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Douglas A. Kahn

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Stock Redemptions: The Standards for Qualifying as a Purchase under Section 302(b)

Cover Page Footnote
Professor of Law, University of Michigan; B.A. 1955, University of North Carolina; J.D. 1958, George Washington University.
STOCK REDEMPTIONS: THE STANDARDS FOR QUALIFYING AS A PURCHASE UNDER SECTION 302(b)*

DOUGLAS A. KAHN**

INTRODUCTION

A distribution from a corporation to its shareholders that is made on account of the shareholders' stock holdings is commonly referred to as a "section 301 distribution" because such distributions are dealt with primarily in section 301 of the Internal Revenue Code. In certain circumstances, property received by a shareholder from a corporation is treated the same as it would be if it had been distributed to the shareholder on account of his stock holding. To the extent that property acquired by a shareholder is so characterized, the transaction is sometimes referred to as one treated as a section 301 distribution. For convenience, references herein to section 301 distributions will include transactions treated as such.

The tax consequence of a shareholder's receiving a section 301 distribution depends upon the "earning and profits" (e and p) of the distributing corporation at the time that the distribution was made. To the extent the distributing corporation had e and p at that time, the section 301 distribution will constitute a dividend which is treated as ordinary income to the shareholder. The amount of a section 301 distribution in excess of the e and p allocated thereto is treated as a return of the shareholder's capital to the extent of his basis in the stock, which basis is reduced by that amount. To the extent that the

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* Certain background portions of this Article have been drawn from D. Kahn, Basic Corporate Taxation (3d ed. 1981).

** Professor of Law, University of Michigan; B.A. 1955, University of North Carolina; J.D. 1958, George Washington University.


2. The term "earnings and profits" (e and p) is a term of art in tax law. In general, it describes the maximum amount of corporate funds that can be distributed to the corporation's shareholders without reducing the level of its capital—i.e., the aggregate amount previously contributed to the corporation by shareholders. For an explanation of the meaning of e and p, its allocation to § 301 distributions, and the manner by which the amount of dividend income is determined, see D. Kahn, Basic Corporate Taxation § 2.11-.16 (3d ed. 1981).

3. E and p can either be for the current taxable year or, alternatively, accumulated since the corporation was formed. Only e and p accumulated after February 28, 1913, however, is taken into account. I.R.C. § 316(a).

4. Id. §§ 301(c)(1), 316(a).

5. Id. § 301(c)(2).
excess section 301 distribution is greater than the shareholder’s basis in his stock, the overage is treated as gain recognized from the sale of the stock, typically a capital gain.\(^6\)

In an attempt to withdraw funds from a closely held corporation without incurring dividend treatment, the controlling shareholders could cause the corporation to redeem some shares of their stock. Each shareholder would then seek to report as gain only the difference between the amount he received from the corporation and his basis in the shares of stock surrendered. Typically that gain will be characterized as a long-term capital gain\(^7\) if the shareholder has held the surrendered stock for more than one year.\(^8\) Because there is no substantive difference between a redemption made pro rata among the shareholders and a section 301 distribution, the tax consequences of both transactions should be the same.\(^9\) Therefore, except for partial and complete liquidations\(^10\) and for certain redemptions of stock

\(^6\) Id. § 301(c)(3)(A). An exception to the above described treatment arises when the distributing corporation has \(e\) and \(p\) accumulated from a period prior to March 1, 1913. I.R.C. § 301(c)(3)(B).


\(^8\) I.R.C. § 1222(3). In addition to the “equivalent to a dividend” exception discussed later in the text, see infra notes 78-132 and accompanying text, other exceptions to capital gain treatment may apply—e.g., the collapsible corporation provisions of § 341. One important exception involves the redemption of section 306 stock (a special type of stock). Subject to the exceptions set forth at § 306(b), the entire amount received by a shareholder in redemption of section 306 stock, not merely the amount received in excess of the shareholder’s basis, is treated as a § 301 distribution to the shareholder. I.R.C. § 306(a)(2).

\(^9\) For example, assume that X Corporation had 120 shares of common stock outstanding. A owned 60 shares, B owned 40 shares, and C owned 20 shares. Each share had a value of $1,000; each shareholder had a basis of $200 in each share of his stock; and X had accumulated \(e\) and \(p\) of $21,000. On June 4, X distributed $6,000 to A in redemption of six of his shares of X; $4,000 to B in redemption of four of his shares; and $2,000 to C in redemption of two of his shares. After the redemption, the percentage of stock ownership of the three shareholders is identical to their percentage of ownership before the redemption—namely, 50% for A, 33 1/3% for B, and 16 2/3% for C. The effect of the redemption is to withdraw $12,000 from X without changing the shareholder’s interests.

\(^10\) A partial liquidation can occur when a corporation terminates one of several actively conducted businesses and then distributes the assets of the terminated business or the proceeds from the sale of such assets, or a combination thereof, in redemption of some shares of its stock. I.R.C. § 346; Treas. Reg. § 1.346-1(b)(2) (1955). A partial liquidation can also occur when the corporation contracts its business and distributes the proceeds acquired from that contraction in redemption of some of its shares of stock. For example, the distribution in redemption of the insurance proceeds received on account of a fire that destroyed several floors of a building owned and operated by a corporation was treated as a distribution in partial liquidation. Imler v. Commissioner, 11 T.C. 836 (1948), acq. 1949-1 C.B. 2; see Rev. Rul. 74-296, 1974-1 C.B. 80 (department store corporation’s elimination of most departments and reduction of floor space, number of employees, inventory, fixed
included in a decedent's gross estate, the tax law treats a pro rata redemption as a section 301 distribution. Thus, the entire amount received in redemption of the stock is treated as dividend income if the corporation has adequate e and p. The shareholder's basis in the redeemed shares is added to and apportioned among his remaining shares of the corporation's stock.

Characterizing a perfectly pro rata redemption as a section 301 distribution is logically sound, but what if the distributions in redemption are somewhat disproportionate? How disproportionate must they be to qualify as a purchase? If shareholders are related, how are the stock holdings of such related parties to be taken into account in determining the proportionality of a redemption? As to this latter question, the Code provides explicit rules for attributing the stock owned by one person to another. Attribution rules are utilized in connection with a number of Code provisions including the redemp-
tion provisions, but the rules are not the same for all purposes. There is no statutory attribution of stock unless expressly provided for in the Code. In determining the tax consequence of a redemption, the attribution rules set forth in section 318 are adopted. A brief outline of section 318 is set forth in Part I of this Article.

This Article discusses the requirements of section 302(b) for characterizing a stock redemption as a purchase rather than as a dividend equivalent. The focus is primarily on two issues: (1) whether the election authorized by section 302(c)(2) to waive family attribution rules should be available to an entity such as a trust or estate; and (2) the determination of the standards to be applied in resolving whether a redemption is "not essentially equivalent to a dividend" so that section 302(b)(1) is applicable.

I. RULES OF CONSTRUCTIVE OWNERSHIP OF STOCK THAT ARE APPLICABLE TO STOCK REDEMPTIONS

To determine the tax consequences of a stock redemption, it is first necessary to ascertain the amount of stock constructively owned by a shareholder under section 318, which provides for attribution in four separate situations:

(1) Family attribution: an individual is deemed to own the stock owned, directly or indirectly, by or for his spouse, children, grandchildren, and parents.

(2) Attribution from certain entities to their beneficiaries or owners:

(a) Stock owned, directly or indirectly, by or for a partnership or estate is considered to be owned proportionately by its partners or beneficiaries; for this purpose, a person whose only interest in an estate is a future interest is not treated as a beneficiary of the estate.

(b) Stock owned, directly or indirectly, by or for a trust is considered to be owned by the beneficiaries thereof in proportion to their actuarially determined interest. For this purpose, unlike

15. Compare I.R.C. § 318 (stock attribution rules applicable to §§ 302, 304, 306(b)(1)(A), 334(b)(3)(C), 382(a)(3), 856(d), 958(b), 6038(d)(1)) with id. § 544 (stock attribution rules applicable to §§ 542(a)(2), 543(a)(7), 543(a)(6), 543(a)(4)).

16. Id. § 302(c)(1).

17. In addition to § 302(b), there are several other statutory provisions that can characterize a stock redemption as a purchase in certain circumstances, see supra notes 8-11 and accompanying text, but this Article deals only with redemptions covered by § 302(b).


19. Id. § 318(a)(2)(A).


21. I.R.C. § 318(a)(2)(B)(i). If all or part of the trust income is taxed to the grantor of the trust under §§ 671-677, however, then all or part of the trust's stocks are deemed to be owned by the grantor. Id. § 318(a)(2)(B)(ii).
the attribution from an estate, a person having a future interest in a trust is a beneficiary thereof.\textsuperscript{22}

(c) A portion of stock owned, directly or indirectly, by or for a corporation will be deemed owned by a shareholder having more than a fifty percent interest in the corporation in proportion to the shareholder’s percentage interest in the corporation as determined by his share of the value of the corporation’s outstanding stock.\textsuperscript{23}

(3) Attribution to certain entities from their beneficiaries or owners:

(a) Stock owned, directly or indirectly, by or for a partner or beneficiary of an estate is deemed to be owned by the partnership or estate.\textsuperscript{24}

(b) Stock owned, directly or indirectly, by or for the beneficiary of a trust, other than certain employees’ trusts, is deemed owned by the trust. However, stock owned by a contingent beneficiary is ignored, if the value of the contingent interest in the trust is actuarially determined\textsuperscript{25} to be five percent or less of the value of the trust’s assets.\textsuperscript{26}

(c) Stock owned, directly or indirectly, by or for a shareholder having at least fifty percent in value of the stock of another corporation is considered to be owned by the latter corporation.\textsuperscript{27}

(4) The holder of an option to acquire stock is deemed the owner of the stock that is subject to the option.\textsuperscript{28}

\begin{itemize}
  \item \textsuperscript{22} See Treas. Reg. § 1.318-2(c), exs. (2), (3), T.D. 6969, 1968-2 C.B. 126, 131.
  \item \textsuperscript{23} I.R.C. § 318(a)(2)(C).
  \item \textsuperscript{24} Id. § 318(a)(3)(A). As noted above, a person having only a future interest in an estate is not a beneficiary thereof. See supra note 20 and accompanying text. A person who was a beneficiary of an estate will cease to be such when he has received all of the property to which he is entitled, provided that he has no claim against the estate and there is no more than a remote possibility that it will be necessary for the estate to seek the return of the property or to seek payment from him by contribution or otherwise to satisfy claims against the estate, including claims for death taxes, or expenses of administration. Treas. Reg. § 1.318-3(a), T.D. 6969, 1968-2 C.B. 126, 131. While considerable caution must be taken, it is possible in some circumstances for an estate to terminate the unwanted attribution of stock to it from a beneficiary, especially the beneficiary of a pecuniary or specific bequest, by distributing the beneficiary’s property to him. See Estate of Weiskopf v. Commissioner, 77 Tax Ct. Rep. (CCH) 3550 (July 29, 1981).
  \item \textsuperscript{25} It appears that, for years beginning after 1970, the actuarial value of a contingent beneficiary’s interest in a trust will be determined according to the methods established (including the table of factors) by Treas. Reg. § 20.2031-10 (1979) for ascertaining estate tax values. See Treas. Reg. § 1.318-3(b), T.D. 6969, 1968-2 C.B. 126, 131 (refers to the pre-1971 estate tax regulations for ascertaining actuarial values).
  \item \textsuperscript{26} I.R.C. § 318(a)(3)(B).
  \item \textsuperscript{27} Id. § 318(a)(3)(C).
  \item \textsuperscript{28} Id. § 318(a)(4).
\end{itemize}
When stock is attributed to a person by section 318, he is treated as if he were the actual owner of the attributed stock.\textsuperscript{29} The stock so attributed may therefore be reattributed to another person. There are two circumstances, however, in which constructively owned stock under section 318 will not be reattributed to another person:

(1) Stock which is constructively owned by an individual under family attribution rules—that is, attribution under section 318(a)(1)—is not reattributed to a member of the individual’s family, but such stock may be reattributed to an entity of which the individual is an owner or beneficiary.\textsuperscript{30}

(2) Stock which is attributed to an entity from a beneficiary or owner thereof is not reattributed from the entity to a different beneficiary or owner of that entity.\textsuperscript{31} This provision prevents “sideways attribution”—that is, attribution of stock from one beneficiary or owner of an entity to another beneficiary or owner as a consequence of attribution to and from an entity.\textsuperscript{32}

The section 318 attribution rules were intended to prevent tax avoidance by an illusory fragmentation of control. By the same token, they were intended to have predictable application to the stock redemption rules of section 302.

\section*{II. Stock Redemptions That Qualify as Purchases}

Section 302(d) provides that, except as otherwise provided in subchapter C, the amounts received by a shareholder in redemption of his

\textsuperscript{29} I.R.C. § 318(a)(5)(A). For example, assume A is a beneficiary of the PT trust, and the PT trust owns 100 shares of stock of X Corporation. The value of A’s actuarially determined interest in the PT trust is 75\% of the value of the trust’s assets. A’s wife, W, is a beneficiary of a pecuniary bequest from her father, F, whose estate is currently under administration. W has not yet received her pecuniary bequest. W’s mother, M, is living and is the primary beneficiary of F’s estate. A is treated as the actual owner of 75 of the 100 shares of X stock owned by the PT trust. W is also treated as the actual owner of the 75 shares of X stock that are attributed to her husband, A. The estate of F is deemed to own the 75 shares of X stock that are attributed to W from A and which were attributed to A from the PT trust. For reasons explained below, see infra note 30 and accompanying text, none of the 75 shares of X are attributed to W’s mother, M.

\textsuperscript{30} I.R.C. § 318(a)(5)(B). In the example in note 29, supra, the 75 shares of X stock that were attributed to W from her husband under family attribution rules could not be reattributed to W’s mother because that would be applying family attribution a second time in the same attribution set. As noted in that example, however, the 75 shares of X are reattributed to the estate of which W is a beneficiary.

\textsuperscript{31} See I.R.C. § 318(a)(5)(C).

\textsuperscript{32} For instance, in the example in note 29, supra, the 75 shares of X stock that were attributed from W to F’s estate cannot be reattributed from the estate to M, the primary beneficiary of the estate. See I.R.C. § 318(a)(5)(C). Prior to the 1964 amendment that adopted this restriction, sideways attribution of an individual’s stock could occur. S. Rep. No. 1240, 88th Cong., 2d Sess. 6-8, reprinted in 1964 U.S. Code Cong. & Ad. News 3396, 3401-03.
stock are treated as a section 301 distribution from the corporation. Two important exceptions to that treatment, sections 302(b)(2) and 302(b)(3), are statutory safe harbors which offer a taxpayer a reliable route to purchase treatment. Under section 302(b)(2), the test for purchase treatment is whether a shareholder's percentage ownership has been substantially reduced. Section 302(b)(3) covers the complete termination of a shareholder's interest. If these provisions are not available to a taxpayer, section 302(b)(1) may provide protection from dividend treatment.

A. Substantially Disproportionate Redemptions

Under section 302(b)(2), if the redemption of a shareholder's stock complies with certain precise tests demonstrating that the redemption is substantially disproportionate, the redemption will be treated as a purchase. In applying these tests, the attribution rules of section 318 are employed in determining stock ownership. To qualify, the redemption must satisfy the following standards:

(1) Immediately after the redemption, the shareholder must own less than fifty percent of the voting power of all classes of stock entitled to vote.

(2) The percentage of outstanding voting stock of the corporation owned by the shareholder immediately after the redemption must be less than eighty percent of the percentage of outstanding voting stock of the corporation owned by the shareholder immediately prior to the redemption.

(3) The shareholder's percentage of outstanding common stock of the corporation, whether voting or nonvoting, before and after the redemption must also meet the eighty percent requirement set forth in the preceding paragraph. If there is more than one class of common stock, the eighty percent requirement is measured according to the fair market value of the common stock.

Section 302(b)(2) applies to redemptions of voting stock or to redemptions of both voting and nonvoting stock. It does not apply to

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33. I.R.C. § 302(c)(1).
34. Id. § 302(b)(2)(B).
35. Id. § 302(b)(2)(C).
36. Id.
37. Id. If the shareholder has no actual or constructive ownership of common stock but does own voting preferred stock, the Commissioner ruled in Revenue Ruling 81-41, 1981-6 I.R.B. 5, that a redemption of the shareholder's voting preferred stock can qualify for the § 302(b)(2) safe harbor even though no common stock is redeemed. Revenue Ruling 81-41 constitutes an extremely liberal construction of § 302(b)(2). The Commissioner relied on the fact that the legislative purpose for requiring a redemption of common stock was to insure that a shareholder would not utilize that safe harbor provision unless his percentage of participating interest in the corporation was substantially reduced. Id. at 6. If the shareholder has no actual or
redemptions of solely nonvoting stock, whether common or preferred. It also does not apply to any redemption that will not be substantially disproportionate with respect to the shareholder's stock because of a plan contemplating subsequent redemptions of other shareholder's stock.

B. Termination of Shareholder's Interest

Section 302(b)(3) provides that a redemption of a shareholder's stock will constitute a purchase if, after applying the attribution rules of section 318, the redemption terminates the shareholder's stock interest in the corporation. A complete termination of a shareholder's interest need not be effected in a single transaction, however. The termination can be accomplished through a series of redemptions provided that they are made pursuant to a firm and fixed plan. The Tax Court has held that if the plan is definite, it need not be written, absolutely binding, or communicated to others.

The Code mitigates the stringent operation of the attribution rules by providing in section 302(c)(2) that the family attribution rules of section 318(a)(1) do not apply to redemptions terminating a shareholder's interest in a corporation if certain requisites are satisfied. These requirements are:

(1) Immediately after the redemption, the distributee has no interest in the corporation, including an interest as an officer, director or employee, other than an interest as a creditor.

(2) The distributee does not acquire any such interest, other than stock acquired by bequest or inheritance, within ten years after the redemption.

(3) The distributee files an agreement attached to his tax return for the year in which the redemption occurred, in which he promises to notify the district director of any interest he may acquire in the corporation within the ten-year period. Such notification shall be made within thirty days after the interest is acquired.

If a distributee who executes an agreement under section 302(c)(2) acquires a forbidden interest in the corporation within the ten-year
period in contravention of the statutory requirement, the provisions of section 302(c)(2) will not apply,\textsuperscript{44} and a tax deficiency may be assessed for the year in which the redemption occurred.

If an individual distributee executes a consulting agreement with the distributing corporation under which the distributee agrees to perform services as a consultant upon request during a stated period of years in exchange for which the corporation agrees to pay a stated dollar amount annually to the distributee, the Commissioner contends that the distributee thereby acquires an interest in the corporation in contravention of the terms of section 302(c)(2).\textsuperscript{45} Indeed, the Commissioner asserts that if a distributee performs services for the distributing corporation within the ten-year period, "with or without compensation," it will render section 302(c)(2) inapplicable.\textsuperscript{46} The validity of those rulings is clouded by the Tax Court's decision in \textit{Lennard v. Commissioner}.\textsuperscript{47}

In \textit{Lennard}, the Tax Court held that a distributee did not acquire a forbidden interest in a distributing corporation merely because he performed accounting services for the corporation in his capacity as the managing partner of the accounting firm employed by the corporation. The court characterized the distributee as an independent contractor and stated that "Congress did not intend to include independent contractors possessing no financial stake in the corporation among those who are considered as retaining an interest in the corporation for purposes of the attribution waiver rules."\textsuperscript{48} The court determined that the "interest" in a corporation which Congress prohibited was one which provided the distributee either with a financial stake in the corporation or with control over its operations.\textsuperscript{49} An employment contract can provide a distributee with such an interest, but the employment of the distributee as an accountant did not provide him with control or with a sufficient financial stake to constitute a prohibited interest, especially since the contract was not made for a term of years but was terminable at any time. The Commissioner's nonacquiescence in \textit{Lennard} indicates that the government disagrees with the decision and may well continue to litigate.

In addition to the above stated requirements, a waiver of the attribution rules is not applicable if all or a portion of the redeemed stock was acquired by the distributee during the previous ten years from a person whose stock ownership would be attributed to the distributee

\textsuperscript{44} I.R.C. § 302(c)(2)(B).
\textsuperscript{46} Rev. Rul. 56-556, 1956-2 C.B. 177, 179.
\textsuperscript{48} \textit{Id.} at 561.
\textsuperscript{49} \textit{Id.} at 561; see Chertkof v. Commissioner 72 T.C. 1113, 1126 (1979); Lewis v. Commissioner, 47 T.C. 129, 137-38 (1966) (Simpson, J., concurring).
under section 318(a); or if a third person owns stock of the corporation
the ownership of which is attributable to the distributee under section
318(a) and such stock was acquired from the distributee within the
previous ten-year period unless the acquired stock is redeemed in the
same transaction.50 Neither of these two restrictions applies if the
acquisition or disposition referred to therein did not have federal
income tax avoidance as one of its principal purposes.51 The Service
has announced that it will not rule on the question of whether an
acquisition or disposition of stock was motivated by tax avoidance
unless the facts and circumstances involved are "materially identical"
to those set forth in five specified rulings.52

By its terms, the waiver of or bar to attribution provided by section
302(c)(2) applies only to the family attribution imposed by section
318(a)(1).53 The question arises as to whether section 302(c)(2) has
any efficacy in the circumstance where the distributee of a stock
redemption is an estate or trust so that the stock attributed to the
distributee does not come from a member of the distributee's family
but rather comes from a beneficiary to a trust or estate. Attribution
from a beneficiary to a trust or estate is provided by section 318(a)(3)
to which the literal terms of section 302(c)(2) do not apply. The
question becomes more complex if the beneficiary of the trust or estate
who causes the attribution problem does not own the attributed stock
outright but rather has constructive ownership as a result of attribu-
tion from a member of the beneficiary's family. The issues then be-
come whether section 302(c)(2) will prevent attribution from the
beneficiary's relative to the beneficiary so that there will then be no
reattrIBUTION to the trust or estate, and if so, who is the proper party
to file the agreement required by section 302(c)(2)(A)(iii).54

51. Id. § 302(c)(2)(B). For an illustration of a non-tax avoidance purpose for a
52. Rev. Proc. 81-10, § 3.01(14), 1981-13 I.R.B. 44. The five specified rulings are
57-387, 1957-2 C.B. 225; Rev. Rul. 56-584, 1956-2 C.B. 179; Rev. Rul. 56-556,
1956-2 C.B. 177.
53. The application of the waiver of attribution rules is illustrated by the follow-
ing example: Assume that at the time of his death A owned all 200 shares of
outstanding stock of X corporation and that those shares did not qualify for § 303
treatment on a redemption. A bequeathed 100 shares of X to his wife, W, and 100
shares of X to their son, S. Subsequently, A's estate was closed, and the shares were
distributed to W and S. X then redeemed all 100 of S's shares and S executed an
agreement pursuant to § 302(c)(2). The attribution rules of § 318 do not apply, and
the redemption of S's stock is deemed a purchase under § 302(b)(3).
54. Consider the example given in note 53, supra, except that the 100 shares
bequeathed to S were instead bequeathed to the Friendly National Bank in trust for
The Commissioner first took the position that a fiduciary of a trust or estate cannot utilize section 302(c)(2) in Revenue Ruling 59-233.\textsuperscript{55} In *Crawford v. Commissioner*,\textsuperscript{56} however, the Tax Court allowed the executrix of an estate to use section 302(c)(2) and thereby avoid family attribution from the decedent’s two children to the executrix, their mother, from whom the stock would be reattributed to the estate under section 318(a)(3)(A) because the mother was the sole beneficiary of the decedent’s estate. The court referred to Revenue Ruling 59-233 with apparent disapproval. In *Crawford*, the mother had also executed a section 302(c)(2) agreement in her individual capacity because the corporation had redeemed stock owned by her individually at the same time that it redeemed the estate’s stock. The Tax Court held that the agreement executed by the executrix was sufficient and expressly declined to pass upon whether the agreement executed by the mother individually should be given any effect.\textsuperscript{57} The Commissioner nonacquiesced in *Crawford*.\textsuperscript{58} He reasserted his rejection of that decision in Revenue Ruling 79-67.\textsuperscript{59}

S. After A’s estate was closed and the stock was distributed to W and to the trustee, the X Corporation redeemed from the trust the 100 shares of stock held in trust for S. The trustee, seeking to comply with § 302(c)(2) in order to avoid attribution rules, executed and filed the agreement required by § 302(c)(2)(A)(iii). The Commissioner has ruled that § 302(c)(2) does not prevent attribution in this case and that the trust is deemed to own the 100 shares of X stock held by W. Rev. Rul. 59-233, 1959-2 C.B. 106, 107; Rev. Rul. 79-67, 1979-1 C.B. 128, 129. The Commissioner’s position is that § 302(c)(2) renders inapplicable family attribution rules pertaining to the party whose stock is redeemed, but it does not preclude the operation of other attribution rules. See Rev. Rul. 59-233, 1959-2 C.B. 106, 107. Here, S is considered as owning W’s 100 shares because of family attribution, but the stock is reattributed to the trust under § 318(a)(3) which is not a family attribution provision and, under the Commissioner’s position, is not vitiated by § 302(c)(2). The Commissioner further contends that an agreement executed by the trustee cannot prevent the attribution from W to S because S is not the distributee (the trust is the distributee) and because the agreement precludes family attribution only to the distributee who executes it. See Rodgers P. Johnson Trust v. Commissioner, 71 T.C. 941, 950 (1979) (statement of the Commissioner’s position). Even if S also were to execute an agreement, the Commissioner maintains that it would have no effect on the attribution from W to S because S is not the distributee of the redemption payment. See Rev. Rul. 59-233, 1959-2 C.B. 106. As noted below, the Tax Court has repudiated the Commissioner’s position on this issue, Rodgers P. Johnson Trust v. Commissioner, 71 T.C. 941, 955 (1979); Crawford v. Commissioner, 59 T.C. 830, 836-37 (1973), nonacq. 1974-2 C.B. 5, and the Fifth Circuit has repudiated the Commissioner’s position that § 302(c)(2) bars only family attribution. Rickey v. United States, 592 F.2d 1251, 1258 (5th Cir. 1979).

\textsuperscript{57} Id. at 836-37.
\textsuperscript{58} 1974-2 C.B. 5.
\textsuperscript{59} 1979-1 C.B. 128, 129.
In *Rickey v. United States*, the Fifth Circuit, in allowing an estate to use section 302(c)(2), went much further than the Tax Court's position in *Crawford*. In *Rickey*, the executrix of the estate executed the agreement required by section 302(c)(2) in order to prevent the attribution to the decedent's estate of stock owned by her step-son. The step-son was one of the residuary legatees of the estate, and his shares of stock were attributable to the estate under section 318(a)(3). Family attribution was not involved. Nevertheless, the Fifth Circuit held that the section 302(c)(2) agreement barred attribution to the estate from the beneficiary. The court rejected what it termed a "labored application of the literal language of the statute."

The Fifth Circuit's position is an unwarranted extension of explicit statutory language. There is nothing in the statute or in the legislative history to suggest that the restriction of the waiver to family attribution was anything other than deliberate. The Tax Court has twice rejected the position adopted by the Fifth Circuit—once in the pre-*Rickey* decision of *Rodgers P. Johnson Trust v. Commissioner* and again in the post-*Rickey* decision of *David Metzger Trust v. Commissioner*. *Metzger Trust* was reviewed by the entire Tax Court, and the decision on this issue was unanimous. Indeed, in the *Metzger Trust* case, the Tax Court rejected the *Rickey* position even though on appeal the case would go to the Fifth Circuit. Ordinarily, under its *Golsen* rule, the Tax Court, in resolving an issue, will adhere to the view adopted by the circuit court to which review of the matter will lie. The Tax Court, however, decided that *Metzger Trust* was distinguishable from *Rickey* because the corporation and the estate in *Rickey* may have been required by the articles of incorporation and the decedent's directions in his will to cause the redemption of the decedent's stock. No such requirement was present in *Metzger Trust*. The Tax Court did not deem the presence of a mandatory redemption agreement to be a sufficient reason to justify the application of section 302(c)(2), but it determined that since the Fifth Circuit gave so much attention to that fact, the circuit court may have thought it significant. The Tax Court decided that because the case before it was distinguishable from *Rickey* on a basis that the Fifth Circuit might consider to be important, the court was not bound by

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60. 592 F.2d 1251 (5th Cir. 1979).
61. *Id.* at 1258.
65. 76 T.C. at 73-74.
its Golsen rule. If appealed, it will be interesting to see if the Fifth Circuit adheres to the view it adopted in Rickey.

Subsequent to the Crawford decision, the Tax Court raised the question of whether the Crawford holding applied only to estates and not to trusts. The Tax Court resolved that question in Rodgers P. Johnson Trust v. Commissioner, where the court held that an agreement, filed under section 302(c)(2) by the trustees of a testamentary trust, was effective to prevent attribution of stock owned by the mother of the beneficiary of the trust to the beneficiary. Accordingly, stock redeemed from the trust was treated as a purchase under section 302(b)(3). While the beneficiary, the son, also filed an agreement in his individual capacity, he was not a distributee of the redemption payment and the court did not pass on the question of whether his agreement had any effect. The agreement filed by the trustees was deemed to be sufficient.

The positions adopted by the Tax Court in Crawford and Johnson Trust raise difficult interpretative questions and problems of administration. The condition section 302(c)(2) exacts for its operation is that the distributee must not acquire an interest in the corporation for a period of ten years following the redemption. Furthermore, if the distributee does acquire such an interest within this period, he must promptly inform the Service. If a fiduciary can preclude family attribution to a beneficiary of the estate or trust by agreeing that the estate or trust will not acquire an interest in the corporation within the ten-year period, is the beneficiary free to acquire such an interest during this period without affecting the treatment of the redemption?

If so, the expansion of section 302(c)(2) for use in such redemptions is questionable. The Tax Court suggested in dictum in Johnson Trust that an acquisition of stock by a beneficiary within the proscribed period would cause the stock to be attributed to the trust or estate under section 318(a)(3) and thereby provide the trust or estate with a prohibited interest in the corporation so that the benefits of section 302(c)(2) would be lost. The Tax Court apparently construes the statutory mandate that a distributee not "acquire" a prohibited interest to include the distributee's constructive acquisition of stock acquired by another and attributed to the distributee under section 318. The court's dictum on this issue, however, appears to apply only to a

66. Id. at 72-74.
68. 71 T.C. 941 (1979).
69. Id. at 955.
70. Id.
71. I.R.C. § 302(c)(2).
72. 71 T.C. at 952.
beneficiary's stock acquisitions. If the beneficiary acquires a prohibited interest in the corporation in some form other than stock, for example by becoming an officer of the corporation, there is no statutory provision to attribute that type of interest to the trust or estate. Section 318 applies attribution rules only to stock interests, and section 302(c)(1) deals only with the constructive ownership of stock.

Assuming the validity of the court's dictum that acquisition of a prohibited stock interest by a beneficiary during the existence of the trust or estate constitutes an acquisition by the trust or estate itself, what if the prohibited interest is acquired after the termination of the entity? In dictum in Johnson Trust, the Tax Court suggests that the acquisition of a prohibited interest in the corporation by the transferee of the assets of the terminated estate or trust may void the section 302(c)(2) election. If, as is by no means certain, the Tax Court will treat the transferee of an estate or trust as the successor to the trust or estate for purposes of applying the ten-year restraint on stock ownership, will that rule apply to all beneficiaries of the entity, including those who had no actual or constructive ownership of the corporation's stock at the time of the redemption, and will it apply to the transferee's acquisition of a non-stock interest in the corporation?

Consider the following example.

_D_ died survived by his wife, _W_, and by a son, _S_, from his first marriage to _M_. _D_ and _M_ both owned stock of the _X_ corporation. _D_'s will left a pecuniary bequest of $30,000 to _S_ and the residue of his estate to _W_. The _X_ stock owned by the estate was redeemed, and the executor filed the agreement required by section 302(c)(2). The estate was promptly terminated, and distributions to the beneficiaries were completed. Four years later, _M_ gives several shares of _X_ stock to _S_. Does the acquisition of _X_ stock by _S_, who is a transferee of some of the assets of _D_'s estate, cause the estate to lose its protection under section 302(c)(2)?

If the Tax Court is correct that an acquisition of an interest in the distributing corporation by a beneficiary of a trust or estate will constitute an acquisition by the trust or estate itself, there will be serious administrative problems. To qualify for section 302(c)(2) relief, the fiduciary of an estate or trust must execute an agreement to notify the Service promptly if the estate or trust acquires an interest in the corporation within the ten-year period. But, if the interest is acquired by a beneficiary of the estate or trust while it is still in existence, so that the interest is attributed to the estate or trust by

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73. I.R.C. § 318.
74. Id. § 302(c)(1).
section 318(a)(3), the fiduciary may not be aware of it. Indeed, the beneficiary may have acquired only a constructive interest in the corporation by virtue of his interest in a partnership, corporation, or another trust which has acquired an actual interest in the corporation. In such cases, it will be especially unlikely that the fiduciary of the distributee estate or trust will have knowledge of the beneficiary’s constructive ownership. Presumably, the fiduciary will not be liable for failing to report the acquisition of an interest of which he has no knowledge. If notice is not given, however, the statute of limitations for assessment and collection of the tax on the redemption will never run. Moreover, the Service is not likely to discover the beneficiary’s actual or constructive ownership of an interest in the corporation, and it is not likely to be reported because of the fiduciary’s ignorance of the facts and the beneficiary’s ignorance of the significance of the acquisition.

In the example above, if M did not give any of her stock to S and if four years after the redemption took place S was employed by X in a managerial capacity, will that employment rescind the operation of the section 302(c)(2) election and cause the redemption to be treated as a dividend equivalent?

The administrative difficulties attendant to construing section 302(c)(2) as permitting elections to be made by fiduciaries strongly suggests that Congress never intended that result. It seems likely that, as the Commissioner contends, the provision was intended to bar family attribution to the distributee himself, but not to bar family attribution to other persons. To date, however, the courts have uniformly rejected the Commissioner’s view.

C. Not Essentially Equivalent to a Dividend

If dividend treatment were to be determined solely on the basis of the mechanical application of the precise criteria contained in sections 302(b)(2) and (3) it could produce unduly harsh results. Accordingly, Congress provided relief by enacting the flexible language of section 302(b)(1).


79. Internal Revenue Code of 1939, Pub. L. No. 76-1, § 115(g), 53 Stat. 1, 48. "If a corporation cancels or redeems its stock... at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essen-
namely, redemptions "not essentially equivalent to a dividend" are treated as purchases.80 Prior to the Supreme Court's decision in United States v. Davis,81 the courts split over the interpretation of that phrase. One line of cases adopted a "strict net effect" test—that is, whether the shareholders' positions resulting from the redemption are substantially different from the positions they would have been in had a dividend been distributed.82 A second line of cases followed a "business purpose" or "flexible net effect" test: whether the redemption was designed to serve a legitimate business purpose.83 In Davis, the Supreme Court repudiated the business purpose test and adopted a strict net effect test.84 Under this test, if a redemption is pro rata or nearly pro rata, it will not qualify as a purchase. The Supreme Court also held in Davis that the section 318 attribution rules are to be applied in determining whether a redemption qualifies under section 302(b)(1) as not essentially equivalent to a dividend.85

The extent to which a redemption must be disproportionate to qualify as not essentially equivalent to a dividend is far from certain. In Davis, the Supreme Court said that to qualify "a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation."86 Although the determination of what constitutes a "meaningful reduction" has been characterized as a question of fact,87 the resolution of that issue often rests on legal standards. While the precise contours of the line dividing meaningful from non-meaningful reductions is not settled, there are a number of rulings and decisions that shed some light on the problem.88 The courts89 and the Commissioner90 have been fairly liberal in applying this provision,
and at least one pair of commentators has criticized them for failing to apply a more restrictive construction.91

A "meaningful reduction of a shareholder's proportionate interest in the corporation" might be deemed to refer to: a significant reduction of the shareholder's voting interest, that is, a loss of some element of control; a reduction in his dividend rights; a reduction in his percentage interest in the proceeds of a complete liquidation of the corporation; or a reduction in some combination of the above.92

1. Redemption of Voting Stock

a. Shareholder had voting control prior to the redemption

When voting stock of a majority shareholder is redeemed, the courts and the Commissioner have looked primarily to the control of the shareholder after the redemption to determine whether a meaningful reduction has occurred.93 The Commissioner's current view is that a reduction of a majority voting interest to a voting interest of no more than fifty percent will be sufficient for section 302(b)(1) but that a reduction of voting interest to a percentage that is greater than fifty percent will not qualify.94 It is possible that a reduction of voting interest to fifty percent or less will not qualify as a purchase if the shareholder retains effective control of the corporation, but the Commissioner has not yet sought to apply section 301 treatment in such circumstances and no court has done so. The Tax Court has suggested, however, that effective control is a factor to be weighed.95

A shareholder may be said to have effective control of a corporation if the shareholder and one or more persons, who are related and friendly to the shareholder but who are not of such relationship that

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91. Postlewaite & Finneran, supra note 89, at 564.
92. See Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964).
93. See, e.g., Benjamin v. Commissioner, 592 F.2d 1259, 1261 n.3 (5th Cir. 1979).
their shares are attributed to the shareholder under section 318, can exercise control of the corporation by joining together and voting their stock in concert. The substantiality of a shareholder’s effective control depends upon the number of persons whose assent the shareholder needs (the fewer needed, the more substantial is the effective control), the total number of shareholders, and the likelihood that the person or persons whose votes are needed will support the shareholder’s corporate proposals.

When a redemption causes a majority shareholder to lose unilateral control of a corporation, it should be treated as a meaningful reduction of his interest regardless of whether the shareholder has “effective control” because of the possibility of obtaining the votes of a friendly co-shareholder, even if the vote of only one such person is needed. The shareholder’s loss of unilateral control renders him vulnerable to a loss of either the continuing friendship or the pliability of the other party. The vulnerability that the shareholder suffers as a consequence of the redemption cannot be equated with a dividend distribution in which no stock was redeemed. Such a redemption, therefore, is not “essentially equivalent to a dividend,” and should be treated as a purchase under section 302(b)(1).

Some commentators have suggested that the determination of a shareholder’s control should be made as of a date prior to the redemption because the legislative history indicates that a shareholder’s incapacity to prevent the occurrence of the redemption was the motivating force for adopting section 302(b)(1). The scope of an act, however, is not necessarily limited to the factual pattern that induced Congress to adopt it. The shareholder’s control after the redemption is a better measure of the extent of his change of position in that his power to compensate for the decline in his stock interest depends upon post-redemption control.

The Eighth Circuit held in a two-to-one decision in Wright v. United States that a reduction of a shareholder’s voting interest from 85% to 61.7% was a meaningful reduction because under state law a two-thirds vote was required to authorize a merger, consolidation or liquidation, or to amend the articles of incorporation, and the shareholder therefore lost the power to make those decisions unilaterally. In Revenue Ruling 78-401, the Commissioner rejected the holding in Wright and stated that such a reduction was not meaningful when there is no indication that any of the types of corporate action that require a two-thirds vote are contemplated for the near future. The negative inference from that qualification is that if an action requiring

96. Postlewaite & Finneran, supra note 89, at 593.
97. 482 F.2d 600 (8th Cir. 1973).
98. Id. at 609.
a two-thirds vote were a serious option at the time of the redemption, the shareholder's loss of unilateral control over that action could constitute a meaningful reduction; but not much reliance can be placed on a negative inference. If, after such a redemption, the shareholder had effective two-thirds control, the redemption might not qualify as a purchase even if the Commissioner adopts the negative inference of his 1978 ruling. However, as noted above, it appears that the loss of unilateral control constitutes a meaningful reduction in the shareholder's interest.\textsuperscript{100} The sole issue, then, in the above-described circumstances, is whether the types of action that require a two-thirds vote are of sufficient significance to characterize a reduction in the shareholder's voting interest to a percentage that is less than two-thirds as meaningful.

For administrative reasons, the question of the meaningfulness of a shareholder's loss of control over corporate actions that require a two-thirds vote should be determined as a general proposition rather than on an ad hoc basis. There would be considerable difficulties encountered in attempting to distinguish those cases where a genuine prospect of liquidation or merger exists from those where an investigation of a possible merger or liquidation has been initiated by the majority shareholder in order to qualify a redemption under section 302(b)(1). Although the application of section 302(b)(1) can rest on a factual inquiry into the presence of special circumstances, such as the nature of the relationship of the shareholders,\textsuperscript{101} the external evidence of a friendly or hostile relationship cannot be manipulated as readily as can evidence of a contemplation of some corporate action. The shareholders' manifestation of a friendly or hostile relationship has significance independent of the tax considerations. The mere contemplation of taking corporate action often will have no independent non-tax consequence. Therefore, contrary to the negative inference in Revenue Ruling 78-401, the imminence of a corporate action requiring a two-thirds vote should be inapposite.

The power of a majority shareholder to cause the corporation to compensate him for the loss of his redeemed shares is so pervasive that the shareholder's loss of unilateral control over even such important steps as the decision to liquidate or to merge pales in significance. The shareholder's loss of control over such corporate decisions makes the redemption less like a dividend than a redemption where no loss of such control occurs—for example, where the shareholder never had two-thirds voting control. Nevertheless, such a redemption is more similar to a dividend than it is to a purchase. While it is a close

\textsuperscript{100} See supra notes 95-99 and accompanying text.\textsuperscript{101} Treas. Reg. § 1.302-2(b) (1955); see Wright v. United States, 482 F.2d 600, 606 (8th Cir. 1973); United States v. Carey, 289 F.2d 531, 537 (8th Cir. 1961); United States v. Fewel, 255 F.2d 496, 499 (5th Cir. 1958); David Metzger Trust v. Commissioner, 76 T.C. 42, 52 (1981).
question, it seems that section 302(b)(1) should not apply to those cases.102

b. Redemption of stock of a minority shareholder

A minority shareholder whose percentage interest of common stock is reduced by a redemption may not have lost a significant voting interest, since he already lacked control, unless his prospects of sharing control by joining with a small number of shareholders is diminished by the redemption.103 Because a shift in voting rights is of less importance to a minority shareholder than to one who has voting control, a reduction of dividend rights and liquidation interests becomes a more significant factor.

If the minority shareholder owns only a miniscule percentage of a corporation, a non-pro rata redemption of any number of his shares of common stock should qualify under section 302(b)(1). For example, in Revenue Ruling 76-385,104 a reduction of a shareholder's percentage interest from .0001118% to .0001081%, a reduction of only 3.3%, was determined to qualify for section 302(b)(1) treatment. A non-pro rata redemption of even one share from such a shareholder bears no similarity to a dividend.

The Commissioner has also ruled that a reduction in common stock from a 27% interest to a 22.27% interest, a reduction of only 4.73 percentage points, is meaningful,105 because, prior to the redemption, the distributee had the prospect of exercising control by joining with only one other shareholder, and the redemption deprived him of that power. On the other hand, in Rodgers P. Johnson Trust, the Tax Court held a reduction of a trust's interest in a corporation, after applying attribution rules, from 43.6% to 40.8% not to be meaningful.106 The Tax Court asserts that non-attribution family relationships are to be taken into account in applying section 302(b)(1) unless hostility among them indicates that they are not likely to act in concert.107

c. Non-statutory attribution of stock held by friendly relatives

A central inquiry with respect to a section 302(b)(1) redemption is whether actual or effective control is retained. As to the latter, attribution is not necessarily restricted to the express provisions of section

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102. Contra Wright v. United States, 482 F.2d 600 (8th Cir. 1973).
106. 71 T.C. at 948. The Tax Court nevertheless treated the redemption as a purchase because it held that a trust's waiver of family attribution under § 302(c)(2) was valid. Id. at 955.
318. The congressional purpose for enacting section 318, however, was to provide predictability and to eliminate the need for making ad hoc judgments as to the extent of the autonomy of members of a family or other related group.\footnote{108} If the relationship of a taxpayer to other shareholders is taken into account, the scope of stock attribution will be expanded to reach circumstances where the facts suggest that concerted action is likely. This approach opens the door to the very kind of inquiry and uncertainty of application that section 318 was intended to prevent. However, uncertainty will arise only in conjunction with the question of the availability of section 302(b)(1), a provision which was included in the 1954 Code to provide a less rigid, and accordingly a less predictable, standard than the more precise standards adopted by sections 302(b)(2) and (3).\footnote{109}

The legislative history of the 1954 Act reveals that while the House of Representatives first sought to eliminate a dividend equivalence test from the section 302 rules because of its vagueness,\footnote{110} Congress ultimately decided to retain that test.\footnote{111} Portions of the legislative history suggest that the reason for this change of position was concern for the plight of a shareholder, the redemption of whose stock was decreed by others who are in control of the corporation. Specifically, the Senate Finance Committee, explaining its decision to reject the House's removal of the 1939 Code's dividend equivalence test, stated:

> 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 the stock if the redemption is not essentially equivalent to a dividend.\footnote{112}

It does not follow that the only type of redemption that can be covered by section 302(b)(1) is one similar to the example given in the first sentence quoted above—namely, one involving exclusively nonvoting stock. Indeed, the cure adopted by the Senate was to reinstate the 1939 Code standard.\footnote{113} Presumably, the solution was considerably broader than needed to resolve the difficulty encountered in the

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109. \textit{See infra} notes 110-114 and accompanying text.
111. \textit{See infra} note 112 and accompanying text.
113. \textit{Id.}
situation set forth in the quoted statement because that situation was merely an example of the harsh consequences that would occur if the only standards for purchase treatment were the rigid standards of sections 302(b)(2) and (3). The breadth of coverage and flexibility of treatment that Congress intended to apply to stock redemptions by adopting section 302(b)(1) is shown by the statement in the Senate Report that the standard to be employed in determining dividend equivalence under the 1954 Code is, in general, the same as the one that was employed in construing a similar provision in the 1939 Code. While it is unlikely that the Senate intended to adopt the entirety of the broad construction that was applied to the 1939 Code, the reference to existing law belies any suggestion that section 302(b)(1) is limited to redemptions of nonvoting stock held by shareholders lacking control.

In sum, the effort to resolve the question of whether the operation of section 302(b)(1) should rest on an examination of the friendly and cooperative nature of the relationship among the shareholders discloses the presence of a tension between two conflicting principles both of which apply to the subject. On the one hand are the section 318 attribution rules which provide precise mechanical tests to promote certainty and predictability. On the other lie the deliberately vague contours of section 302(b)(1) which was intended to provide relief for the harsh consequences in this area of applying only precise mechanical tests.

In the author's view, the tension between the underlying principles of section 302(b)(1) and section 318 should generally be resolved in favor of the former. It might be suggested that because the operation of section 302(b)(1) itself is in issue, it is reasonable to grant priority to the congressional scheme for adopting that provision over the rationale underlying the adoption of a complementary provision. Unfortunately, the simplicity of that argument is sullied by the facts that the identification of the congressional scheme for adopting section 302(b)(1) is not free of doubt and that section 318 is so fundamental to and integrated with section 302 that it is difficult to speak of separate and distinct purposes for those two provisions. In response to the latter point, however, it is significant that sections 302 and 318 were integrated in the House's bill prior to the Senate's insertion of section 302(b)(1) and that Congress' purpose for adopting the rest of section 302 was exactly the same as its purpose in enacting section 318—to provide precise mechanical tests. To the extent that the last minute insertion of section 302(b)(1) conflicts with that original purpose, it

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seems that Congress, believing that the section 302 safe harbor and section 318 attribution tests are too restrictive to be exclusive, deliberately chose a more flexible standard.

Even assuming that the purposes for adopting section 302(b)(1) override the objective of sections 318, 302(b)(2) and (3) to provide precision and predictability, the extent to which it is appropriate to create non-statutory stock attribution rules has to be resolved. A minority shareholder's "effective control" of a closely held corporation by joining with a small number of other shareholders is dependent upon their continuing cooperation. When a shareholder's stock interest, including his constructive stock ownership, is sufficient to provide him with voting control of the corporation, a redemption that deprives him of that position should be treated as a meaningful reduction even if after the redemption the shareholder need find only one other shareholder to join with him in order to exercise control. As previously stated, the vulnerability resulting from losing unilateral control is a substantial change of circumstance that appears to the author to be sufficient to distinguish such a redemption from a dividend distribution.115

Of course, the easier it is under the factual circumstances for a shareholder to obtain the cooperation of one with sufficient shares to provide him with control, the closer the redemption is to dividend equivalence. For example, if the shareholder needs the consent of only one other shareholder and if there are ten other shareholders available to seek as a partner, the "effective control" of the shareholder is fairly close to unilateral control. Conversely, if there is only one other shareholder available, the vulnerability of the redeeming shareholder is far greater. In any event, regardless of the number of other shareholders that are available, the loss of unilateral control is sufficient to constitute a meaningful reduction.

If, after taking into account shares held by friendly relatives, a minority shareholder has effective control, a redemption of his shares should not fall under 302(b)(1) unless the decline in his percentage interest is such that for effective control he needs additional shareholders to join with him. If the number of persons whose cooperation he needs in order to have control is increased, there appears to have

115. See, e.g., Rev. Rul. 75-502, 1975-2 C.B. 111 (Commissioner held that a reduction of a shareholder's actual and constructive interest from 57% to 50% was a meaningful reduction under § 302(b)(1)). The same vulnerability exists where a shareholder's actual stock ownership is insufficient to provide him with control and he has control only by virtue of adding the constructive ownership of shares attributed to him by § 318—i.e., his "control" depends upon the cooperation of the related parties. But, in § 318, Congress made a legislative determination that the potential abuse if such close relationships were not taken into account outweighs considerations of the taxpayer's vulnerability to alienation.
been a meaningful reduction.\footnote{116. See Rev. Rul. 76-364, 1976-2 C.B. 91.} This view of the transaction is essentially a variation on the approach suggested above for the treatment of a redemption where a shareholder loses unilateral control. Neither the Service nor the courts have passed on this issue.

d. Hostility among shareholders

The other side of the question of whether attribution can be judicially expanded to cover friendly relations not listed in section 318 is the question whether hostility or “bad blood” among persons listed in section 318 precludes the attribution of stock or otherwise influences a determination of dividend equivalence. As to the attribution rules themselves, stock will be attributed under section 318 regardless of the hostility among the parties involved.\footnote{117. David Metzger Trust v. Commissioner, 76 T.C. 42, 58-59 (1981); Niemeyer v. Commissioner, 62 T.C. 280, 285-86 (1974), aff’d, 535 F.2d 500 (9th Cir.), cert. denied, 429 U.S. 1000 (1976); cf. Miller v. Commissioner, 75 T.C. 182 (1980) (holding that family hostility does not affect the prohibition under I.R.C. § 267 against a deduction for a loss incurred on a sale between brothers).} This construction conforms with the legislative purpose for adopting section 318. The question remains, however, as to what effect family hostility has on the operation of section 302(b)(1).

The “bad blood” or hostility in a family group can be regarded as a factual circumstance to be considered in determining whether a redemption is meaningful. Under this approach, if the redemption of stock of a shareholder would qualify as a meaningful redemption if it were not for the attribution of stock to him from his relatives, the fact that there is animosity between the family members is a factor to be weighed in favor of qualifying the redemption under section 302(b)(1). This position was adopted by the First Circuit in Haft Trust v. Commissioner,\footnote{118. 510 F.2d 43, 48 (1st Cir. 1975).} and, in dictum, the Fifth Circuit asserted its approval in Rickey v. United States.\footnote{119. 592 F.2d 1251, 1257 n.6 (5th Cir. 1974).} It is noteworthy that Treasury Regulation section 1.302-2(b) may support the Haft Trust decision. The regulation states that the question of dividend equivalence for a redemption “depends upon the facts and circumstances of each case” and that merely “[o]ne of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a).”\footnote{120. Treas. Reg. § 1.302-2(b) (1955).}

The Tax Court’s position on this issue is somewhat ambivalent. In the Haft Trust case, after applying section 318 attribution, the taxpayer’s percentage interest in the corporation was not reduced at all by the redemption; in fact, its percentage interest was increased. In

that context, the Tax Court held that the question of family hostility that was raised by the taxpayer was irrelevant in that stock attribution and the application of section 302(b)(1) did not turn on the actual relationship of the parties involved.121

As previously noted, in reviewing the Tax Court, the First Circuit held family hostility to be a relevant factor.122 A subsequent decision of a majority of the Tax Court in Metzger Trust refined the court's position. In Metzger Trust, the court held that family hostility is a factor in applying section 302(b)(1) in either of two instances: (1) where the taxpayer's actual and constructive stock ownership is insufficient to provide control, bad blood between related persons who are not listed in the section 318 attribution categories can prevent the taxpayer from being treated as having effective control as a consequence of the stock owned by such hostile family members; (2) if, after applying the constructive ownership rules of section 318, the taxpayer's percentage interest is reduced to any extent at all, family hostility is a proper factor in determining whether section 302(b)(1) applies.123 On the other hand, if, after applying constructive ownership rules, the taxpayer's percentage interest was not reduced to any extent, family hostility cannot be taken into account.124

The opinion in Metzger Trust is puzzling because there is no issue in that case concerning attribution among hostile family members. The redemption in question was of stock owned by a trust. The only shareholders remaining after the redemption were friendly family members and trusts for their behalf. The redemptions had separated the hostile family members from co-ownership of the same corporation. After the redemption, one of the beneficiaries of the trust had actual or constructive ownership of 100% of the corporation's stock, and none of his constructive ownership came from unfriendly parties. All of the beneficiary's stock was attributed to the trust under section 318(a)(3)(B). There was hostility among the several beneficiaries of the trust, but that has no bearing on the treatment of a redemption of the trust's stock. While the taxpayers raised the hostility issue, the true thrust of their claim was that the purpose of the redemption was to sever connections between hostile shareholders; and the Supreme Court's decision in Davis precludes resort to a legitimate purpose test in applying section 302(b)(1).

Six Tax Court judges concurred with the result reached by the majority in Metzger Trust,125 and five of those judges joined in an
opinion written by Judge Tannenwald.\textsuperscript{126} In his concurring opinion, Judge Tannenwald criticized the majority for seeking to resolve the hostility question when the issue was not before them on the facts.\textsuperscript{127} In addition, the judge saw little virtue in the majority's distinction between cases where the taxpayer's actual and constructive ownership was reduced to some extent from those where it was not. While Judge Tannenwald did not attempt to resolve the merits of the hostility issue, his opinion does suggest that he and the four judges who joined him lean towards treating hostility as a proper factor to be considered.

2. Redemption of Non-voting Stock

The redemption of non-voting preferred stock by a corporation where the shareholder had no control over the decision to redeem and where the redemption is disproportionate to voting stock holdings is the very circumstance that the Senate gave as an illustration of the need to have a flexible exception to dividend treatment in the 1954 Code.\textsuperscript{128} The determination of whether a shareholder lacks control should rest on the same principles as were discussed above in connection with the redemption of voting stock.

If after applying attribution a shareholder owns only non-voting preferred stock, a redemption of all or any part of the shareholder's stock ordinarily will be covered by section 302(b)(1).\textsuperscript{129} Since the shareholder has no voting interest, the reduction in his right to participate in dividend distributions and in liquidating distributions cannot be compensated by the exercise of control, and so the redemption will constitute a meaningful reduction in his interest. If the shareholder had effective control of the corporation, even though he had no voting stock, because of voting stock held by the friendly family members, perhaps a redemption of the shareholder's non-voting stock would not qualify as a purchase.\textsuperscript{130}

\textsuperscript{126} Judges Fay, Irwin, Sterrett and Hall agreed with the concurring opinion written by Judge Tannenwald. \textit{Id.} at 84.

\textsuperscript{127} \textit{Id.} at 84 (Tannenwald, J., concurring).


\textsuperscript{129} Treas. Reg. § 1.302-2(a) (1955); see Rev. Rul. 77-426, 1977-2 C.B. 87 (redemption of non-voting preferred stock held by shareholder who owned no common stock was treated as a purchase under § 302(b)(1)). Of course, the redemption of section 306 stock may be treated as a § 301 distribution. I.R.C. § 306(a)(2).

\textsuperscript{130} In Private Letter Ruling No. 8133093, (May 22, 1981), X owned all of the voting stock and 60.5% of the non-voting stock of a corporation. The remaining 39.5% of the corporation's non-voting stock was held by Y and by a trust for Y. X and Y were brother and sister. The corporation redeemed all of the non-voting shares held by Y and some of the shares held by the trust. After the redemption, Y had constructive ownership (and the trust had actual ownership) of 31.6% of the corporation's non-voting stock. The Commissioner ruled that the redemption lacked divi-
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If, after the redemption is completed, a shareholder has actual or effective control over the corporation, the redemption of such shareholder's non-voting stock should not qualify under section 302(b)(1) since the shareholder's control provides him a means of substituting for the loss of dividend and liquidation rights. The current treatment of such redemptions is far from clear.

In a pre-Davis ruling, the Commissioner determined that the redemption for good business reasons of all of a corporation's outstanding non-voting preferred stock was covered by section 302(b)(1) where there "was no proportional relationship or pattern of stock ownership existing between the holders of the preferred stock and the holders of the common stock of the corporation." Before the redemption, the corporation's principal shareholder had actual or constructive ownership of sixty percent of the corporation's common stock, and actual ownership of three percent of its preferred. The redemption of the preferred stock that he owned outright was treated as a purchase under section 302(b)(1). The ruling is suspect because, in one sense, the principal shareholder is in a better position after the redemption than before since, as a consequence of the redemption, the common stock that he owned outright, comprising fifty percent of the outstanding stock, was immunized from the senior interests of the preferred shares in which he had previously participated only to a small degree. Moreover, his control over the corporation empowers him to compensate himself from the corporation for any loss that he suffered from the redemption of his preferred shares.

When, both with and without applying section 318 attribution, a shareholder's non-voting stock is held in substantially different proportion to his voting stock holdings and when the shareholder lacks even effective control of the corporation, a redemption of any or all of his non-voting shares should qualify for non-dividend equivalence. If, by virtue of section 302(b)(1), a redemption of a shareholder's voting stock is treated as a purchase, a simultaneous redemption of that shareholder's non-voting stock should be given similar treatment.

3. Section 302(b)(1)—A Proper Construction

In many cases, the uncertainties of the non-dividend equivalence test make it too hazardous an exception to rely on for planning purposes and so constituted a purchase under § 302(b)(1). The question of effective control was not discussed in that ruling, although the issue lurks in the stated facts. The ruling also does not indicate whether a friendly relationship existed between X and Y.


132. Cf. Treas. Reg. § 1.302-3(a) (1955) (when voting common stock is redeemed under the protection of § 302(b)(2), a simultaneous redemption of non-voting preferred stock will also be treated as an exchange).
poses. The scope of the test is unclear, and even if agreement is reached on the proper standard to employ, the application rests largely on the resolution of factual issues. The difficulties of applying section 302(b)(1) are such that it might well be a subject for legislative modification; but in its current form, it has broader application than some commentators would like. If the 1954 Code provision for non-dividend equivalence was intended by Congress to be limited to non-pro rata redemptions of non-voting stock where the shareholder lacks control of the corporation, Congress certainly wrote the statute in a most peculiar way. Contrary to limiting the scope of section 302(b)(1), Congress adopted extremely broad language, "essentially equivalent to a dividend," that mirrors the broadly construed section 115(g) of the 1939 Code; and as previously noted, there is a statement in the legislative history that the construction of section 115(g)(1) of the 1939 Code should apply as well to section 302(b)(1) of the 1954 Code. While a proper construction of the 1954 Code provision almost certainly is narrower than that of the 1939 Code provision, neither the language employed in section 302(b)(1) nor its legislative history lends much support for treating this exception as inconsequential.

Conclusion

The treatment of stock redemptions under section 302(b) is in a state of flux. The certainty and predictability of one of the safe harbor provisions has suffered some strain recently as a consequence of the Tax Court's liberal application, and the Fifth Circuit's overly generous application, of the waiver of attribution provision. If the Tax Court's position is adopted by the Commissioner and by other courts, a number of serious problems of administration and of judicial construction will have to be resolved.

The not essentially equivalent to a dividend standard has proven to possess far more vitality than was generally believed after the Supreme Court's decision in Davis, and the expansion of the significance of that provision has raised issues that previously lay dormant. The extent to which stocks held by friendly family members not within the limited family relationships described in section 318 should be taken into account, and the jural significance of hostility among persons within the section 318 definition of family are just two of the unresolved questions.

When the resolution of an issue hinges on factual determinations, each case will turn on the circumstances there involved. As previously noted, while such an ad hoc administration provides flexibility, it impairs the predictability of consequences. After a number of judicial decisions have been made, however, courts typically will be unwilling to depart from the results reached in prior decisions and so what was originally a flexible standard will become increasingly rigid and pre-
In time, it is likely that section 302(b)(1), if unamended, will become just as mechanical and precise as are the safe harbor provisions that it was designed to ameliorate.

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Dedication

On October 30, 1981, Dean Joseph M. McLaughlin was sworn in as Judge of the United States District Court for the Eastern District of New York. His departure inspires sorrow for our loss and gratitude for all that he has done. With best wishes for great success in his new undertaking,

THE BOARD OF EDITORS

OF THE

FORDHAM LAW REVIEW

Dedicates Volume L

to

JOSEPH M. McLAUGHLIN

JUDGE
UNITED STATES DISTRICT COURT
EASTERN DISTRICT NEW YORK

Buturum Imposuisti Pani Tuo,
Nunc Ibi Dormi.
I am pleased to join the Editors of the Law Review in saluting Dean Joseph M. McLaughlin, who is leaving the hallowed halls of academe to become a Judge in the United States District Court, Eastern District of New York.

Joe’s association with Fordham University has been long and fruitful. After graduating from Fordham College in 1954 and from Fordham Law School in 1959, Joe joined the Law School faculty in 1961; ten years later he became Dean. Due in no small part to Joe’s tireless efforts, the Law School has grown during this twenty year period, both in size and national stature. Joe has also brought great honor to the Law School through his widely read and highly influential work as Chairman of the New York Law Revision Commission, as author of the practice commentary to the New York Civil Practice Law and Rules, and as a regular columnist in the New York Law Journal. The Fordham University community is rightfully proud of Joe McLaughlin.

Joe first came to my attention when he was Drum Major of the Fordham Marching Band, a position he earned because of his inability to play any musical instrument. He was a student of mine at the Law School in first year in Criminal Law where he attained the highest grade in the class. The lure of a uniform, however, was too great, and he left to join the army and serve in Korea. Upon his return, I offered him a scholarship to keep him from making the military a career. His scholastic abilities were outstanding and included the Editorship of this Review. I enticed him to leave private practice and join the faculty; I protected him against the blandishments of other Deans who sought his services and ardently supported him as my successor as Dean of the Law School. Now that I have left the Federal Bench, he is joining it. I assume that if I ever leave Skadden, Arps, Slate, Meagher & Flom, he will join that firm. I feel somewhat responsible for his successful legal career, which most people attribute to his ability, industry, wit and general excellence. In recognition of my role in the success he has achieved, he continues to address me as “Dean” and has found it impossible, he says, to use any more familiar terms, or even “Your Worship,” which I prefer.

Joe McLaughlin has all of the qualities which make for outstanding success in our profession. He is an extremely hard worker, a true scholar of the law with a firm foundation in the classics. He is one of

* Partner, Skadden, Arps, Slate, Meagher & Flom; former Circuit Judge, United States Court of Appeals, Second Circuit; Dean, Fordham University School of Law, 1956-1971; Class of '42, Fordham University School of Law.
the best teachers of law in the history of this Law School, which has known many, and his bar review courses and seminars for state court judges have broadened the reputation he has earned here at Fordham. He is a superb speaker, has a ready wit and has continued the progress of the Law School. Though replacing him as Dean will be most difficult, I am sure that, as a member of the Federal judiciary, Joe will continue to enhance the School’s growing reputation for excellence. We know that the qualities of mind and heart, which have marked his professional life to date, will lead to a successful career on the Bench.

*Ad Multos Annos.*