Boston College Law Review

Volume 9
Issue 2 *Number 2*

Article 8

1-1-1968

Dividend Equivalence Under Section 302(b)(1) of the Internal Revenue Code of 1954—The Relevance of the Necessary Business Transaction

Mary Alice Stephens

DIVIDEND EQUIVALENCE UNDER SECTION 302(b)(1) OF THE INTERNAL REVENUE CODE OF 1954—THE RELEVANCE OF THE NECESSARY BUSINESS TRANSACTION

A distribution out of earnings and profits by a corporation to its shareholders is generally in the form of a dividend, and results in ordinary income taxation to the shareholder.[1] Occasionally, however, a corporation distributes earnings and profits as part of a redemption of its stock. The question then arises whether such a distribution is in essence a dividend or a valid arm's-length transaction. If the former, the distribution would receive ordinary income treatment, regardless of its form. If the latter, it would be taxable as a payment in exchange for a capital asset.[2] It is essential that this distinction be made, since a distribution by a corporation to its shareholders is not taxable as a dividend to the extent that it represents a return of capital investment.[3] In enacting the Internal Revenue Code of 1954, Congress recognized that some guidelines were needed for this determination of the tax consequences to a shareholder of a distribution in redemption of stock. These guidelines are set forth in section 302 of the Code.[4]

Section 302(a) provides that a stock redemption shall be treated as a return of capital if certain conditions are met.[5] These conditions, under which the distribution to the shareholder receives capital gain treatment, are enumerated in section 302(b).[6] Subsection 302(b)(1) provides that a redemption "not essentially equivalent to a dividend" will qualify for capital gain treatment.[7] The application of this subsection presents a difficult factual question in which all facts and circumstances of the transaction are considered to determine whether the redemption is essentially equivalent to a dividend. Consequently, a taxpayer relying on this subsection cannot be certain that his particular redemption will meet the requirements of this condition. The other three conditions are readily identifiable, and can be mechanically applied to any given stock redemption. Section 302(b)(2) permits capital gain treatment of a redemption which is "substantially disproportionate with respect to the shareholder."[8] A redemption is "substantially disproportionate" within the meaning of the section if, immediately after the redemption, (1) the ratio of voting stock, and any common stock, owned by the shareholder, to all such stock of the corporation is less than 80 percent of such ratio at the time of the redemption, and (2) the shareholder owns less than 50 percent of the total combined voting power of all classes of stock. A redemption of all stock of the corporation owned by the shareholder is

1 Int. Rev. Code of 1954, § 61(a)(7).

2 Id. §§ 1201, 1221.

3 See Jones v. Dawson, 148 F.2d 87, 91 (10th Cir. 1945).

4 Int. Rev. Code of 1954, § 302.

5 Id. § 302(a).

6 Id. § 302(b).

7 Id. § 302(b)(1).

8 Id. § 302(b)(2).

treated as a distribution in exchange for the stock by section 302(b)(3).[9] Section 302(b)(4) provides that section 302(a) shall be applicable to redemptions of stock issued by a railroad corporation pursuant to a plan of reorganization under Section 77 of the Bankruptcy Act.[10]

The predecessor of section 302(b) contained only the language of the first of these conditions, allowing capital gain treatment for distributions in redemption made "at such time and in such manner" as not to be "essentially equivalent to a dividend."[11] It had been judicially established, and was generally accepted, that no single determinative test for dividend equivalence could be articulated, and that disposition of each case should depend on a factual inquiry into all aspects of the transaction.[12] As a result of this individual treatment, the administration of this dividend equivalence test produced confusion both among courts applying the standard and among taxpayers seeking to determine whether distributions to them were taxable as capital gain or as ordinary income.

In response to this problem, section 302 of the 1954 Code, as passed originally by the House, contained only the three provisions which are now sections 302(b)(2), (3) and (4).[13] By passing only these "safe harbor" provisions, the House intended to substitute for the 1939 standard a detailed legislative scheme which would permit redemption transactions to be planned with certainty as to their tax consequences.[14]

The Senate, in passing on the bill, concluded that certainty was not to be achieved at the expense of "legislative flexibility."[15] Detailed rules enacted to achieve almost mathematical certainty, the Senate Report stated, "would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws."[16] Finding the "safe harbor" provisions unnecessarily restrictive, "particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place,"[17] the Senate reinstated the test of dividend equivalence in section 302(b)(1). This section enacts a degree of flexibility by allowing capital gain treatment for any redemption found to be a bona fide sale or exchange of stock, notwithstanding that the redemption fails to meet the specific requirements of sections 302(b)(2), (3) and (4).

In appending section 302(b)(1) to the House bill, it was the general intention of the Senate to incorporate the pre-1954 test as to whether a redemption is essentially equivalent to a dividend.[18] After adopting this test in

---

[9] Id. § 302(b)(3).

[10] Id. § 302(b)(4).

[11] Int. Rev. Code of 1939, ch. 1, § 115(g), 53 Stat. 48.

[12] Flanagan v. Helvering, 116 F.2d 937, 939 (D.C. Cir. 1940); McGuire v. Commissioner, 84 F.2d 431, 432-33 (7th Cir. 1936). See Golden, The Dividend Equivalence Test: Forty Years of Confusion, 43 Texas L. Rev. 755, 759 (1965).

[13] H.R. 8300, 83d Cong., 2d Sess. § 302 (1954).

[14] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 35 (1954).

[15] S. Rep. No. 1622, 83d Cong., 2d Sess. 41 (1954).

[16] Id. at 42.

[17] Id. at 44.

[18] Id. at 233.

general, however, the Senate continued to qualify this incorporation and to make more explicit its intention for future application: "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 be properly characterized as a sale of stock by the redeeming shareholder to the corporation."[19] The significance of this statement of proper emphasis and direction of inquiry is not immediately clear. It would seem, however, to indicate an intention that any redemption which, in view of all the relevant facts and circumstances, may properly be characterized as an arm's-length transaction should be deemed an exchange and taxed at capital gain rates. In determining the character of a redemption, courts should consider only factors relevant to the question of whether the redemption was a valid sale. Looking at the effect of the redemption on the shareholder, the court should inquire whether he relinquished some significant part of his interest in the corporation, thereby transferring adequate consideration in exchange for the distribution to him; considering the effect on the corporation, the inquiry should be whether the redemption was dictated by the exigencies of the corporation's business, indicating that the corporation received some bargained-for advantage in return for the distribution by it to the shareholder.

The Senate Committee's directive for future consideration of dividend equivalence has been almost entirely ignored and only its general intention of reinstating the pre-1954 test has been given effect.[20] As a result, while sections 302(b)(2), (3) and (4), the "safe harbor" provisions, have introduced a measure of certainty, what has been incorporated into the 1954 Code in section 302(b)(1) is the element of confusion which the House bill was drafted to eliminate.

The confusion involved in the application of the dividend equivalence test resulted from judicial development of numerous factors in the test and the failure to distinguish between the truly significant criteria and those which were merely makeweight arguments and incidental factors.[21] Recognizing this problem, Congress sought to eliminate the following as criteria in the determination of dividend equivalence under section 302(b)(1) of the 1954 Code:

(1) The redemption was not made by the corporation pursuant to any adopted plan or policy of contraction of business activities, nor was it followed by an orderly procedure looking toward the ultimate dissolution of the corporation or a contraction of its operation.[22]

(2) The corporation continued to operate at a profit after the redemption.[23]

(3) There was a sufficient accumulation of earnings and profits to fund the distribution.[24]

---

[19] Id. at 234.

[20] See, e.g., United States v. Carey, 289 F.2d 531, 536-37 (8th Cir. 1961).

[21] Moore, Dividend Equivalency—Taxation of Distributions in Redemption of Stock, 19 Tax L. Rev. 249, 250-52 (1964).

[22] McGuire v. Commissioner, 84 F.2d 431, 432 (7th Cir. 1936).

[23] Brown v. Commissioner, 79 F.2d 73, 74 (3d Cir. 1935).

[24] William H. Grimditch, 37 B.T.A. 402, 411 (1938).

Despite this attempt on the part of Congress at clarification, courts continue to place reliance on these three criteria.[25]

As to the other criteria, Congress made no specification, but by generally adopting the pre-1954 test, it impliedly endorsed them. Several of these are of questionable relevance to the consideration of dividend equivalence. They are:

(4) The redemption was made pursuant to a motive or scheme of tax avoidance.[26]

(5) The amounts, frequency and significance of past dividends were negligible.[27]

(6) The initiative for the corporate redemption came from the shareholder for his own purposes, rather than from the corporation based on usual business considerations.[28]

There are three further criteria in the dividend equivalence test:

(7) There was no legitimate business purpose for the redemption, or the business purpose asserted was not sufficiently compelling to overcome the other indicia of dividend equivalence.[29]

(8) The distribution was made prorata.[30]

(9) The proportionate ownership and/or control of the shareholders was not materially altered.[31]

It is submitted that these are the only relevant factors and are essential to the consideration of dividend equivalence.

It will be the purpose of this comment to discuss, in general, the relevance of each of the criteria, and, in particular, the significance of involvement of the redemption in a necessary business transaction as a fundamental factor in the dividend equivalence test.

I. Factors Dismissed From the Consideration of Dividend Equivalence

Under pre-1954 tax law, any genuine contraction of the corporation's business was deemed to indicate that the redemption was not essentially equivalent to a dividend.[32] As both redemptions and partial liquidations were treated under the same section of the 1939 Code, corporate contraction was a valid consideration in the dividend equivalence test under that statute.[33] In 1954, however, Congress separated "into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial

[25] See Earle v. Woodlaw, 245 F.2d 119, 126 (9th Cir. 1957).
[26] J. Natwick, 36 B.T.A. 866, 873 (1937).
[27] Id. at 875.
[28] Cf. Bona Allen, Jr., 41 B.T.A. 206, 211 (1940).
[29] Cf. H.F. Asmussen, 36 B.T.A. 878, 883 (1937).
[30] Robinson v. Commissioner, 69 F.2d 972, 973 (5th Cir. 1934).
[31] See Commissioner v. Ahlborn, 77 F.2d 700, 701 (3d Cir. 1935) (dissent).
[32] Joseph W. Imler, 11 T.C. 836, 841 (1948).
[33] Int. Rev. Code of 1939, ch. 1, §§ 115(c), (g), 53 Stat. 46-48.

liquidation."[34] To this end Congress enacted section 346 which defines a partial liquidation as follows:

> (a) In General.—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—
>
> (1) the distribution is one of a series of distributions in redemption of all the stock of the corporation pursuant to a plan; or
>
> (2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year. . . .[35]

Section 331 provides that amounts distributed in partial liquidation of a corporation, as defined in section 346, shall be treated as in part or full payment in exchange for the stock.[36] It was the intention of the Senate that any "corporate contraction" as the concept had developed under the existing law would result in a partial liquidation.[37] By thus isolating the factor of corporate contraction to section 346, the Senate expressly severed this criterion from the determination of dividend equivalence under section 302(b)(1).

Continued operation at a profit, the second of the criteria mentioned above which courts have viewed as indicative of dividend equivalence, developed in connection with, and as a converse of, corporate contraction. The reasoning of courts which employed this criterion appears to be that a business which continues to operate at a profit after the redemption evidences expansion rather than contraction. As a concomitant of the corporate contraction factor, continued operation at a profit is presumed to have been likewise severed from a consideration of section 302 dividend equivalence.[38] It is submitted that, in any case, this factor is totally irrelevant since neither a contraction of the corporation's business nor a declared dividend eliminates the possibility of future profits. Moreover, the introduction of this factor into the dividend equivalence test is at best questionable since, in the case in which it was first invoked, the criterion was interjected almost as an afterthought concluding a long list of facts strongly indicative of dividend equivalence.[39] In no subsequent case has there been found any rationale for its inclusion as a factor for consideration.[40] In view of its probable isolation

---

[34] S. Rep. No. 1622, supra note 15, at 49.

[35] Int. Rev. Code of 1954, § 346(a).

[36] Id. § 331.

[37] S. Rep. No. 1622, supra note 15, at 262.

[38] In every case found in which this factor has been invoked, it has been coupled with the corporate contraction factor. See, e.g., cases cited note 40 infra.

[39] Brown v. Commissioner, 79 F.2d 73, 74 (3d Cir. 1935). Other factors enumerated were: the money with which the corporation purchased the stock came from earnings and profits; after the redemption the shareholder owned 98% of the corporation's stock as compared with 99% prior to the redemption; there was no liquidation of the business; the amount of capital stock was increased.

[40] See, e.g., Commissioner v. Berenbaum, 369 F.2d 337, 340 (10th Cir. 1966); Earle

into section 346 and its general irrelevance, continued operation at a profit should be disregarded in determining whether a redemption of stock is essentially equivalent to a dividend for purposes of section 302(b)(1).

Distributions by a corporation are taxable dividends only insofar as they are derived from earnings and profits.[41] The Code itself defines a dividend as a distribution out of earnings and profits.[42] The significance to the dividend equivalence test of corporate earnings and profits, then, lies in the fact that their existence is a prerequisite to any consideration of dividend equivalence. Under the 1939 Code, however, courts extended this significance by invoking the existence of earnings and profits as positive evidence that the distribution was essentially equivalent to a dividend.[43] As with the consideration of continued operation at a profit, there has been found no rationale expressed to justify reliance on this as a criterion.[44] To assure that this factor would not be given additional force as an independent test, the Senate expressly disclaimed the existence of earnings and profits as a criterion to be weighed in determining dividend equivalence. After instructing that, under the 1954 Code, inquiry should be devoted solely to the question of whether or not the transaction by its nature may be properly characterized as a sale, the Senate Report stated that "for this purpose the presence or absence of earnings and profits of the corporation is not material."[45]

II. Factors of Questionable Relevance to the Consideration of Dividend Equivalence

The provisions of section 302 are designed to permit the return of a capital investment to be taxed at capital gain rates, while at the same time preventing tax avoidance in the form of distributions formally in redemption of stock, but substantially corporate dividends. Accordingly, presence or absence of a scheme or motive of circumventing the tax law has often been referred to as a criterion in the determination of dividend equivalence.[46] This criterion is, however, a false one, and most courts refuse to consider it.[47] Dismissal of the question of motive from the consideration of dividend equivalence is appropriate since it is with the essence of the distribution, i.e., whether a sale or exchange, that section 302(b)(1) is concerned, and not with the motive of those who initiated it. Moreover, a financial transaction, otherwise eligible for a certain tax treatment, is not disqualified from the tax advantage by the mere fact that it was entered into with the intention of reducing tax liability.[48]

---

v. Woodlaw, 245 F.2d 119, 127 (9th Cir. 1957); Flanagan v. Helvering, 116 F.2d 937, 939 (D.C. Cir. 1940).

41 See Jones v. Dawson, 148 F.2d 87, 91 (10th Cir. 1945).

42 Int. Rev. Code of 1954, § 316.

43 See, e.g., William H. Grimditch, 37 B.T.A. 402, 411 (1938).

44 See, e.g., Commissioner v. Berenbaum, 369 F.2d 337, 340 (10th Cir. 1966); Bradbury v. Commissioner, 298 F.2d 111, 115 (1st Cir. 1962); Ferro v. Commissioner, 242 F.2d 838, 842 (3d Cir. 1957); Genevra Heman, 32 T.C. 479, 488 (1959), aff'd, 283 F.2d 227, 231 (8th Cir. 1960).

45 S. Rep. No. 1622, supra note 15, at 234.

46 See, e.g., J. Natwick, 36 B.T.A. 866, 873 (1937).

47 See, e.g., Flanagan v. Helvering, 116 F.2d 937, 939-40 (D.C. Cir. 1940).

48 Gregory v. Helvering, 293 U.S. 465, 469 (1935).

Dividend history of the corporation is a frequently invoked criterion in determining dividend equivalence.[49] A meager or nonexistent dividend policy, or the discontinuance or reduction of payments under an established dividend policy have been found to indicate that the redemption was essentially equivalent to a dividend.[50] The basis of such a view is that the redemption was merely a disguise for dividends which had been previously suppressed. On the other hand, a regular dividend policy has been considered evidence that the redemption was not in fact another dividend, on the apparent ground that, because dividends had been paid according to a systematic, orderly policy, an extraordinary payment from earnings and profits is not indicative of a substitution for a dividend.[51]

It is difficult to formulate a rationale for the application of this criterion. A scanty or nonexistent dividend policy does perhaps evidence the existence of earnings and profits sufficient to fund the redemption, a factor which has been declared by the Senate to be immaterial to the determination of section 302(b)(1) dividend equivalence. Moreover, such a dividend policy may also indicate a motive of tax avoidance, i.e., an intent to have earnings and profits dispersed in a form which would escape ordinary income taxation. Likewise, while a regular dividend history may indicate lack of a tax avoidance motive, it is equally susceptible of the interpretation that the shareholders had tired of paying taxes on their dividends at ordinary income rates and had determined to withdraw some of their accumulated earnings and profits in another form. As noted above, however, a motive of tax avoidance is per se immaterial to the consideration of dividend equivalence. Finally, an extraordinary distribution of earnings and profits by a company with a consistent dividend history may indicate that the redemption was made pursuant to a legitimate business purpose which has been held indicative of nonequivalence. It does not, however, establish such a legitimate business purpose and no weight should be given the mere inference which may arise from a regular dividend policy. Dividend history should have no bearing on the court's determination that the distribution in redemption of stock was or was not essentially equivalent to a dividend.

Whether the initiative for the distribution came from the shareholder for his own purposes, or from the corporation based upon usual business considerations, has often been mentioned as an individual criterion by the courts.[52] This inquiry has been interpreted by some to be only a particular consideration in the general inquiry into motivation.[53] At any rate, no rationale has

---

[49] See, e.g., Commissioner v. Berenbaum, 369 F.2d 337, 340 (10th Cir. 1966); Earle v. Woodlaw, 245 F.2d 119, 127-28 (9th Cir. 1957); Flanagan v. Helvering, 116 F.2d 937, 939 (D.C. Cir. 1940); Thomas Kerr, 38 T.C. 723, 730 (1962), aff'd, 326 F.2d 225, 231 (9th Cir. 1964); Genevra Heman, 32 T.C. 479, 487 (1959), aff'd, 283 F.2d 227, 231 (8th Cir. 1960).

[50] See cases cited note 49 supra.

[51] Arthur H. Squier, 35 T.C. 950, 956 (1961).

[52] See, e.g., Bradbury v. Commissioner, 298 F.2d 111, 117 (1st Cir. 1962); Ferro v. Commissioner, 242 F.2d 838, 842 (3d Cir. 1957); Flanagan v. Helvering, 116 F.2d 937, 939 (D.C. Cir. 1940); Thomas Kerr, 38 T.C. 723, 730 (1962), aff'd, 326 F.2d 225, 231 (9th Cir. 1964).

[53] See, e.g., Ballenger v. United States, 301 F.2d 192, 198 (4th Cir. 1962). See also

been expressed to justify its existence as an individual criterion,[54] and it is submitted that the source of initiative for the redemption has no validity as such. Source of initiative may be significant, however, in its bearing on the court's inquiry into another aspect of the transaction. Where initiative has come from the shareholder, courts have been reluctant to find the existence of a legitimate business purpose for the redemption.[55]

The existence of a legitimate business purpose has likewise been dismissed by at least one court as bearing only upon the irrelevant issue of tax avoidance.[56] It is submitted that while the presence of a legitimate business purpose is immaterial insofar as it evidences lack of tax avoidance motive, it is of considerable import as indicative of the fact that the motivation of the corporation in redeeming its stock was to effect a necessary business transaction. It will be the major contention of this comment that this is precisely the situation to which section 302(b)(1) was meant to apply.

III. Factors Essential to the Consideration of Dividend Equivalence

A. *Prorata Character of the Distribution, and Significant Modification of Proportionate Ownership and/or Control*

Before considering the involvement of the redemption in a necessary business transaction, the factors of prorata nature of the redemption, and if it is not prorata, the failure of the redemption to alter significantly the proportionate ownership of the shareholders must be examined. A dividend is a distribution of cash or other assets out of earnings and profits which does not alter the legal ownership or control of the corporation.[57] Since a prorata distribution and one not prorata which does not significantly alter the shareholder's interest in the corporation are like dividends in this regard, these two factors are of paramount significance as evidence of dividend equivalence.[58] In their treatment of the prorata character of a distribution, courts have avoided the conclusion that it is determinative,[59] and the Treasury rejects any such conclusive presumption by stating in the Regulations that a prorata distribution will *generally* be essentially equivalent to a dividend.[60] Nevertheless, examination of the cases reveals that meaningful alteration of shareholder interests is the most important factor in the determination[61] and is generally controlling.[62]

Mickey & Holden, Distributions Essentially Equivalent to a Dividend—Understanding the Equation, 43 N.C.L. Rev. 32, 39 (1964).

54 See, e.g., cases cited note 52 supra.

55 Kerr v. Commissioner, 326 F.2d 225, 231 (9th Cir. 1964); Ferro v. Commissioner, 242 F.2d 838, 842 (3d Cir. 1957).

56 Northrup v. United States, 240 F.2d 304, 307 (2d Cir. 1957). See Golden, supra note 12, at 763-64; Mickey & Holden, supra note 53, at 38.

57 See In re Luken's Estate, 246 F.2d 403, 405 (3d Cir. 1957).

58 See Mickey & Holden, supra note 53, at 40. See generally Moore, supra note 21.

59 See, e.g., Bains v. United States, 289 F.2d 644 (Ct. Cl. 1961).

60 Treas. Reg. § 1.302-2 (1955).

61 See Mickey & Holden, supra note 53, at 40; Moore, supra note 21, at 252.

62 To ascertain the change in percentage of ownership, the ratio of holdings after the redemption is compared with the ratio of holdings prior to the redemption. Thus, if the holder of 50% of the stock of a corporation redeems 20% of his stock, i.e., 10% of the total stock of the corporation, and this is the sole redemption, his holdings after the redemption are not 40%, but rather 44.44%, not 80% of his prior ownings, but

It should be noted that correct construction of the significant-alteration test requires consideration of the total transaction or series of transactions resulting in a change of ownership, and not of the redemption as an isolated activity.[63] A redemption coupled with a later sale of the redeemed stock by the corporation, or with a sale of unredeemed stock by the shareholder, may effect a radical change in proportionate ownership of the shareholder which would not have resulted from the redemption alone. Likewise, a series of redemptions pursuant to a plan may produce the required alteration of ownership and/or control. In considering the total financial transaction, the courts require a degree of proximity between the related transfers and the redemption in question. The serial redemptions must be obvious steps in a definite plan for alteration of proportionate holdings.[64] The sales to third parties must be reasonably related to the redemption; in one case, a plan was held not to qualify for consideration under the test because it was to extend over an indefinite period of time;[65] in another, a plan which was not contemplated until the year following the redemption was held insufficient to remove the distribution from the category of those essentially equivalent to a dividend.[66] For purposes of the inquiry into modification of shareholder's interests under section 302(b)(1), it is immaterial whether the sale to the third party preceded or followed the redemption.[67]

To receive capital gain treatment on the basis of change in proportionate ownership, the shareholder must establish that, on this sole ground, the distribution to him is not essentially equivalent to a dividend. Just what he must show to prove this is not clear. As passed by the House, what is now section 302(b)(2) provided that any payment for a redemption which reduced the shareholder's ratio of stock ownership by more than 20 percent would be treated as a capital gain to the shareholder.[68] The Senate amended the subsection by inserting the requirement that after the redemption the shareholder own less than 50 percent of the total voting power of the corporation to insure that redemptions satisfying the House's requirement would not receive capital gain treatment on the basis of change in legal ownership alone if the shareholder retained control of the corporation.[69] At the same time, the Senate liberalized the section by reintroducing the dividend equivalence test of section 302(b)(1).[70] These two amendments must be reconciled for a proper understanding of change of ownership as it affects dividend equivalence. It is generally accepted that a redemption which is significantly disproportionate with respect to the shareholder may qualify as disproportionate

---

88.88%. See 1 J. Mertens, Law of Federal Income Taxation § 9.105 (rev. ed. 1962). It should be noted that in determining ownership the attribution rules of § 318 of the Internal Revenue Code of 1954 are applicable.

63 See, e.g., United States v. Carey, 289 F.2d 531, 538 (8th Cir. 1961); Bains v. United States, 289 F.2d 644, 647 (Ct. Cl. 1961).

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

65 Friend v. United States, 345 F.2d 761, 765 (1st Cir. 1965).

66 Tabery v. Commissioner, 354 F.2d 422, 427 (9th Cir. 1965).

67 1 J. Mertens, supra note 62, § 9.104.

68 H.R. 8300, 83d Cong., 2d Sess. § 302 (1954).

69 S. Rep. No. 1622, 83d Cong., 2d Sess. 41 (1954).

70 Id. at 233.

under section 302(b)(1), even though it is not "substantially" so within the meaning of section 302(b)(2).[71] The conclusion seems valid, in view of the case law, that however great the reduction in proportionate ownership, relinquishment of actual control will always be required of one who held 50 percent or more of the total combined voting power prior to the redemption, if he is seeking capital gain treatment on the basis of change in shareholder interest alone.[72] A redemption will therefore be treated as an exchange for purposes of section 302(b)(1) if the shareholder relinquishes some significant portion of his investment interest in the corporation, although his ultimate ownings exceed the reduction requirement of section 302(b)(2), and if, after the redemption, he does not retain actual control over 50 percent or more of the stock of the corporation.

B. *The Necessary Business Transaction*

A redemption which may not properly be characterized as a sale from the shareholder's point of view, on the basis of significant alteration of shareholder interests alone, may still qualify as a valid sale or exchange when viewed from the side of the other party to the transaction, i.e., if an important corporate purpose is served by the redemption. Inquiry into the existence of a necessary business transaction, it is submitted, is consistent with the purposes expressed by the Senate in amending the House bill and should be made in every case in which the alteration of shareholder interests is not sufficient to indicate nonequivalence. In its general explanation of changes in provisions relating to taxation of corporate distributions, the Senate Committee stated that necessary business transactions should encounter minimum interference from the tax law.[73] The desire to protect the shareholder whose stock might be called without his having control over the time of the redemption prompted the Senate's only specific indication of how section 302(b)(1) was to be applied.[74] It is submitted that a redemption dictated by the exigencies of the business is one instance of such a "forced sale" and should receive capital gain treatment under section 302(b)(1).

Two problems arise in connection with this secondary, qualifying criterion. First, the corporate purpose must be clearly distinguishable from the taxpayer's interest. The following corporate purposes have been recognized as sufficient to satisfy the necessary business transaction criterion: improvement of the corporation's credit rating,[75] acquisition of new capital by the corpora-

---

71 D. Herwitz, Business Planning 479 (1966). See generally Moore, supra note 21, at 254. But see Bittker, The Taxation of Stock Redemptions and Partial Liquidations, 44 Cornell L.Q. 299, 323 (1959).

72 Compare Arthur H. Squier, 35 T.C. 950 (1961), which recognized as not essentially equivalent to a dividend a redemption of approximately 7% where the taxpayer relinquished actual control, with Friend v. United States, 345 F.2d 761 (1st Cir. 1965), which held a 7% redemption insufficient to qualify for nondividend equivalence where the shareholder retained actual control. It should be noted that the attribution rules of § 318 relate only to ownership, and are not carried over to the consideration of *actual* control. Arthur H. Squier, supra at 955-56.

73 S. Rep. No. 1622, supra note 69, at 42.

74 Id. at 44. See text accompanying note 17 supra.

75 See, e.g., Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964); Keefe v. Cote,

tion,[76] and satisfying the demands of employees for participation in a stock ownership program.[77] On the other hand, asserted reasons which have been deemed to serve primarily shareholder interests include cancellation of a debt of the shareholder or his estate,[78] and the liquidation or contraction of the shareholder's ownings of a particular stock of the corporation.[79] A redemption may fail to qualify for capital gain treatment on this basis notwithstanding some business advantage to the corporation, if that advantage was not sufficiently important.[80] The problem of distinguishing between the interests of the shareholder and those of the corporation becomes particularly acute in the case of a sole shareholder or a holder of a significant majority of the stock. In such cases courts have been reluctant to find the requisite dichotomy of interests;[81] at least one court has stated that recommendations of a stock redemption by the business, legal, and tax advisors of the corporation, and by the bank handling its finances will be deemed personal advice to one who was virtually the sole shareholder.[82]

In addition to the problem of distinction of interests, there is a great deal of uncertainty as to the requisite degree of necessity of the business transaction. It is well established that the existence of a single bona fide business purpose will not prevent a redemption from being held a dividend equivalent.[83] For example, a general assertion of intention to strengthen the corporation's credit position will ordinarily not suffice to defeat ordinary income treatment of the distribution.[84] Some specific and identifiable exigency must be shown. The kind of compelling need for credit improvement which will occasion capital gain treatment under section 302(b)(1) is illustrated by *Isaac C. Eberly*.[85] In this case, Dun & Bradstreet had reduced the corporation's credit rating from second to third class because the books of the corporation evidenced an extremely unfavorable ratio of fixed assets to liquid assets, and a large debt owed it by the taxpayer, who was virtually the sole shareholder. As a result, it

---

213 F.2d 651 (1st Cir. 1954); Isaac C. Eberly, 10 CCH Tax Ct. Mem. 1157 (1951).

[76] Davis v. United States, 274 F. Supp. 466 (M.D. Tenn. 1966).

[77] Snite v. Commissioner, 177 F.2d 819 (7th Cir. 1949); John A. Decker, 32 T.C. 326 (1959).

[78] See, e.g., Tabery v. Commissioner, 354 F.2d 422 (9th Cir. 1965); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958).

[79] Earle v. Woodlaw, 245 F.2d 119 (9th Cir. 1957). But see Harry F. Cornwall, 48 T.C. 72 (1967), in which relinquishment of an original plan of the taxpayer for total withdrawal from the corporation was deemed to indicate nondividend equivalence of the redemption of a part of the taxpayer's interest, and United States v. Carey, 289 F.2d 531 (8th Cir. 1961), in which the voluntary withdrawal of a shareholder who could no longer manage the business was itself deemed a business purpose of the corporation.

[80] See, e.g., Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); Genevra Heman, 32 T.C. 479 (1959), aff'd, 283 F.2d 227 (8th Cir. 1960).
Cir. 1960).

[81] See Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957); Thomas Kerr, 38 T.C. 723 (1962), aff'd, 326 F.2d 225 (9th Cir. 1964).

[82] Kerr v. Commissioner, 326 F.2d 225, 231 (9th Cir. 1964).

[83] See, e.g., Bradbury v. Commissioner, 298 F.2d 111, 118 (1st Cir. 1962); United States v. Fewell, 255 F.2d 496, 500 (5th Cir. 1958).

[84] See, e.g., Kerr v. Commissioner, 326 F.2d 225, 232 (9th Cir. 1964); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958).

[85] 10 CCH Tax Ct. Mem. 1157 (1951).

was difficult for the company to obtain credit from suppliers; personal guarantees were required on all orders. Dun & Bradstreet refused to reinstate the company at the second class level of credit until the debt of the taxpayer was reduced by half. The taxpayer, who previously had resisted having his stock redeemed in cancellation of the debt, reluctantly agreed to a redemption to the extent of 50 percent of the debt. The court held the distribution not essentially equivalent to a dividend, notwithstanding that there was no "immediate" need for credit improvement due to war shortages.[86] The necessity of available credit at the end of the war and the uncertainty as to when that need might arise was deemed sufficient.

Given the fact that there must be some concrete necessity to the business purpose alleged, the question remains as to the degree of necessity required. Some courts have taken the position that a redemption must be the "only solution to some urgent corporate problem."[87] In such a jurisdiction, any conceivable alternative to a distribution of earnings and profits may be seized upon by the court to defeat capital gain treatment of the distribution. The test applied by these courts is whether the purpose could have been achieved without the distribution of earnings and profits.[88] This view seems overly restrictive. Most courts require that the purpose be "compelling,"[89] "conspicuous,"[90] "the motivating force"[91] or "material and substantial."[92] In hypothesizing alternatives to the distribution, such courts have been satisfied that the redemption was the most feasible and satisfactory course of action from a business standpoint.[93] This would seem the more appropriate approach to the determination of whether the transaction served a valid necessary business purpose, i.e., was an arm's-length sale or exchange occasioning capital gain taxation to the shareholder.

In evaluating a corporate purpose, as with the consideration of significant modification of shareholder interests, it is essential to adopt an approach which views the total transaction involved. This is perhaps most evident in cases relying on acquisition of new capital to overcome dividend equivalence. Acquisition of new capital as a qualifying business purpose can arise in two contexts: Where the stock is redeemed so that it may be resold by the corporation to others in order to acquire new capital; and where the stock is redeemed pursuant to the terms of its issuance, if the issuance itself was effected to acquire new capital for a compelling business purpose. In both of these instances, recognition of the business purpose served necessarily depends on consideration of the transaction as a whole, including the subsequent sales or original issuance, and not of the redemption as an isolated activity.

---

[86] Id. at 1165.

[87] Commissioner v. Berenbaum, 369 F.2d 337, 341 (10th Cir. 1966). See generally Golden, The Dividend Equivalence Test: Forty Years of Confusion, 43 Texas L. Rev. 755, 767-69 (1965).

[88] Golden, supra note 87, at 768.

[89] E.g., Ballenger v. United States, 301 F.2d 192, 199 (4th Cir. 1962).

[90] E.g., Bradbury v. Commissioner, 298 F.2d 111, 117 (1st Cir. 1962).

[91] E.g., Thomas Kerr, 38 T.C. 723, 731 (1962), aff'd, 326 F.2d 225 (9th Cir. 1964).

[92] E.g., Heman v. Commissioner, 283 F.2d 227, 231 (8th Cir. 1960).

[93] See, e.g., Sorem v. Commissioner, 334 F.2d 275, 280 (10th Cir. 1964); John A. Decker, 32 T.C. 326, 332 (1959).

The case of *Davis v. United States*[94] is illustrative of this necessity of viewing the total transaction. In this case the corporation sought to obtain a loan from the Reconstruction Finance Corporation. The incorporators were required to provide an additional $25,000 capital either by making a subordinated loan to the company or by purchasing a new issue of preferred stock or additional common stock. Reluctant to impair the corporation's financial standing by placing a $25,000 debt on the corporate balance sheet, Davis chose to purchase preferred stock in that amount. One condition of the purchase was that the stock would be redeemed when the RFC loan was repaid. At the time of the redemption Davis was the sole shareholder. In deciding whether the distribution was essentially equivalent to a dividend, the court posed the question whether there was, underlying the transaction, a legitimate business purpose which was sufficiently compelling to overcome the fact that the prorata nature of the redemption indicated dividend equivalence. Through a series of rather involved mental steps, the court reached the correct result: given the admittedly valid business purpose underlying the issuance of the preferred stock, and given the agreement at the time of issuance to redeem the stock when the RFC loan was repaid, the conclusion was apparent that the redemption was "simply the final step taken in the completion of [the original business] purpose."[95] Accordingly, the amount received by Davis was treated as a distribution in part or full payment for the stock. Obviously, if the prior aspect of the transaction, the issuance, had been ignored, this redemption would incorrectly have been taxed at capital gain rates. For proper determination of section 302(b)(1) dividend equivalence, then, it is essential that each redemption be considered in the context of the business transaction of which it is part.

IV. Conclusion

There are two fundamentally determinative criteria in the dividend equivalence test: the prorata, or virtually prorata, nature of the distribution, effecting no significant modification of proportionate ownership or control, and the character of the redemption as a necessary business transaction. The very existence of section 302(b)(1) and the regulation indicating that the prorata nature of the distribution is not alone determinative suggest that inquiry into dividend equivalence should encompass more than a mathematical calculation of the degree of change in proportionate holdings. It has been the purpose of this comment to suggest that involvement in a necessary business transaction is the sole valid consideration beyond modification of shareholder interests.

Professor Herwitz has stated that "the plain fact is that there is rarely any corporate purpose served by a redemption transaction."[96] While this may be true, it would be less universally so if transactions were considered in their totality as suggested herein. Almost always, it is activities related to the redemption (e.g., resale to acquire new capital, distribution of the redeemed stock to employees, extension of previously unavailable credit to the corpora-

[94] 274 F. Supp. 466 (M.D. Tenn. 1966).
[95] Id. at 471.
[96] D. Herwitz, supra note 71, at 480.

tion) which give it its character of a necessary business transaction. Perhaps courts could more easily view the corporate purpose in perspective if their consideration of the factors in the dividend equivalence test were serial rather than aggregate; it should first be determined whether the redemption is "not essentially equivalent to a dividend" on the basis of alteration of shareholder interests in the corporation, and, if not, attention should be directed to any alleged business purpose, evaluating its validity, necessity and total effect. Such a step-by-step determination would permit the court to focus more clearly upon each relevant factor, and to appreciate more fully the fundamentally determinative criteria of change of proportionate ownership and involvement in a necessary business transaction. It is submitted that the procedure suggested herein would best effectuate the legislative intent of taxing at capital gain rates any distribution in redemption which may properly be characterized as a valid arm's-length exchange between shareholders and the corporation.

MARY ALICE STEPHENS