1970

Defining Dividend Equivalency under Section 302(b)(1)

Alan R. Gordon

Follow this and additional works at: http://digitalcommons.law.villanova.edu/vlr

Part of the Business Organizations Law Commons, and the Tax Law Commons

Recommended Citation
Available at: http://digitalcommons.law.villanova.edu/vlr/vol16/iss1/5

This Comment is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository. For more information, please contact Benjamin.Carlson@law.villanova.edu.
COMMENTS

DEFINING DIVIDEND EQUIVALENCY UNDER
SECTION 302(b)(1)

Indeed, the problem of dividend equivalency has had a
gremlinesque quality which has endowed it with as many
colors as Joseph's coat.¹

I. INTRODUCTION

When a corporation redeems its own stock from a shareholder in ex-
change for money or other property, the transaction results in a taxable
event. Whether the shareholder should treat the money or property received
as a corporate dividend taxable at ordinary income rates,² rather than as
proceeds from the sale or exchange of property taxable at capital gains
rates,³ is the subject of section 302 of the Internal Revenue Code of 1954.

Section 302(b) provides four instances⁴ in which stock redemptions
will not be treated as dividends to a shareholder: (1) a redemption that is
not essentially equivalent to a dividend; (2) a substantially disproportionate
redemption,⁵ (3) a redemption of all the shareholder's stock;⁶ and (4) a
redemption of the stock of certain railroad corporations.

2. INT. REV. CODE of 1954, § 301 (c) (1), states that a distribution which is a
   dividend (as defined in section 316) shall be included in gross income. INT. REV. CODE
   of 1954, § 316(a), states as a general rule that a dividend is any distribution of
   property made by a corporation to its shareholders out of earnings and profits accumu-
   lated since 1913 or out of the earnings and profits of the current taxable year.
3. INT. REV. CODE of 1954, § 1202, provides a taxpayer with a deduction from
   gross income of 50 percent of the amount that the net long-term capital gain exceeds
   the net short-term capital loss.
4. INT. REV. CODE of 1954, § 303, also provides for capital gains treatment of
   stock redemptions where the distribution is made to pay death taxes.
5. INT. REV. CODE of 1954, § 302(b) (2) (C), provides that a distribution is sub-
   stantially 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 cor-
   poration 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 cor-
   poration at such time.
   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 required of the preceding sentence.
In addition to the above requirements, section 302(b) (2) (B), requires that immedi-
ately after the redemption the shareholders must own less than 50 percent of the total
combined voting power of all classes of stock entitled to vote.
6. The total redemption contemplated under this subsection also includes the
   termination of any beneficial interest one may have. Rev. Rul. 68-388, 1968-2 CUM.
   BULL. 122.

(88)
This last instance is special-interest legislation which has only limited application to the tax problems involved in stock redemptions. The disproportionate redemption contemplated under section 302(b) (2) and the complete redemption contemplated under section 302(b) (3) have been further delineated in this Code section and the Regulations, thus presenting no real problems of interpretation or application.

Section 302(b) (1), however, has been the center of varying interpretations and conflict. This Comment will focus upon that section and attempt to elucidate its "not essentially equivalent to a dividend" standard. In formulating this standard, an attempt will be made to determine the congressional intent underlying this section, and to examine the federal cases, under both the 1939 and the 1954 Internal Revenue Codes, which have treated this area. Particular emphasis will be placed upon the recent United States Supreme Court case of United States v. Davis which represents the first time that the Supreme Court has addressed section 302(b) (1). The Davis holding will be analyzed in an attempt to resolve past conflicts and also to consider some new problems which it has created. Finally, proposed solutions to the continuing problem of defining "dividend equivalence" will be suggested in an effort to overcome some existing flaws remaining after Davis.

II. THE INTERNAL REVENUE CODE OF 1939

Section 115 (g) (1) of the Internal Revenue Code of 1939, the forerunner of section 302(b) (1), simply provided that if a stock redemption was in whole or in part "essentially equivalent to the distribution of a taxable dividend," the amount distributed was to be treated as a taxable dividend rather than as proceeds from a sale or exchange of property. Since this test of a taxable dividend was so highly subjective, the disposition of each case depended upon a factual inquiry into all the aspects of the transaction in an effort to determine whether or not the "net effect" of the transaction more closely resembled a corporate dividend than a sale of stock. Some of the factors considered in this determination included: (1) whether the redemption was made pursuant to a plan of contraction of business activities; (2) whether the corporation continued to operate at a profit
after the redemption;\(^8\) (3) whether there was a sufficient accumulation of surplus to fund a distribution;\(^9\) (4) whether the redemption was made for tax avoidance motives rather than for a legitimate business purpose;\(^10\) (5) whether the corporation had a history of paying dividends;\(^11\) (6) whether the corporation or the individual initiated the redemption;\(^12\) (7) whether the distribution was made on a pro rata basis;\(^13\) and (8) whether ownership in the corporation was materially altered after the redemption.\(^14\)

Because each court considered different factors to be significant, the case law became confusing and uncertain with the result that many factually similar situations ended in opposite conclusions.\(^15\) Probably the only safe

\(^8\) But see p. 95 infra and cases cited note 58 infra.


\(^10\) See Commissioner v. Champion, 78 F.2d 513 (6th Cir. 1935); Commissioner v. Babson, 70 F.2d 304 (7th Cir.), cert. denied, 293 U.S. 571 (1934); Joseph W. Imler, 11 T.C. 836 (1948); Samuel A. Upham, 4 T.C. 1120 (1945).

\(^11\) See Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940) ; E.M. Peet, 43 B.T.A. 852 (1941); J. Natwick, 36 B.T.A. 866 (1937). On the other hand, the Tax Court has held that the presence of a poor dividend record indicates a valid redemption since a dividend would be a departure from past policy. See also Treas. Reg. § 1.302-2 (1955), which states:

The determination of whether or not a distribution is within the phrase “essentially equivalent to a dividend”... shall be made without regard to the earnings and profits of the corporation at the time of the distribution.

\(^12\) See Bittker & Redlich, Corporate Liquidations and the Income Tax, 5 Tax L. Rev. 437, 434 (1950), where the authors state that the most important single standard used by the courts in determining taxability under section 115(g) of the 1939 Code was the existence of a legitimate business purpose.

\(^13\) See Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940) ; Bona Allen, Jr., 36 B.T.A. 791 (1937); L.M. Lockhart, 8 T.C. 436 (1947); Samuel A. Upham, 4 T.C. 1120 (1945); John P. Elton, 47 B.T.A. 111 (1942); Bona Allen, Jr., 41 B.T.A. 206 (1940); Albert T. Perkins, 36 B.T.A. 791 (1937); J. Natwick, 36 B.T.A. 866 (1937); H.F. Asmussen, 36 B.T.A. 878 (1937); Alfred E. Fuhlage, 32 B.T.A. 222 (1935) ; Contra, Patty v. Helvering, 98 F.2d 717 (2d Cir. 1938). See also Gordon: Defining Dividend Equivalency under Section 302(b)(1) (1968). The author suggests a two-fold test from the standpoint of both the shareholder and the corporation:

Looking at the effect of the redemption on the shareholder, the court should inquire whether he relinquished some significant part of his interest in the corporation; thereby transferring adequate consideration in exchange for the distribution to him; considering the effect on the corporation, the inquiry should be whether the redemption was dictated by the exigencies of the corporation's business, indicating that the corporation received some bargained-for advantage
conclusion that could be drawn from a study of the cases dealing with section 115(g) was that this section could not be used as a tax planning tool by the shareholder of a closely held corporation. On the contrary, section 115(g), and more recently section 302(b)(1), were last resorts which were used only when improper planning occurred and the taxpayer could not show a capital transaction under section 302(b)(2) or 302(b)(3). 26

III. The Internal Revenue Code Of 1954

In an attempt to eliminate the confusion and establish uniformity in the federal taxation of stock redemptions, the House of Representatives, when drafting the Internal Revenue Code of 1954, considered a bill 27 which eliminated the "essentially equivalent to a dividend" language contained in the 1939 Code, and substituted instead certain objective guidelines which came to be known as "safe harbors." 28 However, when the House version of the 1954 Code reached the Senate Finance Committee, the latter reinstated the language of the 1939 Code as well as incorporating most of the House's "safe harbor" provisions. 29 The Senate report stated that:

While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. This general rule is supplemented by your committee by the rule of the House bill that a redemption which is substantially disproportionate shall also qualify so as not to be taxable as a dividend. 30

As finally enacted, section 302(b)(1) contained the identical language found in section 115(g)(1), while the other three subdivisions of section

30. Id. at 44-45.
302(b) contained objective criteria from the original House bill. However, the fact that the language of these two sections is similar does not necessarily mean that Congress intended to carry over existing case law interpreting that section. In the final analysis, therefore, it is difficult to determine the extent, if any, to which the prior interpretation of the language "not essentially equivalent to a dividend" is also intended to be incorporated into section 302(b)(1) of the 1954 Internal Revenue Code.

A. The Attribution Rules

In order to fully understand the problems that have arisen in connection with section 302(b)(1), a brief examination of the attribution rules (constructive stock ownership) is necessary. In certain areas of tax law, stock owned or held by one person is considered to be constructively owned by another person or entity for tax purposes. The most common situation in which constructive ownership exists is among members of the same family. On this point section 318(a)(1)(A) states that:

An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse . . . and

(ii) his children, grandchildren, and parents.31

The attribution rules specifically apply to stock redemptions under section 302.32 At first blush, these rules appear to be most significant in determining whether a redemption is substantially disproportionate,33 or whether it qualifies as a complete and total redemption of all the shareholder's stock.34 Moreover, until recently,35 there has been considerable doubt as to whether, in considering the various factors used to determine dividend equivalence under section 302(b)(1), the attribution rules should apply at all. The question which confronted the courts in this regard was whether a judically subjective "net effect" test should include the statutory rules of constructive stock ownership. As will be discussed later in this Comment,36 this question was of primary importance in the Court's opinion in United States v. Davis37 and in this author's suggested solutions of ways to define dividend equivalence. For present purposes, however, it is sufficient that the reader be aware of the attribution rules in order to understand the responses of the Commissioner and the courts to section 302(b)(1).

32. INT. REV. CODE of 1954, § 302(c).
33. INT. REV. CODE of 1954, § 302(b)(2).
34. INT. REV. CODE of 1954, § 302(b)(3).
B. The Commissioner's Position

Pursuant to section 302(b) (1) of the Internal Revenue Code of 1954, the Commissioner of Internal Revenue promulgated a regulation in which only one transaction was specifically accorded the benefits of capital gains treatment: where a shareholder owns only non-voting preferred stock (not section 306 stock) and half of that stock has been redeemed. In addition, the regulation provides that both a pro rata redemption of stock and a redemption of an entire class of stock, if all classes of stock are held in the same proportion, are essentially equivalent to a dividend. These enumerated examples of dividend equivalence, coupled with the fact that the one example of a redemption which is not essentially equivalent to a dividend corresponds entirely with the example given in the Senate Finance Committee's report (and is therefore not a concession by the Treasury Department), strongly indicate that the Commissioner intended to construe the scope and operation of section 302(b) (1) in its narrowest form.

Subsequent to this regulation, the Commissioner has, only in a few other instances, allowed stock redemptions to be taxed at capital gains rates under section 302(b) (1). In one revenue ruling, the Commissioner agreed that section 302(b) (1) applied to a situation in which a two-man corporation, with each shareholder owning 50 percent of the common stock, redeemed a certain amount of preferred shares from one shareholder in order to allow that shareholder to equalize his preferred stock holdings with that of the other shareholder. According to the Commissioner, the redemption was not essentially equivalent to a dividend because "[t]he two shareholders are unrelated and there is no pro rata distribution in whole or in part effected by the transaction."

The Commissioner's emphasis on the fact that the distribution must not be pro rata, either in fact or through attribution, appeared in another instance where section 302(b) (1) was applied to a redemption of common stock which resulted in the parties owning 11 percent of the outstanding stock before redemption and 9 percent after redemption. While this change

38. INT. REv. CODE of 1954, § 306(a) (2), provides that where a shareholder redeems section 306 stock, the amount received shall be treated as a dividend. Section 306(c) (1) defines 306 stock. The most common example of 306 stock is stock received as a dividend for which the shareholder paid no tax upon receipt. The purpose of section 306 is to prevent stock bail-outs - i.e., instead of issuing a taxable cash dividend, the corporation issues a non-taxable stock dividend which the recipient then sells at capital gains rates.
41. See note 29 supra.
44. It was necessary that the shareholders be unrelated because of the attribution rules contained in section 318. If the redeeming shareholder was related, then the distribution would not have changed the constructive ownership position of the shareholders in relation to the corporation, therefore making the distribution essentially equivalent to a dividend.
in ownership would not be a "substantially disproportionate" redemption under section 302(b)(2), it was nonetheless not essentially equivalent to a dividend because "more than 89 percent of [the corporation's] stock was at all times held by persons not closely related to or associated with the selling shareholders, their beneficiaries, or the families of the beneficiaries." 47

In another instance the Commissioner applied section 302(b)(1) to a complete redemption of the preferred stock of a corporation because there was "no proportional relationship or pattern of stock ownership existing between the holders of the two classes of stock." 48

Finally, capital gains treatment was allowed on another occasion to a pro rata redemption of 20 percent of a corporation's preferred stock. The reason posited for the application of section 302(b)(1) in this situation was that both common and preferred stock were held by diverse parties in different proportions and "no single shareholder or family group had more than 25 percent of the voting power." 49

From the foregoing examples, it appears that the Commissioner has retreated from his position that a redemption of preferred or common stock must not be pro rata to a position whereby a pro rata redemption of preferred stock will qualify for capital gains treatment if, in addition, there is a lack of voting power in those shareholders whose stock is being redeemed and the ownership of common stock is not proportionate to the ownership of preferred stock.

C. The Judicial Decisions

Since section 302 provided specific "safe harbors" for capital gains treatment, the incorporation of a subjective dividend equivalence test caused confusion among the courts. As a general rule, the courts continued to apply the same factors and considerations which they had applied in calculating the net effect of the redemption under section 115(g) of the 1939 Internal Revenue Code. 50 For the most part, the courts looked to see if the net effect of the redemption was the same or similar to a distribution of cash or property. In determining this net effect, however, the courts began to disagree on the relevant factors to be considered, and there arose two lines of cases with distinct theories.

1. Strict Net Effect

One line of cases developed what is known as the strict net effect test. Followed unequivocally in the Second Circuit, 51 and to a lesser degree

---

47. Id.
51. E.g., Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967); Hasbrook v. United States, 343 F.2d 811 (2d Cir.), cert. denied, 382 U.S. 834 (1965); Himmel v. Commissioner, 338 F.2d 815 (2d Cir. 1964); Wilson v. United States, 257 F.2d 534
in the First\textsuperscript{52} and Third Circuits,\textsuperscript{53} this test considered only the final effect of the distribution without considering the motives or purpose behind the redemption. The two main factors considered were whether the redemption was made pro rata to all shareholders\textsuperscript{54} and whether there was a substantial change in ownership or control, oftentimes expressed as a significant modification of the shareholder's interest.\textsuperscript{55}

Other factors which have been considered by the courts in determining the strict net effect are those which were considered under the 1939 Code. One such factor involves a determination of whether there has been a corporate contraction.\textsuperscript{56} The redemption and cancellation of stock, coupled with a corporate contraction, would indicate that the net effect of the reduction of capital was not essentially equivalent to a dividend.

Courts have also considered the past dividend policy of the corporation, reasoning that a sudden distribution, where there have been few dividends in the past, is equivalent to a concealed dividend.\textsuperscript{57} Another factor which has been considered in applying the strict net effect test is the availability of earnings and profits,\textsuperscript{58} since the Code defines a dividend as a "distribution of property made by a corporation to its shareholders out of earnings and profits . . . ."\textsuperscript{59} One final factor which is sometimes considered is whether the redemption was initiated by the shareholder or the corporation,\textsuperscript{60} the former tending to prove dividend equivalence.

\begin{itemize}
\item \textsuperscript{52} E.g., Wiseman v. United States, 371 F.2d 816 (1st Cir. 1967); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).
\item \textsuperscript{53} E.g., Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957).
\item \textsuperscript{54} See Harry F. Cornwall, 48 T.C. 736, 749 (1967), where the court noted that because of the various differences in the attributes of preferred and common stock: the element of a disproportionate distribution has generally been considered to be of more weight in determining whether a redemption is essentially equivalent to a dividend in the case of preferred stock than in the case of voting common stock.
\item \textsuperscript{55} See Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962), where the court said that to avoid dividend treatment, the redemption of stock must cause "a meaningful change in the position of the shareholder with relation to his corporation and the other shareholders." Id. at 116. See also Levin v. Commissioner, 383 F.2d 521 (2d Cir. 1967); Hasbrook v. United States, 343 F.2d 811 (2d Cir.), cert. denied, 382 U.S. 834 (1965); Himmel v. Commissioner, 338 F.2d 815 (2d Cir. 1964); Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957); Perry S. Lewis, 47 T.C. 129 (1966); Moore, Dividend Equivalency — Taxation of Distributions in Redemption of Stock, 19 TAx L. Rev. 249, 256 (1964), where the author takes the position that the only criterion to be used in determining net effect is whether there was a significant modification of the shareholder's interest: "Indeed, it may be argued that under section 302(b)(1) a distribution in redemption of stock must effect such a modification [of the shareholder's interest] or be considered ipso facto a dividend."
\item \textsuperscript{56} See Wilson v. United States, 257 F.2d 534 (2d Cir.), cert. denied, 358 U.S. 893 (1958); Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957); Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957).
\item \textsuperscript{59} Int. Rev. Code of 1954, § 316(a).
\item \textsuperscript{60} See Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957).
\end{itemize}
In regard to the above factors, it is submitted that it is erroneous for a court to consider the availability of earnings and profits and that it is of questionable relevance to consider the presence or absence of a corporate contraction. Both the comments made by the Senate Finance Committee and a Treasury Regulation directly on point clearly indicate that the availability of earnings and profits should not be a consideration in determining whether a redemption qualifies under section 302(b)(1). Furthermore, since the drafters of the 1954 Internal Revenue Code have provided a separate section for partial liquidations, it is doubtful that a corporate contraction tending to prove a partial liquidation under section 346 should also be a factor in determining dividend equivalence under section 302(b)(1).

2. Flexible Net Effect

The flexible net effect test, which is followed in all of the other circuits, is merely a modification of the strict net effect test. In addition to considering whether or not the net effect of the redemption is similar to a dividend, this test also considers whether or not the corporation had a legitimate business purpose in connection with the stock redemption. The presence of a business purpose will not in and of itself prove that the redemption is

---

61. See note 19 supra.
62. Id.
63. Int. Rev. Code of 1954, § 346, states in relevant part:
   (a) In General. — For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—
      (2) the distribution 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.
   (b) Termination of a Business. — A distribution shall be treated as a distribution described in subsection (a)(2) if the requirements of paragraphs (1) and (2) of this subsection are met.
      (1) The distribution is attributable to the corporation’s ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.
      (2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part

64. Treas. Reg. § 1.346-2 (1955), states that if a redemption qualifies as a partial liquidation under section 346, then section 302 shall not be applicable to the redemption. See also B. Bittker & J. Eustice, supra note 42, at 278.
65. Bains v. United States, 289 F.2d 644 (Ct. Cl. 1961); United States v. Carey, 289 F.2d 531 (8th Cir. 1961); Heman v. Commissioner, 283 F.2d 227 (8th Cir. 1960); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958); Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957); Earle v. Woodlaw, 245 F.2d 119 (9th Cir.), cert. denied, 354 U.S. 942 (1957); Jones v. Griffin, 216 F.2d 885 (10th Cir. 1954); John A. Decker, 32 T.C. 326 (1959), aff’d, 286 F.2d 427 (6th Cir. 1960); E.H. Stolz, 30 T.C. 530 (1958), aff’d mem., 267 F.2d 482 (5th Cir. 1959).
not essentially equivalent to a dividend. Instead, a business purpose will just be another factor to consider in determining the final outcome.

Courts which follow the flexible net effect approach are themselves split as to where the business purpose must lie. Many courts have taken the position that the business purpose must relate to the stock redemption, not to the issuance of the stock which was later redeemed. Other courts, on the same set of facts, have held that if the issuance of the stock was done with a legitimate business purpose and at the time it was understood that the stock would eventually be redeemed, then the redemption is considered to have satisfied the flexible net effect test.

Two final points should be noted in connection with the flexible net effect test. First, the legitimate business purpose must be that of the corporation, not the redeeming shareholder. Second, the avoidance of taxes by the corporation is not considered a legitimate business purpose which will enable the shareholder to claim the benefits of section 302(b)(1).

3. Alternative-Method Approach

It has been suggested that there is a third test which is different than both the strict and flexible net effect tests. This third test, called the alternative-method approach, provides that:

[T]he form of the transaction is disregarded, and if the parties' purpose could have been accomplished equally as well by means which did not result in a distribution of cash or other assets to the shareholders, then the distribution will be considered essentially equivalent to a dividend.

Although this approach has been called a third test, it seems clear from an examination of the leading case of Kerr v. Commissioner that it is merely a technique for determining the presence or absence of a business purpose under the flexible net effect test. In Kerr, the taxpayer argued that the stock redemption served the valid business purpose of creating a parent-subsidiary relationship between two corporations in order to strengthen...
their credit position, facilitate the free flow of cash between the corporations, and enable the corporations to conserve cash in taxes through the filing of consolidated returns. In rejecting the taxpayer's contention that a sufficient business purpose was established for the transaction not to be considered essentially equivalent to a dividend, the court stated:

A taxpayer should not be allowed to avoid the statutory scheme when he could have accomplished all the business purposes he purports to have wished to accomplish, without in effect obtaining a dividend.78

4. The Supreme Court's Solution: United States v. Davis

It is against this background that the Supreme Court in United States v. Davis74 decided to consider the scope of section 302(b)(1) and to attempt to resolve the questions carried over from section 115(g) of the 1939 Internal Revenue Code. In Davis, the taxpayer and another unrelated individual formed a corporation to manufacture steel castings. The corporation issued 1000 shares of common stock — 250 to the taxpayer, 250 to his wife and 500 to the other individual. Subsequently, the corporation negotiated a loan through the Reconstruction Finance Corporation75 (RFC) which required, as a prerequisite to eligibility for the loan, that the corporation's working capital be increased. In order to increase the current assets of the corporation, the taxpayer made an additional cash contribution to the corporation by purchasing 1000 shares of preferred stock at a price of $25 per share, with the understanding that the corporation would redeem the preferred stock when the loan was repaid and the working capital requirement was no longer necessary.76

In 1963 the loan was finally repaid and the corporation, pursuant to the original understanding, redeemed all of the taxpayer's preferred stock for $25,000 (the amount the taxpayer had originally paid). In the interim, between the time the loan was obtained and the time that it was repaid, the taxpayer had purchased the other individual's 500 shares of common stock and distributed them equally between his son and daughter.

On his 1963 federal income tax return, Davis reported the stock redemption as a capital gains transaction, resulting in no gain. The Commissioner disapproved of this tax treatment and took the position that the redemption was essentially equivalent to a dividend and therefore the total $25,000 was taxable at ordinary income rates. Davis paid the tax deficiency and then brought suit in the Federal District Court for the Middle District of Tennessee77 claiming a refund. The district court took

73. Id. at 236.
74. 397 U.S. 301 (1970).
76. This prior understanding was necessary so that the courts would find a business purpose connected with the redemption of the stock. See notes 66 supra & 78 infra.
the position that the test under section 302(b)(1) was the same as that employed under section 115(g) of the 1939 Code, i.e., what was the net effect of the transaction? Applying the flexible net effect test, the court noted that the corporation issued the stock for the valid business purpose of obtaining a loan and that the taxpayer was merely placing himself in the same position that he was in prior to the RFC loan. Having satisfied the business purpose test, the court thus concluded that the distribution was not essentially equivalent to a dividend.

The government appealed the decision; but the Sixth Circuit affirmed noting that the main purpose behind section 302(b)(1) was to prevent tax avoidance through stock bailouts, and that the transaction in the instant case was not done for the purpose of tax avoidance. Another factor that influenced the court was the fact that during oral argument, the government conceded that it would not have objected to Davis' tax treatment of the redemption had the corporation redeemed the stock when Davis only owned 50 percent of the common, rather than 100 percent, because there would not have been a pro rata distribution in the former situation. The court felt that the tax consequences should not change merely because Davis acquired the additional shares in the interim.

The Supreme Court granted certiorari to consider two issues: (1) whether the attribution rules apply in determining the net effect of a distribution under section 302(b)(1); and (2) whether the redemption of preferred stock originally issued to qualify for an RFC loan is “essentially equivalent to a dividend.”

Addressing himself to the first issue, the taxpayer argued that the attribution rules contained in section 318(a) should not apply in determining whether a distribution is essentially equivalent to a dividend under section 302(b)(1). He contended that under this approach he would own only 25 percent of the corporation's common stock and the redemption would then qualify under section 302(b)(1) because it would not have been pro rata. While the plain language of section 302 states that the attribution rules are applicable “in determining the ownership of stock for purposes of this section,” Davis pointed out that there is no explicit reference to “stock ownership” under 302(b)(1) as there is in 302(b)(2) and 302(b)(3).

In rejecting this argument, the Court noted that “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

---

78. In the district court, the government argued that notwithstanding the flexible net effect test, there was no business purpose connected with the redemption. The court, however, noted that there was a valid business purpose related to the issuance of the stock and that the stock was redeemed in connection with that purpose. *Id.* at 471.
80. *See note 38 supra.*
81. 408 F.2d at 1143.
83. *Id.* at 305-06.
treasury regulation, and the opinion of the leading commentators.\(^{85}\) Furthermore, the Court stated that the attribution rules had to apply to section 302(b)(1) because they would be otherwise effectively eliminated from consideration under section 302(b)(2) and 302(b)(3). If the transaction failed to qualify under the latter subsections as a result of attribution, then, according to the taxpayer's argument, the transaction would nonetheless qualify under section 302(b)(1). Viewing this result as fatally inconsistent the Court stated:

> 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), [the] taxpayer must be deemed the owner of all 1,000 shares of the company's common stock.\(^{86}\)

However, even if the Court had held that the attribution rules were not applicable to section 302(b)(1), the Court could have nonetheless considered the taxpayer to be the owner of all the company's stock. Looking at the family relationships involved, the Court could have enunciated a judicial doctrine which would have had the same effect as the statutory attribution rules. There is precedent for such an approach. Prior to the Code section pertaining to family partnerships,\(^{87}\) the Court formulated its own rule whereby in order for a wife to be considered the husband's partner and thus have the income split between the two parties, the partnership had the burden of proving that the wife contributed capital or "vital services."\(^{88}\) If the Court, absent a Code provision, could declare that income paid to one partner was in fact attributable to the other, it could also declare that stock owned by one party was attributable to another.

Turning to the second issue in the case, the Court concluded that a redemption of stock from a sole stockholder is always essentially equivalent

\(^{85}\) United States v. Davis, 397 U.S. 301, 306 & nn.5-7 (1970). But see Perry S. Lewis, 47 T.C. 129 (1966). In Lewis, the taxpayer owned 49.5 percent of the stock and his sons owned the remainder. Out of a desire to retire and place management in the sons' hands, the taxpayer had the corporation redeem all of his shares. The distribution did not qualify as a complete termination of the shareholder's interest under section 302(b)(3) because he remained an officer (albeit inactive) in the corporation. Nonetheless, and with no consideration whatsoever of the attribution rules, the court held that a stock redemption for retirement purposes was not essentially equivalent to a dividend under section 302(b)(1).


\(^{87}\) Int. Rev. Code of 1954, § 704(e)(2), states, in relevant part:

> [T]he distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital.

\(^{88}\) Commissioner v. Tower, 327 U.S. 280 (1946); Lusthaus v. Commissioner, 327 U.S. 293 (1946). This "capital or vital services" test was later changed, so that in order for a family partnership to be valid for tax purposes, it had to be shown that the parties, in good faith and acting with a business purpose, intended to join together in the conduct of an enterprise. Commissioner v. Culbertson, 337 U.S. 733 (1949).
to a dividend.\textsuperscript{89} In reaching this conclusion the Court reasoned that since the taxpayer owned 100 percent of the common stock prior to redemption and 100 percent after redemption, there was no discernible effect other than that of a dividend.\textsuperscript{90}

Although the taxpayer argued that the language contained in section 302(b)(1) was a continuation of the existing law before 1954, which presumably included the business purpose factor,\textsuperscript{91} the Court took the position that the history of the 1954 legislative revisions showed that Congress did more than merely re-enact prior law in section 302(b)(1). Referring to the Senate Finance Committee report,\textsuperscript{92} the Court declared:

\begin{quote}
[T]hat by making the sole inquiry relevant for the future the narrow one [of] 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.\textsuperscript{93}
\end{quote}

Although the Court concluded that Congress, in finally passing the 1954 Code, rejected past court decisions that had considered factors indicating the presence or absence of a business purpose, it conceded that the "legislative history is certainly not free from doubt."\textsuperscript{94} On the one hand, the Senate Finance Committee stated in no uncertain terms that "under this subsection your committee intends to incorporate into the bill existing law as to whether or not a redemption is essentially equivalent to a dividend under section 115(g)(1) of the 1939 Code. . . ."\textsuperscript{95} On the other hand, it has been suggested that:

\begin{quote}
[t]he 1954 intent to give [section] 346 jurisdiction over redemptions "characterized by what happens solely at the corporate level" indicates
\end{quote}


\textsuperscript{90} See Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967), and Hasbrook v. United States, 343 F.2d 811 (2d Cir. 1965), where the Second Circuit held that in a one-man corporation, the redemption of preferred stock is always pro rata and causes no change in ownership and is therefore always essentially equivalent to a dividend. Although this conclusion appears highly logical at first glance, some unfortunate results can follow. In \textit{Levin}, the taxpayer owned 484 shares, her son owned 331 shares, and her brother owned the remaining 485 shares. In order to comply with the son's desire to acquire the entire business, the taxpayer and her brother redeemed all of their shares. Although normally a complete redemption qualifies for capital gains treatment under section 302(b)(3), this section did not apply here because, among other reasons, the taxpayer remained a director and officer of the corporation. Furthermore, the court attributed all the son's stock to the taxpayer with the result that after the redemption, the taxpayer owned 100 percent of the stock as compared to approximately 60 percent prior to the redemption. This result led the court to hold that "when no reduction, but rather an increase, in control occurs, [a] taxpayer has not parted with anything justifying capital gain treatment." \textit{Id.} at 528.

\textsuperscript{91} According to the government, it was improper even under the 1939 Code to consider the presence or absence of a business purpose for the redemption. 397 U.S. at 310. \textit{See}, e.g., Patty v. Helvering, 98 F.2d 717 (2d Cir. 1938). Furthermore, the government again argued that even if business purpose was relevant, the business purpose must relate to both the original investment and the redemption. 397 U.S. at 307-08 n.9. Since the Court rejected the business factor consideration, it did not answer these two contentions.


\textsuperscript{93} 397 U.S. at 311.

\textsuperscript{94} \textit{Id.}

that the "business purpose" cases of pre-1954 law are not applicable under \[section\] 302(b)(1) .

The elimination of the business purpose factor, whether or not supported by legislative history, results in a more sensible approach to section 302(b)(1). If a stock redemption closely resembles a corporate dividend, then the purpose which motivated the redemption should not act to "convert" the dividend into a sale. Also, the elimination of business purpose will, at least to some degree, make the determination of a transaction's net effect more objective, since the courts will no longer have to delve into the corporation's intent in redeeming the stock.

In his argument for the inclusion of the business purpose factor, Davis asserted that to consider the transaction in the instant case to be essentially equivalent to a dividend would be to elevate form over substance. Clearly if Davis had made a subordinated loan to the corporation and received in return a debt instrument rather than preferred stock, he would have had his $25,000 returned tax-free. Nonetheless, this costly improper tax planning could not be saved by looking to alternative means. According to the Court, the fact that Davis could have planned the transaction in another way was irrelevant. It was also significant to the Court that the net effect of this redemption, irrespective of its purpose and the absence of a tax avoidance motive, was a pro rata distribution of corporate property without any real consideration being given up by the taxpayer.

Finally, it should be noted that the Court limited itself to two conclusions concerning section 302(b)(1): (1) that a redemption of some of the shares of a sole shareholder will always be essentially equivalent to a dividend; and (2) that business purpose is not a factor which should be considered in determining the net effect of a redemption. Beyond this holding, the Court failed to furnish any basic guidelines or objective criteria which would enable the courts to determine when a distribution will fall within section 302(b)(1). Instead, the Court concluded, in somewhat ambiguous terms, that:

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.

96. B. BITTKER & J. EUSTICE, supra note 42, at 293. See also note 63 supra.

97. 397 U.S. at 312-13.

98. There would be no tax in this instance because the payment of principal on the debt will be a recovery of basis to the creditor to the extent that the payment equals the adjusted basis of the debt.

99. Id. at 312.

100. Id. at 307. In a dissenting opinion, Mr. Justice Douglas, joined by Mr. Justice Brennan, argued that a holding that a redemption by a one-man corporation will always be equivalent to a dividend would effectively cancel section 302(b)(1) from the Code, a revision best left to Congress. Id. at 314.

101. Id. at 312.

102. Id. at 313 (emphasis added).
IV. BEYOND DAVIS: SUGGESTED APPROACHES TO A MEANINGFUL REDUCTION OF INTEREST

If the Court in Davis had adopted specific guidelines to measure dividend equivalence under section 302(b)(1), the decision would have successfully ended over thirty years of confusion. On the other hand, if the Court had carefully limited its language and holding to the facts before it, then one could have rightfully assumed that the Davis case had limited application only to one-man corporations. However, by suggesting that the sole test of dividend equivalence is whether or not there has been a meaningful reduction of the shareholder's proportionate interest, the Court has raised several questions which the courts, in interpreting the meaning of this language, will have to answer.

A. What is "Interest"?

Before any conclusion can be drawn as to whether a stock redemption results in a "meaningful reduction in the shareholder's proportionate interest," a determination of the meaning of the word "interest" must first be considered. Two questions seem to emerge from this consideration. They are: (1) does the term "interest" refer to a shareholder's total equity in the corporation; or (2) does it refer merely to a shareholder's control (voting) interest. The Davis decision is silent as to what the proper meaning should be.

The only other utilization of the term "interest" in section 302(b) is contained in section 302(b)(3) which provides for capital gains treatment of a redemption which is in full termination of a shareholder's interest. Under this subsection, a termination of one's interest is defined as a "redemption of all of the stock of the corporation owned by the shareholder." 103 Unlike subsection (b)(2) which measures the substantial disproportionateness of a redemption by the extent of ownership of voting stock in one place 104 and by the extent of ownership of common stock (both voting and nonvoting) in another place, 105 subsection (b)(3) measures the termination of a shareholder's interest by the redemption of all stock, including both common and preferred and voting and nonvoting. In fact, according to the Commissioner, a total termination of one's interest under section 302(b)(3) involves a termination of any beneficial interest one may have, 106 as well as the termination of all legal interest. In applying the definition of "interest" in section 302(b)(3) to the Court's use of that term in the instant case, one can only surmise that a meaningful reduction of "interest" must therefore refer to the shareholder's equity, or total stock holdings irrespective of the control feature. This conclusion is further sup-

103. INT. REV. CODE of 1954, § 302(b)(3).
106. See note 6 supra.
ported by an examination of the one example of a qualifying stock redemption under section 302(b)(1) mentioned by the Senate Finance Committee and the Internal Revenue Treasury Regulation. In both instances, it was pointed out that the redemption of preferred stock from a minority shareholder was "not essentially equivalent to a dividend." Hence, in defining the term "interest," the emphasis has been placed upon the reduction of one's equity rather than one's control.

B. What is a "Meaningful" Reduction?

Since section 302(b)(2) qualifies the taxpayer for capital gains treatment when there is a "substantially disproportionate" redemption as measured by the 80 percent rule, it is safe to assume that a "meaningful" reduction under section 302(b)(1) envisions something less than a 20 percent reduction in interest. Yet, the question of how much less remains unanswered. If a substantial reduction is more than 20 percent, then one might argue that a meaningful reduction would certainly be 18 percent. However, if this were the case, then section 302(b)(2) would be effectively eliminated from the Code, because any near-miss under the latter subsection would nonetheless qualify under 302(b)(1). If, as the Court in Davis noted, the attribution rules must apply to section 302(b)(1) in order to retain the effectiveness and congressional intent of section 302(b)(2), then too, if Congress chose 80 percent as the cut-off point, it is doubtful that a proportionate reduction of less than 20 percent should qualify as a "meaningful" reduction.

Accordingly, it is suggested that unlike the term "proportionate," "meaningful" should not be measured quantitatively as a percentage; but rather, similar to the judicial doctrine of "net effect," it should be measured by the surrounding facts of each case. Although the Court has ruled that the attribution rules apply to section 302(b)(1), the surrounding circumstances of the transaction should be examined to see if, in any particular case, the position and relationship of the parties is such that attribution may in reality be a fiction, and that, absent a mechanical rule of attribution, there has been a real and meaningful reduction of the shareholder's stock interest.

For example, in Estate of Squier, the redemption of corporate stock owned by an estate resulted in that estate owning 63.3 percent of the stock prior to the redemption and 56.8 percent of the stock after redemp-

109. INT. REV. CODE of 1954, § 302(b)(2), provides, among other things, that a redemption is substantially disproportionate when the shareholder's percentage of the total outstanding voting stock immediately after the redemption is less than 80 percent of his ownership of such stock immediately before the redemption, and the shareholder's percentage of all outstanding common stock after the redemption is less than 80 percent of his ownership before the redemption.
110. 35 T.C. 950 (1961).
tion. This is certainly not either a "substantial" or a "meaningful" reduction. However, if the stock owned by the beneficiaries was not attributable to the estate,\(^{111}\) then the estate's real ownership dropped from 50.09 percent before redemption to 41.27 percent after redemption. Since, in reality, the estate no longer held a majority control, and, since the beneficiaries were in sharp disagreement with the estate's trustee as to how the corporation should be managed, there was a meaningful reduction of the estate's interest which was not essentially equivalent to a dividend. When the attribution rules are applied the total reduction is only 10 percent, but the true change in ownership is much more meaningful.\(^{112}\)

Similarly, in *Herbert C. Parker*,\(^{113}\) a stock redemption caused the taxpayer's attributable interest to drop from 97.7 percent to 96.7 percent. By eliminating attribution of his son's stock, the taxpayer's real interest dropped from 50.03 percent to 28.7 percent. The court, holding that the 1 percent reduction was indeed meaningful and not essentially equivalent to a dividend noted:

> The effect of the redemption was to transfer effective control of the corporation from Parker to his son, with whom he had had substantial controversy about the running of the business prior to the redemption. This transfer of control, preceded by disagreements as to the management of the Company, so affects the total factual picture as to persuade us that, notwithstanding the family relations involved, this redemption of petitioners' stock only was not essentially equivalent to a dividend.\(^{114}\)

Although it is believed that the test of a meaningful reduction should be applied in the same manner as it was applied in the *Squier* and *Parker* cases, there is one warning that should be noted. Anytime that a taxpayer is permitted to introduce evidence to prove that the attribution rules are not really measuring the true post-redemption control of the corporation, there is a great opportunity for fraud and perjury. Having the father and son, or the trustee and beneficiaries, attest to business differences, when both parties are interested in the same or similar tax result, will only serve to further confuse the court and befuddle the real issue in the case, *i.e.*, dividend equivalence. Rather than looking at the net effect of the distribution, the courts will have to hear collateral testimony pertaining to family relationships. Therefore, it is suggested that either the court pro-

---

111. *Int. Rev. Code* of 1954, § 318(a) (3) (A), states that: "[s]tock owned directly or indirectly, by or for a . . . beneficiary of an estate shall be considered as owned by the . . . estate.

112. In *Henry McK. Haserot*, 46 T.C. 864 (1966), *aff'd* sub nom. Commissioner *v. Stickney*, 399 F.2d 828 (6th Cir. 1968), the taxpayer, relying on *Squier*, argued that attributing ownership of two corporations to him through ownership of another corporation's shares was "unreal." The court however distinguished the *Squier* case and limited its application to situations in which the taxpayer's direct ownership falls below 50 percent as a result of the redemption.


114. *Id.* at 899-900. *See Moore, supra* note 55, at 252-55.
mulgate strict evidentiary standards in this type of situation, or in the alternative, allow only certain evidence (such as a husband-wife separation not evidenced by court decree)\textsuperscript{115} to show the fiction of a strict application of the attribution rules.

V. IN LIEU OF DAVIS: AN "ECONOMIC BENEFIT" APPROACH

After reviewing the dividend equivalency test enunciated by the \textit{Davis} Court, its propriety still seems very much open to question. In deciding that the transaction was essentially equivalent to a dividend, the Court in effect compared the stockholder's position immediately prior to the redemption with his position immediately after the redemption, and concluded that there was no discernible difference in his ownership of the corporation. As a result of attribution, Davis owned 100 percent of the stock before redemption and 100 percent after redemption.

However, a fairer result might have been obtained if the Court had begun its initial inquiry at the point in time that the shareholder received the stock which was later redeemed. If the Court had compared Davis' position prior to the issuance of the preferred stock with his position after the redemption, it would have been evident that he derived no economic benefit from the transaction and therefore should not have been subject to a taxable income of $25,000 which was, in reality, only a return of his original investment.

This "economic benefit" approach was suggested by the Tax Court in \textit{Joe L. Smith, Jr.}\textsuperscript{116} In \textit{Smith}, a case factually similar to \textit{Davis}, the corporation redeemed shares which it had originally issued in order to improve its balance sheet in connection with an application for a television station which was pending before the Federal Communications Commission. In holding that the redemption was not essentially equivalent to a dividend, the Court measured the net effect by viewing the issuance and redemption of the stock as one transaction, rather than looking only at the net effect of the redemption. The Court stated that:

\begin{quote}
The redemption of petitioner's stock merely was the final step taken in the completion of the corporation's original purpose in the issuance of such shares. Petitioner did not enjoy any monetary or other economic benefit as a result of these transactions.\textsuperscript{117}
\end{quote}

The "economic benefit" approach does not depend upon any consideration of a valid business purpose. However, the absence of a business purpose will most likely correspond with the presence of an economic benefit. The main advantage of this approach, as opposed to the approach

\begin{itemize}
\item \textsuperscript{115} Internal Revenue Code of 1954, § 318(a)(1)(A)(i), states in relevant part, "An individual shall be considered as owning the stock owned . . . by . . . his spouse [unless legally separated under a divorce or separation decree]. . . ."
\item \textsuperscript{116} 49 T.C. 476 (1968).
\item \textsuperscript{117} \textit{Id.} at 484.
\end{itemize}
taken by the *Davis* Court, is that by viewing the transaction in its entirety a court can fairly measure the receipt of income by a shareholder. Since income is defined as "the gain derived from capital, from labor, or from both combined,"\(^\text{118}\) it can be readily seen that Davis, having transferred $25,000 to the corporation and subsequently reacquiring it, received no income on the transaction. He derived no "gain . . . from capital," and, in addition, obtained no economic benefit from the stock redemption. Therefore, it seems reasonable to conclude that in the absence of an economic benefit, the redemption cannot be considered essentially equivalent to a dividend.

**VI. CONCLUSION**

Ultimately the courts will have to experiment with numerous factors in an effort to define meaningful reductions of interest which are not essentially equivalent to a dividend. Discarding such factors as business purpose and corporate contractions, which were previously used to measure the net effect of a corporate distribution, the courts will now examine such factors as the ownership percentage subsequent to redemption and the family relationships where attribution is involved.

It is perhaps unfortunate that the one conclusion which can be drawn from the test of dividend equivalence enunciated in the *Davis* case is that section 302(b)(1) will still be useless for tax planning purposes and will continue to be an area replete with litigation and controversy.

*Alan R. Gordon*

---

\(^{118}\) Eisner v. Macomber, 252 U.S. 189, 207 (1920). See INT. REV. CODE of 1954, § 61(a), which states that "gross income means all income from whatever source derived. . . ."