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TAX-FREE STOCK REDEMPTIONS FROM CLOSELY HELD CORPORATIONS

Frequently the shareholders of closely held corporate business wish to affect a change of ownership and in connection therewith attempt to withdraw the existing earnings and profits of the corporation and have these taxed at the capital gains rate under Sec. 302 of the Internal Revenue Code rather than having them taxed as ordinary dividends under Sec. 301.

Since the early part of the last decade, the Internal Revenue Service has broadened its attack on redemptions by asserting in some cases that the distribution by a corporation in redemption of its stock may be essentially equivalent to dividends constructively received by the shareholders who have not had their shares redeemed. This attack is based upon Sec. 302 (b) (1) of the IRC of 1954. Virtually no problem arises when the selling shareholder sells his interest in toto to a third party or even to the remaining shareholder outright. The problems arise when, due to the lack of available cash in the hands of the proposed buyer, it is decided that the corporation shall redeem all or part of the selling shareholder's interest out of its accumulated earnings.

This note will deal with the three usual redemption situations:

The first concerns the situation in which A and B own virtually all of X Inc. B wishes to retire from business and A wishes to purchase B's interest but is without sufficient cash to accomplish an out-right purchase. X Inc. has sufficient accumulated earnings to effect a redemption of B's shares and thus complete the desired transaction.

In the second A is the sole shareholder of X Inc. B wishes to purchase X's operating assets or a part of these assets but not its accumulated earnings. X redeems enough of A's shares to rid itself of its accumulated earnings and B purchases the remainder or a part of the remainder of A's shares.

In the last situation A and B own virtually all of the shares of X Inc. C wishes to purchase A's interest but has only enough cash to purchase part of it. C purchases what he can and X Inc. redeems the remainder. At the same time X Inc. redeems an equal amount of B's shares so that B and C will own an equal interest in the corporation.

I

The leading case in the first situation is that of *Holsey v. Commissioner of Internal Revenue*.[1] The J. R. Holsey Sales Co., a New Jersey corporation, was organized on April 28, 1936, as an Oldsmobile dealership. Petitioner had been president and a director of the company since its organization. Of the 2500 shares authorized only 20 were issued. These 20 shares were issued to Greenville Auto Sales Co.

On April 30, 1936, petitioner acquired from the Greenville Co. an

1. 258 F.2d 865 3rd Circuit, (1958).

option to purchase 50% of the outstanding shares of the Holsey Co. and a further option to purchase all the remaining shares. In November of 1939, petitioner exercised the first option. Subsequently, the second option was amended to allow an extension of time in its exercise. This revised option was in favor of the petitioner individually and was not assignable to anyone other than a corporation in which he owned not less than 50% of the voting stock.

On January 19, 1951, petitioner assigned his revised option to the Holsey Co. which immediately exercised the option and paid the Greenville Co. $80,000 for the stock held by it. This transaction resulted in the petitioner becoming the owner of 100% of the outstanding stock of the Holsey Co. At the time the option was exercised, the accumulated earnings of the Holsey Co. were in excess of $300,000. The Commissioner determined that the effect of the transaction constituted a dividend to petitioner, the remaining stockholder, on the ground that the transaction was for the benefit of the petitioner and that there was a lack of corporate purpose. These factors, it was contended by the Commissioner, made the redemption essentially equivalent to a dividend.

The 1939 Internal Revenue Code, under which the court decided the case, in Sec. 115 (a), defines a dividend as a distribution made by a corporation to its stockholders. The court, in this regard, stated, "Accordingly unless a distribution which is sought to be taxed to a stockholder as a dividend is made to him or *for his benefit* it may not be regarded as either a dividend or the legal equivalent of a dividend."[2] (emphasis supplied) The court then added:

> ". . . where, as here, the taxpayer was never under any legal obligation to purchase the stock . . . , having merely the option to purchase which he did not exercise but instead assigned . . . , the distribution did not discharge any obligation of his and did not benefit him in any direct sense."[3]

As to the government's second contention, that there was no corporate purpose for the transaction, the court said that it is the effect of the transaction, rather than the purpose which actuated it, which controls the determination of dividend equivalence.

The court added further that the most significant criterion in determing equivalency is whether the distribution leaves the proportionate interests of the stockholders unchanged as occurs when a true dividend is paid.

The IRS acquiesced in the Holsey decision but stated that, "if the stock is in reality purchased by a remaining shareholder and is paid for by the corporation, . . . , the payment will be considered as a dividend to the shareholder who made the purchase."[4]

2. Ibid, p. 868.
3. Id.
4. Rev. Rul. 58-614, C.B. 1958-2,920.

In 1960 the IRS again attempted to establish dividend equivalency on the theory of "lack of corporate purpose" in *Erickson v. United States*[5] In the Erickson case, the majority shareholder of the corporation had died and the executors of his estate desired to liquidate his shares. Of the remaining shareholders, only the taxpayer was actively engaged in the corporate business. Due to this, all were desirous that he assume majority ownership. The taxpayer, however, was limited by his lack of available assets, to the purchase of only a part of the deceased's shares, and the corporation lacked sufficient liquid assets with which to retire the remainder. One of the other shareholders had sufficient funds available to purchase the stock but was not interested in a long term investment. Thus it was agreed that this shareholder would supply the funds and such loan would be secured by the taxpayer's promissory note and the placement of the shares in escrow. With the agreement was the understanding that the corporation would repay the amount from its funds as soon as it was financially able to do so and that the shares would then be retired.[6] One year and four months later the corporation was financially able to complete the transaction and did so by paying the taxpayer's note and taking the shares from him. The court, citing with approval from the *Holsey* case, stated:

> It is not necessary that a corporate purpose for retirement of the shares, as distinguished from a purpose of all of its shareholders, be shown, for the reason that it is the effect of the retirement of the shares, not the purpose which actuated it, which controls the determination of dividend equivalence.[7]

The court further held that the tax consequences of a transaction depend upon the substance of the transaction and are not to be determined solely from the legal form employed. Here, the court said, in reality, the shares involved were purchased by the corporation from the estate, with the taxpayer acting as a temporary respository therefore until the total transaction could be consummated by the corporation's retirement of the shares.

The IRS was justified in believing that a "corporate purpose" was still an essential criterion in determining dividend equivalency because of *Decker v. Commissioner*[8] which was decided by the Tax Court in 1959. One contention made by the IRC was the lack of a valid business purpose but the court held that a plan for the acquisition and redistribution of treasury stock to key employees was a valid business purpose.

As further evidence that the "corporate purpose" doctrine has not been laid to rest, the Tax Court once again relied upon it in *Kerr v. Commissioner,*[9] a 1962 case . Here the court found that the strengthening of

5. 189 F. Supp. 521 (S.D. Ill. N.D. 1960) .
6. It is not clear from the report of the case but apparently the parties treated the transaction as a loan to the corporation in the first instance with it then purchasing the shares from the decendent's estate. This then puts the taxpayer in the position of a surety on the loan.
7. Erickson v. United States, supra note 5 at p. 524.
8. 32 T.C. 326 (1959) .
9. 38 T.C. 723 (1962) .

the credit position of two affiliated corporations and the conservation of cash through the medium of being able to file consolidated returns was not such a valid purpose as to overcome dividend equivalency.

The *Decker* case, however, is more important from the aspect of the Commissioner's argument concerning "benefit" to the remaining stockholders as a criterion for equivalency. Five persons had each originally owned one hundred shares, the total being all of the outstanding shares of the corporation. These stockholders entered into a stock purchase agreement whereby, upon the death of one of the shareholders, the survivors would purchase his shares from his estate. However, when one of the parties to the agreement died, the surviving shareholders lacked sufficient funds to make the purchase in accordance with the agreement. Therefore it was decided that the shareholders would make the purchase but the corporation would immediately purchase the stock from them.[10]

The court held that even though the shareholders were legally obligated to purchase the shares there was not such a benefit to the shareholders as would warrant dividend treatment because there was no true economic benefit advanced. This, the court said, was because the shareholder's interest did not increase.

> 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, . . .[11]

Even though the *Decker* case held as it did concerning the discharge of a legal obligation, one should not place too much reliance on it in cases with different factual circumstances. In *Priester v. Commissioner*,[12] decided by the Tax Court in May of 1962, the major contention made by respondent was that the redemption operated to discharge the petitioner's legal obligation to purchase the stock under a stock-purchase agreement and that this established dividend equivalency. The court, instead of deciding that this did not establish equivalency as in the *Decker* case, determined that the stock-purchase agreement had already been terminated before the redemption. The court added further:

> . . . if the Priester Corporation had then employed its earned surplus to discharge said obligation of petitioner to Marjorie [the selling stockholder], without receiving adequate consideration therefore from petitioner, such action of the corporation would have effected a constructive distribution of a taxable dividend to petitioner. . . .[13]

10. The shareholders were on dangerous ground as will be discussed with the second situation; and why the corporation did not purchase directly from the estate, which would alleviate the danger, is not understood.
11. Decker v. Commissioner, supra note 8 at p. 332.
12. 38 T.C. 316 (1962).
13. Ibid, p. 324.

Further aid for the government in this regard came in *McGinty v. Commissioner,*[14] decided by the Tax Court in September of 1962. In 1946 the petitioner acquired 666 2/3 shares of Berkshire Family Laundry, Inc., out of a total of 2,000 shares outstanding. A testamentary trust owned the remaining 1,333 1/3 shares. In 1950 petitioner bid $40,000 for the stock owned by the trust and his bid was accepted. At the time petitioner did not have the cash necessary to meet his commitment, and the trustees volunteered to help him acquire the money to purchase the stock. On November 21, 1950, the corporation borrowed $42,000 and immediately lent petitioner's wife $40,000 of this amount of the loan. Petitioners wife thereupon paid $40,000 to the trustees, who in turn endorsed the 1,333 1/3 shares to petitioner. In 1954, the corporation acquired the stock from petitioner in cancellation of the note receivable from petitioner's wife.

The court first found that the fact that petitioner's wife was the maker of the note was of no consequence as she was plainly acting upon his behalf. Then the court stated that the redemption operated to discharge the obligation of the note and thus it was substantially equivalent to the payment of a dividend to the extent of accumulated earnings.

Petitioner's major argument was that he could have achieved the same result by having had the corporation purchase the shares directly from the trustees and in this manner could have obtained freedom-from-dividend treatment. The court agreed with this theory but quoted an oft-cited phrase from *Woodruff v. Commissioner:*

> 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.[15]

In 1960, the Tax Court issued a memorandum decision in *Glenn-Minnich Clothing Co. v. Commissioner,*[16] which set forth the proposition that if the remaining shareholders paid for the stock prior to its redemption by the corporation, such would be treated as a constructive dividend. Little litigation has been found on this point but it is believed that the outcome of such prior purchase transactions will always be deemed to be equivalent to a dividend.

Ward v. Rountree[17] is perhaps the most comprehensive opinion written concerning situation one. In the *Ward* case, the taxpayer and his brother each owned one half of two different corporations, one in Missouri and one in Tennessee. The taxpayer was president of the Tennessee Corporation and he formulated its policies and directed its business and administrative activities. He was also vice-president and a director of the Missouri Corporation. In similar fashion, taxpayer's brother was president of the

14. 38 T.C. 882 (1962).
15. 131 F.2d 429, 430, 5th Circuit (1942).
16. ¶ 60,207 P-H Memo T.C. (1960).
17. 193 F. Supp. 154 (M.D. Tenn. Nashville Division, 1961).

Missouri Corporation, fomulated its policies and directed its business and administrative affairs. Because of differences of opinion in the management of the two corporations, it was decided that each brother would relinquish his interest in the corporation of which the other was president. That is, taxpayer would sell his stock in the Missouri Corporation to that corporation, thus leaving his brother the complete owner, and the brother would do the same with his stock in the Tennessee Corporation. The Tennessee Corporation thus purchased the brother's shares at a price based upon the fair market value. Taxpayer reported no income resulting from this purchase, but the IRS determined this to be income to taxpayer in the form of a constructive dividend.

As in previous cases of this kind, the government's major argument was that the transaction was a benefit to the remaining shareholder. The court, citing at length and with approval from the *Holsey* case, stated that unless the transaction serves to discharge an obligation of the remaining stockholder, it is not such a benefit as will give rise to dividend equivalency.

The government further argued that certain factors in this case were indicative of a taxable dividend: (a) that the corporation had no plan of contracting its business activities subsequent to the stock redemption; (b) that there was no plan for dissolution or ultimate contraction; and (c) that only nominal dividends had been paid, notwithstanding the fact that large amounts of undistributed earnings were permitted to accumulate. To this contention, the court stated:

> While such factors may be considered in a proper case to determine whether all purchases of its own stock by a corporation taken together accomplish the same result as a declaration of a dividend, they are not significant here. . . . The important factor here is that the redemption was a *complete* redemption of all the stock owned by Joseph Ward [the taxpayer's brother].[18] (emphasis supplied)

It is thus apparent that in cases in which the factual situation is similar to that of situation one, the IRS is finding it increasingly difficult to establish dividend equivalency. The "lack of corporate purpose" argument seems to have lost favor except in the Tax Court[19] and the argument of "benefit to the remaining stockholder" is restricted to situations in which the transaction operates to discharge a legal obligation.

II

This situation concerns the tax treatment to be given the shareholder whose shares are redeemed in accordance with a plan whereby an outsider purchases only the operating assets of the corporation.

At the outset a caveat is in order. The redemption of A's shares should be accomplished after B's purchase. If the redemption occurs be-

18. Ibid p. 158.
19. Supra note 8.

fore the purchase, it will be deemed essentially equivalent to a dividend to the extent of accumulated earnings and profits.

An early case, *Zenz v. Quinlivan*[20] decided under the 1939 IRC, held that where the taxpayer effects a redemption which completely extinguishes the taxpayer's interest in the corporation, and he does not retain any beneficial interest whatever, such transaction is not the equivalent of the distribution of a taxable dividend.

After this and an earlier case[21] of similar circumstances, the IRS acquiesced, though announcing that such transaction "will be closely scrutinized to determine whether the selling stockholder ceases to be interested in the affairs of the corporation immediately after redemption."[22] Subsequently, the IRS announced that it would apply the *Zenz* case to transactions governed by the 1954 Code, so that the redemption will qualify under Sec. 302(b) (3) as a sale.[23]

Regardless of the acquiescence, however, litigation continued on the subject, with the taxpayer being successful in all instances where his total interest was redeemed.[24] One of the better cases from the taxpayer's stand point was that of *Summerfield v. United States*[25] The taxpayers, husband and wife, had originally owned the stock jointly. Pursuant to a plan for the redemption of the wife's interest, the jointly owned stock was surrendered to the corporation and separate certificates were issued to each. Two days later the corporation redeemed Mrs. Summerfield's stock and the amount paid to her was reflected on the corporation's books as a reduction in capital and earned surplus. The government argued for stock attribution[26] and also dividend equivalency. Citing with approval the *Zenz case,*[27] the court stated that since Mrs. Sumerfield's shares were redeemed, thus extinguishing her entire interest in the corporation, dividend equivalency could not be found.

While freedom from dividend treatment is thus found where the entire interest of the stockholder is redeemed, it has not been afforded where only a part of the interest is surrendered. A recent case concerning this problem is *Neff v. United States.*[28] Here the taxpayer was the sole shareholder of the 100 outstanding shares. In the course of operations it became necessary for the corporation to raise needed capital and, despite there being 400 authorized but unissued shares, the plan which the corporation adopted was for the redemption of 47 of the taxpayer's shares and the reissuance of

20. 123 F.2d 914. 6th Circuit (1954).
21. Edenfield v. Commissioner, 19 T.C. 13 (1952).
22. Rev. Rul. 54-458, 1954-2 C.B. 167.
23. Rev. Rul. 55-745m 1955-2 C.B. 223.
24. In re Lukens' Estate, 246 F.2d 403 3rd Circuit (1957); Mayer v. Donnelly, 247 F.2d 322 5th Circuit (1957).
25. 145 F. Supp. 104 (E.D. Mich., N.D. 1956).
26. Caveat. This case was decided under the 1939 IRC which had no provision analogous to Sec. 318 or the 1954 IRC which concerns stock attribution.
27. Supra note 17.
28. 305 F.2d 455, U.S. Court of Claims (1962). Cert denied, 835. Ct 827.

these. In return the corporation cancelled a note receivable and a loan receivable which the shareholders owed to the corporation. Subsequently 38 of these redeemed shares were sold. The taxpayer's assertion of non-equivalency was founded on two contentions; that the redemption was undertaken exclusively for a valid corporate purpose, to raise corporate capital, and that after the redemption and subsequent to the sale of 38 of the 47 redeemed shares taxpayer's proportionate holdings of outstanding shares had changed radically.

The court first summarized Sec. 302 of the 1954 IRS and Senate Report No. 1622, 83rd Congress, 2nd Session, concerning Sec. 302.[29] It then continued with its determination of equivalency, stating that while evidence of a valid corporate purpose might be used with other evidence, it is not of itself dispositive, ". . . it does not establish, per se, non-equivalence."[30]

The court also placed great emphasis on the fact that the corporation had sufficient authorized but unissued shares which it could have sold to effect the desired purpose.

> The only difference between the newly-issued-stock procedure and the redemption method selected was that the latter resulted in a $19,035 distribution from the corporation's accumulated earnings and profits. In this context the distribution is entirely divested of any relation to the ultimate change in proportionate ownership upon sale of the redeemed shares, and bears every attribute of a pro rata corporate distribution constituting a dividend.[31]

To the taxpayer's contention that his interest had changed radically the court said that the time when the change in proportionate interest is to be determined is immediately after the redemption, not after the whole transaction. Thus, after the redemption the taxpayer held the same interest as before, because he still owned all of the outstanding shares.

III

This situation concerns the tax treatment to be given a remaining shareholder when there has been a pro rata redemption of his and the leaving shareholder's stock. The decision rendered in *United States v. Carey*[32] in 1961, was startling in the light of prior decisions concerning redemption.

Carey-Brown Motors, Inc. had been incorporated in 1948. Carey and

29. Sec. 302(a) is applicable if any one of sub-paragraphs (1), (2), (3) or (4) of sub-section 302(b) applies. Interesting to note is the test which the Senate Committee proposed: "The test intended to be incorporated in the interpretation of paragraph (1) (of 302(b)) 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.*" (emphasis supplied).
30. Neff v. United States, supra note 28 at p. 457.
31. It is interesting to note that this conflicts with prior holdings to the effect that it is the method used and not some alternative method that might have been used which is determinative for tax purposes. Woodruff v. Commissioner, Supra note 15.
32. 289 F.2d 531, 8th Circuit (1961).

Brown each contributed $20,000 and each received 200 of the 400 shares of stock issued. In 1950 a stock dividend was declared and distributed, raising the stock ownership of Carey and Brown to 300 shares each. Brown had other interests in which he participated and had never devoted much time to the operation of the corporation. In 1954, due to an increase in the competiveness of the business, it was decided that Brown should sell his interests to someone who could devote full time to the business of the corporation. At this time, Brown's interest in the corporation was worth about $50,000 and it was soon discovered that an interested buyer with that amount of capital could not be found. However, an employee of the corporation was willing to buy the Brown interest, providing it could be done for $22,000. Thus a reduction in corporate assets was decided upon as the expedient to consummate the original plan of sale. The following arrangement was then entered into:

> 1. Pro rata redemption by the corporation from Carey and Brown of 290 shares (145 each). In exchange the corporation transferred its buildings and book accounts to Carey and Brown.
> 2. A lease of the building to the corporation for a 3 year period.
> 3. Brown then sold two of his remaining shares to Carey and the balance of 153 shares to the employee.

Undoubtedly this was a pro rata redemption, and if the transaction had stopped before the purchase by the employee, the original shareholders would have been given dividend treatment to the extent of earnings and profits. But the court didn't view the transaction at that point and instead considered it as a whole. Citing *Herman v. Commissioner*[33] which had laid out seven different criteria in determining whether a redemption is essentially equivalent to a dividend, the court said that there was no single or conclusive test, and further stated that:

> In our present case . . . The net effect of the redemption upon the two stockholders was very different from the distribution of a dividend. The relations of the stockholders to the corporation were very materially changed. The results of the execution of the plan was very different from the distribution of a dividend. Instead each shareholder retaining his pro rata interest in the company, as is the result of the usual dividend, Brown's interest in the corporation was in all respects completely terminated. Carey for the first time became a majority stockholder and Larson the purchasing employee acquired a stock interest.
> . . . the stock redemption as to Brown and Carey was made as a result of the same identical corporate action and for the same

33. 32 T.C. 479, affirmed, 283 F.2d 227, 8th Circuit (1960). Among these criteria are: The presence or absence of a bonafide corporate business purpose; whether the action was initiated by the corporation or by the stockholders; did the corporation adopt any plan or policy of contraction, or did the transaction result in a contraction of the corporate business; did the corporation continue the corporate business; did the corporation continue to operate at a profit; whether the transaction resulted in any substantial change in the proportionate ownership of stock held by the shockholders; what were the amounts, frequency and significance of dividends paid in the past; was there a sufficient accumulation of earned surplus to cover the distribution, or was it partly from capital.

> business purpose. *If there was no pro rata distribution to Brown, there could be no pro rata distribution as to Carey.*[34] (emphasis supplied)

A further point of interest in the *Carey* case is that the court cited with approval *Mertens Law of Federal Income Taxation*[35] which states:

> . . . it seems correct that no point should be made of the fact that the sale of part of the shares to a third person precedes rather than follows redemption of the balance. Since the two transactions are part of the same plan the order in which the sale and redemption take place should be immaterial . . .

In March of 1962, the Court of Appeals for the Fourth Circuit handed down its decision in *Ballenger v. United States.*[36] Here the taxpayer and the other shareholders owned both preferred and common stock in the corporation. All of the preferred stock and the other shareholder's common stock was redeemed, leaving the taxpayer as the sole shareholder. While the transaction was different from that in *Carey*, as in *Carey* the redemption was pro rata. After deciding that the provisions of the IRC concerning partial liquidation would not suffice to grant freedom from dividend treatment, the court then considered the equivalency aspects. The court determined that two lines of decisions appear in determining equivalency. The first applies a "net effect" test.

> 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 redemption is equivalent to a dividend if the results from the hypothetical dividend and the actual stock redemption are essentially the same.[37]

The court went on to state that under this approach, factors to be considered are whether the same shareholders would have received the identical payments had the redemption been a dividend, and whether the redemption altered the shareholders' control over the corporation, and their respective rights to its future earnings. The court then held:

> Considering all of these factors, it becomes apparent 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.[38] (emphasis supplied)

The second line of cases add to the "net effect" test the further consideration of whether or not there are legitimate business purposes for the redemption. The court cited *Carey* as authority for this point and then went on to find that no valid business purpose existed for the redemption. By distinguishing the *Carey* case to this extent the court did not have

34. United States v. Carey, Supra note 32 at p. 538.
35. Volume 1, Section 0.104.
36. 301 F.2d 192, 4th Circuit (1962).
37. Ibid, p. 196.
38. Ibid, p. 199.

to rule contra to it. The cases do provide an interesting comparison because the court in *Carey* stated that pro rata redemptions are not necessarily to be treated as equivalent to a dividend, but that the whole transaction (net effect?) should be viewed; while the court in *Ballenger* stated that the redemption must not be given capital gains treatment because a pro rata redemption will always be essentially equivalent to a dividend.

What is to be the outcome of *Carey* and pro rata redemption? It is too early to draw any definite conclusions but if the Eighth Circuit continues to view the over-all effect of such transactions rather than the effect immediately after the redemption, and if other Circuits follow this reasoning, taxpayers' percentages of success in such cases will increase.

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