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**CAPITAL GAIN PROBLEMS IN PARTICULAR AREAS
DISPOSITIONS OF CORPORATE STOCK**

Howard M. Kohn

REDEMPTION OF SHARES

Redemptions Generally

This article will discuss the capital gains problems involved in the common garden variety of redemption¹ by a corporation of some of its stock.²

There are several important reasons why the capital gains problems in stock redemption situations require special attention. First, the problems are common. When one shareholder wishes to sell some or all of his shares in a close corporation, it will ordinarily be cheaper for the other shareholders if the corporation purchases his shares than if the other shareholders individually do the buying. Dollars in the corporation are easier to come by because they will have been subjected to but a single tax. Dollars in the shareholders' pockets will have been subjected to a tax at the shareholder level as well (a double tax). Secondly, the capital gains problems in stock redemption situations are potentially serious. The general rule and desired objective is that the redemption of stock will be treated as a sale to the corporation and that any resulting gain will be capital gain.³ If the redemption does not satisfy one of three statutory tests, however, the general rule will not apply and the redemption will be treated as a dividend, resulting in ordinary income tax to the redeeming shareholder on the entire redemption payment.

Thus, if *A* and *B* each owns one-half of the stock of *X* Corporation, and the corporation redeems one-half of each one's shares, each will

1. Any acquisition by a corporation of its own stock in exchange for property is a redemption. INT. REV. CODE OF 1954, § 317(b). (Hereinafter cited as §). The immediate discussion, however, does not include redemptions of § 306 stock or stock in collapsible corporations, and it does not include corporate liquidations. See discussion pp. 285-90, 319-30, 336-38.

2. For a previous discussion of this general subject see Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 91-98 (1959).

3. § 302(a).

probably have received a dividend.⁴ On the other hand, if the corporation redeems all of *A*'s and none of *B*'s shares, so that there is a sellout by *A*, the redemption will ordinarily be treated as a sale, and *A* will pay a capital gain tax on his gain.

In order for the redemption to be treated as a sale, however, it must be "substantially disproportionate,"⁵ or a "termination of interest,"⁶ or "not essentially equivalent to a dividend."⁷ Moreover, in determining the ownership of stock for purposes of these three tests, the complex ownership attribution rules apply.⁸ Under these rules, a person is considered as owning not only stock which he actually owns, but also stock owned by others whose ownership is attributed to him. Accordingly, every redemption must be tested and retested under the attribution rules and all of their possible combinations.

Attribution of Ownership Rules

Family

An individual is considered as owning stock owned by his spouse, his children, his grandchildren and his parents.⁹ On the other hand, there is no attribution between brothers and sisters; nor between in-laws; nor from a grandparent to his grandchildren. Nor is double application of the family attribution rule permitted, to bridge those gaps.¹⁰ Those open areas, particularly the absence of attribution between brother and sister and between in-laws, are frequently very useful in effecting redemptions and in planning for future redemptions, in family situations. For example, where a son-in-law is in the family business it might be highly desirable for him to be permitted to acquire stock, looking to the future day when his father-in-law might wish to have some or all of his stock redeemed. Or, in planning a father's estate, where some but not all of the children are active in the business, he might arrange for some of his stock to go to a child not active in the corporation, and plan for it to be redeemed from that sibling, there being no attribution between brothers and sisters.

4. See § 302(d).

5. § 302(b)(2).

6. § 302(b)(3).

7. § 302(b)(1).

8. § 302(c)(1).

9. § 318(a)(1).

10. Stock attributed to one under the family rule is not treated as owned by him for purposes of again applying the family attribution rule to make another the constructive owner of such stock. § 318(a)(4)(B). Thus, stock owned by son *A* is attributed to his father; but such stock is not reattributed from father to son *B*.

Partnerships

A partnership¹¹ is considered as owning stock owned actually or constructively¹² by the partners; and any stock owned by the partnership is attributed proportionately to the partners.¹³

Estates

Stock owned by an estate is attributed proportionately to the beneficiaries of the estate;¹⁴ and stock owned by any beneficiary is attributed to the estate.¹⁵ "Beneficiaries," however, include only persons with a direct present interest in the property or income. Remaindermen, whether vested or contingent, are excluded.¹⁶ A legatee or heir ceases to be a beneficiary when he receives his entire share in the estate.¹⁷ The Commissioner has ruled, however, that this applies only to a specific legatee; a residuary taker does not cease to be a beneficiary until the estate is closed.¹⁸

Trusts

Stock owned by a trust is attributed to the beneficiaries in proportion to the actuarial value of their interests; and any stock owned by any trust beneficiary will be attributed to the trust unless the beneficiary has only a remote¹⁹ contingent interest.²⁰

Corporations

Similarly, stock owned by a corporation is attributed to a stockholder owning fifty per cent or more in value of the stock of the corporation; and stock owned by any such stockholder is attributed to the corporation,²¹ except that stock is never attributed to the issuing corporation under this rule.²²

11. For this purpose, partnership includes many syndicates, joint ventures and joint ownerships not regarded as partnerships under state law. See § 761(a); *cf.* § 7701(a)(2).

12. Except for the prohibition against double application of the family attribution rule, stock attributed under any attribution rule is considered as actually owned by the attributee for purposes of reattributing it to others under the same or any other attribution rule. § 318(a)(4)(A).

13. § 318(a)(2)(A).

14. The beneficiaries' proportionate interests in the estate will be determined at the date of the redemption. Rev. Rul. 58-111, 1958-1 CUM. BULL. 173.

15. § 318(a)(2)(A). For this purpose, "estate" means the probate estate.

16. Treas. Reg. § 1.318-3. (Hereinafter cited as Reg.).

17. Reg. § 1.318-3(a).

18. Rev. Rul. 60-18, 1960-1 CUM. BULL. 145.

19. A contingent interest is remote if its value, actuarially determined, is 5% or less.

20. § 318(a)(2)(B). In addition, stock is attributed between a trust and a grantor or other person who is treated as the substantial owner of the trust under §§ 671-78.

21. § 318(a)(2)(C). The rule applies even though the stock of the corporation owned by the shareholder is nonvoting or preferred.

22. Reg. § 1.318(b)(1).

Option Rule

A person having an option to purchase stock is considered as owning such stock.²³

The foregoing is but a condensed summary of the ownership attribution rules and their ramifications. Before planning any stock redemption, or any stock retirement agreement looking toward a future redemption, it is absolutely essential that the situation and the relationships be examined and tested under every one of these rules and the various combinations of them. Moreover, in the case of future redemptions, it is important to consider what the effect will be of future changes, such as the death of a shareholder. In this connection, the estate plans of the stockholders might have to be considered. Frequently, the results will depend upon careful timing of the redemption. In every case, the objective of course will be to make certain that a contemplated redemption will not lead to unexpected dividend results by reason of the operation of the attribution rules.

Again, the reason for concern is that the attribution rules apply in determining the ownership of stock for purposes of the tests of section 302 of the Internal Revenue Code under which the redemption will be stamped as a sale or as a dividend. For a redemption to qualify as a sale with resulting capital gain treatment, one of these three tests must be satisfied, even though the redemption is effected pursuant to a pre-existing contract of long standing.²⁴

Section 302 Tests

The Essential Equivalence Test

The redemption will be treated as a sale if it is "not essentially equivalent to a dividend."²⁵ This test, however, is a very uncertain one, and therefore, offers little protection. It can rarely be relied upon without a ruling from the Service.²⁶

There are two other tests, however, which are objective mathematical criteria and which can be relied upon.

The Substantial Disproportion Test

The first of these two objective tests is the substantial disproportion or twenty per cent cut-back test. A redemption will be treated as a sale,

23. § 318(a)(3).

24. § 302(d); Rev. Rul. 56-103, 1956-1 CUM. BULL. 159.

25. § 302(b)(1).

26. A number of rulings have been issued applying this test. For example, see Rev. Rul. 56-182, 1956-1 CUM. BULL. 157; Rev. Rul. 56-183, 1956-1 CUM. BULL. 161; Rev. Rul. 56-521, 1956-2 CUM. BULL. 174.

if the redeeming shareholder's percentage interest in the *common* stock of the corporation (voting and nonvoting) after the redemption is less than eighty per cent of what his percentage interest was before the redemption, and if, in addition, his percentage interest in the *voting* stock of the corporation after the redemption is less than eighty per cent of what that percentage interest was before the redemption and is less than a fifty per cent interest in the voting power of the corporation.²⁷ These requirements apply to each redeeming shareholder separately.²⁸ But if there is a series or group of redemptions pursuant to one plan, they will be treated as a single redemption.²⁹ The ease or difficulty of satisfying this test in any particular situation will depend upon whether the redeeming shareholder is considered under the attribution rules as owning shares actually owned by others, and also whether the corporation has more than one class of stock outstanding.

For example, in a father-son corporation it will be impossible to satisfy this cutback test, since, by the attribution rules, the shares of the non-seller will be attributed to the seller. On the other hand, in a father-son-in-law corporation, the cutback requirement can be readily satisfied, because the son-in-law's shares will not be attributed to his father-in-law. Here again, however, timing may be important. If the senior shareholder dies owning shares which then pass to one to whom the son-in-law's shares are also attributed, a redemption might then not be protected.

If two or more classes of stock are outstanding, then particular care must be taken. A redemption of preferred shares alone will never satisfy the substantial disproportion test, because it will not reduce the percentage interest in the common stock. Likewise, a redemption of non-voting stock alone will not qualify, because it will not reduce the percentage interest in the voting stock. If sufficient voting shares and sufficient common shares are redeemed to meet the twenty per cent cutback test, however, then in the same transaction the corporation can redeem all of the shareholder's preferred or none of it. The substantial disproportion test frequently requires redemptions in big bites. In this connection, it is important to bear in mind that the stock need not be paid for in cash and debt can be issued in payment. Thus, considerable flexibility is afforded.

If the requirements of a disproportionate redemption are satisfied, then the redemption will result in only capital gain and not ordinary dividend treatment.

27. § 302(b) (2).

28. Reg. § 1.302-3(a) (3).

29. § 302(b) (2) (D).

The Termination of Interest Test

Under the second of the two objective tests, a redemption will qualify as a sale with resulting capital gain treatment, if it terminates the shareholder's stock interest in the corporation.³⁰ Here, again, the redemption need not be for cash. Debt can be issued by the corporation in part or full payment.³¹ Not all of the selling shareholder's stock need be sold to the corporation. If the shareholder sells part of his stock to a third person and the corporation redeems the balance in a single transaction, the redemption will qualify as terminating his stock interest in the corporation.³²

If a shareholder is not related to any of the other stockholders within the scope of the attribution rules, then the test of whether a redemption will qualify as terminating his stock interest is a relatively simple one. *All* stock that he owns, of *all* classes, must be redeemed.

On the other hand, if the redeeming shareholder is related to other stockholders under the attribution rules, then the problem is more difficult. If, after the redemption, he is still considered as owning stock in the corporation under any of the attribution rules, then clearly he does not satisfy the termination of interest test. At this point, however, consideration must be given to a very important exception to the broad sweep of the attribution rules. If a redemption would terminate the shareholder's interest but for stock attributable to him under the family attribution rule, then he may still have a termination. For the purposes of the termination of interest test *only*, if certain requirements are met, the family attribution rules are inapplicable.³³ Such relief from family attribution may be extremely valuable when the wish is to redeem the stock of a family member who is not going to be active in the business. For example, suppose husband, wife, son and daughter own all the stock of a corporation, and it is desired to redeem the wife's and the daughter's stock. If the family attribution rules are inoperative (and if no attribution exists under any of the other rules), then a redemption of the wife's and the daughter's stock would terminate the interest of both.

The statutory requirements for relief from the family attribution rules may be referred to as the "10-year look-back" and the "10-year look-ahead" tests. The "10-year look-back" test requires that (a) no person related (within the attribution rules) to the redeeming share-

30. § 302(b)(3).

31. The debt, however, must qualify as true debt. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 32-38 (1959); see also Reg. § 1.302-4(d).

32. *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 55-745, 1955-2 CUM. BULL. 223.

33. § 302(c)(2).

holder at the time of the redemption own stock acquired from him within the preceding 10 years, and (b) none of the redeemed shares have been acquired during that 10-year period from a person whose ownership would now be attributed to the redeeming shareholder.³⁴ Transfers without tax avoidance purpose are excluded.³⁵

The "10-year look-ahead" test requires that immediately after the redemption, and continuing for ten years, the redeeming shareholder have no interest in the corporation as an officer, director, employee or otherwise. He may, however, be a creditor, with the usual rights to enforce his claim. Also he may, during the 10-year period, acquire shares by inheritance.

If the "10-year look-back" and "10-year look-ahead" tests are satisfied, and if the required reporting procedures are complied with,³⁶ then the family attribution rules will be avoided for purposes of the termination of interest test. If the redeeming shareholder will then not own stock under any of the other attribution rules, the redemption of all of his shares will qualify as a sale, with capital gain and not ordinary dividend consequences.

Thus, the relief from family attribution frequently will facilitate redemptions and afford valuable bail-out opportunities in the family corporation situation.

Special Rule for Redemption of Inherited Shares

In a limited area pertaining to certain shares includible in the estate of a deceased shareholder at his death, the strict requirements discussed above for qualifying a redemption for sale rather than dividend treatment can be ignored. A relief provision was adopted by Congress to alleviate the necessity in the closely-held corporation of a forced sale of a decedent's stock to pay death taxes.³⁷ Where that provision applies, stock

34. § 302(c) (2) (B). Transfers to or from a person now deceased, and transfers from a decedent to his estate would appear to be excluded. Cf. Rev. Rul. 57-387, 1957-2 CUM. BULL. 225.

35. The Commissioner has taken a fairly liberal attitude as to transfers which will be regarded as not having had a tax avoidance purpose. See Rev. Rul. 56-556, 1956-2 CUM. BULL. 177; Rev. Rul. 56-584, 1956-2 CUM. BULL. 179; Rev. Rul. 57-387, 1957-2 CUM. BULL. 225.

36. The Commissioner in a questionable recent ruling, Rev. Rul. 59-233, 1959-2 CUM. BULL. 9, has added a further requirement which is not apparent in the statute. He has ruled that relief from family attribution will not apply unless the redemption is from a family member; for example, it will not apply if the redemption is from an estate. Thus, if father and son own all the stock of the corporation, and father is ready to retire from the business, and if the requirements for relief from family attribution are met, the corporation could redeem his shares now, and the redemption would terminate his interest. If his shares are not redeemed, and he dies leaving his wife as sole beneficiary of his estate, and his stock is then redeemed from his estate, under the ruling the estate's interest in the corporation is not terminated. The son's stock is attributed to his mother, and from her to the estate.

37. § 303. See also Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 83 (1959).

may be redeemed by the issuing corporation up to the limits prescribed, and the redemption will be treated as a purchase, free from dividend consequences. Since the basis of the stock normally will be equal to the estate tax value,³⁸ the redemption will ordinarily result in little or no capital gain tax. Thus, such a redemption will be virtually tax-free.

In order for this special redemption provision to apply, the stock to be redeemed must have been included in the decedent's gross estate for federal estate tax purposes.³⁹

Secondly, the value of the stock of the corporation which was so includible in the decedent's gross estate must have aggregated more than thirty-five per cent of the gross estate, or more than fifty per cent of the taxable estate. The taxable estate means the gross estate minus all deductions including the marital deduction, and minus the \$60,000 exemption. Thus, in the estate of a decedent who is survived by a spouse, the stock holding need not necessarily be large in order to satisfy the "more than 50% of taxable estate" requirement. Moreover, for purposes of both the thirty-five per cent and fifty per cent tests, the statute permits aggregating the stock of two or more corporations, if more than seventy-five per cent in value of the stock of each was includible in the decedent's gross estate.

Where those requirements are met, the stock may be redeemed, up to the value of the death taxes (including interest), and the funeral and administration expenses allowable as deductions to the estate.⁴⁰ Generally, the stock may be redeemed from anyone who acquired it from the decedent or his estate.⁴¹

Finally, the redemption must be effected within the period commencing with the date of the decedent's death and ending approximately four and one-half years thereafter.⁴²

There are several practical observations to be made respecting this special relief provision. First, it is not necessary that the redemption proceeds be needed by the estate for the payment of death taxes or adminis-

38. § 1014.

39. The stock need not have been owned by the decedent at the time of his death. Stock includible in the gross estate because transferred in contemplation of death, or for any other reason, qualifies. Reg. § 1.303-2(b).

40. It is immaterial that the allowable administration expenses were taken on the income tax return rather than on the estate tax return. Rev. Rul. 56-449, 1956-2 CUM. BULL. 180.

41. Reg. § 1.303-2(f). The Regulations, however, exclude stock which an heir or legatee has transferred by gift or sale, as well as stock which the executor has distributed in satisfaction of a monetary bequest. The latter exclusion may in some cases disqualify stock passing to a surviving spouse under certain types of formula marital deduction clauses. See Rev. Rul. 56-270, 1956-1 CUM. BULL. 325.

42. The protection of § 303 seems to apply on a first come, first serve basis. Moreover, in determining whether the dollar limitation of § 303 has been exhausted, all prior redemptions within the prescribed period are taken into account, whether or not they qualified for favorable treatment under other provisions of the Code. Reg. § 1.303-2(g).

tration expenses. The provision applies even though the estate is highly liquid. Second, it is not necessary that the redemption be made for cash; debt can be issued by the corporation in payment for the shares. Third, this provision may, therefore, offer an important opportunity in the closely-held corporation, to draw money out of the corporation virtually tax-free. As such, it is an opportunity which should not be overlooked. Finally, the stock holdings might be such that a redemption would shift voting control in an undesirable way. In such a case the provision might be more difficult to use. Even then, however, advantage can be taken of this redemption opportunity, by creating preferred stock, and then redeeming the preferred from the decedent's estate up to the limit permitted by the statute, leaving the common stock positions undisturbed.⁴³

Sale of Stock to Controlled Corporation

Unlike the special provision relating to redemptions to pay death taxes, which grants favorable tax treatment, the special rule relating to sales of stock to controlled corporations⁴⁴ is a loophole-closing provision, imposing a more onerous tax. This special rule is twofold, dealing first with brother-sister corporations and secondly, with parent-subsidiary corporations.

In the brother-sister corporation situation, if one or more persons are in control⁴⁵ of each of two corporations, and they sell stock of Corporation 1 to Corporation 2, the transaction is treated as though they had sold stock of Corporation 2 to Corporation 2 in a redemption transaction, and the general redemption rules are then applied.

In the parent-subsidiary situation, if one corporation controls another corporation, and stock of the parent corporation is sold to the subsidiary, then the transaction is treated as though the parent's stock had been purchased by the parent in a redemption; and the general redemption rules are then applied.

Two observations should be made respecting these special rules. First, in the case of the controlled brother-sister corporation, and in the parent-subsidiary situation, in general the redemption rules cannot be avoided by having the sister corporation or the subsidiary purchase the shares. Secondly, these provisions do not apply to sales of assets. Accordingly,

43. Stock with a substituted basis will qualify. § 303(c). The fact that the preferred stock would be § 306 stock would be immaterial.

44. § 304.

45. Control means ownership of at least 50% of the voting power or at least 50% in value of the stock. For this purpose, the ownership attribution rules in slightly modified form apply. § 304(c).