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THE TAXATION OF STOCK REDEMPTIONS AND PARTIAL LIQUIDATIONS*

Boris I. Bittker†

A. THE PRE-1954 BACKGROUND

Introduction.

When a shareholder transfers stock to the issuing corporation in exchange for money or other property, the transaction may resemble either an ordinary sale of stock to an outsider in an arm's length bargain or the receipt by the shareholder of a dividend from the corporation. The "sale" analogy is appropriate, for example, when the owner of preferred stock instructs his broker to sell his stock and the broker, by chance, effects a sale to the corporation, which happens to be buying up its preferred stock at the time. The preferred shareholder ought to be able to treat the transaction in the same manner as any other sale, reporting the difference between his adjusted basis and the sales price as capital gain or loss. On the other hand, when 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 to his corporation, 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. For shareholders who could adopt such a plan of intermittent "sales" of stock, the tax on dividend income would become a "dead letter."

* This article will appear as part of a book to be published in a few months, dealing with the organization of corporations and with corporate distributions, stock redemptions, liquidations, reorganizations, and related matters under the Internal Revenue Code of 1954. The present version is, in turn, a revision and abridgement of an earlier article by the author, entitled "Stock Redemptions and Partial Liquidations under the Internal Revenue Code of 1954," 9 Stanford Law Review 13 (1956).
† See Contributors' Section, Masthead, p. 394, for biographical data.
It should not be surprising, then, that a "sale" of stock by a shareholder to his corporation is sometimes taxed as a "dividend" instead of as a "sale." The knotty problem that has faced Congress, the Treasury, and the courts over the years—to which there can never be a universally acceptable solution—is the determination of which transfers of stock are to be classified as "dividends" and which as "sales." For a period of more than 30 years, ending in 1954, the general rule was that such transactions were "sales" unless the transaction was "essentially equivalent to the distribution of a taxable dividend," in which event the entire distribution was taxed as a dividend to the extent of current and post-1913 earnings and profits. Although the 1954 Code seeks to provide a more reliable formula, it preserves this ancient and troublesome phrase and there is no escape from a few words of history before we turn to the statutory language of the 1954 Code.

1 Throughout this article, the statement that a distribution in redemption of stock is to be treated as a "dividend" is predicated on an assumption that the corporation's earnings and profits are sufficient to cover the amount of the distribution. The statement that a redemption is to be treated as a "sale" or an "exchange" means that the distribution is to be treated as payment in exchange for the stock. It is assumed throughout that the redeemed stock is a "capital asset" in the hands of the shareholder; this will ordinarily be true of any taxpayer except a dealer in securities. For the special rules that govern "collapsible" corporations, see § 341(a); and, for the redemption of "section 306 stock," see § 306(a)(2) and (b)(1) and (2).

Ordinarily, of course, the shareholder will prefer the redemption to be treated as a sale of his stock, producing capital gain or loss, rather than as a § 301 distribution, taxable to the extent of the corporation's earnings and profits. But if the shareholder is a corporation, entitled to the dividends received deduction of § 243, the tax on a § 301 distribution may be less painful than the capital gain tax on a sale. For the reversal of roles that may occur in these circumstances, see Pacific Vegetable Oil Corp. v. Comm'r, 251 F.2d 682 (9th Cir. 1957), where the taxpayer argued that a redemption was essentially equivalent to a dividend, while the government argued that it was not. A similar reversal of roles may occur if the redeeming corporation has no earnings and profits, since in this event a § 301 distribution will be taxable only to the extent it exceeds the shareholder's aggregate basis for all his stock (both the redeemed and the retained shares), see § 301(c)(2) and (3); but if the transaction is treated as a sale, the taxpayer will realize gain to the extent the distribution exceeds the basis of the redeemed shares. See the last two sentences of Treas. Reg. § 1.302-2(a) (1955). Note also that pre-1913 appreciation in value is not taxed when distributed under § 301(c)(3)(B), but that it enters into the computation of gain if the redemption is treated as a sale.

2 The statute was not uniform throughout this period, however; even though the transaction was treated as a sale, the shareholder's gain on partial liquidations was taxable as ordinary income from 1934 to 1936 and as short-term capital gain (regardless of the holding period) from 1936 to 1942. For a history of the statutory provisions, see Darrell, "Corporate Liquidations and the Federal Income Tax," 89 U. Pa. L. Rev. 907 (1941).

3 1939 Code, § 115(g); although the statute referred only to post-1913 earnings and profits, it was held that current earnings and profits were equally fatal under § 115(g), as they would be in the case of any ordinary dividend. W. H. Weaver, 25 T.C. 1067, 1083-84 (1955).

The "essentially equivalent" phrase first appeared in the Revenue Act of 1921. On providing in 1921 that stock dividends should not be taxed on receipt, Congress recognized the possibility, already described, that stock dividends might be issued and then promptly redeemed as a substitute for ordinary cash dividends. Congress went on, therefore, to provide that the redemption of stock "after the distribution of any such [stock] dividend" could be taxed as a dividend if the transaction was "essentially equivalent to the distribution of a taxable dividend." This provision failed to reach a redemption that was followed, rather than preceded, by a stock dividend, but this omission was corrected in 1924. Two years later, the provision, which ultimately became section 115(g) of the 1939 Code, was amended to apply whenever a corporation cancelled or redeemed its stock "at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend," whether or not such stock was issued as a stock dividend. Despite this change, the courts at first were reluctant to apply section 115(g) unless the redeemed shares had been issued as tax-free stock dividends or in anticipation of a later redemption. Later, however, the courts viewed section 115(g) more sympathetically, in that they came increasingly to start with the assumption that any pro rata redemption was equivalent to a taxable dividend, casting on the taxpayer the burden of establishing that it ought to be treated as a sale instead.\(^5\)

As section 115(g) of the 1939 Code came to be the norm by which all pro rata redemptions were tested, rather than the exception, taxpayers found that the most promising escape was a judicial doctrine that a redemption resulting from a "corporate contraction" (or a "legitimate shrinkage") in the corporation's business activities was not essentially

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\(^5\) The "old" Regulations provided: "A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend. . . . On the other hand a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend." Treas. Reg. 118, § 39.115(g)-1(a)(2) (1953). For an interpretation of the phrase "ceases to be interested in the affairs of the corporation," see Rev. Rul. 408, 1954-2 Cum. Bull. 165.

Although the pre-1954 Regulations explicitly provided only that a redemption of "all" of the stock of a particular shareholder escaped § 115(g), the courts took the position that a redemption of part of the stock of a particular shareholder was equally efficacious: "It changes, pro tanto, his interest in the corporation in the same way that redemption of all his stock would do." Ferris v. United States, 133 Ct. Cl. 257, 261, 135 F. Supp. 286, 288 (1955). As to redemptions that were superficially non-pro rata, but were pro rata in reality either because the loss of the redeemed shares did not seriously affect the shareholder's relative position or because he was closely related to the remaining shareholders, see Pullman, Inc., 8 T.C. 292, 297 (1947); J. Natwick, 36 B.T.A. 866, 876 (1937); note 39 infra.
equivalent to a dividend. The courts also agreed that a redemption for "legitimate business purposes" was not taxable under section 115(g), without, however, agreeing on the meaning of that phrase.\textsuperscript{8} Even less helpful was the solemn announcement that the true test was whether the "net effect" of the redemption was the distribution of a dividend. In its infancy, this "test" was an attempt to escape an inquiry into the "motives and plans" of the shareholder and his corporation.\textsuperscript{7} But since virtually all pro rata redemptions have the "net effect" of a dividend, the courts finally succeeded in converting this "test" into a restatement of the "essentially equivalent" language of the statute or, sometimes, into a pseudonym for the "business purpose" doctrine which it was created to avoid.\textsuperscript{8}

The upshot was that in applying section 115(g) of the 1939 Code, there was no escape from an inquiry into all the facts and circumstances of each case, and predictions were hazardous:

Above all, courts continued to look for a valid business purpose of the corporation, such as (1) enabling the business to operate more efficiently as a sole proprietorship or as a partnership, (2) the conduct of part of its business under separate corporate form, (3) enhancement of its credit rating by calling in stock to cancel stockholder indebtedness, (4) resale of stock to junior executives, (5) provision of a profitable investment for an employees' association, (6) adjustment for a legitimate shrinkage of the business following a fire causing a permanent reduction in productive capacity, (7) elimination of unprofitable departments, or (8) contemplation of ultimate liquidation.

Other factors than business purpose entered into the witch's brew. While the pro-rata feature is seldom disregarded and often held controlling, its effect is not always predictable and courts at times find no dividend, though the redemption is pro rata and upon occasion even find that a nonpro-rata distribution requires dividend treatment. Other factors of varying degrees of significance have been held to be a poor dividend record, combined with large available earnings or profits; the fact that the initiative for the distribution was taken by the shareholder, rather than by the corporation; and the fact that the consideration paid for the redeemed stock bears no relation to its value, book or otherwise.\textsuperscript{9}


\textsuperscript{7} See Flanagan v. Helvering, 116 F.2d 937, 939-40 (D.C. Cir. 1940): "But the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering § 115(g)."

\textsuperscript{8} See Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954): "But the courts generally have not applied the 'net effect' test with strict logic but have broadened its scope to include inquiry into the possible existence of some 'legitimate business purpose,' for the redemption, that is to say, a legitimate corporate purpose as distinguished from a purpose to benefit the stockholder by a distribution of accumulated earnings and profits exempt from the imposition of income tax, ... thus adding a question of motive to the question of ultimate result."

The 1954 Code.

Before 1954, the statute did not distinguish between "redemptions" and "partial liquidations"; in fact, the term "partial liquidation" was defined as "a distribution by a corporation in complete cancellation or redemption of a part of its stock." This, the draftsmen of the 1954 Code thought, led to confusion:

Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions. Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.

Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in part I of this subchapter. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation.10

The language of the 1954 Code, however, fails in its aim of separating partial liquidations from redemptions. According to section 346(a), a "partial liquidation" (which is to be treated as a sale of the surrendered stock) includes a distribution "in redemption of a part of the stock of the corporation," so long as it is "not essentially equivalent to a dividend." Nothing is said in section 346(a) about "distributions characterized by what happens solely at the corporate level by reason of the assets distributed" or about "corporate contractions." Yet section 346 is the section that is supposed to provide the exclusive rule for partial liquidations, segregating them from other redemptions. Not only is section 346(a) innocent of any reference to "corporate contractions," but its language is virtually identical with parts of section 302, the section designed by the draftsmen of the 1954 Code to deal exclusively with those redemptions that are not partial liquidations. For section 302 provides, among other things, that a redemption shall be treated as a sale of the stock if it "is not essentially equivalent to a dividend." If the draftsmen's goal of separating "into their significant elements the kind of transactions . . . incoherently aggregated [by the 1939 Code] in the definition of a partial liquidation" is achieved, it will be by the painful

process of administrative and judicial construction of muddy language.

Whatever simplicity is gained by the new statutory framework, moreover, is easily outweighed by the complications introduced by the distinction between “distributions characterized by what happens solely at the corporate level by reason of the assets distributed” (i.e., partial liquidations) and “distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders” (i.e., certain other redemptions). To determine whether a redemption of stock is to be treated as a sale or as a “dividend” under the 1954 Code, it often will be necessary to examine section 302, relating to ordinary redemptions, as well as section 331(a)(2) and section 346, relating to partial liquidations.11

In the rest of this article, the 1954 Code’s treatment of stock redemptions, partial liquidations, and certain related problems will be dealt with in the following order:

1. Partial liquidations (infra, pp. 305-14).
4. Redemptions to pay death taxes, under section 303 (infra, pp. 327-29).
5. Collateral problems—computation of the shareholder’s gain or loss; the mystery of the disappearing basis; the shareholder’s basis for property received in redemption of stock; recognition of income or loss by the redeeming corporation; and the effect of a redemption on the corporation’s earnings and profits (infra, pp. 329-35).12

11 The Regulations take the position that if a distribution qualifies under § 346 as a partial liquidation, § 302 is not applicable to it. Treas. Regs. § 1.346-2 and § 1.302-1(a) (1955). Often it will be immaterial to the shareholder which section is employed, assuming his distribution qualifies under both § 346 and § 302(a), but § 346 will be preferable if § 306 stock is redeemed (see § 306(b)(2) or if LIFO inventory or property subject to a liability is distributed. See Chommie, supra note 6, at 413-14. Moreover, § 267, which disallows losses on certain “sales or exchanges of property,” does not apply to “distributions in corporate liquidations;” this exemption formerly embraced redemptions of stock whether there was a corporate contraction or not, but because of the more limited scope of the term “partial liquidation” under the 1954 Code, it may be that the exemption no longer applies to § 302(a) redemptions. Infra p. 330. On the other hand, the punitive treatment of collapsible corporations applies to distributions in partial liquidation, but possibly not to § 302(a) redemptions; Treas. Reg. § 1.341-1 (1955) refers to gain from the “actual” sale or exchange of stock of a collapsible corporation, permitting the inference that a § 303(a) redemption is not reached by § 341(a)(1). See Treas. Reg. § 1.302-1(b) (1955), as to “excess” distributions in connection with partial liquidations.

In the opinion of the author, the transfer of stock by a shareholder to his corporation for consideration can qualify as a sale or exchange of a capital asset only if it meets the standards of § 302(a), § 331(a)(2) or § 303. I do not believe, in other words, that such a transaction between the shareholder and his corporation can qualify for capital gain or loss treatment on the independent ground that it is a “sale” of stock, rather than a “redemption,” and hence need not run the gauntlet of § 302(a), § 331(a)(2), and § 303. See Bittker, “Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954,” 9 Stan. L. Rev. 13, 18n.22 (1956).

12 For general discussions of stock redemptions and partial liquidations under the 1954 Code, see Bittker, “Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954,” 9 Stan. L. Rev. 13 (1956) (of which this article is a revised and some-
B. PARTIAL LIQUIDATIONS UNDER SECTION 346

Introduction.

Section 331(a)(2) provides that amounts distributed in partial liquidation of a corporation shall be treated as payment in exchange for the stock. If the stock is a "capital asset" in the hands of the shareholder, his gain or loss (the difference between the value of the distribution and the adjusted basis of the redeemed stock)\(^1\) will be capital gain or loss. While section 331(a)(2) is the operative provision, requiring the distribution in partial liquidation to be treated as the proceeds of a sale of the stock, it is dependent upon section 346, which defines the term partial liquidation. Section 346 provides that a distribution "shall be treated as in partial liquidation" of a corporation if it falls into one of three categories:

1. A distribution that is one of a series of distributions in complete liquidation of the corporation. This category of partial liquidations could have been classed with complete liquidations; it does not invoke the "corporate contraction" concept that is ordinarily associated with the term "partial liquidation."

2. A distribution in redemption of part of the stock of a corporation that is "not essentially equivalent to a dividend." This category of partial liquidations is "characterized by what happens solely at the corporate level by reason of the assets distributed."

3. A distribution that terminates one of two or more active businesses engaged in by the distributing corporation. This category of partial liquidations was created by the 1954 Code; it is a type of corporate contraction that is ipso facto to be treated as a partial liquidation, without reference to the vague criteria of the corporate contraction concept.

These three categories of partial liquidations are discussed hereafter in more detail.\(^2\)

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\(^1\) For certain problems in determining the adjusted basis of the redeemed stock, see infra p. 330.

\(^2\) Senate Report on the 1954 Code, quoted supra p. 307, i.e., it is a statutory adaptation of the "corporate contraction" concept created by the courts under the 1939 Code.

One of a series of distributions in complete liquidation: section 346(a)(1).

Section 346(a)(1) provides that a distribution shall be treated as in partial liquidation of a corporation if it is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan. The relationship of this provision to section 331(a)(1), providing that amounts distributed in complete liquidation of a corporation shall be treated as the proceeds of a sale of the stock, is not clear. If a complete liquidation is consummated by a series of interim distributions without the surrender of any stock until the final distribution is made, the shareholder applies the distributions against the total basis of his stock and recognizes gain only when his basis for all the shares has been fully recovered.\(^{16}\) The problem of reconciling section 346(a) with section 331(a)(1) arises if each interim distribution in the process of complete liquidation is accompanied by a redemption of an appropriate number of shares. There is authority for treating such a series of distributions as the equivalent of a complete liquidation, so that the shareholder's gain or loss would be the difference between the aggregate basis of all his stock and the total value of the liquidating distributions.\(^{17}\) Another approach, however, would be to treat each distribution in partial liquidation as a separate transaction, computing gain or loss each time by subtracting the basis of the redeemed shares from the value of the interim distribution.\(^{18}\)

Corporate contractions: section 346(a)(2).

A distribution is to be treated as in partial liquidation of a corporation under section 346(a)(2) if it (a) "is not essentially equivalent to a dividend," (b) is in redemption of a part of the stock of the corporation pursuant to a plan, and (c) occurs within the taxable year in which the plan is adopted or within the succeeding taxable year. The first of these requirements invokes the "corporate contraction" doctrine and poses some troublesome problems; the second and third requirements are formal in nature and should ordinarily be easily satisfied.

1. "Not essentially equivalent to a dividend."

The language of this part of section 346(a)(2) echoes the phraseology of section 115(g) of the 1939 Code, though it is somewhat less elaborate.

\(^{16}\) Arthur Letts Jr., 30 B.T.A. 800 (1934), aff'd on other grounds, 84 F.2d 760 (9th Cir. 1936). Loss is also computed on an overall basis, either when the final distribution is made or at earlier period if the loss can be accurately determined then. Palmer v. United States, — F. Supp. —, 1 AFTR 2d 863 (D. Conn. 1958).


\(^{18}\) See Meldon v. Comm'r, 225 F.2d 467, 472 (3rd Cir. 1955); J. Paul McDaniel, 25 T.C. 276 (1955); see Courtenay Allington, 31 B.T.A. 421 (1934).
It clearly carries forward to some degree the "corporate contraction" doctrine that was developed under old section 115(g). Thus, the Senate Report on the 1954 Code states that "partial liquidation" in the 1954 Code primarily "involves the concept of 'corporate contraction' as developed under existing law." At another point, the Senate Report states:

The general language of the proposed draft would include within the definition of a partial liquidation the type of cases involving the contraction of the corporate business. Such as for example, cases which hold that if the entire floor of a factory is destroyed by fire, the insurance proceeds received may be distributed pro rata to the shareholders without the imposition of a tax at the rates applicable to the distribution of a dividend, if the corporation no longer continues its operations to the same extent maintained by the destroyed facility. Voluntary bona fide contraction of the corporate business may of course also qualify to the same extent as under existing law.

The corporate contraction doctrine under the 1939 Code embraced not only the overworked destruction-by-fire case, Inler v. Commissioner, but others where the reason for capital gain or loss treatment was even more obscure. Redemptions because a reserve for expansion was no

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19 S. Rep. No. 1622, 83d Cong., 2d Sess. 262 (1954). Despite the use of the term "primarily" by the Report, a distribution that does not reflect a corporate contraction will probably not satisfy § 346(a)(2). See Bittker, supra note 12, at 23.


21 T.C. 836 (1948).

22 The author has previously expressed his belief that the "corporate contraction" standard is not a legitimate test for determining whether a redemption is substantially equivalent to a dividend:

Even if one assumes that a "business purpose" test has a proper place in the interpretation of section 115(g), it is highly questionable that the standard of "legitimate shrinkage" has any economic validity. Courts are impressed with the discontinuance of a part of the business. But what if we have a business which has accumulated a surplus in expectation of an expansion which, for some reason, never occurs? When this corporation distributes the surplus, the stockholders probably will not be protected by the shield of legitimate shrinkage. But in both cases the economic decision made by the directors was essentially the same. They decided that capital was no longer required for the needs of the business and could be distributed among the stockholders through a redemption of capital stock. In one instance the capital had been used for an activity that was being curtailed. In the other, it was capital that had been saved for an activity which never took place. It is hard to understand why one distribution represents a more "legitimate shrinkage" than the other or exhibits a more valid business purpose.

And the "legitimate shrinkage" concept becomes more meaningless when viewed as a standard of taxation under section 115(g). That section is concerned with taxing distributions that are "essentially equivalent" to dividends. No stockholder can escape paying a tax under section 115(a), the section which defines dividends, because the distribution represented a "legitimate shrinkage" of the corporation's activities. A distribution is a dividend under section 115(a) when earnings and profits are separated from the corporation and distributed to shareholders without altering their relative ownership interests. If the same result is achieved as a result of a redemption of stock, it should be taxed as a dividend. Obviously, if we are looking to see whether there has been a distribution of assets without a change in proportionate ownership, it is immaterial whether the distribution was caused by a legitimate shrinkage or by boom-year profits.

Bittker and Redlich, supra note 4, at 472-73. See also Cohen et al., supra note 4, at 37-38:
longer required, or because a shift in the scale or nature of the corporation's operations had caused a decline in its need for working capital, or because property was being distributed to protect it from the claims of corporate creditors, or because an unprofitable department had been liquidated—all have sometimes successfully claimed the mantle of "corporate contraction." It may be going too far to say that under the 1939 Code the royal road to capital gain treatment for cash distributions to shareholders was to find some immediate or potential corporate use for its earnings and profits and wait for a plausible excuse for abandoning that use, but the cases were gradually beating at least a rough trail for astute taxpayers to follow. See the warning in *Kraus v. Commissioner*, involving a manufacturing company which sold a portfolio of securities and redeemed some of its stock with the proceeds:

It is very doubtful if the contours of a contraction test can be prescribed with any measure of success. But even if we assume that we can define "contraction," what is its relevance? By hypothesis the corporation has accumulated profits and is distributing cash representing some of these profits. The corporation does not intend to conclude its existence for the distribution is not one of a series of distributions in complete liquidation of the corporation. The shareholders remain as shareholders, their initial investment is still intact, and their relationships to the corporation and each other have not been altered. In such a setting, the distribution of cash should be treated for what it is—a distribution of profits. The activity at the corporate level which produced the cash and the motivation behind its distribution are not matters which should affect this conclusion.

In this regard, we should not be moved by the emotional case in which cash results from an "involuntary conversion" of a part of the business, as where a branch activity is destroyed by fire and instead of rebuilding the activity the corporation distributes the insurance proceeds. Such proceeds are simply cash profits being distributed. The fire unexpectedly forced the directors to make a decision involving the cessation of the activity. An unexpected but tempting offer to purchase the activity equally would have prompted a directors' meeting.

We may also dismiss the argument based on rewriting history—viz., the corporation originally could have been two corporations, each operating a part of the business, so that a later sale of the assets of one of the corporations would have resulted in its complete liquidation and hence capital gain treatment. Usually the business of a corporation simply expands out of accumulated earnings, a pattern which does not permit the separate incorporation hypothesis. Moreover, even if the situation would have accommodated two corporations at the outset, the shareholders did choose a different route. And the activities of a single corporation over the years are different from the relationships and activities of several corporations over the same period of time. There is, therefore, no justification for discovering hypothetical twins at the last minute.

23 Reserves for expansion: Comm'r v. Champion, 78 F.2d 513 (6th Cir. 1935); Sarah Upham, 4 T.C. 1120 (1945); contra, McGuire v. Comm'r, 84 F.2d 431 (7th Cir. 1936). Decline in working capital needs: Comm'r v. Quackenbos, 78 F.2d 156 (2d Cir. 1935); John P. Elton, 47 B.T.A. 111 (1942); contra, Dunton v. Clauson, 67 F. Supp. 839 (D. Me. 1946); Clarence O'Brien, 20 P-H Tax Ct. Mem. 1140 (1951); Edwin Jones, 11 P-H Tax Ct. Mem. 1428 (1942). Protection v. creditors: Comm'r v. Sullivan, 210 F.2d 607 (5th Cir. 1954); see also L. M. Lockhart, 8 T.C. 436 (1947). Liquidation of department: Comm'r v. Babson, 70 F.2d 304 (7th Cir. 1934), cert. denied, 293 U.S. 571 (1934); Heber Scowcroft Inv. Co., 14 P-H Tax Ct. Mem. 775 (1945). Because the courts rarely, if ever, find it necessary to base a decision on a single factor, it cannot be said with assurance that the element of contraction was the sole foundation for any of the foregoing decisions, though it appears to have been at least persuasive, if not the turning point, in all. It is entirely possible, however, that some of the earlier cases would not pass the more rigorous judicial examination that has been common recently. See Chommie, supra note 15, at 418.

24 6 T.C. 103, 120-21 (1946).
The argument is made that an investment business was conducted... to support the contention that there was a partial liquidation of the company when the securities were sold. But the liquidation of assets of the character we have here does not necessarily result in a liquidation of a "business," nor does the fact that the $150,000 which was distributed was most of the proceeds from the sale of securities stamp them as liquidating distributions.... If the securities represented the investment of accumulated profits, as we are compelled to conclude, the sales of the securities in 1940 operated to return to the company a fund of accumulated profits.

See also Hyman v. Helvering:25

And so also if a corporation invests earnings in plant and equipment, which, in later years, in a policy of contraction of business activities, it decides to sell and to divide the proceeds among its shareholders, the distribution is none the less a dividend, though the device of canceling some of the outstanding shares be adopted as a method of accomplishing the end sought.

These cases are extreme instances of judicial alertness to abuse of the corporate contraction doctrine, however, and it cannot be said that they reflect the prevailing pre-1954 attitude in this area.

Notwithstanding several references to "existing law" in the Senate Report on the 1954 Code, however, the draftsmen of section 346(a)(2) gave at least two indications that the pre-1954 law of "corporate contractions" was not ratified in every respect. The Senate Report states flatly that "a distribution of a reserve for expansion is not a partial liquidation,"26 thus rejecting at least some pre-1954 cases. Moreover, the almost equally clear implication that section 346(a)(2) applies only to redemptions that "terminate a part of the business of the corporation,"27 is not compatible with pre-1954 cases holding that a distribution of excess working capital can qualify as a partial liquidation. Even in the absence of these inconsistencies between the Senate Report and pre-1954 law, it would be improper to interpret a general intention to carry forward "existing law" as either a blanket endorsement of every judicial decision theretofore rendered or as preventing further evolutionary developments in what is at best an imprecise concept imposed upon very divergent sets of facts. In this connection, it is worthy of note that the Imler case28 explicitly described and approved by the Senate Report on the 1954 Code,29 itself states:

The issue here raised presents a question of fact depending on the circumstances of the particular case.... No sole or universally applicable test can be laid down.... Though decided cases are not controlling, they

25 71 F.2d 342, 344 (D.C. Cir. 1934).
28 See note 21 supra.
are helpful as indicating what elements have been considered important, viz., the presence or absence of a real business purpose, the motives of the corporation at the time of distribution, the size of the corporate surplus, the past dividend policy, and the presence of any special circumstance relating to the distribution.\textsuperscript{30}

The existence of conflicting decisions and inconsistent approaches in the pre-1954 case law makes judicial choices in the future unavoidable. The "corporate contraction" doctrine, then, must be viewed as an organic concept, not as a frozen body of rules.

2. Redemption pursuant to a plan.

Section 346(a)(2) requires a "redemption" of stock. Under the pre-1954 law, some courts held that reacquired stock that was held in the treasury had not been "cancelled or redeemed."\textsuperscript{31} Section 317(b) defines "redemption" as a reacquisition of stock by a corporation from a shareholder in exchange for property, whether the stock is thereafter cancelled, retired, or held as treasury stock. This definition, which prevents form from triumphing over substance, does not technically apply to section 346, though probably this was by an oversight. Another problem in this area is whether a distribution accompanying a reduction in the par or stated value of stock constitutes a "redemption," even though no stock is surrendered by the shareholders. The proposed Regulations stated that such a distribution is a "redemption,"\textsuperscript{32} but this announcement was omitted from the final Regulations. Such a distribution was not equivalent to a redemption under the 1939 Code,\textsuperscript{33} and nothing in the 1954 Code suggests that a different rule should be applied in the future.

Section 346(a)(2) requires the corporation to redeem its stock "pursuant to a plan." The term "plan" is not defined in either the Code or the Regulations. No doubt an informal plan will suffice, as in other areas where a corporate adjustment must occur under a plan, but careful counsel will not trust to luck.

3. Distribution in the year the plan is adopted or within the succeeding year.

Since neither the Code nor the Regulations defines the term "plan,"

\textsuperscript{30} 11 T.C. at 840.
\textsuperscript{31} Comm'r v. Snite, 177 F.2d 819 (7th Cir. 1949); Kirschenbaum v. Comm'r, 155 F.2d 23 (2d Cir. 1946), cert. denied, 329 U.S. 726 (1946); contra, Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Smith v. United States, 131 Ct. Cl. 748, 130 F. Supp. 586 (1955).
\textsuperscript{33} Sheehan v. Dana, 163 F.2d 316 (8th Cir. 1947); Beretta v. Comm'r, 141 F.2d 452 (5th Cir. 1944), cert. denied, 323 U.S. 720 (1944).
it is not surprising that they do not state how the time of its "adoption" should be determined. Presumably the time will ordinarily begin to run from the formal action by the shareholders authorizing the redemption, but the Commissioner might be justified on occasion in determining that the plan was "adopted" by informal action at an earlier date and in disqualifying a distribution as too late under section 346(a)(2). See the analogous problem of determining when a plan of complete liquidation was adopted, under section 337.

Termination of one out of two or more trades or businesses: section 346 (b).

The shareholders need not concern themselves with the vagaries of the "corporate contraction" concept if the distribution meets the requirements of section 346(b), relating to a distribution in termination of an active trade or business by a corporation that is engaged in two or more active trades or businesses.34 This provision, which has no counterpart in the 1939 Code, is summarized by the Senate Report on the 1954 Code35 as follows:

[Section 346(b)] provides a description of one kind of distribution which will be considered as being in partial liquidation. Paragraphs (1) and (2) contemplate that the distributing corporation must be engaged in the active conduct of at least 2 businesses which have been actively conducted (whether or not by it) for the 5-year period ending on the date of the distribution. Neither of such businesses may have been acquired within such period in a transaction in which gain or loss was recognized in whole or in part. Thus, a qualifying business may not have been acquired by purchase or a corporate reorganization where so-called "boot" was present. If these requirements are met, one of the active businesses may be distributed in kind (or the proceeds of sale of such a business may be distributed) as long as the corporation immediately after the distribution is engaged in the active conduct of a business as described above. The determination of whether the requirements of [Section 346] (b) have been met shall be made without regard to whether the distribution is pro rata among the shareholders of the corporation.

To qualify under section 346(b), a distribution must meet the following requirements:

1. The distribution must be attributable to the corporation's ceasing to conduct, or must consist of the assets of, a trade or business;
2. Immediately after the distribution, the distributing corporation must be actively engaged in a trade or business;
3. Both the retained trade or business and the one that was distributed (or that gave rise to the distribution) must have been actively conducted (though not necessarily by the distributing corporation) throughout the 5 year period preceding the distribution; and

34 If one of the businesses is conducted by a subsidiary corporation, a distribution of its stock may be governed by § 355 (relating to spin-offs, etc.).
4. Neither trade or business may have been acquired by the distributing corporation within the preceding 5 years in a transaction in which gain or loss was recognized in whole or in part.

This battery of requirements may be understood more easily if their purpose is known. Accepting the "corporate contraction" doctrine as an appropriate test, the draftsmen wanted to create an area in which capital gains treatment would be assured without the necessity of justifying each distribution, case by case, under the vague standards of the courts. They thought that if a corporation with two or more businesses wished to distribute one of them, the distribution should be treated as a partial liquidation. At the same time, they did not want to open a royal road to tax avoidance by allowing a closely-held corporation to accumulate its earnings and profits, invest its surplus cash in assets that the shareholders would like to hold as individuals, and then go through the form of a "corporate contraction" by distributing the newly acquired assets and retaining the business assets. Section 346(b)'s requirement of "active" conduct of a "trade or business" will prevent an evasion of the tax on dividends by a corporate purchase and subsequent distribution of investment securities or real estate in redemption of part of the stock of the corporation. The 5-year rule, coupled with the prohibition on the acquisition of either of the trades or businesses by purchase,\(^6\) will prevent the corporation from accumulating its earnings and profits and investing its surplus in a business (e.g., a farm, ranch, or similar property) that the shareholders would otherwise have acquired with taxable dividends,

\(^6\) The prohibition on acquiring the trade or business during the 5-year period "in a transaction in which gain or loss was recognized in whole or in part" was obviously intended to apply to transactions in which the transferor recognized gain or loss, even though the transferee did not. See the reference to acquisition by "purchase" in the extract from the Senate Report quoted in the text, supra p. 311. Moreover, acquisition by purchase is probably prohibited even though gain or loss was not recognized by the seller because the price paid happens to be exactly equal to the adjusted basis of the acquired trade or business in his hands. The Senate Report's reference to acquisition by "purchase," as well as the purpose of the section, also strongly suggest the purchase (within the 5-year period) of a trade or business from a corporation that recognizes no gain or loss on the sale under § 337 should not qualify; it would seem that gain or loss is recognized in such a "transaction," within the meaning of § 346(b), by the shareholders of the selling corporation on its liquidation, since the sale under § 337 and the liquidation of the selling corporation constitute an integrated transaction. A more sophisticated variation on this theme would be a purchase by the distributing corporation of the stock of a second corporation, followed by a sale by the second corporation of its trade or business to the first corporation, under § 337. Here the liquidation of the second corporation would not produce gain or loss to anyone if the liquidating proceeds were equal to the price paid by the distributing corporation for the stock of the second corporation. But the acquisition of the stock of the second corporation would have produced gain or loss to its original shareholders, and this could be regarded as a "transaction in which gain or loss was recognized in whole or in part" within the meaning of § 346(b). It should be noted, however, that § 346(b) is not as explicit as § 355(b)(2), which, in dealing with a similar problem, prohibits not only the acquisition of a trade or business during the 5-year period but also the acquisition of a corporation conducting the trade or business. See H.R. Rep. No. 2543, 83d Cong., 2d Sess. 37-38 (1954).
with a view to a prompt distribution in "partial liquidation" under section 346(b). It will not, however, prevent a similar plan for avoidance of the dividend tax if the shareholders are patient; after the farm or ranch has been held for 5 years (assuming its operation constitutes the "active conduct of a trade or business"), its distribution can qualify under section 346(b), with a possible exception for transactions that can be characterized as shams.

The principal problem under section 346(b) is the meaning of the term "a trade or business which has been actively conducted," since the distribution must either consist of the assets of, or be attributable to the corporation's ceasing to conduct, such a trade or business. The Regulations under section 346(b) refer to section 355, which permits a corporation to make a tax-free distribution of a controlled corporation if both the distributing and distributed corporations are "engaged in the active conduct of a trade or business." The Regulations under section 355 state that a trade or business consists of "a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities," that the group must include every operation that forms a part of the process of earning income, and that it must ordinarily include the collection of income and the payment of expenses. Among the examples given by the Regulations are: an office building owned by a bank which occupies one floor and rents the remaining ten floors; the manufacture and sale of ice cream at a plant in one state by a corporation that manufactures and sells ice cream at another plant in a second state; and a suburban retail store owned by a downtown store, each store being separately managed and having its own warehouse. The Regulations go on to state that the term "trade or business" does not comprehend investment property, real estate used in the operation of a trade or business, or a group of business activities that do not independently produce income, giving as examples a research division, a factory building used by a manufacturer, a "captive" coal mine, and an executive dining room.37

Although a distribution that does not meet the tests of section 346(b) might be able to qualify under section 346(a)(2)'s more vague standard

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37 Treas. Reg. § 1.346, § 1.355-1(c) and (d) (1955). For rulings based on these Regulations, see Rev. Rul. 56-512, 1956-2 Cum. Bull. 175 (leased mineral property owned by a manufacturing corporation, not a trade or business); Rev. Rul. 56-513, 1956-2 Cum. Bull. 191 (bread division and cracker division of bakery company constituted two trades or businesses); Rev. Rul. 57-333, 1957-2 Cum. Bull. 239 (incidental rental property owned by food company not a trade or business); Rev. Rul. 334, 1957-2 Cum. Bull. 240 (two rental properties owned by real estate corporation constituted, on facts, separate trades or businesses). For more on this subject, which is likely to produce some increasingly fine distinctions over the years, see Young, "Corporate Separations: Some Revenue Rulings Under Section 355," 71 Harv. L. Rev. 843 (1958).
of "corporate contraction," there is already a tendency in the rulings to assume the contrary. In many instances, of course, the taxpayer's inability to obtain a favorable ruling under section 346 will result in abandoning the proposed distribution, because of the vagaries of litigation and the threat of a dividend tax under section 301 if he loses.

C. STOCK REDEMPTIONS UNDER SECTION 302

Introduction.

If a redemption of stock does not meet the qualifications of a partial liquidation, it may nevertheless be accorded capital gain or loss treatment by section 302. Section 302(a) provides that a redemption of stock shall be treated as a distribution in part or full payment in exchange for the stock if it falls into any one of these four categories:

1. A complete redemption of all of the shareholder's stock under section 302(b)(3).
2. A "substantially disproportionate" redemption of the shareholder's stock under section 302(b)(2).
3. A redemption that is "not essentially equivalent to a dividend" under section 302(b)(1).

The first three of these categories (but not the fourth) are discussed hereafter.

By virtue of section 302(d), a redemption that does not fall into one of the foregoing categories is treated as a distribution under section 301. It will constitute a "dividend" to the extent of current and post-1913 earnings and profits and a return of capital to the extent of the excess.

Termination of shareholder's entire interest: section 302(b)(3).

Section 302(b)(3) provides that a redemption shall be treated as a sale if it "is in complete redemption of all of the stock of the corporation owned by the shareholder." If a corporation is owned by A and B, two unrelated persons, a redemption of all of the stock of either A and B will qualify under section 302(b)(3). A redemption of this type was similarly treated as a sale, rather than a dividend, under pre-1954 law.38

1. The attribution rules.

In the foregoing illustration, A and B are not related. What if they are? Section 302(c) provides that in determining the ownership of stock under section 302, the "constructive ownership" rules of section 318(a) shall apply.39 By virtue of these rules, an individual is "considered as

38 Note 5 supra.
39 The 1939 Code did not explicitly attribute stock owned by one person to another
owning" any stock (a) that is owned by certain members of his family (viz., his spouse, children, grandchildren, and parents), (b) that is owned by partnerships, estates, certain trusts, and certain corporations in which he is financially interested, or (c) that is subject to any option held by him. If B was A's son or A's wholly-owned corporation, then, B's stock would be imputed to A (and vice-versa) under section 318(a), with the result that a redemption of the stock actually owned by A would not terminate his interest as required by section 302(b)(3), unless the stock constructively owned by A is also redeemed. In the case of "family" corporations, the constructive ownership rules will frequently prevent a redemption of all the stock actually owned by one shareholder from qualifying under section 302(b)(3), especially because there may be more than one link in the chain of imputed ownership.

2. Waiver of the family attribution rules.

The constructive ownership rules of section 318(a) are not inescapable, however; section 302(c)(2) provides that the family attribution rules shall not apply to a shareholder whose stock is redeemed (a) if immediately after the distribution he has no "interest" in the corporation (including an "interest" as officer, director, or employee), other than an interest as a creditor, and (b) if he does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of the distribution.40

This waiver of the family attribution rules will clear the way to a redemption under section 302(b)(3), if the distributee is willing and able to forego any "interest" in the corporation (except an interest as a creditor and an interest arising from the acquisition of stock by bequest or inheritance) for a period of 10 years. The theory of the family attribution rules and of their waiver may be stated in this fashion: a redemption of all the stock of a shareholder is properly treated as a sale in the application of § 115(g). But in 1951, the Treasury Department announced a proposal to amend the regulations under § 115(g), supra note 4, to provide that the redemption of all of the stock of a particular shareholder would "generally" not be subject to § 115(g), but that "where such shareholder is closely related to remaining shareholders, that factor will be considered along with all other circumstances of the case in determining whether the distribution is essentially equivalent to a dividend." 16 Fed. Reg. 10,312 (1951). The proposed amendment was withdrawn after the 1954 Code was enacted. 19 Fed. Reg. 7159 (1954). Even without the aid of regulations, both the courts and the Internal Revenue Service at times regarded the relationship between a shareholder whose stock was redeemed and the remaining shareholders as significant in applying § 115(g). See Rev. Rul. 55-373, 1955-1 Cum. Bull. 363; Rev. Rul. 55-547, 1955-2 Cum. Bull. 571; Grimditch v. Comm'r, 37 B.T.A. 402, 412 (1938); but see In re Lukens' Estate, 246 F.2d 403 (3d Cir. 1957). 40 A taxpayer who relies on § 302(c)(2) for a waiver of the family attribution rules must agree to notify the Treasury if he acquires any such "interest" in the corporation, and the periods of limitation on assessment and collection of any deficiency resulting from the acquisition of an interest are appropriately extended. 
because it terminates his interest in the corporation as effectively as a sale to a third person. The analogy is not appropriate, however, if after the redemption stock is owned by a member of the ex-shareholder's immediate family; it is sufficiently possible that he will thereby continue his interest in the corporation (without the interference from the outside that might have resulted if he had sold his stock to a third person) that an attribution of his relative's shares to him is a reasonable rule of thumb. If he is willing, however, to give up for a 10 year period any "interest" in the corporation, other than an interest as a creditor or an interest that may be involuntarily acquired by a bequest or inheritance of stock, it is reasonable to waive the family attribution rules and treat the redemption as a sale.

It should be noted that section 302(c)(2) waives only the family attribution rules. There is no escape from the rules that attribute stock to the taxpayer if he has a beneficial or indirect interest in it through partnerships, estates, certain trusts or certain corporations, or if he has an option to buy it. Moreover, stock held by a nominee would undoubtedly be treated as owned by the principal without reliance upon section 318, even if the nominee were not a relative of the true owner.

The conditions attached by section 302(c)(2) to a waiver of the family attribution rules are not without some ambiguities. The prohibition of the ex-shareholder's retention or acquisition of "an interest [in the corporation] as officer, director, or employee" for 10 years could be construed to bar employment only if coupled with profit-sharing or a similar financial stake "in" the corporation, but the Internal Revenue Service has expressed the stricter view that the performance of services, with or without compensation, is fatal.\[41\] It would be more consonant with the purpose of section 302(c)(2) to discriminate between conduct supporting an inference that the redemption of the ex-shareholder's stock did not effectively terminate his financial interest in the corporation and conduct that is consistent with such a termination, and to waive the family ownership rules if the ex-shareholder's conduct falls in the latter category.

Since section 302(c)(2) permits the retention or acquisition of an interest "as a creditor," the shareholder will be able to sell his shares to the corporation on credit, rather than for cash; but the Regulations appropriately warn against obligations "in the form of debt" that in fact give the owner a "proprietary interest."\[42\]

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\[42\] Treas. Reg. § 1.302-4(d) (1955); see Mary Duerr, 30 T.C. 944 (1958); Bittker, "Thin Capitalization: Some Current Questions," 34 Taxes 830 (1956).
3. Restrictions on waiver of family attribution rules.

The waiver of the family ownership rule found in section 302(c)(2)(A) is denied in certain circumstances. Before examining these conditions, which are set out in section 302(c)(2)(B), it may be well to see an illustration of their purpose. If A owns all the stock of a corporation and wishes to give his son a gift of cash, he can of course use funds that he has received as dividends—but only after they have been reported as income. If he raises the funds by causing the corporation to redeem part of his stock, the redemption will probably be taxed as a dividend. But what if A gives his son some stock in the corporation, and then causes this stock to be redeemed? If the transaction can avoid being classified as a sham, the son could claim the shelter of section 302(b)(3), avoiding the family attribution rules of section 318 (which if applicable would take the transaction out of section 302(b)(3) by imputing A's unredeemed shares to his son) by foregoing any "interest" in the corporation for a period of 10 years.

To frustrate plans of the type just described, section 302(c)(2)(B) provides that the family attribution rules shall not be waived:

1. If any part of the redeemed stock was acquired, directly or indirectly, within the previous 10 years by the distributee from a related person; or
2. If any related person owns stock at the time of the distribution and acquired any stock, directly or indirectly, from the distributee within the previous 10 years, unless the stock so acquired is redeemed in the same transaction.

These limitations on the waiver of the family attribution rules are not applicable if the acquisition (in the case of (1) above) or the disposition (in the case of (2) above) did not have "as one of its principal purposes the avoidance of federal income tax." The Regulations state that a transfer "shall not be deemed" to have as one of its principal purposes the avoidance of federal income tax "merely" because the transferee is in a lower income tax bracket than the transferor. It may be, however,
that a transfer to such a person for the purpose of reducing the total family income tax burden would prevent a waiver of the family attribution rules.\footnote{47}

Termination of shareholder's entire interest: Redemptions in conjunction with sales.

Section 302(b)(3) requires, as we have seen, a redemption of "all of the stock of the corporation owned by the shareholder." What if the shareholder sells part of his stock and the corporation, by prearrangement, redeems the rest? In a celebrated pre-1954 case involving a one-man corporation, the Internal Revenue Service contended that such a redemption was a "dividend" to the original shareholder under section 115(g) of the 1939 Code, arguing that the redemption of part of his stock would have been a "dividend" if it occurred before the sale and that the result should be the same where the redemption, by prearrangement, followed the sale. The Court of Appeals for the Sixth Circuit held to the contrary, however, on the ground that the taxpayer's intent "was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation," leading to the conclusion that the redemption did not occur "at such time and in such manner as to make the distribution and cancellation or redemption . . . essentially equivalent to the distribution of a taxable dividend."\footnote{48}

To continue with a sale of part of the stock of a one-man corporation followed by a prearranged redemption of the remaining shares, is it possible that the redemption will be treated as a "dividend" to the purchaser of the other shares? If he bought all the shares and then caused some of them to be redeemed, the redemption would of course not qualify under section 302(b)(3) as a redemption of "all" of his shares. Under the 1939 Code, moreover, it was held that a taxpayer who contracted to buy stock on the installment plan and then caused the corporation to dis-


\footnote{48} Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); accord, Auto Finance Co. v. Comm'r, 24 T.C. 416 (1955), aff'd per curiam, 229 F.2d 318, 889 (4th Cir. 1956). The Internal Revenue Service has acquiesced in Zenz v. Quinlivan so far as the 1939 Code is concerned, Rev. Rul. 54-458, 1954-2 Cum. Bull. 167, and has also announced that such a transaction meets the requirements of § 302(b)(3) of the 1954 Code, Rev. Rul. 55-745, 1955-2 Cum. Bull. 223. If the selling shareholder retains an interest in the corporation, the Internal Revenue Service might assert that the transaction is not covered by its rulings and seek to re-argue Zenz v. Quinlivan, at least for shareholders retaining such an interest. See Bittker, supra note 12, at 35-36; and, for discussions antedating the appellate decision in Zenz v. Quinlivan, see First, "Use of Corporate Funds to Buy Out Shareholders—Acquisitions by Third Parties," N.Y.U. 12th Inst. on Fed. Tax. 191 (1954); Redlich, "The Sale of a Closely-Held Corporate Business," 9 Tax L. Rev. 354 (1954); Note, "Income Tax Problems in the Use of Stock Redemptions to Purchase a Corporation Out of Future Earnings," 67 Harv. L. Rev. 1387 (1954).
charge his obligation to the seller by redeeming some of the shares had received a taxable dividend. See *Wall v. United States*,49 holding that a redemption in such circumstances was the equivalent of a payment by the corporation of the taxpayer's personal debt:

The controlling fact in this situation was that Wall [the buyer] was under an obligation to pay Coleman [the seller] $5,000 in the tax year and that [the corporation] paid this indebtedness for Wall out of its surplus. It cannot be questioned that the payment of a taxpayer's indebtedness by a third party pursuant to an agreement between them is income to the taxpayer. . . . The transaction is regarded as the same as if the money had been paid to the taxpayer and transmitted by him to the creditor; and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt.50

The principle of the *Wall* case is not applicable, however, if the buyer agrees to purchase part of the seller's stock, and the corporation agrees simultaneously to redeem the rest. The Tax Court has held in *Edenfield v. Commissioner*51 that a redemption of the seller's stock did not constitute a dividend to the buyer in a case of this type even though he pledged his shares to insure that the corporation would perform its part of the bargain, so long as he had no personal obligation to acquire the shares that were redeemed. If cash is to be paid for the shares at the closing, there is no practical difference to the buyer between a purchase of all the shares, followed by a redemption from him of some, and a purchase of some shares with a simultaneous redemption of the others from the seller. Under the *Edenfield* case, however, the difference in form would determine whether the buyer received a dividend or not. If some shares are to be paid for at a later date, the *Wall* case finds a dividend if individual purchaser agrees to buy and then causes the corporation to take over his obligation, while the *Edenfield* case protects the purchaser if only the corporation is liable to the seller. Yet it may well be that neither the seller nor the buyer will care, except for tax purposes, whether the buyer's credit or only the corporation's is pledged. The Internal Revenue Service has acquiesced in the *Edenfield* case, however, and it seems to be reasonably well established that the purchase of stock by a corporation is not a taxable distribution to its shareholders, so long as they did not have any personal obligation to buy. And in *Holsey v. Commissioner*52 this principle was applied to a 50 per cent shareholder who

49 164 F.2d 462 (4th Cir. 1947).
50 See also Woodworth v. Comm'r, 218 F.2d 719 (6th Cir. 1955); French v. Comm'r, 26 T.C. 263 (1956).
51 19 T.C. 13 (1952).
52 258 F.2d 865 (3d Cir. 1958).
held an option to acquire the rest of the stock; he assigned the option to the corporation, which thereupon redeemed the optioned stock. The court held that the transaction was not a distribution to the remaining shareholder, since he was under no personal obligation to acquire the stock.

The Internal Revenue Service recently acquiesced in the Holsey case and announced that it will not treat the purchase of one shareholder's stock as a dividend to the remaining shareholders "merely because their percentage interests in the corporation are increased," but that "if the stock is in reality purchased by a remaining shareholder and paid for by the corporation, then, regardless of the form of the transaction, the payment will be considered a dividend to the shareholder who made the purchase." If an agreement requiring the remaining shareholders to buy the stock of a retiring shareholder is "called off," however, in order to substitute a corporate obligation to buy, for the sole purpose of bringing the redemption within the Edenfield case rather than the Wall case, the Commissioner might well be upheld in contending that the transaction was "in reality" a shareholder transaction. The theory would be that the corporation was merely a conduit through which the shareholder obligated himself to acquire the stock.

Substantially disproportionate redemptions: section 302(b)(2).

Because an ordinary dividend effects a distribution of property to the corporation's shareholders without disturbing their relative voting power or interest in the assets and earning power of the corporation, a redemption of stock was most likely to qualify as "essentially equivalent to the distribution of a taxable dividend" under section 115(g) of the 1939 Code if it was pro rata among all the shareholders. Conversely, a non-pro rata redemption ordinarily escaped the clutches of section 115(b). Section 302(b)(2) of the 1954 Code has carried forward this distinction, by providing that a "substantially disproportionate" redemption is to be treated as a sale or exchange of the stock rather than as a dividend. A

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53 Rev. Rul. 58-614, 1958-51 Int. Rev. Bull. 49. The ruling seeks to renounce form as crucial, always a laudable objective, but it cannot obscure the fact that, in practice, often the only reason for a redemption by the corporation rather than a purchase by the remaining shareholders (with dividends income, after taxes) is that the former is taxed more favorably than the latter. In this sense, therefore, form rather than substance controls under the ruling, as under the cases. See Niederkrome v. Comm'r, — F.2d —, 2 AFTR 2d 6155 (9th Cir. 1958); Zipp v. Comm'r, 259 F.2d 119 (6th Cir. 1958); Mayer v. Donnelly, 247 F.2d 322 (5th Cir. 1957); Ferro v. Comm'r, 242 F.2d 838 (3d Cir. 1957); Fox v. Harrison, 145 F.2d 521 (7th Cir. 1944).

54 See Fox v. Harrison, supra note 53, involving the converse situation, in which a shareholder successfully argued that he was the corporation's conduit for the redemption of stock. For another analogy, also the converse of the argument suggested here, see Comm'r v. Court Holding Co., 324 U.S. 331 (1945).

55 Note 5 supra.
shareholder cannot avail himself of section 302(b)(2), however, unless immediately after the redemption he owns (directly and constructively) less than 50 per cent of the total combined voting power of all classes of stock entitled to vote. This restriction on section 302(b)(2) is presumably based on the theory that a reduction in the shareholder’s proportionate ownership is not significant if he retains, directly or constructively, stock representing 50 per cent or more of the voting power.

To be "substantially disproportionate," the redemption must satisfy a mathematical test expressed in section 302(b)(2)(c): the shareholder’s percentage of the total outstanding voting stock\(^{56}\) (owned directly and constructively) immediately after the redemption must be less than 80 per cent of his percentage of such stock immediately before the redemption. The Regulations set out the following example to illustrate section 302 (b)(2):

Corporation M has outstanding 400 shares of common stock of which A, B, C and D each own 100 shares or 25 percent. No stock is considered constructively owned by A, B, C or D under section 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C. For the redemption to be disproportionate as to any shareholder, such shareholder must own after the redemptions less than 20 percent (80 percent of 25 percent) of the 300 shares of stock then outstanding. After the redemptions, A owns 45 shares (15 percent), B owns 75 shares (25 percent), and C owns 80 shares (26\(\frac{2}{5}\) percent). The distribution is disproportionate only with respect to A.\(^{57}\)

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*Must be 80% or less to qualify under section 302(b)(2).

If the corporation has more than one class of stock outstanding, the shareholder cannot make use of section 302(b)(2) unless the redemption

\(^{56}\) The term "voting stock" is defined by the Regulations so as to exclude, at least "generally," stock with contingent voting rights. Treas. Reg. § 1.302-3(a) (1955). The Regulations do not state whether the term "stock entitled to vote," is the same as "voting stock." For problems in identifying "voting stock" and "stock entitled to vote" and in computing "voting power," see Bittker, infra note 69, at 374-75.

\(^{57}\) Treas. Reg. § 1.302-3(b) (1955).
reduces his percentage of common stock (whether voting or nonvoting), as well as his percentage of voting stock. If the corporation redeems only nonvoting stock (whether common or preferred), the redemption cannot qualify under section 302(b)(2) because it will not reduce the shareholder's proportionate ownership of voting stock. But the redemption of non-voting stock can qualify, according to the Regulations, if it is coupled with a redemption of voting stock that would qualify if it stood alone.58

To prevent an obvious abuse of section 302(b)(2), the statute explicitly provides that it does not apply to any redemption under a plan that contemplates a series of redemptions which in the aggregate will not be "substantially disproportionate" with respect to the shareholder. Thus, to return to the illustration above, if the redemption of the stock of A, B, and C was in accordance with a plan by which 75 of D's shares would later be redeemed, the redemption of A's shares would not meet the test of section 302(b)(2). For after the second step, A would own 20 per cent of the total outstanding shares (45 out of 225), an insufficient reduction in his percentage. The redemption of D's shares, however, would apparently qualify even though it was the occasion for disallowing the redemption of A's shares. It should not be assumed that the explicit reference in section 302(b)(2)(D) to a "series of redemptions" is the Commissioner's only weapon against attempts to abuse section 302(b)(2). If a redemption viewed in isolation is "substantially disproportionate" as to a shareholder, but the other shareholders have agreed to sell enough stock to him after the redemption to restore the status quo, the redemption will probably not satisfy section 302(b)(2).

Redemptions not essentially equivalent to dividends: section 302(b)(1).

Section 302(b)(1) provides that a redemption may be treated as a sale of the redeemed stock if it "is not essentially equivalent to a dividend." The language comes from section 115(g) of the 1939 Code. The Regulations state that the application of section 302(b)(1) "depends upon the facts and circumstances of each case."59 Some commentators have argued that any redemption that could have escaped section 115(g) of the 1939 Code will qualify as "not essentially equivalent to a dividend" under section 302(b)(1). But the Senate Report on the 1954 Code rather clearly implies that section 302 is concerned solely with "those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders."60

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REDEMPTIONS AND PARTIAL LIQUIDATIONS

The relative history of section 302(b)(1) also suggests a modest role for it. The provision was added by the Senate Finance Committee after the passage by the House of H.R. 8300, providing for capital gains treatment primarily in circumstances similar to those now set out in section 302(b)(2) ("substantially disproportionate" redemptions) and section 302(b)(3) (terminations of the shareholder's entire stock interest). The addition of section 302(b)(1) is explained in the Senate Report on the 1954 Code as follows:61

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

It is not easy to give section 302(b)(1) an expansive construction in view of this indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock.

Against this background, it is not surprising that the only example of a section 302(b)(1) redemption to be found in the Regulations is a redemption of one-half of the non-voting preferred stock of a shareholder who owns no shares of any other class.62 In a recent ruling, the Internal Revenue Service applied section 302(b)(1) to a redemption of common stock held by four trusts which, with their beneficiaries and the families of the beneficiaries, owned 11 per cent of the stock of the corporation. Another 5 per cent of the stock was owned by trusts created for cousins of the trust beneficiaries, and the remaining 84 per cent was owned by strangers. The redemption apparently did not qualify as "substantially disproportionate" under section 302(b)(2), but the minority position of the trusts whose shares were redeemed justified characterizing the transaction as a "sale" of the stock.63 To be sure, a redemption that is "disproportionate," but not "substantially" so, should not be allowed to use section 302(b)(1) as an easy escape from the rigor of section 302(b)(2).64 But the redemption of a few shares from a minority shareholder can properly be called a non-pro rata redemption, even though it is not "substantially disproportionate" within the meaning of section 302(b)(2).

under section 302(b)(1) although it was not "substantially disproportionate" under section 302(b)(2), the Internal Revenue Service noted that:

In the instant case, the transaction... by its nature can be characterized as a sale of stock by the shareholder. The two shareholders are unrelated and there is no pro rata distribution in whole or part effected by the transaction.\(^{65}\)

The Regulations under section 302(b)(1) state that if a corporation has only one class of stock outstanding, a pro rata redemption "generally" will be treated as a distribution under section 301, rather than as a sale, and that if a corporation has more than one class outstanding, a redemption of an entire class will also "generally" come under section 301 if all classes of stock are held in the same proportion.\(^{66}\) No doubt many fervent arguments will be based on the phrase "generally," in an effort to protect some pro rata redemptions against section 301 by bringing them within section 302(b)(1). One area in which the argument may succeed is the redemption that is pro rata only because of the constructive ownership rules of section 318(a), which according to the Regulations are "one of the facts to be considered" in determining whether a distribution is "essentially equivalent to a dividend."\(^{67}\) This statement, which is weaker than the position taken by the Treasury in the proposed Regulations,\(^{68}\) may open the door to proof that by reason of family estrangement (for example), shares owned by a spouse or by children should not be attributed to the taxpayer whose shares are being redeemed, thus allowing the redemption to qualify under section 301(b)(1) although the attribution rules would prevent it from qualifying as a "substantially disproportionate" redemption under section 302(b)(2).

More dubious is the possibility of applying section 302(b)(1) to a redemption that is pro rata but serves a corporate purpose that might have led to non-dividend treatment under the 1939 Code (such as the acquisition by the corporation of shares for resale to junior employees; or the improvement of the corporate balance sheet by a redemption in cancellation of debts owed by the shareholders to the corporation).\(^{69}\) The re-


\(^{66}\) Treas. Reg. § 1.302-2(b) (1955).

\(^{67}\) Treas. Reg. § 1.302-2(b) (1955). Section 318(a) states that its rules are to be applied only where "expressly made applicable." Section 302(c)(1) states that these rules shall "apply in determining the ownership of stock for purposes of this section." It has been argued that they are not applicable under § 302(b)(1) because it does not expressly refer to the "ownership" of stock. Cohen, supra note 12, at 758-59. But the rules of § 318(a) are "expressly" made applicable "in determining the ownership of stock" under § 302, and consequently it is reasonable to apply them whenever ownership of stock is relevant, whether by statutory direction or otherwise.


\(^{69}\) See Bittker, "Stock Dividends, Distributions in Kind, Redemptions and Liquidations...
peated references in the Senate Report to non-pro rata distributions and the guarded phraseology of the Regulations are hardly conducive to the wholesale importation of pre-1954 law into section 302(b)(1). Moreover, the rulings of the Internal Revenue Service manifest, so far at least, an intent to confine section 302(b)(1) to non-pro rata redemptions.\(^7\) Another illustration of the same reluctance to convert section 302(b)(1) into an escape from section 302(b)(2) is a ruling that redemption of the stock of a decedent's estate is a dividend in its entirety, notwithstanding the corporation's obligation to redeem part of the stock upon the decedent's death under an earlier agreement.\(^7\)

**D. Redemptions by Affiliated Corporations: Section 304**

*Introduction.*

Section 302, which determines when stock redemptions shall be treated as exchanges of the stock and when as dividend distributions, applies to a "redemption" by a corporation of "its" stock. What if a corporation purchases the stock of another corporation? If the two corporations are not affiliated in any way, there is no reason why the transaction should not be taken at face value and treated as an ordinary purchase of stock by the corporation, so that the seller will realize capital gain or loss. But should the same rule apply if the two corporations are affiliated, e.g., if a shareholder sells part of his stock in a parent corporation to its subsidiary? The net effect of such a transaction is about the same as a distribution of assets by the subsidiary to its parent, followed by a redemption by the parent of its own stock; and had the transaction taken the latter form, it would have been taxed as a section 301 distribution unless it qualified under section 302(b)(1) ("not essentially equivalent to a dividend"), section 302(b)(2) ("substantially disproportionate" redemptions), section 302(b)(3) ("termination" redemptions), or section 303 (redemptions to pay death taxes). But when the Internal Revenue Service sought, under section 115(g) of the 1939 Code, to tax the shareholder of a corporation who had sold its stock to its subsidiary, it was held that the transaction was not a redemption by the subsidiary of "its"

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\(^7\) To those already mentioned may be added Rev. Rul. 56-182, 1956-1 Cum. Bull. 157, holding that a redemption of some of the stock of a majority shareholder to enable an employee to increase his holdings under an earlier stock option agreement is "essentially equivalent to a dividend" because it did not produce an "appreciable change in position of the parties involved." See also Rev. Rul. 55-515, 1955-2 Cum. Bull. 222; but note that it has been held that a redemption of stock for the purpose of resale is not pro rata, over the long run, because the resale disturbs the relative position of the shareholders. Smith v. United States, 130 F. Supp. 586 (Ct. Cl. 1955).

stock.\footnote{Rodman Wanamaker Trust v. Comm'r, 11 T.C. 365 (1948), aff'd per curiam, 178 F.2d 10 (3d Cir. 1949).} The 1939 Code was thereupon amended by the Revenue Act of 1950 to require such a transaction to be treated as though the subsidiary had distributed assets to its parent and the parent had redeemed its own stock.

The 1950 legislation did not purport to reach an alternate method of achieving a similar result. If $A$ owns all the stock of two corporations, and sells the stock of one to the other, the economic consequences are the same as though the second corporation had distributed property to him without any surrender of stock, except for the fact (which would often lack any practical consequences) that the second corporation now owns some of the stock of the first corporation. Nevertheless, the Internal Revenue Service was unsuccessful in its efforts to tax such a "brother-sister" redemption as a dividend.\footnote{Comm'r v. Pope, 239 F.2d 881 (1st Cir. 1957); Cramer v. Comm'r, 20 T.C. 679 (1953) (Nonacq.); see also Rev. Rul. 55-15, 1955-1 Cum. Bull. 361. The Service recently announced that it will accept these adverse decisions under the 1939 Code and take steps to revoke outstanding rulings to the contrary. Technical Information Release, Oct. 31, 1958 (TIR-108).}

\textit{Redemptions by affiliates under section 304, 1954 Code.}

The 1954 Code carries forward the 1950 legislation on parent-subsidiary redemptions, and also includes new rules to govern "brother-sister" redemptions. Under section 304, if a subsidiary corporation acquires the stock of a parent, the transaction is to be treated as a redemption by the corporation that \textit{issued} the stock, \textit{i.e.}, the parent. But if a "brother" corporation acquires the stock of a "sister" corporation, the transaction is to be treated as a redemption by the corporation that \textit{acquired} the stock, \textit{i.e.}, the "brother" corporation. In neither instance, however, is the redemption necessarily a section 301 distribution; it may be treated as an exchange if it can meet the tests of section 302(b) or section 303.

It has been suggested that every "brother-sister" pair of corporations is also, by reason of the constructive ownership rules of sections 304 and 318, a parent-subsidiary group. This suggestion is based on the fact that if a person is in control of two corporations, his stock in each one is attributed to the other, so each corporation is in control of the other. The Regulations assume to the contrary that "brother-sister" corporations can be distinguished from parent-subsidiary corporations.\footnote{Treas. Reg. § 1.304-2(c) (1955).} This assumption, which must have been shared by the draftsmen of the 1954 Code, finds support in the statement in section 304(b)(2)(B) that the acquisi-
tion by a subsidiary of its parent's stock shall be taxed "as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation." Since the hypothetical distribution by the acquiring corporation to the issuing corporation could occur only if the latter were in a chain of actual ownership (i.e., an actual parent, grandparent, etc.), it is reasonable to limit the parent-subsidiary rule of section 304(b)(2)(B) to corporations that could have distributed the property upward in an unbroken chain of actual ownership, relegating the "brother-sister" rule of section 304(b)(2)(A) to other related corporations.75

E. Redemptions to Pay Death Taxes: Section 303

Redemptions under Section 303.

Section 303 provides that in certain cases a redemption of stock, the value of which has been included in the gross estate of a decedent for Federal estate tax purposes, shall be treated as a sale of the stock. If the conditions of section 303 are met, the redemption is treated as a sale even though it would, but for section 303, be taxed as a dividend under section 301. For example, if all the stock of a corporation is held by an estate a redemption of part of the stock would not qualify for capital gains treatment under section 302(b)(2) ("substantially disproportionate" redemptions) or under section 302(b)(3) (redemptions in termination of a shareholder's interest); nor, in the absence of other relevant facts, could it qualify under section 302(b)(1) (redemptions "not essentially equivalent to a dividend") or section 331(a)(2) (partial liquidations). If the conditions of section 303 are satisfied, however, such a redemption is treated as a sale.76 Another example is the redemption of stock from an estate, when the stock is divided between the estate and the decedent's sole beneficiary. Because of the constructive ownership rules, the redemption of part or all of the estate's stock could not qualify under section 302(b)(2) or section 302(b)(3). Yet it could qualify under section 303 for treatment as a sale rather than a dividend.

Section 303 contains the following conditions and limitations:

1. The value of the redeemed stock must be included in determining the gross estate of a decedent for federal estate tax purposes. This re-

75 This may be the theory that underlies the examples in the Regulations, § 1.302-2(c). See generally Lanahan, "Redemptions to Pay Death Taxes: Redemptions Through the Use of Related Corporations (Sections 303, 304)," N.Y.U. 15th Inst. on Fed. Tax. 493, 516 ff. (1957).
76 Neither gain nor loss would be realized by the estate, however, if the redemption price were equal to the fair market value of the shares at the date of death, by virtue of § 1014(a).
requirement is satisfied if the value of the stock was included because it was transferred in contemplation of death, because the decedent had a power of appointment over it, because it was held in joint tenancy with the decedent, etc.; the stock need not have been owned by the decedent at the time of his death. If stock was included in the gross estate and could have been redeemed under section 303, the same privilege is extended by section 303(c) to a redemption of "new" stock having a basis determined by reference to the basis of the stock that was actually included, such as stock acquired by the estate as a stock dividend or in a recapitalization or other tax-free exchange.

2. The stock of the corporation (whether redeemed or not) must make up more than 35% of the decedent's gross estate or 50% of his taxable estate. In order to satisfy the 35% or 50% requirement, the stock of two or more corporations may sometimes be aggregated.

3. The total application of section 303 cannot exceed the sum of (a) the death taxes imposed because of the decedent's death and (b) the funeral and administration expenses allowable as deductions for Federal estate tax purposes.

4. The benefits of section 303 are available only to amounts distributed within a limited period after the death of the decedent.

Section 303 is an expanded version of a provision that was enacted in 1950, whose purpose was then stated by the House Committee on Ways and Means as follows:

It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country.

Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free private enterprise.

Despite its stated purpose of protecting against forced sales of family businesses, the danger of which may have been exaggerated and should in any event be allayed by a 1958 amendment to the Internal Revenue Code permitting the federal estate tax to be paid in certain cases in

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77 This privilege may be exercised even though the stock to be redeemed is "section 306 stock" according to the Regulations, § 1.302-2(d). Although the statute is not specific on this point, the Senate Report on the 1954 Code takes the same position. S. Rep. No. 1622, 83d Cong., 2d Sess. 239 (1954).

installments over a 10 year period, section 303 may be employed whether the estate is liquid or not. Even more surprising, stock may be redeemed from specific legatees of stock, donees of gifts in contemplation of death, trustees of inter vivos trusts, etc., even though they may have no obligation to pay any of the death taxes or expenses that give rise to a section 303 redemption. The statement in the 1950 House Report that "the circumstances under which ... relief is available are narrowly defined and will restrict relief to situations in which true hardship exists" is not an accurate description either of the 1950 legislation or of section 303 as it exists today.

F. COLLATERAL PROBLEMS ARISING FROM PARTIAL LIQUIDATIONS AND STOCK REDEMPTIONS

The foregoing sections of this article have sought to answer one question: is the shareholder whose stock has been redeemed to treat the transaction as a sale of his stock, producing capital gain or loss, or as a distribution under section 301, producing ordinary income to the extent of the corporation's earnings and profits and a return of capital thereafter? The redemption will have collateral consequences for both the shareholder and the corporation, however, and to these we will now turn.

Computation of shareholder's gain or loss.

Since a distribution in partial liquidation is to be treated under section 331(a)(2) as "payment in exchange for the stock," gain or loss is com-

70 Harris, "Estate Taxes and the Family Owned Business," 38 Calif. L. Rev. 117, 142-44 (1950). Section 6166, added to the Internal Revenue Code in 1958, permits the federal estate tax to be paid in installments (with interest at 4 per cent) over a period of 10 years if the estate includes an interest in a closely held business (as defined), provided the value of the interest exceeds either 35 percent of the decedent's gross estate or 50 percent of his taxable estate.

80 The Regulations state that § 303 "will most frequently have application in the case where stock is redeemed from the executor or administrator of an estate," and then go on to say that it is also applicable to stock included in the decedent's gross estate and "held at the time of the redemption by any person who acquired the stock by any of the means comprehended by" §§ 2031-2044 of the Internal Revenue Code (i.e., the provisions defining the gross estate for federal estate tax purposes). Treas. Reg. § 1.303-2(f) (1953). The Regulations deny the benefits of § 303 to persons who acquired their stock (a) by gift or purchase from a person "to whom such stock passed from the decedent," or (b) from the executor in satisfaction of a specific monetary bequest. In thus excluding the transferees of qualified persons, the Regulations carry out the purpose of § 303, although it contains no explicit limitation of this type. Because the benefits of § 303 are available to donees in contemplation of death and similar transferees of the decedent, these persons may ally themselves with the Commissioner in an effort to establish that their stock should be included in the gross estate, contrary to the position of the executor. To this incentive is added the stepped-up basis that the stock, whether redeemed or not, will get under § 1014(b)(9) if it is included in the gross estate. The benefits of § 303 and § 1014(b)(9) may outweigh the estate tax cost of including the stock in the estate or the shareholder may not care about the estate tax cost because it will have to be paid by someone else (e.g., the residuary legatees in a case where apportionment of the estate tax is not required).

puted as though the stock had been sold. The same is true of a non-dividend redemption which under section 302(a) is to be "treated as a distribution in part or full payment in exchange for the stock" or of a redemption to pay death taxes under section 303. If the shareholder owns stock purchased at different times and for different prices, he may select the shares to be surrendered to the corporation for redemption, using shares with a high or low basis and a short or long holding period, as he chooses.

But while the shareholder may be able to control the tax consequences of the transaction by shrewdly selecting the shares to be surrendered, he ought not to be able to manipulate the gain or loss to be recognized by surrendering more shares than would be called for in an arm's length transaction. If the redemption is not pro rata, market value will ordinarily govern the number of shares surrendered. But in the case of a pro rata redemption, the number of shares to be surrendered will usually be a matter of indifference to the shareholders. Thus, if X Corporation's net worth is $100,000 represented by 100 shares of common stock, owned one-half by A and one-half by B, and it distributes $40,000 in partial liquidation, one would expect A and B to surrender 20 shares each for redemption, but A and B could just as well surrender 25 shares each. Can they minimize their capital gain or create capital losses, by doing so?

An Internal Revenue Service ruling has answered this question in the negative:

In determining the amount of the gain or loss, regardless of the actual number of shares surrendered for redemption by the stockholders, the total number of shares deemed to have been surrendered is that number which bears the same ratio to the total number of shares outstanding as the [amount] distributed bears to the total fair market value of the net assets of the corporation immediately prior to the distribution. The ruling does not state how the basis of the shares "deemed to have been surrendered" is to be computed; it would seem reasonable to use an appropriate fraction of the total basis of all shares held by the shareholder in question. Despite this ruling, there have been a number of litigated cases in which stock was redeemed at par value, original cost, book value, or other artificial prices, and the shareholder's gain or loss was apparently computed on this basis, rather than by recasting the transaction as provided by the Service.

83 Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954) (minority shareholder paid substantially more than majority holder); Conna'r v. Snite, 177 F.2d 819 (7th Cir. 1949) (redemption at "somewhat" below market value); McDaniel v. Conum'r, 25 T.C. 276 (1955) (varied prices; aggregate proceeds equal to cost); 11 T.C. 836 (1948) (par value and cost); Rosania, P-H Tax Ct. Mem. № 56,116 (par and cost).
Although the aforementioned ruling is applicable by its terms whether the shareholder realized gain or loss on the transaction, a caveat should be interposed with respect to gains. If the shareholder surrenders too few shares, so that the amount distributed to him exceeds the value of the shares he gives up, it is not inconceivable that the transaction will be treated as a sale only to the extent of the fair value of the shares, with any excess being subject to section 301 (taxable as a dividend to the extent of the corporation's earnings and profits). An earlier revenue ruling, holding that a certain redemption constituted a partial liquidation "to the extent that the distribution does not exceed the fair market value of the stock being redeemed," suggests by negative inference that any excess would be a section 301 distribution. This approach conflicts with the previous mentioned ruling, to be sure, but the issue cannot be regarded as closed.

Still another problem is the deductibility of a loss, if the shareholder receives less than the adjusted basis of the shares redeemed. Section 267 disallows losses on the sale or exchange of property between an individual and a corporation of which he owns directly or indirectly more than 50 per cent of the stock. It goes on, however, to make an exception for "losses in cases of distributions in corporate liquidations." This phrase (as used in section 24(b) of the 1939 Code) immunized all non-dividend redemptions, whether they would be classified by the 1954 Code as "partial liquidations" under section 331(a)(2) and section 346 or as "redemptions" under section 302(a). A continuation of the pre-1954 meaning of the phrase is suggested by the apparent lack of any intention to narrow its meaning in 1954, but the Internal Revenue Service has ruled that section 267 forbids the deduction of a loss on a section 302(a) redemption, on the ground that it is not a distribution in liquidation under the 1954 Code.

Even if the loss is not disallowed by section 267, however, it is not necessarily deductible. Higgins v. Smith is still to be conjured with, and it might lead to the disallowance of a loss on a partial liquidation of a one-man corporation, especially if the transaction was tax-motivated. Where there are a number of shareholders, however, Higgins v. Smith

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85 See note 82 supra.
88 308 U.S. 473 (1940).
89 The cases on this point, collected in Bittker, supra note 12, at 54 n.156, are inconclusive.
should not imperil the deduction if control is dispersed or if the shareholders are affected unequally by the redemption.

The mystery of the disappearing basis.

When the redemption of stock is treated as a sale, either because the transaction is a partial liquidation or because it is a non-dividend redemption, the taxpayer can offset the basis of his stock against the proceeds of the redemption in computing his gain or loss. But if the redemption is taxed as a dividend, the mystery of the "disappearing" basis presents itself. For example, if A purchases all the stock of Corporation X for $100,000, and half of the stock is later redeemed for $150,000 in a transaction that constitutes a taxable dividend, does the basis of the redeemed shares disappear? If A had received an ordinary dividend of $150,000, without any surrender of shares, his cost basis of $100,000 would be intact. There is no reason why he should be worse off when the dividend of $150,000 is distributed in redemption of some of his stock. It is said that under the 1939 Code the Internal Revenue Service made appropriate adjustments to preserve the shareholder's basis, but the statutory foundation for such adjustments was flimsy. The 1954 Code is no better, but the Treasury for the first time has stated in the Regulations that in such cases "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." In the hypothetical facts set out above, A would hold the remaining stock of the corporation at his original aggregate basis of $100,000. If the corporation has several shareholders, and all the stock of one shareholder is redeemed in a transaction that is taxed as a dividend (e.g., because he constructively owns some of the remaining shares), the "proper adjustment" will be to transfer the basis of the redeemed shares to the shares owned by the related shareholders.

The basis of distributed property.

If the shareholder receives property, rather than money, in redemption of his stock, he must assign a basis to it for computing depreciation, gain or loss on a sale, etc. If the property is received in a distribution in partial liquidation, and if gain or loss is recognized on its receipt, section

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90 Katcher, "The Case of the Forgotten Basis: An Admonition to Victims of Internal Revenue Code Section 115(g)," 48 Mich. L. Rev. 465 (1950). On several occasions, courts have held that a redemption constituted a sale of the stock rather than a taxable dividend under § 115(g) of the 1939 Code partly because they thought that otherwise the shareholder's basis would be forfeited. Comm'r v. Snite, 177 F.2d 819 (7th Cir. 1949); see Penfield v. Davis, 105 F. Supp. 292, 307-08 (N.D. Ala. 1952), aff'd, 205 F.2d 798 (5th Cir. 1953).


334 provides expressly that its basis shall be its fair market value at the
time of distribution. If the property is received in a non-dividend re-
demption under section 302(a) or section 303, the Code does not state
explicitly how its basis to the shareholder is to be determined, but prob-
ably fair market value is governing here also.\(^{93}\)

If the redemption is treated as a distribution under section 301 rather
than as a sale of the stock, however, the shareholder's basis for the prop-
erty received is determined under section 301(d), which distinguishes
between corporate and non-corporate shareholders. For non-corporate
shareholders, the basis of the property will be fair market value; for
corporate shareholders, the basis will be fair market value or the dis-
tributing corporation's adjusted basis, whichever is lower.

**Recognition of corporate gain or loss on distribution in redemption of
stock.**

Does the corporation recognize gain or loss on distributing its ap-
preciated or depreciated property in redemption of its stock? If the
redemption is treated not as a sale but as a distribution by the corpora-
tion, taxable to the shareholder under section 301, the corporation's
recognition of gain or loss will be governed by the principles applicable
to ordinary distributions of property to shareholders. Gain or loss is
ordinarily not recognized by the corporation, but exceptions are made for
a distribution of installment obligations, appreciated LIFO inventory,
and property subject to a liability in excess of the corporation's basis.\(^{94}\)

If the redemption constitutes a partial liquidation, however, the cor-
poration's gain or loss is governed by section 336, which provides that
gain or loss is to be recognized only on the distribution of installment
obligations. Although section 336 is new in the 1954 Code, the same
principles were applied before 1954, under the Regulations.\(^{95}\)

If the redemption is treated as a sale of the stock under section 302(a)
(redemptions that are not essentially equivalent to a dividend, that are
substantially disproportionate, or that terminate the shareholder's entire
interest in the corporation), the effect of distributing appreciated or
depreciated property is left in some doubt by the statute. It is at least
arguable that a section 302(a) redemption, under which the distribution
is to be treated as received in exchange for "part or full payment for the

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\(^{93}\) In the absence of some other provision prescribing the basis of property, its "cost" is controlling § 1012. This would be the fair market value of the stock given up. If there is a discrepancy between the value of the stock redeemed and the value of the property received, see Rev. Rul. 56-513, supra note 82, on the possibility that the transaction will be recast to bring the values into harmony.


stock," is not governed by section 311(a), which is concerned with distributions by the corporation "with respect to its stock," and a section 302(a) redemption is not a "partial liquidation," so as to bring section 336 into play. If neither section 336 nor section 311 is applicable, the corporation's gain or loss will be determined by pre-1954 case law, under which a distribution of property did not ordinarily result in gain or loss to the distributing corporation.

Even though the distribution of appreciated property does not itself ordinarily produce taxable income to the corporation, income realized in form by the shareholders following the distribution may be imputed to the corporation under the *Court Holding Co.* case and similar doctrines (e.g., in the case of a prearranged sale of property by the shareholders after a corporate sale was "called off"). These principles apply to a distribution of property in redemption of stock, whether the redemption constitutes a dividend under section 302(d), a sale of the stock under section 302(a), or a partial liquidation under section 331(a)(2) and section 346. The courts may be more ready, however, to impute income to the corporation upon the sale of property, especially inventory, if it was distributed in a section 302(d) or section 302(a) transaction than if it was distributed in partial liquidation of the corporation. Section 337, providing that the corporation shall not recognize gain or loss on certain sales of property within the 12-month period following the adoption of a plan of complete liquidation, has no application to a redemption that does not constitute a complete liquidation.

**Effect of redemption on corporation's earnings and profits.**

The effect of a redemption of stock on the corporation's earnings and profits depends upon whether the redemption is treated as a distribution under section 301 or as an exchange of the stock under section 302(a) or section 331(a)(2). The corporation's earnings and profits account is dependent upon the redemption's impact on its shareholders, even though the corporation is unable to ascertain the identity of its shareholders or whether any of them is the constructive owner of shares registered in another name. Note also that if the shareholder has relied upon section

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96 See § 346(a), defining "partial liquidation" as used in Subchapter C of the Code. In Rev. Rul. 57-387, 1957-2 Cum. Bull. 225, the Internal Revenue Service ruled that a § 302(a) redemption is not a "partial liquidation" as that term is used in § 267. The case against treating it as a partial liquidation under § 336 is even stronger, because of the definition in § 346(a).

97 See United States v. Lynch, 192 F.2d 718, 720 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952).

98 See Coshocton Securities Co., 26 T.C. 935 (1956), imposing a penalty for failing to file a personal holding company return on a corporation that concededly did not know, and apparently could not discover, the identity of its beneficial owners.
Section 302(c)(2) for relief from the constructive ownership rules, a distribution that appears to come under section 302(a) may turn out to be a section 301 distribution if the distributee acquires a disqualifying interest in the corporation within the following ten years.

If the redemption is treated as a distribution of property under section 301, the corporation's earnings and profits are to be adjusted under section 312 in the same way as upon any other dividend, i.e., earnings and profits are reduced by the amount of money, the principal amount of any obligations, and the adjusted basis of any other property distributed, with special adjustments in the case of a distribution of appreciated "inventory assets," LIFO inventory, or property subject to liabilities. If the redemption is a partial liquidation or is treated as a sale of the redeemed stock under section 302(a) or section 303, however, section 312(e) provides that the portion of the distribution which is "properly chargeable to the capital account" shall not be treated as a distribution of earnings and profits. Neither the Senate Report nor the Regulations explained how the amount "properly chargeable to capital account" is to be computed, although pre-1954 law was in a state of confusion.99 After the proper amount has been ascertained and deducted, the balance of the distribution presumably reduces earnings and profits in accordance with the rule of section 312(a), as modified by section 312(b) and section 312(c). If the partial liquidation or redemption under section 302(a) or section 303 is not pro rata, the remaining shareholders would suffer unless an appropriate portion of the liquidating distribution were charged to earnings and profits. But if all shareholders participate equally in the liquidating distribution, it is not easy to defend a reduction in earnings and profits on the occasion of a distribution that is not taxed as a dividend.

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99 See Albrecht, "'Dividends' and 'Earnings or Profits,'" 7 Tax L. Rev. 157, 200-07 (1952).