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Financing the Small Credit Risk Corporation Under Section 302(b)(1): A Rejection of the Meaningful Reduction Test

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FINANCING THE SMALL CREDIT RISK CORPORATION UNDER SECTION 302(b)(1): A REJECTION OF THE MEANINGFUL REDUCTION TEST

INTRODUCTION

A decade ago in *United States v. Davis,*[1] the Supreme Court held that a distribution by a corporation to a shareholder in partial redemption of his stock will always be taxed as a dividend unless the redemption results in a meaningful reduction in the shareholder's proportionate interest in the corporation.[2] Although this mechanical "meaningful reduction" test promotes judicial economy,[3] it has also had a serious effect on shareholders of closely held corporations[4] who are often forced to finance the business. These shareholders advance funds with the understanding that the corporation will later return the money by means of a redemption.[5] The redemption of stock for this purpose, however, generally will not result in a reduction of the shareholder's interest in the corporation.[6] It would not meet the specific requirements of sections 302(b)(2) or (3) of the Internal Revenue Code,[7] and also would not qualify under the *Davis* test. The amount distributed in exchange for the stock would therefore be taxed as a dividend under section 301.[8] It has been suggested that these distributions represent nothing more than a return of capital and that to tax them as dividends is a bizarre result mandated by the *Davis* decision.[9]

This Note examines the dilemma faced by shareholders of credit risk closely held corporations that require financing for valid business purposes. It then analyzes the *Davis* decision, concluding that the Court misinterpreted Congress' intent in enacting section 302(b)(1).[10] Finally, this Note suggests a new approach for courts to deal with corporate distributions to a shareholder in repayment of a financing advance.

I. THE DILEMMA

Closely held corporations often are deemed to be unsound credit risks because they are too small or too new.[11] As a result, independent lending

1. 397 U.S. 301 (1970).
2. *Id.* at 313.
3. *See* Albers v. Commissioner, 414 U.S. 982, 985 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1338 (3d Cir.), *aff'g* 56 T.C. 556 (1971).
4. *Id.*
5. *See, e.g.,* Albers v. Commissioner, 414 U.S. 982, 983 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1338 (3d Cir.), *aff'g* 56 T.C. 556 (1971); United States v. Davis, 397 U.S. 301, 302-03 (1970).
6. *See, e.g.,* United States v. Davis, 397 U.S. 301, 302-03 (1970); Eberly v. Commissioner, 10 T.C.M. (CCH) 1157, 1164-65 (1951); Allen v. Commissioner, 41 B.T.A. 206, 212 (1940).
7. I.R.C. §§ 302(b)(2), (3).
8. I.R.C. § 301.
9. Albers v. Commissioner, 414 U.S. 982, 984 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1338 (3d Cir.), *aff'g* 56 T.C. 556 (1971).
10. I.R.C. § 302(b)(1).
11. *Hearings on H R. 8300 Before the Sen. Comm. on Finance,* 83d Cong., 2d Sess. 332 (1954) [hereinafter cited as *Senate Hearings*] (statement of Colin F. Stam).

institutions are reluctant to extend credit to them.[12] The shareholder, therefore, may be forced to lend the funds needed for the corporation's daily business operations.[13] Alternatively, he may temporarily advance funds to increase the working capital of the corporation and to reduce its credit risk, thereby inducing outside institutions to make loans to the corporation.[14] The determination of a court as to whether the transaction between the shareholder and the corporation is debt or equity will have a crucial effect on the tax consequences resulting from the advance.[15] The principal disadvantage to an equity label is that corporate distributions in repayment of an equity advance are taxed to the shareholder as dividends and treated as ordinary income.[16] In contrast, the repayment of a debt advance may be tax free if it is viewed as a return of capital.[17]

Shareholders have employed three approaches in attempting to avoid the dividend tax associated with the repayment of an equity advance. First, they have induced independent lending institutions to make loans to the corporation by personally guaranteeing the corporate debt.[18] Second, they have advanced funds to the corporation, labelling them as debt.[19] Third, assuming the advance represents equity, they have labelled the corporate distributions in repayment of the advance as a stock redemption. Under section 302(b)(1) of the Internal Revenue Code,[20] a stock redemption is taxed at favorable capital gains rates, rather than as ordinary income.[21]

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12. *Id.*

13. *Id.* at 332-33; *see, e.g.*, Sorem v. Commissioner, 334 F.2d 275, 277 (10th Cir. 1964); Herzog v. Commissioner, 22 T.C.M. (CCH) 1595, 1599 (1963); Smith v. Commissioner, 49 T.C. 476, 483 (1968); Estate of Golwynne v. Commissioner, 26 T.C. 1209, 1211 (1956).

14. Lending institutions generally have been more willing to advance loans to credit risk closely held corporations if the shareholder agrees to maintain a higher level of corporate working capital throughout the life of the loan. *See, e.g.*, United States v. Davis, 397 U.S. 301, 302-03 (1970); McFarlane v. Commissioner, 13 T.C.M. (CCH) 467, 470 (1954); Eberly v. Commissioner, 10 T.C.M. (CCH) 1157, 1164-65 (1951); Monk v. Commissioner, 6 T.C.M. (CCH) 1015, 1016 (1947).

15. *See* J. Mertens 4A, The Law of Federal Income Taxation, §§ 26.04a, 26.06, 26.10 (rev. ed. 1979); *Corporate Capitalization: What are the factors used to determine nature of investment?*, 11 Tax. for Accountants 356 (Dec. 1973) [hereinafter cited as *Corporate Capitalization*].

16. *Corporate Capitalization*, *supra* note 15, at 356.

17. *Id.* Another principal advantage to labelling an advance as debt is that the interest payments on debt obligations are deductible by the corporation. *Id.*

18. *See, e.g.*, Casco Bank & Trust Co. v. United States, 544 F.2d 528, 529-30 (1st Cir. 1976), *cert. denied*, 430 U.S. 907 (1977); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 724 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972); Blum v. Commissioner, 59 T.C. 436, 437 (1972); Smyers v. Commissioner, 57 T.C. 189, 192 (1971). *See generally* notes 22-29 *infra* and accompanying text.

19. *See, e.g.*, Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968); P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 789 (3d Cir. 1962); Wilbur Sec. Co. v. Commissioner, 279 F.2d 657, 659 (9th Cir. 1960); Du Gro Frozen Foods, Inc. v. United States, 73-1 U.S. Tax Cas. (CCH) ¶ 9164, at 80,215 (N.D. Ga. 1972), *aff'd per curiam*, 481 F.2d 1271 (5th Cir. 1973). *See generally* notes 31-39 *infra* and accompanying text.

20. I.R.C. § 302(b)(1).

21. *See, e.g.*, United States v. Davis, 397 U.S. 301, 303 (1970); Sorem v. Commissioner, 334

A. *Shareholder Guarantees*

A "good credit" shareholder can reduce the corporation's credit risk and thereby induce outside lending institutions to advance loans by "personally guaranteeing" the loan.[22] The shareholder can argue that repayment of the loan by the corporation should not be taxed to him as a dividend because there is never any distribution of property from the corporation to the shareholder.[23]

In recent years, however, the Internal Revenue Sevice (IRS) has challenged these transactions, arguing that their substance should control over their form.[24] The IRS has contended that, in substance, these shareholder guarantees represent an indirect contribution to capital: the lending institution constructively lends the money to the shareholder who constructively advances the funds to the corporation as equity.[25] When the corporation repays the "loan" to the lending institution it is in effect making a distribution to the shareholder—a dividend under section 316.[26] The shareholder is then actually repaying his loan to the independent lending institution.[27] Faced with these arguments, courts have applied the traditional tests for distinguishing debt from equity[28] in order to determine whether there was a bona fide loan by the

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F.2d 275, 280-81 (10th Cir. 1964); Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954). *See generally* notes 40-73 *infra* and accompanying text.

22. Casco Bank & Trust Co. v. United States, 544 F.2d 528, 529-30 (1st Cir. 1976), *cert. denied,* 430 U.S. 907 (1977); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 724 (5th Cir.), *cert. denied,* 409 U.S. 1076 (1972); Blum v. Commissioner, 59 T.C. 436, 437 (1972); Smyers v. Commissioner, 57 T.C. 189, 192 (1971). *See generally* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 4.10, at 4-40–43 (4th ed. 1979).

23. *See, e.g.,* Ackerson v. United States, 277 F. Supp. 475 (W.D. Ky. 1967); Princess Coals, Inc. v. United States, 239 F. Supp. 401 (S.D.W. Va. 1965). In addition, the corporation's repayment of the loan to the lending institution should not be characterized as a dividend representing the release of the shareholder's legal obligation to repay the loan because under the guarantee agreement the shareholder's legal obligation to repay does not arise until the corporation defaults. When there is no default, the shareholder's legal obligation to repay never arises and thus cannot be released. Princess Coals, Inc. v. United States, 239 F. Supp. at 411-12. *See also* Kobacker v. Commissioner, 37 T.C. 882, 893 (1962).

24. The concept of substance over form has been applied in many areas of the tax law. For instance, when a shareholder makes an advance to a corporation labelled as debt, the courts will deem it as equity if that is the substance of the transaction. *See* B. Bittker & J. Eustice, *supra* note 22, ¶ 4.02, at 4-5–7. Substance is also crucial in the determination of ownership of stock. *Id.* ¶ 9.21 at 9-10–12, ¶ 9.30, at 9-36–37. A stock redemption which in form is a sale of stock by the shareholder to the corporation will be treated as a dividend if in substance the transaction is essentially equivalent to a dividend. *Id.* ¶ 9.01, at 9-2–3.

25. Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 550 (1968); *see* Blum v. Commissioner, 59 T.C. 436, 439 (1972).

26. Section 316 defines a dividend as a distribution by a corporation to a shareholder to the extent of earnings and profits. I.R.C. § 316(a). Section 316 creates an irrebuttable presumption that every distribution by a corporation is first out of earnings and profits and only when there are no earnings and profits can a distribution be a return of equity. *See* B. Bittker & J. Eustice, *supra* note 22, ¶ 7.02, at 7-8.

27. Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967); Ackerson v. United States, 277 F. Supp. 475, 476-77 (W.D. Ky. 1967).

28. Smyers v. Commissioner, 57 T.C. 189, 198 (1971); *see* Murphy Logging Co. v. United

independent lending institution to the corporation or a constructive equity advance by the shareholder to the closely held corporation. Through the application of these tests, Circuit Courts of Appeals have held that the shareholder guarantees represent constructive equity contributions.[29] The repayment of the loans by the corporation, therefore, would be taxed to the shareholder as a dividend.[30] Thus, shareholder guarantees have been eliminated as a method of financing small closely held corporations.

B. *The Advance—Debt or Equity*

Shareholders of small corporations have also attempted to avoid the dividend tax by labelling their advance as debt, the repayment of which is not taxable as a dividend.[31] Courts, however, closely scrutinize shareholder

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States, 378 F.2d 222, 224 (9th Cir. 1967); Fors Farms, Inc. v. United States, 66-1 U S. Tax Cas. (CCH) ¶ 9206, at 85,359 (W.D. Wash. 1966). "The determination of whether advances by stockholders to a closely held corporation are debts or contributions to capital must be based on a wide variety of considerations. The factors to be considered in such a case have been enumerated as follows: (1) the names given to the certificates evidencing the indebtedness, (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of the principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of dividend money; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the initial advances were used to acquire capital assets; (13) the failure of the debtor to pay on the due date or to seek postponement." Du Gro Frozen Foods, Inc. v. United States, 73-1 U.S. Tax Cas. (CCH) ¶ 9164, at 80,214 (N.D. Ga. 1972) (citation omitted), *aff'd per curiam*, 481 F.2d 1271 (5th Cir. 1973); *see* Tyler v. Tomlinson, 414 F.2d 844, 847-48 (5th Cir. 1969).

The application of all the debt-equity tests to the problem of shareholder guarantees confuses the issue because at the same time the courts attempt to decide two distinct issues: (1) whether the lending institution was actually advancing funds to the corporation or constructively advancing funds to the shareholder, and (2) assuming there is a constructive shareholder advance, whether the nature of the advance was debt or equity. Most of the debt-equity tests are irrelevant in determining whether the independent lending institution was dealing with the shareholder or the corporation. They only become relevant in determining the nature of the shareholder's constructive advance when it is decided that the lender was constructively advancing the loan to the shareholder. A two-step process, therefore, should be used to deal with the problem of shareholder guarantees. The first step focuses solely on whether the lending institution was actually advancing the funds to the corporation, relying on its credit as security for repayment, or whether the lending institution was in fact dealing with the shareholder and made the loan solely on the basis of the shareholder's credit position. The only relevant inquiry is whether any lender would have made a similar loan to the credit risk corporation without the shareholder guarantee. If the answer to this inquiry is affirmative, a valid loan by the lending institution to the corporation should be held to exist, even if all the other debt-equity tests indicate otherwise. If the answer to the inquiry is negative, courts should apply step two, that is, all the other debt-equity tests, to determine whether the constructive advance by the shareholder to the corporation represents debt or equity.

29. Casco Bank & Trust Co. v. United States, 544 F.2d 528, 533-35 (1st Cir. 1976), *cert. denied*, 430 U.S. 907 (1977); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 719-24 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972); *see* B. Bittker & J. Eustice, *supra* note 22, ¶ 4.10, at 4-41 to 42.

30. See note 26 *supra*.

31. *Corporate Capitalization*, *supra* note 15, at 356. A distribution by a corporation will only

advances to determine the true character of the investment.[32] The overriding consideration in distinguishing debt from equity is whether the shareholder was looking for the best return on his investment, regardless of benefit to the corporation. A shareholder looking primarily for the best return on his money is more likely to be deemed a creditor, while one seeking primarily to benefit the corporation is more likely to be deemed to have made an additional contribution to equity.[33] An arms length creditor would not subordinate his loan,[34] would charge a high rate of interest,[35] and would probably require collateral in the event of default.[36] Because a shareholder of a close corporation often advances funds to upgrade the corporation's credit position, he is inclined to subordinate his advance[37] and to charge a relatively low rate of interest.[38] Under these circumstances, regardless of what the parties label the

be taxed as a dividend to the extent of earnings and profits. I.R.C. §§ 316, 301. Throughout this Note it will be assumed that there are sufficient earnings and profits to cover the distribution.

32. S.P. Realty Co. v. Commissioner, 27 T.C.M. (CCH) 764, 766-68 (1968); Lynch v. Commissioner, 31 T.C. 990, 991-92, *aff'd*, 273 F.2d 867 (2d Cir. 1959); 4A J. Mertens, *supra* note 15, § 26.04a.

33. Slappey Drive Indus. Park v. United States, 561 F.2d 572, 581 (5th Cir. 1977); United States v. Title Guar. & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943); Jaeger Auto Fin. Co. v. Nelson, 191 F. Supp. 693, 696-97 (E.D. Wis. 1961); Abrams v. Commissioner, 23 T.C.M. (CCH) 1546, 1551 (1964); 4A J. Mertens, *supra* note 15, § 26.06, at 39-40.

34. When an arms length creditor makes an advance that is risky, he will look for maximum protection to insure that he will be repaid. He will not make his rights to repayment inferior to the rights of general creditors. *See, e.g.,* United States v. Snyder Bros. Co., 367 F.2d 980, 985 (5th Cir. 1966), *cert. denied,* 386 U.S. 956 (1967); Diamond Bros. Co. v. Commissioner, 322 F.2d 725, 732-33 (3d Cir. 1963); Charter Wire, Inc. v. United States 309 F.2d 878, 879 (7th Cir. 1962), *cert. denied,* 372 U.S. 965 (1963); P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 789-90 (3d Cir. 1962); Oak Hill Fin. Co. v. Commissioner, 40 T.C. 419, 432 (1963).

35. Interest rates are generally a function of relative risk. J. Van Horne, Fundamentals of Financial Management 330 (2d ed. 1974). Therefore, when an arms length creditor makes a loan to a high risk corporation, he would charge a high rate of interest. If the courts find that the interest rate is not sufficiently high, they will hold that the advance is equity. *Compare* Scriptomatic, Inc., v. United States, 397 F. Supp. 753, 759 (E.D. Pa. 1975) (7% rate of interest held to be that which arms length creditor would have required given credit risk of corporation), *aff'd,* 555 F.2d 364 (3d Cir. 1977) *with* S.P. Realty Co. v. Commissioner, 27 T.C.M. (CCH) 764, 767 (1968) (5% held not to be that which creditor would have required).

36. An arms length creditor would probably take steps to insure that he will be repaid for loans made to a credit risk corporation. One method generally used to insure the repayment of a loan is to take collateral. *See, e.g.,* United States v. Snyder Bros. Co., 367 F.2d 980 (5th Cir. 1966), *cert. denied,* 386 U.S. 956 (1967); National Sav. & Trust Co. v. United States, 285 F. Supp. 325 (D.D.C. 1968); A.R. Lantz Co. v. United States, 283 F. Supp. 164 (C.D. Cal. 1968), *aff'd,* 424 F.2d 1330 (9th Cir. 1970).

37. An advance which is subordinate to the rights of general creditors will be much more effective in reducing the credit risk of the corporation. Since a primary motive for the advance is often the reduction of this credit risk, shareholders have been strongly motivated to subordinate their advances. *See, e.g.,* United States v. Snyder Bros. Co., 367 F.2d 980, 981 (5th Cir. 1966), *cert. denied,* 386 U.S. 956 (1967); Diamond Bros. Co. v. Commissioner, 322 F.2d 725, 727 (3d Cir. 1963); Charter Wire, Inc. v. United States, 309 F.2d 878, 879 (7th Cir. 1962); P.M. Fin. Corp. v. Commissioner, 302 F.2d 786, 787-88 (3d Cir. 1962); Oak Hill Fin. Co. v. Commissioner, 40 T.C. 419, 434 (1963).

38. If the corporation requires the funds for valid business purposes, both the shareholder and the corporation would prefer that the funds remain within the corporation rather than be paid out

advance, the advancer is clearly acting as a shareholder and not as a creditor. Therefore, the majority of advances by shareholders to credit risk closely held corporations have been held to be equity.[39]

C. *Repayment of Equity Advance—Dividend or Valid Stock Redemption*

Generally, sections 316 and 301[40] govern distributions from a corporation to a shareholder. Section 316 raises an irrebuttable presumption[41] that every distribution is out of earnings and profits and thus taxed as a dividend under section 301, unless another Code section provides a different result.[42] Section 302(b)(1) provides an exception if the redemption distribution is "not essentially equivalent to a dividend."[43] Shareholders of small corporations have argued that the distribution by the corporation in repayment of the equity advance is not essentially equivalent to a dividend under section 302(b)(1) and thus taxable only on the excess of the repayment over the advance, at capital gains rates.[44]

This approach has caused much controversy. Initially, the argument is based on a problematic concept. When one individual sells stock to another in exchange for property, the transaction is characterized as a sale of a capital asset and the seller is taxed on the gain at capital gains rates.[45] A stock redemption is conceptually difficult[46] because it is a sale of stock by a shareholder to the corporation that originally issued it in exchange for property. On one hand, the transaction could be characterized as a sale of a capital asset because it is the sale of stock by one legal entity to another in

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to the shareholder as interest. This often motivates shareholders to charge a low rate of interest on the advance. *See, e.g.*, S.P. Realty Co. v. Commissioner, 27 T.C.M. (CCH) 764, 767 (1968) (no prudent businessman would have risked charging only 5% interest on an advance).

39. There are several tests which courts apply in determining whether an advance represents debt or equity. *See* note 28 *supra*. When these tests have been applied to shareholder advances to their credit risk closely held corporations, most of these tests indicate that the advance represents equity. Slappey Drive Indus. Park v. United States, 561 F.2d 572, 583 (5th Cir. 1977), Restland Mem. Park v. United States, 509 F.2d 187, 190-91 (5th Cir. 1975); Midland Distrib., Inc. v. United States, 481 F.2d 730, 733 (5th Cir. 1973); Fin Hay Realty Co. v. United States, 398 F.2d 694, 699 (3d Cir. 1968); Wilbur Sec. Co. v. Commissioner, 279 F.2d 657, 662 (9th Cir. 1960); O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123, 126 (9th Cir. 1960); Gilbert v. Commissioner, 248 F.2d 399, 409 (2d Cir. 1957); Gooding Amusement Co. v. Commissioner, 236 F.2d 159, 165 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957); Du Gro Frozen Foods, Inc. v. United States, 73-1 U.S. Tax Cas. (CCH) ¶ 9164, at 80,215 (N.D. Ga. 1972), *aff'd per curiam*, 481 F.2d 1271 (5th Cir. 1973); S.P. Realty Co. v. Commissioner, 27 T.C.M. (CCH) 764, 767 (1968); Matthiessen v. Commissioner, 16 T.C. 781, 787 (1951), *aff'd*, 194 F.2d 659 (2d Cir. 1952).

40. I.R.C. §§ 316, 301.

41. B. Bittker & J. Eustice, *supra* note 22, ¶ 7.02, at 7-8.

42. Section 316(a) provides: "Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof." I.R.C § 316(a).

43. I.R.C. § 302(b)(1).

44. United States v. Davis, 397 U.S. 301, 305-07 (1970); Sorem v Commissioner, 334 F 2d 275, 280-81 (10th Cir. 1964); Keefe v. Cote, 213 F.2d 651, 657 (1st Cir 1954)

45. Stock is a capital asset. I.R.C. § 1221. Capital gains treatment applies only to the "sale or exchange of a capital asset." I.R.C. § 1222(1), (3).

46. Himmel v. Commissioner, 338 F.2d 815 (2d Cir. 1964); B. Bittker & J Eustice, *supra* note 22, ¶ 9.01.

exchange for property.[47] On the other hand, the transaction could be characterized as a dividend because it involves the distribution of property by a corporation to a shareholder.[48]

Congress has attempted to give these transactions a more definite character. The Revenue Acts of 1921 and 1926 provided that stock redemptions would be treated as a sale unless the distribution was "essentially equivalent to a dividend."[49] The essentially equivalent language was only intended to apply when there was no valid business purpose for the transaction other than a tax avoidance motive.[50] The provision was also included in the Internal Revenue Code of 1939.[51] When applying this provision to specific facts, however, courts disagreed on the proper interpretation of the language.[52]

Most courts adopted a business purpose test, holding that no redemption would be essentially equivalent to a dividend unless there was no valid business purpose for the redemption other than a tax avoidance motive.[53] A

47. B. Bittker & J. Eustice, *supra* note 22, ¶ 9.01, at 9-2 to 3.

48. *Id.* at 9-3.

49. The Revenue Act of 1921 provided: "A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend." Revenue Act of 1921, Pub. L. No. 57-98, § 201(d), 42 Stat. 227, 228-29 (current version at I.R.C. § 302). The Revenue Act of 1926 made § 201(d) applicable "(whether or not such stock was issued as a stock dividend), at such time and in such manner as to make the . . . redemption in whole or in part essentially equivalent to the distribution of a taxable dividend." Revenue Act of 1926, Pub. L. No. 69-20, § 201(g), 44 Stat. 9, 11 (current version at I.R.C. § 302).

50. United States v. Davis, 397 U.S. 301, 308-09 (1970); *see* Levin, *Stock Redemptions Under IRC Sections 302, 303, and 304,* 80 Dick. L. Rev. 434, 448 (1975).

51. Int. Rev. Code of 1939, Pub. L. No. 76-1, § 115(g), 53 Stat. 1, 48 (current version at I.R.C. § 302). "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 essentially equivalent to the distribution of a taxable dividend, the amount so distributed . . . shall be treated as a taxable dividend." *Id.*

52. United States v. Davis, 397 U.S. 301, 309 (1970).

53. Sorem v. Commissioner, 334 F.2d 275, 280-81 (10th Cir. 1964); United States v. Carey, 289 F.2d 531, 538-39 (8th Cir. 1961); Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954); Smith v. Commissioner, 49 T.C. 476, 483 (1968); Estate of Golwynne v. Commissioner, 26 T.C. 1209, 1212-13 (1956); Upham v. Commissioner, 4 T.C. 1120, 1127 (1945); Rosania v. Commissioner, 15 T.C.M. (CCH) 580, 584-85 (1956); McFarlane v. Commissioner, 13 T.C.M. (CCH) 467, 470 (1954); Sagner v. Commissioner, 12 T.C.M. (CCH) 1355, 1357 (1953); Eberly v. Commissioner, 10 T.C.M. (CCH) 1157, 1165 (1951); Smith v. Commissioner, 10 T.C.M. (CCH) 1124, 1130 (1951); Monk v. Commissioner, 6 T.C.M. (CCH) 1015, 1020-21 (1947); Allen v. Commissioner, 41 B.T.A. 206, 212 (1940); Koch v. Commissioner, 26 B T.A. 1025, 1027 (1932). It should be noted that some of these courts referred to the test as the "flexible net effects test."

In United States v. Davis, 397 U.S. 301 (1970), the Court noted that at first § 115(g)(1) of the 1939 Code was interpreted as only applying to tax avoidance schemes, and that although the focus later changed to the effect of the distribution, many courts continued to rely on a valid business purpose as evidence that the transaction was not essentially equivalent to a dividend. *Id.* at 309. *See also* B. Bittker & J. Eustice, *supra* note 22, ¶ 9.02, at 9-5; Chommie, *Section 346(a)(2): The Contraction Theory,* 11 Tax. L. Rev. 407, 411 (1956).

minority adopted the strict net effects test[54] under which a transaction could be characterized as a dividend, regardless of motive, if there were a pro rata distribution of funds by the corporation to the shareholder that caused no change in the shareholder's proportionate interest in the corporation.[55]

The Internal Revenue Code of 1954 provides that a stock redemption will be treated as a sale or exchange of a captial asset if the redemption is "not essentially equivalent to a dividend" under section 302(b)(1).[56] The circuit courts continued their split on the proper interpretation of the essentially equivalent language,[57] and in 1970 the Supreme Court granted certiorari in *United States v. Davis*[58] to clarify the meaning of this confusing phrase.

In *Davis*, the taxpayer owned 100% of the stock in his corporation through the attribution rules.[59] The corporation needed additional funds for its daily operations and could not obtain independent financing because it was deemed a credit risk.[60] The corporation was offered a loan if it increased its working capital by $25,000 and maintained this level throughout the life of the loan.[61] The taxpayer therefore advanced the money in exchange for 1000 shares of preferred stock which, it was understood, would be redeemed upon the repayment of the loan.[62] Immediately after the corporation repaid the loan it redeemed the preferred stock.[63] The IRS claimed that the distribution of the $25,000 was a taxable dividend under sections 316 and 301.[64] Davis contended that the valid business purpose for the redemption and the absence of a tax avoidance scheme placed the redemption under the protection of section

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54. Only the Second Circuit had unequivocally adopted the strict net effects test under which the valid business motives for the redemption are completely irrelevant. Levin v. Commissioner, 385 F.2d 521, 526 (2d Cir. 1967); Hasbrook v. United States, 343 F.2d 811, 814 (2d Cir.), *cert. denied*, 382 U.S. 834 (1965); *see* United States v. Davis, 397 U.S. 301, 303-04 n.2 (1970). In ascertaining whether the distribution was essentially equivalent to a dividend, some courts looked at the effect of the transaction rather than the taxpayer's motive. In all these cases the redemptions which were exactly pro rata were held to be essentially equivalent to a dividend. Commissioner v. Sullivan, 210 F.2d 607, 609 (5th Cir. 1954); Commissioner v. Roberts, 203 F.2d 304, 307 (4th Cir. 1953); Boyle v. Commissioner, 187 F.2d 557, 560 (3d Cir.), *cert. denied*, 342 U.S. 817 (1951); Smith v. United States, 121 F.2d 692, 695 (3d Cir. 1941); Flanagan v. Helvering, 116 F.2d 937, 940 (D.C. Cir. 1940).

55. Hasbrook v. United States, 343 F.2d 811, 813, (2d Cir.), *cert denied*, 382 U.S. 834 (1965); Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964).

56. I.R.C. § 302(b)(1).

57. *Compare* Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967) *and* Wiseman v. United States, 371 F.2d 816 (1st Cir. 1967) *and* Hasbrook v. United States, 343 F.2d 811 (2d Cir.), *cert. denied*, 382 U.S. 834 (1965) (applying the strict net effects test) *with* Commissioner v. Berenbaum, 369 F.2d 337 (10th Cir. 1966) *and* Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962) *and* United States v. Fewell, 255 F.2d 496 (5th Cir. 1958) (applying the business purpose test).

58. 397 U.S. 301 (1970).

59. *Id.* at 304-07. The Court held that the attribution rules of I.R.C. § 318, apply to § 302(b)(1) redemptions. 397 U.S. at 304-07. Thus, the stocks owned by Davis' wife and children were attributed to him. *Id.* at 305-07.

60. *Id.* at 302.

61. *Id.*

62. *Id.* at 302-03.

63. *Id.* at 303.

64. *Id.*

302(b)(1) and was therefore not taxable as a dividend.[65]

The Supreme Court interpreted the legislative history behind section 302(b)(1) of the 1954 Code as rejecting the business purpose test.[66] The Court held instead that no redemption qualifies for capital gains treatment under section 302(b)(1) unless it results in a "meaningful reduction of the shareholder's proportionate interest in the corporation."[67] Because Davis owned 100% of the outstanding stock of the corporation both before and after the redemption, the transaction did not satisfy the meaningful reduction test, and the Court held the distribution taxable as a dividend.[68]

The *Davis* decision has had a very unfavorable effect on small corporations. Generally, when a shareholder advances funds to his credit risk closely held corporation for valid business financing purposes, the distribution by the corporation in repayment of the advance does not result in any reduction in the shareholder's proportionate interest in the corporation.[69] Prior to the *Davis* decision, repayments of such advances for financing purposes would not be taxed as a dividend because of the valid business purpose for the transaction.[70] The *Davis* test ignores any business purpose underlying the transaction.[71] As a result, any distribution by a corporation to a shareholder in repayment of an equity advance will be taxed as a dividend.[72]

Shareholders of closely held corporations which require financing to meet business requirements but are too risky to obtain outside financing are now faced with a perplexing dilemma. They must choose either to advance the funds and, upon repayment, be taxed as if they had received a dividend,[73] or refuse to advance the funds, thus jeopardizing the future of the corporation.

II. CONGRESSIONAL INTENT AND THE MEANINGFUL REDUCTION TEST

The present situation is not only inequitable, but also inconsistent with congressional intent. While courts have correctly analyzed transactions in-

65. *Id.*

66. *Id.* at 311-12.

67. *Id.* at 313.

68. *Id.*

69. The distribution of property by a corporation to a shareholder in repayment of an earlier advance which was made for valid business purposes is not normally intended to change the relationship between the shareholders and the corporation. Rather, it is only intended to repay the shareholder and keep his relative rights constant. *See, e.g.*, United States v. Davis, 397 U.S. 301, 302-03 (1970); Eberly v. Commissioner, 10 T.C.M. (CCH) 1157, 1164-65 (1951); Allen v. Commissioner, 41 B.T.A. 206, 212 (1940). Therefore, the meaningful reduction test will generally not be met.

70. The repayments would be a valid stock redemption under the business purpose test. *See* note 53 *supra* and accompanying text.

71. 397 U.S. at 312.

72. *See* note 69 *supra*. If the distribution does not meet the meaningful reduction test it will be deemed essentially equivalent to a dividend and taxed as a dividend under §§ 301 and 316. This results from the operation of § 302(d) which states that "[e]xcept as otherwise provided in this subchapter, if a corporation redeems its stock . . . and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies." I.R.C. § 302(d).

73. *See* notes 41-72 *supra* and accompanying text.

volving shareholder guarantees and direct advances,[74] the validity of the Supreme Court's approach in resolving the stock redemption issue is not free from doubt.[75] It is contended that Congress never intended the result which *Davis* dictates.

A. *The Senate Committee on Finance*

In preparing the 1954 Code, the House of Representatives eliminated the "essentially equivalent" language and provided only objective tests, setting forth specific guidelines to determine whether a redemption is to be taxed as a dividend or as a gain on the sale of a capital asset.[76] The Senate Finance Committee, citing an example with facts strikingly similar to those in *Davis,*[77] pointed out that the House provisions would have an unfavorable effect on a small corporation that looks to its shareholders for valid business financing. Under the House version, the repayment of the shareholders' equity advance would be taxed as a dividend.[78] The Committee recommended that the Senate reinsert the essentially equivalent language to prevent this result.[79]

74. *See* notes 22-39 *supra* and accompanying text.

75. Commentators have expressed dissatisfaction with the *Davis* decision. Levin, *supra* note 50, at 448-50; Comment, *Defining Dividend Equivalency Under Section 302(b)(1),* 16 Vill. L. Rev. 88, 106-07 (1970); Note, *United States v. Davis: A Judicial Panacea For Dividend Equivalency In The Closely-Held Corporation,* 31 Ohio St. L.J. 806, 818-19 (1970); Note, *Stock Redemptions Essentially Equivalent To A Dividend,* 7 Willamette L.J. 168, 176-80 (1971). Several Justices of the Supreme Court have also indicated their dissatisfaction. Albers v. Commissioner, 414 U.S. 982, 985 (1973) (Powell, J., dissenting, joined by Douglas, J., and Blackmun, J.), *denying cert. to* 474 F.2d 1338 (3d Cir.), *aff'g* 56 T.C. 556 (1971)

76. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 35, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4017, 4209-10.

77. *Senate Hearings, supra* note 11, at 332-33 (statement of Colin F. Stam). As in *Davis,* the example used by the Committee also involved a distribution to a controlling shareholder in a repayment of a financing advance. *Id.*

78. "Under the proposed code, this normal method of financing small corporations is virtually precluded. The reason is that under section 302 of the bill, if the corporation should redeem [the shareholder's] preferred stock, while he still holds his 50 percent of the common stock, the amount he gets in repayment of his preferred stock is treated as a dividend. . For the small corporation, which looks to its common stockholders for preferred stock financing, this section is a serious roadblock, because of the dividend tax consequences of redemption of the preferred." *Id.* at 333.

79. S. Rep. No. 1622, 83d Cong., 2d Sess. 44-45, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 4675 [hereinafter cited as Senate Report]. "Under present law it is not clear when a stock redemption results in capital gain or ordinary income. Some courts have held that a distribution disproportionate to the shareholders' ownership of common stock in the corporation results in capital-gains treatment, but no definite test has developed. While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive. . . . Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend." *Id.* The Supreme Court in *Davis* recognized one exception to the meaningful reduction test. When the redeeming shareholder cannot control when the redemption might be called, every redemption will qualify under § 302(b)(1). United States v. Davis, 397 U.S. 301, 312-13 (1970). The Court based this exception on the Committee Report which stated that the House provisions were unnecessarily restrictive particularly in the case of a noncontrolling shareholder *Id* at 310-11. However, the implication of including "particularly" in the Committee Report was to

Relying on this recommendation, the Senate reinserted section 302(b)(1) into the 1954 Code.[80] Thus, *Davis* is inconsistent with the congressional intent because it dictates the precise result that Congress apparently intended to avoid by reinserting section 302(b)(1) into the Code.

B. *The Senate Report*

After noting that "no definite test has developed" to determine when a stock redemption would receive capital gains treatment,[81] the Senate Report stated that a redemption would qualify if it

> is not essentially equivalent to a dividend. The test intended to be incorporated in the interpretation of § 302(b)(1) is in general that currently employed under section 115 (g)(1) of the 1939 Code. Your committee further intends that in applying this 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 by the redeeming shareholder to the corporation. For this purpose the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. [Section 302(b)(1)] does not apply to such redemption notwithstanding the absence of earnings and profits. The fact that the proceeds of the redemption are not taxable as ordinary income to X results through application of section 302 (d) and section 301.[82]

In *Davis,* the Supreme Court interpreted the Senate Report as more than a mere reenactment of prior law.[83]

1. The Example

The Court first pointed to the example in the Senate Report[84] as evidence of congressional intent to reject the business purpose test.[85] The Court noted that the example is a pro rata distribution held to be essentially equivalent to a dividend, that is, the strict net effects test approach.[86] Although the example appears to illustrate only the strict net effects test, a closer examination reveals that it also demonstrates the business purpose test. This is evident because the example was conspicuous in its failure to include a business purpose for the redemption.[87] Thus, even if the business purpose test were

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suggest that the House provisions also were unnecessarily restrictive in other cases to a lesser degree. The language clearly indicates that the Committee intended to include repayments of financing advances by corporations to shareholders within the protection of § 302(b)(1). *See* note 78 *supra.*

80. Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4870-71.

81. *Id.* at 44, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 4675.

82. *Id.* at 233-34, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 4870-71.

83. 397 U.S. at 310.

84. Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News 4621, 4871. "Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption."

85. 397 U.S. at 312.

86. *Id.* The Second Circuit unequivocally adopted the strict net effects test. *See* note 54 *supra.*

87. *See* note 84 *supra.* Had the Senate intended to reject the business purpose test it could

used, section 302(b)(1) would not apply because the transaction represents a pro rata distribution of funds from the corporation to a shareholder without a valid business purpose for the redemption.[88] Had the Senate intended to reject the business purpose test, as the Court suggested, it would have included a valid business purpose for the redemption within the example. The omission indicates that there was no such intent.

The *Davis* Court also interpreted the example to mean that a tax avoidance scheme is unnecessary for a redemption to be treated as essentially equivalent to a dividend.[89] The Court reasoned that if there are no earnings and profits there cannot be a tax avoidance scheme, and assumed that the purpose for expressly omitting earnings and profits in the example was to suggest that a transaction can be essentially equivalent to a dividend without a tax avoidance scheme.[90] It is contended, however, that Congress omitted earnings and profits from the example only to emphasize their immateriality in making a section 302(b)(1) determination under these circumstances. A distribution is a dividend only to the extent of earnings and profits.[91] If a corporation has no earnings and profits any distribution it makes cannot be a dividend.[92] This leads to the conclusion that in the absence of earnings and profits no distribution can be essentially equivalent to a dividend and section 302(b)(1) would always apply. Congress, however, omitted earnings and profits from the example precisely to emphasize that a distribution *can* be essentially equivalent to a dividend even in the absence of earnings and profits.[93] In such cases the distribution would be governed by section 301(c)(2)[94] rather than section 302(b)(1). Therefore, the two inferences drawn by the *Davis* Court from the example are inaccurate.

2. The Meaningful Reduction Test

In developing the meaningful reduction test, the Court first implied that prior to the enactment of the 1954 Code, the inquiry included whether there was a tax avoidance motive for the redemption.[95] If there were, the transaction would be essentially equivalent to a dividend.[96] The Court then noted that the 1954 Code dramatically changed prior law by shifting the inquiry from whether there was a tax avoidance scheme to whether the transaction

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have stated in the example that the shareholder caused the corporation to redeem its stock for valid business purposes. If the Senate had done so, the fact that the distribution was essentially equivalent to a dividend would clearly indicate that the business purpose test was rejected. In fact, no business purpose was included within the example. Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4871.

88. This has been held to be essentially equivalent to a dividend under the business purpose test. *See* cases cited note 53 *supra*.

89. 397 U.S. at 311-12.

90. *Id.*

91. I.R.C. § 316(a).

92. *See id.*

93. Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4871. The report indicated that the redemption in the example would be essentially equivalent to a dividend "*notwithstanding* the absence of earnings and profits." *Id.* (emphasis added).

94. *See id.* at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4871

95. United States v. Davis, 397 U.S. 301, 308-09 (1970).

96. *Id.* at 309.

could be characterized as a sale.[97] As a result, the Court was forced to interpret this *new* inquiry, and reasoned that a transaction could be characterized as a sale only if there was a meaningful reduction in the shareholder's proportionate interest in the corporation.[98] The conclusion that followed was that a distribution will qualify as a valid stock redemption under section 302(b)(1) only if the meaningful reduction test is met.[99]

a. *Characterized as a Sale—Old or New*

The *Davis* Court interpreted the legislative history underlying section 302(b)(1) as more than a mere reenactment of prior law.[100] The Court found that the inquiry had changed from whether there was a tax avoidance scheme to whether the transaction could be characterized as a sale.[101] A stock redemption has characteristics of both a sale and a dividend, and one can safely assume that stock redemptions were originally granted capital gains treatment precisely because they could be characterized as a sale.[102] This is clear because a capital gain is defined as the sale of a capital asset[103] and, by granting stock redemptions capital gains treatment, Congress expressed its belief that these transactions could be characterized as a sale.[104] This inquiry does not evidence a dramatic change from prior law. Rather, Congress merely articulated the traditional inquiry that originally motivated it to grant these transactions capital gains treatment. Thus, the inquiry of whether the transaction could be characterized as a sale was not a new phenomenon. The validity of the meaningful reduction test must, therefore, be determined.

b. *Propriety of the Meaningful Reduction Test*

The Court interpreted the language "characterized as a sale" as requiring a meaningful reduction in the shareholder's interest in the corporation.[105] The Court incorrectly assumed that the definition of "sale" implicitly excludes transactions by a controlling shareholder whose interest in the corporation is not meaningfully reduced. This is inaccurate because a sale of stock by

97. *Id.* at 311.
98. *Id.* at 313.
99. *Id.* at 313.
100. *Id.* at 310.
101. *Id.* at 311.
102. *See* notes 103-04 *infra* and accompanying text.
103. I.R.C. § 1222.
104. Stock redemptions were originally granted capital gains treatment because the Supreme Court found that these transactions could be characterized as a capital transaction rather than as a dividend. Lynch v. Turrish, 247 U.S. 221, 229-31 (1918). The Revenue Acts of 1921 and 1926 limited this general rule only when tax avoidance schemes were employed. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 228-29 (current version at I.R.C. § 302); Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11 (current version at I.R.C. § 302). This indicates that stock redemptions are generally treated as capital transactions because they can be characterized as a sale or exchange of a capital asset, and that the only time that they cannot be so characterized is when a tax avoidance scheme is being employed.
105. United States v. Davis, 397 U.S. 301, 313 (1970).

controlling shareholder to an independent third party will be characterized as a sale and taxed accordingly even when there is no meaningful reduction in the shareholder's interest.[106] In fact, the sole distinction between the sale of stock by a controlling shareholder to an independent third party and such a sale to his corporation is that in the former situation there is no doubt that the parties are at arms length and have a valid business purpose for entering into the transaction. In the latter case, however, there is some doubt as to the parties' bargaining position and intentions. If the parties can show that, as in transactions between independent parties, both the shareholder and the corporation had valid business purposes for entering into the sales agreement, the transaction should be characterized as an arms length sale. Characterization of a transaction as a sale, therefore, necessarily requires the application of the business purpose test rather than the meaningful reduction test.

The meaningful reduction test is also inconsistent with the language in the Senate Report which states that "[t]he test intended to be incorporated in the interpretation of [section 302(b)(1)] is in general that currently employed under section 115 (g)(1) of the 1939 Code."[107] Thus, Congress expressly provided that the test to be applied under section 302(b)(1) was one that courts applied under the 1939 Code—either the business purpose test[108] or the strict net effects test.[109] The meaningful reduction test is obviously different from the business purpose test because in the former, the business purpose for the redemption is irrelevant.[110] The meaningful reduction test also differs from the strict net effects test as it was applied under the 1939 Code because the strict net effects test held only exactly pro rata distributions as essentially equivalent to a dividend;[111] the meaningful reduction test holds even non-pro rata distributions essentially equivalent to a dividend.[112] The Supreme Court's application of a *new* test is therefore contrary to the express intent of Congress.

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106. Section 1222 states that capital treatment applies to the "sale or exchange of a capital asset." I.R.C. § 1222(1). There is no provision changing this result if the redeeming shareholder is a controlling shareholder who does not meaningfully reduce his interest in the corporation via the sale.

107. Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4870.

108. *See* note 53 *supra* and accompanying text.

109. *See* notes 54, 55 *supra* and accompanying text.

110. United States v. Davis, 397 U.S. 301, 312 (1970).

111. *See* Commissioner v. Sullivan, 210 F.2d 607, 609 (5th Cir. 1954); Commissioner v. Roberts, 203 F.2d 304, 307 (4th Cir. 1953); Boyle v. Commissioner, 187 F.2d 557, 560 (3d Cir.), *cert. denied,* 342 U.S. 817 (1951); Smith v. United States, 121 F.2d 692, 695 (3d Cir. 1941), Flanagan v. Helvering, 116 F.2d 937, 940 (D.C. Cir. 1940).

112. While in *Davis* the meaningful reduction test was applied to a pro rata distribution, United States v. Davis, 397 U.S. 301, 313 (1970), post-*Davis* cases have interpreted the test to hold even non-pro rata distributions essentially equivalent to a dividend. *See, e.g.,* Jones v. United States, 72-1 U.S. Tax Cas. ¶ 9349 (D.N.J. 1972); Niedermeyer v. Commissioner, 62 T.C. 280 (1974), *aff'd,* 535 F.2d 500 (9th Cir.), *cert. denied,* 429 U.S. 1000 (1976); Fehrs Fin Co. v. Commissioner, 58 T.C. 174 (1972), *aff'd,* 487 F.2d 184 (8th Cir. 1973), *cert. denied,* 416 U.S. 938 (1974). For a discussion of the courts' interpretation of the meaningful reduction test since *Davis,* see Randall, *Recent Interpretations of the "Meaningful Reduction" Test of I.R.C. Section 302(b)(1),* 1977 B.Y.U.L. Rev. 253, 257-74.

c. *Which Test Applies*

Congress did not intend that both tests be applied. It painstakingly pointed out that the inquiry into whether the transaction could be characterized as a sale was the *sole* inquiry.[113] Nevertheless, it remains to be determined which test should be applied.

Certain stock redemptions will qualify as a valid sale under section 302(b)(1) if either the business purpose test or the strict net effects test is applied. An example of this is a non-pro rata distribution for valid business purposes.[114] Other stock redemptions, however, will be essentially equivalent to a dividend, regardless of which test is applied. An example of this is a pro rata distribution without a valid business purpose for the redemption.[115] Between these two extremes is a gray area in which the transaction has characteristics of both a sale and a dividend.[116] These transactions cause much confusion because on the same set of facts the application of the business purpose test will result in a characterization of the transaction as a bona fide sale while the application of the strict net effects test will result in a characterization of essentially equivalent to a dividend.[117] The only reason for the difference in result, however, is the different starting point from which the tests analytically approach the transaction.

The business purpose test assumes that a sale of stock by a shareholder to a corporation can be characterized as a valid sale if the parties are acting at arms length with valid business purposes when entering into the transaction.[118] If the transaction can be characterized as an arms length sale, the fact

113. Congress attempted in the 1954 Code to eliminate the considerable confusion that existed in the decisional law concerning whether a distribution was essentially equivalent to a dividend. Jacobson, *Corporate Distributions: Not Essentially Equivalent to a Dividend; Assignment of Income and Other Problems,* 33d Ann. N.Y.U. Inst. on Fed. Tax. 1007, 1007 (1975). The courts' split between the business purpose test and the strict net effects test caused confusion because, on the same set of facts, they would provide opposite results. *See* cases cited notes 53, 54 *supra* and accompanying text. It appears that Congress must have intended to adopt only one of the tests. This was evidently the reason Congress included only one inquiry under § 302(b)(1). Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4870-71.

114. Under the business purpose test, the example would not be essentially equivalent to a dividend because of the valid business purpose for the redemption. *See* cases cited note 53 *supra*. Under the strict net effects test, the example would not be essentially equivalent to a dividend because the distribution is not pro rata. *See* cases cited note 54 *supra*.

115. Under the business purpose test this example would be essentially equivalent to a dividend because there is no valid business purpose for the redemption. *See* cases cited note 53 *supra*. Under the strict net effects test the example would be essentially equivalent to a dividend because it is a pro rata redemption. *See* cases cited note 54 *supra*.

116. B. Bittker & J. Eustice, *supra* note 22, ¶ 9.01, at 9-2-4.

117. There was confusion in cases in which there was a pro rata distribution for valid business purposes. Under the business purpose test, there would be a valid stock redemption because there was a valid business purpose for the redemption. *See* cases cited note 49 *supra*.

118. The business purpose test inquires whether there was a valid business purpose for the redemption. *See* cases cited note 53 *supra*. If such a purpose can be found, then the distribution will qualify as a valid stock redemption. Section 302(a) refers to a valid stock redemption as payment in exchange for stock. I.R.C. § 302(a). It can be inferred, therefore, that under the business purpose test, a transaction can be characterized as a sale of stock if there is a valid business motive for both parties in entering into the transaction.

that it could also be characterized as a dividend is irrelevant, and it will be treated as a valid stock redemption under section 302(b)(1).[119] The strict net effects test, however, approaches the problem differently. The analysis assumes that a distribution can be characterized as a dividend if it is an exactly pro rata distribution by a corporation to a shareholder without changing his proportionate interest in the corporation.[120] If the transaction can be characterized as a dividend it will be treated as essentially equivalent to a dividend even though it has characteristics of a sale.[121] Because in this gray area the transaction could be characterized as both a sale and a dividend, the only reason these tests provide opposite results is that they approach the problem from opposite starting points; the strict net effects test inquires only whether the transaction can be characterized as a dividend and the business purpose test inquires only whether the transaction can be characterized as a sale.

In the Senate Report, Congress expressly provided that the sole inquiry was whether the transaction by its nature could be characterized as a sale.[122] Congress affirmed the business purpose test approach and rejected the strict net effects test approach. Therefore,the proper inquiry under section 302(b)(1) is whether there is a valid business purpose for both the corporation and the shareholder to enter into the sale agreement so that the transaction could be characterized as an arms length bona fide sale of stock.

III. A SUGGESTED APPROACH

When the shareholder's and the corporation's business purpose for entering into the transaction is apparent at the time of the redemption, the application of the business purpose test results in capital gains treatment under section 302(b)(1).[123] Distributions in repayment of shareholders' financing advances, however, need special treatment because, although there is a valid business purpose for the transaction as a whole, it may not be apparent at the time of the redemption.

119. If a valid business purpose is found for a transaction, the courts that apply the business purpose test, will not hold that the transaction is essentially equivalent to a dividend merely because it is also pro rata. *See* cases cited note 53 *supra*.

120. The cases which have applied the strict net effects test have begun their analysis by stating that " '[t]he hallmarks of a dividend . . . are pro rata distribution of earnings and profits *and* no change in basic shareholder relationships.' " Hasbrook v. United States, 343 F.2d 811, 813 (2d Cir.), *cert. denied*, 382 U.S. 834 (1965) (quoting Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964)).

121. These courts have held that the purpose behind the redemption is irrelevant in making a § 302(b)(1) determination. Hasbrook v. United States, 343 F.2d 811, 814 (2d Cir.), *cert. denied*, 382 U.S. 834 (1965); Northup v. United States, 240 F.2d 304, 307 (2d Cir. 1957). Thus, these courts have ignored that the motive of the parties in issuing and redeeming the stock may be to obtain valid business benefits for each, a characteristic of a valid sale.

122. Senate Report, *supra* note 79, at 234, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4870-71.

123. *See, e.g.*, McFarlane v. Commissioner, 13 T.C.M. (CCH) 467, 468 (1954) (capital gains treatment granted to redemption of stock in exchange for cancellation of debt owed by shareholder to corporation when purpose of transaction was to improve corporation's credit rating); Eberly v. Commissioner, 10 T.C.M. (CCH) 1157, 1165 (1951) (same); Monk v. Commissioner, 6 T.C.M. (CCH) 1015, 1016-18 (1947) (same).

A. *The Section 302(b)(1) Contribution*

The proper approach for dealing with distributions by corporations in repayment of a shareholder's valid business financing advance should recognize a new kind of contribution to equity, termed a "section 302(b)(1) contribution." This transaction has two central characteristics: a valid business financing purpose for the advance[124] that is short term in nature.[125] If the distribution has both characteristics, it should not be taxed as a dividend, even if earnings and profits are present, because it is a return of equity.[126]

1. Business Purpose Test

The business purpose test is the proper one to apply in determining whether a redemption was not essentially equivalent to a dividend under section 302(b)(1).[127] There has been, however, a dispute on the proper application of this test. Some courts have looked only at the transaction at the time of the redemption to ascertain a separate business purpose for the redemption.[128]

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124. In Part II, *supra,* it was determined that the valid business purpose test should apply to § 302(b)(1) transactions. *See* notes 113-22 *supra* and accompanying text. That test, however, is analyzed and refined here, and it is concluded that its inquiry may have to be extended to the time the *advance* was made. *See* notes 127-34 *infra* and accompanying text.

125. *See* notes 135-49 *infra* and accompanying text.

126. Section 301(c)(2) provides that the "portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock." I.R.C. § 301(c)(2). In Albers v. Commissioner, 414 U.S. 982 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1338 (3d Cir.), *aff'g* 56 T.C. 556 (1971), Justice Powell stated that "the redemption of preferred stock provided petitioners nothing more than a return of [equity]." *Id.* at 984. The facts in *Albers* were almost identical to those in *Davis,* 397 U.S. 301 (1970). In *Albers,* the shareholders advanced funds to increase the working capital of the corporation so that it would qualify for an outside loan which was to be used to replace a barge. Albers v. Commissioner, 414 U.S. 982, 982-83 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1331 (3d Cir.), *aff'g* 56 T.C. 556 (1971). The parties stipulated that the shareholders were to be repaid for their advance when the loan was repaid and this in fact occurred. *Id.* The distribution in repayment of the shareholder advance, in both *Albers* and *Davis,* would qualify as a repayment of a § 302(b)(1) contribution.

A § 302(b)(1) contribution should be distinguished from an ordinary contribution to capital, the repayment of which is governed by § 316. *See* notes 40-42 *supra* and accompanying text. The distribution by a corporation in repayment of a § 316 contribution will always be taxed as a dividend unless there are no earnings and profits. *Id.* Section 316 defines a dividend as any distribution by a corporation to a shareholder, but only to the extent of earnings and profits. I.R.C. § 316(a). Section 301 provides that a dividend will be includable in gross income. I.R.C. § 301(c)(1). If there are no earnings and profits, the distribution will not be a dividend and therefore will not be taxable. I.R.C. § 301(c)(2).

127. *See* notes 113-22 *supra* and accompanying text.

128. Commissioner v. Berenbaum, 369 F.2d 337, 341 (10th Cir. 1966); Ballenger v. United States, 301 F.2d 192, 199 (4th Cir. 1962). In United States v. Davis, 397 U.S. 301, 307 n.9 (1970), the IRS argued that "even if business purpose were relevant under § 302(b)(1), the business purpose present here related only to the original investment and not at all to the necessity for redemption." *Id. See also id.* at 303 n.2. ("Even among those courts that consider business purpose, however, it is generally required that the business purpose be related, not to the issuance of the stock, but to the redemption of it.").

Others have looked at both the time of the advance and the time of the redemption to determine whether there was a business purpose.[129] Legislative history supports the latter view. In the example used by the Senate Finance Committee,[130] the only business purpose stated was the actual advance of the funds.[131] There was no separate business purpose for the distribution. The Committee clearly intended that this be a valid section 302(b)(1) stock redemption.[132] It is contended, therefore, that although there must be a valid business purpose for the redemption, it is not appropriate to limit the scope of the inquiry to the time of the redemption. Parties often manifest their intentions of a valid business purpose in the transaction as a whole.[133] While there may be a valid business purpose for the redemption it may not manifest itself to the courts if they irrationally assume that the redemption exists as an independent event rather than as only one part of an entire transaction.[134] Thus, courts should inquire whether there was a valid business purpose for the transaction as a whole.

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129. Cobb v. Callan Court Co., 274 F.2d 532, 538 (5th Cir. 1960); Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954); Davis v. United States, 274 F. Supp. 466, 471 (M.D. Tenn. 1967), *aff'd*, 408 F.2d 1139 (6th Cir. 1969), *rev'd*, 397 U.S. 301 (1970); Smith v. Commissioner, 49 T.C. 476, 482-83 (1968); Estate of Golwynne v. Commissioner, 26 T.C. 1209, 1212-13 (1956)

130. *Senate Hearings, supra* note 11, at 332 (statement of Colin F. Stam).

131. The example stated that "[t]he corporation needs further financing, but it is too small and new to get public financing." *Id.* No reference is made to the purpose of the redemption of the stock.

132. The Committee first emphasized the tremendous hardship which the safe harbor provisions of the House bill would cause for shareholders of small corporations that look to their shareholders for financing. *Id.* It then changed the House bill by including § 302(b)(1) Senate Report, *supra* note 79, at 44, *reprinted in* [1954] U.S. Code Cong. & Ad. News at 4675. This can only indicate that Congress intended advances made by shareholders to small corporations for valid business financing purposes to be protected under § 302(b)(1).

133. *See, e.g.*, Albers v. Commissioner, 414 U.S. 982 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1331 (3d Cir.), *aff'g* 56 T.C. 556 (1971); United States v. Davis, 397 U.S. 301 (1970); Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954). In both *Albers* and *Davis* the shareholders advanced the funds because the corporation needed financing for valid business purposes. 414 U.S. at 984; 397 U.S. at 302. It was understood by the parties that the funds would be distributed to the shareholders in partial redemption of their stock when that business purpose was fulfilled. 414 U.S. at 983; 397 U.S. at 302-03. Thus, the business purpose could be detected only if the courts looked at the whole transaction. In *Keefe*, the court noted that the shares were originally issued to the shareholder on the condition that they would later be redeemed. 213 F.2d at 657. The court held: "Thus it could be found that there was a corporate purpose in issuing the shares, and it could also be found that they were *redeemed* in carrying out that corporate purpose." *Id.* (emphasis added).

134. The facts of *Davis* illustrate this point. In *Davis* the business purpose for the advance was the corporation's need for valid business financing. United States v. Davis, 397 U.S. 301, 302-03 (1970). The shareholder, however, did not want to permanently invest funds into the corporation. It was therefore understood by the parties that the money would be repaid upon the happening of an agreed event. *Id.* Thus, the valid business purpose for the redemption was that the corporation would not have received the advance it needed unless it agreed to the later redemption. This, however, would not be evident if the court only examined the transaction at the time of the redemption. It becomes clear only if one examines the advance in conjunction with the redemption.

2. Short Term Nature

The second requirement of a section 302(b)(1) contribution is the short term nature of the business purpose. While not mentioned in the section's legislative history[135] nor required by decisions applying the provision,[136] this additional element will maintain a logical pattern in this area of the tax law. An example illustrates this logical framework. Assume that corporation X is formed by shareholder A who makes a $20,000 contribution to equity. Shareholder A also makes a bona fide loan to the corporation of $15,000. In the first year of operations, corporation X earns $25,000 in earnings and profits. The corporation has one bank account that now has a cash balance of $60,000 of which $15,000 represents debt, $20,000 equity and $25,000 earnings and profits. The corporation distributes $10,000 to shareholder A.

Under the current tax law the tax consequences of a distribution cannot be determined unless the source from which the funds are distributed is known. If the source is earnings and profits, the entire distribution is taxable as a dividend.[137] If the source is equity, the distribution is not taxable because it represents a return of capital.[138] If the source is loaned funds, the distribution is not taxable because it represents the repayment of a loan.[139] When the true source of the funds is a bank account which is composed of earnings and profits, equity, and debt, however, the mere transfer of cash from the account to the shareholder cannot logically indicate the true source from which the funds were distributed. The tax law logically approaches the problem of determining the source of a distribution by employing a two step process. The first step is to examine the intentions of the parties at the time the source was created. This identifies the character of the source. The second step is to determine whether there is a link between the source and the distribution.[140]

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135. *See* notes 76-80 *supra* and accompanying text.

136. Neither the business purpose test, the strict net effects test, nor the meaningful reduction test considered whether the funds were used for a short-term purpose. *See* cases cited notes 53, 54, 112 *supra*.

137. A dividend is treated as a distribution out of earnings and profits to the extent thereof, I.R.C. § 316(a), and it is included in gross income. I.R.C. § 301(c)(1).

138. A distribution which is not a dividend will not be taxable but will reduce the basis of the stock. I.R.C. § 301(c)(2).

139. A distribution in repayment of a debt is tax free. *Corporate Capitalization*, *supra* note 15, at 356.

140. Although courts have not expressly applied this two step process, the application has been implicit. For example, in Albers v. Commissioner, 414 U.S. 982 (1973) (Powell, J., dissenting), *denying cert. to* 474 F.2d 1331 (3d Cir.), *aff'g* 56 T.C. 556 (1971), Justice Powell noted that: "On the . . . facts it seems plain that the redemption of preferred stock provided petitioners nothing more than a return of the capital they were compelled by the Commission to pay into A & S to obtain the additional financing the corporation needed to remain in business. To tax that return of capital at ordinary income rates is an extraordinary result." *Id.* at 984. Justice Powell concluded that the distributed funds were part of equity rather than earnings and profits. *Id.* To do so he had to apply implicitly the two-part test. He first analyzed the intention of the shareholder at the time of the advance. He determined that, by its nature, the advance was to be distributed to the shareholder when the business need for the funds terminated. When the funds were in fact distributed in close proximity to the termination of the business need, Justice

For example, assume that in the previous example the loan agreement stated that the corporation would repay the shareholder $10,000 on a given date and that it did in fact do so. Applying the two step test, the first inquiry examines the intent of the parties at the time the source was created. In this case, the loan agreement clearly establishes that the loan source would be used to make a distribution of $10,000 to the shareholder on a given date. The second step is to determine whether the distribution can be traced by both time and amount to the character of the loan source. In this example, the distribution is made on the given day and at the established amount. The process thus establishes that the transaction is a repayment of a loan. Accordingly, it is not taxable.

Application of this two step analysis to ordinary equity contributions governed by section 316, elucidates the reason for that section's presumption.[141] Section 316 establishes an irrebuttable presumption[142] that if there are earnings and profits, every distribution is made out of that source.[143] In other words, applying step two of the test, there can never be a link between the equity source and the distribution if there are earnings and profits. If step one is applied, it appears that section 316 assumes that at the time of the contribution the parties intended that the funds contributed by the shareholder as equity would never be distributed from that particular source unless there was no other source available. It thus becomes evident that section 316 in effect presumes that in every industry or business there is a minimum capital requirement necessary for the corporation to continue its foreseeable ordinary operations.[144] This minimum capital requirement may consist of the long term fixed assets, machinery, equipment, supplies and working capital, which at the time of the advance by the shareholder, appear necessary for the

Powell applied step two and found a link between the equity source and the distribution. Only through the implicit application of this two-part test could Justice Powell have concluded that this distribution should not be taxed because it represented a return of capital.

In Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954), the court concluded that the distribution by the corporation was to carry out the corporate purpose of repaying the shareholder for his prior financing advance. *Id.* at 657. Here again, the court could not have concluded that the funds were distributed out of equity rather than out of earnings and profits without implicitly applying the two step test.

141. I.R.C. § 316(a).

142. B. Bittker & J. Eustice, *supra* note 22 ¶ 7.02, at 7-8.

143. I.R.C. § 316(a).

144. Schnitzer v. Commissioner, 13 T.C. 43, 64 (1949) (advance held to be equity because made for "essential equipment or materials needed in [the business]"), *aff'd per curiam*, 183 F.2d 70 (9th Cir. 1950), *cert. denied*, 340 U.S. 911 (1951). Not all advances, however, are contributions to equity or to the corporation's financial foundation. In J.I. Morgan, Inc. v. Commissioner, 30 T.C. 881 (1958), *rev'd on other grounds*, 272 F.2d 936 (9th Cir. 1959), for example, the court found an advance to be debt because "[t]he original capital investment . . . would have been adequate to continue the operations of the business." *Id.* at 890. The courts have therefore recognized that a central characteristic of an ordinary equity contribution is that the funds are advanced for the purpose of purchasing assets essential for the continuous operation of the business. If the purpose for the advance is not to purchase such assets, an argument can be made that the advance is not an ordinary contribution to capital. In *Morgan* the taxpayer successfully argued that his advance was debt. *Id.* There is no reason to assume that a taxpayer could not successfully argue that an advance is a source of capital other than debt.

business' continued existence.[145] This minimum capital requirement is in essence the financial foundation of the corporation. When the shareholder provided this financial foundation to the corporation, he intended that it never leave the corporation. Rather, he intended that it perpetuate itself within the corporation as long as the corporation continued its ordinary operations.

The reason for the section 316 irrebuttable presumption is now clear; while the corporation continues its ordinary operations, every distribution must be out of earnings and profits. This is because the parties would never intend to make a distribution from a source representing the very financial foundation necessary for the corporation to continue its ordinary operations. Partial liquidations[146] fall neatly into this logical framework. In partial liquidations, the corporation does not continue the ordinary operations that were foreseeable at the time that the financial foundation was created. Rather the business operations contract.[147] This contraction, if genuine and permanent in nature,[148] creates a surplus in the financial foundation and a distribution by the corporation can be traced, at least partially, to the surplus of the financial foundation created by the contraction. Thus, the distribution would not be taxed because it represents a return of capital.

Because of this "unspoken assumption" of section 316, it is presently assumed that *every* advance by a shareholder to a corporation is intended to be allocated into either of two sources: a bona fide loan source or an ordinary contribution to the financial foundation of the corporation governed by section 316.[149] It is suggested, however, that it is possible for a shareholder to

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145. *See* Schnitzer v. Commissioner, 13 T.C. 43, 59-64 (1949), *aff'd per curiam*, 183 F.2d 70 (9th Cir. 1950), *cert. denied*, 340 U.S. 911 (1951); B. Bittker & J. Eustice, *supra* note 22 ¶ 4.04, at 4-13. Supplies and working capital should be included because a corporation could not operate without at least a minimum supply of liquid assets. In fact, a safe ratio of liquid assets to current liabilities is often said to be two to one. G. Welsch, C. Zlatkovich, & J. White, Intermediate Accounting 1025 (4th ed. 1976).

146. "[A] distribution [is] in partial liquidation of a corporation if [it] is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or [it] is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b)." I.R.C. § 346(a)(1), (2).

147. A distribution will qualify as a partial liquidation if the distribution results from a "genuine contraction of the corporate business." Treas. Reg. § 1.346-1(a) (1955).

148. There are three essential elements which must be met for a partial liquidation to be genuine. First, it must be permanent in nature. Second, it must change the nature of the business significantly. Third, there must be a substantial reduction in the corporation's net worth. Jacobson, *supra* note 113, at 1024-27.

149. Courts have never held that a contribution by a shareholder is anything but an ordinary contribution to equity or a valid debt. Even so, prior to *Davis*, 397 U.S. 301 (1970), courts sidestepped the problem by finding that a distribution by a corporation to a shareholder in repayment of a financing advance was a valid stock redemption under § 302(b)(1) if a valid business purpose could be found. *See* cases cited note 53 *supra*. In reality, however, the nature of a corporate repayment of a shareholder's prior financing advance is equivocal. Although it could be either a sale or a dividend, *see* notes 116-117 *supra* and accompanying text, it is in

advance funds to the corporation, yet neither intend to create a valid debt, nor intend them to become part of the financial foundation of the corporation. Instead, it is possible that at the time of the advance the parties intended that the funds be used only for a short term purpose and for a short period of time and then be returned to the shareholder. This type of contribution, when made for a valid business purpose, is the section 302(b)(1) contribution.

B. *Application*

The suggested approach will reveal a clear section 302(b)(1) contribution in some cases. For example, assume that a corporation enters into a two year contract to produce specially manufactured goods and is thus required to deal with a specific supplier. Because the supplier will not extend credit to the corporation unless it improves its credit standing, the shareholder advances funds to increase the working capital. There is an understanding that he will be repaid upon termination of the contract, and he is in fact repaid at that time. A valid business purpose for the repayment is clear when it is viewed in conjunction with the advance. In addition, the advance is short term in nature because the shareholder intended only that the funds remain with the corporation during the term of the contract. The subsequent distribution can be traced by both time and amount to the purpose of the advance. This distribution, therefore, would not be taxed as a dividend, but would be a return of equity even if there are earnings and profits within the corporation at the time of the distribution.

There are situations in which section 302(b)(1) would not apply. For instance, a shareholder may advance funds to his corporation to expand its operations and purchase a building essential for its business. If the corporation makes a distribution to the shareholder while the building is being used, the distribution would not qualify as a repayment of a section 302(b)(1) contribution even if stock was exchanged. Although there is a business purpose for the transaction, there is no link between the purpose for which the funds were advanced and the later distribution. The advance is clearly a section 316 contribution because the plan for expansion required an increase in the financial foundation of the corporation.

The application of section 302(b)(1) contribution treatment may not be clear in some situations. Assume a shareholder advances funds to increase the working capital of the corporation so that it may obtain an outside loan it needs to purchase a building essential to its operations. Assume also that the parties agree that the advance will be reimbursed upon repayment of the loan and that this occurs. It is clear that there is a valid business purpose for the repayment when it is viewed in conjunction with the advance. It is unclear, however, whether the short term requirement is met. It could be argued that the purpose for the advance was to obtain a loan that was short term in nature and, because the repayment can be linked by both time and amount to the purpose of the advance, the transaction should receive section 302(b)(1)

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reality a distribution which on its face is no different from a dividend distribution The real question is how to differentiate the distributions which should be taxed as a dividend from those which should not because they represent a return of capital. The suggested approach analyzes the transaction to answer precisely this question.

treatment. It could also be argued, however, that, in substance, the purpose of the advance was to purchase assets that are long term in nature and that the short term purpose requirement is not met. Under this view, the fact that the parties' choice of short term debt as the form of financing the purchase should be irrelevant. It is suggested that the proper analysis is in terms of the financial foundation.[150] If the shareholder intended to expand the operations of his business, there would be an increase in the financial foundation of the corporation. Thus, although the advance was used to obtain a short term loan, the substance of the advance is linked to the long term nature of the assets acquired and thus becomes part of the financial foundation. If the shareholder intended to replace existing assets, however, there would be no increase in the financial foundation of the corporation. Under these circumstances, the advance should not be linked to the replacing assets, but to the short term loan because the purpose of the advance was to use short term debt as the financing means to replace assets.[151]

The suggested 302(b)(1) contribution approach adequately covers a myriad of situations and furthers Congress' intent in adopting the provision. It also resolves the dilemma currently facing shareholders of small, credit risk corporations, and fits into the logical pattern of the tax law.

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150. This discussion assumes that the corporation is not undercapitalized and that the financial foundation is sufficient to maintain the foreseeable ordinary business operations. If the corporation is undercapitalized, the advance may have the general characteristics of a § 316 contribution and a redemption in repayment of such a contribution should be taxed accordingly.

151. If the financial foundation is adequate to maintain the foreseeable ordinary operations of the corporation, it should adequately finance the replacement of obsolete essential assets. This is because such replacement is an ordinary and necessary expenditure of operating a business. The corporation, however, is not required to liquidate its assets to finance the replacement. It may borrow funds as an alternative means of financing. Under these circumstances, an advance made to qualify for an outside loan is intended for the purpose of using debt as the means of financing and, if the debt is short term in nature, the advance will qualify as a § 302(b)(1) contribution.