

JUDICIAL APPLICATION OF THE ESSENTIALLY EQUIVALENT TO A DIVIDEND LANGUAGE UNDER THE 1954 INTERNAL REVENUE CODE

BACKGROUND

Adam Smith, in his *Wealth of Nations* was disposed to consider an *uncertainty* in what a person ought to pay in taxation as great an evil as *inequality*.¹ If this be a truism, than in no area of the Internal Revenue Code has this constituted such a reality than corporate distributions which are subject to the label, "essentially equivalent to a dividend." Over the past forty years,² the victims are many who have fallen prey to the virginal innocence of this legislative phrase, which can at best be characterized as blatantly uncertain. "The development of rules," it was said, "for determining whether a distribution by a corporation in exchange for part of its outstanding stock is to be treated as producing dividend income or capital gain or loss to its shareholders is a most *perplexing matter*."³ Judge Foley of the District Court for the Northern District of New York, laboring under the 1939 Code, was less

¹ See Nolan, *The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal*, 65 Harv. L. Rev. 255 (1951). Nolan cites this caveat by Adam Smith, taken from 3 Smith, *Wealth of Nations* 257 (5th ed. 1789), in the introductory portion of his article and then goes on to discuss, in 42 pages, the uncertainty of stock redemption under the Internal Revenue Code of 1939. In conclusion, he states: "We are long past committed to a highly technical and detailed tax statute, and no section should escape the degree of specificity reasonably necessary to assure predictable and uniform results." *Id.* at 297.

² The 'essentially equivalent' language of § 115(g), 1939 Code, first appeared in the Revenue Act of 1921, as an aftermath of *Eisner v. Macomber*. On providing in 1921 that stock dividends would not be taxed on receipt . . . Congress recognized . . . that stock dividends might be issued and then promptly redeemed as a substitute for ordinary cash dividends. Congress went on, therefore, to provide that the redemption of stock 'after the distribution of any such [stock] dividend' could be taxed as a dividend if the transaction was 'essentially equivalent to the distribution of a taxable dividend.' This provision was defective, however, because it failed to reach a redemption of stock that *preceded* a stock dividend; and this omission was corrected in 1924. Two years later, the provision, which ultimately became § 115(g) of the 1939 Code, was amended to apply whenever a corporation cancelled or redeemed 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,' *whether or not such stock was issued as a stock dividend*.

Bittker, *Federal Income Taxation of Corporations and Shareholders* 209-10 (1959).

³ Cohen, *Redemptions of Stock Under the Internal Revenue Code of 1954*, 103 U. Pa. L. Rev. 739 (1955).

If a corporation which has earnings or profits distributes cash or other property to its shareholders without the surrender of stock by the shareholders, it is clear that they have dividend income which is subject to tax at surtax rates. It is equally clear that if the shareholders sell their stock to third parties at a profit, the selling shareholders normally realize capital gain even though the difference between the sales price and their cost for their stock is due solely to accumulated earnings in the corporation. But where the shareholder sells his stock back to the issuing corporation rather than to third parties, there may be difficulty in determining whether as a practical matter the surrender of the shares is a meaningless gesture or whether it is of such significance as to warrant treating the proceeds from the corporation as though they had been received on a sale to third parties.

euphemistic. He called it a "nightmarish problem."⁴ Another writer, seeking solution to the question whether dividend equivalency could ever be averted when a shareholder parted with less than all of his shares summarized: "This is the area where some courts adopted the net effect test, others the motive-for-redemption test, and still others the bona fide partial liquidation test." His conclusion: "Confusion and uncertainty resulted in all areas."⁵

As an aftermath of this wholesale puzzling, Congress enacted the Internal Revenue Code of 1954 and codified the uncertainties in this area. So much so, that Judge Van Oosterhout, who had the opportunity of interpreting the "essentially equivalent to a dividend" language in one of the first cases to reach a circuit court under the new code, was prone to remark: "the problem of statutory construction presented by this appeal has been described as nightmarish," voicing agreement "that it is very difficult to ascertain from the provisions of the 1954 Code the precise object which Congress was seeking to accomplish by the changes that it made in existing law."⁶

Planned circuitry? Obviously not! And yet, considering the cogent analysis of one writer in dealing with this problem, such a cynical argument could well be advanced. He remarked that in applying section 115(g)(1), the essentially equivalent to a dividend language of the 1939 Code, the courts have consistently stated that the facts of each case must be individually considered. He continued:

The so-called 'net effect' doctrine came into being when the courts began saying that whether a cancellation or redemption of stock is 'essentially equivalent' to a taxable dividend depends upon the 'net effect' of the distribution rather than the motives and plans of the shareholders of the corporation. About all that can be said today of the 'net effect' doctrine is that only the effect of the distribution should be considered without inquiring into the motives for such distribution. . . . A close study of the decided cases, however, will indicate that the courts never stopped inquiring into the 'purpose' of the distributions, they had for consideration More recent decisions have finally said simply that distributions have the 'net effect' of dividends if they are 'essentially equivalent' to dividends. . . . In other words, the courts have finally come to realize that the 'net effect' doctrine added nothing to the words used in the code.⁷

Thus, after fourteen years of judicial decision,⁸ the application of the

⁴ *Wilson v. United States*, 154 F. Supp. 341, 342 (N.D.N.Y. 1957) and repeated in *United States v. Fewell*, 255 F.2d 496, 499 (5th Cir. 1958).

⁵ *Murphy, Dividend Equivalency—The End of the Beginning?*, 10 Tax L. Rev. 213, 219 (1954).

⁶ *United States v. Carey*, 289 F.2d 531, 536 (8th Cir. 1961).

⁷ *Jones, How Stock Redemptions Produce Dividend Income*, 36 Taxes 437, 438 (1958).

⁸ The "net effect" doctrine was first enunciated by the late Chief Justice Vinson when a member of the Court of Appeals for the District of Columbia in *Flanagan v. Helvering*, 116 F.2d 937, 939-40 (D.C. Cir. 1940). The Fifth Circuit came full circle in 1954 on this problem in stating: "'Net effect' is a paraphrase for 'essentially equivalent.'" *Commissioner v. Sullivan*, 210 F.2d 607, 609 (5th Cir. 1954).

"essentially equivalent to a dividend" language stands divorced of any definitive guideline.

But to assist Judge Van Oosterhout, surely the *what* of the matter can be gleaned from the following Senate Report:

Existing law is complicated by the fact that stock redemptions are included within the terms of the partial liquidation provisions.⁹ Thus, a redemption of all of the stock of 1 of 2 sole shareholders of a corporation may result in capital-gain treatment to the redeemed shareholder. The result occurs, however, not by reason of the use of any particular assets of the corporation to effect the redemption but because the distribution when viewed at the shareholder level is so disproportionate with respect to the outstanding shareholder interests as not to be substantially equivalent to a dividend.

Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro-rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in Part I of this subchapter. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation. [Footnote added.]¹⁰

However, the *how* of the matter is quite another story. Professor Bittker opines:

The language of the 1954 Code . . . fails hopelessly in its aim of separating partial liquidations from redemptions. According to Section 346(a), a partial liquidation (which is to be treated like a sale of the surrendered stock) includes a distribution 'in redemption of a part of the stock of the corporation' that is 'not essentially equivalent to a dividend.' Nothing is said in Section 346(a) about distributions characterized by what happens solely at the corporate level or about corporate contractions. Yet Section 346 is the section that is supposed to provide the exclusive rule for partial liquidations, segregating them from other redemptions. Not only is Section 346(a) innocent of any reference to corporate contractions, but its language is virtually identical with parts of Section 302, the section designed by the draftsmen of the 1954 Code to deal exclusively with those redemptions that are *not* partial liquidations. For Section 302 provides, among other things, that a redemption shall be treated as a sale of the stock if it 'is not essentially equivalent to a dividend.' If the draftsmen's goal of separating into their significant elements

⁹ Under the Internal Revenue Code of 1939, no distinction was made between partial liquidation and redemption, and in fact partial liquidation was defined "as distribution by a corporation in complete cancellation or redemption of a part of its stock" under section 115(i).

¹⁰ S. Rep. No. 1622, 83d Cong., 2d Sess. 49 (1954).

the kind of transactions incoherently aggregated by the 1939 Code in the definition of a partial liquidation is achieved, it will be by the painful process of administrative and judicial construction of muddled language.¹¹

Under the 1939 Code, corporate contraction or legitimate shrinkage was but a factor in determining dividend equivalency according to section 115.¹² Now, under the 1954 Code, the problem is twofold. Ever present is the *perplexing* problem of determining dividend equivalency¹³ (aided, abetted and oft times befuddled by the attribution rules of section 318). In addition the court must distinguish between distributions which originate at the shareholder level and those at the corporate level.¹⁴ In closely held corporations, where "the shareholder is but the shadow of the corporation"¹⁵ such a determination may well be impossible.

This then is but a very brief history of the "essentially equivalent to a dividend" language of the 1954 Internal Revenue Code. However, in view of

¹¹ Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 Stan. L. Rev. 13, 18 (1956). But see Chommie, Section 346(a)(2): The Contraction Theory, 11 Tax L. Rev. 407, 413 (1956) where it is pointed out that the separateness of the two distinct approaches to stock redemption transactions is inferred largely from the Committee Reports; the Code itself is far from explicit. However, section 331(b), together with the fact that section 302 is contained in Part I of subchapter C dealing with Distributions by Corporations and section 346 is in Part II dealing with Corporate Liquidations, would seem to justify the assumption that the courts will take a similar approach.

¹² Treas. Reg. § 29.115-9 (1940). See also, Chommie, *supra* note 11 at 417, . . . all the circumstances were to be considered in determining whether a distribution in redemption was in partial liquidation or was "essentially equivalent" to a taxable dividend and that corporate contraction was just one of the many factors to be considered. Even in cases where it was held that contraction was the dominant factor, the courts were ordinarily careful to point out that the terms of Section 115(g)(1)—"time" and "manner"—did not permit "definite rules of construction." The acceptable test was the so-called "net effect" test.

¹³ The Senate Reports state that in interpreting the essential equivalent language of 302 and 346, existing laws apply. "The test intended to be incorporated in the interpretation of Paragraph 302(b)(1) is in general that currently employed under Section 115(g)(1) of the 1939 code." S. Rep. No. 1622, 83 Cong., 2d Sess. 234 (1954); 3 U.S. Code Cong. & Ad. News 4871 (1954). Section 346(a) "is intended to provide a definition of partial liquidation which replaces that contained in Section 115(i) of the 1939 Code. Primarily, this definition involves the concept of 'corporate contractions' as developed under existing law." *Id.* at 262, 3 U.S. Code Cong. & Ad. News at 4899. In discussing the extent to which 346(a)(2) incorporates prior case law, McDonald, *Tax Considerations in Corporate Divisions: Contraction and Liquidation*, 39 Taxes 994 (1961), points out that both Bittker, *op. cit. supra* note 2, at 216-19 and Chommie, *supra* note 11, at 425-29, suggest that only "contraction" cases are applicable.

However, Chommie states that one of the most convincing arguments against limiting section 346(a)(2) to corporate contractions is the use of the word "primarily" in the Senate Report. *Ibid.* However, "the Senate Report at one point flatly implies that Section 346(a) is concerned only with redemptions that 'terminate a part of the business of the corporation.'" Bittker, *supra* note 11, at 23. But, says Bittker, "primarily" refers to the entire definition of 346(a), not merely to that part in 346(a)(2). The secondary implication which Chommie seeks could very well be the type of partial liquidation defined by 346(a)(1) leaving corporate contractions as the sole basis for applying 346(a)(2). *Id.* at n.38.

¹⁴ Bittker, *supra* note 11, at 18.

¹⁵ *Bradbury v. Commissioner*, 298 F.2d 111, 113 (1st Cir. 1962).

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its evolution, it seems odd that it should survive in unaltered form. Yet, clearly it appears from the Senate Reports that Congress in enacting the 1954 Code was familiar with the interpretation given the dividend-equivalent language, and from the legislative history as a whole, it equally appears that Congress had no intention of altering the pre-1954 judicial derivations. And in fact, the criticisms lodged against such language were not only rejected by the Senate in 1954 but also by the Advisory Group on Subchapter C in 1957 and the American Law Institute in 1958. This, despite the seemingly infallible logic of the dissentors.¹⁶

Nevertheless, however uncertain the past may have been—the question before us is how great will be the future evils under the 1954 Code? Just how muddy the language?

The purpose, then, of this commentary is to analyze the developments of the “essentially equivalent to a dividend” language under the 1954 Code.

SECTION 302(b)(1)

*Bradbury v. Commissioner*¹⁷—The First Circuit, in a recent ordinary case, involving ordinary people and ordinary issues, went to extraordinary lengths to insure posterity that the skeletons under section 115(g) of the 1939 Code shall not rest undisturbed. The court, called upon to decide the question whether the cancellation of petitioner's indebtedness to a corporation and an additional credit to her account, upon the redemption of forty-four shares of stock which she held in the corporation, was a distribution essentially equivalent to a dividend within the meaning of section 302(b)(1), reiterated the time-worn battle slogans of the 1939 Code in a somewhat stronger tone than the pre-1954 judiciary would have dared.

From the facts, it appears that at the time of the distribution in question, petitioner, who organized the L. L. Bradbury Corp. for the purpose of carrying on the lumber manufacturing business, formerly carried on by her deceased husband, held 177 of the 288 shares of common stock then outstanding. The remaining stock was held by her daughter (86 shares) and her son-in-law (25 shares). From July 30, 1938, through July 1956, the Bradbury Corporation continually maintained an “open account” in petitioner's name on its books. Petitioner as treasurer utilized this drawing account to pay her personal expenses, etc., and all her dividends and salary were credited to this account. Throughout this period, the account showed a continuous debit balance and as of July 2, 1956, the date of the distribution, amounted to \$21,068.94. The corporation had a dividend history although no dividends were declared or paid from 1953 to 1956 inclusive. During this period, cash surplus ranged from \$2,000 to \$4,000, earnings and profits were negligible but the corporation did have accumulated earnings and profits of approximately \$50,000. However, according to the uncontradicted testimony of the company president, the petitioner's son-in-law, these were in fixed assets such as timber, the basis of the business, and obsolete mill buildings that had to be replaced.

¹⁶ McDonald, Tax Considerations in Corporate Divisions: Contraction and Liquidation, 39 Taxes 994, 998 (1961).

¹⁷ 298 F.2d 111 (1st Cir. 1962).

Allegedly, this obsolescence precluded effective competition thereby creating a business crisis.

Faced with the alternatives of modernizing its saw mill operations or perhaps being forced out of business, the corporation sought a construction loan from the bank with whom the corporation in the past had frequently borrowed money to cover operating expenses. The bank officials requested financial statements and in a subsequent conference with the three shareholders, informed petitioner that the bank "did not like" the account due from her and that the petitioner's account should be "cleaned up some way," although no specific method of "cleaning up" was mentioned. Thereafter, the shareholders discussed the matter among themselves, and apparently at Mrs. Bradbury's suggestion, it was decided that she would transfer forty-four shares of her stock to the corporation and that her account would be credited in the amount of \$22,489.28. A new financial statement reflecting this transaction was presented to the bank and shortly thereafter the construction loan was granted. Petitioner considered the proceeds as a distribution in full payment in exchange for the redemption of her stock and reported long term capital gain. The Commissioner in his notice of deficiency determined that the taxpayer received a taxable dividend. The tax court, in accord, predicated "essential equivalence" on the "net effect" of the following factors:

- (1) Suggestion of the reduction in capital did not stem from an external influence, viz., the bank but from the individual shareholders.
- (2) The redemption was not motivated by a legitimate corporate business purpose since the financial condition did not appear to be bettered by the redemption nor was the construction loan substantially larger than prior operating loans.
- (3) Petitioner was by far the dominant stockholder.
- (4) The corporation had not adopted a plan of contraction nor was there a contraction of the corporate business.
- (5) And at all times, there was sufficient earned surplus to cover the distribution.

On appeal, the petitioner, challenged generally the tax court's determination of essential equivalency and specifically the finding that the redemption was not actuated by a legitimate business purpose. HELD: The net effect of the cancellation of a major stockholder's indebtedness to the corporation upon redemption of forty-four shares of stock which because of section 318 effected no basic change in ownership or control of the corporation amounted to a distribution essentially equivalent to a dividend even though the redemption was actuated by the legitimate corporate business purpose of obtaining a bank loan.

The force of the decision rests on the court's conclusion that the redemption was virtually pro rata since the constructive ownership of stock rules of section 318 attributes the daughter's stock to petitioner. Thus, her proportionate interest in the corporation before and after the redemption was substantially unaltered.¹⁸ The court conceded a legitimate business purpose; recognized that in a proper case, the presence of a legitimate corporate busi-

¹⁸ Id. at 117.

ness purpose may well be relevant as an offsetting factor to a determination of dividend equivalence but strongly urged that "business purpose" is but one factor to be considered. Standing alone, it could not be conclusive nor in the instant case could it be an offsetting factor since here the shareholder was but the shadow of the corporation. The court reasoned that "in terms of business purpose, the shareholder cannot realistically be divorced from the board of directors. It would consequently be unwarranted to turn the presence or absence of dividend equivalence on a distinction where there is really no difference."¹⁹

The decision, as such is not monumental—not a landmark case by any stretch of the imagination. We have nothing more than a determination of a "close case"²⁰ based upon a factual inquiry of all attendant circumstances. Considering the facts in their most favorable light, a determination could have gone either way. However, since it is one of the early cases to be decided under the "essentially equivalent" language of the 1954 Code and since it does touch upon a majority of the problems in this area, certain of the language should be examined.

Strong emphasis was placed on the pro rata nature of the distribution in determining dividend equivalence. Drawing heavily from their prior decision in *Keeffe v. Cote*,²¹ the court stated that pro rata "must be regarded as the basic criterion" and "must be accorded a pre-eminent position. And, where . . . present, the record must contain conspicuously countervailing considerations to dispel the aura of dividend equivalence which their presence irresistibly impels. We do not find these countervailing considerations present here."²²

Considering that *Cote* "actually" owned approximately the same percentage of corporate stock as *Bradbury* "constructively" owned; that the distribution in discharge of taxpayer's indebtedness in *Cote* was held not to be essentially equivalent to a dividend under section 115(g) because of an overriding legitimate corporate business purpose; and that the constructive stock ownership rules are but one of the facts to be considered in determining whether a distribution is essentially equivalent to a dividend,²³ perhaps such language is overly strong and such reliance unjustified. The court talks in terms of the net effect of attendant circumstances yet premises all of these circumstances upon a single base—the attribution rules of section 318. Accordingly, petitioner was considered the dominant or virtually sole stockholder which enabled the court to find a pro rata distribution; to find that the petitioner's interest in the corporation was substantially unaltered by the redemption; to further find that the legitimate corporate business purpose could not be a vital consideration since the shareholder was but the shadow of the corporation. This snow-balling result is inconsistent with the court's own

¹⁹ Id. at 118. "... a business-purpose test is often no more than the statement of a conclusion, especially in the close corporation context where shareholder and corporate motives are almost merged." Gratch, *How to Redeem a Shareholder's Stock*, 39 *Taxes*, 169, 177 (1961).

²⁰ Supra note 17, at 118.

²¹ 213 F.2d 651 (1st Cir. 1954).

²² Supra note 17, at 116-17.

²³ Treas. Reg. § 1.302-2(b) (1955).

interpretation of "net effect" for said the court: "The so-called net effect test is not a weighted formula by which to solve the issue before the court. The net effect of the transaction is not evidence or testimony to be considered; it is an inference to be drawn or a conclusion to be reached."²⁴ From the over-emphasized pro rata effect of the distribution and the total disregard of the regulations²⁵ which state that attribution rules are but a factor to be considered, could such a proper conclusion be reached? Query then whether the court was not in fact guilty of what it was in fact condemning?

Furthermore, it is possible to take issue with the court's very interpretation of "net effect" which it borrowed from the *Sullivan* case,²⁶ decided in the Fifth Circuit in 1954, because in the later case of *Cobb v. Callan Court Co.*,²⁷ also of the Fifth Circuit, the court reasoned:

In this case we find perhaps more of the factors lending weight on one side or the other of the balance, than are present in most of such cases. For the most part the factors, both in numbers and importance, are on the side of Callan. The determination of the dis-

²⁴ Supra note 17, at 115; citing *Commissioner v. Sullivan*, 210 F.2d 607, 609 (5th Cir. 1954). If certain criteria are "basic" and must be afforded a pre-eminent position, obviously they must be given additional weight or emphasis. Does this not imply a weighted test?

Without attempting to reargue the case, certain factors did not seem to receive their due emphasis—if in fact a net-effect test leading to a conclusion rather than a weighted test was to be followed. The bank examined the balance sheet and refused the loan with the item "Due from officer" representing the accumulated debt of petitioner. Petitioner did not have funds to pay the debt. The corporation had practically no cash surplus with which to pay a dividend whereby petitioner could acquire funds to satisfy her debt. At a meeting, variously termed, of the officers, the shareholders or the individuals, all being the same, the redemption of stock was devised as a matter of "cleaning up" the financial statement, which as revised, was accepted by the bank and the loan granted. Personal advantage to petitioner was in issue, but considering that the petitioner was 68 years old at the time of the transaction, and had been transferring her stock periodically since 1949 to her daughter and son-in-law intending that they should eventually have full control of the stock, it might well be that she incurred a detriment. In fact, after discussions extending from 1950 through 1957, petitioner, in February 1958, transferred all her remaining stock to them in return for their note. Thus, to redeem her stock, she obligated herself to a tax liability which she had no need to incur and for which she testified, and her children both concurred, there was no known personal reason nor advantage (Petitioner's Brief, pp. 5-10). But for the business purpose, there would have been no redemption. Further, as we have seen, if the transaction were considered a "sale" then capital gains treatment would follow. When the sale is to a third party, the transaction has all the indications of a sale, but when the buyer is the corporation, the exact nature becomes somewhat clouded. But here we may speculate. Was there time for such a sale to a third party? In view of the fact that no dividends were paid during the past three years, and future dividends were questionable because of their present business crisis, plans for reconstruction etc., would there even be a buyer? Thus, motivated by a legitimate business purpose, the corporation purchased the stock—not only to expedite the loan but to retain the stock in the closely held family corporation. The jury in *Cote* had far less to work with in finding an overriding business purpose, and thus a distribution within the meaning of section 302(b)(1), than did the court in the instant case. Nor was it any comfort to Bradbury that the case was "close." A taxpayer is in no position to average out his losses, nor should the law compel such an attempt.

²⁵ Supra note 23.

²⁶ Supra note 24.

²⁷ 274 F.2d 532 (5th Cir. 1960).

strict court that the . . . redemption was not essentially equivalent to a taxable dividend is clearly not erroneous.²⁸

Certainly, this is a weighted formula test—the same test that the *Bradbury* court rejected in theory but applied in fact. However, the point of the matter is that both *Sullivan* and *Callan Court Co.* were decided under the 1939 Code where uncertainty was more the rule than the exception, and so long as the determination of net effect is unsettled in the Fifth Circuit, its value as precedent remains highly suspect. *Bradbury*, since it was a case of first impression in the First Circuit under the 1954 Code, should not the court have tried to set precedence rather than rely on it? In view of the turbulent history of the “essentially equivalent” language under the 1939 Code?

Whether or not a “legitimate corporate business purpose” will ever amount to a “conspicuously countervailing consideration” in the First Circuit, and elsewhere, as a matter of precedence, is placed squarely in doubt by the *Bradbury* language. The court cites *United States v. Fewell*,²⁹ for the *true rule* that a single bona fide corporate purpose (improving the credit standing of the corporation) will not standing alone conclusively prevent a determination of dividend equivalence. But this begs the question. Since we are in an area of factual inquiry, any *true rule* is unrealistic. Any redemption or purchase of stock is necessarily predicated upon a number of factors, all of which, regardless of the language of the court, are considered in determining whether the distribution is essentially equivalent to a dividend. Furthermore, the court was called upon to decide whether section 302(b)(1) was properly applied to the facts of the case,³⁰ not whether or not the distribution was prompted by a legitimate corporate business purpose “standing alone.” But even if that was the precise issue before the court, the Senate Report does not foreclose the possibility of finding for the taxpayer:

The test intended to be incorporated in the interpretation of paragraph [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.³¹ [Emphasis supplied.]

Moreover, *Fewell* is distinguishable in that the court reversed and remanded because of erroneous instructions which presented the jury with an alternative of finding either essentially equivalent to a dividend *or* a corporate business purpose—no mention was made of net effect. Since the net effect test was utilized in both *Cote* and *Bradbury*, they appear more compatible and perhaps should have been so considered. Thus, the use of *Fewell* to dilute petitioner’s argument of legitimate corporate business purpose, as found

²⁸ Id. at 538.

²⁹ 255 F.2d 496 (5th Cir. 1958).

³⁰ Id. at 498.

³¹ S. Rep. No. 1622, 83 Cong., 2d Sess. 234 (1954); 3 U.S. Code Cong. & Ad. News 4870 (1954) (Detailed Discussion of Bill).

in *Cote*, might well be the type of muddy language Professor Bittker had in mind. This in fact is the general criticism of *Bradbury*. Considering we have a factual inquiry of a "close case," it is difficult to quarrel with the result. But because of these same circumstances, the overpowering use of language and the anxious clinging to pre-1954 Code cases cannot be condoned.

In any event, if the sagging guide lines of the 1939 Code are to be avoided, it will be incumbent upon the courts, deciding the early cases like *Bradbury*, to insure that their opinions are replete with sound reasoning and proper analysis. Prior precedent should be used with an eye to the future—discriminately, so as to insure some degree of predictability or certainty. Otherwise, the essentially equivalent language of the 1954 Code may direct itself more to tax entrapment than to discouraging tax avoidance.

*Neff v. United States*³²—Following on the heels of *Bradbury*, the oscillating course of this decision clearly exemplifies not only the uncertainty in applying 302(b)(1), but more importantly, affords us a glimpse of the extremes to which the "essentially equivalent" language may propel a court.

Neff, for tax purposes, was the sole shareholder of a corporation whose authorized capital consisted of 500 shares of common stock. Of the 100 shares issued and outstanding—ninety-nine shares were owned by Neff and the remaining share by his wife. To raise additional capital needed to profitably operate the business, the corporation redeemed forty-seven of plaintiff's shares in exchange primarily for the cancellation of his indebtedness. Within a year, thirty-eight of these shares had been sold at a substantial profit. The Commissioner considered the corporate distribution and cancellation of indebtedness essentially equivalent to a dividend and taxable as ordinary income. In a suit for refund, Neff argued that the government's assessment was in error because the redemption was undertaken exclusively for a legitimate corporate business purpose to raise corporate capital and that as a result of the redemption and subsequent sale of thirty-eight shares by the corporation, his proportionate interest in the corporation had been substantially altered. HELD: Redemption from a corporation's sole shareholder of stock which the corporation later resells to third parties at a substantial profit to raise needed operating capital is a distribution not essentially equivalent to a dividend.

Judge Durfee, dissenting, considered the net effect of the redemption as a pro rata distribution of earnings and profits. He reasoned that if the corporation needed more capital it could have issued additional of the 400 authorized but unissued shares and sold these in precisely the same manner. He stated further:

the assets of the company would have remained intact prior to the sale, the total assets would have been enlarged by an identical amount of new capital from the sale and Neff's proportionate ownership in the corporation would have been altered to a degree substantially equivalent to the change that resulted from the transaction as it actually occurred. . . . It appears to me that in reaching a

³² 301 F.2d 330 (Ct. Cl. 1962).

contrary result the majority has overlooked entirely the realities of the closely held—or in this case, single-owner corporation.³³

Judge Darr, in a concurring dissent, was equally aroused but reached his conclusion on more pragmatic grounds:

As stated in the majority opinion, immediately before the redemption the corporation needed . . . capital; could not borrow . . . from the banks; and no purchaser would buy stock from Mr. Neff. Obviously the stock had no market value before the redemption. The amount paid to Mr. Neff for the stock would not fix the market value. Therefore, the only criterion for the value of the stock is the book value which was said to be \$852.47 per share. However, this includes the \$19,035 received by Mr. Neff as an asset. Assuming that this amount was a dividend, the book value of each share of the corporation's stock was \$662.12. . . . Before the redemption Mr. Neff's 99 shares at book value were worth \$65,549.88 and after the completion of the redemption plan his 52 shares at book value were worth \$109,386.16. The result is that Mr. Neff's remaining 52 shares of stock after the redemption plan was completed were worth \$43,836.28 more than his 99 shares of stock before the redemption. It might also be noted that after the redemption plan, Mr. Neff still remained in control of the corporation . . . \$19,035 to the good.³⁴

In view of the persuasive reasoning of the dissentors, it is difficult to reconcile the court's application of section 302(b)(1). The majority's main point of contention was that the redemption and subsequent sale substantially altered Neff's proportionate interest in the corporation. His stock ownership was reduced from ninety-nine per cent to fifty-six per cent. "The fact that the resale was accomplished over a period of some 9 to 12 months . . . would not change the complexion of the transaction," said the court.³⁵

Although these facts imply an application of the substantially disproportionate redemption of stock provisions of section 302(b)(2), the court expressly disclaimed any such reliance in view of the "immediately after the redemption" language of that subsection. A further justification, although not mentioned by the court, was the fact that the taxpayer did not own less than fifty per cent of the total combined voting power after the redemption as required by section 302(b)(2)(B). Despite the above, the court extended the scope of this disproportionate redemption test by using it as the determinant for judging dividend equivalence under section 302(b)(1). The language in the Senate Report certainly opens the door to such a conclusion³⁶ but in so finding here:

³³ *Id.* at 334.

³⁴ *Id.* at 335.

³⁵ *Id.* at 332.

³⁶ *Infra* note 41. See Treas. Reg. *supra* note 23, and Gratch, *How to Redeem a Shareholder's Stock*, 39 *Taxes* 169, 178 (1961) where the writer believes that section 302(b)(1) should be extended to cover a "bona fide attempt to meet the requirements of the specific tests of section 302(b)(2) or (3) which fail because of some technical over-

the court had to make the unwarranted assumption that the redemption and consequent change in proportionate holdings were so closely related that they should be treated as steps in the same transaction. It has been suggested that the proper test in such a situation is whether the steps 'were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.' There is little indication in this case that the subsequent sale was so closely related to the redemption as to justify its inclusion in that transaction.³⁷

As argued by the taxpayer, the legitimate corporate business purpose was the coalescing factor. Unfortunately, as the dissent pointed out, a finding of a legitimate corporate business purpose is the most dubious part of the entire transaction, and on motion for reconsideration of the original decision, the case was reargued.³⁸

Judge Durfee, this time writing for the majority, reversed on essentially the same argument advanced by his prior dissent incorporating Judge Darr's analysis to buttress his finding that the distribution was essentially equivalent to a taxable dividend. Added emphasis was given the fact that the taxpayer's proportionate interest in the corporation was not altered immediately after the redemption and in fact resembled a pro rata distribution constituting a dividend.³⁹

The reason for reversal was attempted by Judge Whitaker in a concurring opinion:

I concurred in the former opinion because I thought we should compare Neff's relationship to the corporation before the redemption with his relationship after all sales of his stock had been made. I am afraid this ignores the provision of section 302, that the comparison must be made between the situation before and 'immediately after the redemption.'⁴⁰

As in *Bradbury*, considering the overall atmosphere of the decision, it may be difficult to quarrel with reversal in this case but considering the language, it is certain that the court was unwisely exercising judicial liberty. Both Judges Durfee and Whitaker have ingrafted a requirement onto

sight or some very indirect attribution of ownership"; Rev. Rul. 55-462, 1955-2 Cum. Bull. 221 where a redemption was held to qualify under section 302(b)(1) although it was not "substantially disproportionate" under section 302(b)(2). The IRS noted that "in the instant case, the transaction . . . by its nature can be characterized as a sale by the shareholder. The two shareholders are unrelated and there is no pro rata distribution in whole or part affected by the transaction."

³⁷ Note, 48 Va. L. Rev. 1171, 1175 (1962).

³⁸ *Neff v. United States*, 305 F.2d 455 (Ct. Cl. 1962). Prior decision, *supra* note 32, vacated and withdrawn.

³⁹ In dealing with legitimate corporate business purpose, Durfee stated, "We do not believe that the presence of such corporate purpose establishes *per se* non-equivalence." *Id.* at 457. This is a much more conservative statement of the rule than that contained in the *Bradbury* case and would appear to be more consistent with the legislative intent and far more helpful in establishing future guidelines.

⁴⁰ *Supra* note 38, at 459. See the discussion in *Decker v. Commissioner*, *infra* note 69, a case which repels such a conclusion.

302(b)(1) that in determining dividend equivalency—we *must* consider the transaction *immediately after* the distribution. True, in applying the mechanical tests of 302(b)(2) and (3), “immediately after” is a legislative requirement but (b)(1) is void of such language. As a matter of statutory construction, it would appear that it was the manifest intent of Congress *not* to so restrict 302(b)(1).

This was the crux of Judge Laramore’s dissent in the instant decision. He stressed the fact that the Senate Report calls for a “factual inquiry”⁴¹ in determining the present question; that Mr. Neff’s proportionate ownership was diminished per force of the sale and that the nine to twelve month period necessary to complete the sale should not alter the situation because of the difficulty in marketing the stock. He raised this same argument writing for the majority in the prior decision and his interpretation of the Senate Report and scope of 302(b)(1) went unquestioned. There, the dissent attacked the so-called legitimate corporate business purpose, both Judges Durfee and Darr stressing issuance of additional stock as the proper solution, not redemption. This they believed merely aggravated the capital crisis. Yet, in defense of the prior decision, it should be noted that if, as Judge Darr stated, no buyer would purchase from Neff, how could the corporation hope to sell the stock? Neff and the corporation were one and the same! The answer must lie in the fact that prospective buyers were less reluctant after Neff decreased his holdings. If the redemption was the inducement, then Neff’s legitimate corporate business purpose argument takes on added significance. Surely we cannot divorce ourselves from the fact that had Neff sold his stock to the subsequent buyers in his own name rather than in the name of the corporation, no *dividend* tax would have been assessed. Also, if the 100 shares issued and outstanding represented the authorized capital of the corporation, a second hard look at Judge Laramore’s argument would be necessary. However, the amount of stock authorized should not have been emphasized as much as it was. The statutory procedure for additional authorization is relatively simple, especially in a one man corporation.

In view of the above reasoning, Judge Durfee’s request that we look at the realities of the closely held corporation presents somewhat of an anomaly. Moreover, considering some of Durfee’s language, this writer urges that we look also at the realities of statutory construction.

*United States v. Carey*⁴²—This case represents the first interpretation of the essentially equivalent language of the 1954 Code.⁴³ It should, therefore, preface any discussion of section 302(b)(1). It should, that is, but for the result!

The case involved a two-man corporation, Carey-Brown Motors Inc., in which each stockholder was the record owner of 300 shares. During a period

⁴¹ S. Rep. No. 1622, 83d Cong., 2d Sess. 233 (1954), in discussing subsection (b) of section 302, states: “In lieu of the approach in the House, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry.”

⁴² 289 F.2d 531 (8th Cir. 1961).

⁴³ *Id.* at 536-37.

of increasing business activity, Brown, unable to devote time to the business, decided to terminate his interest. This would require a buyer with \$50,000 and a personal interest in the automobile business. Larson, a present employee was the only such purchaser to be found but unfortunately, he had but \$22,000. Thus to effect the sale in the best interests of the business, the following plan was agreed upon: (1) A pro rata redemption by the corporation from each shareholder of 145 shares by a transfer to them of the corporate buildings and book accounts; (2) followed by a lease-back to the corporation of the buildings for a period of three years; (3) a sale by Brown to Carey of two shares and to Larson, the remaining 153 (purchase price was \$22,239); (4) a change in corporate name to Carey-Larson Motors Inc.; (5) election of Larson as treasurer; and (6) complete severance of Brown's interest in the corporation.

The tax court considered the redemption and reduction of the capital structure to be a necessary expedient in meeting the unexpected business crisis and thus, a distribution within the meaning of section 302(b)(1). The Government appealed on a claim of error in interpreting the essentially equivalent language of the Code. HELD: In applying the established criteria of the 1939 Code for determining dividend equivalency to the facts as found by the trial court, the conclusion that the redemption when viewed at the stockholder level under section 302 is not essentially equivalent to a dividend, cannot be reversed since there is substantial evidentiary support. Nor was it shown that it was induced by an erroneous view of the law.

The court basically resorted to a net effect test⁴⁴ in reviewing the six-step transaction, the specific nature of which, for present purposes of discussion, is of little importance. The significant feature of the decision is the scope of review enunciated by the court for it clearly establishes a proper guide-line for future decisions. As a matter of speculation, query whether *Bradbury* could have been decided by a mere per curiam reciting the instant case. Certainly, the application of *Carey* would have obviated the lengthy and questionable discussion of the many reasons for affirmance—all factual in nature. All too often, facts can be cast in different light to produce different inferences, the result of which may tend to "muddy" rather than enlighten judicial expression. Where the court feels that the moving party has not sustained its burden of proof—where they fail to show that the finding below was unsupported by substantial evidence or was induced by an erroneous view of the law—a commentary on the area of law as in *Bradbury* adds nothing to the decision and may in fact, result in dicta unduly restricting the future application of present criteria.

Despite the above, the *Carey* result is difficult to accept. True the Government did not question the capital gains treatment afforded Brown because of the termination of his interest; however, considering the termination of interest provision of section 302(b)(3), the facts would admit of no other conclusion. But continued the court, "the stock redemption as to

⁴⁴ The court in stating that net effect is at least a factor implies that it was applying a slightly different net-effect test than that resorted to under the 1939 Code. This would seem to equate net effect with some other equally important factors. In application, however, the tenor of the decision reflects a general net effect approach—considering all factors.

Brown and Carey was made as a result of the same identical corporate action and for the same business purpose. If there was no pro rata distribution to Brown, there could be no pro rata distribution to Carey.⁴⁵ This is an obvious non sequitur. In the first place the better rule is that the pro rata nature of the distribution is but a factor in dividend equivalency.⁴⁶ Secondly, the case is severely criticized and on a very sound basis;⁴⁷ Judge J. Spencer Bell classifying the redemption as part of a broader plan and conceding capital gains treatment to the withdrawing shareholder, questioned the correctness of affording capital gains treatment to the shareholder remaining in the business. "Since he was to be the sole owner of the corporation, the redemption of a part of his stock, being unessential to the effectuation of the plan . . . should have been viewed as being a pro rata distribution and equivalent to a dividend."⁴⁸ There is no valid reason why a legitimate corporate business purpose characteristic of Brown's redemption should sweep in the redemption of Carey's stock merely because in point of time, they were similar.

It is interesting to note that Brown could have simply redeemed all of his 300 shares at capital gains rates under 302(b)(3) and Carey could have then sold 153 of his shares to Larson, accomplishing the same result and avoiding the entire problem. Obviously, Carey wanted a slice of the accumulated profits. This the court ignored in finding an overall corporate plan to reduce the outstanding stock to a level which would allow Larson to purchase and which would thus benefit all concerned.

Perhaps the court's justification is that since the above transaction could have resulted in capital gains treatment, the situation did not *really* involve an attempt to get profits out but rather a valid business purpose to shift stock ownership in the best interests of the corporation. If this was the case, it's unfortunate that the court did not clearly express its reasoning for this is

⁴⁵ Supra note 42, at 539.

⁴⁶ This is a debatable point, but the growing emphasis afforded a legitimate corporate business purpose sustains this approach. See the analysis in *Ballenger v. United States*, 301 F.2d 192, 196-98 (4th Cir. 1962), discussed in text following note 49 infra; *Bradbury v. Commissioner*, supra note 17, at 117 (dictum) (pro rata distribution not conclusive evidence); and the treatment by Bittker, op. cit. supra note 2, at 232-34.

The regulations under § 302(b)(1) state that if a corporation has only one class of stock outstanding, a pro rata redemption "generally" will be treated as a distribution under § 301. . . . No doubt many fervent arguments will be based on the term "generally," in an effort to protect some pro rata redemptions against § 301 by bringing them under the aegis of § 302(b)(1).

Id. at 233.

But the Senate Report . . . rather clearly implies that § 302 is concerned solely with 'those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders. . . .' It is not easy to give § 302(b)(1) an expansive construction in view of . . . [the] indication that its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock.

Id. at 232. See also Rev. Rul. 56-182, 1956-1 Cum. Bull. 157 holding that a redemption of some of the stock of a majority shareholder to enable an employee to increase his holdings under an earlier stock option agreement is "essentially equivalent to a dividend" because it did not produce an appreciable change in position of the parties involved.

⁴⁷ *Ballenger v. United States*, 301 F.2d 192 (4th Cir. 1962).

⁴⁸ *Id.* at 197 n.10.

a much more liberal approach to the problem than is evidenced by prior or subsequent cases. The court is permitting a legitimate business purpose to prevail despite a concurrent tax avoidance motive.

*Ballenger v. United States*⁴⁹—Judge J. Spencer Bell, in a very informative opinion, attempted to shape the course of events taken by the essentially equivalent language of the 1954 Code. Regarding the issue as factual in nature he paraphrased the scope of review enunciated in *Carey* as involving two questions: (1) whether the court below applied the correct criteria for determining dividend equivalency and (2) whether the findings of fact were supported by substantial evidence? "With the possible exception of the Ninth Circuit," he said, "every court of appeals appears to be in agreement. . . ."⁵⁰

In applying section 302(b)(1), he noted that the cases are viewed solely from the shareholder's perspective and that two distinct lines of cases appear. The first applies a "strict 'net effect' test" and the second, a net effect test but with a further consideration, *i.e.*, whether or not there are legitimate business purposes for the redemption. His interpretation of net effect, considering the verbiage of *Bradbury* and like decisions, is certainly a rose among thorns. He states:

Under this test, the court must hypothesize a situation where the corporation did not redeem any stock, but instead declared a dividend for the same amount. The court then must examine the situation after the dividend and compare it with the actual facts of the case when stock was redeemed, viewed always from the shareholders' vantage point. The redemption is essentially equivalent to a dividend if the results from the hypothetical dividend and the actual stock redemption are essentially the same. . . .⁵¹

It is submitted that this test as stated would have greatly facilitated the *Neff* result for basically the case was decided on the fact that no business purpose was served by redeeming his stock, and absent such a finding, the results from a hypothetical dividend and the actual stock redemption were essentially the same. It would also have given very definite meaning to the *Bradbury* definition of net effect, to the extent that the court equated net effect with "an inference to be drawn or a conclusion to be reached."⁵²

In applying the *Ballenger* test, the court considered certain pertinent factors: (1) whether the same shareholders would have received the identical payments had the redemption been a dividend (in *Neff*, yes; in *Bradbury*, perhaps not, if her son-in-law's testimony is to be believed); (2) whether the redemption altered the shareholders' control over the corporation and

⁴⁹ Supra note 47.

⁵⁰ Id. at 196. He notes that both cases in the Ninth Circuit which have taken a contrary view, *Pacific Vegetable Oil Corp. v. Commissioner*, 251 F.2d 682 (9th Cir. 1957) and *Earle v. Woodlaw*, 245 F.2d 119 (9th Cir. 1957), have a dissenting opinion. See generally *Ballenger v. United States*, supra note 47, at 196 n.8 for a breakdown by circuits. For our purposes, consider the fact that both of these cases were decided under the 1939 Code. Perhaps the court will reappraise the situation when faced with a 1954 Code decision.

⁵¹ Id. at 196.

⁵² See notes 23 to 28 supra and accompanying text.

their respective rights to its future earnings (emphatically yes in *Neff* since he was the sole stockholder and likewise in *Bradbury* to the extent that a majority shareholder controls the corporation); (3) whether the redemption is part of a broader plan (this precludes incorporation of the term "immediately after" into 302(b)(1) as attempted in *Neff*—further the "broader plan" factor should be cautiously applied in view of the instant court's criticism of *Carey* which was decided on this broader plan basis).

The court avoids any lengthy discussion of pro rata as in *Bradbury* by establishing almost a conclusive presumption that "every pro rata redemption will be equivalent to a dividend, for in no way can it result in any alteration in the relationship of the shareholders, both with respect to their share of the distribution in question and in respect to future control and profits."⁵³

As to the second line of cases, the court stresses that a business purpose is not restricted to purposes which insure successful operation of the business. "Personal business affairs of the shareholders also warrant attention," e.g., *Carey* where the redemption was supposedly part and parcel of a shareholder's complete withdrawal from the business. As evidenced by the *Carey* case, this is difficult to apply and Judge Bell quickly added that "of course, an acceptable business purpose can never be reducing income taxes for the purpose of the statute is to prevent distribution . . . at the lower capital gains rate."⁵⁴ As a practical matter, this differentiation between corporate and personal business affairs may tend to confuse more than to enlighten for it has been suggested that the courts are losing sight of the proper meaning of business purpose:

The utilization of business purpose by many of the courts—and by the way it is used by the Internal Revenue Service today—is a far cry from the business purpose doctrine developed in *Gregory v. Helvering*.⁵⁵ In the *Gregory* case, 'business purpose' . . . referred to the corporate reality of the transaction in terms of the statutory

⁵³ Supra note 47, at 197. Bittker is in complete accord for his position is that section 302(b)(1) can apply only to non pro rata redemptions. The Taxation of Stock Redemptions and Partial Liquidations, 44 Cornell L.Q. 299, 322-25 (1959).

⁵⁴ Supra note 47, at 197.

⁵⁵ 293 U.S. 465 (1935). The Supreme Court held that full compliance with the letter of the spin-off statute was not enough if the transaction was otherwise indistinguishable from an ordinary dividend. The taxpayer was the sole stockholder of A corporation which held, among its assets, 1000 shares of B corporation. These taxpayer wished to sell to a third party, thus she caused C corporation to be organized, transferred this stock to C corporation in consideration for which C corporation issued all of its stock to the taxpayer. A few days later, C corporation was dissolved, its assets distributed to taxpayer who then sold them to the third party. The Commissioner determined a deficiency on the theory that the net result was an ordinary dividend distribution of the assets by A corporation to the taxpayer, and that the "reorganization" provisions should not be confined to transactions having some purpose other than tax avoidance. The tax court held for the taxpayer. The Second Circuit reversed and the Supreme Court affirmed:

The whole undertaking was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Id. at 470.

purpose. . . . [A]n analysis of *Helvering v. Gregory* shows that there was no reality in the situation, and to many of us that's all 'business purpose' means today. Is there reality? Is what is accomplished a reality, and have we done what we sought to do? [Footnote added.]⁵⁶

"Purity of motive" is another business purpose factor which in turn compels an inquiry into whether the redemption initiated with the shareholders or the corporation; whether the corporation had been declaring adequate dividends; and whether there were "in fact" corporate earnings and profits. Query whether *in fact* means available for distribution? If this be the proper interpretation, reconsider the facts in *Bradbury*: a corporation in critical need of capital, little cash on hand, threatened by severe competition, accumulated earnings and profits tied up in fixed assets necessary for the continuation of the business, no money changed hands, merely a paper entry—yet the distribution was essentially equivalent to a dividend. Much was made of the accumulated earnings and profits but were these *in fact* corporate earnings and profits?⁵⁷

At any rate, courts following the second approach find the shareholder-corporate officer *sameness* in close corporations to be a very real obstacle in untangling the various purposes. The court noted that "recourse in such circumstances should be to the factors emphasizing the net effect of the transaction if the statute is to be reasonably applied."⁵⁸ This seems to say that when incisive distinctions cannot be made as to who initiated the distribution, the shareholder or the corporation, the over-riding business purpose factor should not be considered. *Keeffe v. Cote*⁵⁹ is consistent with this proposition but this same court in *Bradbury* was not prone to permit repetition and accordingly, included this factor on the dividend equivalency side of the balance (or drew an inference in favor of a dividend depending upon your choice of interpreting the court's use of net effect).

"The only difference then between the two lines of cases is that courts following the first will tax as a dividend any redemption for which tax avoidance is likely to be a motivating factor, while courts adhering to the

⁵⁶ Substance v. Form in Corporate Activities—A Series of Panel Discussions, N.Y.U. 20th Inst. on Fed. Tax 975, 979 (1962).

⁵⁷ Judge Phillips, dissenting in *World Publishing Co. v. United States*, 169 F.2d 186 (10th Cir. 1948), argued in a similar vein, while protesting to the assessment of an accumulated earnings tax. In rejecting the notion that the corporation should have distributed the earnings as dividends he stated:

Surely, a business enterprise, with obsolete and badly worn equipment, might, during the War period, legitimately set aside a reserve fund to replace that equipment, when available, and to construct the building necessary to house such equipment. To do so would be ordinary business prudence.

Id. at 192. Thus the analogy may be drawn that *Bradbury*, unable to meet competition, was in no position to distribute fixed assets necessary for the continuation of the business by way of dividends. This would be imprudent. Consequently, the corporation did not *in fact* have earnings and profits available for distribution.

⁵⁸ *Supra* note 47, at 198.

⁵⁹ 213 F.2d 651, 657 (1st Cir. 1954) (legitimate business purpose prevailed over a pro rata redemption where the court admitted that they could not distinguish between "stockholder-taxpayer and principal if not as a practical matter the only corporate officer . . .").

second line of cases adopt a more flexible approach, by some times permitting a legitimate business purpose to prevail despite a concurrent tax avoidance motive."⁶⁰

However, in deciding the case at hand, the court found it unnecessary to make such an election for either choice would compel an affirmance of the district court's finding of dividend equivalency. The facts are these. The corporation was organized in 1949 with common and preferred stock issued to all stockholders which preferred, plaintiffs contend, was issued for a valid business purpose; "to prevent the liquidation of the business upon the death of one of its partners." In 1953 a resolution was adopted by the corporation calling for liquidation of all the stock both common and preferred held by all parties other than the taxpayers. These resolutions referred to the transaction as a partial liquidation. They made no reference to retirement of taxpayers' stock, either preferred or common. However, plaintiffs argue that when the stock of all other shareholders was redeemed, the reasons for issuing preferred stock ceased to exist and this in itself constituted a valid business reason for subsequently redeeming their preferred stock. The lower court termed the distribution essentially equivalent to a dividend grounded on the fact that the corporation had never paid a dividend on the common stock; that the corporation had liquid earnings and profits in excess of the distribution; and that stock ownership and voting control of the corporation were not changed by the retirement.

Judge Bell, speaking for the majority on appeal, reached the same result but in a much easier fashion. Viewing the facts under a strict net effect test, because the distribution was pro rata, the court's virtual *res ipsa* doctrine created a burden of proof that the plaintiffs could not sustain.

Nor would the result be any different, reasoned the court, if the test of an over-riding legitimate corporate business purpose were followed for "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption. Even if it had been originally understood that the preferred stock would eventually be redeemed, such a fact is not, without more, a legitimate business justification."⁶¹

In negatively defining what the court considers to be a legitimate business purpose, the court seems to require that the transaction alleviate a business crisis. Perhaps rightly so for if the transaction is to over-ride a dividend finding under a strict net effect test, it should amount to something more than ordinary corporate activity. Support for this contention is provided by Judge Bell in the manner in which he distinguishes two 1939 Code cases.⁶² In both cases, as he points out, "the courts found a legitimate business purpose in the redemption of stock, the issuance of which had been justifiable, because at that time, it was understood that the stock would eventually be redeemed." However, "we cannot follow these cases because we can see no

⁶⁰ Supra note 58.

⁶¹ Supra note 47, at 199.

⁶² Cobb v. Callan Court Co., 274 F.2d 532, 538 (5th Cir. 1960); Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954).

business purpose here, apart from the avoidance of taxes, advanced by the redemption."⁶³

In one case, the redemption was in cancellation of an indebtedness owing to the taxpayer and carried on the corporate books because its existence reflected adversely on the corporation's credit standing.⁶⁴ In the other, the redemption of preferred from the dominant shareholder was pursuant to a plan of reorganization following bankruptcy. The corporation was indebted to the taxpayer; initially satisfied the debt by issuing him common and second mortgage bonds; but later cancelled the bonds and issued preferred in order to improve the fiscal position of the new company and reduce the amount of the fixed interest charges. At the time of the transaction, it was agreed that the corporation would redeem the preferred as soon as it was in a position to do so.⁶⁵ Thus, it can be seen that in both cases, the redemption was the result of sound but ordinary corporate activity. True, both shareholder and corporation benefited but there was no urgency associated with the redemption and as in the *Neff* case, there were alternative methods available which would bring about the same result. It is submitted that the *Bradbury* "business purpose" is what the court has in mind; the immediacy of the redemption to satisfy a corporate purpose where alternative solutions are either lacking or impractical.

*Thomas Kerr*⁶⁶—Petitioner was the sole stockholder of two independent corporations, Helix Milling Co. and Kerr-Grain Corporation. Because the milling business necessitated a steady line of bank credit and because his bank talked of "certain advantages—both credit-wise and tax-wise," petitioner transferred his Kerr-Grain stock to Helix for \$50,000. The Commissioner considered the transaction a section 304(a)(1) redemption,^{66a} thus treating the proceeds as a taxable dividend over the petitioner's claim of 302(b)(1).

In deciding the issue of dividend equivalency, the court applied Judge Bell's "strict net-effect" test⁶⁷ and sustained the deficiency assessment. *Kerr*,

⁶³ Supra note 47, at 199 n.21.

⁶⁴ *Keefe v. Cote*, supra note 62. The stock was originally given to the taxpayer in settlement of his claim for salary, the purpose of the exchange of the stock for the note being a corporate one, i.e., to improve the corporation's credit. Thus it could be found that there was a corporate purpose in issuing the shares and it also could be found that they were redeemed in carrying out that corporate purpose and the jury so found.

⁶⁵ *Cobb v. Callan Court Co.*, supra note 62.

⁶⁶ 38 T.C. No. 73 (Aug. 27, 1962).

^{66a} If a corporation, in return for property, acquires stock of another corporation from one in control of both corporations before the acquisition, such property shall be treated as received in redemption of stock of the acquiring corporation. As to the person transferring stock, the amount received shall be treated as a distribution of property under Section 302(d), unless as to such person, the amount received is to be treated in exchange for the stock under 302(a) or 303. Treas. Reg. § 1.304-2 (1955).

⁶⁷ The instant court found no plan of contraction or actual contraction; the initiative for the stock transfer came from petitioner; at a time when the corporation had accumulated (in fact) earnings and profits; that cash dividends had never been paid; that the distribution was pro rata; and that petitioner's proportionate interest in the corporations was unaltered (applying the constructive stock ownership rules of section 318(a)(2)(C), petitioner continued to own 100 per cent of the outstanding stock of both corporations).

arguing off-setting or over-riding corporate business purpose, took the position that the creation of a parent-subsidiary relationship strengthened the credit position of the two corporations, facilitated the free flow of cash between the corporations, and enabled the corporations to conserve cash through the medium of filing consolidated returns. The court was unmoved due to the fact that petitioner had not shown that the bank requested the transfer as a "condition precedent to future financing" nor did he establish that the corporations were "unable to obtain adequate financing prior to the transfer." Thus, no showing of business *crisis*. The court, recognizing that the filing of consolidated returns by affiliated corporations often results in tax savings, thus conceded a "minimal bona fide business purpose in the stock transfer" but held the "*mere existence of a single bona fide business purpose will not of itself conclusively determine* [emphasis supplied]"⁶⁸ the applicability of section 302(b)(1), citing *Fewell*, *Bradbury*, *Neff*, etc. The emphasized phrase was, as far as this discussion is concerned, one of the "battle slogans" under the 1939 Code; thus, note well the context in which it is used. This court very properly equates a *minimal* bona fide business purpose with the time worn *single* bona fide business purpose and forecloses any argument of uncertainty. On the other hand, *Bradbury* equates a *business purpose argument* with the *single* bona fide business purpose thereby fostering both uncertainty and inequality—uncertainty in that the so-called slogan must be applied to the particular facts and not reiterated as an abstract rule of law—inequality in that taxpayers in a *Ballenger* court, for example, would have the benefit of arguing over-riding business purpose.

REDEMPTION OF STOCK WHICH EFFECTS A DISCHARGE OF SHAREHOLDER'S INDEBTEDNESS TO A THIRD PARTY

*Decker v. Commissioner*⁶⁹—*Decker* was the first of four cases thus far deciding whether or not such a transaction amounted to a taxable dividend under the 1954 Code. Basically, the facts consist of a corporation of five shareholders who had entered into an agreement whereby, upon the death of a stockholder, the survivors would purchase the decedent's stock at book value. In 1954 such a transaction took place but immediately upon purchase the stock was transferred to the corporation for an amount equal to the purchase price. Holding the stock in treasury, thereafter the corporation began transferring it to key employees at a substantial gain. The tax court, concluding that the *net effect of the transaction when completed amounts to a purchase by the corporation* of the deceased stockholder's shares, held: payments made by the corporation to the surviving shareholders were not essentially equivalent to dividends under Section 115 (g) of the 1939 Code and Section 302 of the 1954 Code. Three persuasive reasons were advanced for the decision:

[1] From the standpoint of the company, by adjusting its book entries⁷⁰ this could be made to appear the same as the distribution

⁶⁸ Supra note 66, at 10.

⁶⁹ 32 T.C. 326, aff'd per curiam, 286 F.2d 427 (6th Cir. 1960).

⁷⁰ This would require reducing the accumulated and undivided profits by the amounts paid out for the stock and not entering the treasury stock as an asset.

of a dividend. . . . However, this would be somewhat unrealistic in view of the fact that the company has since realized over \$75,000 from the sale of this stock to key employees . . . the cash paid out by the corporation did not wind up in the hands of the shareholder to whom a dividend is sought to be charged but in the estate of a deceased stockholder which simply sold the stock for that amount. [Footnote added.]⁷¹

[2] Petitioners did not receive any true economic benefit from the transactions when considered as a whole. They had the same amount of cash and the same number of shares of stock after the transactions were completed as they had before the death of the deceased stockholder. Their stock represented a higher percentage of equity in the basic assets of the company, but those basic assets were reduced proportionately so the stock actually represented the same values assuming that the book value for which the stock was bought and sold represented the value of the underlying assets.⁷²

[3] Petitioner's obligation here was to purchase stock for its book value. Presumably, the stock was worth what was paid for it. Had petitioners bought and retained the stock, their net worths would have remained the same. The corporation did not pay a pre-existing debt of the petitioners, the satisfaction of which would increase their net worths. They realized no economic benefit from the transaction. And here the resale to the corporation was *obviously a part of a plan* to buy the stock of the deceased stockholder in a manner that was best for all concerned. [Emphasis supplied.]⁷³

From a careful reading of the case and in view of the subsequent cases to be discussed, the two most essential elements of the opinion were the finding of "no economic benefit" to the petitioner and a "plan." The former is obvious for the court uses it as a central theme in all three of its reasons. However, the latter is not, and as the *Idol* and *McGinty* cases discussed *infra* point up, it is by far the most important. In a dominant shareholder-close corporation situation, if it can be established that the corporation had no intention of redeeming the stock or no legitimate reason to, then the transaction is shareholder motivated. This, as we have seen, shifts an almost insurmountable burden of proof onto the taxpayer. On the other hand, here it was shown that the corporation had a legitimate use for the redeemed stock and which, coupled with the lack of economic benefit to petitioner, clearly supports the result reached.

The case is further significant considering the court's treatment of *Wall v. United States*,⁷⁴ its biggest stumbling block in applying 302(b)(1). Wall, a fifty per cent stockholder, had obliged himself on a number of promissory notes to purchase the remaining stock interest. Both the notes, and his equity in the stock, he subsequently turned over to the corporation which

⁷¹ *Supra* note 69, at 332.

⁷² *Id.* at 333.

⁷³ *Ibid.*

⁷⁴ 164 F.2d 462 (4th Cir. 1947).

entered the stock on its books as treasury stock. When the corporation paid out on the notes, the transaction was regarded as though the money had been paid to Wall and transmitted by him to the creditor. The court was unwaivering in its position that the corporation had satisfied Wall's existing indebtedness out of its surplus, thus in legal effect, Wall had received a dividend. Among others, the court rejected the argument that Wall received no economic benefit nor could he incur a taxable gain until he sold his stock. Considering that Section 115(g)(1) of the 1939 Code was conditioned by the phrase "at such time . . . as to make the distribution and . . . redemption . . . essentially equivalent to . . . a taxable dividend," the court's conclusion is proper for it implies application "immediately after" the distribution.⁷⁵ The taxpayer further argued that the stock held in treasury was consideration for the discharge of his obligation but this too was rejected because his proportionate interest in the corporation remained the same before and after the corporate acquisition. One further statement of opinion is worthy of note: "If Wall had paid for the stock in cash and then sold the stock to [the corporation] for the same price, he would clearly have been taxable on the latter transaction under Section 115(g) if the payment . . . was made from surplus."⁷⁶

This in essence, however, is the *Decker* case. Thus to distinguish it, the court first cites *Wall* as establishing certain factual criteria that should be considered; points out that there is no magic formula or combination of these criteria that will give the conclusive answer; talks of according proper weight to each factor; and then concludes that tax avoidance was not a major consideration in the transaction, stressing the existence of the corporate plan to prevent the stock from falling into the hands of widows, minors or outsiders, and to sell the stock to key employees. With respect to this latter point, observe the court's language:

There was no corporate business purpose for the corporation [in *Wall*] to pay these obligations and the only ones benefiting therefrom were the stockholders. . . . In our case, none of the petitioners ever had complete ownership . . . and we believe there was a sound business reason for the corporation to acquire the stock. While petitioners may have been obligated to purchase the stock of a deceased stockholder, this is a different sort of obligation from those in . . . *Wall*. . . .⁷⁷

I doubt if the court was correct in the last statement, for as we have seen, the *Wall* court didn't seem to think so. At any rate, the distinguishing

⁷⁵ The court in *Wall* stated:

We are not now concerned with the broad question whether the business in which the taxpayer is engaged will ultimately result to his advantage and show a profit on his investment when it is finally liquidated, but with the much narrower question whether in 1939 the taxpayer in legal effect received a dividend from the corporation through the payment by it of the \$5000 note

Id. at 465. Consider the court's language in Milton F. Priester, note 87 *infra*, on this point—especially the text to note 84 *infra*.

⁷⁶ *Supra* note 74, at 465.

⁷⁷ *Supra* note 69, at 333.

feature, which is blatantly obvious, is the existence of the corporate plan. Considering that the court used a weighted test, this was a major factor in the decision. Furthermore the economic benefit theory advanced by *Decker*, was facilitated by the fact that the "time" provision of 115(g) was not carried over into the 1954 Code. Thus, the court could view the transaction from a broader base.

*Milton F. Priester*⁷⁸—Here the petitioner was a minority shareholder in a two-stockholder corporation. He entered into an agreement to purchase all the stock of the majority holder; payments to be made in installments subject to a default clause which would mature all unpaid installments and an escrow agreement which would permit the escrow agent to sell petitioner's deposited stock in satisfaction of the debt. When it became apparent that he could not meet the first installment, petitioner secured another investor to purchase the stock. The sale was conditioned by petitioner's assurance that the corporation would purchase or redeem said stock within six months to a year from date of purchase at a profit to the investor. As a result of the sale and subsequent redemption, petitioner became sole shareholder of the corporation.

On these facts, the Commissioner argued, as he did in *Decker*, that the corporation had employed its earned surplus in discharge of petitioner's obligation to a third party, without adequate consideration. The results then, effected a *constructive distribution* of a taxable dividend to petitioner of the amount paid to the investor in redemption of his stock under the principle of *Wall v. United States*.⁷⁹ To support this contention, the Commissioner had to argue that the investor was but a mere straw.

The tax court, however, made short work of such an argument noting that not only was the investor a professional by reputation, but that the terms of his purchase agreement negated such a finding. Moreover, the court concluded that the petitioner did not receive either directly or indirectly any of the amount which the corporation paid to the investor. This is, in essence, the rationale in *Decker*, i.e., petitioner received no *economic benefit*.⁸⁰ The court further reasoned that the corporation could not discharge an indebtedness of the petitioner by the redemption because his obligation had already been cancelled when the investor purchased the stock. It is submitted that this does nothing more than to dilute the force of the decision. It is not a *sequitur* for if it had been found that the investor was a straw then Judge Tietjens might well have been writing for the majority rather than for the dissenters stating: "When the smoke cleared . . . [t]he net effect was a taxable dividend to petitioner."⁸¹ The court will always look through form to the substance of the transaction.⁸²

⁷⁸ 38 T.C. No. 36 (May 29, 1962).

⁷⁹ Supra note 74.

⁸⁰ The court referred to *Holsey v. Commissioner*, 258 F.2d 865 (3d Cir. 1958) (1939 Code), involving a similar situation where it was stated that "the real question is whether the taxpayers received any financial or economic benefits as a result of the redemption of the stock. . . ." In concluding, the court also cited *Decker*.

⁸¹ Supra note 78, at 14.

⁸² E.g., *Gregory v. Helvering*, supra note 55. Also, see the discussion of *Edgar S.*

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One further argument by the Commissioner worthy of note was the proposition that the petitioner benefited indirectly by becoming the sole remaining stockholder and possibly by an appreciation in the value of his stock due to such undivided ownership of the company. In rejecting this argument, the court reasoned from *Holsey v. Commissioner*⁸³:

It is of course, true that the taxpayer was benefited indirectly by the distribution. The value of his own stock was increased, since . . . he became sole stockholder. But these benefits operated only to increase the value of the taxpayer's stock holdings; they could not give rise to taxable income within the meaning of the Sixteenth Amendment until the corporation makes a distribution to the taxpayer or his stock is sold. . . .

[I]f a man owns shares in a corporation which gradually become more valuable through the years he is not taxed because of the increase in value even though he is richer at the end of each year than he was at the end of the year before. If he disposes of that which has increased, of course he must pay tax upon his profit. All of this is hornbook law of taxation; nobody denies it.⁸⁴

The court then drew three conclusions in reaching its result:

- (1) petitioner received none of the distribution in redemption of the investor's stock, to wit, no economic benefit;
- (2) the corporation did not discharge an existing financial obligation of the petitioner;
- (3) nor did he receive any indirect taxable benefit by becoming the sole stockholder, without more.

It is submitted, that in deciding this case, the first conclusion could well have been determinative under the rationale of *Decker* for there the court went to great lengths pointing out that there could be no taxable event if, in fact, no economic benefit passed to the taxpayer. The existence of a corporate plan or a legitimate corporate use for the stock (a corporate intent to purchase the stock) might be difficult to establish on these facts, but then the case was not argued on this point, so obviously such evidence would be lacking. However, if we assume that the stock was worth what the corporation paid, then it did receive consideration, and as *Decker* points out, to find a dividend would require ignoring the redeemed stock now held in treasury.⁸⁵

It may well be that this argument is open to the criticism that it contravenes the express intent of Congress in separating the "essentially equivalent to a dividend" language into what happens at the shareholder level

Idol, text to note 87 et seq. *infra*, where the court, in an analogous situation looked through the form to the substance of the transaction and found a taxable dividend, and *Bradbury v. Commissioner*, *supra* note 17, at 114 where the court stressed that tax laws deal with "realities" and look at the "entire transaction."

⁸³ *Supra* note 80.

⁸⁴ *Id.* at 868.

⁸⁵ *Supra* note 69, at 332.

[302(b)(1)] and the corporate level [346(a)(2)], for here we are talking of corporate intent as being a necessary ingredient if the transaction is to fall within 302(b)(1). But the cases compel this conclusion. This "corporate intent" is no different than the legitimate corporate business purpose discussed in *Bradbury, Neff, Carey, Ballenger et al.* Thus, as a factor to be considered in determining net effect, it is a necessary ingredient in any determination of section 302(b)(1). Considering the *Ballenger* opinion, this is belaboring the obvious. However, the point of contention is that "corporate business purpose", viewed as a factor, requires examination at the corporate level, to wit, corporate motive. Consequently, if "business purpose" is a proper consideration under 302(b)(1), and the courts are unanimous that it is, how can dividend equivalency be decided solely by looking at what happens at the shareholder level?

Obviously then, Congress only intended that one type of redemption be divorced from section 115 in drafting section 346(a)(2)—that of corporate contraction.⁸⁶ *Legitimate* corporate shrinkage, should be distinguished from this line of cases where there is no lessening of corporate activity. The former are partial liquidations, the latter may or may not be taxable dividends.

*Edgar S. Idol*⁸⁷—The third case in point of time is perhaps the most interesting of the series. It is significant in that it highlights the ease with which the tax court will look past the form to the substance of the transaction in finding dividend equivalence.

Idol, desirous of purchasing the outstanding stock of Speedway Transports Inc. (hereinafter referred to as Speedway) represented by ninety shares held by one Florman, entered into a contract of sale and an escrow agreement. By the terms of the agreement, the stock was registered in Idol's name, he in turn promising to deliver to the escrow agent \$112,500 in exchange for the stock. Idol, further assumed management control of the corporation. To effect the agreement, Idol borrowed \$112,500 from Security Credit Company on February 28, depositing it in his own bank account. The following day he *loaned* Speedway \$60,000 which the corporation on that same day used to redeem forty-eight shares of Florman's stock. Also on the 29th, Idol issued a check payable to Florman in the amount of \$52,500 for which he received the remaining forty-two shares of Speedway stock held in escrow. These he used as security for his loan.

On February 28, Idol also entered into an agreement with Speedway and Cassens Transport Co. (hereinafter referred to as Cassens) whereby Cassens would purchase thirty-two of Idol's forty-two shares for \$40,000. Immediately following the purchase, a special meeting was to be held during which the corporation would redeem the thirty-two shares held by Cassens in exchange for operating rights and equipment of Speedway. On March 1, Speedway issued to Idol its promissory note for the \$60,000 and on May 1, the agreement with Cassens was consummated. Idol applied the \$40,000 re-

⁸⁶ See the discussion, *supra* note 13, where Professor Bittker states this conclusion.

⁸⁷ 38 T.C. No. 47 (June 27, 1962).

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ceived from Cassens as well as \$41,300 received from Speedway in subsequent payments on its note, against his loan from Security Credit.

On these facts, the tax court sustained the Commissioner's contention that the payments by Speedway to Idol on its alleged note constituted distributions essentially equivalent to dividends within the meaning of section 302(b)(1). The court reasoned that despite all the evidence of indebtedness, the transaction

was wholly lacking in substance. The sole purpose of the transaction initiated by Idol was the satisfaction of his personal obligation to Florman No corporate purpose was served by the reacquisition by Speedway of 48 shares of its stock from its sole stockholder.⁸⁸ Therefore, although the parties have cast the transaction in the form of loan, we are convinced . . . that no actual borrowing of funds by Speedway from Idol took place. [Footnote added.]⁸⁹

The court cited *Wall* as authority although recognizing that factually, the case was not squarely in point. Alternatively, it treated the corporate payments as distributions in partial discharge of Idol's indebtedness to Security Credit.

As to the transaction with Cassens, the Commissioner called it "tax-motivated sham manipulations and in actuality constituted a sale of assets by Speedway to Cassens followed by a dividend distribution . . . of \$40,000 to Idol"⁹⁰ and well it was for there was considerable evidence indicating that all Cassens was interested in was the equipment.

The tax court agreed:

It is true . . . that on its face the transitory registration of stock ownership in the name of Cassens followed by registration in the name of Speedway and accompanied by a shifting of stock certificates representing 32 shares from Idol to Cassens to Speedway, formally complies with the requirements of stock redemption under section 302(b)(3) of the 1954 Code, and *looks* like a . . . 'complete redemption of all the stock . . . owned by [Cassens].'

[However, it] was so transitory and so clearly inconsistent with the actual purposes and intentions of the parties and the *ultimate results* . . . to be entirely lacking in substance. The purpose of Speedway was to transfer assets to Cassens and it did so; the purpose of Cassens was to acquire . . . assets of Speedway and it did so. Thus, in effect, Cassens purchased assets from Speedway even though it momentarily received stock in order to do so.⁹¹

⁸⁸ The first paragraph of the stock purchase contract states that the "Vendor hereby sells to Vendee all of the capital stock of Speedway Transports Inc." Paragraph 4 authorized Idol to sell the stock prior to his discharge of liability to Florman in the event of a sale of Speedway's business or assets. The stock was registered in Idol's name and he exercised complete management and control of Speedway. On these facts, the court was of the opinion that Idol was the sole owner of the corporate stock.

⁸⁹ Supra note 87, at 14.

⁹⁰ Id. at 15.

⁹¹ Id. at 17-18.

Despite the lengthy opinion, the court does place its thumb on the pulse of the matter in stating: "Petitioners have not established that Speedway had a real intention to reduce its capital or to redeem any part of its outstanding stock."⁹² Failing thus, everything is shareholder motivated. Considering that the court, looking through form, found the distribution to be constructively pro rata and that earnings and profits were (in fact) available for distribution, either test set out in *Ballenger* would produce the same result.

Nevertheless, the pervading factor in this line of cases is inescapable here, *i.e.*, what economic benefit did Idol receive with respect to the \$60,000 transaction. If Florman sold forty-two shares to Idol and the corporation redeemed the remaining forty-eight, there would be no dividend. As the *Decker* court concluded, the *net effect of the transaction when completed amounted to a purchase by the corporation*.

However, the argument is without merit in view of the above quoted language of the opinion—" . . . actual purposes and intentions of the parties and the ultimate results . . ." states the court—not *or* the ultimate results. Thus, speaking in the conjunctive rather than the alternative, the court imposes a dual aspect. In terms of the earlier discussion this duality is "economic benefit" and "corporate intent or plan." As stated, the language of the court supports the conclusion reached in *Decker* emphasizing the fact that the finding of "no economic benefit" without the finding of a "plan" is not sufficient to prevent the operation of section 302(b)(1) in cases of this nature.

*Aloysius J. McGinty*⁹³—Last but certainly not least, *McGinty* in raising still another problem in this area brings out the distinguishing features of the important pre-1954 Code cases.

In substance, *McGinty*, a minority stockholder in 1950, contracted to purchase all the remaining outstanding stock of the B Corporation. The purchase was financed by a formal loan of \$40,000 executed by the corporation to *McGinty's* wife. The proceeds of the loan were turned over to the sellers who endorsed their shares to *McGinty*. In 1954, petitioner as sole stockholder surrendered the shares thus purchased to the corporation for redemption in cancellation of his wife's indebtedness. HELD: The discharge of indebtedness in consideration for the shares was essentially equivalent to a dividend and taxable to the extent of \$19,000 of available (in fact) corporate earnings and profits—citing the *Wall* case.

Heavy reliance was placed on the distinction between *Holsey* and *Wall*, decided under the 1939 Code.⁹⁴ In the former the taxpayer had assigned

⁹² *Id.* at 17.

⁹³ 38 T.C. No. 89 (Sept. 17, 1962).

⁹⁴ The court stated that the *Priester* court, *supra* note 78, in applying *Holsey*, recognized the operative scope of the *Wall* case. However, the "undisputed" point of contention that the court relies on from *Priester* was, in that decision, pure unadulterated dictum. The context in which it is contained was not a conclusion of the *Priester* court but rather a premise of the Commissioner's argument as re-stated by the court. Courts, faced with the responsibility of deciding cases on the basis of a factual inquiry would do well to refrain from such practices.

an "option to purchase" to the corporation—thus no obligation on the part of the taxpayer to purchase, and in the latter the taxpayer was under a contractual obligation to purchase—which obligation was discharged when the corporation assumed his notes. True, the latter is similar to the instant case and is forceful precedent for finding a dividend. However, the other conclusion in *Holsey*, that of no economic benefit to the taxpayer, is available for argument, conditioned, of course, on the finding of a plan.

McGinty argued that he could have achieved the same result by having the corporation purchase the stock directly from the seller. However, "the point is that he did not," countered the court—unmindful apparently of the extent to which the *Decker* court went beyond the form to the substance of the transaction. In finding that the corporation distributed a dividend in discharge of petitioner's indebtedness, the court drew from the language of several 1939 Code cases as a complete answer to petitioner's position:

. . . it is form which often must prevail, when the delicate question involved is whether the extraction of a corporation's earned surplus has been accomplished at less than the rates taxed upon ordinary income If a taxpayer has two legal methods by which he may attain a desired result, the method pursued is determinative for tax purposes without regard to the fact that different tax results would have attached if the alternative procedure had been followed Indeed the statute directs that the 'manner' of the transaction be the controlling factor.⁹⁵

This is the novel feature of the decision, for the tap of a "form over substance" result will almost invariably give off a hollow sound. At any rate, note the emphasis afforded the word "manner" in the above passage.⁹⁶ Since this was a term of the essentially equivalent to a dividend provision of the 1939 Code, it might well justify the form over substance result in these pre-1954 Code cases. Section 115(g) stated "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." Thus, if the taxpayer chose a *manner* that was essentially equivalent to a dividend, it would be controlling. But since section 115(g) has been codified into section 302(b) and the language "in such manner" eliminated, it could well be that the justification for the above results was also eliminated. Net effect, ultimate result, no economic benefit and the finding of a plan are more appropriate tools in a working of section 302(b)(1). Submitted, therefore, that the form over substance argument contravenes the application of any net effect test⁹⁷ and has no significance within the mean-

⁹⁵ Supra note 93, at 5.

⁹⁶ The *McGinty* court recognized this in a footnote of its opinion but considered it unimportant because it believed that the 1954 Code provisions "were intended to incorporate the interpretation given section 115(g) of the prior law." Ibid. The inference running here is that the court intended *all* existing law to carry over into section 302. The Senate Report expressly negates this.

⁹⁷ "In determining the incidence of taxation, we must look through form and search out the substance of a transaction." *Commissioner v. Court Holding Co.*, 324 U.S. 331, 333 (1945).

The basic concept of tax law is particularly pertinent to cases involving a series

ing of section 302. Considering the extent to which the *Idol* court looked through form in finding a dividend, the instant court's argument cannot stand. If any degree of certainty is ever to be achieved in this area of the law, the test of net effect must be likened to a double-edged sword—surely it *must* cut both ways. Therefore, the case would more properly have been decided on the basis of the first three cases of this series, *i.e.*, conceding no economic benefit to the petitioner but finding no evidence of a plan rather than on the court's nebulous concept of form over substance.

CONSTRUCTIVE STOCK OWNERSHIP

*Archbold v. United States*⁹⁸—A corporation redeemed all of its issued and outstanding preferred stock, held exclusively by the petitioner. At the time of the transaction, petitioner's husband and son held eighty-nine per cent of the issued and outstanding common stock which was constructively attributed to her by virtue of section 318. As a result, the distribution was held to be essentially equivalent to a dividend within the meaning of section 302(b)(1) because her proportionate interest in the total combined stock of the corporation before and after was constructively considered to be ninety-eight per cent. Thus, her percentage of ownership and degree of control over the corporation was unaltered by the redemption.

The court further found that there was no contraction; that there was no evidence as to the initiation of the redemption, and in so closely held a corporation such evidence would not be significant; and that the corporation had, in fact, earned surplus in excess of the distribution. However, the most significant factor considered by the court was that petitioner's holdings were by reason of section 318 substantially identical before and after the distribution. Nor should this be surprising, if in fact the *Bradbury* case was rightfully decided. Recall that the *Bradbury* court, applying section 318, determined that the distribution was pro rata, treating it as the "basic criterion" and affording it a "pre-eminent position."⁹⁹ But even, if one wishes to quarrel with the *Bradbury* court, the virtual conclusive presumption attached to pro rata distributions as reasoned by Judge Bell in the *Ballenger* case¹⁰⁰ would compel such a result.

However, the point of discussion is not whether the distribution is pro rata but rather whether it should be considered pro rata per force of section 318, and if so, whether the same significance should attach to a *constructive* pro rata redemption as to an *actual* pro rata redemption. In answer to the first, the rules of section 318 are expressly made applicable to section 302 by reason of section 302(c)(1) which states that "... section 318(a) shall apply in determining the ownership of stock for purposes of this section."

of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of a relief from taxation. The series of closely related steps in such a plan are merely the means by which to carry out the plan and will not be separated.

Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954).

⁹⁸ 201 F. Supp. 329 (D. N.J. 1962).

⁹⁹ See text to *supra* note 22.

¹⁰⁰ See text to *supra* note 53.

One writer, however, advances an argument exempting 302(b)(1). He notes that the words "ownership" and "owned" are found only in sections 302(b)(2) and (b)(3); that 302(b)(1), the section that deals broadly with redemptions not essentially equivalent to a dividend, is silent as to these terms. It then follows in his opinion, as a matter of strict statutory construction that section 318 does not apply to section 302(b)(1).¹⁰¹ As a practical matter, however, both the Treasury Regulations to the 1954 Code¹⁰² and more importantly, the general interpretation of the courts have favored its application. Thus, the question is more one of degree of application.

The Commissioner in two early rulings went no further than attribution of ownership in finding that the redemption distributions did not qualify for sale or exchange treatment under section 302(b)(1),¹⁰³ thus treating the application of section 318 as conclusive. As stated earlier, the *Bradbury* and, from the above language, the *Archbold* courts are relatively in accord. On the other hand, it has been urged that if "this section [302(b)(1)] is to offer any flexibility, the attribution should not be conclusive—but merely a factor."¹⁰⁴ Judge Spencer Bell in *Ballenger* implies as much suggesting that "the attribution of ownership rules should not be too literally applied,"¹⁰⁵ and the regulations expressly state that constructive stock ownership is but "one of the facts to be considered."¹⁰⁶

Consequently, placing section 318 in its proper perspective, *i.e.*, a fact to be considered, we gain insight into both the argument advanced above exempting the application of 318 to 302(b)(1) and the arguments to be advanced. Moreover, it has been urged that section 302(b)(1) should be used to alleviate the hardships of the attribution rules for it is quite conceivable that (1) a taxpayer could lose the capital gains treatment of section 302(b)(2) because of a technicality in not having several additional shares redeemed; (2) the transaction would fall outside of 302(b)(1) because the distribution would be constructively pro rata per force of section 318; and (3) yet because of other factors, the transaction might in fact be a sale rather than a redemption.

If the virtually conclusive dividend presumption attaches alike to both *actual* pro rata distributions and *constructive* pro rata distributions, then I fear my hypothetical taxpayer will completely agree with Adam Smith, for surely the uncertainties involved will work a grave evil.

The problem is further illustrated by Professor Bittker in his statements

... that by reason of family estrangement (for example), shares owned by a spouse or by children should not be attributed to the taxpayer whose shares are being redeemed, thus allowing the redemption to qualify under §302(b)(1) although the attribution rules would

¹⁰¹ Cohen, *Redemptions of Stock Under the Internal Revenue Code of 1954*, 103 U. Pa. L. Rev. 739, 759 (1955).

¹⁰² Treas. Reg. § 1.302-1 (1955).

¹⁰³ Rev. Rul. 56-103, 1956-1 Cum. Bull. 159; Rev. Rul. 55-515, 1955-2 Cum. Bull. 222.

¹⁰⁴ Gratch, *How to Redeem a Shareholder's Stock*, 39 Taxes 169 (1961).

¹⁰⁵ Supra note 47, at 199 n.20.

¹⁰⁶ Treas. Reg. § 1.302-2(b) (1955).

prevent it from qualifying as a 'substantially disproportionate' redemption under §302(b)(2).¹⁰⁷

The reasoning is quite simple. When dissension between shareholders threatens to dissolve the corporation, the underlying rationale for attribution is completely rebutted. A stockholder at odds with other stockholders cannot realistically be considered as controlling the corporation merely because the latter's stock is constructively attributed to him. Thus, the application of section 302(b)(1) in this situation is not only justified from the standpoint of statutory purposes but as a matter of economic policy.¹⁰⁸ "Taxation of this transaction as a sale or exchange . . . would probably increase the frequency of corporate buy-outs, with a concomitant decrease in the severity and longevity of dissension. Such treatment would also decrease the cost of such buy-outs to the corporation. . . ."¹⁰⁹ The result, at any rate, has caused some concern lest these redemptions which fail to meet the mechanical test of 302(b)(2) and (3) because attribution made them essentially pro rata, might also fail to qualify for capital gains treatment for the same reason.¹¹⁰

*Thomas G. Lewis*¹¹¹—The most that can be said for this case is that it increased the above mentioned concern because

. . . the picture thus presented is one of corporate withdrawals from time to time by a dominant stockholder for her needs, where the corporation has never declared a dividend although having sufficient accumulated earnings and profits to do so, followed finally by a cancellation of the indebtedness in exchange for stock upon the death of that stockholder when only her estate had an interest in the enterprise, when such cancellation and redemption could not possibly have any economic effect upon any stockholder-corporation relationship, and where there was no plan either to contract the corporate enterprise or to use the redeemed shares in any manner for a corporate purpose.¹¹²

The decedent held a fifty-five per cent ownership of the corporate stock, the remainder being held by her daughters and their husbands. Her with-

¹⁰⁷ Bittker, *Federal Income Taxation of Corporations and Shareholders* 233-34 (1959).

¹⁰⁸ *Supra* note 104, at 177-78.

¹⁰⁹ *Id.* at 178.

Another situation which should fall within section 302(b)(1) is when the redemption is the result of the distributor's complete in fact and not just form retirement from the business. Here again, harmony and continuity of corporate management and skill seem to be the primary forces behind the redemption, and they seem to be sufficient to overcome any presumption that the transaction was a scheme to drain off corporate earnings at capital gains rates.

Ibid.

¹¹⁰ Sutter, *Corporate Distributions of Property; Stock and Stock Rights—Dividend or Redemption?* 39 *Taxes* 982, 983 (1961).

¹¹¹ 35 T.C. 71 (Oct. 20, 1960).

¹¹² *Id.* at 78.

drawals exceeded \$20,000 at the time of her death and aside from her corporate stock, the value of her estate was less than her indebtedness owing to the corporation. Thus, her estate sold fifty shares to the corporation in satisfaction of the debt reducing the estate's ownership from fifty-five per cent to forty-five per cent and distributed the remaining stock to her daughters.

The tax court conceded that under the 1939 Code this might not have been "essentially equivalent to a dividend" because the redemption materially altered the proportionate ownership of the estate. In fact, if the redemption had been effected by the decedent while alive, it could have qualified for capital gains treatment under the mechanical test of section 302(b)(2) had a few additional shares been redeemed to reduce her retained percentage to forty-three per cent. But since section 318 caused the estate to be considered as owner of 100 per cent of the stock,¹¹³ the redemption was held to be a pro rata distribution and a taxable dividend.

The pivotal point of decision was the pro rata nature of the distribution. In view of what has been said, if we can question the *Bradbury* court's overindulgent application of the constructive pro rata effect, what of the instant decision? Here, the court used a double application of section 318 whereby the daughters were treated as owning the stock of their husbands and the estate as owning the stock of the daughters in order to conclude that the redemption was pro rata. If attribution is but a factor, should the court have so heavily relied upon a constructive finding of pro rata? Should they have stated that they "must" so attribute the stock? In answering this question, bear in mind the exception to the constructive ownership rules as provided in section 318(a)(4)(B) pertaining to stock owned within a family group. The exception is intended to make clear that unless the stock is directly attributable to the individual whose stock ownership is in question, the constructive ownership rules of section 318(a)(1) do not apply, thus eliminating the type of double attribution operative in the instant case. At least with respect to family groups, Congress has recognized the harshness of such practice. The exception does not apply to estates, but its very existence should be a further consideration in determining the true pro rata nature of the distribution and the weight to be afforded such a constructive pro rata finding. Furthermore, why wasn't the redemption brought within the shelter of section 303? From the facts as presented, it appears that the mechanics of that section have been satisfied.

*Estate of Arthur H. Squier*¹¹⁴—Judge Raum, who had decided the *Lewis*

¹¹³ Applying the constructive ownership rules of section 318(a), we must consider that the stock owned by the husbands of the three daughters is to be attributed to the daughters themselves under paragraph (1)(A)(i); that the stock thus attributed to them must be treated under paragraph (4) as 'actually owned by' them; and that therefore their own stock plus the stock thus attributed to them must in turn be attributed to the estate under the second sentence of paragraph (2)(A) [Therefore] the estate is to be regarded as owning 100 per cent of the stock.

Supra note 111 at 78.

¹¹⁴ 35 T.C. 950 (Mar. 16, 1961).

case, also decided *Squier*. The case was cast in a similar setting whereby an estate held 50.09 per cent of a corporation's stock directly and a total of 63.30 per cent directly and constructively, the remainder being held by an unrelated party. The corporation had an extremely conservative history of dividend payments but more importantly, as emphasized by the court, there was a cleavage between the estate and those persons whose stock was attributed to it. Thus, a redemption of estate stock sufficient to reduce the estate's direct holding to 41.27 per cent and its attributed holdings to 56.82 per cent was held not essentially equivalent to a dividend. The court reasoned that while section 318 precluded the redemption from satisfying the mechanical tests of section 302(b)(2) and (3), they did not make the redemption pro rata since there was a substantial minority interest.

The court did an admirable job in distinguishing *Lewis* on its facts despite the contentions of the parties which revolved largely around the applicability of the *Lewis* decision. It would have been very easy for the court to "muddy" its decision by over-emphasizing any pro rata effect or dominant shareholder position by applying section 318, especially in view of its strong pro rata language in *Lewis*. But to the contrary, Judge Raum tersely remarked that "in spite of the attribution rules . . . the redemptions herein in fact resulted in a crucial reduction of the estate's control over the corporation. . . . We think these circumstances serve to distinguish the *Lewis* case."¹¹⁵ Not only did the Commissioner acquiesce in the decision but it was followed in the much weaker *Parker* case.

*Herbert C. Parker*¹¹⁶—The taxpayer held 50.3 per cent of the corporate stock; his son whose stock was attributed to the taxpayer owned 47.4 per cent, and the balance or 2.3 per cent was held by an outsider. When the taxpayer sold sixty per cent of his stock to the corporation, the Commissioner contended that he failed to meet the tests of section 302(b)(1) arguing

. . . that the constructive ownership rules of section 318 must be applied in determining essential equivalence to a dividend under section 302(b)(1); that Congress intended to confine section 302(b)(1) to non-voting preferred stock redemptions and minority stock redemptions; and that, in any event, this redemption does not qualify for sale or exchange treatment even under the more liberal rule of section 115(g)(1) of the 1939 Code.¹¹⁷

However, the court recognized that the

effect of the redemption was to transfer effective control of the corporation from Parker to his son, with whom he had had substantial controversy about the running of the business prior to the redemption. This transfer of control, preceded by disagreements as to the management of the Company, so affects the total factual picture as to persuade us that, notwithstanding the family relations involved,

¹¹⁵ Id. at 955-56.

¹¹⁶ 20 CCH Tax Ct. Mem. 893 (1961).

¹¹⁷ Id. at 900.

this redemption of petitioners' stock only was not essentially equivalent to a dividend.¹¹⁸

Note the mandatory language of the Commissioner in stating that the attribution rules *must be applied*. This language was used in *Lewis* and inferred in *Bradbury*, among others. The court here, however, places attribution in its true perspective relying heavily on *Squier* and distinguishing *Lewis* because there "the findings [were] devoid of any reference to controversy or adversity of interest among the various shareholder interests."¹¹⁹

The result coincides with the present views of two writers, Bittker¹²⁰ and Gratch,¹²¹ discussed *supra*, although the latter in treating this line of cases was not too optimistic about the future. He pondered whether

the courts will be more flexible in their application of the attribution rules to Section 302(b)(1) or whether they will accept the Commissioner's conclusive approach but will hold that a different definition of 'equivalent to a dividend' is to be applied in these constructive ownership cases, or whether they will fully sustain the Commissioner, remains to be seen.¹²²

However, if *Lewis*, *Squier* and *Parker* are indicative of a trend, it would appear that Gratch is unnecessarily concerned. On the other hand, considering the emphasis of section 318 in *Archbold*, a post dated case, perhaps he is justified for the decision is not clear as to which Gratch-alternative the court was following.

CORPORATE CONTRACTION AS A FACTOR IN DETERMINING NET EFFECT

It is interesting to note at this point that in the discussion of the cases, from *Bradbury* to *Archbold*, the courts, determining the applicability of section 302(b)(1), consider "business contraction" as a relevant factor. Yet, in the introduction of this commentary, it was clearly shown that distributions resulting from business contractions, if they are to be classed as "not essentially equivalent to a dividend," must find sanction under section 346(a)(2). If that section primarily involves the concept of corporate contractions,¹²³ and if the purpose in codifying Section 115 of the 1939 Code was to reclassify "those distributions characterized by what happens solely at the corporate level by reason of the assets distributed . . . within the concept of a partial liquidation,"¹²⁴ how then can these courts justify such language? Perhaps the most obvious answer lies in the fact that Congress defined the tests to be applied in interpreting the essentially equivalent language of the 1954 Code as those generally being applied under the 1939 Code. The courts, in alluding to the case law under the latter have indis-

¹¹⁸ Ibid. The *Bradbury* court discussed *Lewis*, *Squire* and *Parker* in footnote 7 of its opinion reaching this same result. *Bradbury v. Commissioner*, 298 F.2d 111, 116-17 (1st Cir. 1962).

¹¹⁹ *Supra* note 117.

¹²⁰ *Supra* note 107 and accompanying text.

¹²¹ *Supra* notes 108, 109 and accompanying text.

¹²² *Supra* note 104, at 176.

¹²³ See the Senate Report, *supra* note 13 and the accompanying discussion.

¹²⁴ See text to note 10 *supra*.

criminally and in toto applied the early tests which treated both redemption and partial liquidation as factors determinative of the essentially equivalent language of section 115. The extracts of court language throughout this commentary should make this obvious. However, to resolve any doubt, consider the following cases.

*Sullivan v. Bookwalter*¹²⁵—This 1963 reported case deals principally with the court's charge to the jury which for our purposes is clearly indicative of the argument advanced above. The court instructed the jury that the case must be decided within the essentially equivalent to a dividend language of section 302. Said the court:

If you find that there was a bona fide business purpose in the transfer of . . . stock . . . that there was a plan to contract the . . . business and ultimately to abandon it . . . then these factors may be considered, although not controlling, as supporting plaintiff's contention that the transaction was a sale or exchange of a capital asset.

Factors to be considered by you in determining whether or not the transaction was essentially equivalent to a dividend are:

1. Whether the distribution resulted in any substantial change in ownership or control.
2. Whether there was any contraction in corporate business.
3. Whether or not there is a legitimate business purpose for the redemption of the stock.
4. Whether there were earnings or profits available and the effect on corporate finances as compared with a regular dividend.
5. The net effect of the over-all transaction.¹²⁶

Following these detailed instructions, the jury found that the acquisition of stock of an incorporated automobile dealership for \$240,000 by an incorporated finance company, both of which corporations were controlled by the plaintiffs, was undertaken for the bona fide business purpose of *contracting* the automobile dealership activities with a view to ultimately concentrating on the financing business. Accordingly, the sale of such stock by the plaintiffs to the finance company was not a distribution essentially equivalent to a dividend, within the meaning of section 302.

The charge is devoid of any mention of section 346, supposedly, that section designated by Congress to deal with corporate contraction or partial liquidation. The court, in enunciating a strict net effect test incorporating as factors, both contraction and business purpose, very definitely "muddies the draftsmen's goal of separating into their significant elements the kind

¹²⁵ CCH 1963 Stand. Fed. Tax Rep. (63-1 U.S. Tax Cas.) ¶ 9,151, 87,247 (Jan. 1963).

¹²⁶ *Id.* at 87,249.

of transactions incoherently aggregated by the 1939 Code in the definition of a partial liquidation.¹²⁷ If the court was aware of the separation of distributions which may have capital-gain characteristics at the shareholder level from those characterized by what happens solely at the corporate level, as attempted by the draftsmen of the 1954 Code,¹²⁸ it is not reflected in the opinion for as Professor Chommie states:

Section 346, labeled Partial Liquidations defined, provides the basic criteria for determining whether a distribution in redemption because of what 'happens solely at the corporate level' is to be given capital gains or dividend treatment. This determination depends on whether the distribution in redemption is 'essentially equivalent' to a dividend or is 'a genuine contraction of the business.'¹²⁹

Thus, this imposition of corporate contraction as an important consideration in determining dividend equivalency under section 302(b)(1), questions the usefulness of that section in light of the congressional intent that section 302 looks only to events at the shareholder level.¹³⁰ The courts in refusing to recognize the distinction, raise the further question whether or not the cleavage is more theoretical than practical or in a more hackneyed vein, whether or not it is possible to teach old dogs new tricks. The latter may seem a bit unfair, if in fact the courts do recognize the difference and if it does admit of a practical application. However, it is submitted that clarity of expression should be a judicial tool of the trade and not merely a rare and enlightening event. If the distinction is real, the courts should really distinguish it!

SECTION 346(a)(2)¹³¹

A distribution is to be treated as in partial liquidation of a corporation under §346(a)(2) if it (a) 'is not essentially equivalent to a dividend,' (b) is in redemption of a part of the stock of the corporation pursuant to a plan, and (c) occurs within the taxable year in which the plan is adopted or within the succeeding taxable year. The first of these requirements invokes the 'corporate contraction' doctrine and poses some troublesome problems; the second and third requirements are formal in nature and should ordinarily be easily satisfied.¹³²

The pattern of judicial development is therefore the issue before us—to explore the certainties of section 346(a)(2), if it does admit of certainty, and to highlight its judicial treatment under the 1954 Code.

Addressing ourselves to the "certainties," we have already seen that

¹²⁷ See text to note 11 *supra*.

¹²⁸ *Supra* note 10 and accompanying text.

¹²⁹ Chommie, Section 346(a)(2): The Contraction Theory, 11 Tax L. Rev. 407, 412 (1956).

¹³⁰ Cf. Gratch, *op. cit. supra* note 104, at 176.

¹³¹ Section 346 defines the term "partial liquidation" although section 331(a)(2) is the operative provision requiring the distribution in partial liquidation to be treated as the proceeds of a sale of the stock.

¹³² Bittker, *op. cit. supra* note 107, at 216.

despite several references to "existing law" in the Senate Report, pre-1954 law of "corporate contractions" was not ratified in all respects.¹³³ Nor would such an interpretation be proper in view of such persuasive language to the contrary in the case of *Joseph Imbler*,¹³⁴ cited with approval in the Senate Report.¹³⁵ The tax court stated:

The issue here raised presents a question of fact depending on the circumstances of the particular case No sale or universally applicable test can be laid down Though decided cases are not controlling, they are helpful as indicating what elements have been considered important, viz., the presence or absence of a real business purpose, the motives of the corporation at the time of distribution, the size of the corporate surplus, the past dividend policy, and the presence of any special circumstance relating to the distribution.¹³⁶

This basically is Professor Bittker's argument for he believes "it would be improper to interpret a general intention to carry forward 'existing law' as either a blanket endorsement of every judicial decision theretofore rendered or as preventing further evolutionary developments in what is at best an imprecise concept imposed upon very divergent sets of facts."¹³⁷ With his argument so conditioned, he concludes that "the existence of conflicting decisions and inconsistent approaches in the pre-1954 case law makes judicial choices in the future unavoidable. The 'corporate contraction' doctrine, then, must be viewed as an organic concept, not as a frozen body of rules."¹³⁸

It is difficult to quarrel with his conclusion since literal or inflexible interpretations, as evidenced by the discussion of section 302(b)(1), unduly restricts any type of factual inquiry. However, issue may be taken over whether or not section 346(a)(2) involves an "imprecise concept." Divorced from its imprecise setting under the 1939 Code, and placed in its proper perspective under the 1954 Code, it may readily admit to certainty of application.

*United States v. Carey*¹³⁹—As indicated in the previous discussion of this case, the Eighth Circuit had the first shot at interpreting the "essentially equivalent" language of the 1954 Code. Unfortunately, the court sidestepped a legitimate opportunity to rule on the precise application of section 346(a)(2) and to differentiate it from section 302(b)(1).

The trial court held that the redemption, since it resulted in a reduction of capital (thus a contraction of corporate activity) and because it was part of a plan, completed within the time limits prescribed by section 346(a)(2),

¹³³ S. Rep. No. 1622, 83d Cong., 2d Sess. 262 (1954) stated flatly that a distribution of a reserve for expansion is not a partial liquidation.

¹³⁴ 11 T.C. 836 (Nov. 22, 1948).

¹³⁵ *Supra* note 133.

¹³⁶ *Supra* note 134, at 840.

¹³⁷ *Supra* note 132, at 219.

¹³⁸ *Ibid.*

¹³⁹ 289 F.2d 531 (8th Cir. 1961) (*supra* note 42).

was a distribution in partial liquidation. The circuit court, summarily concluding that "Congress had no intention to change the meaning of 'essentially equivalent to a dividend' as interpreted by the courts on cases arising under the 1939 Code,"¹⁴⁰ affirmed on the sole ground that section 302(b)(1) was properly applied. The court in disposing of section 346(a)(2) stated:

Thus we deem it unnecessary to determine the troublesome and doubtful question of what constitutes a contraction of business under § 346, and the additional question of whether the court was justified in determining in its second conclusion that the transaction resulted in a contraction of the corporate business such as to warrant the application of § 346(a)(2).¹⁴¹

Little can be said for such language for the tendency here certainly is to discourage future resort to section 346(a)(2). If the court considers this to be a *troublesome* and *doubtful* area and that Congress has failed in its attempt to clarify the mechanics of this section, how can it justify its own abdication of a judicial function, that of interpreting the law. On this point the opinion is of little value. Certainly it could have provided a far greater service to the taxpayers and the practicing bar by at least venturing an opinion as to whether or not it considered the particular corporate activity involved a legitimate partial liquidation.

Furthermore, the court failed to consider the treasury regulation which provides that where both sections 302 and 346 apply—the latter section is controlling.¹⁴² Query whether this means that the court should have ruled on section 346 for had it been applicable, it would have been determinative. True, the result would have been the same, but considering the criticisms leveled at the court's application of section 302(b)(1) and the fact that it was a case of first impression under the new code, the need for interpretation takes on more significance.

An attempt at "perspective" can be found in *Ballenger v. United States*,¹⁴³ which was previously discussed, where the applicability of section 346(a)(2) was raised on the court's own initiative.¹⁴⁴ The redemption in question was a final step resulting in complete liquidation of the corporation's preferred stock over a several year period. However, the court could find no evidence of a *plan* of contraction and in fact corporate operations were steadily expanding. This factor was afforded primary consideration although the court conceded that a legitimate contraction is not the sole factor.¹⁴⁵ Other facts considered were the corporation's poor dividend history, earned surplus in excess of the distribution and the unaltered proportion of stock ownership and control.

¹⁴⁰ Id. at 537.

¹⁴¹ Id. at 536.

¹⁴² Treas. Reg. § 1.346-2 (1955).

¹⁴³ 301 F.2d 192 (4th Cir. 1962) (supra note 49).

¹⁴⁴ The taxpayer did not argue "partial liquidation" nor was the case tried before the district court on that theory.

¹⁴⁵ Judge Spencer Bell cites the sharp criticism of such a reliance on corporate contraction as a legitimate test in determining whether a redemption is essentially equivalent to a dividend in Bittker, *The Taxation of Stock Redemptions and Partial Liquidations*, 44 Cornell L.Q. 299, 307 n.22 (1959).

Apart from a poor dividend history, these same factors were considered in *Bradbury v. Commissioner*,¹⁴⁶ also previously discussed, where the court was likewise unable to find a plan or policy of contraction. In *Bradbury*, as in *Ballenger*, the taxpayer did not seek protection under section 346(a)(2) although she did argue "contraction" as a factor to be considered in determining the "net effect."

The evidence of a "contraction" consisted of the following facts. The Bradbury Corporation was engaged principally in the manufacture of long lumber but as an adjunct to its main operation, it also manufactured box shocks which were made into boxes in a separate building called the "box mill." The taxpayer asserted that the capacity of the new mill, after the then existing box commitments were completed, made possible the closing of the box mill and elimination of that activity. The Commissioner argued that this contraction or narrowing of activities was not specifically in contemplation at the time the stock was redeemed and the construction loan negotiated. In answer to this the petitioner, in her reply brief, cites an expression in *United States v. Fewell*¹⁴⁷ to the effect that the transaction need only result in a contraction of the corporation's business. This may have little merit in view of the "pursuant to a plan" language of section 346(a)(2), but the point of the matter is petitioner was arguing section 302(b)(1). Thus the issue of legislative purpose is squarely raised. If Congress intended distributions which result from a legitimate shrinkage or contraction of a corporation's business to be treated under section 346(a)(2), petitioner should have argued partial liquidation in the alternative and marshalled her facts accordingly. By arguing "contraction" as a factor in determining net effect, petitioner completely ignores the legislative purpose in separating certain types of redemptions that are not essentially equivalent to a dividend. Not only was her contraction argument diluted by such an approach, but the taxpayer had to meet head on the attribution rules of section 318. Whether or not the taxpayer could have advanced a strong enough argument of partial liquidation, is pure conjecture. However one thing is certain, in pursuing section 346(a)(2) she could have avoided what turned out to be her biggest obstacle, the attribution rules of section 318. They do not apply to partial liquidations, thus, the taxpayer might well have had an easier road to travel.¹⁴⁸

¹⁴⁶ 298 F.2d 111 (1st Cir. 1962) (supra note 17).

¹⁴⁷ 255 F.2d 496, 500 (5th Cir. 1958).

¹⁴⁸ The advantage of arguing section 302(b)(1) lies in the judicial recognition of an over-riding legitimate corporate business purpose, which was basically the taxpayer's argument. This would be of little help under section 346(a)(2) considering that a "dividend" ruling was determined by the Treasury Service on the following facts—A corporation engaged in the business of buying raw skins, tanning and selling the leather to a certain segment of the leather trade, showed consistent profits up until the last two years. The demand for the leather suffered a serious, if not a permanent decline. In an effort to revitalize the business, the corporation changed over to another type of raw skin but losses continued while inventory accumulated. Because of the depressed market and grim future prospects, purchases were reduced and inventories liquidated with an eye to complete liquidation if losses continued. Thus, the corporation proposed to redeem a portion of its stock with cash from the sale of Government bonds and from the proceeds of the inventories being liquidated in the ordinary course of business. Obviously, we have a legitimate

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*Fowler Hosiery Co. v. Commissioner*¹⁴⁹—This case not only presents a novel application of section 346(a)(2), but in supplying a definition to the “requirements of a plan” within the meaning of the section, lends some support to the taxpayer’s argument in *Bradbury*.

In the instant case, the taxpayer, Fowler Hosiery Co., attempted to avoid the capital gains treatment afforded a 346(a)(2) distribution. The taxpayer and its wholly-owned subsidiary, Fowler of Canada, sold all of their non-fixed assets and leased all of their fixed assets to Kayser and Co. of New York and its wholly-owned subsidiary, Kayser and Co. of Canada, Ltd., respectively. Subsequent to the transactions, Fowler of Canada distributed \$1,500,000 in dividends to the taxpayer, both corporations treating the distribution as a dividend to allow the taxpayer to take advantage of a substantial foreign tax credit under section 902.

The argument advanced in favor of dividend rather than partial liquidation was that the distribution resulted wholly from accumulated earnings and profits; there was no redemption of all or part of Fowler of Canada’s stock; and that the distribution was not made pursuant to a plan of complete or partial liquidation adopted by Fowler of Canada on or prior to the date of distribution. Thus said the taxpayer, the distribution was essentially equivalent to a dividend.

The court, however, sustained the tax court and the Commissioner’s determination that the distribution was received by the taxpayer in partial liquidation of Fowler of Canada and that it resulted in a long term capital gain. In adopting the tax court’s rationale, the court stated:

The Tax Court acknowledged that ‘the distribution to qualify under Section 346(a)(1) or (2) must be made pursuant to a plan’ but found no statement in the Code or regulations that the plan must be one so denominated in a formal resolution of the stockholders. Accordingly, the court held that a ‘plan’ has been established if the taxpayer has adopted formally or informally a plan which *as a matter of fact shows* itself to constitute a plan of complete liquidation or redemption of a part of the stock.¹⁵⁰

The court further held that it was immaterial that no stock was actually redeemed since the taxpayer was the sole stockholder; its interest in Fowler of Canada remained the same whether or not any portion of the stock was retired. Nor does a section 346(a) redemption necessarily require the physical surrender or cancellation of the stock. The court considered this a question of fact, correctly resolved by the tax court in favor of the Commissioner.

business purpose here but a genuine contraction could not be found. Rev. Rul. 60-322, 1960-2 Cum. Bull. 118.

¹⁴⁹ 301 F.2d 394 (7th Cir. 1962).

¹⁵⁰ Id. at 397. Also see, Rev. Rul. 59-240, 1959-2, Cum. Bull. 113. The adoption of a plan of liquidation after a distribution has been made will not qualify the distribution under section 346. However, where the management characterizes a distribution as a liquidating dividend by adopting a plan of complete liquidation, and there is a surrender of stock in connection with such distribution, subsequent modification of the plan to one which qualifies as a plan of partial liquidation will not cause the previous distributions to be treated as dividends.

Additional support for this position can be found in *McGregor v. United States*,¹⁵¹ a case where a corporation adopted a plan of liquidation of its wholly-owned construction company and lumber yards located in four states, but because of the prevailing market, required five years to complete the sale of these assets. The court held that it was not necessary that there be a cancellation of stock contemporaneously with each separate distribution in the series of distributions. A shareholder's stock need not be physically cancelled until he has been paid in full his amount due in liquidation.

It should also be noted that no attempt was made in these cases to engraft a requirement that the transaction must be considered "immediately after" the distribution as in the *Neff* case. To the contrary, these cases expressly negate any such requirement, and since the language of 346(a)(2) and 302(b)(1) is basically the same, it is arguable that this further rebuffs the court's interpretation in *Neff*.

Therefore, considering the paucity of decisions under section 346(a)(2), if vagueness of application is the reason, it may well be attributed to both the practicing bar and the judiciary. However, this is not a condemnation by any means. If a lawyer is to serve the best interests of his client, he would be highly imprudent to pursue a statutory remedy, the mechanics of which are shrouded in doubt and uncertainty. If this be the character of the partial liquidation doctrine, surely the bar in seeking devious remedies should be exhorted and not admonished.

But the fact of the matter is, as evidenced by the decided cases, that a degree of certainty has been injected into the application of section 346(a)(2). This despite Judge Van Oosterhout in *Carey* and Professor Bittker's earlier prophesies of gloom. From *Fowler* we learn that "pursuant to a plan" is satisfied if the plan is informal. *McGregor* informs us that the plan may take place over a period of years, and from the revenue ruling,¹⁵² we know that it must be in effect prior to the distribution. Furthermore, a more definite guideline is available if we are willing to apply a literal reading to the following ruling which states:

Where a corporation has earnings available, in order for the distribution of assets by it to its shareholders to be treated as a partial liquidation, the distribution must result from a genuine contraction of the business of the corporation. See *Joseph V. Imler v. Commissioner*. . . .¹⁵³

Considering that the ruling echoes the language of the Senate Report and is borne out by the case law, the obvious question, therefore, is why not accept it? For contained within this ruling, lies the preciseness attempted by the draftsmen of the 1954 Code, *i.e.*, to merely set apart from the difficult factual inquiry incident to section 302(b)(1), one type of redemption which in fact admits of certainty. Eliminating "contraction" as a factor to be considered under section 302(b)(1) should facilitate the dividend-determining process. But as we have seen, this has not been the case and the reason is all too

¹⁵¹ CCH 1960 Stand. Fed. Tax Rep. (60-1 U.S. Tax Cas.) ¶ 9298.

¹⁵² Supra note 150.

¹⁵³ Supra note 148, at 119.

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obvious. The courts and the practicing bar have refused to divorce "contraction" from section 302(b)(1) redemptions. Since more often than not, the cases are being argued on and decided under section 302, the caveat that "if . . . the definition of a partial liquidation is achieved, it will be by the painful process of . . . judicial construction of muddy language" should more appropriately refer to section 302(b)(1).

However, all of the language in the above mentioned cases has not been perspicuously penned. The *Ballenger* court looked for a legitimate contraction in determining dividend equivalency. The court afforded it "primary consideration" but stated it was not to be the "sole factor." But note, nowhere in the Senate Report, the revenue rulings or the regulations is corporate contraction considered to be a "factor," that is to say, a "part of the whole" in determining dividend equivalency. Corporate contraction is the "whole," the end result of applying the factors enumerated in the *Imler* case, quoted above. To say that "corporate contraction" is a factor is to say that "net effect" is a factor in determining the application of section 302(b)(1). Obviously this is wrong, for they are not the means to an end but rather the end themselves.

Thus the language in *Ballenger* is no more than a judicial hang-over from prior case decision. Before the 1954 Code, contraction was but a factor in determining dividend equivalency under section 115. In its codification, the draftsmen recognized that contraction was a distinguishable concept, *i.e.*, these redemptions took the corporation one step closer to complete liquidation as distinguished from redemptions which merely exhausted accumulated earnings and profits. The latter find their tax shelter from a determination that the transaction was in reality a sale. The inquiry is factual, the guidelines flexible, but the net effect of the transaction must be a sale and not a redemption. The former is protected from ordinary income tax treatment because corporate activity has been reduced by virtue of the assets distributed. The nature of the inquiry is similar to the latter, but it is directed solely at an end determination of whether or not there has been a legitimate corporate contraction.

In the Detailed Discussion of the Bill, the Senate stated, "it is intended that a genuine contraction of the business as under present law will result in partial liquidation."¹⁵⁴ However, this does not mean that all of the present judicial language dealing with contraction shall be carried forward as implied in *Ballenger*. This is because the context of contraction has been altered for it is no longer considered merely a *factor* in dividend equivalency. What is meant is that those cases in which a genuine contraction has been determined shall hereafter act as a guide in the factual inquiry incident to the application of 346(a)(2).

The misunderstanding in *Ballenger* was the same misinterpretation that led one writer to remark:

It is very doubtful if the contours of a contraction test can be prescribed with any measure of success. But even if we assume that we

¹⁵⁴ S. Rep. No. 1622, 83 Cong., 2d Sess. 262; 3 U.S. Code Cong. & Ad. News 4899 (1954).

can define "contraction," what is its relevance? By hypothesis the corporation has accumulated profits and is distributing cash representing some of these profits. The corporation does not intend to conclude its existence, for the distribution is not one of a series of distributions in complete liquidation of the corporation. The shareholders remain as shareholders, their initial investment is still intact, and their relationship to the corporation and each other has not been altered. In such a setting, the distribution of cash should be treated for what it is—a distribution of profits. The activity at the corporate level which produced the cash and the motivation behind its distribution are not matters which should affect this conclusion.¹⁵⁵

This misses the point. If the transaction is merely "a distribution of profits," it is a dividend regardless of the fact that it was initiated at the corporate level. *Bradbury* and *Neff* are poignant examples. As for mere distributions of accumulated profits without more, the Senate, in the Detailed Discussion of the Bill, explained that such a "distribution of a reserve for expansion is not a partial liquidation."¹⁵⁶ What the writer describes is the *Carey* transaction where there was merely a contraction of capital and not a contraction of corporate activity, but as we have seen, the *Carey* case was not decided under 346(a)(2)—it is not precedent in this area (nor should it be considered precedent under section 302(b)(1)). On the other hand, *Fowler* is typical of what the legislature had in mind, as are the very restrictive revenue rulings.¹⁵⁷ The search is directed toward the finding of reduced corporate activity as determined by the assets distributed, for as Professor Bittker states:

The emphasis on the *nature* of the assets distributed, as a test of partial liquidation, leaves little room for distributions that do not result from corporate contractions, since only in the case of corporate contractions has it been thought that the nature of the distributed assets was an important element in determining whether the distribution was essentially equivalent to a dividend. It is not likely therefore, that section 346(a)(2) will be satisfied by distributions that do not reflect a corporate contraction.¹⁵⁸

CONCLUSION

It is fair to say that a determination as to whether or not a corporate distribution is essentially equivalent to a taxable dividend presents, to this day, a perplexing problem. This is not to say that the problem is irremedial; for within the Treasury Regulations, the Revenue Rulings and, more importantly, the decided cases, rest ample criteria for resolution. Moreover, the present status is more directly a result of the language in the Senate Report. Stating that the tests to be applied in these determinations are "generally"

¹⁵⁵ Cohen, A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders, 52 Colum. L. Rev. 1, 37-38 (1952).

¹⁵⁶ Supra note 154.

¹⁵⁷ Supra note 148.

¹⁵⁸ Bittker, Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954, 9 Stan. L. Rev. 13, 23 (1956).

or "primarily" those presently applied, has resulted in wholesale importation of pre-1954 Code decisional language, much of which is incompatible with the legislative purpose of separating partial liquidations from redemptions. A weeding out process is required, but this will not begin until a saturation point is reached which will enable the judiciary and the bar to mold their opinions and their arguments exclusively from 1954 Code-decisional law.

When that point is reached, a section 302(b)(1) determination will direct itself solely towards a strict net effect test. In the interests of uniformity, the test will be a weighted test for the inquiry will remain factual in nature. As such, some factors will necessitate more favorable consideration within the context of the particular case.

A business purpose for the redemption which gives the transaction its sale-like qualities, will be a factor among other factors. Unnecessary is the distinction between "strict net effect" and "net effect with an overriding business purpose." This merely fosters subtle language whose meaning is incident only to the particular case but which has a tendency of reappearing as a *true rule* as in *Bradbury*.¹⁵⁹ Permitting a legitimate business purpose to prevail despite a concurrent tax avoidance motive (which was the *Carey* case although the court was reluctant to say so) can more properly be treated *within* a net effect test. Therefore, afford the "business purpose" its due weight and conclude that, all factors considered, the transaction was a sale and not a redemption in contra-distinction to the doctrine of vicarious taxation introduced by the court in *Carey*.¹⁶⁰ After all, a legitimate business purpose in these cases is no more than a legitimate use for the stock redeemed, to wit a plan. *Neff*,¹⁶¹ *Carey*¹⁶² and especially *Decker*¹⁶³ are indicative of the types of plans involved. Thus conceding the business purpose or plan in a 302(b)(1) inquiry, we necessarily must look at the motive for the distribution, *i.e.*, the corporate purpose. Here again we run afoul of the Senate Report for there we are urged to view the transaction solely at the shareholder level.¹⁶⁴ This is impossible as evidenced by the total acceptance of business purpose in the decided cases,¹⁶⁵ thus, we can say that this has already been weeded out.

The virtual conclusive presumption¹⁶⁶ of dividend equivalency now afforded pro rata or substantially pro rata distributions is warranted, but far too often it is overly stated as in *Bradbury*. The pro rata effect of the distribution, like business purpose, is a factor to be considered. In a *Bradbury*¹⁶⁷ or *Neff*¹⁶⁸ situation, it should be given considerable weight whereas

¹⁵⁹ See text to supra note 17.

¹⁶⁰ See text to supra note 42.

¹⁶¹ See text to supra note 32 (corporation needed capital and nobody would purchase from Neff).

¹⁶² Supra note 160 (shift in stock ownership to benefit the corporation).

¹⁶³ See text to supra note 69 (purchase of stock for resale to key employees). See also text to supra note 77.

¹⁶⁴ Text to supra note 10.

¹⁶⁵ *Ballenger* court summarizes the decided cases placing them into categories—net effect in which business purpose is a factor and net effect with an overriding business purpose. See text to supra note 49.

¹⁶⁶ See discussion in *Ballenger v. United States*, text to supra note 49.

¹⁶⁷ Supra note 159 (substantially pro rata as a result of attribution of stock among family members enjoying a close friendly relationship).

¹⁶⁸ Supra note 161 (sole stockholder situation).

in a *Lewis*¹⁶⁹ or *Parker*¹⁷⁰ situation, it should be cautiously applied.

A further prominent factor to be considered in any net effect test is whether or not the taxpayer actually received an "economic benefit" or a "taxable gain." Since this factor was developed under the 1954 Code-case law,¹⁷¹ it will be worthy of future consideration for it also affords the court another opportunity to view the distribution at the shareholder level. In view of the latter, it is expressly sanctioned by the Senate Report. The force of this factor lies in the fact that the conditional language of section 115, "at such time and in such manner," was discarded in the drafting of the 1954 Code, thus permitting the court complete freedom in looking through the form of the transaction to the substance.¹⁷²

Contraction, long an important consideration in dividend equivalency has no place in present determinations despite the fact that the 1954 Code decisions abound with such language. Again, this is nothing more than an improper carry-over of the decisional law under the 1939 Code. Surely time, and the beneficial recognition that 302(b)(1) determinations will be facilitated by discarding considerations of corporate contraction, will effect a remedy. Corporate activity is and will continue to be viewed from the standpoint of business purpose, not contraction, within this area of dividend equivalency.

Contraction, then, is but one type of redemption which Congress intends to be individually examined. As such it shall continue to be narrowly viewed, and its tests, rigidly applied. For this reason not all contractions will incur the favor of 346(a)(2). A contraction of the capital structure, or a reduction of inventory, where the corporate activity is not simultaneously reduced, will result in dividend equivalency. This, regardless of whether or not the distribution is pursuant to a plan, informal or formal, and whether or not the stock is simultaneously cancelled or redeemed. The primary 346(a)(2) consideration is the nature of the assets distributed as opposed to a 302(b)(1) determination which requires that the net effect of the transaction resembles a sale.

This is not to say that corporate contractions which fail the tests of 346(a)(2) may not still find shelter under 302(b)(1). The regulations are not too explicit on this point, requiring only that the former must govern when both are applicable. However, both *Ballenger* and *Carey*, as strong precedent, indicate a judicial willingness to decide the cases under 302(b)(1) when the net effect of the transaction compels such a result despite the undercurrent of 346(a)(2). In these cases, the contraction in and of itself is not significant. Rather, it is the corporate activity which motivated the contraction that both nurtures the business purpose and encourages a

¹⁶⁹ See text to *supra* note 111 (double application of section 318, estate—beneficiaries of the estate—spouse of the beneficiaries, which resulted in virtual pro rata distribution).

¹⁷⁰ See text to *supra* note 116 (dissension among stockholders whose stock is to be attributed).

¹⁷¹ See the rationale of *Decker v. Commissioner*, *supra* note 69, and the cases following within the "Discharge of Indebtedness" section.

¹⁷² See the discussion in *Decker v. Commissioner*, *supra* note 69, and *Aloysius J. McGinty*, *supra* note 93.

STUDENT COMMENTS

302(b)(1) finding. The concepts are separate and distinguishable and eventually will be so recognized. Surely the courts cannot continue indefinitely their present practice of alluding to "contraction" in a 302(b)(1) determination but never discussing it.

Nor will the practicing bar continue to avoid the alleged uncertainties of legitimate corporate contraction, if in fact the contraction is legitimate, in favor of the more flexible 302(b)(1). This is especially true in cases involving constructive ownership of stock which renders the distribution virtually pro rata. Judicial expression is so firmly entrenched that the weight afforded a pro rata distribution will not lessen with time. Since the attribution rules do not apply to 346(a)(2), a further hard look at this section should be expected from the practicing bar in the future. If we interpret *Bradbury* as a warning that *Carey* decisions will be few and far between, this "hard look" may be close at hand—and a rash of section 346(a)(2) decisions may just be that "weeding" force.

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