Income Tax--Stock Redemption: "Essentially Equivalent to a Dividend"

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Recommended Citation
Available at: https://researchrepository.wvu.edu/wvlr/vol73/iss3/18

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state or a municipality which "substantially interferes" with the owner's use and ownership of his property is a taking of such property without compensation and is prohibited by the West Virginia constitution.

The New York court in Clement noted that, in general courts have been reluctant to find a problem of a *de facto* taking. The court reasoned that this is probably because the problem has not often arisen. Today's widespread urban renewal projects and modern highway construction promise more and more *de facto* taking cases. At present the problem is not of great magnitude in West Virginia, though it may increase in the future. The West Virginia court might well look to Clement in fashioning a modern rule to provide appropriate relief to prevent serious injustice in situations involving the wholesale appropriation of property by eminent domain.

*James M. Henderson, II*

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**Income Tax—Stock Redemption:**

"Essentially Equivalent To A Dividend"

In 1945 taxpayer and E. B. Bradley organized a corporation. In exchange for property contributions, Bradley received five hundred shares of common stock and taxpayer and his wife each received two hundred fifty shares. Taxpayer later purchased an additional one thousand shares of preferred stock at a par value of twenty-five dollars per share in order for the company to qualify for a federal loan, the corporation agreeing to redeem the preferred stock when the loan had been repaid. Before the redemption, taxpayer bought Bradley's five hundred shares and divided them between his son and daughter. Then in 1963, when the corporation redeemed the preferred stock, taxpayer, in his personal income tax return, did not report the twenty-five thousand dollars received by him as income. "Rather, taxpayer considered the redemption as a sale of his preferred stock to the company—a capital gain transaction under section 302 of the Internal Revenue Code resulting in no tax since taxpayer's basis in the stock equaled the amount he received for it."¹ The Commissioner disagreed with this and took

¹ United States v. Davis, 90 S. Ct. 1041, 1043 (1970). *Int. Rtf. Code of 1954, § 302* provides that a redemption of stock by a corporation shall be treated as a distribution in part or full payment in exchange for the stock thus
the position that the redemption, under sections 301,2 302,3 and 3164 of the code, was essentially equivalent to a dividend and therefore taxable as ordinary income. Consequently, taxpayer paid the deficiency and brought suit for a refund. The District Court ruled in taxpayer's favor5 and the court of appeals affirmed, holding that the redemption was "not essentially equivalent to a dividend" and therefore qualified for capital gain treatment.6 The United States Supreme Court granted certiorari.7 Held; reversed. Through application of the family attribution of ownership rules to the stock redemption, the distribution by the corporation was essentially equivalent to a dividend and taxable as such. Davis v. United States, 90 S. Ct. 1041 (1970).

Sections 3018 and 3169 of the Internal Revenue Code provide that a distribution by a corporation should be included in a taxpayer's gross income as a dividend out of earnings and profits to the extent such earnings and profits exist. However, certain exceptions to the application of this rule are found under section 302.10

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qualifying for capital gains treatment if any of the following conditions are met:

1) the redemption is not essentially equivalent to a dividend;
2) the distribution is substantially disproportionate with respect to the shareholder;
3) the redemption is a complete redemption of all the stock owned by the shareholder.

2 INT. REV. CODE OF 1954, § 301 provides in part that a distribution of property or money by a corporation to a shareholder with respect to its stock is included in gross income to the extent the amount distributed is a dividend under section 316.

3 See note 1, supra.

4 INT. REV. CODE OF 1954, § 316 provides that:
[T]he term "dividend" means any distribution of property made by a corporation to its shareholders-
1) out of its earnings and profits accumulated after February 28, 1913, or
2) out of its earnings and profits of the taxable year . . . without regard to the amount of the earnings and profits at the time the distribution was made. Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which Section 301 applies, such distribution shall be treated as a distribution of property for the purposes of this subsection.

6 Davis v. United States, 408 F.2d 1139 (6th Cir. 1969).
8 INT. REV. CODE OF 1954, § 301 [hereinafter references to The Internal Revenue Code will be by section number only].
9 § 316.
10 § 302, See note 1 for these exceptions.
Section 302\textsuperscript{11} allows capital gain treatment for corporate distributions made in a stock redemption. Gain is recognized to the extent that the distribution exceeds taxpayer's basis for his stock. Redemption transactions are afforded two safe "harbors" from dividend treatment: "The substantially disproportionate test of subsection (b) (2) which requires a specified decrease in the taxpayer's percentage ownership of voting stock (and all common stock as well, if non-voting common is present); and the complete termination test of subsection (b) (3) which requires all of taxpayer's stock to have been redeemed."\textsuperscript{12}

Taxpayer in this case admitted that these two exceptions did not apply to his situation because section 302 (c) (1)\textsuperscript{13} provides for the application of the attribution of ownership rules of section 318 (a) to sections 302 (b) (2) and (b) (3). Therefore, taxpayer was considered to own all the common stock owned by his wife and children in addition to the stock held in his own name.\textsuperscript{14}

Taxpayer argued that the attribution of ownership rules do not apply to section 302 (b) (1), and that the distribution by the corporation in redemption of his one thousand shares of preferred stock was not essentially equivalent to a dividend. Therefore he claimed that he qualified for capital gain treatment. The preliminary question to be considered was the applicability of the attribution of ownership rules of section 318 (a) to section 302 (b) (1).

The treasury regulations state that the determination of whether or not a distribution is essentially equivalent to a dividend depends upon the facts and circumstances of each case.\textsuperscript{15} Constructive stock ownership is merely one of the factors to be considered in making this determination.\textsuperscript{16} Furthermore, section 318 (a) specifies that the attribution rules are to be applied only where expressly made applicable. Since section 302 (c) (1) provides that the attribution rules are to be applied in determining the "ownership of stock",\textsuperscript{17} the argument has been made that the attribution rules

\textsuperscript{11}Id.
\textsuperscript{12}D. Herwitz, \textit{Business Planning} 476 (1966).
\textsuperscript{13}§ 302 (c) (1): [S]ection 318 (a) shall apply in determining the ownership of stock for purposes of this section.
\textsuperscript{14}United States v. Davis, 90 S. Ct. 1041 (1970).
\textsuperscript{15}Treas. Reg. § 1.302-2 (1960).
\textsuperscript{16}Id.
\textsuperscript{17}§ 302. \textit{See also}, Lewis v. Commissioner, 35 T. O. 71 (1960), which held that section 302 (c) made the constructive ownership rules of section 318 (a) applicable (with certain exceptions to be discussed later) to redemption tests.
are not applicable to section 302 (b) (1) because it does not expressly refer to the "ownership of stock." However, it is reasonable to apply the attribution rules whenever the "ownership of stock" is relevant, whether by statutory direction or by implication.\textsuperscript{18}

The historical development of section 302 (b) (1) supports the application of the attribution rules to it. Attribution rules were a part of the 1954 Code as originally proposed, but there was not a section comparable to 302 (b) (1). When that section was added during the course of the legislative process, there was no evidence that the applicability of the attribution rules was to be restricted; rather, the attribution rules were apparently to be applied to the entire section 302.\textsuperscript{19}

Several court decisions have applied the constructive ownership rules in accord with the Treasury's interpretation. In Levin v. Commissioner,\textsuperscript{20} the taxpayer argued that the family attribution rules should not be applied to section 302 (b) (1). The argument was based principally upon three prior court decisions: Lewis v. Commissioner,\textsuperscript{21} Ballenger v. United States,\textsuperscript{22} and Himmel v. Commissioner.\textsuperscript{23}

In Lewis the tax court ignored the stock attribution rules in deciding the 302 (b) (1) issue. However, the concurring opinion pointed out that the court treated Lewis as owning his son's shares, thus producing the same results as if the attribution rules had been expressly applied. In Ballenger the attribution rules were applied, although dictum indicated that they should not be applied too literally to section 302 (b) (1).

Levine's reliance on Himmel (in which the court applied the attribution rules to determine that if a dividend had been paid on the common stock rather than a redemption of the non-voting cumulative preferred, taxpayer would have constructively received less than he did as a result of the redemption) was simply misplaced. The Court in Levin applied the attribution rules to section 302 (b) (1), noting that there may be cases in which strict application of the rules may be inappropriate, but Levin did not present such a case.

\textsuperscript{20} 385 F.2d 521, 526 (2d Cir. 1967).
\textsuperscript{21} 47 T. C. 129 (1966).
\textsuperscript{22} 301 F.2d 192 (4th Cir. 1962).
\textsuperscript{23} 338 F.2d 815 (2nd Cir. 1964).
Where disharmony in the family relationship exists, attribution may be inappropriate. Thus the redemption of taxpayer's shares in a family estrangement situation might qualify for capital gain treatment under section 301 (b) (1) although the attribution rules would prevent it from qualifying as a substantially disproportionate redemption under section 302 (b) (2).\(^{24}\) In Davis, however, there was no such family discord and the court was able to apply section 318 to section 302 (b) (1) without considering this factor. Taxpayer was therefore deemed to be the owner of all the shares of common stock held by his family.

After the attribution rules were applied in Davis, a remaining question was whether a corporation's redemption of part of the shares of a sole stockholder is "always 'essentially equivalent to a dividend' within the meaning of that phrase in section 302 (b) (1) . . . ."\(^{25}\) Generally, a distribution of property by a corporation to the extent of its earnings and profits is treated as a dividend and includible in the shareholder's gross income.\(^{26}\) Section 302 (b) (1) is an exception to this general rule providing that a redemption is not includible in gross income as a dividend if the redemption is "not essentially equivalent to a dividend."\(^{27}\) The question in Davis and similar cases is one of equivalency; if equivalency is present, the distribution is taxable as a dividend.\(^{28}\)

Most courts in their determination of whether a redemption is essentially equivalent to a dividend have considered the net effect of the transaction to be the single most important consideration. The net effect test has in practice been applied in two different ways, termed strict or flexible, so that really there are two different tests.\(^{29}\)

"Under the 'strict net effect' test, if the taxpayer ends up in the same position after the distribution as he would have occupied had a dividend been declared, the net effect of the transaction is held to be the payment of a dividend."\(^{30}\) Applying the strict net effect test to Davis, taxpayer, because of the attribution rules, would be considered to own all the common stock of the corporation, so the distribution to taxpayer in payment for his preferred

\(^{21}\) See Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); Estate of Arthur H. Squier v. Commissioner, 35 T. C. 950 (1961).


\(^{23}\) § 316 (a); § 301 (a); § 301 (c).

\(^{24}\) § 302 (b) (1).

\(^{25}\) Kerr v. Commissioner, 326 F.2d 225 (9th Cir. 1964).

\(^{26}\) See Kerr v. Commissioner, 326 F.2d 225 (9th Cir. 1964).

\(^{27}\) Davis v. United States, 408 F.2d 1139, 1142 (6th Cir. 1969).
stock would be pro rata on his common stock. And pro rate distributions of earnings and profits with no basic change in shareholder relationships are the hallmark of a dividend.\textsuperscript{31}

In the past many courts, through application of the "flexible net effect test," have allowed a business purpose for the redemption to moderate the decisiveness of a strict net effect result.\textsuperscript{32} However, Ballenger \textit{v. United States}\textsuperscript{33} held that an acceptable business purpose can never be the reduction of income taxes since the purpose of the statute is to prevent distribution of the earnings of the corporation to the shareholders at the lower capital gain rates; and, an appearance of tax avoidance is present where a shareholder receives money for a sale of stock rather than stock in exchange for stock.\textsuperscript{34} Thus, a taxpayer who could have accomplished his business purpose without obtaining a dividend should not be allowed to avoid the statutory scheme. In \textit{Davis} taxpayer could have achieved the same objectives without at the same time effecting a distribution of corporate earnings at capital gains rates by exchanging his preferred stock for common stock. Since he chose to have the corporation redeem his stock by a distribution of corporate earnings, he had to bear the tax consequences of the transaction.

When a corporation pays a dividend, the effect is to transfer property from the company to the shareholders without any change in the relative status of the stockholders. Where the effect of a redemption, as in the \textit{Davis} case, is the same, the distribution must be held "essentially equivalent to a dividend."\textsuperscript{35} A primary step in making such a determination must be whether the redemption of stock has caused a meaningful change in the position of the shareholders. In other words, the pro rata distribution of earnings and profits is the earmark of a dividend, "and must be regarded as the basic criterion of whether a particular distribution more closely equates a sale or a dividend."\textsuperscript{36}

\textsuperscript{31}See, \textit{e.g.}, Hasbrook \textit{v. United States}, 343 F.2d 811 (2d Cir. 1965). In Bradbury \textit{v. Commissioner}, 298 F.2d 111, 115-16 (1st Cir. 1962), the court stated: "Dividends are distributions of earnings and profits to the stockholders which do not change their proportionate interests in the corporation. Consequently, as we have stated: "Logically, a redemption of its stock by a corporation is 'essentially equivalent to the distribution of a taxable dividend;' . . . whenever the practical result of the transaction is to distribute accumulated earnings essentially \textit{pro rata} among the shareholders while leaving the ownership of the corporation basically the same."" [citations and footnotes omitted].

\textsuperscript{32}Keefe \textit{v. Cote}, 213 F.2d 651 (1954) (1st Cir. 1954).

\textsuperscript{33}301 F.2d 192 (4th Cir. 1962).

\textsuperscript{34}See Kerr \textit{v. Commissioner}, 326 F.2d 225 (9th Cir. 1964).


\textsuperscript{36}Bradbury \textit{v. Commissioner}, 298 F.2d 111, 116 (1st Cir. 1962).
As Justice Douglas emphasized in his dissent, the practical effect of *Davis* may be cancel section 302 (b) (1) from the Code.\(^{37}\) Nevertheless, the decision ends the confusion surrounding the lower courts’ application of the “flexible net effect” test under which a legitimate business purpose might make a stock redemption not “essentially equivalent to a dividend.” As the result of this decision there are no doubts remaining as to the application of section 318 to section 302 (b) (1). On the other hand, as previously mentioned, the decision does not deal with the possibility of exceptions to section 318, such as family hostility.\(^{38}\)

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Insurance—Pyramided Recovery
Under Multiple Uninsured
Motorist Provisions

As a result of a collision between an automobile, not covered by an uninsured motorist provision, and an uninsured vehicle, Mark Arminski, young suffered injuries in excess of $20,000. An action for bodily injuries was instituted in Mark's behalf by his father, Dr. Thomas Arminski, to whom the defendant insurance company had issued a policy covering two cars and providing for family protection and uninsured motorist coverage. Dr. Arminski had paid two separate premiums for the uninsured motorist coverage. The defendant's liability for bodily injuries under the family protection clause was limited to $10,000 for each person and $20,000 for each accident.

The trial court found that defendant insurer, because it charged two separate premiums for its coverage, was liable for $20,000 notwithstanding the limitation of the family protection clause. On appeal the Michigan Court of Appeals, adopting a literal reading of the policy, held: reversed and remanded for judgment to be entered in favor of defendant. *Arminski v. United States Fidelity and Guaranty Co.*, 178 N.W.2d 497 (Mich. Ct. App. 1970).

The trial court distinguished the present case from the only Michigan decision on point, *Horr v. Detroit Automobile Inter-