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ordinary income from lapse of restrictions, an event which may occur many years later and which yields no money with which to pay the resulting tax liability.

Closely held corporations and their employees have long been the butt of discrimination under the income tax in the area of employee stock purchase arrangements.[51] Unless the Regulations are modified or are applied by the Service to permit legitimate use of restrictions designed to fix fair market value, close corporations will face even harsher discrimination simply because the fair market value of their shares is so difficult to ascertain.

51. See Bergen, *supra* note 9.

II

COSTLY TRAPS IN CORPORATE STOCK PURCHASES FROM SHAREHOLDERS

Zolman Cavitch

No area of tax law is more important to the closely-held corporation and its shareholders than the set of rules governing the purchase by a corporation of its own stock. When a shareholder retires from an active role in the corporation's affairs, he also may want to terminate or reduce his stockholdings. When a disagreement arises between two opposing groups of shareholders, it may be essential that one group be bought out. When the shareholders of a closely-held corporation get around to thinking of the problems likely to arise upon the death of one of them, they may conclude that a death redemption agreement is essential. And when a dominant shareholder needs a substantial amount of cash, he may look fondly at the corporate till and conclude that he should sell some of his stock back to the corporation. In all of these not-uncommon situations, the complex tax problems commonly thought of as "redemption problems" are likely to be present.

The importance of this tax area is partly attested by the fact that in 1954, Congress found it necessary to adopt a new and highly complex statutory pattern of rules, exceptions to the rules, and exceptions to the exceptions.[1] The objective of this article is considerably more modest

1. INT. REV. CODE OF 1954, §§ 301-04, 318, 331(a)(2), 346 [hereinafter cited as CODE §], contain the relevant statutory material.

than the breadth of the subject warrants. It is: first, to review briefly the basic statutory pattern, and second, to point out the major pitfall areas which have been emphasized in ten years of cases, rulings, and experience.

DEFINITION OF "REDEMPTION"

A redemption, for our present purposes, occurs whenever a shareholder transfers part or all of his stock to the issuing corporation, or to certain related corporations, in exchange for cash or other property.[2] There are only two possible exceptions. First, if the property received by the shareholder is other stock in the same corporation, and second, if the property received back is 80% or more of the stock of a former subsidiary.[4] In both exceptions the transaction may be completely tax-free. In all other situations, the redemption rules will apply, and where they apply, the tax alternative is not between a taxable and a tax-free transaction, but rather between ordinary dividend treatment on the full proceeds[5] and sale or exchange treatment — that is, capital gain on the profit or capital loss on the loss.[6] The difference in tax between the unfavorable dividend treatment and the favorable sale or exchange treatment can, of course, be astronomical.

THE STATUTORY PATTERN — IN BRIEF

The statutory pattern begins with an unfavorable general rule, namely: every distribution of property by a corporation to a shareholder with respect to the corporation's stock is treated as an ordinary dividend to the extent that the corporation has current or accumulated earnings and profits.[7] Fortunately, there are three broad and important exceptions to the general rule; for a redemption to be favorably treated as a sale or exchange transaction, it *must* fit into one of these exceptions.

One exception to the unfavorable general rule is the partial liquidation transaction. Under a special section of the Internal Revenue Code, if a redemption is incident to a substantial contraction of the corporate

2. CODE § 317(a). "Property," for this purpose, does not include stock of the issuing corporation or rights to acquire such stock.

3. If common stock is exchanged for common stock of the same corporation, or if preferred stock is exchanged for preferred stock of the same corporation, the exchange will be tax-free, irrespective of whether the exchange is with the issuing corporation or with a third party. CODE § 1036. If the exchange is with the issuing corporation, even though it may be for stock of a different class, the transaction may qualify as a tax-free "reorganization." CODE §§ 354(a)(1), 368 (a)(1)(E).

4. CODE § 355.

5. The statement in the text assumes that the corporation has current or accumulated earning and profits sufficient to cover the amount of the distribution. See CODE §§ 301(c)(1), 316.

6. CODE § 302(a).

7. CODE §§ 301(a), (c)(1), 316(a)

business, favorable sale or exchange treatment applies. Moreover, there is no complication by virtue of the attribution of ownership rules.[8]

A second exception applies with respect to certain redemptions following the death of a stockholder.[9] Where the stock of a single corporation constitutes either more than 35% of the value of the decedent's gross estate, or more than 50% of his taxable estate, the corporation may redeem an amount of stock not in excess of death taxes and funeral and administration expenses.[10] The amount so distributed will be treated as full payment for the stock redeemed and, therefore, no tax will ensue. This exception, of course, affords an important opportunity to bail funds out of a family corporation. Where applicable, it rarely should be bypassed. But unfortunately, its favor depends upon the death of the shareholder and therefore provides little flexibility from a planning standpoint.

The third and perhaps most important exception applies when the transaction meets one of the three favorable tests of section 302.[11] In determining whether the transaction meets one of the three favorable tests of section 302, highly complex attribution of ownership rules apply. Further complicating the statutory pattern in certain instances is the fact that relief can be obtained from the application of the family attribution rule. Even for a tax statute, the statutory pattern in relation to section 302 transactions is highly complex.

THE COSTLY TRAPS

After ten years' experience with this statutory pattern, it has become apparent that the pitfalls — the costly traps — are hidden in the complexity of the third exception, the one dealing with the various section 302 transactions.

Costly Trap No. 1: Failure to Meet One of Three Favorable Tests

The costly trap which is most pervasive is the failure to appreciate the fact that the relevant general rule is unfavorable. All distributions of property in redemption of stock are treated as ordinary dividend distributions *unless* one of the three exceptions applies. Normally, this means that it is essential that one of the three favorable tests of section 302 be met.

8. CODE §§ 331(a)(2), 346; S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954). See also Treas. Reg. § 1.346-1(a) (1955) [hereinafter cited as Reg. §]. For a discussion of the attribution rules, see p. 342 *infra*.

9. CODE § 303.

10. If the decedent owned at the time of his death 75% or more in value of all of the outstanding stock of two or more corporations, the stock in such corporations may be aggregated for the purpose of applying the 35% or 50% tests. CODE § 303(b)(2)(B).

11. CODE § 302(b).

The "Basket" Provision

One of these tests is the so-called "basket" provision, the catch-all provision that was inherited from the 1939 Internal Revenue Code. If the redemption is not essentially equivalent to a dividend, it will be favorably taxed as a sale or exchange.[12] The great bulk of litigation in the redemption area, even to the present date, centers on the alleged applicability of this catch-all test.[13] This is hardly surprising. The basket provision is almost totally worthless as a meaningful planning tool. By and large, the only redemptions which are clearly not equivalent to a dividend are those which satisfy one of the objectively applied tests of section 302. If a planned redemption cannot be brought within one of the other *objective* tests, it rarely will be certain that the basket provision test will be met. Accordingly, its usefulness is largely reserved for those situations where a redemption has not been planned with sufficient awareness of the tax traps and the taxpayer is now in court. He has little recourse but to argue that the "basket" test has been met. If he can convince the court that his transaction combined some emotionally appealing mixture of good faith, careless counsel, and *some* change in economic position other than merely the receipt of cash or other property, he may find the "Promised Land." But the many cases are simply irreconcilable.

The "Substantially Disproportionate" Test

The second of the three tests under section 302 is much more meaningful. Favorable sale treatment will obtain if the redemption is substantially disproportionate with respect to the particular shareholder.[14] A redemption is substantially disproportionate if all three of the following factors are present:

(1) After the redemption, the particular shareholder must own less than 50% of the total combined voting power of all classes of voting stock; and

(2) The shareholder's percentage ownership of voting stock after the redemption must be less than 80% of his percentage ownership of voting stock immediately before the redemption; and

(3) The shareholder's percentage ownership of common stock — both voting and nonvoting common — after the redemption must be

12. CODE § 303(b)(1).

13. United States v. Carey, 289 F.2d 531 (8th Cir. 1961); Commissioner v. Decker, 286 F.2d 427 (6th Cir. 1960); Bains v. United States, 289 F.2d 644 (Ct. Cl. 1961); Estate of Arthur Squier, 35 T.C. 950 (1961), *acq.*, 1961-2 CUM. BULL. 5; Herbert C. Parker, 30 P-H Tax Ct. Mem. 976 (1961); *cf.* Neff v. United States, 301 F.2d 330, *vacated and new opinion substituted,* 305 F.2d 455 (Ct. Cl. 1962), *cert. denied,* 372 U.S. 913 (1963).

14. CODE § 302(b)(2).

less than 80% of his percentage ownership of common stock immediately prior to the redemption.

The test is wholly mathematical. If the figures work out right, sale or exchange treatment applies.[15] There is no need to inquire into motive, purpose, purity of heart, or any of the other intangibles which are so difficult to fathom.

The Complete Termination Test

Similarly, the third favorable test is wholly objective. Favorable sale treatment applies if the redemption completely terminates the entire stock interest of the particular shareholder.[16] To meet this test, all of the stock in the corporation owned by the shareholder must be redeemed, not simply the stock of a particular class.

Costly Trap No. 2: Failure to Take Into Account the Complex Attribution of Ownership Rules

If one could stop at this point, he might justifiably conclude that the complexities of the redemption tax pattern have been grossly exaggerated. It sounds simple; and it would be, were it not for the applicable attribution of ownership rules.

In determining whether a redemption satisfies the basket test, the 20% cutback test, or the complete termination test, it is not sufficient to look merely at the stock owned by the particular shareholder before the redemption and compare it to his *own* interest immediately after the redemption. Both the before and after look must embrace not only the stock actually owned by the shareholder, but also the stock owned by a wide assortment of other persons and entities.[17]

Family Attribution

An individual is considered as owning stock which is actually owned by his spouse, children, grandchildren, and parents.[18] The only favorable comments which can be made in this connection are that family attribution for this purpose does not include stock owned by a grandparent, brother, or sister, and that family attribution rules may not be applied

15. It should be emphasized that the shareholder's *percentage* interest must be cut back by more than 20%. It is not enough merely to redeem more than 20% of the *number* of shares owned by him. Suppose, for example, that a shareholder owns 30 of the 100 shares outstanding or 30% of the total. In order to satisfy this test, he must own less than 24% of the outstanding stock after the redemption. If 7 of his shares are redeemed — that being more than 20% of the number of shares owned by him — he will continue to own 23 out of 93 shares outstanding or 24.7% of the total.

16. CODE § 302(b)(3).

17. CODE § 318.

18. CODE § 318(a)(1).

twice in the same chain.[19] For example, suppose that a grandfather, his wife, their son, and their grandson each owns one-fourth of the stock of a corporation. The grandchild's one-fourth is redeemed. In applying the three favorable tests of section 302, the grandchild will be treated as owning his father's one-fourth, both before and after the redemption. But he will *not* be treated as owning the one-half actually owned by his grandparents. Moreover, the Service may not indirectly reach this conclusion by asserting that the one-half owned by the grandparents is properly imputed to their son, and the three-quarters actually and constructively owned by the son are then properly imputed to *his* son.

Partnership Attribution

Stock which is owned by a partnership is treated as being owned proportionately by its partners; and stock which is owned by a partner is treated as being owned by the partnership.[20]

Estate Attribution

Stock owned by a decedent's estate is treated as being owned proportionately by the beneficiaries, and stock owned by a beneficiary is treated as being owned by the estate.[21] With respect to estate attribution, as indeed with respect to all of the attribution rules except family attribution, double and triple and quadruple attribution can apply. It is primarily because of this multiple attribution that the tax analysis of a proposed redemption can be extremely complicated and, indeed, lead to a doubtful or adverse conclusion in situations seemingly far removed from danger. By way of a rather conservative example, two brothers own all the stock of *X* Corporation in equal shares. Their father, who owns no interest in *X*, dies. The two brothers are equal beneficiaries of his estate. Normally, as we have seen, there is no attribution between brothers, and it might seem that inasmuch as the father had no interest in the corporation, his death should have no effect on whether one of the brothers' stock can be safely redeemed. But during such time as both brothers remain beneficiaries of the estate, a redemption of the stock of one brother might well result in ordinary dividend treatment to him. Thus, under the estate-beneficiary attribution rules, each of the brothers' stock would be

19. CODE § 318(a)(4)(B).

20. CODE § 318(a)(2)(A).

21. *Ibid.* Only persons who have a direct present interest in the estate are considered beneficiaries for this purpose; a person who has only a remainder interest is not considered an estate beneficiary. See examples in Reg. § 1.318-3(a)(1), (2) (1955), as amended, T.D. 6462, 1960-1 CUM. BULL. 49. But, although not entirely clear, it may be that the remainderman of a testamentary trust, as distinguished from the remainderman of a legal life estate, will be subject to the trust-beneficiary attribution rules even though the estate is still open and the testamentary trust is not yet formally established.

attributed to the estate, and then, by applying the same rules once again, would be attributed from the estate proportionately to the brothers. In this way, each shareholder would be a constructive owner, both before and after the redemption, of one-half of his brother's stock. He would be a 75% shareholder before the redemption — his own stock plus one-half of his brother's — and a 50% shareholder after the redemption — one-half of his brother's 100% interest. Since the redemption would satisfy neither of the two *objective* tests of section 302, the only hope for favorable sale treatment would depend upon satisfying the "basket" provision. And although the "basket" test might very well be met, it normally would be foolhardy to plan on it.

Timing can be of vital importance with respect to estate attribution rules. A legatee who is not a residuary legatee will no longer be considered a beneficiary once his legacy is satisfied, even though the estate remains open.[22] Suppose, for example, that a father and son each owns one-half of the stock of a corporation. The father dies, survived by his son and a daughter. The father's will leaves a $50,000 bequest to his son and the residuary estate to his daughter. During such time as the son is still a beneficiary of the estate, the corporation will be unable to redeem the estate's stock without grave tax risk, since attribution between the estate and the son will apply. But if the estate first satisfies the son's legacy, he will no longer be a beneficiary of the estate. The stock actually owned by the estate could then be redeemed. Since no attribution would apply, there would be a complete termination of the estate's interest and one of the objective tests of section 302 clearly would be met.

It must be borne in mind in this connection, however, that the Service takes the position that the interest of a residuary beneficiary cannot be completely satisfied until the estate is closed[23] — a view which significantly limits the flexibility otherwise available through judicious timing.

Trust Attribution

Stock which is owned by a trust is considered as being owned by the beneficiaries in proportion to their actuarial interests in the trust. This is true regardless of whether the beneficiary is an income beneficiary or a remainderman and, if a remainderman, whether his interest is contingent and remote, or vested and substantial.[24] But when attribution is applied in the opposite direction — from the beneficiary to the trust — the rules are somewhat different. Stock owned by the beneficiary

22. Reg. § 1.318-3(a) (1955), as amended, T.D. 6462, 1960-1 CUM. BULL. 49; Rev. Rul. 60-18, 1960-1 CUM. BULL. 145; Rev. Rul. 58-111, 1958-1 CUM. BULL. 173.

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

24. CODE § 318(a)(2)(B).

is attributed in its entirety to the trust, not simply in proportion to his interest; but if the beneficiary has only a *contingent* interest worth 5% or less of the trust corpus, he is not considered a beneficiary for this purpose, and none of his stock is attributed to the trust.[25]

Corporation Attribution

Attribution also applies between a corporation and a shareholder who owns 50% or more in value of the corporation's stock.[26] Thus, if Corporation *A* owns any shares in Corporation *B*, the shares owned by *A* would be attributed proportionately to a shareholder owning 50% or more in value of the stock of Corporation *A*. Conversely, if a shareholder of Corporation *A* owning 50% or more of *A*'s stock, owns stock in Corporation *B*, the stock would be constructively owned by Corporation *A*.

Option Attribution

Lastly, a person who has an option to purchase corporate shares will be treated as actually owning those shares.[27]

The detailed attribution rules concededly are complex and virtually impossible to memorize. But the important thing is not to memorize the frightening details, but rather to remember that complex attribution of ownership rules apply with respect to the section 302 tests and that no present redemption or contract for future redemption should be planned without making a detailed analysis of the particular facts as they are affected by these rules.

Costly Trap No. 3: Failure to File Required Statement When Family Attribution Rule Can Thereby Be Avoided

A third costly trap has been highlighted by two very recent cases which emphasize the highly technical nature of some of the relevant rules.[28] There is a relatively large area of situations where relief can be obtained from the bothersome family attribution rules. Thus, if a particular redemption completely terminates the stock interest actually owned by a shareholder and if, in addition, the ten-year look-ahead and ten-year look-back rules are satisfied, the shareholder will not be plagued with the attributed ownership of stock owned by a family member.[29]

25. *Ibid.*

26. CODE § 318(a)(2)(C).

27. CODE § 318(a)(3).

28. Van Keppel v. United States, 321 F.2d 717 (10th Cir. 1963); Archbold v. United States, 311 F.2d 228 (3d Cir. 1963).

29. CODE § 302(c)(2). The Internal Revenue Service, however, has issued a questionable Ruling to the effect that relief from family attribution can be obtained only in situations where the *redeemed shareholder* would be treated under the family attribution rule as owning stock of a family member. In the Service's view, relief from family attribution can never apply

The Ten-Year Look-Back Rule

The ten-year look-back rule relates to whether or not there have been certain transfers between related parties during the past ten years.[30] Although these rules are difficult to understand, they are fully set out in the statute. Since they relate to events which have or have not transpired in the past, little can be done to make the facts fit the law.

The Ten-Year Look-Ahead Rule

With respect to compliance with the ten-year look-ahead rule, careful planning and execution can make all the difference. The ten-year look-ahead rule is satisfied when the shareholder whose stock is redeemed retains no interest whatever in the corporation other than as a creditor and acquires no such interest within ten years after the redemption except by bequest or inheritance.[31] This is the *substance* of the ten-year look-ahead rule. But the substance is not enough. There is another requirement set forth in the statute, one which is purely mechanical, very easy to meet and, by the same token, very easy to overlook. The shareholder whose stock is redeemed must file an agreement to notify the Internal Revenue Service of any prohibited type of acquisition within the next ten years.[32] The Service has indicated in its Regulations that this agreement must be filed with the taxpayer's timely filed income tax return for the year in which the redemption occurs.[33]

What happens if this perfunctory chore is inadvertently overlooked, or if the return is filed late? Is the ten-year look-ahead rule violated so that there is no relief from family attribution, with the possible result that a redemption which could otherwise qualify for favorable sale treatment now will be taxed in full as ordinary income? One court of appeals has said "yes"; the statute means what it literally says, even though the result may appear unduly harsh.[34] Another court of appeals was more sympathetic and held that where the omission is inadvertent and the Internal Revenue Service is not prejudiced by a tardy filing, the Service may be required to accept a late filing.[35]

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when the redeemed shareholder is an estate or a trust and the family attribution rule is simply an essential link in a multiple attribution chain imputing ownership to such estate or trust. Rev. Rul. 59-233, 1959-2 CUM. BULL. 106.

30. CODE § 302(c)(2)(B). For a more detailed treatment of this and other redemption tax problems, see CAVITCH, OHIO CORPORATION LAW WITH FEDERAL TAX ANALYSIS § 9.33 (1961).

31. CODE § 302(c)(2)(A).

32. CODE § 302(c)(2)(A)(iii).

33. Reg. § 1.302-4(a) (1955).

34. Archbold v. United States, 311 F.2d 228 (3d Cir. 1963).

35. Van Keppel v. United States, 321 F.2d 717 (10th Cir. 1963).

There undoubtedly is more to be heard on this question from the courts and perhaps from Congress. But the moral is clear. The careful lawyer will not rely on the possibility of being salvaged by a sympathetic court. Where satisfaction of the ten-year look-ahead rule can guarantee favorable sale treatment, this insurance should not be thrown away by a failure to comply with one of the few *easy* requirements.

Costly Trap No. 4: Assumption That a Valid Business Purpose Will Guarantee Favorable Tax Treatment

Costly Trap No. 4 is the assumption, seemingly widely held, that a redemption will be treated favorably as a sale if it is motivated by a pure heart, that is, by the absence of any desire to take unfair advantage of the Government. This is a wildly inaccurate and dangerous assumption. The only safe exceptions to ordinary dividend treatment upon which to rely are the ones which are objectively applied — those which depend to no extent on the taxpayer's state of mind. In applying these objective rules, the fact that a redemption is effected pursuant to a long-existing contractual commitment of the corporation to purchase shares of a deceased or retired executive is of no help whatever.[36] Nor is the fact that a redemption is negotiated in order to eliminate an obstreperous shareholder. And the objective rules make no favorable mention of the fact that a redemption is of preferred stock pursuant to a redemption option long ago reserved to the corporation.[37] It may very well be that in all of these instances, and in others where a redemption is a part of a normal business deal, and not motivated by tax considerations, a court may be sufficiently favorably impressed to hold that the unreliable "basket" test has been met.[38] But this possibility is hardly a guarantee even if the taxpayer is in court. And it is not likely to be of substantial aid if the taxpayer is trying to avoid going to court. Again, the only safe planning course is to comply with one of the objectively-applied exceptions to dividend treatment where purity of purpose is not a virtue.

Costly Trap No. 5: Assumption That Unfavorable Treatment Can Apply Only Where the Issuing Corporation Is the Purchaser

Costly Trap No. 5 is one which has had somewhat less publicity than some of the others and on this basis alone requires mention. The fact is that the Internal Revenue Code for many years has contained some sanction against the free use of the issuing corporation itself bailing out its shareholders at capital gain rates by redeeming its stock. It

36. See Rev. Rul. 56-103, 1956-1 CUM. BULL. 159.
37. See Reg. § 1.302-2(b) (1955); Rev. Rul. 56-265, 1956-1 CUM. BULL. 156.
38. See note 13 *supra.*

therefore occurred to some ingenious taxpayers in the late 1940's that it might be less costly to have a *different* corporation purchase the stock of the shareholder, namely, a wholly-owned subsidiary of the issuing corporation or a corporation owned by the same shareholders in substantially the same proportion. Such a transaction was technically not a redemption and therefore escaped the statutory limitations on the free use of redemptions. But the realistic economic position of the shareholder might not be different. Thus, if an individual owning all the stock of corporations *A* and *B* caused Corporation *B* to purchase one-half of his stock in Corporation *A,* our happy shareholder would now have cash in his pocket and he still would be in 100% control of both corporations. A court of appeals in 1949 pointed out that there was no statutory mandate for treating such a sale as anything other than a sale, and accordingly held for the taxpayers. Congress promptly responded, and since 1950 there *have been* statutory limitations.[39] Generally speaking, a purchase of shares by a subsidiary corporation or by a brother corporation must satisfy one of the three favorable tests of section 302 to give rise to favorable sale treatment. In short, the important thing to remember is that the loophole has long been closed.

SUMMARY

The foregoing discussion may be summarized briefly:

(1) The general rule is that every distribution of property by a corporation with respect to its stock will be treated as an ordinary dividend to the recipient to the extent of the corporation's earnings and profits.

(2) There are three broad statutory exceptions to this unfavorable treatment. The first and broadest exception lies in satisfying one of the three favorable tests of section 302. The second exception applies when the redemption is incident to a partial liquidation of the corporation. And the third exception relates to certain post-death redemptions.

(3) Ten years of cases and rulings demonstrate that there are a number of pitfall areas, particularly with respect to the broad exception of section 302. Costly Trap No. 1 is the failure to appreciate that a redemption which is neither a partial liquidation nor a qualified post-death redemption will be *unfavorably* taxed unless it meets one of the three favorable tests of section 302. Costly Trap No. 2 is the failure to take into account the exceedingly complex attribution of ownership rules which apply in determining whether one of the section 302 tests is met. Costly Trap No. 3 is the danger of overlooking the timely filing of a simple statement where that filing may enable the shareholder to

39. CODE § 304.