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COMPLETE STOCK REDEMPTION IN A FAMILY CORPORATION: A WARNING ABOUT THE PITFALLS OF TWO STANDARDS

I. INTRODUCTION

The shareholder in a family business, who has built his nest egg for retirement by developing a closely held corporation and increasing the value of his equity therein, has one major tax planning problem in finding a method of liquidating his interest so as to realize the fruits of his labor to the maximum possible extent. Generally, minimized tax consequences are secured through capital gains treatment of the sale or exchange of his stock interest. Although the shareholder would in almost all cases be entitled to this tax preference if the stock were transferred to an unrelated third person, the very nature of a closely held corporation militates against both the availability and desirability of a transaction cast in that form. It is dubious that any market for these securities would exist, and it is even more

1. See generally Holloway, Closely Held Corporations — Pre-Termination Planning, 32 N.Y.U. Tax Inst. 785 (1974). Very typically, the founder and guiding light of the small business is also its major, if not its majority, shareholder and creditor. His fiduciary duty to increase the net worth of the corporate assets coincides with his private interest as an equity participant, insofar as the factor of net worth bears on the value of his share in the venture. See generally J. KRAHMER & T. HENDERER, VALUATION OF SHARES OF CLOSELY HELD CORPORATIONS (Tax Management Portfolio No. 221 1973).

2. Except in the rare event that the retiring shareholder is in the business of selling stock, the shares will be a capital asset in his hands. I.R.C. § 1221(1). The sale or exchange of a capital asset, if held for the period of the statutory minimum or longer, will result in the realization of long-term capital gain or loss. Id. § 1222(3), (4). Since the shareholder in a closely held corporation will invariably meet the holding period requirement, he may either deduct 50% of the long-term capital gain from his gross income, id. § 1202, or elect to have such gain taxed according to a three-tiered alternative tax scheme. Id. § 1201(b).

3. The lone exception to this rule appears in the sale or exchange of § 306 stock. I.R.C. § 306(c). In general, the amount realized from the transaction is treated as “gain from the sale of property which is not a capital asset.” I.R.C. § 306(a)(1)(A) (1976). Most often, § 306 is stock issued as a stock dividend (other than common on common), which by reason of § 305(a) was not includible in the shareholder’s gross income at the time of the receipt, and will be includible at the time of its disposition to the same extent as if the shareholder had received money rather than stock. Id. § 306(c)(1)(A).

4. To insure a continuing coincidence of management and ownership, dispositions to an unwanted outsider are often precluded by various restrictions imposed on the transferability of the stock by the articles of incorporation or by the by-laws. J. KRAHMER & T. HENDERER, supra note 1, at A-3. In the alternative, or in addition to the aforementioned limitations, restraints on the alienation of stock may arise from buy-sell arrangements between the shareholders and the corporation. See generally W. DONALD, CORPORATE BUY-OUT AGREEMENTS (Tax Management Portfolio No. 106-3rd 1975).

5. Even in the absence of restraints on the alienation of the stock, few outsiders — individual or institutional — would seek such an investment, inasmuch as it lacks...
unlikely that the taxpayer would want the benefits of capital gains treatment at the sacrifice of maintaining operational control within the family group — a consideration which may have prompted the selection of the corporate organization initially. Transferring the stock to the corporation itself may well be the only practicable means by which the retiring shareholder can recognize any economic gain at all while preserving the restricted circle of management to the family unit. Yet, however clearly a redemption of stock may be indicated, uncertainty persists in the tax consequences to be accorded the redeeming shareholder.

As a general proposition, the purchase by a corporation of its own shares is deemed for tax purposes to be a distribution in the nature of a dividend for which the redeeming shareholder will recognize ordinary income. Presumably, this policy reflects the fear that a shareholder, particularly one in a closely held corporation, can too easily use redemption as a means of avoiding taxation of distributions of corporate earnings as dividends. Accordingly, the redeeming shareholder must fit the disposition

the security of a readily accessible market in which the shares could be resold. It has been suggested that perhaps only the lure of obtaining a stepped-up basis in appreciated inventory assets at a capital gains rate by a complete liquidation following the redemption would induce anyone outside the natural orbit of the immediate family to purchase the stock. See J. Krahmer & T. Henderer, supra note 1, at A-47. For a general discussion of the issues involved, see also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 11-15 to 11-18 (3d ed. 1971).

6. Furthermore, the enterprise in corporate form may in large measure be predicated upon the tax advantages afforded to small businesses electing under Subchapter S. I.R.C. §§ 1371-1379. Because the corporation can make the election only with the consent of all of its shareholders, transfer to a new shareholder will result in the termination of such favored status if the latter should refuse to elect such treatment within 60 days after his acquisition. Id. § 1372(e)(1)(A) (1976).

7. As a general proposition, none of the remaining shareholders in the corporation will have the financial wherewithal to purchase the stock of the retiring shareholder. In addition, few may be willing to part with personal capital when the purchase of these shares by the corporation has the effect of increasing the pro rata ownership interests of the nonredeeming shareholders. Although this amounts to a redistribution of the stock redeemed, the Internal Revenue Service (Service) has taken the position that the purchase will not be treated as a constructive dividend to the remaining shareholders merely because their percentage interests are increased. Rev. Rul. 58-614, 1958-2 C. B. 920. On the other hand, constructive dividend treatment will be accorded the nonredeeming shareholders who fail to redeem under a periodic redemption plan to the extent of the stock actually redeemed by other shareholders. I.R.C. § 305(c).

8. Section 317(b) of the Internal Revenue Code (Code) provides in pertinent part: "[S]tock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b).

9. I.R.C. § 316(a). The Code defines a dividend as any distribution of property by a corporation to its shareholders, as provided in § 301, if it is made: 1) out of earnings and profits accumulated after February 28, 1913; or 2) out of earnings and profits for the current taxable year. Id. § 316(a)(1), (2). As a general rule, any distribution of property to its shareholders is conclusively presumed to be a dividend, unless otherwise provided. Id. § 316(a).

10. Id. § 301(a). The extent to which the distribution is includible in ordinary income is limited by the definition of a dividend. Id. § 301(a)(1). See note 9 supra.

11. From the standpoint of the shareholder, the sale or exchange of his stock to the corporation in many instances should not be treated any differently than any
of his stock within one of the three general situations provided for in section 302(b) of the Internal Revenue Code (Code), in which the potential for manipulation is deemed to be outweighed by sufficient bona fides to warrant exchange treatment. Nevertheless, the express operation of rules of constructive ownership to all redemptions has made the requisite other sale of shares. See notes 2-4 and accompanying text supra. Presumably, the statutory policy is aimed at forestalling the majority shareholders from simply withdrawing corporate earnings at capital gains rates without any accompanying substantial reduction in the extent of their interests and influence in the corporation. B. BITTKER & J. EUSTICE, supra note 5, at 9-2. These leading commentators have noted:

[W]hen the owner of a one-man corporation having only common stock outstanding foregoes dividends for a period of years and then "sells" some of his shares to the corporation for cash, the transaction is more like a "dividend" than a "sale". Although the shareholder has surrendered some of his stock, his interest in the corporation's assets and his control of the corporation's fate are undisturbed. If the transaction were not taxed as a "dividend", moreover, the shareholder could enter upon a long-range program of intermittent transfers of stock, employing tax-free stock dividends if necessary to replace his shares and to restore the corporation's stated capital for the benefit of nervous creditors.

Id.

12. I.R.C. § 302(b). I.R.C. § 302(a) provides in pertinent part: "If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock." Id. (emphasis added). The first kind of redemption qualifying as an exchange is one which is "not essentially equivalent to a dividend." Id. § 302(b)(1). The status of a § 302(b)(1) redemption appears to be in some doubt following the decision of the Supreme Court in United States v. Davis, 397 U.S. 301 (1970). The Court indicated that in order for a redemption to qualify under § 302(b)(1), there must be a "meaningful reduction in the shareholder's proportionate interest in the corporation." Id. at 313. For a discussion of the extent to which Davis has rendered the "not essentially equivalent to a dividend" standard surplusage in light of the alternative "substantially disproportionate" test under § 302(b)(2), see Henkel, How to Dispose of a Decedent's Interest in a Proprietorship, Partnership, or Corporation: the Structure of, and Parties to, the Transaction, 34 N.Y.U. Tax Inst. 1557, 1568-69 (1976). In one recent ruling, however, the Service itself has affirmed the continuing vitality of § 302(b)(1) in circumstances where § 302(b)(2) would not apply. See Rev. Rul. 75-512, 1975-2 C.B. 112 (applying Davis test of "meaningful reduction"). See also note 152 infra.

The second kind of redemption treated as an exchange is a distribution which results in "substantially disproportionate" ownership by the shareholder. I.R.C. § 302(b)(2). Substantial disproportionateness has been statutorily defined for situations where:

(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.

Id. § 302(b)(2)(C)(i)–(ii).

The third kind of redemption for which the shareholder may obtain capital gains treatment is one "in complete redemption of all of the stock of the corporation owned by the shareholder." Id. § 302(b)(3).

A fourth kind of redemption qualifying for exchange treatment is limited to plans of reorganization by railroad corporations under § 77 of the Bankruptcy Act, 11 U.S.C. §§ 205-208 (1970), and has no application to the closely held corporate situation. I.R.C. § 302(b)(4).

13. I.R.C. § 318(a). Briefly, in addition to stock actually owned by him, a taxpayer is deemed to own stock owned by certain members of his family, id. § 318(a)(1); by
substantial alteration of the shareholder's interest difficult to attain in the family business context. To achieve capital gains treatment, the shareholder has been increasingly forced to rely upon a section 302(b)(3) partnerships of which he is a partner or by estates of which he is a beneficiary, id. §318(a)(2)(A); by trusts of which he is taxable as beneficiary or as owner, id. §318(a)(2)(B); and by any corporation of which he owns 50% or more in value of the stock, id. §318(a)(2)(C). For a general discussion of the operation of the attribution rules, see B. BITLER & J. EUSTICE, supra note 5, at 9-10 to 9-16.

The Code applies all the attribution rules to any redemption. I.R.C. §302(c)(1). Although §302(b)(1), by treating a redemption not essentially equivalent to a dividend as an exchange, appears to focus on the intrinsic nature of the distribution, the Service has indicated that this determination requires at least consideration of the extrinsic factor of ownership of the nonredeemed shares. Treas. Reg. §1.302-1(b) (1955). The Supreme Court has endorsed this administrative provision in United States v. Davis, 397 U.S. 301 (1970).

14. The primary area of concern and difficulty lies in the imputation of stock owned by members of the redeeming shareholder's family to him for purposes of measuring the bona fides of the transfer. Section 318 of the Internal Revenue Code provides in pertinent part:

(a) General Rule. — For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(i) Members of family. —

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

(ii) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(iii) his children, grandchildren, and parents.


While a redemption of stock may have the same effect as a pro rata stock dividend to the nonredeeming shareholders (see note 7 supra), the transfer of interest is illusory whenever the nonredeeming shareholders are all, or in part, alter egos of the redeeming shareholder. See note 11 supra. The constructive ownership rules, I.R.C. §318, serve to preclude the taxpayer from claiming as an exchange a transfer of legal title which does not divest him of beneficial enjoyment both directly and indirectly. Without attribution, the family group would be able through a simple artifice to extract earnings at capital gains rates. For example, a father could transfer some of his shares to his son who had previously owned no stock and then have the son's shares redeemed by the corporation in toto. All that has happened in substance is a momentary reallocation of legal title within the intimate family group. In this respect, constructive ownership rules may be viewed as a statutory assignment of equity doctrine to preclude this kind of device. See generally R. RICE & T. RICE, 2 FAMILY TAX PLANNING 663 (8th ed. 1975).

In the first place, the redemption will not qualify under §302(b)(1), since assuming that some of the remaining shareholders bear one or more of the prohibited familial relationships to the redeeming shareholder, the redeeming stockholder will be charged both before and after the transaction with owning that stock. It would be highly unlikely that, taking into account this imputed stock ownership, his proportionate economic interest would be meaningfully reduced by the redemption where the constructively owned shares represent any significant portion of all nonredeemed shares. See note 12 supra. Even if complete termination of interest is achieved, it does not follow that the transaction would likewise be protected under the dividend equivalency test of §301(b)(1). See note 12 supra. In fact, it is the ordinary operation of §318 which inhibits the application of the "not essentially equivalent to a dividend" standard. See, e.g., Bradbury v. Commissioner, 298 F.2d 111, 116 (1st Cir. 1962); Estate of Arthur H. Squier, 35 T.C. 950, 955 (1961), acq., 1961-2 C. B. 5; Thomas G. Lewis, 35 T.C. 71, 75-78 (1960).

Moreover, to meet the substantially disproportionate standard of §302(b)(2), the shareholder's remaining interest, after taking into account the stock interests retained by other members of his family, must be less than 50% of the total voting power of the corporation. I.R.C. §§302(b)(2)(B), (c)(1), 318. Furthermore, even if the
redemption in complete termination of stock interest as the only realistic way open to him, because only in this circumstance will the shareholder be able to avoid the application of the family attribution rules. The statutory waiver of their operation, however, is expressly conditioned upon the redeeming shareholder not retaining an association with the corporation “other than an interest as a creditor.”

The deceptively vague scope of this proviso invites litigable questions because the taxpayer in most instances will have to maintain some connection to the corporation following the transfer of the stock. In all probability, if the corporation has paid the full redemption price in cash, the shareholder cannot be denied the waiver if he retains no financial stake in the corporation whatsoever. Unfortunately, while this kind of redemption comports neatly with the statutory requirements, in practice both law and business judgment will cast the transaction in a different form. In many jurisdictions, immediate payment of the purchase price would be legally impermissible to the extent the disbursement would impair the corporate capital structure. Moreover, payment in a lump sum to a redeeming shareholder with substantial stockholdings, even if lawful, might well deplete the working capital of the corporation to the point of seriously retarding its future growth and earnings. Instead, the small corporation will

family attribution hurdle can be surmounted, subsection (b)(2) cannot ordinarily apply to any redemption of preferred stock, since the terms of the statute not only require the redeeming shareholder to hold less than 80% of his percentage interest in the voting stock of the corporation prior to the redemption but also mandate that he reduce his common stock, whether voting or not, to less than 80% of his percentage interest in the corporate common stock prior to the redemption. Id. §302(b)(2)(C); see note 12 supra.

15. I.R.C. §302(c). Section 302(c)(1)(A) will avoid only the application of the family attribution rules to a redemption in complete termination of interest. The taxpayer, however, will always be charged with owning shares under the application of all other rules of constructive ownership of §318(a). Treas. Reg. §1.302-4(f), T.D. 6969, 1968-2 C.B. 126. See note 13 supra.

16. I.R.C. §302(c)(2)(A)(i). In addition to the requisite complete termination, availability of the waiver is predicated upon the condition that “immediately after the distribution the distributee has no interest in the corporation (including an interest as an officer, director, or employee), other than an interest as a creditor.” Id.

17. Id. In addition, the redeeming shareholder is precluded from holding positions of control in corporate management. Id. The statute further requires the distributee not to acquire an interest in the corporation other than an interest as a creditor, except by bequest or inheritance of a stock interest only, within 10 years from the date of the distribution. Id. §302(c)(2)(A)(ii). This provision appears to create an irrebuttable presumption that a “complete termination” followed by a reacquisition of an interest within the stated period of time are deemed integrated steps in a single transaction. Cf. note 14 supra (momentary reallocation of legal title in son followed by redemption by son deemed redemption by father). For a general discussion of the pervasive nature of the step-transaction doctrine in the tax law, see B. Bittker & J. Eustice, supra note 5, at 14-101 to 14-103.

18. See, e.g., MODEL BUSINESS CORP. ACT §6 (1974) (only to the extent of unreserved and unrestricted earned surplus); DEL. CODE tit. 8, §160 (1974) (only to the extent stated capital is not, or will not become, impaired).

19. The generally accepted definition of working capital focuses upon the needs of the particular company: Working capital ... does not include the total liquid funds with which the business is conducted. It is not the property which the business has: that is, it is not the excess of current assets over current liabilities. Working capital, rather, is
ordinarily finance any inter vivos redemption, unlike the redemption from a decedent or his estate, of significant proportions by issuing a promissory note for the balance to be paid on an installment basis. Although the statute implicitly and judicial decisions explicitly have endorsed this redemption arrangement, proper characterization for tax purposes of the shareholder's post-redemption relationship is not conclusively determined by the fact that the instrument in its form purports to evidence a corporate debt obligation. If the note is classified in substance as a continuing equity

an allowance for the sum which the company needs to supply from its own funds for the purpose of enabling it to meet its current obligations as they arise and to operate economically and efficiently. Alaska S.S. Co. v. Fed. Maritime Comm'n, 344 F.2d 810, 823 n.17 (9th Cir. 1965), quoting Barnes, Economics of Public Utility Regulations 495 (1942) (emphasis omitted).

20. Quite often the estate of a decedent shareholder may also redeem, either pursuant to a preexisting agreement or out of the necessity of liquidating assets in order to pay the estate and death taxes. However, funding the redemption price in the post-mortem situation is a less severe problem for the corporation due to the availability of pre-mortem life insurance planning. See generally Barton, Methods of Terminating Stockholder Interests in Closely Held Corporations, 32 N.Y.U. Tax Inst. 811 (1974); Ben-Horin, Use of Life Insurance to Fund Buy-Out Agreements, 28 N.Y.U. Tax Inst. 819 (1970). The major disadvantage to this device lies in the inability of the corporation to deduct the premiums as ordinary business expenses. I.R.C. § 264(a)(1). Further relief for the estate from the danger of having the distribution treated as a dividend taxable at ordinary income rates when the redemption does not qualify under § 302 is the possible application of § 303 to redemptions, which need not be complete or substantially disproportionate, by the estate of a decedent shareholder. I.R.C. § 303 (1976). For an analysis of this provision prior to the Tax Reform Act of 1976, see generally W. Van Deman, Corporate Stock Redemptions — Section 303 (Tax Management Portfolio No. 91–3d 1974); Jacoby, Financing Estate Tax with 303 and 6166, 32 N.Y.U. Tax Inst. 79 (1974).

21. I.R.C. § 453. If the corporate notes constitute the consideration for the stock redemption, the shareholder may elect the installment method of reporting his capital gain. Estate of Lipman v. United States, 376 F.2d 455, 458 (6th Cir. 1967). See note 143 infra. Potentially, and in the alternative, a cash basis taxpayer might attempt to treat the redemption as an open transaction in order to defer recognition of gain until the basis in the redeemed stock has been recovered. See e.g., Nina J. Ennis, 17 T.C. 465 (1951).

22. The Third Circuit recognized that it was the duty of the courts "to look beyond the literal terms in which the parties have cast the transaction in order to determine its substantive nature." Fin Hay Realty Co. v. United States, 396 F.2d 694, 696 (6th Cir. 1968). It traced the origin of this obligation to the following circumstance:

In a corporation which has numerous shareholders with varying interests, the arm's-length relationship between the corporation and a shareholder who supplies funds to it inevitably results in a transaction whose form mirrors its substance. Where the corporation is closely held, however, and the same persons occupy both sides of the bargaining table, form does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will with no countervailing pull. This is particularly so where a shareholder can have the funds he advances to a corporation treated as corporate obligations instead of contributions to capital without affecting his proportionate equity interest. Labels, which are perhaps the best expression of the subjective intention of the parties to a transaction, thus lose their meaningfulness.

Id. at 697.
interest in the enterprise, or as a lesser proprietary participation in the corporate venture, then the shareholder will be denied capital gain treatment. Moreover, characterization of the note as the stock interest will also have serious tax ramifications for the corporation.

A recent shift in the administrative policy of the Internal Revenue Service (Service) has compelled the installment payout redeeming shareholder to contend not only with the possibly adverse characterization of the corporate debt instrument under section 302(b)(3), but also with the uncertain extent of the "other than an interest as a creditor" proviso of section 302(c)(2)(A)(i) in a family business situation. With respect to section 302, the Service will not ordinarily issue advance rulings or determination letters in regard to the question of whether an interest in a corporation is

24. See text accompanying note 64 infra.

25. I.R.C. §302(d). Comparison of the tax consequences which flow from successfully meeting the requirements of §302(b)(3) and §302(c)(2)(A), with those which result if the shareholder is unable to overcome one or both of these statutory hurdles, illustrates the importance to the taxpayer of obtaining §302(a) exchange treatment. First, assuming he can fit the redemption within the §302(b)(3) complete termination of interest provision, then, unless the shareholder is otherwise able to procure open transaction treatment (see note 21 supra), each installment of a §302(b)(3) redemption will consist of three parts: 1) a return of his adjusted basis in the stock, which is not taxable; 2) gain, reflecting the excess of the purchase price over his adjusted basis, which is taxable at capital gains rates; and 3) the interest value of the sum of 1) and 2) at the greater of the rate established by the parties or statutory imputed rate, id. §483, which is taxable as ordinary income. Id. §64 (1976).

In determining whether all of the stock of the shareholder has been redeemed, the family attribution rules will be applied. Id. §302(c). See also Treas. Reg. §1.302-4 (1955). If the redemption therefore fails under section 302(b)(3), the entire amount of each installment will be treated as a distribution by the corporation with respect to its stock and taxed as ordinary income to the extent it constitutes a dividend. I.R.C. §§302(d), 301(c), 316(a). The redemption might not qualify under §302(b)(3) either because the shareholder's direct interest in the corporation (the note) is reclassified as equity or because the shareholder is thereby unable to avoid his indirect interest in the corporation by virtue of the stock owned by members of his family. Moreover, if the corporate note is reclassified as equity, subsequent worthlessness of the instrument will generate only a capital loss deduction, id. §165(g), rather than an ordinary loss for a bad debt. Id. §166(e).

26. If the installments are considered to be dividends, the corporation would not be allowed any deduction for interest payments. I.R.C. §163(a). See note 25 supra.

Although the issue has not yet been resolved, reclassification of the note as equity may terminate the availability of the Subchapter S election if the corporation is thereby deemed to have more than one class of stock. I.R.C. §1371(a)(4). See note 6 supra. This proposition, however, has been rejected by the Seventh Circuit in United States v. Portage Plastics Co., 486 F.2d 632 (7th Cir. 1973). Accord, Amory Cotton Oil Co. v. United States, 468 F.2d 1046, 1051 (5th Cir. 1972); Shores Realty Co. v. United States, 468 F.2d 572 (5th Cir. 1972). As a result of these adverse holdings, the Service has, for the present, agreed to forego further litigation of this issue. Technical Information Release 1248 (July 27, 1973). See B. BITTKER & J. EUSTICE, supra note 5, at 6-8 n.17.

27. An advance ruling is a written statement by the National Office of the Internal Revenue Service which "interprets and applies the tax laws to a specific set of facts." Rev. Proc. 72-3, §2.20, 1972-1 C.B. 698, 699. A determination letter is a written statement by a District Director of the Service in response to a written inquiry which applies to particular facts "the principles and precedents previously announced by the National Office." Id. §2.03, 1972-1 C.B. at 699.

The general practice of the Service in issuing rulings and determination letters has been to answer the inquiries of individuals, with respect to the tax effects
to be treated as stock or as indebtedness. Furthermore, it will not under any circumstances issue such pretransactional opinions whenever the redemption price is contingent upon the future earnings of the corporation. In light of this current reticence on the part of the Service to guide the taxpayer toward the accomplishment of his legitimate tax objective, this comment focuses on the potential areas where the nature of the shareholder's post-redemption relationship to the corporation as an installment payee would most likely subject his asserted exchange treatment to challenge by the IRS.

II. HISTORICAL BACKGROUND

A. Pre-1954 Code

For as long as the tax structure has subjected corporate income to double taxation at ordinary income tax rates, a battle has raged between shareholders and the Internal Revenue Service. The shareholders have sought ways of avoiding or ameliorating the tax burden they bear upon receipt of a distribution by the corporation whose source, corporate income, has already been taxed to the corporation. In contrast, the Service has resisted the efforts of stockholders to cloak their transactions in the most tax advantageous garb. The source of this battle lies in the fact that the Code divides distributions to shareholders into those received in their capacity as shareholders and those received by reason of some other relationship to the corporation; however, articulation of the distinction has proved difficult and elusive. Where a distribution was accompanied by the surrender of stock to the issuing and distributing corporation, the early Code provided a test of "essential equivalence to a dividend" to be met before categorization as a dividend could be made; in other words, the distribution of their acts or transactions, whenever the interests of sound tax administration would be served thereby. Rev. Proc. 72-3, § 2.01, 1972-1 C.B. 698, 699. The Service, however, has delineated the areas in which, because of the inherently factual nature of the problems involved, it will defer, or ordinarily will defer, its judgment. Id. § 5.01, 1972-1 C.B. at 701. Rev. Proc. 72-9, 1972-1 C.B. 719, as amplified by Rev. Proc. 74-22, 1974-2 C.B. 476, set forth those specific areas.

29. The Service will not issue advance rulings or determination letters "where the consideration given in redemption by the corporation in exchange for a shareholder's stock in the corporation consists entirely or partly of the corporation's promise to pay an amount that is based upon or contingent on future earnings of the corporation." Rev. Proc. 76-1, 1976-1 C.B. 542.
30. I.R.C. § 11 taxes the corporation on its income. The shareholder must include dividends in his gross income when they are distributed, id. § 301(c)(1), subject to a $100 exclusion. Id. § 116.
31. The language of the Code used to draw this distinction has been "a distribution . . . made by a corporation to a shareholder with respect to its stock . . . ." Id. § 301(a) (emphasis added).
32. E.g., a creditor, an employee, a donee, a landlord, or a tenant of the corporation.
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was presumed to be in connection with an exchange. This, however, was little more than circumlocution that necessitated an inquiry into all the facts and circumstances of each case.\(^\text{34}\) The Service eventually developed some objective guidelines by which the bona fides of the redemption as a sale could be measured. The earliest criterion to emerge was the change in the relative ownership of the corporation.\(^\text{35}\) A pro rata redemption resulting in no net change was generally presumed to be a dividend, while a redemption not in proportion to the respective stockholdings was ordinarily treated as a sale of stock by the shareholder from which he would realize capital gain or loss.\(^\text{36}\)

The simplicity of this distinction hardly escaped the attention of shareholders bent on extracting corporate earnings at capital gains rates. Of particular attraction was the availability of the device of fashioning redemptions which appeared not to be pro rata but which, in view of the close relationship to the remaining shareholders, in effect did not seriously alter the shareholder’s relative enjoyment of the corporate venture.\(^\text{37}\) To counter this gambit, the Internal Revenue Service came to regard familial relationship as a significant factor to be considered in determining whether the distribution was essentially equivalent to a dividend.\(^\text{38}\) When the aggregate risk capital of the family economic unit was the source of the distribution, the Service viewed the redemption as an insufficient dilution of control over corporate affairs to warrant characterization of the distribution as a return of capital.\(^\text{39}\) This was particularly true where the shareholder

\(^\text{34}\) Although the intention of the parties was certainly relevant in this regard, it lacked objective certainty. B. Bittek & J. Eustice, \textit{supra} note 5, at 9–5. To escape inquiry into the subjective motive of the shareholder, courts fashioned a “business purpose” test whose focal point was the existence of a legitimate purpose at the corporate level for the distribution “as distinguished from a purpose to benefit the stockholder by a distribution of accumulated earnings and profits.” Keith v. Cote, 213 F.2d 651, 657 (1st Cir. 1954). For a compilation of some of the factors courts seized upon to find distributions not essentially equivalent to a dividend, see Treusch, \textit{Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code}, 32 \textit{Taxes} 1023, 1037 (1954). Although “business purpose” apparently has no application to § 302 redemptions following \textit{United States v. Davis}, 397 U.S. 301 (1970) (see note 12 \textit{supra}), this judicial doctrine remains a source of interest in the area of partial liquidations. I.R.C. § 346. If the distribution qualifies as a partial liquidation, tax treatment is controlled by § 346 irrespective of the classification under § 302. Treas. Reg. § 1.346–2 (1955). The shareholder will be entitled to capital gains treatment for a qualifying partial liquidation. I.R.C. § 331(b).


Unlike the 1954 Code, the 1939 Code, in the application of § 115(g), did not require any attribution of ownership. The United States Treasury did, however, seek to amend its regulation in the area of complete redemptions to reflect its growing concern for such transactions. 16 Fed. Reg. 10,312 (1951) (withdrawn upon enactment of 1954 Code).

\(^\text{39}\) B. Bittek & J. Eustice, \textit{supra} note 5, at 9–4 n.3, 9–10 n.1. As one commentator has noted, the concept of income itself should be related to the spending

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himself retained some capacity to direct or otherwise participate in the policymaking of the corporation.\textsuperscript{40}

Nevertheless, without some means by which a shareholder can legitimately withdraw from the corporate venture short of requiring his entire family to divest at the same time, the owners of a closely held corporation will become locked into their investment.\textsuperscript{41} Acceptance by the courts and the Service of the idea that a redemption of all of the stock interest of a particular shareholder evidenced sufficient bona fides of an exchange provided the shareholder a simple but drastic solution.\textsuperscript{42} To be sure, if the remaining shareholders were all members of his family over whom he asserted some degree of control and with whom he had shared, and would continue to share, the financial rewards of holding stock in the corporation, the result of the redemption would be merely to rearrange the investment interests within the family without any change in the unit's percentage ownership.\textsuperscript{43} Nonetheless, however contrary to economic reality it may be,\textsuperscript{44} it has been the established policy of the tax laws to regard each individual family member as a separate income tax entity.\textsuperscript{45}

The Service determined, however, that permitting the redeeming shareholder to retain direct personal participation in corporate policymaking, seemed to allow exchange treatment to be given where in effect nothing

unit. H. Groves, \textit{Federal Tax Treatment of the Family} 4 (1963). Groups into which individuals collect, particularly the family, often earn and expend income for the good of the whole rather than exclusively or even primarily for the benefit of the person having legal title. \textit{Id.} Power and influence also tend to be family oriented, making the allocation of legal rights within the group of superficial importance. \textit{Id.} See note 14 supra.

\textsuperscript{40} It is significant that as early as 1926 Congress adopted the dividend equivalence standard in order to block a bailout of corporate earnings in the guise of an exchange transaction. Bacon, \textit{Share Redemptions by Publicly Held Companies: A New Look at Dividend Equivalence}, 26 \textit{TAX L. REV.} 283, 302 (1971). The preventive emphasis of this policy naturally focused on the shareholder who controlled the purse strings of the corporation, "especially one which has only a few stockholders." \textit{Id.} at 302 n.35, \textit{quoting} H.R. Rep. No. 356, 69th Cong., 1st Sess. 30 (1926). As a consequence, a controlling shareholder could not qualify for exchange treatment unless he also gave up control of corporate affairs. Bacon, supra at 302.

\textsuperscript{41} Bacon, supra note 40, at 302. See also notes 4–5 & 7 and accompanying text supra.

\textsuperscript{42} Treas. Reg. 118, §39.115(g)–1(a)(2) (1939) recognized that if any redemption would alter the interests in a corporation in a non-pro rata manner, it would be the redemption of all the stock owned by a particular shareholder. Although the Service would not go beyond this, the courts extended this rationale to partial redemptions. \textit{See, e.g.,} Ferris v. United States, 135 F. Supp. 286, 288 (Ct. Cl. 1955). Today, a partial redemption must meet the specific statutory formulations of "substantially disproportionate" reductions of interest. I.R.C. § 302(b)(2).

\textsuperscript{43} See note 14 and accompanying text supra.

\textsuperscript{44} \textit{See} note 39 and accompanying text supra. It has been suggested that the rules of constructive ownership reflect in some measure the notion of family solidarity. Klein, \textit{Familial Relationships and Economic Well-Being: Family Unit Rules for a Negative Income Tax}, 8 \textit{Harv. J. LEGIS.} 361, 364 (1971).

\textsuperscript{45} I.R.C. § 1. Although joint returns by married couples are elective, pooling of income is not compelled. Mandatory joint liability among family members according to their respective shares in the total family income may well be unconstitutional. \textit{Cf.} Hoeper v. Tax Comm'r of Wis., 284 U.S. 206 (1931) (attempt by a state to measure one
changed as a result of the transfer of the stock interest. Therefore, to forestall circumvention in this manner, only complete redemptions which caused the shareholder to cease his interest in the affairs of the corporation would escape dividend characterization.

B. The 1954 Code

In drafting the 1954 Internal Revenue Code, Congress was fully aware of the uncertainty under preexisting law as to whether a redemption of stock would be taxed as a sale or as a dividend. Although the original House version of section 302 attempted to resolve the difficulty by providing definite tests for ascertaining under what circumstances a redeeming shareholder should realize a capital gain, the Senate found this approach too restrictive and, in addition, restored the dividend equivalency test. In doing so, the Senate Committee on Finance reported:

In general . . . your committee intends to incorporate into the bill existing law as to whether or not a reduction is essentially equivalent to a dividend under section 115(g)(1) of the 1939 Code, and in addition to provide three definite standards [sections 302(b)(2)-(4)] in order to provide certainty in specific instances.

In further recognition of the need to prevent the practice of tax avoidance which had dominated the redemption area under the previous law, rules were adopted which considered the shareholder to own the stock held by other taxpaying entities whose relationships to the shareholder too easily lent themselves to the roles of strawmen in such schemes.

One of the three "definite standards" provided by Congress was the codification of the test of complete redemption of all the shareholder's stock in the corporation contained in section 302(b)(3). In weighing the interest

person's income tax by reference to the income of another held contrary to due process of law). But see Fernandez v. Wiener, 326 U.S. 340 (1945) (community property state may deem property of one person to be that of another).

46. See cases cited in note 37 supra.
49. H.R. 8300, 83d Cong., 2d Sess., § 312, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4236–37, trichotimized corporate instruments into securities, participating stock, and nonparticipating stock. Id. Securities were defined as unconditional obligations to pay a sum certain with an unconditional interest requirement not dependent on corporate earnings. Id.
51. S. Rep. No. 1622, 83d Cong., 2d Sess. at 233, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4870. The first two of these standards were more or less statutory restatements of judicially fashioned doctrines. See note 42 supra.
52. See I.R.C. § 318; note 13 supra.
54. See note 42 and accompanying text supra.
55. I.R.C. § 302(b)(3).
of facilitating by this means shifts in ownership among the shareholders of a closely held corporation\textsuperscript{56} against the potential bailout of corporate earnings through the use of an artifice,\textsuperscript{57} Congress enacted a new section 302 which struck a compromise position. This statutory pattern requires the prospective redeeming shareholder to clear two hurdles. First, in order to terminate his stock interest, whatever rights the shareholder has following the transaction must not constitute a disguised equity interest.\textsuperscript{58} Additionally, in order to fall within the statutory waiver of the family attribution rules\textsuperscript{59} whose effect would otherwise be to prevent termination of the shareholder's stock interest, the taxpayer must not retain a relationship to the corporation beyond that of a creditor.\textsuperscript{60} The Treasury Regulations promulgated recognized a prohibited "proprietary" interest that was something less than that of equity ownership but something more than that of a creditor:

For the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.\textsuperscript{61}

C. The Position of the Internal Revenue Service

The status of installment redemptions has continued to be a source of dispute between the redeeming shareholder and the Service. By treating a section 302(b) redemption as a distribution in part or full payment of the stock, the statute on its face contemplates corporate payments made in part when the stock is transferred and in part at a later time.\textsuperscript{62} Yet, in spite of its

\textsuperscript{56} See generally Chirelstein, Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares, 78 YALE L.J. 739, 750 (1969).
\textsuperscript{58} I.R.C. § 312(a). See note 14 supra.
\textsuperscript{59} I.R.C. § 302(c)(2)(A)(i).
\textsuperscript{60} I.R.C. § 302(c)(2)(A)(i).
\textsuperscript{61} Treas. Reg. § 1.302-4(d) (1955).
\textsuperscript{62} I.R.C. § 302(a). In addition, the fact that the redeeming shareholder may remain a creditor of the corporation while obtaining the benefit of the waiver of imputed family stock ownership implies the permissibility of the installment payout. Id. § 302(c)(2)(A)(i). Judicial authority has followed this view. See Perry S. Lewis, 47
own regulation which appears aimed at just this situation, the Service has been reluctant to approve redemption on credit as a method of divesting the shareholder of all proprietary interest in the corporation. Given the availability of redemptions with installment payments as a general proposition, considerable debate in specific instances has been engendered when the purported debt instrument has been tested against both layers of the statute. On the one hand, to preclude classification of the corporate obligation as an equity interest, the shareholder must have sufficient rights on the note; acceptance of less security than what a reasonably prudent lender would demand under the circumstances may justify the conclusion that the uncollected balance represents venture capital which the shareholder left at the risk of the enterprise. On the other hand, while retention of too much security may not in itself be fatal to exchange treatment, if members of the redeeming shareholder's family continue to own a stock interest, an inference of personal control of the affairs of the corporation may be warranted.

The tension created by these opposing statutory requirements, however necessary to curb tax avoidance, has placed even the redeeming shareholder who lacks such motives but who has advanced the corporation all or part of the redemption price, in the precarious position of predicting what legal

T.C. 129 (1966); note 22 supra. See also Alfred N. Hoffman, 47 T.C. 218, 235–36 (1966), aff'd per curiam, 391 F.2d 930 (5th Cir. 1968).

63. See text accompanying note 61 supra.

64. See note 29 supra. See also notes 68–69, 71 & 74 infra. The Service has apparently acquiesced to the possibility that the redemption on credit may satisfy §302. See Rev. Rul. 59–119, 1959–1 C.B. 68.

65. See text accompanying notes 58–60 supra.

66. See Fin Hay Realty Co. v. United States, 398 F.2d 694, 698 (3d Cir. 1968). Degree of risk serves as the point of departure in resolving debt vs. equity classification questions. As the Third Circuit has stated: [T]he ultimate question [is] whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship. Since there is often an element of risk in a loan, just as there is an element of risk in an equity interest, the conflicting elements do not end at a clear line in all cases. Id. at 697 (footnote omitted). Comparing the form which a similar transaction would have taken had it been consummated with an outside lender rather than with a shareholder is useful in determining whether an advance was too speculative to be considered a loan. Id.


68. The Service has taken the position that the mere possibility that a shareholder could reacquire his stock in the enforcement of his claim may be a greater right than that of a creditor. See Rev. Proc. 72–9, 1972–1 C.B. 719; Treas. Reg. §1.302–4(d) (1955). This appears to fly in the face of the statute, which makes the fact of reacquisition, rather than its potentiality, trigger adverse tax consequences. I.R.C. §302(c)(2)(A)(ii). See notes 16 & 17 supra. However, the Service has also indicated that the right to enforce the corporate obligation upon default on the payments by acquiring the assets of the corporation will not be considered a prohibited interest under §302(c)(2)(A)(ii). Treas. Reg. §1.302–4(e) (1955).

69. A similar recurring problem involving the ability of a shareholder in a closely held corporation to become its bona fide creditor frequently arises in the context of whether the corporation will be allowed an interest deduction as it discharges the advancement. Fear that debt service may be used to disguise a dividend has led the Service to challenge the characterization of the transaction in many instances. The
characterization will be given to his relationship with the corporation under the terms of the installment agreement. Predictions in the absence of an advance ruling or determination letter are little more than hazardous guesses. Although the Service has promulgated a checklist of information to be included in a request for an advance ruling under section 302 where the corporation has distributed its notes or obligations, it has maintained a suspicious attitude toward particular aspects of such redemptions. Moreover, the extent to which this checklist may continue to serve the prospective redeeming shareholder in framing a transaction that will qualify for capital gains treatment has been undercut by a 1976 policy statement that the Service will not generally commit itself by an advance ruling or determination letter with respect to whether an interest in a corporation is to be treated as stock or indebtedness. Yet, it is this classification which stands at the threshold of every inquiry into a section 302(b)(3) redemption on credit.

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70. See REV. PROC. 73-35, 1973-2 C.B. 491. Specific factors include: 1) the terms of the instrument; 2) the period over which payments are to be made; 3) profit and loss statements of the corporation over the preceding three years; 4) agreements of subordination to the claims of general creditors; and 5) existence of a reversionary interest in the stock in the event of a default on the instrument. Id. § 3.04-3(a)-(e).

71. Prior to 1976, the Service would not issue any rulings or determination letters on the application of § 302(b) where the consideration given in redemption by the corporation consists entirely or partly of its notes payable, and the shareholder's stock is held in escrow or as security for payment of the notes with the possibility that the stock may or will be returned to him in the future, upon the happening of specified defaults by the corporation.

REV. PROC. 72-9, § 3.01, 1972-1 C.B. 719. This provision has been superseded. See note 29 and accompanying text supra.

Attention has also centered on the extent of the payout period. The Service will not ordinarily issue any advance rulings or determination letters where this period extends more than 15 years from the date of issuance. REV. PROC. 72-9, § 4.01-3, 1972-1 C.B. 719. This hesitancy may be motivated by a concern that a prolonged payout period which gives the shareholder a fixed and steady income partakes more of a substitute for dividends than a bona fide effort to terminate the shareholder's interest. See Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), rev'g 18 T.C.M. (CCH) 306 (1959); Claude J. Lisle, 35 T.C.M. (CCH) 627 (1976).


Prior to 1976, the Service maintained a policy against ordinarily issuing advance rulings or determination letters on the issue of whether advances to "thin" corporations constituted loans or equity investments for purposes of § 163. REV. PROC. 72-9, § 4.01-1, 1972-1 C.B. 19-20. This provision was deleted by REV. PROC. 76-19, 1976-1 C.B. 560, because in the view of the Service it was embraced by its amplification of § 4.02-1 of REV. PROC. 72-9, 1972-1 C.B. 718, under which it will not ordinarily issue advance rulings or determination letters with respect to whether any interest in a corporation represents stock or indebtedness.
III. ANALYSIS OF REDEMPTION ON CREDIT

The extent to which a particular redemption on credit may qualify for capital gains treatment as a complete termination depends upon an examination of the legal rights conferred by the purported debt instrument in light of the considerations underpinning the statute. At the outset, the question of whether the shareholder has terminated his equity participation in the corporation is a difficult one. Debt and equity express merely the conclusion that different tax consequences ought to flow, but neither the Code nor judicial interpretations have defined the distinguishing characteristics with precision. Determinations with respect to substantial economic reality in different factual situations have by necessity been made on an ad hoc basis. Nevertheless, recurrent themes in the case law have served to highlight those objective factors that courts will look to in evaluating the bona fides of the transaction as an exchange.


74. The debt-equity distinction has long pervaded and plagued the application of the corporate tax laws. The major areas in which the issue has been raised include: 1) the receipt of the purported debt in exchange for property ("typically" I.R.C. § 351); 2) the deduction taken by the corporation when interest is paid or accrued during the term of the obligation (id. § 163); and 3) the collection of the obligation at maturity by the holder or the attempt to write it off as "worthless" (id. §§ 1232, 302, 303, 346, 165(g), 166(a), (d)). See generally B. BITTKER & J. EUSTICE, supra note 5, at 4-5 to 4-39.

In an effort to bring certainty to an unsettled area, Congress delegated authority to the Secretary of the Treasury to define corporate stock and indebtedness for all tax purposes. I.R.C. § 385(a). Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 613. Since the passage of the Tax Reform Act of 1969, however, not only have no regulations been issued, but the Service has also shown a growing reluctance to articulate this distinction even on an ad hoc basis. See notes 27 & 28 and accompanying text supra.

75. See Lyon, Federal Income Taxation, 1957 Ann. Survey Am. L. 123 wherein the author stated:

One might say that this is one of those areas of the tax law where the virtues of vagueness exceed the vices; that courts must look to all the facts and circumstances of each case to see what is really "intended" or what has "substantial economic reality"; and that it is salutary to tell taxpayers only that there is a danger zone which they enter at their peril.

Id. at 142. No workable legal standard has emerged from the judicial decisions. The factual determination of debt or equity has not lent itself to a proscribed set of rules susceptible of computerized application. The Third Circuit noted that "neither any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present." Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968) (citation omitted). The Tax Court has indicated that it can only provide a modest degree of guidance in a "landscape of shifting sands." Wingate C. Underhill, 45 T.C. 489, 492 (1966), citing United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7 (1st Cir. 1966).

76. Among the criteria which have been looked to in determining the true nature of the investment are: 1) intention of the parties; 2) identity between creditors and shareholders; 3) extent of the participation in management by the holder of the instrument; 4) ability of the corporation to obtain funds from outside sources; 5) "thinness" of the capital structure; 6) risk involved; 7) formalities observed; 8) relative position of the obligee to other creditors regarding payment; 9) voting rights retained; 10) provision for a fixed rate of interest; 11) contingency on the obligation to repay; 12)
As a point of departure, intention of the parties fundamentally differentiates extensions of credit from equity participations. While a shareholder may eventually reap profits far in excess of his original outlay, a creditor expects nothing more than the amount of his investment with a charge for interest to be returned to him. Because the corporation does not obligate itself to return any part of the property it receives from a shareholder, the shareholder risks loss of his entire investment if the corporation fails, against potentially unlimited financial rewards if it succeeds. The creditor, on the other hand, obtains a guarantee of repayment of that which he advances. Accordingly, it has been suggested that debt can be objectively viewed as an "unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." While this approach serves to underscore the significant areas in which the redeeming shareholder may anticipate challenge, it does not indicate what criteria are to be used and what respective weights will be given in resolving ambiguities.

Ambiguities arise not only because the redemption agreement in a closely held corporation represents the product of bargaining between parties on both sides of the table, but also because of the inherent difficulty the shareholder may have in assuming the role of a creditor where self-interest or family relationships are involved. The reality of the power to

source of interest payments; and 13) presence or absence of a fixed maturity date. Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968). See also cases cited id. at 696 n.9.

77. For a summary of the various factors which go into the determination of intent, see Tomlinson v. 1661 Corp., 377 F.2d 291 (5th Cir. 1967).

78. As compensation for not sharing in the net profits of the corporation, the creditor is given the assurance of payment independent of risk. See Plumb, supra note 69, at 404. When the payment date arrives, he has the right to dip into the corporate capital to satisfy his claim. Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935).

79. See Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956). In cases involving extraordinary matters such as a statutory merger, state law may require the corporation to pay the shareholder an appraisal remedy. See, e.g., PA. STAT. ANN., tit. 15, § 1515 (Supp. 1977).

80. See Plumb, supra note 69, at 404.


82. See notes 75 & 77 supra.

83. See P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 789 (3d Cir. 1962).
force payment in the event of default may be questioned when the intention to exercise it may be doubtful.84 While a true lender's primary concern is repayment and not enhancement of the earnings of the corporation,85 the redeeming shareholder would naturally be reluctant to insist on enforcement where to do so would deprive his family business of needed funds or even place it at the brink of financial collapse. Whether expressed by a subordination agreement or inferred from the family relationship, the disposition on the part of a redeeming shareholder to forego immediate action against his "debtor" reflects an abiding concern for the continued financial well-being of the corporation,86 which casts the proper characterization of the installment note into some doubt. Nevertheless, total disinterest in the future profits of the corporation does conflict with the best interests of the installment creditor. Liquidation today severely undermines any expectation of repayment tomorrow. Profits, in the first instance, are the projected source of all debt payments.87

The limitation of exchange treatment to complete terminations of stock interest, together with the limitation that a shareholder retain no interest in the corporation other than that as a creditor in cases where control of the corporation remains in the hands of the shareholder's family, represents an integrated approach in assuring a genuine severance of interest in the financial fortunes of the corporation.88 However, the debt-equity distinction and the proprietor-creditor distinction are separate though related issues. The Service naturally has insisted that the terms of the redemption instrument, while qualifying the interest as debt under section 302(b)(3),89 be subject to a stricter scrutiny with respect to the question of the availability of the waiver of the family attribution rules.90 In fact, the regulation corresponding to section 302(c)(2)(A)(i)91 in part indicates a conscious policy by the Service to establish certain objectively ascertainable criteria which

84. Absence of security may tend to negative indebtedness where there is a history of losses. Wood Preserving Corp. v. United States, 347 F.2d 117, 119 (4th Cir. 1965). If other creditors would have demanded security, doubt may be raised on both the intent to enforce payment and the expectation of repayment. Id. But cf. J.S. Biritz Constr. Co. v. Commissioner, 387 F.2d 451, 459 (8th Cir. 1967) (legitimate reason for incorporation to limit personal liability sufficient to sustain debt owed by corporation to its 100% shareholder). Nevertheless, it has been recognized that "where the debtor and creditor are related, the lender might understandably offer more lenient terms than could be secured elsewhere." C. M. Gooch Lumber Sales Co., 49 T.C. 649, 659 (1968), vacated, 406 F.2d 290 (6th Cir. 1969).
86. Plumb, supra note 69, at 460.
87. The Eighth Circuit noted that "[m]any lenders rely upon expected earnings for payment of their debts as liquidation of a corporation or any business venture usually is a salvage operation resulting in only a small percentage being paid to the creditor." J.S. Biritz Constr. Co. v. Commissioner, 387 F.2d 451, 458 (8th Cir. 1967). See also Estate of Miller v. Commissioner, 239 F.2d 729, 732 (9th Cir. 1956).
88. See text accompanying notes 37-40, 46 & 52 supra.
89. See notes 66, 76-77 & 82 and accompanying text supra.
90. See notes 14, 68 & 71 and notes 28 & 29 and accompanying text supra.
create an irrebuttable presumption of the proscribed tax avoidance purpose. 92
Notwithstanding the regulation's per se approach, recent decisions by the Tax Court reflect a judicial willingness to consider all the surrounding circumstances in determining whether the redemption was born of a bona fide effort to surrender control and influence in the management of corporate affairs. 93

Despite the fact that its opinion in Perry S. Lewis94 turned on whether the distribution was “not essentially equivalent to a dividend,” the Tax Court seized the opportunity to express some significant views regarding the bounds of permissible interests as a creditor within the meaning of section 302(c)(2)(A)(i). 95 In spite of the broad prohibition against retention of an interest as an officer or director enunciated in the statute,96 the majority strongly hinted that it would not apply this prohibition as literally as the Service might have wanted.97 The Lewis court regarded as significant the failure of the retiring shareholder to perform any services, to receive any compensation, and to exercise the powers attaching to the corporate office.

92. By its terms, the regulation does not seek to establish tests to classify the purported debt but merely to determine if the family attribution rules may be avoided. See text accompanying note 61 supra. The thrust of the regulation is to clarify what kinds of interests beyond those specifically addressed in the statute are sufficient to bar the availability of the waiver provisions of § 302(c)(2). The existence of any one of certain objectively ascertainable factors, such as subordination, ipso facto denies the waiver. Treas. Reg. § 1.302–4(d) (1955). Curiously, since § 302(c)(2) only has significance where the shareholder has completely terminated his own equity interest, the regulation does not apply unless the instrument is deemed to represent an indebtedness. Thus, what the regulation deems a proprietary interest per se could only serve as a criterion in the determination of an equity interest.


94. 47 T.C. 129 (1966). The taxpayer-father owned 49.5% of the stock in the corporation at the time of the redemption. Id. at 130. Over a period of time, he had gradually reduced his 100% ownership by sales of his stock to his sons. Id. In addition, he had reduced his role in the active conduct of the business so that even as president and director his services were on a diminished scale, consisting for the most part of consulting with and giving advice to his sons regarding the business. Id. at 131. Under the terms of the redemption agreement, the corporation was required to make a monthly payment of principal and interest with an option to pay more up to a fixed price. Id. At the end of each year, the taxpayer would deliver the number of shares corresponding to the amount of principal discharged while retaining the right to vote any of the shares not paid for. Id. at 130–31. The court found a legitimate purpose reasonably related to business exigencies, and not founded upon the machinations of other shareholders whose stock would otherwise be attributable to him. Id. at 134. See note 34 supra. The vitality of the rationale in Lewis has been left in doubt by the decision in United States v. Davis, 397 U.S. 301 (1970). See note 12 supra.

95. 47 T.C. at 133.

96. Section 302(c)(2)(A)(i) requires the distributee to have “no interest in the corporation (including an interest as officer, director, or employee) . . . .” I.R.C. § 302(c)(2)(A)(i) (emphasis added).

97. 47 T.C. at 134–35. The Lewis majority emphasized that the formal retention was not just a front for the redeeming shareholder. Id. at 135. The Tax Court specifically distinguished the case of a minority shareholder and active participant in the business who as a result of the transaction completely terminated his participation from the situation involving only a partial redemption by a majority shareholder who continued in a position of control. Id. at 133.
and directorship he had retained. Judge Simpson indicated that it was not the mere ability to direct corporate affairs, but that power coupled with a subjective inclination to use it, which is proscribed. Judge Simpson indicated that although the statute creates a presumption of willingness to exercise his retained power to control the corporation, it is rebutted by a showing that the redeeming shareholder no longer benefited from the successful activities of the corporation except insofar as he continued to receive the installment payments.

Continued active participation in the management of the affairs of the corporation may not be the only impediment to the redeeming shareholder. Retained control has also been found in the ability to maintain access to corporate benefits. Although every person who receives remuneration for services rendered benefits from the success of the enterprise, the Tax Court adopted a less stringent standard in the case of Estate of Milton S.

98. Id. at 130-31. Following the redemption, the taxpayer became the vice president, but only inquired infrequently on how the business was progressing. Id. at 131.

99. Id. at 136 (Simpson, J., concurring). Judge Simpson, in a concurring opinion in which Judge Atkins joined, expressed the view that insofar as the taxpayer had already disengaged himself from the active management of the business, there was no longer a business purpose to redeem in order to transfer management into younger hands. Id.

100. Id. at 137 (Simpson, J., concurring). In reaching this conclusion, the concurring opinion relied upon the legislative history surrounding the enactment of § 302(c)(2). Id. The purpose of the provision denying waiver of the family attribution rules was merely to assure a bona fide severance of interest and not to withhold capital gains from those who were officers in name only. Id., citing H.R. Rep. No. 1337, 83d Cong., 2d Sess. 36 (1954), S. Rep. No. 1662, 83d Cong., 2d Sess. 45 (1954). Both §302(c)(2) and its legislative history supported an inference of a narrow concern for the situation in which there was a nominal transfer of stock in a family corporation but where the transferor in fact continued to control the corporation and benefit by its operations. 47 T.C. at 137-38 (Simpson, J., concurring).

101. Id. at 137 (Simpson, J., concurring). See Leon R. Mayer, 46 T.C. 65, 86, modified, 383 F.2d 883 (8th Cir. 1967). In a prior ruling, a terminating shareholder sought to have his nominee serve on the board of directors of the corporation in order to protect his post-redemption interest as a creditor on an installment payout. Rev. Rul. 59-119, 1959-1 C. B. 68, 69. Under the installment note, the taxpayer would be paid the balance of the redemption price over an eight-year period. Id. at 69. The Service not only ruled that the assertion of the prohibited interest as a director could be indirect through an agent, but also indicated that the fact that the nominee's sole duty as director was to determine whether the conditions of the redemption agreement were being complied with did not save the shareholder's interest from being violative of the terms of §302(c)(2)(A)(i). Id. at 70. On the other hand, if the designation of a representative were limited to attending the meetings of the board of directors as an observer and not in the capacity of a director, officer, employee, or advisor, the Service indicated that the availability of the waiver of the family attribution rules would not be adversely affected. Id. at 71.

102. See Beatrice Levin, 47 T.C. 258, 264 (1966), aff'd, 385 F.2d 521, (2d Cir. 1967). Although the Tax Court in Lewis did not reach the question of whether the retention of a nominal office or directorship would comply with §302(c)(2)(A)(i), it did express concern over the apparent qualification of the taxpayer in his capacity as a corporate officer to participate in a medical policy which the board of directors had authorized to be procured. 47 T.C. at 135. Moreover, the coincidence of the cessation of the retained position with the final installment on the redemption might well have been indicative of more than a nominal position in the corporate power structure. Id.
Lenard. In Lenard, following complete redemption of his stock on credit, the decedent-taxpayer had continued not only to perform accounting services for the corporation but also to counsel his son with respect to potential corporate acquisitions. In holding that the father had not retained a prohibited interest as an employee, the court emphasized that the corporate involvement proscribed by the statute had to be greater than the financial stake of someone who merely provides the corporation with goods and services. The Tax Court noted that the manner in which the decedent had performed these services was beyond the control of the corporation, and the court found this indicative of an independent relationship to the corporation. Furthermore, the court directed its attention to the extent to which the employment duties actually performed in fact influenced the corporation. Contrary to the Service's position, influence in this respect could not be presumed from the fact that consultation was given. Evidence which suggested that the advice was in fact knowingly given with the intent to control the direction of corporate affairs would be necessary.

A retained proprietary interest may also be inferred from the subordination of the note to the claims of general creditors, since the "power to demand payment at a fixed date" as well as the reasonableness of the expectation that the corporation will be able to meet its obligation to pay when due are placed in doubt. In addressing this aspect, the Lenard court chose not to follow that portion of the regulation which demanded

103. 61 T.C. 554 (1974).
104. Id. at 561.
105. Id.
106. Id.
107. Id. at 562.
108. In Rev. Rul. 7-104, 1970-1 C.B. 66, the Service found a five-year consulting contract, to be performed by the redeeming father for a corporation which prior to the redemption was owned solely by him and his children, to constitute a prohibited retained interest which precluded waiver of the family attribution rules. Id.
111. The Tax Court, in discussing the effect of thin or inadequate capital in relation to debt, noted that:

[A] corporation's financial structure in which a wholly inadequate part of the investment is attributed to stock while the bulk is represented by bonds or other evidence of indebtedness to stockholders is lacking in the substance necessary for recognition for tax purposes, and must be interpreted in accordance with [the] realities.

Sam Schnitzer, 13 T.C. 43, 62 (1949), aff'd, 183 F.2d 70 (9th Cir. 1950), cert. denied, 340 U.S. 911 (1951). The debt-equity ratio is a significant factor "bearing on the reasonableness of the expectation of repayment, reflecting the extent of the cushion by which the purported creditors are shielded against the effects of business losses . . . ." Plumb, supra note 69, at 512-13 (footnote omitted). This is particularly true when the inadequacy is tied to the subordination of obligations held by its shareholders. Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969).


As a general rule, even though not statutory, treasury regulations have the force and effect of law. Hess v. United States, 537 F.2d 457 (Cl. Cl. 1976). So long as they are reasonably adapted to the statutory objective, not plainly inconsistent with the statute that authorized them and are duly promulgated, the regulations are as
characterization of the instrument as a proprietary interest, opting instead for an ad hoc balancing approach.\textsuperscript{113} It indicated that additional characteristics of equity participation would have to be present to render the interest other than that of a creditor.\textsuperscript{114} Curiously, in relying on \textit{Kraft Foods Co. v. Commissioner},\textsuperscript{115} the Lenard Court suggested that relegating subordination to the rank of a criterion in resolving this issue was dictated by the test employed in determining whether the instrument constituted debt.\textsuperscript{116}

Subordination strongly implies a sharing in the risks of the enterprise, or at least a willingness to do so.\textsuperscript{117} Whether or not this will be deemed a capital risk depends upon the expectation of repayment,\textsuperscript{118} which may turn on the substantiality of the nonsubordinated debt in relation to the binding on the courts as the statute itself. See \textit{Yellow Freight System, Inc. v. United States}, 538 F.2d 790 (8th Cir. 1976); \textit{Universal Drilling Co. v. United States}, 412 F. Supp. 1231 (E.D. La. 1976). It is not within the province of the courts to revise the regulations by decisional process unless there exists a clear statutory justification for such action. \textit{Markarian v. United States}, 352 F.2d 870 (7th Cir. 1965).

\textsuperscript{113} 61 T.C. at 563. The court regarded as significant the fact that the subordination was undertaken in order that the balance would not have to be reported to its bankers. \textit{Id.} Moreover, the decedent's rights had been discharged within four months of the redemption. \textit{Id.} at 557-58.

\textsuperscript{114} \textit{Id.} at 563.

\textsuperscript{115} 232 F.2d 118 (2d Cir. 1956). In \textit{Kraft}, the Second Circuit considered the corresponding tax question from the standpoint of the corporation — whether the corporate taxpayer could deduct interest payments under section 23(b) of the 1939 Code (now I.R.C. \textsection 163). 232 F.2d at 121. In 1934, the taxpayer declared a dividend of 6\% debentures payable in 1948 in order to preserve its cash position. \textit{Id.} at 121. Both the Service and the Tax Court (21 T.C. 513 (1954)) had previously concluded that no genuine debtor-creditor relationship was created between the taxpayer and its parent corporation and sole shareholder with respect to the payments of interest, which were in reality nondeductible dividend distributions. 232 F.2d at 122. In reversing the judgment below, the Second Circuit agreed that any arrangement between a parent corporation and its wholly owned subsidiary invited close scrutiny. \textit{Id.} at 123. Nevertheless, recognition of an intercorporate transaction was mandated in the absence of evidence of self-dealing which would taint the separate identities. \textit{Id.} at 124-25. The transaction involved could not be disregarded for tax purposes merely because of the presence of the suspect relation between the parties. \textit{Id.} at 126.

\textsuperscript{116} 61 T.C. at 561. In \textit{Kraft}, the Commissioner asserted that the alleged creditor interest would be subordinated to the claims of outside general creditors in the event of the taxpayer's insolvency. 232 F.2d at 125. Assuming this assertion arguendo, the Second Circuit noted that such subordination did not necessarily imply a stock interest. \textit{Id.} "Debt is still debt despite subordination." \textit{Id.} at 125-26 (footnote omitted). However, the \textit{Kraft} court relied on the judicial doctrines of equity which would adjust the priorities of debt interests in a forced liquidation. \textit{Id.} at 126 n.11. \textit{See Pepper v. Litton}, 308 U.S. 295 (1939) (fraud); \textit{Taylor v. Standard Gas & Electric Co.}, 306 U.S. 618 (1939) (abuse of the power to dominate). The Tax Court, in Estate of Milton S. Lenard, 61 T.C. 554 (1974), thus extended a doctrine rooted in subordinations by operation of law to a case of voluntarily agreed-upon subordination. \textit{See note 108} and accompanying text \textit{supra}. It does not appear to have considered subordination as a factor with respect to the statutorily separate question of whether the decedent had thereby retained an interest other than that as a creditor. 61 T.C. at 561-63.

\textsuperscript{117} Congress has recognized subordination as one of the factors to be considered by the Service in formulating the regulations defining corporate debt and stock. I.R.C. \textsection 385(3)(2). See note 74 \textit{supra}.

\textsuperscript{118} The Tax Court has required the shareholder to have "a genuine and reasonable expectation" that the investment will be paid at a certain time in all events and regardless of the earnings of the corporation. \textit{Jewel Ridge Coal Corp.}, 21 T.C.M. (CCH) 1048, 1055 (1962), \textit{aff'd}, 318 F.2d 695 (4th Cir. 1963). The difference
anticipated corporate profits. In this respect, ownership of corporate instruments denominated "preferred shares" does not foreclose the possibility of having only the interest of a creditor. Recognizing that such shares do not participate in the management of the corporation, the Tax Court, speaking in Bernard E. Niedermeyer, found the subordination of the shares to the rights of general creditors indicative of an equity interest, but did not hold this factor dispositive.

As the discussion of subordination implies, concern centers on the necessity that at some time the shareholder will be totally disassociated from the corporation. While in general a long term payout period may be suspect in the view of the Service, repayment over an extended duration may be necessitated if the principal amount cannot otherwise be reasonably between a risky loan and the assumption of an entrepreneurial risk is only a question of degree. See note 66 supra.

Congress also seems to have recognized risk as an objective factor bearing on a determination of creditor status. In discussing § 385, it stressed the importance of "whether the corporation's debt-equity structure is such that it is reasonable to expect that it will meet its obligation to pay the principal and interest ... when due." S. REP. NO. 552, 91st Cong., 1st Sess. 137, reprinted in [1969] U.S. CODE CONG. & AD. NEWS 2027.

119. See Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969).

120. The categorization of the holder of a subordinated instrument is subject to conflicting interpretations. Subordinated debt, although similar in priority, nonetheless may differ significantly from preferred stock in that "ultimately the holder must be paid a definite sum at a fixed time ..." Plumb, supra note 69, at 423-24, quoting Commissioner v. O.P.P. Holding Corp., 76 F.2d 11, 12 (2d Cir. 1935). On the other hand, by relinquishing the right to payment until other rights are satisfied, the right to recover the investment under a subordination agreement remains inchoate, subjecting the capital to the risks of the business until an uncertain time in the future. Plumb, supra note 69, at 421-23.

121. For a discussion of some of the factors which go into the determination of this question of fact, see O.H. Krus Grains & Milks v. Commissioner, 279 F.2d 123, 125-26 (9th Cir. 1960); Wilbur Security Co., 31 T.C. 938, 948 (1959), aff'd, 279 F.2d 657 (9th Cir. 1960).

122. 62 T.C. 280 (1974). The taxpayers owned 21.58% of the common stock of the corporation and 5.85% of the preferred. Id. at 281-82. Niedermeyer and his wife terminated their entire common stock interest in September of 1966 but retained the preferred stock until December when it too was redeemed in toto. Id. at 293. Both at the time of sale and thereafter, neither served as an officer, director or employee of the corporation. Id. Because their sons remained the primary stockholders, the petitioners had to obtain waiver of the family attribution rules in order to qualify for capital gains treatment. Id. In discussing whether the redemption of the common stock constituted a complete termination of interest, the Tax Court had to determine what effect the retention of the preferred stock had on the requirement of not having any interest in the corporation other than an interest as a creditor. Id. at 288-89. The court noted that although a preferred shareholder had no right to participate in the management of the corporation, that fact, standing alone, did not foreclose the issue of its characterization. Id. at 289.

123. Id. Inasmuch as the holder of preferred shares would be paid in the event of liquidation only "from the money and/or property available for distribution to shareholders," preferred stock was subordinated in priority to the general creditors. Id.

124. Id. at 289. The Tax Court emphasized that the corporate directors discretion in timing preferred dividends together with the lack of an unconditional obligation to pay the principal sum certain on or before a fixed maturity date also entered into its determination. Id.
discharged from projected annual earnings. Courts have sustained the validity of prolonged obligations as debt in recognition of the legitimacy of this business purpose. In dictum in its most recent case touching this matter, the Tax Court intimated that a payout period of twenty years, together with "other factors," might require equity characterization. Without specifying what the "other factors" might be, the court suggested that they must evidence a tax avoidance motive.

The payout period cannot, nevertheless, have the potential to be indefinitely protracted. One of the most significant features of debt is the existence of a fixed date at which the holder will become unconditionally entitled to enforce payment. While its presence does not assure classification of the obligation as debt, its absence is nearly always fatal to such a classification. Without some fixed point in time by which the financial

125. The fear of the Service is that this means of redemption offers the corporation an attractive method of implementing a substitute plan for nondeductible dividend payments. Moreover, from the point of view of the investor, the difference between the debtor's promise to return the principal at a time well beyond his death to his estate and no promise at all is perhaps only a conceptual one, since in each there is no promise the investor will ever reinvest the capital during his lifetime. See Claude J. Lisle, 35 T.C.M. (CCH) 627, 639 (1976) (20 year redemption notes).

126. Id., citing Mountain State Steel Foundries v. Commissioner, 284 F.2d 737 (4th Cir. 1960), rev'g, 18 T.C.M. (CCH) 306 (1959) (27- and 44-year redemption notes); Commissioner v. H.P. Hood & Sons, 141 F.2d 467 (1st Cir. 1944) (40-year income debentures issued in exchange for stock); Monon R.R., 55 T.C. 345 (1970) (50-year income debentures issued in exchange for stock).

127. Claude J. Lisle, 35 T.C.M. (CCH) 627, 639 (1976). The taxpayer and his brother, the major shareholders in a mortuary business begun by their father, entered into separate redemption agreements. Id. at 628. None of the stock of the remaining shareholders would have been attributed to either redeeming shareholder. Id. Other shareholders who sought to acquire control of the corporation caused it to offer to redeem all of the shares held by each of them. Id. Although the taxpayer did not wish to terminate his employment as president at that time, his brother executed a redemption agreement calling for the balance of the redemption price to be paid in 240 consecutive monthly installments with the declining balance bearing interest at 7% per annum and secured by the shares being sold. Id. at 630. Under its terms, the brother could reacquire the right to vote the stock only upon default by the corporation. Id. Apparently this provision was designed to safeguard the other shareholders from interference in the management of the corporation on the part of the taxpayer. Id. at 631. Subsequently, the taxpayer entered into an arrangement with the corporation by which it would redeem all of his shares in accordance with similar installments over a 20-year payout period. Id. at 631-33. The Commissioner unsuccessfully challenged exchange treatment for the brothers under § 302(b)(3), and the interest deductions by the corporation under § 163, on the grounds that the length of the installment period coupled with the retention of the voting rights evidenced an insufficient severance to constitute a complete termination of interest. Id. at 639-94.

128. Id.


130. Maturity dates also attach to preferred stock, so other factors must also be considered. See notes 120-124 and accompanying text supra. In Mary Duerr, 30 T.C. 944 (1958), the taxpayer received as part of a redemption and reorganization debenture bonds having a payment schedule that was fixed but payable only out of income. Id. at 946. The Tax Court held the new securities to resemble preferred stock because the restriction to income indicated the holder continued to share in the risks of the enterprise. Id. at 947.

131. Plumb, supra note 69, at 413. Long term investments leave the corporation free to treat the funds as corporate capital without due regard to any upcoming
interest of the ex-shareholder will definitely be terminated, the bona fides of the severance of that interest from the corporate fortunes may be placed in issue. Accordingly, a series of cases have shown the need for evidence, of a firm and fixed plan, not subject to discretionary changes, by which the corporation is clearly required to redeem all of the stockholder’s shares.

The redeeming shareholder may be motivated by family considerations to limit his rights as a creditor by conditioning the payment of the obligation to the existence of sufficient earnings or income. Although such a contingency partakes of an equity flavor, the fact that the schedule of installment payments depends upon the earnings will generally not preclude classification of the instrument as debt, provided a fixed ultimate date for payment of the full principal amount is set. Moreover, all of the payment. Lack of a sinking fund or reserve to provide for ultimate retirement may be critical. Id. at 415–16.


133. In Otis P. Leleux, 54 T.C. 408 (1970), the Tax Court emphasized the lack of a contractual obligation to retire all of the shareholder’s stock in denying him exchange treatment under §302(b)(3). Id. at 415. Following an accident which exposed the corporation to liability in excess of its insurance coverage, the taxpayer, who was president, chairman of the board and its 85% owner, “sold” all of his stock for a corporate note. Id. at 409, 411. In rejecting his claim for capital gains treatment, the court dismissed the shareholder’s contention that the complete redemption was structured on an informal basis in order to allow the corporation to maintain adequate working capital. Id. at 419. The court found this contention unconvincing because the corporation had sufficient capital at all times to discharge the “obligation.” Id. In addition to the absence of a written instrument by which a duty to redeem all of the shares according to a firm and fixed plan could be inferred, the Tax Court regarded the cessation of redemptions following advice by the Internal Revenue Service that such transactions would be accorded dividend equivalency treatment as indicative of nothing more than a gentleman’s agreement which could be revoked or altered at will. Id.

134. In Bernard E. Niedermeyer, 62 T.C. 280 (1974), the Tax Court also found a lack of a fixed and firm plan to redeem all of the taxpayer’s preferred shares from the agreement to redeem all of his common shares, but indicated that the presence or absence of a writing was not in itself dispositive but required a consideration of all the surrounding circumstances. Id. at 290–92. See note 122 supra.


136. It may be inferred that the investor has embarked on the corporate adventure and assumed its risks to the same extent as has a preferred shareholder, at least when the ripeness of the obligation is tied to a contingency which may never occur. Plumb, supra note 69, at 414–15. See also notes 120–124 and accompanying text supra. Preferred stock, however, is also contingent upon the discretionary action of the board of directors before a right to corporate earnings will arise. Plumb, supra note 69, at 430.

Congress has indicated that the certainty of the obligation to repay is a factor which may be considered by the Service in characterizing a corporate instrument as debt or stock “whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money’s worth and to pay a fixed rate of interest.” I.R.C. § 385(b)(1), Tax Reform Act of 1969, Pub. L. No. 91–172, § 415(a), 83 Stat. 613.

137. Plumb, supra note 69, at 415, citing Charles E. Curry, 43 T.C. 667, 693 (1965); Leach Corp., 30 T.C. 563, 571–72, 576 (1958). The existence of a fixed ultimate date is
installment payments prior to that date may be circumscribed by state law regulating corporate distributions in redemption.\textsuperscript{138}

Finally, a hidden participation in the risks and fruits of the corporate venture may be inferred from a lack of certainty in the interest rate or the redemption price. While the bona fide lender is entitled to interest,\textsuperscript{139} measurement of the amount payable by a percentage of the earnings may evidence the potentially unlimited participation generally associated with equity insofar as the compensation for the use of the capital is keyed to the success or failure of the corporate venture.\textsuperscript{140} Moreover, if the principal amount of the obligation depends upon the results of subsequent corporate activities, the possibility of recouping much more or much less than the amount of credit extended may warrant characterization of the arrangement as "a device adopted in order to share the financial results of the operations along with the shareholders."\textsuperscript{141} Although lack of a fixed price has considerable bearing on the question of whether or not the transaction would be viewed as a sale or exchange,\textsuperscript{142} some contingency is allowed, particularly where there is difficulty in establishing the fair market value of the redeemed shares.\textsuperscript{143}

IV. Conclusion

Although the full extent of an interest other than that as a creditor must await future development, several points do seem apparent. Thus far, the Tax Court has limited its inquiry of the post-redemption relationship to not in itself enough if it is too far in the future. See John Kelley Co. v. Commissioner, 326 U.S. 512, 526 (1946). But see notes 125-127 and accompanying text supra.

\textsuperscript{138} See note 18 and accompanying text supra. In Claude J. Lisle, 35 T.C.M. (CCH) 627 (1976), the taxpayer sent out his notice of intent to retire and redeem at a time when the corporation had insufficient corporate surplus under California law to consummate the entire purchase. Id. at 636. Accordingly, the corporate resolution of acceptance provided for purchase only when, as, and if there was sufficient legal source. Id. Although the case did not involve potential attribution, the Tax Court noted that "[p]ayment of any obligation is conditioned upon the legality of such payment; [i]n effect, the statute is read into the agreement." Id., quoting Mountain State Steel Foundries v. Commissioner, 284 F.2d 737, 742 (4th Cir. 1960), rev'd, 18 T.C.M. (CCH) 306 (1959).

\textsuperscript{139} Plumb, supra note 69, at 433. Failure to provide for it may indicate a primary concern for enhancement of earnings. Id., citing Curry v. United States, 396 F.2d 630, 634 (5th Cir.), cert. denied, 393 U.S. 967 (1968), and Jewell Ridge Coal Corp. v. Commissioner, 318 F.2d 695, 699 (4th Cir. 1963). See notes 29 & 85 and accompanying text supra.

\textsuperscript{140} Plumb, supra note 69, at 437, citing Portage Plastics Co. v. United States, 301 F. Supp. 684, 689 (W.D. Wis. 1969), rev'd, 470 F.2d 308 (7th Cir. 1972). The inference may be weakened by the limitation of profit participation to a reasonable floor and ceiling. Plumb, supra note 69, at 437.

\textsuperscript{141} Plumb, supra note 69, at 442 (footnote omitted).

\textsuperscript{142} Id. at 442-43.

\textsuperscript{143} Valuation may have to be made according to a capitalization of earnings where the transaction remains open. See Gordon A. Erickson, 56 T.C. 1112 (1971) (redemption price determined in part by earnings from project in progress at time of redemption). Installment reporting under section 453, I.R.C. § 453, will not then be allowed. See In re Steen, 509 F.2d 1388 (9th Cir. 1975), noted in 22 VILL. L. REV. 165 (1977); note 21 supra.
instances of personal participation in the decisionmaking process of the corporate enterprise.\textsuperscript{144} Pinpointing control and influence within a family business is at best an elusive task. Perhaps it is in light of this difficulty and the machinations which preceded the 1954 Code\textsuperscript{145} that the Service has taken a rather dim view of the bona fides of such redemptions. Nevertheless, the courts have thus far confined dividend treatment to cases in which the circumvention has been realized; mere potential circumvention has not yet precluded exchange treatment.\textsuperscript{146} The willingness of the courts to weigh competing interpretations of the relationship by a consideration of all the surrounding facts and circumstances should encourage the taxpayer to develop and preserve clear and unambiguous documentation detailing the rights and duties of the respective parties.\textsuperscript{147}

This tendency to view the transaction in its totality offers further guidance in undecided areas. Although its per se approach to subordination has been rejected,\textsuperscript{148} the Service's position with respect to conditional payments has not yet been tested by judicial examination. While courts could conclude that an obligation to make payments whose amount or certainty depended upon the existence of sufficient earnings at the time the payment becomes due represented an equity or proprietary interest per se, it is submitted that it now appears unlikely that they would do so. The fact that an express nexus to corporate earnings exists is not very different from the contingency which subordination injects.\textsuperscript{149} It may be assumed, therefore, that courts will also view conditional payments as merely evidence of a failure to terminate the equity participation. Should courts adopt this position, it is then submitted that little remains of the regulation accompanying section 302(c)(2)(A)(i)\textsuperscript{150} as a test for the availability of the waiver of the family attribution rules.

This is not to suggest, however, that judicial decisions have entirely denuded the regulation of its importance as a statement of Service policy. On the contrary, the foregoing aspects retain their force in resolving the initial issue of whether there has been a termination of a shareholder interest in the corporation. These considerations, together with other expressed areas of concern,\textsuperscript{151} articulate, however incoherently, the Service's emerging distinction between corporate stock and indebtedness. The extent to which courts have gone to sustain the efforts of the departing shareholder to extricate himself from corporate involvement\textsuperscript{152} foreshadows the likeli-

\textsuperscript{144.} See notes 92–109 and accompanying text supra.
\textsuperscript{145.} See notes 37 & 46 and accompanying text supra.
\textsuperscript{146.} See notes 97, 100 & 112–116 and accompanying text supra.
\textsuperscript{147.} See notes 132–134 and accompanying text supra.
\textsuperscript{148.} See text accompanying notes 92 & 113 and notes 100 & 101 and accompanying text supra.
\textsuperscript{149.} See note 120 & 136 supra.
\textsuperscript{151.} See notes 29, 66–68 & 71 and text accompanying note 28 supra.
\textsuperscript{152.} In its most recent decision that discussed § 302(b)(3), the Tax Court found a complete termination of the equity interest of both the taxpayer and his brother, even though each retained the right to vote the stock as security for the payment of the full purchase price. Claude J. Lisle, 35 T.C.M. (CCH) 627, 635, 637 (1976). While the court
recognized that the presence of voting rights in itself strongly suggested the existence of an equity interest, id. at 637, it stated that "the opportunity for effective exercise and the ability to affect decision-making bears more on the question of beneficial ownership than the mere right to vote." Id., citing Ray A. Maher, 55 T.C. 441, 451 (1970), aff'd in part and rev'd in part, 469 F.2d 225 (8th Cir. 1972). The court reached its conclusion despite the fact that the taxpayer's brother retained the voting power even after the taxpayer had redeemed his shares. 55 T.C. at 451. The justification the Tax Court had raised was the need for the brother to counter any influence the taxpayer exerted in the corporation after the redemption of the brother's stock on an installment note. Id. See notes 34 & 94 supra.

In discussing the effect of the retention of title in the stock by the shareholders with the accompanying right to vote the interest, the Tax Court indicated that this did not dispose of the question of who was the owner for tax purposes, noting that

"[s]uch retention of title is merely for security purposes; and the security thus provided for the seller is comparable to that which he would have acquired if he had first transferred the title to the purchaser and had then simultaneously reacquired the same for security purposes, through a mortgage from the purchaser. These two methods of providing security for deferred payments are treated alike for income tax purposes, since they have identical objectives and effects."

35 T.C.M. (CCH) at 636, quoting Floyd R. Clodfelter, 48 T.C. 694, 700 (1967), aff'd, 426 F.2d 1391 (9th Cir. 1970) (citations omitted). See note 84 supra.

The Second Circuit has defined the rights inherent in a shareholder's interest to include: 1) the right to vote and thereby exercise control; 2) the right to participate in the earnings of the corporation; and 3) the right to share in the net assets upon liquidation. Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964). The Service has apparently adopted this standard in evaluating whether there has been a meaningful reduction of interest for purposes of section 302(b)(1). Rev. Rul. 75-502, 1975-2 C.B. 111. In the case before it, the Service found significance in the reduction of an estate's voting rights in the corporation from 57% to 50% when accompanied by a corresponding reduction in participation in earnings and in rights upon liquidation, because the redemption produced a situation in which control was shared with another single unrelated shareholder. Id. at 112. See Rev. Rul. 75-512, 1975-2 C. B. 112 (redemption by minority shareholder who took no part in management held not essentially equivalent to a dividend when the proportionate interest in the three aforementioned factors was reduced from 30% to 24.3%). Such rulings may be extended to all redemptions. As one journal posited in commenting on them,

"[It] would seem that a redemption would qualify as an exchange under Section 302(a) when a shareholder terminates his direct ownership through redemption, and afterwards, his constructive ownership does not amount to voting control of the corporation or otherwise constitute control over its management."


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