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Stock Redemptions From Close Family Corporations Under Section 302

Since the enactment of the 1954 Internal Revenue Code, persons wishing to redeem stock in close family corporations have found that the attribution rules create a new obstacle to attaining capital gains treatment for the proceeds from their redemptions. Because the limits on the applicability of the attribution rules to section 302 in general and its dividend equivalence test in particular have not thus far been adequately defined, many redemptions from close corporations are executed without definite understanding of their tax consequences. The author of this Note explores the present problem and suggests an approach that would aid redeeming stockholders in anticipating the tax consequences of their redemptions.

INTRODUCTION

The stock redemption provisions of the 1954 Code are of special significance to owners of stock in closely held family corporations, for when such stockholders wish to sell their stock, often the only available or the only interested purchaser with liquid purchasing power is the corporation itself.¹ A sale of such stock to the issuing corporation constitutes a redemption,² which may be denied capital gains treatment and be taxed as a dividend.³ This

¹ The charter or by-laws of most close family corporations place restrictions upon the transfer of their stock. These restrictions often give the corporation (1) a pre-emptive right to purchase the stock of a shareholder should he decide to sell, (2) an option to purchase upon the happening of a particular event, or (3) an option to "call" at the discretion of the corporation or its board of directors. In addition, these buy-out arrangements often provide for the transfer of a deceased shareholder's stock to the corporation at a fixed or ascertainable price. 2 O'NEAL, CLOSE CORPORATIONS § 7.05 (1958). Similar restrictions may also be imposed by agreements among the shareholders or between the corporation and its shareholders. See 12 FLETCHER, PRIVATE CORPORATIONS § 5453 (perm. ed. rev. repel. 1957).

² A redemption is the retirement of stock or bonds by the issuer through a repurchase. Stock is "treated as redeemed by a corporation if the corporation acquires the stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, or held as treasury stock." INT. REV. CODE OF 1954, § 317(b).

³ When a redemption of stock is taxed as a dividend, the basis of the redeemed stock is often lost to the taxpayer. For example, if a taxpayer redeems all his stock in X corporation, with a cost basis to him of $100,000, and it is taxed as a dividend, his initial cost of $100,000 would not only be
possibility is particularly onerous to the executor of an estate who may be forced to sell its stockholdings in a close family corporation to retain stock ownership in the surviving shareholders or to pay off estate debts.\textsuperscript{4}

The purpose of this Note is to consider some of the problems involved in securing capital gains treatment for redemptions by close family corporations. It will place special emphasis upon the determination of when such redemptions are not essentially equivalent to a dividend, for this will frequently be the only means to secure capital gains treatment for these redemptions.

I. NONDIVIDEND TREATMENT OF REDEMPTIONS UNDER SECTION 302(b)(2) AND (3)

A redemption of stock will be treated as a sale and taxed at the capital gains rate if it qualifies under one of the provisions of section 302(b).\textsuperscript{5} A redemption will qualify under this section if

\textit{losted, but he would be taxed on the proceeds of the redemption at ordinary income tax rates. See generally Brodsky \& Pincus, The Case of the Reappearing Basis, 34 TAXES 675 (1956); Katcher, The Case of the Forgotten Basis: An Admonition to Victims of Internal Revenue Code Section 115(g), 48 MICH. L. REV. 465 (1950). The Advisory Committee on Subchapter C of the Internal Revenue Code has suggested a change in § 302 to alleviate the possible harsh effects of lost basis. See Hearings Before the House Committee on Ways and Means on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, 86th Cong., 1st Sess. 485-86 (1959).}

4. Ordinarily when an estate sells stock, there will be very slight tax consequences since the basis of the stock will have been adjusted to its fair market value at the date of the decedent's death, thus limiting the capital gains tax on the sale to any appreciation that occurs between the date of the basis adjustment and the date of the sale. INT. REV. CODE OF 1954, § 1014(a).

5. (b) REDEMPTIONS TREATED AS EXCHANGES.—

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) SUBSTANTIALLY DISPROPORTIONATE REDEMPTION OF STOCK.—

(A) IN GENERAL.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) LIMITATION.—This paragraph shall 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.

(C) DEFINITIONS.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.
it is not essentially equivalent to a dividend, if it is substantially disproportionate to the shareholder's prior interest, or if it is a complete termination of the shareholder's interest. The application of section 302(b) to determine whether a redemption will be treated as a sale, however, requires more than an application of these tests to stock held by the shareholders; section 302(c)(1) specifically provides that in determining stock ownership for purposes of section 302, the constructive ownership rules of section 318(a) shall apply.

Under section 318, a taxpayer's stockholdings are deemed to include stock constructively owned by him. Under the family attribution rules of this section, a person is deemed to constructively own stock owned by a member of his family. Similarly, under the entity attribution rules, stock owned by a partnership, a trust, or an estate is constructively owned by the partners or beneficiaries, and stock owned by the partners or beneficiaries is constructively owned by the partnership, trust, or estate. This pro-

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(3) TERMINATION OF SHAREHOLDER'S INTEREST.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(5) APPLICATION OF PARAGRAPHS.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

INT. REV. CODE OF 1954, § 302(b).

6. The sale treatment accorded the redemption of stock issued by railroad corporations in certain reorganizations under § 302(b)(4) is beyond the scope of this Note.

7. See generally Ringel, Surrey & Warren, Attribution of Stock Ownership in the Internal Revenue Code, 72 HARV. L. REV. 209 (1958). Section 318(a) is similar in effect to the other constructive ownership sections of the Code. See INT. REV. CODE OF 1954, §§ 267(b), 544(a).


9. Family members for purposes of § 318(a) include an individual's spouse, children, grandchildren, and parents.

10. INT. REV. CODE OF 1954, § 318(a)(2). For an example of attributing
vision makes it very difficult for redemptions by close family corporations to qualify as sales under the objective tests of section 302(b) that require a redemption to be either substantially disproportionate or a complete termination of the shareholder's interest. A discussion of some hypothetical redemptions will illustrate this point.

A. **Substantially Disproportionate Redemptions**

A redemption is "substantially disproportionate" within the meaning of section 302(b)(2) if, immediately after the redemption, the redeeming shareholder owns less than 50 percent of the total combined voting stock of the corporation and his own voting power has been reduced by more than 20 percent as a result of the redemption. Consider, for example, the situation where \( H \) owns 60 of the 100 issued and outstanding shares of \( X \) corporation and \( P \) owns the remaining 40 shares. If \( H \) dies, leaving \( W \), his wife, as the sole beneficiary of his estate, any redemption of 24 or more shares would be substantially disproportionate; the estate would own 36 of the then outstanding 76 shares, or 47.4 percent, and its percentage of voting control would have been reduced by more than 20 percent. Any resulting gain would therefore be taxed as a capital gain.

If the facts of the example are changed to make \( X \) corporation a close family corporation, with \( P \) being the son of \( H \) and \( W \), the constructive ownership rules of section 318 would apply, and the redemption would fail to qualify as substantially disproportionate. Under the family attribution rules, \( P \)'s stock would be attributed to \( W \) upon the death of \( H \), making her the constructive owner of his 40 shares; the 40 shares of stock owned constructively by \( W \), the beneficiary of the estate, would then be attributed to the estate by the entity attribution rules, making it the constructive owner of all 100 shares of \( X \) corporation's stock. Since immediately

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2. The estate formerly had 60% \([60 \div 100]\) of the voting control; it now has 47.4% \([36 \div 76]\). Therefore, its percentage of voting control has been reduced by 21% \([100-(47.4 \div 60)]\).
3. Twenty-four is the minimum number of shares that must be redeemed to qualify the redemption in this hypothetical for capital gains treatment under § 302(b)(2). The redemption of any number of shares from 25 to 60 would also satisfy the requirements of § 302(b)(2).
4. This hypothetical involves a two-step attribution from the son to the mother and from her to the estate. If this were a two-step attribution among
after any redemption, the estate would still be the constructive owner of 100 percent of the outstanding voting stock, no redemption from this hypothetical estate could ever be substantially disproportionate.

B. COMPLETE TERMINATION OF SHAREHOLDER'S INTEREST

Section 302(b)(3) provides that in the case of a complete redemption of all the stock of a single shareholder, the proceeds will be taxed as capital gains. In addition, the savings clause of section 302(c) provides that in determining whether a termination of the shareholder's interest has taken place, the family attribution rules of section 318(a)(1) may sometimes be waived. This savings clause will be invoked if, immediately after the distribution, the shareholder does not have any interest in the corporation other than that of a creditor; if he does not acquire any interest in the corporation within ten years of the date of the redemption; and if there is no person who owns stock that would be attributable to the redeeming shareholder under section 318(a) who acquired it from the redeeming shareholder ten years before the redemption, unless this stock is redeemed simultaneously. The Internal Revenue Service has ruled that this waiver applies only to situations where the distributee constructively owns stock by virtue of the application of the family attribution rules of section 318(a)(1); section 302(c)(2) was not intended to be used to waive the entity attribution rules of section 318(a)(2). For any redemp-


17. The “interests” forbidden by this section include an interest as an officer, director, or employee of the corporation. INT. REV. CODE OF 1954, § 302(c)(2)(A)(i).

18. In addition, he must agree to notify the Internal Revenue Service if he acquires any interest in the corporation within 10 years after the redemption, and he must not during that period acquire any of the shares that were redeemed from a person whose stock would be attributable to him by § 318(a). INT. REV. CODE OF 1954, § 302(c)(2).

19. Rev. Rul. 59-233, 1959-2 CUM. BULL. 106. This ruling held that a trust that completely terminated its interest in a corporation could not avail itself of the savings clause provision. All of the stock of the corporation involved was owned by H and the trust. The trust had been created by the will of H's deceased wife for the benefit of their children. The stock of the father was attributed to the children by § 318(a)(1)(A)(ii), and then from the children to the trust by § 318(a)(2)(B). This resulted in the trust constructively owning 100% of the corporate stock. Although this ruling in-
tion in which the family attribution rules are not used in the final step of attribution of ownership to the distributee, therefore, the savings clause cannot be used by the taxpayer. Therefore, if $H$ owns 60 of the 100 issued and outstanding shares of $X$ corporation and $S$, his son, owns the remaining 40 shares, $H$ could, by complying with the savings clause, redeem all of his shares in $X$ corporation, and any resulting gain would be taxed at the capital gains rate. Should $H$ die before effecting the redemption, however, this result would not necessarily follow. All of the stock would then pass to his estate. If his wife, $W$, were the sole beneficiary of the estate, the stock of the son would be attributed to his mother by the family attribution rules, and then to the estate, the distributee, by the entity attribution rules. Because the family attribution rules would not have been used in the final attribution to the distributee, the savings clause would not be available to allow the estate to avoid attribution and completely terminate its interest in the corporation.

The application of section 318 to certain redemptions of stock held by estates may thus prevent them from qualifying for capital gains treatment under the substantially disproportionate or the termination of interest tests of section 302(b). This does not, however, necessarily mean that those redemptions will be taxed as dividends. A redemption that does not qualify under those tests may still qualify as a sale under section 302(b)(1) if it is not essentially equivalent to a dividend.\(^2^0\)

II. THE DIVIDEND EQUIVALENCE TEST OF SECTION 302(b)(1)

The dividend equivalence test of section 302(b)(1) is the only part of section 302 to be carried forward from the 1939 Code.\(^2^1\) In fact, the language of the Senate Report on this section indicates that Congress intended to re-enact essentially the same dividend

volved a redemption of stock held by a trust, the same holding would be reached in the case of an estate because attribution to estates is also under § 318(a)(2), not § 318(a)(1).

The result reached in Revenue Ruling 59-233 has been vigorously attacked. See Gleason & Jones, Recent Ruling Creates Double Attribution in Redemptions; Perils Buy-Out Plans; Error Seen, 12 J. TAXATION 268 (1960).

20. The failure of a redemption to qualify under the substantially disproportionate or the termination of interest tests in no way affects its ability to qualify as not essentially equivalent to a dividend. INT. REV. CODE OF 1954, § 302(b)(5); Ballenger v. United States, 301 F.2d 192, 195 (4th Cir. 1962).

equivalence test that existed under the 1939 Code. Therefore, to assess the dividend equivalence test of section 302(b)(1), a consideration of both its development under the 1939 Code and its application under the 1954 Code is necessary.

A. THE DIVIDEND EQUIVALENCE TEST UNDER THE 1939 CODE

The present dividend equivalence test was first enacted in the 1926 Internal Revenue Act. Section 201(g) of that act discarded previous distinctions between ordinary redemptions and redemptions involving stock dividends and made the dividend equivalence test applicable to all redemption distributions; such distributions were treated as sales unless they were essentially equivalent to a dividend.

The 1939 Code adopted the dividend equivalence test in section 115(g). This test, like its predecessors, provided no standards

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22. In general, under this subsection your committee intends to incorporate into the bill existing law as to whether or not a reduction [sic] is essentially equivalent to a dividend under section 115(g)(1) of the 1939 Code . . . . Paragraph (1) of subsection (b) provides that subsection (a) will apply if the redemption is not essentially equivalent to a dividend. 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.


23. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11. The dividend equivalence test had its roots in Eisner v. Macomber, 252 U.S. 189 (1920), where the Supreme Court held that since a stock dividend was not a distribution of company assets, it was not constitutionally taxable as income. This decision made it possible for corporations to distribute nontaxable stock dividends in lieu of cash dividends, then immediately redeem that stock at capital gains rates. This tax loophole was closed by § 201(d) of the Revenue Act of 1921, which made stock dividends taxable as ordinary income if the stock issued as a dividend was cancelled or redeemed "at such time and in such manner as to make the distribution . . . essentially equivalent to the distribution of a taxable dividend . . . ." Ch. 136, § 201(d), 42 Stat. 228–29 (1921); see 61 CONG. REC. 7507 (1921) (remarks of Senator McCumber). Section 201(f) of the 1924 Revenue Act changed the scope and effect of the above provision by applying the dividend equivalence test to redemptions preceding as well as following stock dividends. Ch. 234, § 201(f), 43 Stat. 255 (1924). Furthermore, § 201(g) of the 1924 Revenue Act classified all distributions by a corporation in cancellation or redemption of part of its stock as partial liquidations. Ch. 234, § 201(g), 43 Stat. 255 (1924).


25. See generally Gutkin & Beck, Stock Redemptions as Taxable Events Under Section 115(g): The Impressionistic Test, 80 J. ACCOUNTANCY 285 (1945); Miller, Stock Redemptions, N.Y.U. 6TH INST. ON FED. TAX 307 (1948); Owen, Stock Redemptions and Partial Liquidations Under the 1954 Code, 32 TAXES 979 (1954); Note, Stock Redemption or Cancellation Taxable as Dividend—Section 115(g) of the Revenue Act of 1934, 49 HARV. L. REV. 1344 (1936).
to follow in applying the test to corporate redemptions.\textsuperscript{26} The courts were thus forced to formulate their own standards, and as a result, they created a judicial test known as the "net effect" test.\textsuperscript{27} This test originally provided that "the net effect of the distribution [in redemption] rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering section 115(g)."\textsuperscript{28} Among the relevant factors considered in applying the "net effect" test are (1) the past dividend history of the redeeming corporation;\textsuperscript{29} (2) the amount of past earnings available for a dividend;\textsuperscript{30} (3) the presence of a business purpose;\textsuperscript{31} (4) whether the stockholder or the corporation initiated the redemption;\textsuperscript{32} (5) whether the redemption terminated


\textsuperscript{27} Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940).

\textsuperscript{28} Id. at 939-40. Subsequent application of the test broadened it to include inquiry into the possible existence of some legitimate business purpose for the redemption. See, e.g., Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954).

\textsuperscript{29} A past history of dividend payments is considered evidence that the redemption is not a substitute for a dividend. See, e.g., Fred B. Snite, 10 T.C. 523 (1948), aff'd, 177 F.2d 819 (7th Cir. 1949), nonacq., 1948-2 Cum. Bull. 6 (withdrawn), acq., 1950-1 Cum. Bull. 5; J. Natwick, 36 B.T.A. 866 (1937); Henry B. Babson, 27 B.T.A. 859 (1933), aff'd, 70 F.2d 304 (7th Cir.), cert. denied, 293 U.S. 571 (1934), nonacq., XII-1 Cum. Bull. 14 (1933). In T. Pierre Champion, 27 B.T.A. 1312 (1930), aff'd, 78 F.2d 513 (6th Cir. 1935), the Board of Tax Appeals stated that a record of substantial dividends "is not compatible with a studied intent to avoid taxation."

\textsuperscript{30} Dividend treatment is imposed, in any case, only to the extent of earnings and profits accumulated since February 28, 1913, or earned in the year of distribution. INT. REV. CODE OF 1954, § 316(a). Therefore, the presence of a large earnings surplus for a number of years prior to a redemption is a factor suggesting a dividend distribution. See, e.g., Rheinstrom v. Conner, 125 F.2d 790 (6th Cir.), cert. denied, 317 U.S. 654 (1942).

\textsuperscript{31} The factors considered in the "net effect" test have not been given equal weight. The presence of a "business purpose" has been one of the factors weighed most heavily by courts in determining whether a redemption is essentially equivalent to a dividend. In fact, the mere presence of a "business purpose" actually overcame the other factors in Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954). See Dean, The New Section 115(g) Regulations, N.Y.U. 11TH INST. ON FED. TAX 587, 591 n.20 (1953).

Because the presence of a "business purpose" has been given such great weight, it has sometimes been considered a separate test of dividend equivalence in addition to the "net effect" test. Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962). The prevailing view, however, is that the "business purpose" inquiry is not a separate test. See Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).

For an exhaustive list of transactions that are considered valid business purposes for a redemption, see Treusch, Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code, 32 Taxes 1023, 1037 (1954).

\textsuperscript{32} When the initiative for a redemption comes from the corporation, this
the shareholder's interest in the corporation; (6) whether there was a scheme of tax avoidance; (7) whether the corporation contracted or extinguished its business in any way; and (8) whether the distribution in acquisition of stock caused a significant change in the position of the recipient with respect to other shareholders or to the corporation.

The inquiry into the change in position of the shareholder caused by the redemption is the most important inquiry under the net effect test. One of the characteristic features of a dividend is that it is a distribution of corporate assets that does not disturb the relative position of any stockholder with respect to the ownership and control of the corporation. The most obvious example of a redemption that would have this result is a pro rata redemption; by reducing the stockholdings of each shareholder proportionately, it leaves the ownership and control of the corporation unchanged. A redemption that is not completely pro rata and reduces the stockholdings of only a few shareholders may, however, still be essentially equivalent to a dividend if it does not indicate both a business purpose and the absence of a tax avoidance motive. Bona Allen, Jr., 41 B.T.A. 206 (1940), nonacq., 1940–1 CUM. BULL. 5.

33. [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. Treas. Reg. 118, § 39.115(g)–1(a)(2) (1953). See also Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). The Internal Revenue Service interpreted “ceases to be interested in the affairs of the corporation” to mean that the taxpayer, in addition to redeeming all his stock, has resigned as an officer and director of the corporation and has no interest, direct or indirect, in the corporation... [and] there is no relationship, other than business, between the individual concerned and any other shareholder, and no member of his family is, or will be, associated with the corporation. Rev. Rul. 408, 1954–2 CUM. BULL. 165, 166.

34. See Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940).
35. Under the dividend equivalence test of the 1939 Code, a corporate contraction was an indication that a partial liquidation had taken place and that capital gains treatment should be accorded the redemption. Murphy, Dividend Equivalency—The End of the Beginning?, 10 TAX. L. REV. 213, 215 (1955).
36. See In re Estate of Lukens, 246 F.2d 403 (3d Cir. 1957). Some courts have stated that the question of lost basis is a consideration in determining whether a redemption should be taxed as a dividend. See Fred B. Snite, 10 T.C. 523 (1948), aff'd, 177 F.2d 819 (7th Cir. 1949); William H. Grimditch, 37 B.T.A. 402 (1938). See generally note 3 supra.
change the actual control of the corporation. Because this type of
redemption has the same effect upon corporate control as a pro
rata redemption, it is said to be "essentially pro rata."

B. THE DIVIDEND EQUIVALENCE TEST UNDER THE 1954 CODE

Although "in general" Congress intended the dividend equiva-
ence test as developed under the 1939 Code to remain unchang-
ed in the 1954 Code, it did make two changes in the test. First,
the 1954 Code separates liquidating distributions from all other
types of corporate distributions. Thus, unlike section 115(g)
(1) of the 1939 Code, section 302(b)(1) does not apply to re-
demptions in complete or partial liquidation of a corporation;

40. A redemption will be considered pro rata even though it is not pre-
cisely pro rata as to all stockholders if it is, in terms of economic realities,
essentially pro rata. See, e.g., Bradbury v. Commissioner, 298 F.2d 111
(1st Cir. 1962); Pacific Vegetable Oil Corp. v. Commissioner, 251 F.2d 682
(9th Cir. 1957). Thus, a redemption from a shareholder that would reduce
his ownership in the corporation from 91.3% to 89.7%, although techni-

cally not pro rata, would be considered essentially pro rata since in all
practical respects the redemption would effectuate no basic change in the
ownership or control of the corporation. Bradbury v. Commissioner, supra.

To avoid the pro rata effect, the redemption must produce a significant
change in ownership and control of the corporation. Neff v. United States,
301 F.2d 330 (Ct. Cl. 1962).

41. See note 22 supra and accompanying text.

42. INT. REV. CODE OF 1954, § 346.

43. As a result of the separation in the tax treatment of corporate
liquidations from the treatment of all other types of corporate distributions
in the 1954 Code, the dividend equivalence test of § 302(b)(1) has been
narrowed; it now applies only to redemptions viewed from the standpoint
of the shareholders. The dividend equivalence test of § 346(a)(2) will af-
ford capital gains treatment to redemptions that are "not essentially equiva-

ten to a dividend" from the corporation's standpoint. This change in the
scope of the dividend equivalence test was explained in S. REP. NO. 1622,
83d Cong., 2d Sess. 49 (1954).

The effect of this change is to separate some of the factors of the dividend
equivalence test of the 1939 Code between the new "dividend equivalence"
tests of § 302(b)(1) and § 346(a)(2). Thus, such factors as whether the corpo-
rated continued to operate at a profit and whether the corporation con-
tacted or extinguished its business would generally not be considered in re-
demptions attempting to qualify under the provisions of § 302(b)(1), but
would instead be considered in assessing redemptions attempting to qualify
under § 346(a)(2). One authority has stated that this change in emphasis
is so important "that cases under the 1939 Code applying the 'net effect'
test cannot be relied upon to insure capital gains consequences on a re-
demption under the general language of Section 302(b)(1) of the 1954 Code.

... [It] appears clear that a new body of case law will be developed in
this area. Code Commentary, MERTENS, FEDERAL INCOME TAXATION
§ 302, at 33 (1955). See generally Ballenger v. United States, 301 F.2d 194
(4th Cir. 1962).

Despite the fact that the 1954 Code has separated partial liquidations
from all other corporate distributions, the presence of a corporate con-
traction may still be a relevant factor in the dividend equivalence test in
section 346(a)(2) now governs all distributions in complete or partial liquidations.

Second, and more important from the standpoint of a close family corporation, the constructive ownership rules of section 318(a) are made applicable to redemptions under section 302. Under the 1939 Code, the courts had rejected the application of any constructive ownership rules to the "net effect" test on the ground that members of families, of trusts, and of estates were separate taxable entities and should not be taxed as units.

Since section 302(c)(1) provides that the attribution rules of section 318(a) apply to section 302 generally, the Treasury and the leading cases have taken the position that section 318(a) applies to the dividend equivalence test of section 302(b)(1).

The importance of this change from the standpoint of the redeeming shareholder cannot be overemphasized, for attribution has the effect of centralizing stock ownership. This makes more redemptions essentially pro rata and, thus, increases the likelihood that a given redemption will be found to be essentially equivalent to a dividend.

1. The Lewis Case

The most important case applying section 318(a) to the dividend equivalence test pursuant to section 302(c)(1) was Thomas.
G. Lewis. In that case, the decedent, who was the majority stockholder and president of a family corporation, owed 20,500 dollars to the corporation for withdrawals made over a period of years. At the time of his death, the decedent owned 156 shares of the corporation’s 283 outstanding shares; the decedent’s daughters, who were the beneficiaries of the estate, and their husbands owned the remaining 137 shares. To pay the 20,500 dollar debt to the corporation, the decedent’s estate transferred to the corporation 51 shares of stock in full payment of the debt; the remaining 105 shares were distributed to the beneficiaries. The Tax Court applied the constructive ownership rules of section 318(a) strictly by attributing the stock of the beneficiaries’ husbands to the beneficiaries under the family attribution rules and from the beneficiaries to the estate under the entity attribution rules. As a result, the court was forced to “appraise the facts of this case in light of the assumption that the estate owned all of the stock.” Thus, any redemption from the estate would have been pro rata because after the redemption the estate would still retain 100 percent control.

Although this case made it clear that the Tax Court believes that the attribution rules are applicable to the dividend equivalence test of section 302(b)(1), it did not determine how much weight these rules should command in the “net effect” test. The Tax Court seemed to give them great weight when it stated that this redemption might not have been treated as a dividend under the 1939 Code. This dictum suggests that if the attribution rules make a redemption pro rata, it will be taxed as a dividend despite the fact that all of the other factors in the “net effect” test suggest non-dividend treatment. This interpretation would make the attribution rules the controlling factor in applying the dividend equivalence test under the 1954 Code, and their strict application would supersede the case law that developed under the 1939 Code.

The court’s choice of the word “might” is significant, however, because it is not entirely clear that the redemption in Lewis would not have been treated as a dividend under section 115(g)(1) of

50. 35 T.C. 71 (1960).
51. Id. at 78.
52. Cases decided subsequent to Lewis have reaffirmed the position that the attribution rules are applicable to the dividend equivalence test. See Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); Neff v. United States, 301 F.2d 330 (Ct. Cl. 1962); Archbold v. United States, 201 F. Supp. 329 (D.N.J. 1962); Estate of Arthur H. Squier, 35 T.C. 950 (1961), acq., 1961–2 CUM. BULL. 5; Herbert C. Parker, 20 CCH Tax Ct. Mem. 893 (1961).
53. 35 T.C. at 75–77.
54. See note 45 supra and accompanying text.
the 1939 Code. Although the redemption would not have been considered pro rata because no attribution rules applied, the facts of the Lewis case indicate that other significant factors were present that, under the "net effect" test of section 115(g)(1), might have resulted in the redemption being accorded dividend treatment. For example, there was no business purpose for the redemption, there were no dividends paid from 1935 to 1954 despite sufficient accumulated earnings and profits, and there was no plan to contract the corporate business. Therefore, despite the apparently conclusive weight given to the effect of the attribution rules in Lewis, the Tax Court might regard the presence or absence of the other factors in the "net effect" test as controlling. That is in fact what the Tax Court did in the Squier case.  

2. The Squier Case

In Estate of Arthur H. Squier, the stock in a close corporation was controlled by three different interests at the death of the corporation's president. The decedent's estate owned 50.09 percent, the estate's beneficiaries owned 13.21 percent, and an unrelated minority interest owned 36.70 percent. A major dispute developed between the executor and the beneficiaries of the estate over the appointment of a new president. Due to the estate's controlling position in the corporation, the executor prevailed in this dispute, but considerable friction and strained relations between the executor and the beneficiaries resulted. Subsequently, the estate was forced to redeem nearly one-third of its stock with the corporation in order to pay the outstanding debts of the decedent, and as a result, the estate lost its controlling position. The redemption was attacked by the Commissioner on the ground that it was essentially equivalent to a dividend. The Commissioner reasoned that since the Lewis case required a strict application of the attribution rules, the estate in Squier could be considered the owner of 63.30 percent of the stock before the redemption and 56.82 percent after the redemption. He concluded that since the relation of the taxpayer to the corporation was not changed in any aspect by the redemption, the redemption was an essentially pro rata distribution and, thus, essentially equivalent to a dividend.

55. See Pedrick, Stock Redemptions, the "Law" and the Profits, 49 Ill. B.J. 786, 792 (1961).
57. 35 T.C. 950 (1961).
58. After the redemption, the estate's percentage share of ownership was reduced to 41.27%; the beneficiaries' interest increased to 15.55%; and the unrelated minority interest increased to 43.18%. Thus, the estate could no longer exercise independent control over the corporation. Id. at 952.
59. See notes 36–40 supra and accompanying text.
The Tax Court reaffirmed the rule of Lewis that the attribution rules of section 318 should be strictly applied to redemptions under section 302 and recognized that the effect of this strict application would seem to be to make the distribution essentially pro rata. Under the facts present in the Squier case, however, the court found that despite the application of the attribution rules, the redemption was not essentially pro rata. An essentially pro rata distribution produces no change in the ownership and control of the corporation, and in fact, the control of the corporation in Squier had changed hands. The family estrangement between the estate and the beneficiaries caused by the dispute over the selection of a new president meant that the redemption "in fact resulted in a critical reduction of the estate's control over the corporation." 

60. After the redemption, the estate and its beneficiaries owned 56.82% of the corporate stock. Thus, when the attribution rules were applied, the redemption did not significantly change the ownership and control of the corporation.

61. The Tax Court applied similar reasoning in its decision in Herbert C. Parker, 20 CCH Tax Ct. Mem. 893 (1961), to reach a determination that a redemption was not essentially equivalent to a dividend. In Parker, the taxpayer, who was in his seventies, owned 49.7% of the shares issued and outstanding of H.C. Parker, Inc. The only other sizeable interest was the 47.4% owned by his son. The taxpayer and his son became involved in a dispute over the management of the corporation; the son wanted to pursue a plan of expansion, while his father favored the status quo. As a result of the dispute, the taxpayer agreed to "sell" all of his stock to the corporation in five installments, and in the first installment, he "sold" 60% of his stock to the corporation. The Commissioner attacked the transaction on the ground that it was a redemption that was essentially equivalent to a dividend. He argued that the Lewis case called for the strict application of the attribution rules, and that they would make the taxpayer the constructive owner of 97.1% of the corporation's stock before the redemption and 96.7% after the redemption. Under this reasoning, there was no significant change in the ownership and control of the corporation, and therefore, the redemption was essentially pro rata and equivalent to a dividend. The Tax Court rejected the Commissioner's plea for strict application of the attribution rules and held that the redemption was not essentially equivalent to a dividend. In distinguishing Parker from Lewis, the court said:

In Thomas G. Lewis . . . we applied the attribution rules of section 318. In that case, however, the findings are devoid of any reference to controversy or adversity of interest among the various shareholder interests . . .

[A]fter taking the entire record into account, including the relationships involved and the history of sharp and continuing disagreement between Parker and Parker Jr., we conclude on the unusual facts presented that the redemption brought about a significant change of control and we hold that the redemption here at issue was not essentially equivalent to a dividend under section 302(b)(1) . . .

Id. at 900-01. (Emphasis added.) As in Squier, therefore, the court refused to consider the effect of applying the attribution rules when it found that the redemption caused a significant change in actual control, which was evidenced by the disagreement between the related stockholders.

62. 35 T.C. at 955-56.
Furthermore, the redemption increased the unrelated minority interest in the corporation from 36.70 to 43.18 percent.\textsuperscript{63} Finally, the fact that the corporation had a record of past annual dividends mitigated against this redemption being essentially equivalent to a dividend.\textsuperscript{64}

3. The Attribution Rules and the Dividend Equivalence Test

In avoiding the harsh consequences of dividend treatment that would have resulted from a strict application of the attribution rules, the Tax Court in \textit{Squier} seems to have used family estrangement as a justification for reaching a just result. The court failed to consider the more significant question—whether there are certain redemptions under section 302(b)(1) to which the attribution rules should not be applied at all. Professor Bittker has indicated that in certain instances, the attribution rules should not be applied to redemptions under section 302(b)(1).\textsuperscript{65} He avoids the apparently contrary intent of section 302(c)(1)\textsuperscript{66} by relying upon the language of the Treasury Regulations under section 302(b)(1), which state that a pro rata distribution will "generally" be essentially equivalent to a dividend.\textsuperscript{67} This use of the word "generally" might indicate that some pro rata redemptions should be treated as sales under section 302(b)(1). Professor Bittker specifically suggests that this argument might be successful where a redemption is made pro rata because of the application of the attribution rules to the dividend equivalence test.\textsuperscript{68} He suggests further that proof of family estrangement should succeed in avoiding the application of the attribution rules to a redemption of stock in a close family corporation so that the redemption may nevertheless qualify as not essentially equivalent to a dividend under section 302(b)(1).

Implicit in this suggestion is the idea that the attribution rules should not be strictly applied to the dividend equivalence test. Instead, they should be applied only if the facts of the particular redemption reveal a realistic basis for equating constructive ownership with actual ownership and it appears from a factual inquiry that the policy of the attribution rules would be furthered by their application. The policy behind the attribution rules is to prevent

\textsuperscript{63} \textit{Ibid.}
\textsuperscript{64} \textit{Id.} at 956.
\textsuperscript{66} See text accompanying note 7 \textit{supra}.
\textsuperscript{67} Treas. Reg. \textsection 1.302–2(b) (1963).
\textsuperscript{68} The position of the regulations is that the attribution rules are only one of the factors to be considered in determining dividend equivalence. \textit{Ibid.}
tax avoidance in cases where one member of a family unit is able to control the stock owned by the other members or where a trust or an estate can control the stock owned by its beneficiaries. In effect, the attribution rules are merely statutory aids for determining whether a stockholder is merely a "dummy" stockholder with no real voice in the control of the corporation.

The constructive ownership that results from applying the attribution rules thus should not be considered actual ownership for purposes of dividend equivalence unless a distribution to one family member is actually a dividend to another family member or unless the family member receiving the distribution has actual control over the remaining shareholders by virtue of the family relationship. For example, consider the situation where $X$ corporation has 100 shares outstanding—a decedent’s estate holds 60 shares for $W$, the sole heir, and the remaining 40 shares are owned by $S$, who is $W$’s adult son. Under Lewis and Squier, unless some family estrangement between $W$ and $S$ is shown, the attribution rules apply to make any redemption from the estate pro rata and thus essentially equivalent to a dividend. Under the broader approach suggested above, however, the application of the attribution rules is not automatic. This redemption could be made at capital gains rates by $W$, the estate beneficiary, under section 302(b)(3) and the savings clause of section 302(c)(2) immediately after she receives the stock from the estate. Since the redemption would not be equivalent to a dividend after a distribution to $W$, the mere presence of the estate should not be considered an indication of a tax avoidance motive calling for the strict application of the attribution rules. Furthermore, under the facts in the hypothetical, the distribution to $W$ is not likely to be essentially equivalent to a dividend to either $W$ or $S$. Neither $W$ nor the estate after redeeming the entire 60 shares would have control of the corporation through manipulation of $S$, $W$’s adult son.

71. See In re Estate of Lukens, 246 F.2d 403 (1957); Plowden-Wardlaw, Constructive Ownership Under the 1954 Internal Revenue Code, 26 FORDHAM L. REV. 441 (1957).
72. It must also be considered that the estate will suffer the loss of the stock’s basis if it is taxed as a dividend. See note 3 supra. However, under the facts of the hypothetical, the basis of the stock may not be entirely lost, for to be consistent with the concept of economic unity embodied in the constructive ownership rules, the court might shift the basis of the estate’s stock to $W$, and from her to $S$. Indeed, this result is suggested
Undoubtedly, in some situations this factual analysis will support the strict application of the attribution rules to prevent tax avoidance. Consider, for example, X corporation, a close corporation with 100 shares outstanding. A decedent's estate holds 60 shares for S, the decedent's son and sole heir. The remaining 40 shares are owned by W, S's wife, who received the shares as a gift from S just prior to the death of the decedent. A redemption of the 60 shares of the estate would not qualify as a termination of the shareholder's interest because the shares of W would be attributed to the estate through S, and the savings clause would not prevent this entity attribution. The savings clause would also be unavailable to save a complete termination of S's shares after distribution of the estate because of S's disqualifying transfer to W within the ten-year period immediately prior to the redemption.

Both of these redemptions should be held to be essentially equivalent to a dividend through application of the attribution rules; in both cases, cash will have been distributed by the corporation to S, who will remain in control of the corporation by virtue of the family relationship between him and W. It is justifiable to burden S with the constructive ownership of W's shares because S's relationship to W gives him what is tantamount to actual ownership of these shares. Under the rationale of Lewis and Squier, this sort of factual analysis would never even be reached; the attribution rules would be strictly applied in the absence of proof of actual family estrangement.

Other commentators have also argued that section 318(a) should not be strictly applied to the dividend equivalence test. Their argument relies upon section 302(b)(5), which provides that the fact that a redemption fails to qualify under one of the objective tests of section 302(b) will not affect its outcome under the dividend equivalence test. The strict application of the attribution rules would in many instances completely negate the purpose and meaning of section 302(b)(5). That section suggests that

by the Treasury Regulations. See Treas. Reg. § 1.302–2(c), examples 1–2 (1962). However, such shifting of basis would be fair only if W has a continuing interest in the shares of S and in the affairs of the corporation.

73. See note 19 supra and accompanying text.
74. INT. REV. CODE OF 1954, § 302(c)(2)(B)(ii); see text accompanying notes 17 and 18 supra.
76. An amendment to § 302(b) has been recommended to provide that in determining whether a redemption is essentially equivalent to a dividend,
section 302(b)(1) was meant to protect certain redemptions that fail to qualify as substantially disproportionate or as a termination of a shareholder's interest from being taxed unfairly. If the attribution rules are applied strictly to section 302(b), such redemptions will also fail to qualify as not essentially equivalent to a dividend.

CONCLUSION

While the two hypotheticals above illustrate almost opposite factual situations, each would receive the same tax treatment under the rationale of Lewis and Squier. This illustrates the injustice created by strictly applying the rigid attribution rules to the otherwise subjective dividend equivalence test. Section 302(c)(1) should be interpreted to make the dividend equivalence test entirely subjective, and flexible enough to be applied equitably to all redemptions. At the same time this approach would further the intention that Congress reflected when it rejected, as too restrictive, a proposal that section 302(b) be limited to such objective tests as those now found in sections 302(b)(2) and 302(b)(3) for determining nondividend treatment of redemptions. Congress intended to make the determination of whether a redemption would be taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry.

The constructive ownership rules of § 318 shall not be applicable. Under this proposal, family relations would be considered along with the other facts and circumstances of the case. The Advisory Committee apparently proposed this change because of the judicial misinterpretation of § 302(b)(5), for in concluding its recommendation, the committee stated:

'It is believed that this amendment reflects the intent of the present statute, which now states that the fact that the redemption does not qualify under (b)(2) or (b)(3) shall not be taken into account in making the determination under (b)(1).


A strict interpretation of the language of §§ 318(a), 302(b)(1), and 302(c)(1) could also lead to the conclusion that the attribution rules do not apply to § 302(b)(1). Section 302(c)(1) makes the attribution rules of § 318(a) applicable only "in determining the ownership of stock for purposes of this section." Since § 302(b)(1) does not expressly refer to "ownership" of stock, the attribution rules might be inapplicable to it. See Cohen, supra note 75, at 758–59; Plowden-Wardlaw, supra note 71, at 460–61. Professor Bittker rejects this argument because "the rules of § 318(a) are 'expressly' made applicable 'in determining the ownership of stock' under § 302, and consequently it is reasonable to apply them whenever ownership of stock is relevant, whether by statutory direction or otherwise." Bittker, supra note 65, at 324 n.67.


78. Id. at 233.
test is not to become as objective as the other tests of section 302 (b), but is to approximate the "net effect" test under the 1939 Code, then section 302(c)(1) must not be strictly interpreted. The attribution rules of section 318 should be applied only to those dividend equivalence cases in which constructive ownership is, in fact, tantamount to actual ownership.