stock to a newly formed holding company in exchange for the holding company's stock plus its assumption of the shareholder's liability. Or assume that the shareholder transferred all the stock of the operating company to a wholly owned holding company in exchange for additional stock of the holding company plus cash. Are the tax consequences of these transactions determined under Section 351? Or should they be governed by Section 304? Initially, the courts disagreed on which provision should control in these overlap situations.[154]

In an effort to strengthen the anti-bailout objectives of Subchapter C, Congress settled the overlap issue by providing that Section 304 generally will take precedence.[155] The Joint Committee on Taxation explained the amendment as follows:[156]

> The Act extends the anti-bailout rules of sections 304 * * * to the use of corporations, including holding companies, formed or availed of to avoid such rules. Such rules are made applicable to a transaction that otherwise qualifies as a tax-free incorporation under section 351.

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[152] Reg. § 1.304–3(a).

[153] Cf. Rev. Rul. 80–189, 1980–2 C.B. 106; Broadview Lumber Co. v. United States, 561 F.2d 698 (7th Cir.1977).

[154] Compare Gunther v. Commissioner, 92 T.C. 39 (1989), affirmed, 909 F.2d 291 (7th Cir.1990); Commissioner v. Haserot, 355 F.2d 200 (6th Cir.1965) and Haserot v. Commissioner, 46 T.C. 864 (1966), affirmed sub nom. Commissioner v. Stickney, 399 F.2d 828 (6th Cir.1968) with Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir.1973), cert. denied, 414 U.S. 1045, 94 S.Ct. 551 (1973).

[155] I.R.C. § 304(b)(3).

[156] Staff of Joint Committee on Taxation, General Explanation of Tax Equity and Fiscal Responsibility Act of 1982, supra note 56, 142–43.

> Section 351 generally will not apply to transactions described in section 304. Thus, section 351, if otherwise applicable, will generally apply only to the extent such transaction consists of an exchange of stock for stock in the acquiring corporation. However, section 304 will not apply to debt incurred to acquire the stock of an operating company and assumed by a controlled corporation acquiring the stock since assumption of such debt is an alternative to a debt-financed direct acquisition by the acquiring company. This exception for acquisition indebtedness applies to an extension, renewal, or refinancing of such indebtedness. The provisions of section 357 (other than sec. 357(b)) and Section 358 apply to such acquisition indebtedness provided they would be applicable to such transaction without regard to section 304. In applying these rules, indebtedness includes debt to which the stock is subject as well as debt assumed by the acquiring company.

* * *

This rule, like several other anti-bailout measures in Subchapter C, is much less significant as long as dividends and long-term capital gains are taxed at the same low rate.

Niedermeyer v. Commissioner

United States Tax Court, 1974.
62 T.C. 280, affirmed per curiam 535 F.2d 500 (9th Cir.1976),
cert. denied 429 U.S. 1000, 97 S.Ct. 528 (1976).

■ STERRETT, JUDGE: * * *

[In 1966, the taxpayers, Bernard and Tessie Niedermeyer, owned 22.58% of the common stock of American Timber & Trading Co., Inc. ("AT & T"). They also owned 125 of the 2,136 outstanding shares of AT & T preferred stock. Two of the taxpayers' sons, Bernard, Jr. and Walter, owned 67.91% of the common stock of AT & T.

Lents Industries ("Lents") was another corporation controlled by the Niedermeyer family. In 1966, the taxpayers and their sons, Bernard, Jr. and Walter, did not own any stock of Lents, but three other sons (Ed, Linus and Thomas) each owned 22⅓% of the Lents common stock.

On September 8, 1966, the taxpayers sold their AT & T stock to Lents for $174,975.12, but they retained all their preferred stock until December 28, 1966, when they contributed the preferred to a family foundation. After this contribution, the taxpayers ceased to have any interest in AT & T. Since the time of their sale of AT & T common stock, neither of the taxpayers was an officer, director or employee of the company.

The Niedermeyer family had long been active in the business of manufacturing special wood products in Oregon. During 1963, a family dispute arose between Bernard, Jr. and his brothers, Ed, Linus and Thomas. The brothers had been partners in Niedermeyer-Martin Co., another wood product enterprise, but the dispute caused the partnership to incorporate. During the mid-1960's, Bernard, Jr., as controlling shareholder of AT & T, refused to allow AT & T to do any business with Niedermeyer-Martin Co., which became a competitor. The acquisition by Lents of the taxpayers' common stock in AT & T was part of an effort by Ed, Linus and Thomas Niedermeyer to gain control of AT & T.

On their joint federal income tax return for 1966, the taxpayers reported a long-term capital gain of $168,321.58 on the sale of their AT & T common stock to Lents. The Commissioner determined that the entire proceeds of the sale were taxable as ordinary income because the transaction was covered by Section 304(a) and was essentially equivalent to a dividend. Ed.]

OPINION

The ultimate question to be decided in this case is whether petitioners realized a capital gain or received a dividend on the sale of their AT & T common stock to Lents in 1966. The resolution of this question depends on whether the sale in question was a redemption through the use of a related corporation under the provisions of section 304(a)(1) and, if so, whether the distribution by Lents to petitioners is to be treated as in exchange for the redeemed stock under the provisions of section 302(a) or as of property to which section 301 applies.

Section 304(a)(1) provides, in pertinent part, that, if one or more persons are in "control" of each of two corporations and if one of those corporations acquires stock in the other corporation from the person or persons in control, then the transaction shall be treated as a distribution in redemption for purposes of section 302. Section 304(c)(1) defines the term "control" as "the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock." Section 304(c)[(3)] then states that the constructive ownership of stock rules contained in section 318(a) shall apply for the purpose of determining "control," except that the 50-percent limitations of sections 318(a)(2)(C) and 318(a)(3)(C) shall be disregarded for such purpose.

It is clear that by its terms section 304(a)(1) applies to the factual situation of this case. Prior to the transaction here in question, petitioners, husband and wife, together actually owned 1,083.117 shares out of the 4,803.083 outstanding shares of AT & T common stock, its only class of stock entitled to vote. Two of petitioners' sons owned 3,263.072 shares. Thus a total of 4,346.189 shares, or 90.49 percent, of the outstanding voting stock of AT & T was actually or constructively owned by petitioners. Three of petitioners' other sons owned 48 out of 72 shares, or 67 percent, of the outstanding stock of Lents, the ownership of such stock being constructively attributable to petitioners. Consequently, under section 304(c)(1), either petitioner, or both, are regarded as the person or persons in control of both AT & T and Lents prior to the transaction in question. Accordingly, under section 304(a)(1) the transaction in which Lents acquired petitioners' AT & T common stock must be treated as a redemption. The fact that neither petitioner actually owned stock in the acquiring corporation is of no concern here. * * *

Petitioners object to the applicability of section 304 on the ground that the attribution rules of section 318(a) should not be applied in this case. They base this position upon what they term the "bad blood" exception to the attribution rules as applied in Estate of Arthur H. Squier, 35 T.C. 950 (1961). In *Squier,* a case under section 302 involving the question of whether a distribution was essentially equivalent to a dividend, this Court decided that, based in part on a "sharp cleavage" between the executor of the taxpayer estate and members of the Squier family, and notwithstanding the attribution rules, the redemption in fact resulted in a crucial reduction of the estate's control over the corporation. The Court held that the distribution there was not essentially equivalent to a dividend and implicit in this conclusion was the belief that the attribution rules were not conclusive in all events in determining whether there had been a significant change of control which would allow the conclusion that the distribution was not essentially equivalent to a dividend. We note that in Robin Haft Trust, 61 T.C. 398 (1973), this Court decided that, in light of United States v. Davis, 397 U.S. 301 (1970), the rationale of *Squier* was no longer applicable to section 302(b)(1).

Besides here, as was not the case with *Squier,* no evidence was adduced to show that there were any disputes or cleavage between petitioners and any of their sons. The falling out was apparently between petitioners' sons. Apparently, petitioners would have us infer from the disagreements between Bernard E. Niedermeyer, Jr., majority shareholder of AT & T, and three other of their sons, who together were majority shareholders of Lents, that petitioners did not in fact control either corporation. We are unwilling to make this assumption and consequently petitioners' argument fails on its facts.

Moreover, we are of the opinion that the "control" test of sections 304(a)(1) and 304(c) requires that the attribution rules be applied in every case. Congress expressly indicated that the attribution rules of section 318 are to be applied in determining "control" for section 304 purposes. Section 304(c)(2) states that "Section 318(a) (relating to the constructive ownership of stock) *shall* apply for purposes of determining control under paragraph (1)." (Emphasis supplied.) Under section 304(c)(1) "control" is defined only as the ownership (either actually or constructively) of certain amounts of stock. Through the use of precise rules of attribution Congress intended to remove the uncertainties existing under prior law, which had no specific statutory guidance for constructive ownership of stock in the area of corporate distributions and adjustments, in the administration of the provisions where attribution was deemed appropriate. H.Rept. No. 1337, to accompany H.R. 8300

(Pub.L. No. 591), 83d Cong., 2d Sess., p. A96 (1954). See also *Coyle v. United States,* supra at 490. We think the attribution rules require, through their employment in section 304, that petitioners be treated as in actual control of both AT & T and Lents, notwithstanding any "bad blood" between petitioners' sons.

Petitioners assert that even though the sale is to be treated as a distribution in redemption of Lents' stock under section 304(a)(1), they are entitled to treat the distribution as in full payment in exchange for their stock under section 302(a) by meeting one of the tests contained in section 302(b). The determination under section 302(b) is to be made by reference to the issuing corporation's stock, here the AT & T stock, except that the 50-percent limitations of sections 318(a)(2)(C) and 318(a)(3)(C) are to be disregarded in applying the attribution rules of section 318(a). Sec. 304(b)(1).

Section 302(b) sets forth certain conditions under which a redemption of stock shall be treated as an exchange. If none of those conditions are met, section 302(d) provides that the distribution will then be treated as one to which section 301 applies. Petitioners do not contend that section 302(b)(2) or 302(b)(4) is applicable but they argue that the transaction in question meets the test of either section 302(b)(1) or 302(b)(3).

The test of section 302(b)(1) requires that the redemption be "not essentially equivalent to a dividend." To meet the test of nondividend equivalency the redemption must, after application of the attribution rules of section 318(a) to the stock ownership interests as they existed both before and after the redemption, result in "a meaningful reduction of the shareholder's proportionate interest in the corporation." *United States v. Davis,* supra at 313. In resolution of the question of dividend equivalency, the fact that the transaction in issue may have had a bona fide business purpose is no longer relevant. *United States v. Davis,* supra at 312. Furthermore, the applicability of the attribution rules in section 302(b)(1) is not affected by any "bad blood" between petitioners' sons. *Robin Haft Trust,* supra at 402–403.

As stated above, prior to the redemption petitioners owned, either actually or constructively, 90.49 percent of the outstanding common stock of AT & T. After the redemption, petitioners actually owned no AT & T common stock, although they did own 125 shares out of 2,136 outstanding shares of that corporation's preferred stock. However, petitioners constructively owned 82.96 percent of the outstanding common stock of AT & T comprised as follows: 3,055.221 shares actually owned by their son Bernard E. Niedermeyer, Jr., 207.851 shares actually owned by their son Walter E. Niedermeyer, and 67 percent of the 1,083.117 shares, or 725.688 shares, actually owned by Lents and constructively owned by their sons E. C., L. J., and T.J. Niedermeyer. Sec. 318(a)(5)(A). We do not think a reduction in ownership of the AT & T common stock from 90.49 percent to 82.96 percent constitutes a meaningful reduction of petitioners' proportionate interest in AT & T in the instant case. See Friend v. United States, 345 F.2d 761, 764 (C.A.1, 1965); Stanley F. Grabowski Trust, 58 T.C. 650, 659 (1972); *Fehrs Finance Co.,* supra at 185–186. With such a small change in a high percentage interest, petitioners' control and ownership of AT & T is essentially unaltered and cannot be considered to have undergone a meaningful reduction. An 82.96-percent interest clearly is sufficient to dominate and control the policies of the corporation.

Petitioners next assert, under several theories, that they terminated their interest in AT & T as contemplated in section 302(b)(3). The test provided therein allows the redemption to be treated as an exchange "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." Unless the conditions of section 302(c)(2) are satisfied to exempt petitioners from application of the family attribution rules of section 318(a)(1), these rules apply in their entirety in determining whether there has been a redemption of petitioners' complete stock interest in AT & T.

Petitioners sold all their AT & T common stock to Lents on September 8, 1966, and contributed all their AT & T preferred stock to the Niedermeyer Foundation on December 28, 1966. On September 24, 1968, petitioners filed an amended return for the calendar year 1966 to which was attached the agreement called for in section 302(c)(2)(A)(iii).

It is clear that, if they are to meet the requirements of the test of section 302(b)(3), petitioners must show that they completely terminated their stock interest in AT & T and in so doing they must be able to effect a waiver of the family attribution rules of section 318(a)(1) through use of section 302(c)(2).

While section 1.302–4(b), Income Tax Regs., states that the agreement specified in section 302(c)(2)(A)(iii) must be attached to a return timely filed for the year in which the distribution occurs, several cases have held that some delay in filing the agreement does not vitiate it, and we find those cases to be applicable here where petitioners filed the agreement upon discovering their inadvertent failure to do so earlier. United States v. G.W. Van Keppel, 321 F.2d 717 (C.A.10, 1963); Georgie S. Cary, 41 T.C. 214 (1963).

However, the fact that a proper agreement was filed alone does not effect a waiver of the family attribution rules unless the other requirements of section 302(c)(2) are satisfied. The only other requirement in question here is that petitioners must have had no interest in AT & T, other than an interest as a creditor, immediately after the distribution referred to in section 302(b)(3). In the instant case, however, petitioners retained their 125 shares of AT & T preferred stock, at least until December 28, 1966, after the redemption of all their AT & T common stock on September 8, 1966.

Petitioners contend that ownership of these 125 shares of AT & T preferred stock until December 28, 1966, does not prevent application of the exemption provided in section 302(c)(2) and consequently qualification under section 302(b)(3) as having completely terminated their stock interest in AT & T. Petitioners make the following arguments to show that the AT & T preferred stock retained until December 28, 1966, was not the retention of an interest other than that of a creditor and implicitly was not the retention of a stock interest in AT & T: (1) The preferred stock was actually debt; (2) a de minimis rule should be applied; (3) the relinquishment of their preferred stock interest in AT & T on December 28, 1966, was "immediately after" the sale of their AT & T common stock on September 8, 1966; and (4) at the time of the sale of their AT & T common stock they intended to donate their AT & T preferred stock to charity before the year's end.

While citing no cases in their support, petitioners first argue here that the characteristics of the AT & T preferred stock are those commonly associated with debt instruments. We do not agree. A number of factors have been considered in resolution of this question of fact, see O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123, 125–126 (C.A.9, 1960), affirming a Memorandum Opinion of this Court; Wilbur Security Co., 31 T.C. 938, 948 (1959), affd. 279 F.2d 657 (C.A.9, 1960); however, we see no useful purpose in reciting all the factors but will confine discussion herein only to those we think relevant.

While it is true that the preferred stockholders had no right to participate in the management of the corporation, such fact is not so uncharacteristic of preferred stock rights as to be conclusive, standing alone, of the question at hand. John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946). We think that the following facts are indicative of the equity flavor of the preferred stock: There was no unconditional obligation to pay a principal sum certain on or before a fixed maturity date; the timing of preferred "dividends" was discretionary with the corporate directors; upon liquidation the preferred stockholders would be paid "from the money and/or property available for distribution to shareholders," which indicates to us that the preferred stock was subordinated in priority to the general creditors; AT & T's articles of amendment to the articles of incorporation used the terms "dividends," "preferred stock," and "shareholders" with reference to the instruments in question; and the preferred stock was created during a reorganization by a transfer of earned surplus to AT & T's capital account.

We think petitioners' second argument attempting to interject a de minimis rule allowing the retention of some small stock interest while qualifying under section 302(b)(3) is wholly without merit. Section 302(b)(3) clearly requires no less than a complete termination of all petitioners' stock interest in the corporation.

Petitioners next assert that they had no interest in AT & T "immediately after the distribution," as the phrase is used in section

302(c)(2)(A)(i), because the December 28, 1966, contribution should be considered to have occurred immediately after the September 8, 1966, redemption. We assume petitioners believe that if they satisfy this requirement of having no interest "immediately after" the redemption, they will also satisfy the requirement in section 302(b)(3) of having completely terminated their stock interest in AT & T. While we express no opinion on petitioners' apparent belief, we think the words "immediately after" must be given their ordinary meaning and that consequently December 28 cannot be considered "immediately after" September 8. Cf. Commissioner v. Brown, 380 U.S. 563, 570–571 (1965).

Petitioners' final argument to satisfy the requirements of sections 302(b)(3) and 302(c)(2)(A)(i) is that, at the time of the transfer of their AT & T common stock to Lents, they intended to donate their remaining AT & T preferred stock to charity by the end of 1966. Petitioners did in fact contribute their 125 shares of AT & T preferred stock to the Niedermeyer Foundation on December 28, 1966.

While petitioners' contention in this regard is not entirely clear, their argument appears to be that the September 8, 1966, transfer was but one step in a plan to terminate completely their interest in AT & T, the final step in such plan being their December 28, 1966, contribution of their remaining preferred stock. The only case cited by petitioners, Arthur D. McDonald, 52 T.C. 82 (1969), involved the question of whether a plan, calling for the redemption of that taxpayer's E & M preferred stock which was followed by a reorganization in which the taxpayer exchanged his E & M common stock for Borden stock, resulted in a distribution with respect to the preferred stock, which was essentially equivalent to a dividend under section 302(b)(1). The Court concluded that, after completion of the plan, the taxpayer's direct interest in E & M was terminated and consequently the redemption was not essentially equivalent to a dividend. Petitioners have not urged, and we consider it wise since the attribution rules would frustrate them, that their intention to donate the AT & T preferred stock by year's end shows that the redemption comes within the provisions of section 302(b)(1). Rather, they apparently contend that their intentions to donate the AT & T preferred stock constituted a plan to terminate their interest in AT & T which, with use of section 302(c)(2)(A), satisfies the requirements of section 302(b)(3).

Where redemptions were executed pursuant to a plan to terminate one's interest in a corporation, it has been held that dividend equivalency may be avoided where the individual redemptions are component parts of a single sale or exchange of an entire stock interest. In Re Lukens' Estate, 246 F.2d 403 (C.A.3, 1957), reversing 26 T.C. 900 (1956); Jackson Howell, 26 T.C. 846 (1956), affd. 247 F.2d 156 (C.A.9, 1957); Carter Tiffany, 16 T.C. 1443 (1951).[4] Where there is a plan which is comprised

[4] The cited cases were decided under the "essentially equivalent to the distribution of a taxable dividend" standard of sec. 115(g)(1), I.R.C. 1939. Sec. 29.115–9, Regs. 111, provided that

of several steps, one involving the redemption of stock that results in a complete termination of the taxpayer's interest in a corporation, section 302(b)(3) may apply. Otis P. Leleux, 54 T.C. 408 (1970); Estate of Oscar L. Mathis, 47 T.C. 248 (1966). However, the redemption must occur as part of a plan which is firm and fixed and in which the steps are clearly integrated. *Otis P. Leleux,* supra at 418.

We regard the evidence presented on petitioners' behalf as too insubstantial to prove the existence of such a plan. Petitioner Bernard E. Niedermeyer's self-serving statement during the trial that at the time of transfer of the AT & T common stock on September 28, 1966, he intended to donate the AT & T preferred stock to charity by year's end, and petitioners' prior history of contributions do not establish to us a firm and fixed plan in which all the steps are clearly integrated.

The plan certainly was not in writing and there was no evidence of communication of petitioners' asserted donative intention to the charity or to anyone. One of petitioners' sons testified that Lents acquired petitioners' AT & T common stock in an attempt to gain control of AT & T. However, no mention at all was made by this son of any desire on petitioners' part to terminate their total interest in AT & T. Petitioners could easily have changed their minds with regard to any intent to donate the preferred stock. Clearly petitioners' decision to donate the preferred stock has not been shown to be in any way fixed or binding. * * * We note that *Arthur D. McDonald,* supra, cited by petitioners, involved a written plan which was fixed as to its terms and apparently binding. By the above discussion we do not mean to indicate that all such plans need to be in writing, absolutely binding, or communicated to others, but we do think that the above-mentioned factors, all of which are lacking here, tend to show a plan which is fixed and firm.

Since petitioners have not established that the redemption is to be treated as an exchange under section 302(a), the proceeds are to be treated as a distribution of property to which section 301 applies and as a dividend as determined by the respondent.

Decision will be entered for the respondent.

PROBLEMS

1. The *Niedermeyer* case is a good example of a tax planning blunder. It illustrates the need for sensitivity to provisions such as § 304. In reading the case, make sure you can answer the following questions:

   (a) Why did § 304 apply to the sale by the taxpayers of their AT & T common stock to Lents?

"a cancellation or redemption by a corporation of all of 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." Under present law, sec. 302(b)(1) would now appear applicable if completion of the plan results in a meaningful reduction in the taxpayer's proportionate interest in the corporation.

(b) Given that § 304 applies, how do you test the "redemption" to determine if the taxpayers have a dividend?

(c) Why were the taxpayers unable to waive family attribution and qualify for "sale" treatment under § 302(b)(3)?

(d) How could they have avoided this unfortunate result?

2. Bail Corporation and Out Corporation each have 100 shares of common stock outstanding. Claude owns 80 shares of Bail stock (with a basis of $40,000, or $500 per share) and 60 shares of Out stock (with a basis of $9,000, or $150 per share.) The remaining Bail and Out shares are owned by one individual who is not related to Claude. Bail has no current or accumulated earnings and profits. Out has no current and $5,000 of accumulated earnings and profits. Determine the tax consequences to the various parties in each of the following alternative transactions:

(a) Claude sells 20 of his Out shares, in which he has a $3,000 adjusted basis, to Bail for $4,000.

(b) Claude sells all of his Out shares to Bail for $12,000.

(c) Same as (a), above, except that Claude receives $3,000 and one share of Bail stock (fair market value—$1,000) for his 20 Out shares.

(d) Same as (a), above, except that Claude receives one share of Bail stock (fair market value—$1,000) and Bail takes the 20 Out shares subject to a $3,000 liability that Claude incurred to buy the 20 shares of Out stock.

3. Is Section 304 still necessary?

H. REDEMPTIONS TO PAY DEATH TAXES

Code: § 303(a), (b)(1)–(3), (c). Skim § 6166.

When a shareholder of a closely held corporation dies, it sometimes is necessary to liquidate all or part of the decedent's stock to raise cash to pay death taxes and other expenses. If the shares are not readily marketable and the family as a whole does not want to lose control, a redemption may be an important component of the decedent's estate plan. Because the basis of the stock normally will have been stepped-up to its fair market value at the decedent's death,[157] a redemption qualifying for exchange treatment can be accomplished virtually tax-free—a once-in-a-lifetime opportunity for a painless withdrawal of corporate earnings.

Section 303, one of several income and estate tax provisions offering relief for owners of closely held businesses,[158] makes it possible to avoid dividend treatment and achieve full recovery of basis on a redemption

[157] I.R.C. § 1014(a).

[158] E.g., I.R.C. §§ 302(c)(2) (waiver of family attribution when testing redemptions), 2032A (estate tax valuation of certain real property), 6166 (extension of time to pay estate tax). Section 303 contains no "closely held" business requirement, but the vast majority of Section 303 redemptions involve close corporations.

even if the transaction does not come within one of the Section 302(b) tests. If several detailed requirements are met, distributions in redemption are treated as a sale or exchange rather than a dividend up to the sum of federal and state death taxes and allowable funeral and administrative expenses.[159] Curiously, however, the estate is not required to use (or even need) the redemption proceeds to pay taxes and expenses.

To qualify under Section 303, the value of the redeemed stock must be included in determining the decedent's gross estate for federal estate tax purposes.[160] The other principal requirements relate to the relationship of the decedent's holdings in the corporation to his total gross estate and the timing of the distribution.

Relationship of Stock to Decedent's Estate. Congress concluded that income tax relief was justified only when a decedent's holdings in the corporation represented a substantial portion of his gross estate. Section 303(b)(2) requires that the value of all the stock of the distributing corporation included in the decedent's gross estate must exceed 35 percent of the total gross estate less certain expenses deductible for federal estate tax purposes. A special rule permits the stock of two or more corporations to be aggregated for purposes of this 35 percent test if 20 percent or more in value of each such corporation's total outstanding stock is included in the gross estate. For purposes of the 20 percent requirement, stock held by the decedent's surviving spouse as community property, or held with the decedent prior to death in joint tenancy, tenancy-by-the-entirety, or tenancy-in-common, is treated as if it were included in determining the value of the decedent's gross estate.[161] If a decedent's holdings are close to the 35 percent mark, it may be desirable to engage in various lifetime and post-mortem maneuvers to ensure that Section 303 will be available.

Timing of the Redemption. Section 303 applies only to amounts distributed within a reasonable time after the decedent's death. The redemption must occur within 90 days after the expiration of the three year assessment period for federal estate taxes.[162] If the estate becomes embroiled in a controversy with the Service and files a petition for redetermination of estate tax with the Tax Court, the period is extended to 60 days after the Tax Court's decision becomes final.[163] A further extension is provided if the estate is eligible and elects to pay estate taxes in installments over the extended period (up to 15 years) provided by Section 6166.[164] But if the redemption occurs more than four years after death, the amount that can qualify for Section 303 treatment is limited

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159 I.R.C. § 303(a).

160 Id.

161 I.R.C. § 303(b)(2)(B).

162 I.R.C. § 303(b)(1)(A). See I.R.C. § 6501(a).

163 I.R.C. § 303(b)(1)(B).

164 I.R.C. § 303(b)(1)(C).

to the lesser of unpaid death taxes and administrative expenses immediately before the distribution or death taxes and expenses actually paid during the one year period beginning on the date of distribution.[165]

Eligible Shareholders. Although Section 303 is most commonly used by the decedent's estate, other shareholder-beneficiaries sometimes are eligible for its benefits if their interest "is reduced directly (or through a binding obligation to contribute) by any payment" of death taxes or administrative expenses.[166] In the normal case where the decedent's will provides that taxes and expenses are payable out of the residuary estate, specific legatees of stock (including a spouse receiving a bequest eligible for the unlimited marital deduction) are not eligible to use Section 303.

Distributions of Appreciated Property. The most likely asset for a Section 303 redemption is cash, but a corporation that distributes appreciated property to redeem its shares must recognize gain under the now familiar rule in Section 311(b).

PROBLEM

George died last year and his gross estate is $14,000,000. George's estate expects to incur a total of $600,000 of death taxes and allowable deductions for expenses and losses under §§ 2053 and 2054. George's gross estate includes stock in X Corporation (fair market value—$1,200,000) and Y Corporation (fair market value—$2,400,000). The fair market value of all of the outstanding X and Y stock is $8,400,000 and $9,600,000, respectively. George's wife, Adele, also owns $1.200,000 of X stock. (She and George held a total of $2,400,000 of X stock as tenants-in-common during his life.)

If Y Corporation redeems shares from George's estate, will the redemption qualify for exchange treatment under § 303?

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165 I.R.C. § 303(b)(4).

166 I.R.C. § 303(b)(3).