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CONSTRUCTIVE OWNERSHIP UNDER THE 1954 INTERNAL REVENUE CODE

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ON JUNE 11, 1957, the Court of Appeals for the Third Circuit rendered its decision in *Lukens' Estate v. Commissioner*.[1] The court, in reversing the Tax Court, held that the proceeds of the redemption of the taxpayer's stock in a family corporation received in 1948 should not be deemed the equivalent of a dividend under section 115(g) of the 1939 Revenue Code.[2]

The facts in that case were briefly these. The decedent (whose estate is the taxpayer) originally owned 100 per cent of the shares. In 1946 he had given some shares to his son and daughter. In 1948 he caused 446 of his 547 remaining shares to be redeemed, and in 1950 he gave all his remaining shares to his children. The son, both before and after the redemption, was in active management of the corporation. The decedent very seldom appeared at the company's plant, although the son did defer on occasions to his father on matters of policy. The Tax Court reached its decision on the grounds that in 1948 there was no complete termination of decedent's interest, and that by means of gifts to his own immediate family he had assured himself of the continuance of the business as before and was simply extracting from the company some of its unneeded profits. The circuit court, in holding that the redemption constituted one step in a complete termination, pointed out that the redemption alone greatly reduced decedent's fractional interest in the company.[3] The fact, said the court, that the redemption correspondingly increased the children's proportionate ownership did not change this result since they were not dummy stockholders.

The *Lukens* case, decided under section 115(g) of the 1939 Code, the forerunner of present section 302[4] with its allied section 318, illustrates

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1. 246 F.2d 403 (3d Cir. 1957).

2. Int. Rev. Code of 1939, § 115(g), 52 Stat. 497 (now Int. Rev. Code of 1954, §§ 302, 303, 304):

"Redemption of stock.

"(1) In general. If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

3. 246 F.2d at 406. By the redemption decedent's 35% interest was reduced to 10%.

4. Int. Rev. Code of 1954, § 302. All statutory references in the text of this article except where specifically designated otherwise are to the Internal Revenue Code of 1954.

some of the difficulties that may be expected to result from the enactment of the "attribution rules" of section 318 in their present form and their application to stock redemptions.

If the *Lukens* redemption had taken place today, would the result have been the same, or would the proceeds of the redemption have been treated as the equivalent of a dividend, because, since the stock of the children would have been attributed to the decedent, there was no complete termination of stock interest and no substantial difference between the percentage interest of the decedent before and after the redemption?

The reference in the opinion of the circuit court to the fact that it did not consider the son and daughter as dummy stockholders is significant. Presumably, had the court thought otherwise the result of the case would have been different. There would have been no complete termination of stock interest. In a very real sense the "attribution rules" or rules of constructive ownership scattered through the Internal Revenue Code are statutory guideposts to a determination of who or what is or is not a "dummy."

If, for instance, a husband and wife each own 50 per cent of a corporation and the stock of either is redeemed *in toto,* has the spouse whose stock has been redeemed really terminated his or her entire interest in the corporation? Has there in practice been a substantially disproportionate redemption? Or, is the position of the distributee insofar as control of the corporation is concerned for all practical purposes substantially identical with what it was before the redemption? Does it make any difference whether the stockholders are husband and wife, father and son or mother-in-law and son-in-law; whether the stockholders although unrelated are partners; or whether the stock is owned by an estate and its sole beneficiary? Or in a somewhat different situation, is it equitable to allow an individual to deduct a loss arising from a sale by him to a corporation of which he owns over 50 per cent of the stock?[5] Would it be possible to circumvent the personal holding company provisions of the statute as to stock ownership[6] by registering the stock in the names of more than five members of the family or business associates?[7]

It is obviously necessary to consider more than actual ownership. If the legislative and judicial theories of taxation are to function properly, these close economic interests have to be taken into account and constructive as well as actual ownership considered.

Some rules of constructive ownership, such as those having to do with

5. Id. § 267 disallows such a deduction.

6. Id. § 542(a)(2).

7. See id. § 544 for the rules determining stock ownership in personal holding company cases.

personal holding companies,[8] foreign personal holding companies,[9] sales of certain property between related taxpayers,[10] and the disallowance of losses and expenses between related taxpayers[11] have been part of our law for a considerable period of time. But it was not until the 1954 Code that these rules of constructive ownership were specifically extended to the very important field of corporate distributions to shareholders.[12] Section 318 spells out in considerable detail the new rules of constructive ownership, the so-called attribution rules.

In view of the detailed definitions of constructive ownership appearing in section 318 and in view of the fact that much of that language appears in other sections of the Code[13] it seems advisable to discuss the provisions of that section at some length and then to examine the effect of those provisions on certain common business transactions.

The Senate Committee Report for the Eighty-Third Congress, Second Session,[14] states that the 1954 Code attempts to recast the provisions of the House bill dealing with tax treatment of corporate distributions and adjustments. It further states that this part of the statute was rewritten in order to provide a degree of certainty which is lacking in the existing law.[15] The Committee further stated that changes were necessary in order to remove unwarranted restrictions on necessary or desirable business transactions or to preclude the use of avoidance devices which have proved successful under the 1939 Code.[16] Thus, they have sought to provide more flexibility and to liberalize the present law with respect to nonrecognition of gain or loss in cases which involve the mere tightening of rules in other areas to insure that transactions which are in substance, athough not in form, dividend transactions by corporations to their shareholders, are subject to tax at ordinary income rather than at capital gain rates.

8. Int. Rev. Code of 1939, § 404, 52 Stat. 559 (now Int. Rev. Code of 1954, § 544).

9. Id. § 333, 52 Stat. 547 (now Int. Rev. Code of 1954, § 554).

10. Id. § 117(o)(1), 65 Stat. 504 (now Int. Rev. Code of 1954, § 1239).

11. Id. § 24(b)(2), 52 Stat. 464 (now Int. Rev. Code of 1954, § 267).

12. In 1951 the Commissioner attempted to amend the old Regulations by providing that for the purposes of determining whether a distribution to a shareholder was the equivalent of a dividend an individual would be considered as owning the stock owned by closely related members of his family. See p. 459 infra.

13. The American Law Institute takes the position that a single set of uniform rules of stock attribution should be utilized throughout the Code, rather than have different rules varying according to substantive situations involved as in the present Code. See ALI Interim Report, May 14, 1957, Federal Income, Estate and Gift Tax Statute.

14. S. Rep. No. 1622, 83d Cong., 2d Sess. 230 (1954).

15. Id. at 233.

16. Id. at 230.

THE SPECIFIC ATTRIBUTION RULES

Family Attribution

Section 318 provides that stock owned by a taxpayer includes stock constructively owned by such taxpayer. An individual is considered to own the stock owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and by or for his children, grandchildren, and parents. This rule is similar in many respects to the rules of constructive ownership under other sections of the Code which have been in effect for some years.[17] There are, however, certain differences. Unlike some of the other sections, constructive ownership under section 318 does not apply to a legally separated spouse, nor does it apply to brothers and sisters, to "lineal descendants" other than children and grandchildren, or to "ancestors" other than a parent. While the stock of grandchildren is attributed to the grandparent, the converse is not true.

An illustration of the application of these rules of family ownership is given in the Regulations.[18] *H*, his wife *W*, his son *S* and his grandson (*S*'s son) *G*, own the 100 outstanding shares of stock of a corporation, each owning 25 shares. The Regulations state that *H*, *W* and *S* are each considered as owning 100 shares. *G* is considered as owning only 50 shares, that is, his own and his father's. In other words, *H* is treated as owning the stock owned by himself, his wife, his son, and his grandson. *W* is treated as owning all of the stock owned by herself, her husband, her son and her grandson. *S* is treated as owning the stock owned by himself, his father, his mother, and his son. *G*, the grandson, is treated as owning the stock actually owned by himself and his father, but is not treated as owning the stock owned by his two grandparents. This illustration in the Regulations is a good example of stock of a grandchild being attributed to his grandparent, but stock of a grandparent not being attributed to the grandchild. This seemingly, at first, inconsistent treatment[19] has a good deal of sense to it from a practical point of view. It is relatively easy to see, in the example given, that *H* might well control the stock of *G*, while it is not particularly likely that *G* would have too much to say about how *H* dealt with or voted his stock.

Even though the stock of *H* and *W* would not be attributed to *G* because of the exclusion of grandparents from section 318(a)(1), one might have thought that since *G*'s stock is attributed to *S*, and since *S*'s stock is attributed to *H* and *W*, that therefore *G*'s stock constructively owned by *S* would by means of this two-step attribution be attributed to

17. See p. 442 supra.

18. U.S. Treas. Reg. § 1.318-2(b) (1955).

19. See note 13 supra.

H and *W*, with the result that *G*, as well as the other members of the family, would be deemed to own 100 shares. It is specifically provided, however, in section 318(a)(4)(B) that stock of the grandparents attributed to the father is not again attributed to the son.[20] It is noteworthy, however, that this exception to two-step attribution applies only under the family rule, and that under all other rules of section 318, stock constructively owned by a person or entity is treated as actually owned by him or it for the purposes of attributing such ownership to other entities.[21] The Regulations give as an example of the prohibition of two-step attribution in family cases the following:

" . . . if F and his two sons, A and B, each own one-third of the stock of a corporation, under section 318(a)(1), A is treated as owning constructively the stock owned by his father, but is not treated as owning the stock owned by B. Section 318(a)(4)(B) prevents the attribution of the stock of one brother through the father to the other brother, an attribution beyond the scope of Section 318(a)(1) directly."[22]

Partnership Attribution

Section 318(a)(2)(A) provides that:

"Stock owned, directly or indirectly, by or for a partnership . . . shall be considered as being owned proportionately by its partners. . . . Stock owned, directly or indirectly, by or for a partner . . . shall be considered as being owned by the partnership. . . . "

The Regulations[23] illustrate this proposition as follows: *A* and *B*, individuals, each have a 50 per cent interest in a partnership. The partnership owns 50 of the 100 outstanding shares of stock of a corporation, the remaining 50 shares being owned by *A*. *B* actually owns no stock of the corporation individually. The partnership is considered as owning 100 shares. *A* is considered as owning 75 shares. In other words, the partnership is treated as owning all of the outstanding stock of the corporation because there is attributed to the partnership all stock owned by any partners, in this case the stock of *A*. This would be true regardless of how small the interest of a partner is in the partnership. *A* is treated as owning the 50 shares owned by him individually and one half

20. Int. Rev. Code of 1954, § 318(a)(4): "(B) Members of family.—Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be treated as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock."

21. Id.: "(A) In general.—Except as provided in subparagraph (B) stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3), be treated as actually owned by such person."

22. U.S. Treas. Reg. § 1.318-4 (1955).

23. Id. § 1.318-2(C), Example (1).

of the 50 shares owned by the partnership in which he has a 50 per cent interest.

What happens to *B*, the other 50 per cent partner? The Regulations say nothing about *B*'s position. However, the effect of section 318(a)(4)(A) is to provide that stock constructively owned by a partnership shall be treated as actually owned by it for the purpose of attributing such ownership to another partner.[24] Apparently, then, if the statute is to be read literally, *B* will be regarded as owning 50 shares, consisting of one half of the 50 shares actually owned by the partnership and one half of the additional shares constructively owned by the partnership by virtue of *A*'s ownership.

This result is caused by so-called "sidewise attribution" and "back attribution." By "sidewise attribution" is meant attribution from a partner to a partner, from a shareholder in a corporation to another shareholder in that corporation, or from a beneficiary in a trust or estate to another beneficiary. "Back attribution" is attribution from a partner to his partnership, from a shareholder to his corporation, or from a beneficiary of a trust or estate to the trust or estate. *A*'s shares here are "back attributed" to the partnership, and reattributed from the partnership to *B*, thus in effect constituting "sidewise attribution" from *A* to *B*.[25]

Estate-Beneficiary Attribution

Section 318(a)(2)(A) provides rules relating to estates and their beneficiaries similar to those relating to partnerships and partners. Stock owned, directly or indirectly, by or for an estate is considered as being owned proportionately by its beneficiaries, and stock owned, directly or indirectly, by or for a beneficiary of an estate is considered as being owned by the estate.

The Regulations[26] give the following example of the rule: decedent's estate, in which *A* has a 50 per cent interest in fee, *B* has a life estate in 50 per cent, and *C* has a remainder interest in 50 per cent after *B*'s life estate, actually owns 50 of the outstanding 100 shares of corporation *X*. *A, B* and *C* are unrelated individuals; *A* owns 12 shares, *B* owns 18, and *C* owns 20.

As to the estate itself, it is considered as owning: (a) the 50 shares which it actually owns; (b) the 12 shares owned by *A*, who has a 50 per cent interest in the fee; and (c) the 18 shares owned by *B*, who has a life estate in the remaining 50 per cent of the estate, or a total of 80 shares. The estate is not considered to own the stock owned by *C*, since the Regulations state that *C* is not considered a beneficiary of the estate

24. Int. Rev. Code of 1954, § 318(a)(4)(A).

25. For the effect of this in cases of redemption of stock, see p. 455 infra.

26. U.S. Treas. Reg. § 1.318-3(a), Example (1) (1955).

since he has no direct present interest in the property held by the estate, nor in the income produced by such property.

As to beneficiary *A*, he is regarded as owning: (a) the 12 shares he actually owns; (b) one half of the 50 shares owned by the estate; and (c) one half of the 18 shares actually owned by beneficiary *B* but considered constructively owned by the estate under section 318, or a total of 46 shares. This is an example of the indirect "sidewise attribution" by means of "back attribution" to the estate and reattribution to another beneficiary mentioned above.

As to beneficiary *B*, he, according to the Regulations, is regarded as owning: (a) the 18 shares which he actually owns; (b) one half of the 50 shares owned by the estate; and (c) one half of the 12 shares actually owned by *A*, but considered constructively owned by the estate. This is another example of indirect "sidewise attribution," but perhaps an even more unjustifiable one than in the case of *A*, since in this instance *B* has only a life interest in the shares owned by the estate.

The practical results of these rules involving an estate and its beneficiaries will be discussed below. For the moment, it is only necessary to allude to the fact that it might be impossible to redeem entirely the stock of brothers who are not within the prohibited family relationship but who were beneficiaries of their father's estate, even though the estate itself owned no shares at all in the stock of the corporation being redeemed.

While it is necessary for the administration of the tax laws and for the safety of the revenue to have attribution rules as between partners and partnerships, and estates and beneficiaries, the attempt to be specific in these matters has in some instances such as that just referred to resulted in a situation which is neither necessary for the administration of the tax laws nor necessary for the safety of the revenue, nor equitable to the taxpayers involved. This will become clearer when the effect of these rules is studied in connection with stock redemptions under section 302.[27]

Trust-Beneficiary Attribution

Section 318(a)(2)(B) provides in effect that stock owned, directly or indirectly, by or for a trust is treated as though it were owned by its beneficiaries in proportion to the actuarial interests of the beneficiaries in the trust. The Regulations illustrate this proposition with the following example:

"... if a trust owns 100 percent of the stock of Corporation A, and if, on an actuarial basis, W's life interest in the trust is 15 percent, Y's life interest is 25 percent, and Z's remainder interest is 60 percent, under this provision W will be considered to be the owner of 15 percent of the stock of Corporation A, Y will be considered to be

27. See p. 455 infra.

the owner of 25 percent of such stock, and Z will be considered to be the owner of 60 percent of such stock."[28]

The statute further provides that stock owned by a beneficiary is treated as owned by the trust unless the beneficiary's interest in the trust is a "remote contingent interest." A "remote contingent interest" is defined as an interest, the value of which, under the maximum exercise of discretion by the trustee in favor of the beneficiary, is computed actuarially to be 5 per cent or less of the value of the trust property.

The Regulations illustrate this proposition as follows:

"A testamentary trust owns 25 of the outstanding 100 shares of the stock of a corporation. A, an individual, who holds a vested remainder in the trust having a value, computed actuarially, equal to 4 percent of the value of the trust property, owns the remaining 75 shares. Since the interest of A in the trust is a vested interest rather than a contingent interest (whether or not remote), the trust is considered as owning 100 shares. A is considered as owning 76 shares."[29]

If, however, *A* has a contingent remainder rather than a vested remainder, then even though he still has a 4 per cent actuarial interest, the trust would not be regarded as owning any of the stock actually owned by *A*, since his interest would be both contingent and remote.[30]

As previously pointed out, the result in the case of a trust is different from the result in the case of an estate. Here, the trust is regarded as owning not only its own stock but all of *A*'s stock, since he has a vested remainder, and all of the stock of any beneficiary of a trust is considered owned by the trust unless the interest of a beneficiary is a remote contingent interest. In the case of an estate, if the beneficiary does not have a present interest in the property or income (for example, a remainderman, even if vested) his stock is not regarded as being owned by the estate.

Insofar as stock owned by an estate or trust being considered as being owned by the beneficiaries thereof, section 318(a)(2)(A) says, in part: "Stock owned, directly or indirectly, by or for [an] . . . estate shall be considered as being owned proportionately by its . . . beneficiaries." Section 318(a)(2)(B) says, "Stock owned, directly or indirectly, by or for a trust shall be considered as being owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust." This is the opposite situation to that just discussed. In this situation the attribution appears to be treated the same whether there is an estate or a trust involved, except for the use of the word "proportionately" in one instance and "actuarial" in the other. The beneficiary of a trust or estate should be treated as owning the stock owned by the trust or

28. U.S. Treas. Reg. § 1.318-3(b) (1955).

29. Id. § 1.318-2(c), Example (2).

30. Id. Example (3).

estate in the same ratio that the interest of such beneficiary bears to all the interests in said trust or estate. This relationship should be measured by making some distinction as to the proportion of the interest of the remainderman. In other words, if the interest of the remainderman is small, the attribution should be in proportion to income interests, whereas if the interest of the remainderman is substantial, the attribution should be in proportion to actuarial interests.

The statutory rules as to trusts apply also to those trusts in which a person is treated as the owner of a trust because of his control. In such cases the owner or grantor of the trust should be treated as owning the stock held by that trust.

Corporation-Stockholder Attribution

Section 318(a)(2)(C) provides:

"(C) *Corporations.*—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

(i) such person shall be considered as owning the stock owned, directly or indirectly, by or for that corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation; and

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person."

The Regulations[31] illustrate the meaning of section 318(a)(2)(C) by the following example. Unrelated individuals, *A* and *B*, own 70 per cent and 30 per cent, respectively, in value of the stock of corporation *M*. Corporation *M* owns 50 of the 100 outstanding shares of stock of corporation *O*, the remaining 50 shares being owned by *A*. Corporation *M* is considered as owning 100 shares because there is attributed to it all of the stock owned by its 50 per cent stockholder, *A*. *A* is regarded as owning not only his own stock but 70 per cent of the 50 shares owned by corporation *M*, giving him actual and constructive ownership of 85 of the 100 shares outstanding. Stockholder *B*, who owns no stock himself, is not regarded as owning any stock constructively, since he owns less than 50 per cent of the stock of corporation *M*.

It should be noted that the family attribution rules are applicable in determining whether a shareholder owns 50 per cent or more of the stock of another corporation.[32] Here, for instance, if *A* had owned 30 per cent of corporation *M* and his father had owned 40 per cent, *A* would have been considered as owning over 50 per cent of corporation *M*, and therefore 70 per cent of corporation *O* stock would be attributed to *A*.[33]

31. Id. Example (4).
32. See note 20 supra.
33. It should be noted, however, that in two of the subjects cross-referenced in § 318(b),

Options

Provision is made in the statute to cover cases where a person has an option to acquire stock rather than ownership of it.[34] Such stock is considered as owned by the option holder.

SECTION 318 AS IT AFFECTS STOCK REDEMPTIONS IN GENERAL

Although section 318, by its terms, specifically applies to redemptions by related corporations,[35] to dispositions of section 306 stock,[36] to matters relating to the basis of property received in certain liquidations of subsidiaries,[37] and to special limitations on net operating loss carryovers,[38] this article is only concerned with its specific application to stock redemption.

In the *Lukens* case, the decedent's stock was redeemed by the corporation for $22,300, its book value, which was the same amount originally paid for it by the decedent many years before. The importance of the application of the attribution rules to stock redemptions is well illustrated by this case. Section 302(a) sets forth the general rule to the effect that if a corporation redeems its stock the redemption proceeds will be treated as having been received in exchange for the stock (that is, capital gain treatment) if paragraph (1), (2), (3), or (4) of section 302(b) applies. Otherwise they will be accorded dividend treatment. Thus if the *Lukens* redemption (assuming it had taken place after the passage of the 1954 Code) had complied with the provisions of section 302(b) there would have been no tax at all, whereas if it had not so complied (assuming for the purpose of illustration that taxpayer was in the 90 per cent bracket) the tax would have been over $20,000! Whether the redemption does comply with section 302(b) depends upon section 318, since section 302 says that section 318(a) shall apply in determining the ownership of stock for the purposes of the section. As to whether section 318 applies not only to 302(b)(2) and (3) but also to the whole of section 302, the Regulations say that it does,[39] but cogent arguments

namely § 304, relating to redemption by related corporations, and § 382(a)(3), relating to special limitations on net operating loss carryovers, attribution between corporations and stockholders is required even though the stockholder owns less than 50% in value of the stock of the corporation.

34. Int. Rev. Code of 1954, § 318(a)(3): "Options.—If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock."

35. Id. § 304.

36. Id. § 306(b)(1)(A).

37. Id. § 334(b)(3)(C).

38. Id. § 382(a)(3).

39. U.S. Treas. Reg. § 1.302-1 (1955).

can be made in opposition to the view that it applies to section 302(b)(1).[40]

Section 302 sets up three specific tests in addition to the general test of 302(b)(1) for determining whether the proceeds of a redemption should be treated as a dividend. One test has to do with stock issues by railroad corporations in certain reorganizations, a subject outside the scope of this article. The other two specific tests are the "substantially disproportionate redemption" test set forth in section 302(b)(2),[41] and the "termination of shareholder's interest" test set forth in section 302(b)(3).[42]

In order to meet the "substantially disproportionate redemption" test of section 302(b)(2) two conditions must be satisfied immediately after the redemption: (1) the shareholder must then own less than 50 per cent of the total combined voting power of all classes of stock;[43] and (2) the percentage of voting power which he owns must be less than 80 per cent of what it was immediately before the redemption.[44] A series of redemptions may not be utilized to avoid the rules of substantial disproportionality.[45] Furthermore, in determining whether the percentage requirements of section 302(b)(2) have been satisfied, all the attribution rules of section 318 are applicable.[46]

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40. See p. 460 infra.

41. Int. Rev. Code of 1954, § 302(b)(2): "(A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder."

42. Id. § 302(b): "(3) Termination of shareholder's interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."

43. Id. § 302(b)(2): "(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote."

44. Id. § 302(b)(2): "(C) Definitions.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determination shall be made by reference to fair market value."

45. Id. § 302(b)(2): "(D) Series of redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

46. Id. § 318(a)(4).

In determining whether the "complete termination" test of section 302(b)(3) has been met, the family attribution rules do not apply if the conditions of section 302(c)(2) are complied with. Briefly, these conditions are that the terminated stockholder, referred to in the statute as the "distributee," shall not within the ten years following the redemption have any interest in the corporation other than as a creditor, nor acquire any interest other than through inheritance and shall file an agreement to notify the Secretary of the Treasury of such acquisition. These conditions are sometimes referred to as the ten-year "look forward" rule.[47]

Further conditions, sometimes referred to as the ten-year "look back" rule, are that there must not have been within the ten years immediately preceding the redemption a transfer of stock to or from the distributee within the relationships covered in section 318.[48] The "look back" rule, however, is abrogated if the acquisition or disposition by the distributee did not have as one of its principal purposes the avoidance of federal income tax.[49]

REDEMPTIONS OF STOCK UNDER THE VARIOUS SPECIFIC ATTRIBUTION RULES

Family Attribution

In the illustration given by the Regulations where *H, W* and their son *S* and grandson *G* each own 25 of the 100 outstanding shares of corpora-

47. Id. § 302(c):

"(2) For determining termination of interest.—(A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution, the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and . . . ."

48. Id. § 302(c)(2):

"(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction. . . ."

49. Id. § (B):

". . . .

"The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax."

tion *X*,[50] none of the stock owned by *H, W* or *S* could be redeemed and receive capital gains treatment under the substantially disproportionate redemption test of section 302(b)(2), since each is deemed to own 100 per cent of the stock before and after the redemption. *G* could meet the test of section 302(b)(2) since after the redemption he would constructively own 25 out of 75 shares or 33⅓ per cent, which is both less than 50 per cent of total voting power and less than 80 per cent of his ownership before redemption. Redemption of anything less than 17 of *G*'s shares would not receive capital gain treatment since he could not meet the "less than 80 per cent" test of section 302(b)(2).

If, however, instead of having a portion of his stock holdings redeemed, one of the shareholders, *H, W, S* or *G*, had all of his or her shares redeemed, could such a shareholder receive capital gain treatment under the "complete termination" test of section 302(b)(3)? That would depend upon the circumstances. Section 302(c) provides in effect that the family attribution rules do not, provided certain conditions are present or are met, apply to a redemption in complete termination of the stockholder's interest in the corporation. Consequently, it would be possible to receive capital gain treatment if all of such stockholder's shares were redeemed, provided the conditions of section 302(c) were present or met. Section 302(c) provides that in determining whether a shareholder's interest in a corporation has been completely terminated, the family attribution rules will *not* apply provided that: (1) after the distribution the distributee owns no interest in the corporation except as a creditor; (2) the distributee does not acquire any such interest within the following ten years; and (3) the distributee agrees to notify the Secretary of the Treasury if he does acquire an interest as in (2) within the ten years.

Despite the existence of all three provisos, the family attribution rules *will* apply in a complete termination case if either: (1) any of the stock redeemed was acquired by the distributee within a period of ten years ending upon the redemption date from a person the ownership of whose stock would be attributable to the distributee under any of the attribution rules of section 318(a); or (2) the distributee had within the same ten-year period transferred stock to any person within the attributable relationship and that person owned any stock of the redeeming corporation at the time of the redemption. The section further provides that even if there has been such a transfer during the "ten-year look-back" period, the family attribution rules will *not* be applied if the acquisition or disposition of stock did not have as one of its principal purposes the avoidance of federal income taxes.[51]

50. See p. 444 supra.

51. The Senate Finance Committee Report, supra note 14, at 237 states that such a transfer of stock ". . . shall not be deemed to have as one of its principal purposes the

A re-examination of the facts of the *Lukens* case should be made in conjunction with section 318(a)(1)(A),[52] superimposed upon the tests of section 302(b)(2) and section 302(b)(3). Absent section 318, Lukens would have been able to qualify under the substantially disproportionate redemption test of section 302(b)(2) because after the redemption he would have owned less than 50 per cent of the voting stock and his interest (7 per cent) would have been less than 80 per cent of what it was before.[53] But because of the application of section 318 he could not meet the test of section 302(b)(2), since the attribution of his son's and daughter's stock necessarily results in his constructive ownership of 100 per cent of the outstanding stock both before and after the redemption.

As to meeting the "complete termination" test of section 302(b)(3), with or without section 318, Lukens could not do so unless the actual redemption was but one step in an over-all plan to terminate his entire interest by means of a redemption combined with gifts. Assuming that there was a complete termination by means of the over-all plan theory, would the meeting of the test of section 302(b)(3) be vitiated by the impact of section 318?

Provided certain conditions are met the family attribution rules are inapplicable to complete termination situations.[54] At the time Lukens' stock was redeemed there were persons in being within the prohibited relationship, namely the children, who had acquired their stock from the distributee, namely the decedent, within ten years preceding the redemption. Hence the condition of section 302(c)(B)(ii) would not be met, unless the disposition of stock by the decedent to his children two years before the redemption had not had as one of its principal purposes the avoidance of federal income taxes. Who is to say whether such avoidance was or was not one of the things decedent had in mind when he made the transfer? And if it were, was it one of his principal purposes? What better way would there be of obtaining capital gains treatment upon a prospective stock redemption than by first giving away to a close relative all the stock that the stockholder did not intend to have redeemed and then claiming a complete termination of his or the transferee's stock?

avoidance of Federal income tax merely because the transferee is in a lower income tax bracket than the transferor."

52. The fact that the Lukens estate is a party should not confuse the reader into believing that the estate-beneficiary attribution rules were involved. The distributee was Lukens himself, not his estate. He happened to die before the case came to court.

53. 80% of 35% = 28%.

54. See note 47 supra.

Partnership Attribution

In the illustration given in the Regulations[55] where *A* owned 50 of the outstanding shares, the *AB* partnership, of which *A* is a 50 per cent partner, owned the remaining 50, and *B* individually owned no shares, it would appear that a redemption of the stock owned by the partnership would not be able to meet either the test of section 302(b)(2) or the test of section 302(b)(3) if *A* remains a partner, because after the redemption the partnership would still be deemed to own all of the outstanding stock of the corporation. A portion of the redemption proceeds then might be deemed the equivalent of a dividend to *B* even though he individually owned no stock either before or after the redemption. Apparently, because of the existence of section 318(a)(4), this would be true regardless of how small an interest in a partnership a partner has and regardless of the fact that such partner might own no stock in the corporation.

Nor would it be possible for *A* to receive capital gain treatment on a redemption of his stock as long as he retains a 50 per cent interest in the partnership for he could not comply with the less than 50 per cent voting part of the test of section 302(b)(2).[56] There is no specific attribution from partner to partner except in the language of section 318(4)(A). It has already been suggested that not only should "sidewise attribution" be eliminated, but that a partnership as back attributee should be treated as owning stock of partners only if the partner has a 50 per cent interest in the partnership and owns some stock, and that once stock is thus attributed back to the partnership it should not then be reattributed to other partners.[57]

Estate-Beneficiary Attribution

In the illustration given by the Regulations where the decedent's estate, in which *A* had a 50 per cent interest in fee, *B* had a life estate in 50 per cent and *C* had a remainder interest in 50 per cent after *B*'s life estate, owned 50 per cent of corporation *X* stock and where *A*, *B* and *C*, unrelated individuals, owned individually 12, 18 and 20 of the outstanding shares respectively,[58] none of the stock owned by the estate can be redeemed[59] at capital gain rates under section 302(b)(2) or (3) since

55. See p. 445 supra.

56. Presumably if A became less than a 50% partner at the time his stock was redeemed, he might be able to qualify under § 302(b)(2).

57. See note 13 supra.

58. See p. 446 supra.

59. Except under § 303 which provides in effect that a distribution in redemption of stock includible in the gross estate will not be treated as the equivalent of a taxable dividend if such distribution does not exceed the sum of the estate taxes and funeral and administration expenses provided that the value of all of the corporation's stock includible in the decedent's gross estate exceeds either 35% of the gross estate or 50% of the taxable estate.

the estate would be deemed still to own the stock owned by *A* and *B* which would constitute more than 50 per cent of the 50 shares then outstanding.

Referring once again to the *Lukens* case and changing the facts to the extent that Lukens is assumed to have died shortly after a gift of 65 per cent of his stock to his son and daughter, and that his estate caused its 35 per cent interest to be redeemed, what would be the result under the 1954 Code? Even though Lukens could have received capital gains treatment had he caused the balance of stock owned by him to be redeemed during his lifetime by complying with the conditions of section 302(c), a redemption of the estate's stock (if his son and daughter are beneficiaries of his estate) could not be achieved without dividend equivalency treatment because the stock of the beneficiaries would be attributed to the estate.[60]

This difference in result is due to the failure of Congress to extend the family attribution exclusion accorded termination cases by section 302(c)(2)(A) to the estate-beneficiary attribution rules. In other words, had section 302(c)(2)(A) instead of reading, "In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if . . . " read "In the case of a distribution described in subsection (b)(3), section 318(a) shall not apply if . . . ," the difference in result in the Lukens situation would not exist and most of the formidable problems in connection with "buy-sell" agreements[61] would not arise.

As far as the effect of the rule upon the redemption of stock owned by beneficiaries of the estate in the illustration in the Regulations is concerned, if *A*'s 12 shares were redeemed, he would be deemed still to own one half of the estate's stock (that is, 25 shares) plus one half of *B*'s stock (that is, 9 shares) or a total of 34 out of a remaining 88 shares, or 38.6 per cent. Prior to the redemption he would have owned 46 per cent of the total outstanding shares. While, therefore, he would have met the "less than 50 per cent" test of section 302(b)(2), he would not have met the "less than 80 per cent" test. (80 per cent of 46 per cent = 36.8 per cent.)

On the other hand, all of *B*'s stock could be redeemed at capital gains rates under section 302(b)(2), since like *A* he would have no difficulty

60. Rev. Rul. 103, 1956—1 Cum. Bull. 159. Decedent owned 27% of the stock of the corporation and his son, the sole beneficiary of his estate, owned 48%. The corporation was required by a contract to buy 13% of the estate's stock. It bought all. The ruling held that this could not be treated as a complete termination since the estate was considered as the owner of the stock owned by the beneficiary, the son, and his stock was not redeemed. The entire purchase price was therefore treated as a dividend.

61. See p. 461 infra.

with the "less than 50 per cent" part of the test. Before redemption he actually owned 18 per cent plus constructively 25 of the estate's shares and 6 of *A*'s, or a total of 49 per cent. After redemption he would constructively own half of the estate's and half of *A*'s or 31 per cent, which is less than 80 per cent of his former holdings.

As to *C*, none of the stock is attributed to him because as a remainderman he has no present income in the estate. Therefore all he has to do to achieve capital gains treatment is to cause a redemption of as many shares as will lessen his interest after such redemption to less than 80 per cent of what it was before. (From 20 per cent to less than 16 per cent, or 5 shares.)

It is difficult to see any justification for the disparate results as to *A* and *B* shown by this illustration. The difficulties likely to be encountered under the combination of sections 302 and 318, as interpreted by the Regulations, and the inequity of the results can be seen even more clearly in a situation where *A* and *B*, brothers and jointly 50 per cent beneficiaries of their father's estate, own respectively 90 per cent and 10 per cent of corporation *X* stock. Even though there is no family attribution between brothers and even though the estate itself owns no shares, the stock of neither could be redeemed without dividend equivalency treatment because the stock of the brother whose stock was not redeemed, (for example, *A*'s 90 per cent), would be attributed to the estate and reattributed to the estate's beneficiaries, so that each brother would be deemed still to own (through the estate) 50 per cent of the outstanding shares.

The inequitable and unnecessary results visible in these two illustrations of estate-beneficiary attribution, could be avoided by the elimination of what is in effect "sidewise attribution."

Trust-Beneficiary Attribution

The examples of estate and trust-beneficiary attribution given in the Regulations[62] appear to produce the rather startling result that whether a redemption occurs while an estate is in administration or is deferred until a testamentary trust has been set up may make an incalculable difference to the taxpayers involved. In Revenue Ruling 55-547,[63] a situation involving section 115(g) of the 1939 Code, a corporation had 1500 shares of stock outstanding, 999 owned by the decedent, 1 by his wife and 500 by the son who had been running the business for some years prior to decedent's death. Decedent's will left the stock in trust to the widow for life with a power of invasion, and remainder to the son. The son, unwilling to assume full responsibility unless he owned and

62. See pp. 446-48 supra.

63. Rev. Rul. 547, 1955—2 Cum. Bull. 571.

controlled all of the stock, caused the corporation to redeem the 999 shares from the trustee. The Commissioner ruled that since the son had a substantial and fixed interest as a remainderman, the redemption of the shares could not be considered a complete severance with the corporation, and constituted a distribution essentially equivalent to a dividend. There were no specific attribution rules under the 1939 Code in connection with redemption of stock. It would appear, however, that the same result would be true under the 1954 Code, although it seems probable that had the 999 shares been redeemed while they were in the hands of the executor, the result would have been different. Such subtle distinctions between the treatment of the ownership of stock to a remainderman of an estate and a remainderman of a trust seem to serve no useful purpose insofar as the administration of the law or the safety of the revenue are concerned, and are likely to place executors in such situations in an unenviable position.

Corporation-Stockholder Attribution

In the example given in the Regulations[64] where the outstanding shares of *O* corporation were held, 50 by *A*, 0 by *B*, and 50 by corporation *M*, of which *A* owned 70 per cent and *B* 30 per cent, a redemption of either the stock owned by *A* or of that owned by corporation *M* would fail to meet the tests of section 302(b)(2) or section 302(b)(3). Corporation *M*, after redemption, would be deemed as still owning 100 per cent of corporation *O*'s stock because of the attribution to it of all of its shareholder *A*'s stock. *A*, after the redemption, would be deemed still to own 70 per cent of corporation *O*'s stock through his 70 per cent interest in corporation *M*. Only if *A* first rid himself of more than 20 per cent of his *M* corporation stock, could he have his 50 per cent of *O* stock redeemed at capital gain rates.

1954 CODE SECTION 302(b)(1) AS THE EQUIVALENT OF 1939 CODE SECTION 115(g)

If it is impossible to escape dividend equivalency treatment under the specific mathematical tests of sections 302(b)(2) and 302(b)(3) because of the impact of the "attribution" rules of section 318, is it possible to escape such treatment under section 302(b)(1)?[65] One might think so in view of section 302(b)(5) which provides that in determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account.

64. See p. 449 supra.

65. Int. Rev. Code of 1954, § 302(b)(1) says simply that subsection (a) which gives capital gains treatment to redemptions shall apply if the redemption is not essentially equivalent to a dividend.

The similarity of the language of section 302(b)(1) and of 1939 code section 115(g) is significant.[66] The old Regulations[67] construed the statutory language of section 115(g) to mean:

"A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution. . . . On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect the distribution of a taxable dividend."

The Treasury then took the position that even if all of the stock of a shareholder which he *actually* owned were redeemed, the saving provision of the Regulations would be inapplicable if, considering the shareholder's family as a single tax unit, its relative position after the redemption were substantially equivalent to its position before.

The meaning of the Regulations and the position of the Treasury were tested in *Estate of Searle v. Commissioner*.[68] The Searle family and the Chapin family each owned 50 per cent of the outstanding 1,000 shares of stock; E. B. Chapin owned 100, I. G. Chapin's Estate owned 400, L. Searle owned 299 and I. F. Searle's Estate owned 201. After certain redemptions to permit shareholders to satisfy their indebtedness to the corporation, the Chapin and Searle families each owned 280 shares; E. B. Chapin 100, I. G. Chapin's Estate 180, and L. Searle 280. In holding that the redemption was not the equivalent of a dividend, the court said:

"There is no merit in respondent's contention that because prior to the transactions in question, the members of the Searle family owned 500 shares and those of the Chapin family owned 500 shares, and thereafter members of each family owned 280 shares, and hence, there being no change in the proportional ownership of the two families, 'from a realistic and practical rather than a technical standpoint' there was a pro rata distribution. The ownership of stock in a corporation vests in the individual who owns it, not the family to which he belongs. The regulation relates to 'the stock of a particular shareholder', not that of a family. Besides, the question here is not what effect the transactions had as to the proportionate ownership of the stock, but rather whether the proceeds from the transactions were distributed pro rata among all of the shareholders."[69]

Following the decision in the *Searle* case, the Treasury in 1951 proposed to add the following to the sentence of the Regulations previously quoted:

" . . . however, where such shareholder is closely related to remaining shareholders, that factor shall be considered along with all other circumstances of the case in determining whether the distribution is essentially equivalent to a dividend."[70]

66. See note 2 supra.

67. 26 C.F.R. § 29.115-9 (1949); 26 C.F.R. § 39.115(g)-1(a)(2) (Rev. 1953).

68. 9 CCH Tax Ct. Mem. 957 (1950).

69. Id. at 963.

70. 16 Fed. Reg. 10312 (1951).

The publication of the proposed amendment was greeted with protests from all sides and as a result was never adopted, although not officially withdrawn. Then came the enactment of the 1954 Code containing the provision in section 302(c) that,

" . . . except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section."[71]

If by "this section" is meant the whole of section 302(b), then section 302(b)(1), even though substantially identical with 1939 Code section 115(g), does not mean the same thing. That the Commissioner and the Internal Revenue Service think this is so is evidenced by their published rulings.[72] Yet the language of the report of the Senate Finance Committee[73] seems perfectly clear. In discussing section 302(b) it says, in part:

" . . . under this subsection your committee intends to incorporate into the bill existing law as to whether or not a reduction [sic] is essentially equivalent to a dividend under Section 115(g)(1) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances. . . .

" . . . the test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under Section 115(g)(1) of the 1939 Code. Your committee further intends that in applying the Test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock. . . . "[74]

The test employed by the cases under section 115(g)(1) was certainly not that of the narrow and strict attribution rules of the present section 318.[75] It was more like the business purpose test as developed by the courts.[76]

A somewhat ingenious argument has been advanced to bolster the position that the attribution rules of section 318 do not apply to section 302(b)(1).[77] Section 318 starts off:

"For purposes of those provisions of this subchapter to which the rules contained in this section are *expressly* made applicable. . . . " (Emphasis added.)

71. Int. Rev. Code of 1954, § 302(c)(1).

72. Rev. Rul. 103, 1956—1 Cum. Bull. 159.

73. S. Rep. No. 1622, 83d Cong., 2d Sess. 230 (1954).

74. Id. at 233.

75. Smith v. United States, 131 Ct. Cl. 748, 130 F. Supp. 586 (1955); Ada M. McFarlane, 13 CCH Tax Ct. Mem. 467 (1954); Marie W. F. Nugent-Head Trust, 17 T.C. 817 (1951).

76. Sullivan v. Commissioner, 210 F.2d 607 (5th Cir. 1954); Chester E. Spangler, 18 T.C. 976 (1952); G. E. Nicholson, 17 T.C. 1399 (1952); Isaac C. Eberly, 10 CCH Tax Ct. Mem. 1157 (1951).

77. See Cohen, Redemptions of Stock Under the Internal Revenue Code of 1954, 103 U. Pa. L. Rev. 739 (1955).

Section 302(c)(1) says:

" . . . section 318(a) shall apply in determining the *ownership* of stock for purposes of this section." (Emphasis added.)

The words "ownership" and "owned" occur in sections 302(b)(2) and 302(b)(3) but not in section 302(b)(1). Therefore, it is said that, as a matter of pure statutory construction, section 318 cannot be applicable to 302(b)(1).

Whatever the strength of this semantic argument may be, there is no doubt that viewed in conjunction with the existence of section 302(b)(5) and the clear intention of the Senate Finance Committee, the present position of the Internal Revenue Service is at variance with the generally held notion that section 302(b)(1) provides a kind of safety valve to protect taxpayers in situations where the strict attribution rules operate unfairly. It would seem that legislative clarification of this important point is imperative.

If the Internal Revenue Service insists upon applying the attribution rules of section 318 to section 302(b)(1), we may expect taxpayers to attempt to defend themselves upon the ground that the distribution constitutes a partial liquidation. Section 318 is not applicable to partial liquidations.[78] Section 346(a) provides that:

" . . . a distribution shall be treated as in partial liquidation . . . if . . . (2) the distribution is not essentially equivalent to a dividend, is . . . pursuant to a plan . . . including (but not limited to) a distribution which meets the requirements of subsection (b)."

Subsection (b) refers to contraction of the business. Thus it would appear to be possible to obtain capital gains treatment pursuant to a "business" plan even though there is no contraction of the business and despite the rules of section 318.[79]

PROBLEMS IN THE PLANNING AND ADMINISTRATION OF ESTATES CAUSED BY THE IMPACT OF SECTION 318 ON SECTION 302 OF THE 1954 CODE

A very common business device where small, closely held corporations form a substantial asset of the taxpayer's property, is the "buy-sell" agreement funded by life insurance. Frequently the life insurance on stockholders' lives is owned by the corporation and provides the only source of liquid funds available to the estate of the deceased stockholder.

These agreements usually restrict the sale of stock during the lifetime of the shareholder and provide that upon the death of a shareholder either the other shareholders or the corporation itself or both will pur-

78. Int. Rev. Code of 1954, § 346.

79. I.e., something similar to the business purpose doctrine of the cases under Int. Rev. Code of 1939, § 115(g), 52 Stat. 497.

chase all of the decedent's stock. The usual, and perfectly bona fide, purposes of such arrangements are: (1) to pass complete control to the surviving stockholders; (2) to assure liquidity to the estate of the deceased stockholder without unfavorable tax treatment; and (3) to avoid, if possible, claims on the part of the Government for an unreasonably high valuation of the stock for estate tax purposes.

Since it is clear[80] that the estate-beneficiary attribution rules of section 318(a)(2)(A) apply to redemptions in complete termination of interest situations under section 302(b)(3), redemptions from estates of stockholders under such "buy-sell" agreements where close relatives are both stockholders and estate beneficiaries are likely to receive dividend treatment with catastrophic results to the estates involved. "Catastrophic" is not too strong a word.[81] Imagine, for instance, the redemption under one of these "buy-sell" agreements of $100,000 worth of stock upon which, for example, an estate tax of $35,000 has been levied. If the estate is in the 65 per cent surtax bracket, dividend equivalency treatment of the redemption by means of the combination of estate and income taxes will result in the wiping out of the entire $100,000! It is no wonder that the hair of executors and their attorneys is turning white.

Take the not uncommon situation where a father owns at the time of his death 65 per cent of the stock of a business that he created, having, in order to lessen estate taxes, some years prior to his death, given 10 per cent of the stock to his daughter, and where the daughter's husband owns the remaining 25 per cent which he purchased from his father-in-law over the years that he had been active in the business. Let us assume that the son-in-law, being an astute businessman, made as one of the conditions for his purchase of the stock an agreement that as between his father-in-law and himself all of the stock of the first one to die should be redeemed by the corporation.

Assuming the death of the father occurs first, initially the executor has to worry as to whether or not he can safely have the corporation redeem any stock under section 303.[82] Suppose that it is a close decision as to whether the value of the stock constitutes 35 per cent of the gross estate or 50 per cent of the taxable estate? If he has to rely on the 50 per cent test, can the executor always be sure, before he has the stock redeemed, what bequests in the will or what property passing outside it will qualify for the marital deduction?

Having wrestled with the intricacies of section 303, the executor's

80. See p. 450 supra.

81. See Swados, Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement, 26 Fordham L. Rev. 189 (1957).

82. See note 59 supra.

next big problem is to determine the effect of a redemption of all of the estate's stock in accordance with the terms of the existing contract in view of the combination of the family and estate attribution rules. This will depend largely upon the dispositive provisions of the father's will.

If the will names the wife, daughter and son-in-law as beneficiaries, all of the outstanding stock will be attributed to the estate, and the redemption could not qualify under section 302(b)(2) or (3). Similarly, if the will names the wife and daughter as co-beneficiaries, the stock of the son-in-law would be attributed to the daughter by family attribution and the stock thus constructively owned by the daughter, as well as that actually owned by her, would be attributed to the estate by estate-beneficiary attribution.

If the will simply names the widow as sole beneficiary, would the stock of the daughter be attributed to the widow and through her to the estate? Or would the non-application of family attribution in complete termination cases prevent this? If the conditions of section 302(c) are not present, the estate would be deemed to own the 10 per cent owned by the daughter and the test of section 302(b)(3) could not be satisfied. However, since section 318(a)(4)(B) prohibits two step family attribution, the stock of the son-in-law could not be attributed to the daughter, then to the widow and then to the estate. Consequently, before the redemption the estate would be deemed to own 75 per cent of the stock, namely the 65 per cent actually owned and the 10 per cent constructively owned through the daughter. After the redemption it would be deemed to own 10 of the 35 shares outstanding, or less than 29 per cent. This result would appear to meet both tests of section 302(b)(2), and render the redemption of all of the estate's stock safe.

If the estate is left to the widow for life in the form of a legal life estate with a remainder to the daughter, the stock of the daughter will be attributed to the widow by family attribution and by estate attribution from the widow to the estate. Consequently, the estate will be deemed to own 75 per cent of the stock. If the daughter, under such a setup, is not regarded as having a present interest in the estate, as appears from the Regulations, then the stock of the son-in-law cannot be attributed to the daughter by family attribution, reattributed to the widow by family attribution, and then attributed to the estate by estate-beneficiary attribution. However, if the daughter is considered to have a present interest in the estate, as in the case of a vested remainderman of a trust, then the stock of the son-in-law could be attributed to the daughter by family attribution and attributed to the estate directly by trust-beneficiary attribution. In the former case, the substantially disproportionate test could be met; in the latter case it could not.

Suppose that the decedent, instead of leaving any property to the daughter, leaves property to the daughter's children. Any stock owned by the children would be attributed to the estate, but the children own no stock, and since the rules of family attribution might be inapplicable, the stock of the children's parents (that is, the daughter and the son-in-law) might not be attributed to the children and hence to the estate. Consequently, the complete termination test under such circumstances could be met, provided the conditions of section 302(c) governing the abolition of the family attribution rules are present. One of the conditions of section 302(c) is that there must not be a person owning stock attributable to the distributee who acquired any stock directly or indirectly from the distributee within ten years. Both the daughter and the son-in-law acquired their stock from the father within the ten years. Does this prevent inapplicability of the family attribution rules? In other words, is the father the distributee, or is the estate the distributee? It would appear that the estate is the distributee, and that the estate of the deceased is not the same as the decedent.[83] If, then, the decedent is an entity separate and distinct from the estate, there is no person in being who acquired the stock from the distributee, that is, the estate, and therefore the stock owned by the daughter and son-in-law will not be deemed to be owned by their children, because the conditions of the subsection are met. Even if it is determined that the daughter and son-in-law did acquire their stock from the distributee, the family attribution rules still might not be applicable if it were shown that the acquisition of the stock by the son-in-law and daughter did not have, as one of its principal purposes the avoidance of federal income tax. It would seem fairly obvious that in most cases the acquisition by the daughter will be for reasons other than the avoidance of federal income taxes, specifically, perhaps, the lessening of estate taxes, and the acquisition by the son-in-law is more likely to have been for business reasons than for any other purpose, particularly in view of the condition of the stock purchase agreement that stock be redeemed upon the decedent's death so as to give him full control.

Suppose in our fact situation that the son-in-law had died first, and assume that his will left everything to his wife. Here, the father's stock would be attributed to the daughter by family attribution and the stock thus attributed to the daughter would be attributed to the son-in-law's estate by estate-beneficiary attribution. Consequently, if the family attribution rules apply, the son-in-law's estate would be deemed to be the owner of 100 per cent of the outstanding stock, so that no part of the

83. Compare Adams v. Commissioner, 110 F.2d 578 (8th Cir. 1940), with Estate of Jacques Ferber, 22 T.C. 261 (1954). In determining whether a certain transaction was entered into for profit, the court in Waterman's Estate v. Commissioner, 195 F.2d 244 (2d Cir. 1952), pointed out that the estate and decedent were separate and distinct taxpayers.

son-in-law's stock could be redeemed, because his father-in-law's stock attributed to his estate will always exceed 50 per cent of the amount outstanding. However, if the family attribution rules are inapplicable, this result would not follow. If the family attribution rules are not applicable, the father's stock will not be attributed to his daughter, and hence the estate would be deemed to be the owner of only 35 per cent of the stock. Thus if both the son-in-law's estate's stock and the daughter's stock were redeemed at the same time, the redemption would receive capital gains treatment if the family attribution rules were actually inapplicable. The answer to this would depend upon whether or not the stock redeemed has been acquired by the distributee from a person (the father-in-law) whose stock would be attributable to the distributee.[84] Who is the "distributee"? In other words, did the estate which is the distributee acquire the stock from the son-in-law, that is, the decedent, or the father? If the former, then it would seem that the condition of section 302 (c)(2)(B)(i) is met, because *at the time of distribution* there is no person in being (the son-in-law being dead), from whom the distributee had acquired the stock within ten years. If it is considered that the distributee, that is, the estate, acquired its stock from the father by purchase within the ten year period, the family attribution rules will apply, and as a result the father's stock would be attributed to the son-in-law's estate by means of father to daughter and daughter to estate. This would be so despite the fact that so long as the son-in-law was alive his father-in-law's stock would not be attributable to him either by direct family attribution (fathers- and sons-in-law are not within the prohibited relationship) or by two step attribution through the daughter, because of the existence of section 318(a)(4)(B).

Another very common situation met with is the case where the husband owns 60 per cent of the stock and his wife 40 per cent. Often such a ratio is the result of good estate practice as it existed before the advent of the marital deduction. Frequently in such cases the corporation owns life insurance upon the life of the husband. If at the time of the husband's death, his wife is both a stockholder and a beneficiary of his estate, no part of the husband's shares can be redeemed with the insurance proceeds without such proceeds being treated as a dividend to the estate. What, if anything, can be done?

If there were sufficient corporate funds available, the wife's shares could be redeemed while husband and wife were both alive with a good chance of capital gain treatment, depending upon how long before redemption the wife had acquired her stock; if she had acquired any of it within the ten-year period; and whether the acquisition had as one of its principal purposes the avoidance of federal income tax.

84. Int. Rev. Code of 1954, § 302(c)(2)(B)(i).

If there were not sufficient corporate funds available, which would be much more likely to be the case, the problem could be solved only by engaging in practices that would normally be characterized as unbusinesslike and unnatural, such as creating an inter vivos trust for the wife and cutting her out of the will.[85]

It would be foolish for the wife to give her stock back to her husband after the careful way in which it was transferred out of his estate. A return gift would not only incur gift tax liability but would increase the estate tax liability of the husband. Presumably, the wife could give away all of her stock to her children, and if the children were not beneficiaries of their father's will, the children's stock could not be attributed to the wife and from the wife to the estate because of the inapplicability of the family attribution rules in a complete termination case. This result could not be achieved if the wife retained any shares of stock at the time of the redemption from her husband's estate. Perhaps it might be possible to figure out how much of the wife's stock it would be feasible to redeem over the next few years, transfer the rest to the children and carry out the redemption as funds were available in the corporation to do it. If at the time of the husband's death, the wife owned no stock, the redemption from the husband's estate would receive capital gain treatment. However, unless the partial redemptions of the wife's stock could be considered as mere steps in a complete termination, the distributions to her would not comply with the tests of sections 302(b)(2) or (3). Even if they were considered as a complete termination, and she complied with the "ten-year look-forward" rule of section 302(c), there would be persons in being, namely the children, owning stock, the ownership of which is attributable to the distributee who acquired such stock from the distributee within ten years.[86] Query, whether relief could be obtained under the last sentence of section 302(c) or whether the disposition of the wife's stock would not be considered to have as one of its principal purposes the avoidance of federal income tax, namely the avoidance of dividend equivalency treatment in the future redemption of the stock of the husband's estate.

Conclusion

It must be quite apparent that, while constructive ownership as well as actual ownership must be considered in order to administer our tax system effectively, the present attribution rules, scattered as they are throughout the 1954 Code, are both too complex and too sweeping in their application. Particularly in connection with their application to

85. Moreover this might not be effective because of the widow's right to elect to take against the will.

86. Int. Rev. Code of 1954, § 302(c)(2)(B)(ii).

stock redemptions is legislative repair necessary. Careful consideration should be given to the following points: (1) the extension of the non-applicability of family attribution to estate-beneficiary attribution in complete termination cases under section 302(b)(3); (2) the elimination of "sidewise attribution"; (3) the limitation of "back attribution" to cases where the shareholder, partner or beneficiary owns a reasonably substantial interest, and where the back attributee actually owns some stock in the corporation and its ownership thereof is an issue; (4) legislative clarification of the non-applicability of the strict specific attribution rules to section 302(b)(1); (5) the formulation of a single set of attribution rules for use throughout the entire Code with such substantive variations as may be required set forth as exceptions.

To attribute stock from one beneficiary of an estate to another beneficiary when the estate itself owns no stock is unnecessary and inequitable. To penalize an estate to the tune of thousands of dollars because a few shares of stock are owned by a legatee whose legacy consists of a small piece of jewelry, and to make that penalty, at least in theory, depend upon the date of the delivery of the jewelry in relation to the date of the redemption of the estate's shares is to make the tax laws into an absurdity.