CHAPTER 9

Problems and Procedures in Shifting Shareholder Control and Bailing Out of a Going Business

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§ 9.1—How the Problem Can Arise.

A common, and often difficult, problem in corporate practice arises in connection with the termination of a particular stockholder’s stock interest or the reduction of a stockholder’s interest to a proportionately smaller amount. The problem may arise in any of a number of different ways, some of the more important of which are the following:

(1) A shareholder—perhaps an elderly and dominant shareholder—may want to retire from the business and transfer his stock interest to others in the firm.

(2) Disagreement may arise between two opposing groups of shareholders, requiring, as a practical matter, that some arrangement be made for the buy-out of one of the groups.

(3) Two or more shareholders may want to make some provision for the shares of the first to die to be purchased.

(4) A particular shareholder may need a substantial amount of cash which he can raise only by a sale of a part or all of his shares in the closely held corporation.

Generally speaking, two methods are available for shifting shareholder control: (1) a purchase and sale of shares at the shareholder level (that is, one or more shareholders personally purchase the shares of the shareholder who desires to sell); or (2) a purchase of shares by the corporation itself. The problems and procedures differ very substantially between a shareholder purchase, on the one hand, and a corporate redemption, on the other hand.

§ 9.2—Shifting Control Through Purchase of Shares by Co-Shareholders.

We direct our attention first to a survey of some of the procedures and problems incident to a stock purchase at the shareholder level. As will be readily apparent from the discussion which follows, the tax and nontax problems incident to a shareholder

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1 A proposed change in the proportionate stock interest among the existing shareholders—the subject matter of this chapter 9—is to be distinguished from a sale by existing shareholders of all or a majority of the stock to outsiders. The latter subject is discussed in Chapter 12 infra.

2 The latter alternative will be referred to in this chapter, albeit somewhat inaccurately, as a “redemption,” as distinguished from a “shareholder purchase.”
purchase are considerably less involved than they are in the case of a redemption of shares.

§ 9.21—Common areas of contract negotiation.

The attorney should consider the following areas of contract negotiation, perhaps among others:

[1]—Selecting the method of price determination. Since there will be no quoted market value for shares in a closely held corporation, the determination of a fair price is often the most difficult single aspect of negotiating a contract for the purchase and sale of shares. The determination of price, or the selection of the method to be used in determining price, will depend upon the particular circumstances, so that no generalizations are completely valid. It should, however, be noted that where the contract employs a method for determining price, the following methods are the most commonly used:

[a]—Book value. The price occasionally is set at the book value of the shares to be sold. Book value of each share to be sold is determined by dividing the corporation’s net worth\(^2\) as set forth on the corporation’s balance sheet by the total number of outstanding shares.\(^3\)

[b]—Book value plus premium. Since book value ordinarily will not reflect any value which the corporation has as a going concern, or any unrealized appreciation in value of physical assets, the price will sometimes be determined by taking the book value per share and adding to that figure a stated premium. Very often the amount of the indicated premium will be the product of haggling, rather than of an expert attempt to evaluate the assets of the business.

[c]—Appraisal. Occasionally, particularly in the case of a contract for the future purchase and sale of shares—for example, upon the death of one of several shareholders—the purchase price will be the amount which is determined by an expert appraisal made at that future time. By way of example, the contract may require the buyer and seller each to appoint an appraiser and, perhaps, the two appraisers so selected to select a third appraiser. The amount determined by such appraisers will then be the purchase price.\(^4\)

[d]—Capitalization of earnings. Sometimes the price will be determined by a capitalization of the corporation’s earnings at a predetermined rate for a certain number of years immediately preceding the purchase and sale. By way of example,
the contract may set the price per share at the average annual per share earnings over
the last preceding five-year period, multiplied by some predetermined figure.  

[e]—Stated price. The contract may simply state a price certain. The parties
in negotiating the price may have employed one or more of the above-stated methods,
but for the sake of simplicity the method may not be recited in the contract. Where
a price certain is stated in a contract for a purchase and sale at an indefinite future
time—for example, at the death of a shareholder—it may be advisable to provide in
the contract for annual or other periodic changes in the price by mutual agreement
of the parties.

[f]—Mutual bidding. Another method, particularly useful where there are two
groups of shareholders who are antagonistic to each other, is the use of some variation
of the “counter-bid” approach. By way of example, each group might submit a sealed
bid stating a price at which it is willing to purchase the shares of the other group;
the group bidding the highest per share price might then be obligated to purchase
the shares of the other group.  

A variation of this basic method is for one of the two
groups to set a price at which it will either buy or sell, with the obligation set in advance
for the other group to elect either to buy or sell at the price so submitted.

[2]—Seller’s warranties. There are various warranties which the seller is
normally required to make. Thus, the seller’s title to the shares which he purports to
sell, his capacity to transfer good title to those shares and the absence of liens or
encumbrances thereon, are all subjects of the usual warranties.

Perhaps the most difficult warranty relates to the accuracy of the corporation’s
relevant balance sheet. In almost all instances, the purchaser relies on the corporation’s
balance sheet in determining the price. Accordingly, the purchaser should consider
whether he is content to rely on the accuracy of the balance sheet or whether the seller
should be required to warrant the accuracy of the relevant balance sheet. Particularly
if the seller is a shareholder-officer who has been in a better position than has the
purchaser to know the financial condition of the corporation, it might be appropriate
for the seller to warrant that the corporation owns all of the assets set forth on the
balance sheet, that all known liabilities are reflected on the balance sheet, and that
the balance sheet is prepared in accordance with sound and accepted accounting
principles and practices. 

In addition, whether or not the seller is more familiar with the corporation’s financial
condition than is the purchaser, the parties should consider whether the purchaser is
to assume the entire risk as to unknown liabilities of the corporation. In many cases
it will be appropriate for the seller to promise that if in the future any liabilities are
disclosed to be owing as of the date of the sale, which liabilities were not disclosed
on the corporate balance sheet as of the date, then the seller will be required to make
a refund or some other adjustment in the purchase price.  

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5 See Form No. 26 infra.  
6 See Form No. 27 infra.  
7 See Form No. 28, par. 5(b), (d), (h), and (i) infra.  
8 See Form No. 28, par. 5(i) infra.
fact that an income tax deficiency may be asserted against a corporation some years after the tax year involved, such a warranty by the seller as to undisclosed liabilities is important.

[3]—Providing security for deferred installments of purchase price. If the purchaser is not paying cash to the extent of the entire purchase price, consideration should be given as to what security, if any, should be furnished by the purchaser to the seller for the payment of the unpaid balance. In many cases the shares which are the subject of the sale will be pledged to the seller as security for the unpaid balance.

[4]—Imposing restrictions on transferability of shares to implement future purchase and sale. Where the contract relates to a future sale and purchase—for example, a death buy-and-sell agreement—it will usually be important from both the buyer’s and seller’s standpoints that the seller’s obligation to sell follow his shares even into a transferee’s hands. If the obligation to sell is simply personal with the particular selling shareholder, a gift or other disposition by that shareholder during his lifetime may cut off the purchaser’s right or obligation to purchase. Accordingly, care should be taken to make certain that the obligation will be binding on the transferees of the seller.9

§ 9.22—How to use insurance to fund death buy-sell agreement. If an agreement for the future purchase and sale of shares will be operative upon the death of a shareholder, it is often desirable that life insurance be used to fund the purchaser’s obligation.

[1]—How the usual “cross-insurance” arrangement operates. Insurance funding for a purchase at the shareholder level is usually effected by the so-called cross-insurance arrangement. Under this arrangement, each shareholder is the owner and beneficiary of an appropriate amount of life insurance on the lives of the other shareholders. By way of example, suppose that each of A and B owns half the stock of X Corporation. A and B enter into an agreement whereby the survivor of them is obligated to purchase the shares of the first to die. It is estimated that the purchase price will be approximately $50,000. In order to make certain that the survivor will have the necessary cash, A takes out $50,000 of insurance on B’s life and B takes out $50,000 of insurance on A’s life. If A dies first, B will receive the insurance proceeds on A’s life, thereby obtaining all or a part of the cash required to meet his obligation. Similarly, if B dies first, A will receive all or a part of the cash required by him to meet his purchase obligation.10

The cross-insurance funding of a buy and sell agreement at the shareholder level can work effectively and easily if there are only two or three shareholders. But where

9 See Form No. 9, Sec. 2(a) and § 2.18[4] supra. Similar restrictions will often be desirable in order to make the contract price binding for estate tax valuation purposes. This matter is explored in more detail in § 9.4 infra.
10 See Form No. 23, par. 5 infra.
there are a substantial number of shareholders, the complexity and the premium cost may be overwhelming. Suppose, for example, that a corporation with a total worth of $1,000,000 has ten equal shareholders, all of whom are employed by the corporation. The shareholders enter into an agreement obligating the surviving shareholders to purchase the stock of a deceased shareholder. In order to be fully funded by cross-insurance, each of the ten shareholders would own and be the beneficiary of nine separate insurance policies, each in the amount of $100,000. That would be a total of ninety policies with an aggregate face value of $9,000,000. That simply is not feasible.

[2]—How a joint life policy can eliminate inequality. It should be observed that by the use of this cross-insurance arrangement, the survivor of A and B will obtain a business worth $100,000, while the decedent’s estate will end up with cash of only $50,000. This inequality will be partly eliminated by the fact that the decedent’s estate will also have the cash value of the insurance policy on the survivor’s life. If A and B, after being made aware of this difference in treatment, consider it to be a significant obstacle, they should consider the possible desirability of a joint life policy arrangement in lieu of the cross-insurance arrangement. Under the joint life policy arrangement, one policy for $100,000 might be taken out on the joint lives of A and B, payable on the death of the first decedent, one-half to the decedent’s estate and one-half to the survivor. The proceeds payable to the survivor are used by him to purchase the deceased’s shares pursuant to the buy and sell agreement. The survivor would thereby obtain the business, worth $100,000, and the decedent’s estate would obtain $100,000 of cash. Perhaps needless to say, the one joint life policy for $100,000 is more expensive than two separate policies, each for $50,000, under the cross-insurance arrangement.

Also, many co-shareholders are not concerned with the objective of maintaining economic equality even after death. When confronted with the question, many co-shareholders will respond that they do not care which of them is more greatly enriched through the use of insurance, so long as the first decedent’s family is fairly reimbursed for the value of the decedent’s interest. Even here, the joint life policy may be useful, and more economical than two separate cross-insurance policies. Thus, the joint life policy might be taken in an amount equal to the value of the decedent’s interest, rather than in an amount equal to the value of the entire corporation. The entire proceeds would then be payable to the survivor, who would be obligated to purchase the decedent’s shares pursuant to the buy and sell agreement. The survivor would thereby obtain the business, worth $100,000, and the decedent’s estate would obtain $100,000 of cash. Perhaps needless to say, the one joint life policy for $100,000 is more expensive than two separate policies, each for $50,000, under the cross-insurance arrangement.

[3]—Why the shareholders, not the corporation, should pay premiums. Where insurance is used to fund a death buy-and-sell arrangement at the shareholder level, the insurance will be owned by the shareholders, not by the corporation. That being true, it is important from a tax standpoint that the shareholders, and not the corporation, pay the premiums. If the corporation pays the premiums on insurance owned by the shareholders, the payment will be taxed as income to the
shareholders. Accordingly, the shareholders will have obtained no income tax advantage by causing the corporation to pay the premiums. Furthermore, the payment of premiums by the corporation might be characterized as a constructive dividend rather than as additional compensation paid to shareholder-officers. If the payment is held to be a dividend distribution, it will not be a deductible item by the corporation for federal income tax purposes. In order to avoid any such question of characterization and possible double taxation, the shareholders, not the corporation, should pay the premiums where the insurance is designed to fund a purchase at the shareholder level.

[4]—Why the Shareholders, Not the Corporation, Should Purchase Stock. When a shareholder is contractually obligated to purchase another shareholder's stock, he must not succumb to the temptation to have the corporation purchase the stock for him. This is especially likely when a corporation has just two shareholders and one dies. From a nontax standpoint, it makes no difference whether the surviving shareholder or the corporation purchases the stock. Either way, the surviving shareholder ends up as the sole shareholder. But if the surviving shareholder is contractually obligated to purchase the decedent's stock, then his causing the corporation to purchase the stock instead — relieving the shareholder of his personal liability — will be treated as a taxable dividend to the surviving shareholder.

§ 9.23—How to use a preferred stock issue to dilute value of common stock.

Situations will occasionally arise in which the high value of a corporation’s common stock will be an obstacle to accomplishing the objectives of the corporation and the shareholders. In these situations the dilution of the common stock value through the issuance of new preferred stock may be highly desirable. Although the problem of diluting common stock values is not confined to the area of shareholder purchase of stock, it is commonly found in this area and is therefore discussed at this point.

[1]—Typical problems which can be solved by diluting value of common stock. Some of the most often encountered situations in which the dilution of common stock value is desirable are the following:

[a]—Enabling junior executives to purchase. A dominant shareholder may wish to sell a portion of his common stock to junior executives in order to increase their incentive. The common stock may, however, have a value which is so high that the junior executives are unable to purchase a sufficiently significant interest to provide them with the desired degree of participation in the future growth of the company. If the value of the dominant shareholder’s common stock can be diluted, a larger proportion of the common stock can be purchased by the junior executives.


12a In Peterson v. Commissioner, 74 T.C.M. 90 (1997), not only did the surviving shareholder have to recognize dividend income, he had to pay a civil fraud penalty.
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[b]—Facilitating funding of death buy-and-sell agreement. Two shareholders desire to enter into a buy-and-sell agreement operative upon the death of the first of them to die. Neither shareholder is likely to have the cash necessary to make the purchase and one or both of them are uninsurable. A substantial dilution of the common stock value may make feasible such an agreement notwithstanding the unavailability of insurance funding. Or, even where the shareholders are insurable, the dilution reduces the insurance premium cost of funding a purchase of the common stock.

c—Facilitating estate-planning objectives of shareholder. An individual who owns the sole or controlling stock interest might wish to dilute the value of the common stock by an issue of preferred stock, in order to bequeath the common to a child who is active in the business and the preferred to a child who is not active in the business. This dilution may make possible the equal treatment of the children from a dollar and cents standpoint without imposing upon them a business relationship onerous to both.\[^{13}\]

d—Freezing the value of a shareholder’s estate. The preferred stock recapitalization can be an effective technique for freezing the value of a dominant shareholder’s estate for federal estate tax purposes. By converting a part of his common stock interest to a preferred stock interest and giving or selling his remaining common stock to younger family members, the dominant shareholder can transfer future growth to a younger generation while still retaining whatever power, income, or status, he still demands.

The difficult problem in this area is likely to be the valuation problem. The dominant shareholder’s estate-freezing objective is best served if the preferred stock has terms that depress its ultimate value for estate tax purposes and keep the dividend flow as modest as possible. On the other hand, a relatively low value for the newly issued preferred stock means a relatively high value for the common stock, with a correspondingly greater gift tax on the gift or deemed gift of the common stock. After a period of several years of attempting to deal with this problem in different ways, the current solution is embodied in I.R.C. Sections 2701 through 2704, enacted in 1990. The current statutory rules are aimed at making certain that the preferred stock is not overvalued, so that the transferred common stock will be adequately valued for federal gift tax purposes.\[^{13a}\] In some instances the proper application of these rules will result in a clear and acknowledged over-valuation of the common stock. It is important, however, for taxpayers and practitioners to abide by these complex rules; a failure to do so is likely to result in highly burdensome gift tax or estate tax deficiencies. The important planning point is that, even though the transferred stock must now be adequately valued for gift tax purposes, perhaps even over-valued, the preferred stock recapitalization is once again an important technique for freezing the estate of a dominant shareholder.


\[^{13a}\] See § 9.23[4], infra.
[2]—How preferred stock issue can dilute common stock value. If a corporation issues preferred stock as a dividend on its outstanding common, the preferred will necessarily dilute the value of all of the common stock. Suppose, by way of example, that a corporation has only one shareholder, that the corporate business is worth $100,000, and that the only class of stock outstanding is common stock. If the corporation creates a new class of preferred stock and issues to its common stockholder such an amount of the preferred stock as has a value of $80,000, the value of the outstanding common stock will necessarily be reduced to $20,000. Since our assumption is that the corporate enterprise is worth $100,000, the value of all of its outstanding stock (common and preferred) can be worth only $100,000.

Alternatively, if preferred stock is issued to one of several shareholders in exchange for a part of his common stock, the per share value of the common may not be affected, but the value of the common which is retained by the recipient of the preferred will necessarily be reduced.

[3]—The alternative methods of issuing preferred stock. The issuance of preferred stock can be effected in one of two different ways: (1) the stock can be issued as a preferred stock dividend on all of the outstanding common stock, or (2) it can be issued to less than all of the existing common stockholders in a recapitalization exchange pursuant to which one or more of the common stockholders exchanges a portion of his common stock for an amount of preferred stock equal in value to the common stock so surrendered. Each of these alternatives has certain advantages and disadvantages.

[a]—Advantages and disadvantages of preferred stock dividend alternative. The dividend method has the advantage of relative simplicity. The directors need simply pass a resolution declaring a dividend of the desired number of shares of preferred stock payable on an indicated date with respect to each share of common outstanding as of a certain date; on the payment date the requisite certificates are executed and delivered. In addition, the dividend method involves no income tax risk to the shareholders on account of the receipt of the preferred stock. The Internal Revenue Code makes clear that a stock dividend does not constitute taxable income.\footnote{\textit{I.R.C.} \S 305. A number of exceptions to the favorable rule are set forth in the statute, but they are not relevant for this purpose. It should be noted, however, that the preferred stock will clearly be “Section 306 stock,” if the corporation has earnings and profits at the time of its issuance. See \S 9.23[5] \textit{infra}.}

\footnote{The value of the preferred stock is not always easy to determine. \S 9.23[4] \textit{infra}.}

\footnote{If the preferred stock received in the exchange is more or less than the value of the surrendered common stock, adverse gift tax or income tax consequences are likely to follow. See \S 9.23[4], \textit{infra}.}

\footnote{If the preferred stock has not previously been authorized by the Articles, it will be necessary to amend the Articles in order to create the preferred. See \S 13.2 \textit{infra}, for the procedure involved in amending Articles.

See Form No. 4 \textit{infra}, for sample terms of preferred stock.}
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A possible disadvantage of the dividend method of issuing the new preferred stock is the fact that all of the shareholders will receive the preferred stock. If the purpose for the preferred stock issue can be served just as adequately by an issuance of preferred to less than all of the shareholders, the dividend method will result in the corporation being unduly burdened with making larger cash dividend payments on its outstanding preferred stock than is necessary. Another, less significant, disadvantage of the dividend method may be relevant if the preferred stock is par value stock. Since the stated capital of the corporation may not be less than the aggregate par of the outstanding par value stock, the dividend method may require that the corporation have a substantial amount of surplus which can be capitalized incident to the issuance of the preferred. On the other hand, if the preferred stock has no par value, it is not necessary to transfer any amount of surplus to stated capital.

[b]—Advantages and disadvantages of preferred stock recapitalization alternative. The recapitalization alternative will often be more desirable than the dividend alternative. In a recapitalization exchange the common stockholder who seeks to dilute the value of his common stock transfers to the corporation a portion or all of his common stock and receives preferred stock equal in value to the common so surrendered. No other common stockholders participate in the exchange. The usual advantage of this recapitalization method over the dividend method is that the corporation need issue no more preferred stock than is required to serve the purpose which motivates the issuance.

The disadvantage of the recapitalization method is that it may involve some slight income tax risk. The recapitalization exchange will be feasible in most cases only if assurance can be given that the exchange of common stock for new preferred stock is a tax-free exchange to the participating stockholder. Ordinarily, the common stock will have a value in excess of its adjusted basis to the shareholder. If the appreciated value were taxed to the participating shareholder for income tax purposes, the tax cost might be prohibitive. In this connection the Internal Revenue Code states that a recapitalization exchange is one type of tax-free reorganization exchange. The type of preferred-for-common exchange under discussion constitutes a recapitalization (reorganization) exchange within the meaning of the Internal Revenue Code; if the relevant sections of the Internal Revenue Code could be interpreted literally, the exchange would clearly be tax-free.

As will be observed in more detail in subsequent chapters, however, various judicial exceptions have been engrafted onto the literal language of the reorganization.

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18 See § 7.15 supra.
19 Id.
20 If the participating stockholder receives preferred which exceeds in value the common surrendered, the excess may be held to be taxable compensation for federal income tax purposes or a gift by the other shareholders for gift tax purposes; if the preferred stock is worth less than the common surrendered, the deficiency may be held to be taxable compensation to the other shareholders for income tax purposes or a gift to the other shareholders for gift tax purposes. See § 9.23[4] infra.
21 § 368(a)(1)(E) of the Code defines “reorganization” to include “recapitalization”; § 354(a)(1) provides that an exchange pursuant to a plan of reorganization of stock or securities in a party to the reorganization is tax-free.
22 §§ 11.43 and 12.76 infra.
sections of the Internal Revenue Code. One of these judicial exceptions is the “business purpose” rule which requires that a transaction meeting all of the literal requirements of the Code for treatment as a tax-free reorganization exchange must nevertheless serve a business purpose in order to be tax-free.\textsuperscript{23} The question arises as to whether a business purpose is served when the motivating reason for the recapitalization exchange is to dilute the value of a shareholder’s common stock, thereby facilitating a present or future shift of control to persons who will be actively managing the corporate enterprise. Several cases and two revenue rulings have fairly definitely answered that question favorably to taxpayers.\textsuperscript{24} If the preferred-for-common recapitalization exchange is truly motivated by the desire to expedite a shift of control to persons who are or will be the managers of the business, little, if any, income tax risk will attend the exchange. In brief, therefore, if the attorney can satisfy himself that a bona fide business purpose motivates the exchange, the recapitalization method of diluting the value of common stock will usually be preferable to the dividend method.\textsuperscript{25}

\textbf{[4]—The valuation problem.} The preferred stock recapitalization will almost always present a valuation problem that requires a high degree of judgment and sophistication.

\textbf{[a]—Introduction—a brief history.} As previously indicated, the preferred stock recapitalization can be an effective technique for transferring a common stock interest to younger family members while freezing the value of the transferor’s estate for federal estate tax purposes.\textsuperscript{26} For that reason, it was a highly popular technique prior to 1987. Indeed, many taxpayers were tempted to go further, by whipsawing the Service on valuation arguments. Thus, for gift tax purposes the taxpayer would argue that the various attributes given to the preferred stock gave it a value equal to its stated


\textsuperscript{25} For several years prior to 1982, the National Office issued a large number of private letter rulings stating that the particular preferred stock recapitalization was indeed tax-free. The requests for rulings were undoubtedly motivated by the niggling fear that a Revenue Agent might challenge the presence of a business purpose. In Rev. Proc. 82-30, 1982-1 Cum. Bull. 165, the National Office announced that it will no longer issue advance rulings on the tax status of a recapitalization unless the recapitalization is a part of a larger transaction and it is impossible to determine the tax consequences of the larger transaction without making a determination with regard to the recapitalization. The reason for this policy was simply to make more efficient use of manpower. In effect, the National Office is saying that too many ruling applications were received on this precise question; the published authorities should be relied on more often without bothering the National Office.

In 1988, this Revenue Procedure was modified to make rulings more freely available to publicly owned corporations, and even to closely held corporations where the issue is different from the issues discussed in certain enumerated revenue rulings. The issue discussed in Rev. Rul. 74-269 (see N. 24, supra), however, is one of the no-ruling areas.

\textsuperscript{26} See § 9.23[1][d], supra.
liquidation preference, thereby reducing the value of the common stock by that amount. In many instances the terms of the preferred stock were designed to absorb the entire value of the corporation, with the transfer of common stock being valued at zero. Once the gift tax audit was completed, or after the audit period expired, the corporation might pay little or no further dividends on the preferred stock, thereby keeping the preferred shareholder’s estate from being unduly enhanced.

The Service fought back with a detailed Revenue Ruling in 1983 that attempted to set strict guidelines for valuing preferred stock.\(^{27}\) That, apparently, was not an adequate answer. In 1987, Congress responded to the Service’s plea by enacting the short-lived and much maligned Section 2036(c), the so-called “anti-freeze statute.” Under Section 2036(c), the transfer of a common stock interest coupled with the retention of certain senior interests was treated as an incomplete transfer for estate tax purposes. As a consequence, any appreciation in the value of the transferred common stock was still includable in the transferor’s estate. This statute effectively killed the preferred stock recapitalization as an estate freezing technique, but it was clearly a case of over-kill. In 1990, Congress responded to the urging of many taxpayer groups by retroactively revoking Section 2036(c). At the same time, Congress enacted Sections 2701 through 2704, an entirely different approach to curbing the undervaluation of transfers of business interests to family members. Our concern at this point is with Section 2701, which applies only to transfers after October 8, 1990.\(^{28}\)

[b]—The special valuation rules of I.R.C. Section 2701. The special valuation rules are contained in I.R.C. Section 2701.

[i]—How the statute operates. Section 2701 is based on a subtraction method of determining the existence and amount of a gift of common stock. The value of all stock interests held by family members is the starting point. The value of the preferred stock held by certain family members (usually the older generation) after the transfer is then subtracted from the aggregate starting value. The difference is the amount of the gift. The higher the value of the preferred stock, the lower is the value of the common stock. Conversely, the lower the value of the preferred stock, the higher is the value of the common stock. Therefore, taxpayers can be prevented from abusing the valuation process in this area by making certain that the preferred stock is not overvalued. That is the approach of Section 2701. It establishes a number of rules that keep the valuation of preferred stock as low as possible so that the transferred common stock will be valued as high as possible—in some cases higher than its actual value.

Section 2701 is invoked if an individual transfers an interest in a corporation to a family member and retains certain rights that are senior to the transferred interest. Under certain prescribed circumstances, the retained rights are valued at zero, thereby increasing the value of the transferred interest. In other circumstances, the retained


\(^{28}\) I.R.C. § 2702 deals with transfers in trust with the retention of certain interests and is beyond the scope of this treatise. I.R.C. § 2703 deals with the effect of contractual restrictions on valuation of business interests and is discussed at § 9.4, infra. I.R.C. § 2704 deals with the treatment of the lapse of voting and liquidation rights.
rights are valued, but at their lowest possible value. In all circumstances, the transferred interest is assigned a stated minimum value. Lastly, and perhaps most significantly, any retained rights that are assigned a value other than zero must in fact be exercised in order to avoid a subsequent, and potentially disastrous, gift tax or estate tax liability.

[ii]—What constitutes a transfer that invokes the statute. The special valuation rules are invoked if an individual transfers an interest in a corporation to a family member and the transferor or an applicable family member retains certain rights that are senior to the transferred interest. Thus, the statute is invoked not only when the retained rights are held by the transferor, but also when the retained rights are held by the transferor's spouse, or an ancestor of the transferor or spouse, or the spouse of any such ancestor.28 A "transfer" includes, for this purpose, not only a gift or sale but also a redemption, recapitalization, contribution to capital, or other change in the capital structure of a corporation, if the transferor retains a relevant preferred interest.29

The retained rights must constitute an “applicable retained interest” in order for the statute to be invoked.30 That includes liquidation, redemption, conversion rights, or preferred dividend rights. Dividend rights are considered an applicable retained interest for this purpose, however, only if the transferor and certain members of his family own 50 percent or more of the vote or the value of all of the stock of the corporation immediately before the transfer.31 In determining whether any of these rights have been retained, it is not only the stock owned by the transferor that is counted. The stock that is also owned by the transferor's spouse, any ancestor of the transferor or his spouse, and the spouse of any ancestor, is also counted. In addition, for all determinations of ownership for the purposes of this statute, each individual is treated as owning any stock that is owned indirectly through a corporation, partnership, trust, or other entity. In brief, very broad attribution of ownership rules apply.

The transfer must be made to a member of the transferor's family in order for the statute to be invoked. For this purpose, a transferor’s family means the transferor’s spouse, a descendant of the transferor or spouse, and the spouse of any descendant.31a Thus, it should be noted that the transferee must be the spouse or a younger generation. By contrast, the retained preferred interest must be possessed by the spouse or an older generation. The statute is not invoked when a transfer is made to a sibling or an ancestor. Nor is it invoked when a transfer is made to an unrelated key employee.

[iii]—How retained interests are valued. When the statute is invoked by a relevant transfer, its effect is to suppress the value of the retained interest, thus

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28 I.R.C. §§ 2701(a)(1) and 2701(e)(2).
29 I.R.C. § 2701(e)(5).
30 I.R.C. § 2701(b).
31 I.R.C. § 2701(b)(1). In determining this 50 percent ownership, stock owned by a transferor’s siblings and descendants is counted, in addition to the other persons and entities that are described in the text immediately following. I.R.C. § 2701(e)(3)(B). The Regulations expand this attribution rule to include any descendant of the parents of the transferor or the transferor’s spouse. Treas. Reg. § 25.2701-2(b)(5).
31a I.R.C. § 2701(c)(1).
increasing the value of the transferred interest. This is accomplished by the imposition of certain arbitrary valuation rules.

If the retained interests do not include a right to receive a “qualified payment,” all of the retained interests are valued at zero. Thus, for example, if a transferor of common stock retains a right simply to receive an amount in liquidation of the corporation, that right will be valued at zero. If, in addition, the retained interest confers a right to a noncumulative dividend, both of the retained interests will be valued at zero because a noncumulative dividend right is not ordinarily a “qualified payment.”

If the retained interest includes a right to a “qualified payment,” and also includes one or more liquidation, put, call, or conversion rights, the value of all of the retained rights is determined as if each liquidation, put, call, or conversion right were exercised in the manner resulting in the lowest value for all of the retained rights. A “qualified payment” means a cumulative preferred dividend payable on a periodic basis at a fixed rate or at a rate which bears a fixed relationship to a specified market interest rate. The clear purpose of this basic valuation rule is to prevent the use of seemingly value-enhancing rights to distributions to inflate the value of the retained interest when the option is left open for that right never to be exercised.

The Conference Committee Report gives this example: 

Example: Father retains cumulative preferred stock in a transfer to which these valuation rules apply. The cumulative dividend is $100 per year and the stock may be redeemed at any time after two years for $1,000. The value of the cumulative preferred stock is the lesser of (1) the present value of two years of $100 in dividends plus the present value of the redemption for $1,000 in year two, or (2) the present value of $100 paid every year in perpetuity.

(iv)—Elective treatment by the transferor. An interesting and important part of these special rules is the availability of an elective treatment by the transferor. If the transferor so elects, an otherwise “qualified payment” can be treated in whole or in part as not being a qualified payment. In that event the retained interest is valued at a lower amount, or zero, which will increase the value of the transferred interest. By so doing, however, the transferor avoids the possible future adjustments in transfer tax liability that will be made if qualified payments are not in fact made (see subdivision [vi], below). By the same token, a transferor may elect to treat a retained right to dividends in whole or in part as a “qualified payment,” to be paid in the amounts and at the times specified in the election, provided that the amounts and the times are not inconsistent with the terms of the retained preferred

31b I.R.C. § 2701(c)(3)(A). The transferor may elect, however, to treat a noncumulative dividend right as a “qualified payment.” See subsection [iv], infra.


31d By the same token, a right that must be exercised at a specific time and at a specific amount is not considered a liquidation, put, call, or conversion right. I.R.C. § 2701(c)(2)(B). Instead, it is a right that is taken into account in valuing the retained interest.

31e Neither the statute nor the regulations refer to an objective standard for selecting the applicable discount rate. Presumably, taxpayers must rely on the advice or testimony of experts in the banking and money management field.

stock. By so electing, the transferor obtains the immediate advantage of valuing the retained interests, thereby decreasing the value of the transferred interest. The disadvantage of making the election is that the retained interests thereby become subject to future adjustments if the specified payments are not in fact made.

In most cases it will be advisable to retain the valuation advantage of a qualified payment, and to elect that advantage when it would not otherwise be available. If qualified payment status is retained, or elected, the immediate transfer tax cost will be minimized, and this bird-in-the-hand advantage is likely to be determinative in most cases. In addition, the risk that a double tax may be incurred will be avoided. Although Treasury Regulations contain favorable rules that provide adjustments for later gift and estate tax valuations when the special valuation rule applies on an initial transfer, those rules do not always provide complete relief and contain traps for the unwary.

The advantages of opting for an immediate value for the preferred stock will usually depend on the transferor’s willingness to bind himself to a fixed cumulative dividend or to a timely payment of the specified noncumulative dividend, thereby avoiding future transfer tax adjustments. In some instances it may be desirable for the transferor to retain the flexibility of having noncumulative dividends passed, thereby avoiding a build-up of his taxable estate, even though that means an immediate zero valuation for the preferred stock. This might be the case when the combined value of the common and preferred stock is relatively low in relation to the value of the transferor’s other assets. In this circumstance, the gift tax cost may be little or nothing in any event, and the transferor is less likely to need or want a dividend on the preferred stock.

[v]—Minimum value for common stock. These special valuation rules require that a specified minimum value be attributed to a gift of common stock. If a transferor transfers common stock to a member of his family (generally, the spouse or a descendant), the minimum value that may be attributed to the common stock is the value it would have if all of the common stock of the corporation were worth 10 percent of—

(1) the total value of all of the stock, of whatever class, of the corporation, plus
(2) the total amount of debt owed by the corporation to the transferor and certain other members of his family (generally, the spouse and any ancestor).

Clearly, this minimum value may substantially exceed the actual value of the transferred common stock.

\[31g\] I.R.C. § 2701(c)(3)(C)(ii). See Prop. Treas. Reg. § 25.2701-2(c)(2), (d), Ex. 5, for further detail relating to a partial decision.

\[31h\] See § 9.23[4][b][vii], below.

\[31i\] If, however, the transferor has voting control of the corporation, either through the preferred stock or otherwise, the failure to pay the noncumulative dividend is likely to constitute a taxable gift in that year to the common stockholders. See Ltr. Rul. 8723007.

\[31j\] I.R.C. § 2701(a)(4).

\[31k\] The regulations take the favorable position that short-term debt incurred with respect to the current conduct of business—for example, accrued salary—is not “debt” for this purpose. Prop. Treas. Reg. § 25.2701-3(c)(2).
[vi]—Adjustments for failure to pay dividends. A cumulative preferred dividend right ordinarily constitutes a “qualified payment,” and a noncumulative preferred dividend right constitutes a “qualified payment” if the transferor so elects. As a consequence, the transferor may value his retained preferred stock and take that value into account in determining the value of the transferred common stock. That leaves open the possibility that the indicated dividends on the preferred stock will not in fact be paid, even though they have been taken into account in lowering the value of the transferred common stock. These special valuation rules anticipate this possibility and plug the loophole that would otherwise exist.\textsuperscript{31l} If a qualified payment, including a noncumulative dividend that the transferor elected to treat as a qualified payment, is not paid in full within four years of its due date, the transferor may incur an additional transfer tax. This is true because the transferor will be deemed to have made an additional gift in a specified amount if he transfers the retained interest during his lifetime. Similarly, if the transferor retains the interest until his death his estate will be increased by a specified amount.

The amount of the additional gift or increase in the taxable estate is determined by treating all of the preferred dividends as having in fact been timely paid from the time of the transfer until the time of the taxable event, and the amounts reinvested at a yield equal to the discount rate used in determining the value of the retained interest, and subtracting from that total the value of the payments actually paid.\textsuperscript{31m} The increase in taxable gifts or in the taxable estate can not, however, exceed a percentage of the increase, from the date of the original transfer to the date of the subsequent taxable event, in the value of all stock interests in the corporation that are junior to the retained interest. The percentage limitation is equal to the percentage of the preferred class of stock owned by the transferor on the date of the subsequent taxable event. Thus, if the common stock does not increase in value after the transfer, no additional gift tax or estate tax liability is occasioned by the failure to pay preferred dividends that constitute “qualified payments.”

Perhaps needless to say, this subsequent adjustment rule can result in large, and usually unanticipated, tax deficiencies. This is especially true because of the likely inapplicability of the gift tax statute of limitations.\textsuperscript{31n} When the compounded growth in the reinvestment of the deemed dividend is added to the simple interest accumulated for many years on a gift tax deficiency, the sum may be staggering indeed. This provision is likely to become a proverbial “trap for the unwary” in the years following 1990.

[vii]—Adjustments to prevent double taxation. These special valuation rules have the potential for imposing a double transfer tax. Thus, if a retained preferred stock interest is not given its full value at the time when common stock is transferred to a family member, the value of the transferred common stock is correspondingly increased and the gift tax cost is thereby increased. If the retained preferred stock is valued at its full fair market value when a subsequent gift is made or when the

\textsuperscript{31l}I.R.C. § 2701(d).
\textsuperscript{31m}Both the deemed payments and the actual payments are valued on the basis of the time value of money at the discount rate used in valuing the retained interest.
\textsuperscript{31n}See [d], below.
The transferor dies, the amount of the initial reduction in value is taxed twice for transfer tax purposes. Fortunately, the Treasury Regulations contain rules that usually enable taxpayers to avoid this double tax pitfall.\footnote{31o Treas. Reg. § 25.2701-5.}

The transferor is entitled to reduce the taxable amount of his or her later gifts, or his or her taxable estate, by an appropriate amount when the special valuation rules result in a valuation of preferred stock, at the time of the initial transfer, at an amount that is less than its fair market value. The amount of the reduction is usually the amount by which the value of the common stock was increased by the application of the special valuation rule. If, however, the retained preferred stock declines in value from the date of the initial transfer to the time of the later disposition, that decline in value is subtracted from the amount of the reduction.\footnote{31p Treas. Reg. § 25.2701-5(b)(2), (c).}

In no event may the reduction, or the remaining portion of the reduction, be greater than the amount necessary to reduce the transferor’s federal estate tax to zero.\footnote{31q Treas. Reg. § 25.2701-5(a)(3).} The available reduction is first applied to the transferor’s subsequent gifts for federal gift tax purposes. Any amount remaining at the transferor’s death reduces the transferor’s taxable estate for federal estate tax purposes.

Ordinarily, when the special valuation rule applies, the initial transferor of common stock is the same person who retains the preferred stock. But that is not necessarily true. The special valuation rule can also apply when the preferred stock is retained by the transferor’s spouse, or ancestor, or spouse of an ancestor (the so-called “applicable family members”).\footnote{31r See [ii], above.}

If the owner of the preferred stock makes a gift of that stock, or dies, during the initial transferor’s lifetime, no adjustment is made to the preferred stockholder’s gift or estate tax; instead, the appropriate reduction is allocated to the initial transferor.\footnote{31s Treas. Reg. § 25.2701-5(a)(2), (3).} It is the initial transferor, after all, who incurred the additional gift tax on account of the application of this special valuation rule. If the owner of the preferred stock (other than the initial transferor) still owns the preferred stock at the time of the initial transferor’s death, the preferred stock is deemed to be transferred at the time of the initial transferor’s death in a manner that gives rise to the appropriate reduction in the initial transferor’s taxable estate.\footnote{31t Treas. Reg. § 25.2701-5(c)(3)(ii).} If the initial transferor is the person who retains the preferred stock and sells it during his or her lifetime, or if an applicable family member retains the preferred stock and sells it during the initial transferor’s lifetime, the initial transferor’s estate is entitled to a reduction in the same manner as if the preferred stock was held by the initial transferor at the time of his or her death at a value equal to the consideration received on the sale.\footnote{31u Treas. Reg. § 25.2701-5(c)(3)(i).}

This favorable adjustment to avoid double taxation applies on a lifetime transfer or sale only if the transfer is to a person other than the initial transferor or an applicable family member of the initial transferor; that is, other than the initial transferor’s spouse, ancestor, or spouse of an ancestor. If the initial transferor owns the preferred stock at the time of his or her death, however, the appropriate reduction is available even

\footnotesize{\textit{PROCEDURES IN SHIFTING SHAREHOLDER CONTROL}}

\textit{§ 9.23[4]}
though the legatee of the preferred stock is an applicable family member. Similarly, if an applicable family member other than the initial transferor retains the preferred stock and continues to own it at the time of the initial transferor’s death, the preferred stock is deemed to be transferred at the time of the initial transferor’s death to a person other than the initial transferor or an applicable family member of the initial transferor. Accordingly, the estate of the initial transferor may utilize the reduction irrespective of the identity of the ultimate recipient of the preferred stock. If, however, an applicable family member owns the preferred stock and dies during the lifetime of the initial transferor, the preferred stock must pass to persons other than the initial transferor or an applicable family member of the initial transferor in order for the reduction to be available to the initial transferor.\textsuperscript{31v}

These adjustment rules are fairly intricate. They can be illustrated by the following examples that are adapted from the examples in the Treasury Regulations.\textsuperscript{31w}

Example 1: P owns all of the stock of X Corporation, which consists of 1,500 shares of noncumulative preferred stock and 1,000 shares of common stock. P receives a noncumulative dividend that he does not elect to treat as a “qualified payment.” The preferred shares are worth $1,000 per share, for a total value of $1,500,000. The common shares are worth $500 per share, for a total value of $500,000. On January 15, 1993, P makes a gift of all of his common stock to C, his child. For gift tax purposes P must treat the gift as being $2,000,000 because the preferred stock is valued at zero under the special valuation rules. On January 15, 1994, when the preferred stock is still worth $1,500,000, P makes a gift of all of his preferred stock, plus $500,000 in cash, to C. For his 1994 gift tax purposes, P may reduce the amount of his gift by $1,500,000, the amount of his 1993 overvaluation, so that his 1994 gift is $500,000.

Example 2: The facts are the same as in Example 1, except that on January 15, 1994, the preferred stock is worth only $1,200,000. The amount of the reduction is decreased to $1,200,000. The $300,000 difference between the 1993 overvaluation of $1,500,000 and the 1994 reduction of $1,200,000 is lost; it is not later available to P for gift tax or estate tax purposes.

Example 3: The facts are the same, except that on January 15, 1994, P sells the preferred stock to an unrelated person for $1,000,000. P dies on July 1, 1994. P’s estate may reduce the value of the taxable estate by $1,000,000, just as though P had owned the preferred stock at his death, with a value of $1,000,000.

Example 4: The facts are the same, except that on January 15, 1993, the preferred stock is owned by P’s parent, GP. GP dies on July 1, 1994, still owning the preferred stock, which is still worth $1,500,000. GP bequeaths the preferred stock to persons other than P or an applicable family member of P. P is entitled to a reduction in 1994 and subsequent years, for gift and estate tax purposes, of an aggregate amount of $1,500,000.

Example 5: The facts are the same as in Example 4, except that P dies on July 1, 1994. At that time, GP is still alive and the preferred stock is still worth $1,500,000.

\textsuperscript{31v} Treas. Reg. § 25.2701-5(a)(2).
\textsuperscript{31w} Treas. Reg. § 25.2701-5(d).
P’s estate may reduce the taxable estate by $1,500,000, as though P owned the preferred stock at death.

It must be emphasized that the transfer tax adjustment on account of the application of the special valuation rule is not transferable. It must be used by the initial transferor (or in some cases the transferor’s spouse if the initial gift is split) or not at all. This is true even though the initial transferor dies and leaves his or her entire estate to his or her spouse in a manner that qualifies for the marital deduction. In that event no reduction in the taxable estate is needed in order to reduce the taxable estate to zero. Nevertheless, the reduction does not transfer to the spouse to be utilized at the time of her later death. It is simply wasted. Proper estate planning therefore requires that this adjustment be taken into account before the marital deduction is applied, so there will be no over-qualification of the marital deduction bequest resulting in an unnecessarily higher estate tax when the surviving spouse dies. If the marital deduction formula provides that the smallest amount necessary to reduce the taxable estate to zero is to be allocated to the marital deduction bequest, the available adjustment will first be utilized to reduce the taxable estate and the proper result should automatically obtain. Or, if a part or all of the surviving spouse’s share of the estate is left in a so-called “QTIP trust,” the executor should make the proper allocation between the marital deduction portion and the non-marital portion. If the entire estate is simply left outright to the surviving spouse, or in a marital deduction trust for the surviving spouse, the available adjustment will be wasted, and to that extent double taxation will have been incurred.

[c]—The exceptions to the special valuation rules. There are exceptions, both express and implied, to the application of this special valuation rule. It does not apply if market quotations are readily available on an established securities market for either the transferred stock or the retained stock.31x Nor does it apply if the transferred stock is of the same class as the retained stock, or would be of the same class except for nonlapsing differences in voting power.31y Thus, for example, the statute does not apply if a parent transfers nonvoting common stock to a child and retains voting common stock. Also, the regulations take the position that the statute does not apply to the extent the transfer results in a proportionate reduction of each class of stock owned by the transferor and all applicable family members in the aggregate immediately before the transfer.31z For example, if A and his father together own 60 percent of both the common and the preferred stock in a corporation, and A makes gifts of both his common and preferred stock to A’s children, so that after the gift the combined holdings of A and his father are 40 percent of both the common and preferred stock, the statute does not apply. If the gift by A had reduced the combined holdings of A and his father in the common stock to 40 percent and in the preferred stock to 50 percent, the statute would apply to the valuation of 10 percent of the common stock, or to one-half of the gift. And, lastly, this special valuation rule does not apply if the applicable family members are the transferor’s spouse, any ancestor of the transferor or his spouse, and the spouse of any ancestor.

31x I.R.C. §§ 2701(a)(1)(B) and 2701(a)(2)(A).
31y I.R.C. §§ 2701(a)(2)(B) and (C).
31z Prop. Treas. Reg. § 25.2701-1(c)(4). The applicable family members are the transferor’s spouse, any ancestor of the transferor or his spouse, and the spouse of any ancestor.

The transferor retains only a creditor interest in the corporation. A redemption of all of the stock owned by a shareholder in exchange for a promissory note with fixed interest and principal payments is not subject to the statute.

[d]—Waiver of gift tax statute of limitations. An important change in the gift tax statute of limitations places a substantial premium on adhering as closely as possible to the new valuation rules. If a transfer is subject to the new valuation rules and is not reported on a gift tax return, the gift tax statute of limitations is completely waived. This does not necessarily mean that the transfer must be reported as a gift. It does require, however, that the transfer be disclosed on the return, or in a statement attached to the return, in a manner adequate to apprise the IRS of the nature of the item. The proposed regulations require that an inordinately high degree of detail be furnished with the gift tax return in order for the IRS to be “adequately apprised.” Thus, according to the proposed regulations, the taxpayer must furnish the IRS with, among other details, a description of the method used to value the transferred and retained interests, the actuarial factors and discount rates used in the valuation, and, in the case of an equity interest that is not actively traded, the financial and other data used in determining value, including five years of balance sheets, earnings statements, operating results, and dividends paid. This degree of detail is apparently required when the transaction is not treated to any extent as a gift but is simply reported for information purposes, and is also required when the transaction is treated as a gift and reported as such on a gift tax return. Practitioners must be aware that the audit of an estate tax return may disclose a gift tax omission that may have occurred many years prior to the decedent’s death. If the statute of limitations is waived under this provision, the resulting gift tax deficiency plus interest accrued for many years can be devastating. A growing awareness of this risk is likely to result in meaningful compliance with these special valuation rules and the need to adequately apprise the IRS of any transaction subject to the rules.

[5]—How the taint of Section 306 affects planning. When preferred stock is issued tax-free by a going corporation, it will often be characterized as “Section 306 stock,” with potentially adverse tax consequences on its later disposition. When stock which is so characterized, or tainted, is sold to a purchaser other than the issuing corporation, the full proceeds of sale, not simply the profit element, are likely to be taxed to the seller as ordinary income to the extent of the corporation’s earnings and profits at the earlier time when the Section 306 stock was issued. If the tainted stock is redeemed by the issuing corporation, the full proceeds of the redemption are likely to be taxed to the seller as ordinary income to the extent of the corporation’s earnings.

31aa The retained interest must be an equity interest in order for the statute to be invoked. Treas. Reg. § 25.2701-2(b)(1).

31bb I.R.C. § 6501(c)(9), enacted by the 1990 Tax Act. This is true even where the gift is occasioned by a subsequent adjustment attributable to unpaid preferred dividends. See [b], above.

31cc Treas. Reg. § 301.6501(c)-1(e).

32 The history and significance of the tax loophole which was closed by the enactment of Section 306 in 1954 are discussed briefly in ch. 2, Incorporation Planning and Procedure.

33 I.R.C. § 306(a)(1)(A)(ii). See [b], below, for the possible exceptions to this adverse rule.
and profits at the time of their redemption.\textsuperscript{34} Also, if the tainted stock is donated to a charitable organization, only the taxpayer’s basis, not the full fair market value, may be deducted as a charitable contribution.\textsuperscript{34.1} In each of these events, the tax consequence is likely to be adverse. Fortunately, however, there are a number of important exceptions to this adverse treatment. The business advisor must make sure that a planned disposition will be protected by one of them.

\[a\]—What constitutes Section 306 stock. Preferred stock issued as a dividend on the outstanding common stock will always constitute Section 306 stock, if the corporation has any amount of earnings and profits at the time of the issuance.\textsuperscript{35} If, however, preferred stock is issued in a recapitalization—that is, in exchange for common stock—it will constitute Section 306 stock only if the effect of the transaction is the same as a stock dividend.\textsuperscript{36} In determining whether the transaction has the effect of a stock dividend, the test which is applied is to substitute, hypothetically, cash in lieu of the preferred stock distribution. If that hypothetical cash would be taxed as a dividend to the recipient, the preferred stock will be characterized as Section 306 stock.\textsuperscript{37} If, by contrast, the cash would be treated as having been received in a sale or exchange transaction, the preferred stock will not constitute Section 306 stock. The critical rules for making this test are the redemption rules of Section 302, to which the reader is referred.\textsuperscript{38}

Example: X corporation has 100 shares of common stock outstanding. A owns 70 shares, and four unrelated key employees own the balance. In order to make it feasible for the minority shareholders to purchase the balance of the common stock upon A’s death, X is recapitalized. A surrenders 50 of A’s shares for a new issue of preferred stock having an equivalent value, and the shareholders enter into an agreement relating to the purchase of A’s remaining 20 common shares upon A’s death. A’s percentage of common stock is cut back from 70 percent to 40 percent (20 shares out of a total of 50 shares outstanding after the recapitalization). The cut-back will satisfy one of the favorable tests under Section 302 for sale or exchange treatment if cash had been distributed in lieu of preferred stock. Accordingly, the preferred stock will not constitute Section 306 stock.\textsuperscript{39}

\textsuperscript{34} I.R.C. § 306(a)(2). See [b], below, for the possible exceptions to this adverse rule.

\textsuperscript{34.1} Pescosolido v. Commissioner, 883 F.2d 187 (1st Cir. 1989).

In addition, ordinary income treatment means that the 39.6 percent top individual rate of tax may be applicable, rather than the maximum 28 percent rate that is applicable to long-term capital gain.

\textsuperscript{35} I.R.C. §§ 306(c)(1)(A) and 306(c)(2). The significance of the earnings and profits requirement in planning an issuance of preferred stock at the inception of the corporate life is discussed in ch. 2, Incorporation Planning and Procedure.

\textsuperscript{36} I.R.C. § 306(c)(1)(B). The issuing corporation must also have some amount of earnings and profits at the time of the issuance, or in the fiscal year in which the preferred stock is issued. See Treas. Reg. § 1.306–3(a) and Rev. Rul. 79–274, 1979–2 Cum. Bull. 131.

\textsuperscript{37} Treas. Reg. § 1.306–3(d).

\textsuperscript{38} See § 9.33[2], infra.

\textsuperscript{39} This favorable result will follow even if the preferred stock possesses the same, or greater, voting power than was possessed by the redeemed common stock. See Rev. Rul. 75–236, 1975–1 Cum. Bull. 106 for the relevant definition of “preferred stock.” See Ltr. Rul. No. 7737006 for a private ruling on this point.
The important point is that not all preferred stock issued tax-free in a recapitalization exchange is Section 306 stock. In many instances, proper attention to the applicable rules at the planning stage, and structuring the transaction in accordance with those rules, can result in a recapitalization exchange which relieves the preferred stock from the taint of Section 306.

[b]—When a disposition of Section 306 stock is not adversely taxed.

Even if preferred stock clearly constitutes Section 306 stock, not all subsequent dispositions will result in dividend characterization under the unfavorable general rule. The following exceptions to adverse treatment apply:

[i]—Tax-free transfers. Transfers of stock on which gain or loss is not recognized do not become recognized—that is, taxed—simply because the stock is Section 306 stock. Thus, gifts of Section 306 stock do not result in taxable income. Instead, the Section 306 stock characterization will carry through to the donee, with potentially adverse tax treatment when he disposes of the stock. Similarly, the “sale” of Section 306 stock by means of a tax-free statutory merger, or by means of any other type of reorganization, will not result in taxable gain at that time.

[ii]—Dispositions after death. When a new owner of Section 306 stock has a basis for that stock that is not determined by reference to the basis of the prior owner, the stock loses its Section 306 taint. The most significant application of this rule relates to the death of the original owner of Section 306 stock. Since the decedent’s estate and its beneficiaries take a new basis equal to the fair market value of the stock upon the death of the owner, and since that fair market value has no relationship to the decedent’s basis, the Section 306 taint is wiped out at death.

This beneficial rule is particularly important since it is often contemplated that the original owner of the preferred stock that is received on a recapitalization exchange will hold that stock until his death. If he does, the initial taint will have little significance. Suppose, for example, that X Corporation has outstanding 100 shares of common stock, 80 shares of which are owned by A, and 20 shares are owned by his son, B. Because of A’s increasing age, and his desire to motivate B to take over more of the management responsibilities, he causes the corporation to issue a new class of preferred stock to him in exchange for all of his common stock. The preferred stock will constitute Section 306 stock. Any sale or redemption of the stock by A during his lifetime, unless it

40 For a more detailed treatment of Section 306 stock, see Cavitch, Tax Planning for Corporations and Shareholders (Matthew Bender 1992), § 8.06; for the National Office’s application of the ownership attribution rules in this precise area, see § 8.06[2][b] of that treatise.

41 I.R.C. § 306(b)(3).

42 If preferred stock is received in the exchange, however, it will be characterized as Section 306 stock. I.R.C. § 306(c)(1)(B).

43 Treas. Reg. § 1.306-3(e).

44 The attribution rules of Section 318 apply in determining whether the receipt of cash, in lieu of preferred stock, would be treated as a dividend. I.R.C. § 306(c)(4). Thus, in our example, A will still be considered as owning his son’s common stock. Since A will be treated as the owner of all of the common stock, both before and after the receipt of the preferred stock, the preferred stock would have been taxed as a dividend if it had been cash. See § 9.33, infra.
fits within one of the other exceptions, may be characterized as a dividend. But A intends to keep the preferred stock until his death, at which time he will bequeath it to his wife or to his children who are not active in the business. Any sale or redemption by them after A’s death will be free of the Section 306 taint.

[iii]—Complete termination of stock interest. If the holder of Section 306 stock sells his stock to any person or entity who is not within the attribution relationship of Section 318 of the Internal Revenue Code, and if the sale terminates completely his stock interest in the corporation, the penalty of Section 306 will not apply. In determining whether his stock interest has been completely terminated, the attribution rules of Section 318 are applicable. If the holder of Section 306 stock has his stock redeemed by the issuing corporation, the Section 306 penalty will not apply if the redemption satisfies the complete termination of interest test of Section 302(b)(3) of the Code.

(iv)—Complete liquidations. If Section 306 stock is redeemed in a transaction which constitutes a complete liquidation, the penalty of Section 306 treatment will not apply.

[v]—Transactions not in avoidance of federal income tax. Section 306 tax treatment will not apply on the disposition of Section 306 stock if the IRS is satisfied that the distribution of the stock and the subsequent disposition or redemption of the stock were not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. This exception is highly subjective, and its usefulness as a planning tool is inhibited by that. Also, the National Office will not ordinarily issue advance rulings on whether this exception will be applicable with respect to a proposed transaction.

§ 9.3—How to Shift Shareholder Control and Bail Cash Out of Corporation Through Corporate Purchase of Its Own Shares.

In the preceding section we were concerned with the relatively uncomplicated problems incident to shifting control through a shareholder purchase of stock. We now turn to the more complex tax and nontax problems incident to shifting control and bailing cash out of a corporation through a redemption of shares.

46 In the case of a sale, as distinguished from a redemption, it does not appear that relief from family attribution can be obtained by satisfying the “10-year look-ahead” and “10-year look-back” rules. See § 9.33[2][c], infra, for these rules.
47 I.R.C. § 306(b)(1)(B). In the case of a redemption, it would seem that relief from family attribution will be available if the “10-year look-ahead” and “10-year look-back” rules are met.
48 I.R.C. § 306(b)(2).
49 I.R.C. § 306(b)(4).
§ 9.31—A comparison of the redemption with the shareholder purchase.

The dollars used by the purchaser, whether the corporation or the remaining shareholders, are after-tax dollars, so that a higher effective tax rate makes the available dollars more costly. Under current tax rates this factor is likely to favor the redemption; that is, the effective tax rate for a corporate purchaser is likely to be 34 percent, whereas the likely effective tax rate for an individual purchaser is likely to be 36 percent or 39.6 percent.1 But this will not always be so; a definitive answer will require a close look at the present and anticipated tax brackets of both the corporation and the shareholders.1a Clearly, if the dollars that can be made available to the shareholders of a conventionally taxed C corporation represent the net amount available after both the corporate tax and the individual tax, the double tax burden of a shareholder purchase is almost certain to be too great to be feasible. In many instances, the redemption is still less costly from a tax standpoint than a shareholder purchase.

In addition, where a future buy-out is to be funded with life insurance, and the corporation has more than three shareholders who are to be parties to the agreement, the mechanics and cost of life insurance funding of a shareholder purchase may be overwhelming.1b With several shareholders, life insurance funding of a redemption is more easily managed, and often much less costly.1c

Furthermore, a redemption will sometimes be motivated, not by a desire to shift shareholder control, but by the real or hoped-for advantage of bailing cash out of the corporation at a minimum tax cost.2 In this latter event, the shareholder purchase alternative is necessarily ruled out.

§ 9.32—Michigan law requirements and procedures.

A purchase or redemption of shares may arise under various conditions. It is very common that such a purchase arises pursuant to provisions in a buy-sell agreement or as a result of negotiations prompted by various reasons.3 In addition to these methods, it is expected that increasing use will be made of a statutory provision whereby a corporation may issue one or more classes or series of shares which are redeemable at the option of the corporation in such property, at such prices, within such periods and under such conditions as are contained in the Articles.4

Inasmuch as the payment by a corporation for its own shares decreases the net worth of the corporation,5 restrictions on a corporation’s right to purchase its shares must

§ 9.3

1 If the corporation is an S corporation, the effective tax rate will be the same for both a redemption and a shareholder purchase.
1a See § 1.11[2], supra.
1b See § 9.22 supra.
1c See § 9.34 infra.
3 A power to deny or restrict the transferability of stock will not be implied and will be strictly construed and a corporation may lose its right to first option to purchase if it does not confirm strictly to the procedures prerequisite to exercise of the option. Fletcher v. Kentucky Inns, Inc., 88 Mich. App. 456, 276 N.W.2d 619 (1979).
4 M.B.C.A. § 304a (discussed at § 2.11(1)(b)(ii)).
5 To the extent that the corporation pays for its own shares in cash or other property, the corporation’s
of necessity be imposed for the protection of the corporation’s creditors. In this connection, the Michigan statutes set forth two specific tests to determine whether a corporation may purchase its own shares: the equity insolvency test and the balance sheet test.6

When a Michigan corporation acquires its own shares by purchase or redemption, the shares so acquired constitute authorized but unissued shares. This reflects the abolition of “treasury shares” under the Michigan Business Corporation Act. If the shares redeemed or purchased by the corporation are subject to a pledge or security interest for payment of the purchase or redemption price, such shares are not canceled and do not constitute authorized but unissued shares until the purchase or redemption price is paid. The acquired or pledged shares may not be voted.7

§ 9.33—How to assure that seller will avoid dividend tax treatment.

A shareholder who sells his or her stock to a fellow shareholder or to any other individual is assured of obtaining favorable sale or exchange tax treatment.36 By contrast to the relative ease of determining the tax status of the seller in a shareholder purchase, a redemption may require an exceedingly involved analysis to determine the income tax status of the seller. A redemption can often result in the payment to the seller being taxable to the seller in full as with no offset available to the seller for his or her basis in the shares surrendered. When the seller’s basis is relatively high in relation to the sale price, characterization of the redemption as a dividend may be intolerable.37 Even when the seller has little or no basis to offset the sale price, characterization as a dividend means that the effective tax rate is likely to be 39.6 percent instead of 20 percent.37a Since large dollars are likely to be involved, this rate of 31 percent. See § 1.11[1] supra. Also, sale or exchange income, or capital gain, may be offset in full by any capital loss incurred by the taxpayer; other types of income can be offset only to a limited amount by capital losses (see I.R.C. § 1211).

36 This is particularly likely to be the case when the sale is to take place after the shareholder’s death. In that event, the basis of the stock is likely to be stepped-up to its fair market value at the date of death, or six months after the date of death. I.R.C. § 1014.
37a If the sale takes place after August 10, 1998, and is characterized as a sale or exchange, rather than as a dividend, and the stock is “qualified small business stock” held for more than five years, only one-half of the gain is subject to capital gain tax, under I.R.C. § 1202. Similarly, if the QSB stock has been held for at least six months and its sale proceeds are used to purchase other QSB stock within 60 days after the sale, the gain is entirely deferred, under I.R.C. § 1045. See § 1.11[1][b][iv] supra.
differential (39.6 is approximately 100 percent more than 20) can be an extremely important factor. Furthermore, if a redemption is treated as a dividend distribution, installment reporting will not be available on the receipt of the corporation’s promissory note, whereas it is almost certainly available if the redemption is treated as a sale or exchange.\footnote{37b} In addition, if the redemption is not treated as a sale or exchange, the seller will not be able to rely upon the capital gain exclusion or the tax-free rollover opportunity for qualified small business stock.\footnote{37c} The purpose of the following discussion is to determine in which situations unfavorable dividend treatment will be avoided and what steps can be taken in appropriate instances to assure that avoidance.

\[1\]—How the tax problem arises. If there were no relevant limitation in the Internal Revenue Code, a redemption transaction could be the basis for a most obvious tax loophole. Consider, for example, the following illustrations:

1. A is the sole shareholder of X Corporation. A’s cost basis for those shares is $100,000. X has $75,000 of accumulated earnings which X would pay to A as a dividend but for the very high personal income tax that would result. Accordingly, in an attempt to avoid a prohibitively high tax and at the same time receive $75,000 cash, A sells half of the shares to X for $75,000. A’s tax objective is to have that sale treated as a sale, with $50,000 of the total cost basis offsetting the $75,000 proceeds and only the $25,000 profit subject to tax at a relatively modest 20 percent rate. Realistically, however, A is in the same position after the sale that A would have been in if A had simply received a $75,000 dividend from the corporation. A is still the sole shareholder of the corporation and has received $75,000 cash.

2. Suppose A and B each own half the stock of X Corporation; each has a cost basis of $50,000 for his shares. X has $75,000 of accumulated earnings which A and B would like to place in their pockets. Accordingly, both surrender half of their stock to X for $37,500, hoping to pay a tax at 20 percent on the gain of $12,500. Realistically, A and B are in the same position as they would be had X distributed the $75,000 as a dividend. They are still the equal shareholders of the corporation and they have $75,000 in pocket.

In both of the above illustrations, the redemptions have essentially the same effect as a dividend distribution and should be so taxed. It is therefore not surprising that the Internal Revenue Code has long contained limitations on the right of a shareholder to treat a sale of shares to the issuing corporation as a sale for income tax purposes.

Before to 1954, the only statutory limitation was that the proceeds of a redemption would be treated as a dividend distribution if the redemption was essentially equivalent to a dividend distribution.\footnote{38} That vague and general language resulted in endless litigation and in the development of a large number of judicial tests to distinguish between a “good” (i.e., taxable as a sale) and a “bad” (i.e., taxable as a dividend) as a sale or exchange.
redemption transaction. In 1954, Congress attempted a more definitive delineation between “good” and “bad” redemptions than had been developed by the courts under the prior, inadequate statutory provision. The present statutory rules are very helpful and at the same time relatively complicated.

[2]—How to avoid ordinary dividend treatment under the usual redemption rules of Section 302 of the Internal Revenue Code. The tax status of most redemption distributions will be determined by the rules contained in Section 302 of the Internal Revenue Code.

[a]—The three favorable shareholder tests under Section 302 of the Internal Revenue Code. Under the redemption rules of Section 302, a redemption is treated favorably as a sale (and not as a dividend distribution) if the redemption satisfies one of several tests. Three of these tests are applicable if the redemption effects a sufficiently significant change in the redeemed shareholder’s relationship to the corporation. They are, by far, the most important tests. In most cases it will be prohibitive as far as taxes are concerned to effect a redemption unless one of these tests is satisfied.

[i]—The basket test of dividend equivalence. Favorable sale or exchange treatment will be applicable, even though the redemption satisfies neither of the subsequently discussed mathematical tests, if the redemption is not essentially equivalent to a dividend. This is virtually the same vague and general test which was in the Internal Revenue Code before 1954 and is not ordinarily reliable as a planning guide. There are, however, some instances in which the basket test is emerging as a reliable guide, particularly with respect to partial redemptions from minority shareholders. This is true notwithstanding the limiting effect of the Supreme Court’s 1970 decision in United States v. Davis. Indeed, it is largely on account of the Davis case that the National Office has issued a series of rulings involving the basket test. These rulings, in turn, presently form the nucleus around which a degree of significant planning can be effected.

See, for example, Northup v. United States 240 F.2d 304 (2d Cir. 1957); Kirschenbaum v. Commissioner, 155 F.2d 23 (2d Cir.), cert. denied, 329 U.S. 726 (1946); Boyle v. Commissioner, 187 F.2d 557 (3d Cir. 1951).

I.R.C. §§ 302 and 318. It is not necessary that the redemption be at a gain in order for ordinary dividend treatment to apply; that treatment can apply even though the redemption proceeds are less than the shareholder’s cost basis for his shares.

Where favorable sale or exchange treatment applies on a redemption at a loss, a deduction may nevertheless be disallowed for the loss if the selling shareholder and certain persons and entities whose ownership is attributed to him own more than 50 percent in value of the corporation’s outstanding shares. I.R.C. § 267. See Estate of Hanna v. Commissioner, 319 F.2d 54 (6th Cir. 1963).

I.R.C. § 302(a).

A fourth test is much more narrow. It applies if the redemption is attributable to a sufficiently significant change at the corporate level. It is discussed at § 9.33[3], infra.

If the corporation has no earnings and profits (see § 7.21, supra ) the redemption distribution will be treated as a sale or exchange even though none of the favorable tests in Section 302 is satisfied. In addition, see §§ 9.33[3] and 9.33[4], infra.

I.R.C. § 302(b)(1).


[A]—The significance of the Davis case. Prior to Davis, some courts interpreted this basket provision to permit a relatively flexible approach to specific cases. These courts would look not only to the degree of cut-back of a redeemed shareholder’s stock interest, but also to the motivating reasons behind the redemption. If the purpose for the redemption was a persuasive business purpose other than tax avoidance, these courts were inclined to hold in favor of sale or exchange treatment. Other courts looked to the end result of the transaction to determine whether, entirely apart from motive, the effect was to place cash or other property in the shareholders’ pockets without significantly altering the proportionate stock interest. If this was the effect, the redemption was taxed as a dividend distribution.

The Davis case resolves much of this debate. Davis stands clearly for two propositions; namely, that the constructive ownership rules apply fully to the basket test, and that a valid business motivation is irrelevant in determining whether a redemption is equivalent to a dividend. Under the rationale of Davis, a redemption always has the effect of a dividend (assuming that the corporation has earnings and profits) if, after the application of constructive ownership rules, there is no meaningful reduction in the shareholder’s proportionate interest. Stated differently, a redemption will satisfy the basket test for favorable sale or exchange treatment if, after the application of constructive ownership rules, there has been a ‘meaningful reduction’ in the shareholder’s proportionate interest. This means that there must be some amount of reduction in percentage interest by virtue of the redemption, but the required degree of reduction will depend on other circumstances.

Although the precise boundaries of the Davis rationale have not yet been drawn, and perhaps will never be drawn, the basket test is a helpful planning tool in three types of situations; namely, the redemption of preferred stock, a redemption which occasions a loss of voting control by the affected shareholder, and a redemption from a minority, noncontrolling shareholder.

[B]—Redemption of preferred stock. It is reasonably certain that the basket test will assure sale or exchange treatment when a part or all of the preferred stock is redeemed from a shareholder who owns, actually and constructively, only preferred stock, even though only a small percentage of his stock is redeemed.

46 See, for example, Commissioner v. Decker, 286 F.2d 427 (6th Cir. 1961); Parker v. Commissioner, 20 T.C.M. 893 (1961); Himmel v. Commissioner, 338 F.2d 815 (2d Cir. 1964).

47 See, for example, Neff v. United States, 305 F.2d 455 (Ct. Cl. 1962); Swan v. Commissioner, 42 T.C. 291 (1964), aff’d 355 F.2d 795 (6th Cir. 1966).

48 See § 9.33[2][b], infra.

49 For one of many indications that business purposes was indeed read out of the basket provision by Davis, see Sawelson v. Commissioner, 61 T.C. 109 (1973).


51 Rev. Rul. 77–426, 1977–2 Cum. Bull. 87. If the preferred stock possesses voting rights, and the shareholder owns, both actually and constructively, only preferred stock, a redemption which reduces the holder’s voting power by more than 20 percent, and leaves him with less than 50 percent of the corporation’s total voting power, will qualify as a sale or exchange under the 20 percent cut-back test of Section 302(b)(2). The implication in Rev. Rul. 77–426 that such a redemption cannot qualify under the 20 percent cut-back test because the holder experiences no reduction in common stock ownership is inaccurate.

Favorable sale or exchange treatment is also likely to be available under this test where the shareholders own both preferred and common stock, the preferred stock is owned in substantially different proportions from the common stock, and all of the preferred stock is redeemed. But when the preferred and common are owned in substantially the same proportions, after the application of constructive ownership rules, a redemption of the preferred will constitute a dividend. This latter conclusion, considered in conjunction with the Davis rule that a legitimate business purpose for the redemption is not a saving feature, means that the common shareholders of a corporation will rarely be well-advised to furnish additional funds to the corporation by way of subscribing pro-rata to an issue of preferred stock. Even if the funds are clearly needed by the corporation, and even though the need is known to be temporary, the subsequent redemption of the preferred stock will almost certainly constitute a dividend. By contrast, if the needed funds are advanced by way of a loan, the subsequent repayment is not likely to be taxed at all.

[C]—Preservation or loss of voting control. The preservation or loss of absolute voting control is emerging as one of the critical facts in applying the Davis rationale that a meaningful reduction in proportionate interest is required in order to satisfy the basket test. In an important ruling issued in 1975, an estate owned 250 shares, and the sole beneficiary of the estate owned 750 shares. The remaining 750 shares actually and constructively owned by the estate constituted 57 percent of the total outstanding shares. The estate’s 250 shares were redeemed. After the redemption the estate was the constructive owner of 50 percent of the stock. The reduction in seven percentage points, leaving the estate a 50 percent shareholder, did not satisfy the substantially disproportionate test, but the Service ruled that it constituted a meaningful reduction in the estate’s interest, thereby satisfying the basket test. In so ruling, the Service emphasized the importance of the estate’s reduction from a dominant voting interest to simple equality with a single unrelated individual. The ruling went on to indicate that had the reduction been anything less than seven percentage points, it would not have qualified as a sale or exchange. The ruling seems clearly correct. Voting control is indeed significant, and the loss of control ought to qualify under the meaningful reduction requirement. This would be true, presumably, even if the estate had actually and constructively owned 51 percent before the redemption, and the reduction was only by one percentage point.

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52 See Commissioner v. Estate of Antrim, 395 F.2d 430 (4th Cir. 1968), decided before Davis, but probably still good law. See also Ltr. Rul. 9326017.

53 See Gray v. Commissioner, 56 T.C. 1032 (1971); Grabowski Trust v. Commissioner, 58 T.C. 650 (1972); Hays v. Commissioner, 30 T.C.M. 378 (1971); Miele v. Commissioner, 56 T.C. 556 (1971), aff’d per curiam, 474 F.2d 1338 (3d Cir. 1973); cert. denied, 414 U.S. 982, reh’g denied, 414 U.S. 1104 (1973). Even if the preferred stock owned by simply one of the several shareholders is redeemed, the redemption is likely to constitute a dividend if it effects no significant change in the voting power of the redeemed shareholder. See Rev. Rul. 85–106, 1985–2 Cum. Bull. 116.

54 See § 2.23, supra, for the related advisability of capitalizing the new corporation partly with debt securities.


56 For a similar indication, from the Tax Court, that the preservation or loss of voting control by a shareholder who possesses control before the redemption is a critically important factor, see Benjamin v. Commissioner, 592 F.2d 1259 (5th Cir. 1979). See also Niedermeyer v. Commissioner, 62 T.C. 280 (1974), aff’d per curiam, 535 F.2d 500 (9th Cir. 1976).

By contrast, when a redemption reduced the shareholder’s voting power from 60 percent to 55 percent, the Service ruled that the distribution was a dividend.\textsuperscript{57} The importance which the National Office attaches to the preservation of voting control was illustrated in a 1985 Technical Advice Memorandum.\textsuperscript{57.1} In this ruling, a husband and wife owned 58 percent of the voting stock and approximately one-half of the nonvoting common stock. Most of the corporation’s equity was represented by the nonvoting common stock. All of the nonvoting common stock owned by the husband and wife was redeemed. As a consequence, the equity ownership of the husband and wife was reduced from approximately 60 percent to less than 10 percent, but their voting power remained at 58 percent. The National Office ruled that the redemption was essentially equivalent to a dividend, relying solely on the fact that their voting control was preserved without change. It is possible that a court would not so hold where the reduction in equity participation is so drastic, but the strict attitude of the National Office is clear.

A redemption from a controlling shareholder which still leaves the shareholder in the same control position will not satisfy the meaningful reduction standard. Suppose, however, that a shareholder owns more than two-thirds of the corporation’s voting power, and that under relevant state law the shareholder has absolute power to control a merger, or recapitalization, or sale of substantially all assets, or other fundamental changes in the corporate structure. After the redemption the shareholder owns, actually and constructively, more than a majority of the voting power, so that he or she still controls the board of directors, but has less than the two-thirds vote necessary for absolute control. Will such a reduction satisfy the meaningful reduction standard of \textit{Davis}? Three courts have held that this degree of change in the shareholder’s control position is sufficient to invoke the favorable application of the basket test.\textsuperscript{58} But the Service disagrees.\textsuperscript{59} Continued litigation is a virtual certainty.

[D]—Redemption from noncontrolling shareholder. Perhaps the most difficult area in which to draw the line between a sale or exchange and a dividend is the characterization of a redemption of common stock from a noncontrolling shareholder. Clearly, if the redemption meets the substantially disproportionate test, it will be treated as a sale or exchange. But suppose that the percentage reduction falls short of the required 20 percent cutback. Will it nevertheless qualify under the dividend equivalence exception? Although the applicable guidelines are emerging slowly, with each new case and ruling, certain generalizations seem to be valid.


\textsuperscript{57.1} Ltr. Rul. 8552009.

\textsuperscript{58} In \textit{Wright v. United States}, 482 F.2d 600 (8th Cir. 1973), the shareholder’s interest was cut back from 85 percent to 62 percent. \textit{Wright} deals with the characterization of boot in a reorganization, not a redemption, but the court made the sale or exchange characterization by reference to the basket test of § 302. See § 12.82, infra, for a discussion of the importance of the \textit{Wright} case in the boot area. In \textit{Rickey v. United States}, 427 F. Supp. 484 (W.D. La. 1976), the shareholder’s interest was reduced from 72 percent to 58 percent. In \textit{Patterson Trust v. United States}, 729 F.2d 1089 (6th Cir. 1984), the shareholder’s actual and constructive stock interest was cut back from 80 percent to 63 percent.

If the shareholder, before the redemption, owns actually and constructively only a tiny percentage of the common stock, and his stock ownership has no appreciable bearing on the control of the corporation, almost any reduction in stock ownership is likely to be considered “meaningful.” Thus, where the taxpayer was cut back from 41.4 percent to 36.1 percent, a cutback of 12.8 percent, the Service ruled that there had been a “meaningful reduction,” resulting in capital gain characterization, because the taxpayer was a small minority owner who exercised no control over corporate affairs and took no part in management. Even though the cutback was less than 20 percent, it effected a meaningful reduction in his voting rights and his participation in corporate earnings and liquidation distribution.\(^{60}\)

Similarly, even if the shareholder, before the redemption, owns actually and constructively a substantial percentage of the outstanding common stock, and the redemption effects a significant realignment of voting power, it is likely to constitute a meaningful reduction giving rise to sale or exchange treatment. Thus, in a 1984 ruling\(^ {61}\) the taxpayer owned 28.57 percent of the outstanding common stock and each of three other unrelated shareholders owned 23.81 percent of the stock. The taxpayer’s percentage interest was cut back to 23.08 percent, a reduction of approximately 19 percent. The interest of each of the other three shareholders was increased to 25.64 percent. In ruling that the transaction gave rise to capital gain, the Service pointed out that (1) the taxpayer went from a position of having control of the corporation simply with the cooperation of one other shareholder to a position where that was not possible, (2) the taxpayer was no longer the largest single shareholder, and (3) his dividend and liquidation rights were cut back. Although the ruling provides no clue as to which change or changes in the taxpayer’s position were critical, the chances are that this relinquishment of control with the cooperation of only one other shareholder was the persuasive factor.\(^ {62}\)

By contrast, if the redeemed shareholder’s percentage interest is substantial before the redemption, and remains substantial after the redemption, and the redemption does not effect a realignment of voting power among the shareholders, the redemption is very likely to be characterized as a dividend. Thus, the Tax Court has held that a percentage reduction from 43.6 percent to 40.8, a reduction of approximately 6 percent, was not a meaningful reduction where it resulted in no significant change in the control of the corporation.\(^ {63}\) Although it is possible that a court might hold that a redemption under these circumstances qualifies as a sale or exchange if the percentage cutback

\(^{60}\) Ltr. Rul. 8504009. Similarly, in Rev. Rul. 76–385, 1976–2 Cum. Bull. 92, the redeemed shareholder’s percentage cutback was only 3.3 percent, but the redeeming corporation was publicly owned and the taxpayer’s percentage interest was miniscule.

\(^{61}\) Rev. Rul. 84–114, 1984–2 Cum. Bull. 90. This ruling deals with the characterization of boot in a preferred stock recapitalization, not a redemption, but the same tests of I.R.C. § 302 are controlling.

\(^{62}\) Similarly, in Rev. Rul. 76–364, 1976–2 Cum Bull. 91, the redeemed shareholder’s percentage interest was reduced from 27 percent to 22.27 percent, a reduction of 17.5 percent. This reduction changed the shareholder’s power to control the corporation with the cooperation of one other shareholder to a position where the cooperation of two other shareholders was required. The Service ruled that the redemption qualified as a sale or exchange.

is very close to 20 percent, it would be unwise indeed to plan a redemption based upon such a hope.  

[ii]—The 20 percent cutback, or “substantially disproportionate,” test. Favorable sale treatment will obtain if the redemption is substantially disproportionate with respect to the particular shareholder. A redemption is substantially disproportionate if all three of the following factors are present:

1. The particular shareholder must own after the redemption less than 50 percent of the total combined voting power of all classes of voting stock; and
2. the shareholder’s percentage ownership of voting stock after the redemption must be less than 80 percent of the shareholder’s percentage ownership of voting stock immediately before the redemption; and
3. the shareholder’s percentage ownership of common stock—both voting and nonvoting common—after the redemption must be less than 80 percent of the shareholder’s percentage ownership of common stock immediately prior to the redemption.

If we assume that a particular shareholder will own less than 50 percent of the total voting power of the corporation after the redemption, and the corporation has outstanding only one class of stock, the “substantially disproportionate” test will be met if the shareholder’s stock interest percentage is cut back by more than 20 percent. Consider two examples. In each it is assumed that X owns 450 shares out of 1,000 outstanding shares, being 45 percent of the outstanding shares. To qualify under the substantially disproportionate test, it is necessary that X own after the redemption less than 36 percent (80 percent of 45 percent) of the then outstanding shares.

63a Rev. Rul. 75–512, 1975–2 Cum. Bull. 112, supports a favorable conclusion under these circumstances (the percentage cutback was 19 percent), but it is not likely that the Service would so rule at the present time under those identical facts. The Service’s attempt to distinguish Rev. Rul. 75–512 in Rev. Rul. 85–106 (See Note 63, supra) is not convincing.

64 I.R.C. § 302(b)(2).


The statutory requirement that the shareholder’s percentage ownership of common stock be reduced applies only where the shareholder owns, either actually or constructively, some amount of common stock prior to the redemption. Thus, where a shareholder owned only voting preferred stock possessing 49 percent of the total voting power of all outstanding classes of stock, and all of the common stock was owned by unrelated persons, a redemption of an amount of his voting preferred stock which reduced his voting power by more than 20 percent qualified as a sale or exchange under the 20 percent cut-back test of Section 302(b)(2). The National Office so concluded even though the shareholder, owning no common stock (actually or constructively) before the redemption, could not possibly have a reduction in common stock ownership. Rev. Rul. 81–41, 1981–1 Cum. Bull. 121.

If the shareholder owns both voting and nonvoting common stock before the redemption, the reduction in his common stock interest is determined by aggregating the common stock. It is not necessary that each class of common stock be cut back by more than 20 percent. Thus, even if the shareholder’s percentage of nonvoting common stock is not cut back at all, the redemption will satisfy the 20 percent cutback test if his percentage of total common stock is sufficiently reduced. Rev. Rul. 87–88, 1987–2 Cum. Bull. 81.
It is proposed that the corporation purchase 91 of X’s shares (being one share in excess of 20 percent of X’s numerical share interest). The redemption will not qualify under the “substantially disproportionate” test inasmuch as after the redemption X will continue to own 39 percent of the outstanding stock (being 359 out of the then outstanding shares of 909). Since 39 percent is more than 80 percent of his percentage ownership (i.e., 45 percent) before the redemption, there has not been a sufficient cutback of X’s interest.

Suppose that 141 of X’s shares are redeemed. After the redemption X will own 309 shares out of a total outstanding of 859, and X’s percentage ownership of all outstanding shares will therefore be 35.9 percent. This redemption will qualify as being substantially disproportionate since X’s interest after the redemption is less than 80 percent of X’s 45 percent ownership interest immediately prior to the redemption.

[iii]—The complete-termination test. Favorable sale treatment will obtain if the redemption completely terminates the stock interest of the particular shareholder. In order to satisfy this test, it is necessary that all of the shareholder’s stock—voting and nonvoting, preferred and common—be redeemed.

[b]—The complexities occasioned by the attribution of ownership rules. If we could stop right at this point in reciting the tax problems incident to a redemption, we would conclude that the tax determination is not a difficult one to make. However, in determining the applicability of any one of the three favorable tests set forth in Section 302 of the Internal Revenue Code, it is not sufficient merely to look at the particular shareholder’s stock interest immediately after the redemption. A detailed and complicated set of rules set forth in the statutes provides that for this purpose a particular shareholder will be considered as owning the stock owned by certain other persons or entities. These “attribution of ownership” rules make immeasurably more complicated the determination of whether the redemption will give rise to favorable sale treatment.

[i]—Family attribution. Perhaps the most commonly encountered attribution rule is “family attribution.” A particular shareholder will be considered as owning not only his own stock, but also the stock which is owned by his spouse, children, grandchildren, and parents. Suppose, by way of example, that a corporation has one

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68 I.R.C. § 302(b)(3).
69 I.R.C. §§ 302(c)(1) and 318. The only exception to the applicability of the attribution of ownership rules is the statutory exception which is discussed at § 9.33[2][c], infra in the text. It is possible that “bad blood”—that is, severe disagreement among the persons within the attribution group—may alleviate the effect of the attribution rules, but this is simply a conjecture at the present time. Compare Cerone v. Commissioner, 87 T.C. 1 (1986), Niedermeyer v. Commissioner, 62 T.C. 280 (1974), aff’d per curiam, 535 F.2d 500 (9th Cir. 1976), and Metzger Trust v. Commissioner, 603 F.2d 459 (5th Cir. 1982), on the one hand, with Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975). The Service’s continuing opposition to considering “bad blood” as an alleviating factor in applying the attribution of ownership rules is set forth in Rev. Rul. 80–26, 1980–1 Cum. Bull. 66.
70 I.R.C. § 318(a)(1).
71 In some instances, family attribution will not ap-

hundred shares of common stock outstanding, and that a husband, wife, son, and grandchild each owns twenty-five of those outstanding shares. Under the family-attribution rule, each of these shareholders will be considered as owning the following number of shares:

1. The husband will be considered as owning all 100 of the outstanding shares, being his own, his wife’s, his son’s and his grandchild’s. Accordingly, in instances where family attribution is applicable, the redemption of simply the 25 shares owned by the husband would not be within any of the favorable tests of Section 302.

2. The wife will be considered as owning all 100 of the outstanding shares, being her own, her husband’s, her son’s, and her grandchild’s.

3. The son will be considered as owning all 100 of the corporation’s outstanding shares, being his own, his parent’s, and his child’s.

4. The grandchild will be considered as owning 50 of the corporation’s outstanding shares, being his own and his father’s. Although a grandchild’s shares are imputed to the grandparents, a grandparent’s shares are not imputed to the grandchild. Accordingly, the 50 shares which are owned by the husband and wife will not be imputed to the grandchild. Furthermore, only the 25 shares actually owned by the son, and not the 50 additional shares imputed to the son from his parents, will be deemed constructively owned by the grandchild. For the purpose of applying the family-attribution rules, no double attribution is permitted. Thus, the Internal Revenue Service may not impute the husband’s and wife’s stock to the son and, under the same family-attribution rules, through the son to the grandchild.

If the grandchild’s 25 shares actually owned by him are completely redeemed by the corporation, the redemption will qualify as a substantially disproportionate redemption, since immediately prior to the redemption the grandchild will be treated as owning 50 percent of the outstanding shares, and after the redemption will be treated as owning 25 of the corporation’s outstanding shares. These 25 shares will constitute 33 1/3 percent of the 75 total outstanding shares after the redemption. Since 33 1/3 percent is less than 80 percent of the 50-percent interest the grandchild was deemed to own prior to the redemption, the redemption will qualify for favorable sale treatment.

[ii]—Partnership attribution. There are attribution rules between a partnership and its partners. Thus, corporate stock which is owned by a partnership is treated for purposes of Section 302 as being owned proportionately by its partners; in addition, stock which is owned by a partner is treated as being owned by the partnership. Suppose, by way of example, that A and B are equal partners. The partnership owns fifty shares of a corporation’s stock and A personally owns the remaining fifty shares. Assuming that A and B are not related within the meaning of the family-attribution rules, A and B and the partnership will be treated as owning the following shares:

ply. See § 9.33[2][c] infra. The examples set forth in this subsection are based on the assumption that the statutory provisions which grant relief from family attribution are not applicable or are not complied with.

(1) The partnership will be treated as owning all 100 shares of the corporation’s stock, being its own 50 shares plus all of A’s 50 shares.

(2) A will be treated as owning 75 of the corporation’s shares, being his own 50 shares and one-half of the partnership’s shares.\textsuperscript{74}

(3) B will be treated as owning 25 shares of the corporation’s stock, being one-half of the shares which are actually owned by the partnership. It must be emphasized that stock which is constructively owned by a partnership (or by an estate, trust, or corporation) is not considered as owned by it for the purpose of making another person a constructive owner of that stock. Thus, for the purpose of determining the amount of stock owned \textit{by the partnership}, we must look to the stock actually and constructively owned by it (100 shares), but for the purpose of determining the amount of stock owned by a partner, we attribute to him only his proportionate share of the stock actually owned by the partnership (50 shares, of which B is deemed to own one-half).\textsuperscript{75}

In view of the actual and constructive ownership interests indicated above, the corporation cannot safely redeem the partnership’s fifty shares, since under the attribution rules the partnership will still be deemed to own all of the corporation’s stock after the redemption. Similarly, the corporation cannot safely redeem A’s fifty shares, since after the redemption A will still be treated as owning one-half of the partnership’s shares, or 50 percent of the outstanding stock, an ownership interest which will not qualify under either the substantially disproportionate or the complete-termination tests.\textsuperscript{76}

[iii]—\textit{Estate-beneficiary attribution.} Attribution also applies between an estate and its beneficiaries. Thus, the beneficiaries of an estate are deemed to own proportionately the shares owned by an estate and an estate is deemed to own all of the shares owned by its beneficiaries.\textsuperscript{77} Only persons who have a direct present interest in the estate are considered beneficiaries for this purpose; a person who has only a remainder interest in property is not considered an estate beneficiary.\textsuperscript{78} Although the Treasury Regulations are not entirely clear, it appears that this restrictive definition of beneficiary applies only in the case of remainder interests after a \textit{legal} life estate, as distinguished from trust remaindermen. If so, the limitation is not often helpful, inasmuch as legal life estates are a rarity in these days of sophisticated estate planning. Furthermore, the trust-beneficiary attribution rules (discussed in subdivision [iv] infra) apply to and from most trust remaindermen; this fact, plus multiple attribution possibilities, will often mean that effective attribution applies between an estate and the beneficiaries of a trust which is the beneficiary of an estate.

\textsuperscript{74} Treas. Reg. § 1.318–2(c), Ex. (1).
\textsuperscript{75} I.R.C. § 318(a)(5)(C).
\textsuperscript{76} It is possible that in appropriate circumstances a redemption of all the shares owned by the partnership or by A would qualify for sale treatment under the general, basket provision. Assurance to that effect, however, would be impossible absent a favorable ruling from the National Office of the Internal Revenue Service.
\textsuperscript{78} Treas. Reg. § 1.318–3(a), Exs. (1) and (2).
Example: A father and son each owns 50 shares of Corporation X’s outstanding stock. The father dies. His will leaves his entire residuary estate in trust for the lifetime benefit of his wife (or daughter, or brother, or secretary), and upon her death the corpus is to be distributed outright to the son. Under the trust-beneficiary rules (see subdivision [iv] infra), the son’s shares are attributed to the trust, and since the trust is the beneficiary of the estate, they are further attributed under the estate-beneficiary rules to the estate. A redemption of the shares actually owned by the estate will still leave the estate the constructive owner of all the outstanding shares. Under the Service’s view, this is true even though the trust is a testamentary trust for which letters of trusteeship have not yet been issued by the Probate Court, or which is not yet funded to any extent.79

There can not, however, be “sidewise attribution,” and that has an important bearing on estate-beneficiary attribution rules. Suppose, by way of example, that two brothers own in equal shares all of the stock of X Corporation. Their father, who owns none of the shares of X and has no connection whatever with the corporation, dies. The two brothers are equal beneficiaries of the estate. Even so, the stock of one of the brothers may safely be redeemed; the estate may not be used as a vehicle to attribute one of the brother’s stock to the other. Stock which is constructively owned by an estate (or by a partnership, trust, or corporation) is not considered as owned by the estate for the purpose of making another the constructive owner of such stock. Since, in our example, all of the stock which is deemed owned by the estate is merely constructively owned by it, the estate to beneficiary rule cannot apply at all. A redemption from either brother, even while the estate is open, would qualify for favorable tax treatment under the complete-termination test.80

Particularly with respect to the application of the estate-beneficiary attribution rules, the precise timing of a redemption can mean the difference between favorable sale treatment and unfavorable dividend treatment. A specific legatee will no longer be considered a beneficiary of an estate even though the estate remains open, if his beneficial interest is completely satisfied by a partial distribution.81 Suppose, by way of example, that a father and son each owns one-half of the stock of a corporation. The father dies, survived by his son and a daughter. The father’s will leaves a $50,000 bequest to the son and the residuary estate to the daughter. During such time as the son is still a beneficiary of the estate, the corporation will be unable to redeem the estate’s stock without exposing the estate to the substantial danger that the redemption distribution will be taxed to it as an ordinary dividend. Since the estate will be deemed to own all of the stock actually owned by the son, the redemption would not reduce the stock interest deemed to be owned by the estate. If, however, the estate were to satisfy the son’s legacy, the son would no longer be considered a beneficiary of the estate for this purpose and his stock interest would therefore not be attributed to the estate. The estate’s actual stock interest could then be redeemed, effecting a complete

79 Rev. Rul. 67–24, 1967–1 Cum. Bull. 75. In this ruling, the beneficiary of the trust was the income beneficiary, but the same result should follow even if the relevant beneficiary is simply a remainderman, provided that his interest is not both remote and contingent. See § 9.33[2][b][iv] infra.
80 I.R.C. § 318(a)(5)(C).
termination of the estate’s interest. In order to make certain that the payment of the bequest will completely satisfy the son’s beneficial interest, it is important that the son and the estate execute mutual releases of their rights one against the other.\textsuperscript{82}

Unfortunately for planning purposes, however, the Service takes the position that the interest of a residuary beneficiary can never be completely satisfied for attribution of ownership purposes until the entire estate is closed.\textsuperscript{83} Under this view, which is probably valid, a partial distribution to one of several residuary legatees, purportedly satisfying his claim against the estate, will not terminate his status as a beneficiary. Presumably, this adverse conclusion will follow even if the beneficiary’s claim is in fact satisfied in full, and even if the beneficiary and the estate have executed mutually binding releases. Only the formal closing of the estate can terminate the residuary beneficiary’s status as a beneficiary. The strictness of this rule can in many cases make it exceedingly difficult, perhaps impossible, to redeem corporate stock owned by an estate so long as any residuary beneficiary of the estate is also a shareholder. In some such cases, the redemption from the estate may nevertheless satisfy the 20 percent cut-back test, but if careful computations indicate that the test is not met, the redemption should be postponed until after the estate is closed. Alternatively, in some instances, a partial distribution of the estate’s stock to a residuary beneficiary, although not terminating the beneficiary’s status as a beneficiary of the estate, may make possible a redemption from the beneficiary even though the estate is still open. This greater flexibility might be present because a redemption directly from an individual may bring into play the provisions for relief from family attribution, whereas there is never relief from estate-beneficiary attribution.

Example: A decedent’s estate owns 50 shares of the 100 shares of outstanding stock of X Corporation. The other 50 shares are owned by the decedent’s son. The residuary beneficiaries of the estate are the decedent’s widow and his son. The stock may not be safely redeemed from the estate, because the son’s stock would be attributed to the estate under the estate-beneficiary attribution rules, with the result that the estate will be deemed the 100-percent shareholder of X both before and after the redemption. If the estate, even though it remains open, distributes the stock to the widow in partial satisfaction of her residuary bequest, X Corporation may safely redeem the stock from her, provided she satisfies the requirements for waiver of attribution between her and her son.\textsuperscript{84}

\textbf{[iv]—Trust-beneficiary attribution.} There is attribution between a trust and its beneficiaries. Stock which is owned by a trust is deemed to be owned by the beneficiaries in proportion to the actuarial interest of the beneficiaries in the trust;\textsuperscript{85}

\begin{itemize}
  \item \textsuperscript{82} Treas. Reg. § 1.318–3(a). These Regulations were upheld in \textit{Estate of Webber v. United States}, 404 F.2d 411 (6th Cir. 1968).
  
  For the effectiveness of a binding contract which effects a mutual release between a specific legatee and the estate, see \textit{Estate of Weiskopf v. Commissioner}, 77 T.C. 135 (1981).
  
  
  See § 9.33[2][c], infra for the rules and requirements relating to waiver of family attribution.
  
  \textsuperscript{85} I.R.C. § 318(a)(2)(B). If a trust beneficiary renounces his beneficial interest in the trust, and the renunciation is effective under state law, he will no longer be considered a trust beneficiary for the purpose of attributing the trust’s stock to him. Rev. Rul. 71–211, 1971–1 Cum. Bull. 112.
\end{itemize}
stock which is owned by a beneficiary of a trust is deemed to be owned by the trust unless the beneficiary’s interest is a “remote contingent interest.” 86 A contingent interest worth 5 percent or less of the value of the trust property is a remote contingent interest for this purpose. 87

A so-called “grantor trust” is treated differently for this purpose than other types of trusts. 88 Very briefly, a grantor trust is a trust in which the grantor has retained a beneficial interest, or the power to alter, amend or revoke the trust. 89 It also includes a trust created by another, if a person other than the grantor has the power to terminate the trust. 90 In this situation, the person having the power to terminate the trust is treated as the grantor. This latter type of grantor trust is often found in marital deduction planning for federal estate tax purposes. If the marital deduction trust gives the surviving spouse not only the income, but also the power to take down all of the trust corpus during lifetime, the surviving spouse is in the same position for this purpose as though the spouse were the grantor of a grantor trust.

However the grantor trust is created, the constructive ownership rules provide that the owner of a grantor trust will be deemed to own the shares owned by the trust, and the trust will be deemed to own the shares owned by the grantor. It is not clear whether this modification of the trust-beneficiary attribution rules preclude the application of beneficiary attribution, or whether it is simply in addition to beneficiary attribution.

Suppose, for example, that Corporation X has 100 shares of stock outstanding. 50 shares are owned by a marital trust pursuant to which A, the widow, is entitled to the income, she possesses a testamentary power of appointment, and has the unrestricted right to drawn down the corpus of the trust at any time. The other 50 shares are owned by A’s son, B. If A, as sole owner of the grantor trust, is treated as the exclusive owner of the trust shares, a redemption of the trust shares will be treated as though it were a redemption from A. If the family attribution rule between A and B can be waived (see Section 9.33[2][c] infra ), the redemption will satisfy the complete termination test. Similarly, a redemption of B’s shares will satisfy the complete termination test, if the family attribution rule can be waived. But if the trust-beneficiary rules are still applicable, a redemption of the trust’s stock will still leave the trust as the constructive owner of B’s shares (unless his interest is contingent and remote), and a redemption of B’s shares might still leave him as the constructive owner of a proportionate amount.


A beneficiary’s interest in a trust is “contingent,” for this purpose, if it is conditioned on survivorship without regard to whether survivorship is a condition precedent or a condition subsequent. Rev. Rul. 76–213, 1976–1 Cum. Bull. 92. Thus, apparently, property law concepts and labels which often draw meaningless distinctions between “vested” and “contingent” are not relevant; the determination is made on the basis of whether or not the interest is in fact contingent on one or more significant happenings.

87 In computing the value of a beneficiary’s interest, it is assumed that the trustee will exercise to the maximum extent any discretionary power in favor of the beneficiary. I.R.C. § 318(a)(2)(B).

88 A trust which is tax-exempt as a part of a qualified employee benefit plan (see § 5.2 supra ) is also treated differently. There is no attribution whatever between such a trust and its beneficiaries. I.R.C. §§ 318(a) (2)(B)(i) and 318(a)(3)(B)(i).

89 I.R.C. §§ 671–678.

90 I.R.C. § 678.
of the trust’s shares. The Service apparently takes the more favorable view that the
grantor trust attribution rule preempts the trust-beneficiary attribution rules. 91

[v]—Corporation-shareholder attribution. Attribution also applies
between a corporation and a shareholder who owns 50 percent or more in value of
the corporation’s stock. 92 Thus, if Corporation A owns any shares in Corporation B,
the shares owned by A would be attributed proportionately to any person owning 50
percent or more in value of the stock of Corporation A. Conversely, such 50 percent
or more shareholder’s stock in Corporation B would be deemed owned by Corporation
A.

[vi]—Option attribution. Lastly, a person who has an option to purchase
corporate shares will be treated as actually owning those shares. 93 By way of example,
suppose that A and B own all of the stock of X Corporation. A has the option to purchase
the stock owned by B. If the stock actually owned by A is redeemed by the corporation,
the redemption proceeds will almost certainly be treated as an ordinary dividend
distribution to A, inasmuch as he will be considered as owning all of the stock which
he has an option to purchase from B.

The application of this “option attribution” rule raises certain interesting problems.
Suppose, in our example, that contemporaneously with the redemption of A’s shares
the parties by mutual agreement terminate the option. Will the redemption qualify
as a complete termination of A’s interest? In all probability the redemption will qualify
as a complete termination; at present there is no authoritative answer to the question.

Suppose that A’s option to purchase B’s shares is not exercisable until the expiration
of three years after the date of the redemption from A. Will the option to purchase
at a future date invoke the attribution rule, so that the redemption will not effect a
complete termination of A’s interest? In all probability such an option exercisable in
the future will be considered an option for this purpose. The Service has so ruled. 93.1
and the courts will almost certainly agree.

Suppose that the code of regulations of the corporation prohibits any shareholder
from selling his shares to anyone other than the issuing corporation without first offering
to the other shareholders a right of first refusal. If a particular shareholder’s stock were
redeemed, would the fact that he might have had a right of first refusal over another
shareholder’s stock be considered an option for this purpose? In all probability, he
would not be considered as having an option for this purpose. Similarly, if a person
will have an option to purchase stock upon another shareholder’s death, he will probably
not be considered presently the owner of those shares. If an option is exercisable only
on the happening of a significant contingency, it is probably not an option for this
purpose.

92 I.R.C. §§ 318(a)(2)(C) and 318(a)(3)(C).
93 I.R.C. § 318(a)(4). Warrants and convertible debentures, exercisable at the discretion of the holder,
to purchase its own shares, however, the corporation will not be deemed the owner of those shares for the
purpose of making its 50 percent or more shareholder the constructive owner of the optional shares. Rev.

[vii]—Caveat respecting multiple attribution. We have already observed instances, in the preceding discussion, where multiple attribution was applied. This possibility, and this danger, cannot be over-emphasized. Multiple attribution can apply when the entity (that is, partnership, estate, trust, corporation or option) attribution rules are relevant. That is, double or triple, or more, attribution rules can be combined in a single chain to impute ownership far from the actual owner, provided only that (1) the family-attribution rule may not be employed more than once in order to attribute stock to a person and, again, to attribute stock from that same person to another, and (2) stock which is constructively owned by an entity (that is, a partnership, estate, trust or corporation) cannot be constructively imputed to a member of that entity under the entity to member rule.94

Example: A partnership owns 50 shares of X Corporation’s stock. The other 50 shares are owned by a trust in which A owns a 50 percent actuarial interest. A is married to B, who is a 5 percent partner in the partnership. A is the constructive owner of 25 of the trust shares, being one-half thereof, by virtue of the trust-beneficiary rules. Those shares are further attributed to A’s spouse, B, by virtue of the family-attribution rules. From B they are attributed to the partnership by virtue of the partnership attribution rules. The result is that the 50 shares actually owned by the partnership may not safely be redeemed from it. After the redemption, the partnership would still be the constructive owner of 25 of the 50 outstanding shares, or 50 percent. This constructive interest would preclude qualification under either the 20-percent cut-back test or the complete termination test.

The possibilities are endless. The moral is that in planning a stock redemption, extreme care must be taken to ascertain family and business relationships, and the existence of trusts, estates, and options. The pervasiveness of these attribution rules can, in appropriate cases, be one of the most troublesome traps in tax and business planning.

[c]—When relief can be obtained from the important family-attribution rules. Under certain circumstances, relief from the application of the important family-attribution rules will be obtained. In view of the relative importance of the family-attribution rules and the substantial additional measure of flexibility which is obtained by virtue of the provisions affording relief from family attribution, it is essential that corporate counsel understand the complex pattern of this relief provision.

Relief from the application of the family-attribution rule will be obtained if all three of the following conditions are satisfied.95

(1) The redemption must completely terminate the stock interest actually owned by the shareholder.96

--- Footnotes ---

94 But the stock constructively owned by the entity can be reattributed to another entity of which the first entity is a member. For example, a trust constructively owns the stock actually owned by a beneficiary. The constructively owned stock may not be imputed to another beneficiary. But if the trust is a direct beneficiary of a decedent’s estate which is still open, the trust’s constructively owned shares will be further attributed to the estate.

95 I.R.C. § 302(c)(2).

96 In no event will relief from family attribution be obtained in determining whether the redemption effects a 20-percent cutback (see § 9.33[2][a][ii] supra (Rel.48—5/05 Pub.400))
(2) The so-called ten-year look-ahead rule is satisfied.

(3) The so-called ten-year look-back rule is satisfied.

[i]—Satisfying the “ten-year look-ahead” rule. The ten-year look-ahead rule will be satisfied if the following three factors coincide:

(1) The shareholder whose stock is completely redeemed must retain no interest whatever in the corporation, including any interest as a shareholder, officer, director, or employee. The following retained interests have been held or ruled to violate the statutory requirement, with the drastic consequence that a redemption which would otherwise be treated as a sale or exchange has been treated as an ordinary dividend distribution:

(a) The redeemed stock was placed in escrow and the former shareholder retained voting and dividend rights over the stock.

(b) The redeemed shareholder, who was the mother of the remaining shareholders, remained as a director and officer at a nominal salary, simply “out of respect.”

(c) The redeemed shareholder was a party to a contract obligating him to perform consultation services for an annual compensation.

(d) The redeemed shareholder remained as a trustee of a voting trust which owned the remaining voting shares of the corporation.

(e) The redemption agreement required that the redeemed shareholder’s attorney be appointed to the corporation’s Board of Directors to protect his interest as a creditor.

(f) The redeemed shareholder was appointed, within 10 years after the redemption, as custodian for his children of stock in the corporation.

100 Rev. Rul. 70–104, 1970–1 Cum. Bull. 66. If, however, the redeemed shareholder, after the redemption, is an independent contractor, not an officer or an employee, the law is unclear. In Estate of Lennard v. Commissioner, 61 T.C. 554 (1974), acq. 1974–1 Cum. Bull. 3, acq. withdrawn and nonacq. substituted, 1978–2 Cum. Bull. 3, the Tax Court held that a continuing relationship as an independent contractor did not violate the 10-year look-ahead rule. Several years later, in Lynch v. Commissioner, 801 F.2d 1176 (9th Cir. 1986), reversing 83 T.C. 597 (1984), the Court of Appeals for the Ninth Circuit held that providing any post-redemption services, either as an employee or as an independent contractor, violates the 10-year look-ahead rule. Continued litigation is almost certain. In the meantime, the Service continues to disagree with the Tax Court’s favorable approach, as witness its nonacquiescence in Lennard. See, also, Ltr. Rul. 8944076. For a more detailed discussion of this issue, see Cavitch, Tax Planning for Corporations and Shareholders (Matthew Bender 1974), § 7.03[3][c][iii].

(Rel.48—5/05 Pub.400)

By contrast, the Service has ruled that where the redeemed shareholder received property from the corporation in payment for his shares, and leased the property back to the corporation for a fair rental, the redeemed shareholder’s interest was completely terminated.\textsuperscript{104} The Service has also ruled that if the redeemed shareholder is not obligated to perform any services at all, but is entitled to an unfunded lifetime pension in a fixed amount not dependent on corporate earnings, and his rights are not subordinated to the claims of general creditors, the 10-year look-ahead rule is not violated.\textsuperscript{104a}

The redeemed shareholder may, however, retain a bona fide creditor position with the corporation. Thus, for example, if the shareholder’s stock is completely redeemed and a part or all of the redemption price is deferred, he will not be considered as retaining a prohibited interest with the corporation merely on account of being a creditor. The Treasury Regulations indicate, however, that the creditor’s claim must not in any sense be a proprietary interest in the corporation and must not be subordinate to the claims of general creditors.\textsuperscript{105} Presumably, a subordination to a single creditor, and not to creditors generally, will not violate the requirement set forth in the Regulations.\textsuperscript{105a}

(2) The redeemed shareholder must not acquire any of the prohibited interests set forth in (1) above within the ten-year period following the redemption. He may, however, acquire a further stock interest by way of bequest or inheritance.\textsuperscript{106} And his appointment as executor of an estate which owns stock in the corporation will be treated as a permitted inheritance.\textsuperscript{107} Similarly, if by virtue of the subsequent three months, to pay the note. The subordination was designed simply to avoid reporting the note to the corporation’s bank. Initially, the Service acquiesced in the Lennard decision. Four years later, however, the acquiescence was withdrawn and a nonacquiescence was substituted. The nonacquiescence is significant. It probably means that the subordination of a promissory note to all general creditors is, in itself, fatal to its classification as a bona fide debt. See, also, the Service’s similar argument in Dunn v. Commissioner, 615 F.2d 578 (2d Cir. 1980), in which both the Tax Court and the Appellate Court held for the taxpayer because of the relatively strong facts indicating that a bona fide debt was indeed intended by the parties. Notwithstanding, careful counsel will insist that no general subordination be made.

\textsuperscript{104a} Rev. Rul. 84–135, 1984–2 Cum. Bull. 80. Even if the redeemed shareholder’s unfunded pension rights are conditioned on his promise not to compete with the corporation, the Service will apparently rule favorably. See Ltr. Rul. 8314018.
\textsuperscript{105} Treas. Reg. § 1.302–4(d). The Treasury Regulations state that the creditor interest must not be a proprietary interest and must not be subordinate to the claims of general creditors. The conjunctive seems to be deliberate. But in Estate of Lennard v. Commissioner, 61 T.C. 554 (1974), acq. 1974–1 Cum. Bull. 3, acq. withdrawn and nonacq. substituted, 1978–2 Cum. Bull. 3, the redeemed shareholder received a demand promissory note which was subordinated to all general creditors, and the court nevertheless held that he did not retain a prohibited interest. In so holding, the Tax Court reasoned that if, notwithstanding the general subordination, the other factors indicate that the creditor interest is a bona fide debt, the retained creditor interest is permissible. In Lennard, the bona fides of the debt was indicated by the facts that it was paid in full in three months and the corporation was in a financial position, throughout the

\textsuperscript{105a} See Lynch v. Commissioner, 83 T.C. 597 (1984), reversed on a different ground, 86–2 U.S.T.C. ¶ 9731 (9th Cir. 1986).
\textsuperscript{106} I.R.C. § 302(c)(2)(A)(ii).
\textsuperscript{107} Rev. Rul. 72–380, 1972–2 Cum. Bull. 201. Although the appointment as executor of the decedent’s estate is not the acquisition of a prohibited interest, the designation of the executor as president
death of a parent, the redeemed shareholder accepts a designation as successor trustee of a trust that owns stock in the redeeming corporation, the ten-year look-ahead rule is not violated. 108

(3) The former shareholder must file with his personal income tax return for the year in which the redemption takes place a statement setting forth certain information relating to the redemption; the statement must contain the redeemed shareholder’s agreement promptly to notify the Secretary of the Treasury if he acquires a prohibited interest in the corporation within the ten-year period. 109 For many years, the Treasury Regulations took the strict position that the agreement must be attached to a timely filed return for the year in which the redemption occurs. Most courts rejected this strict time requirement, 110 even to the point of permitting the filing at any time prior to the trial of the case. 111 Early in 1978, the Service relented and amended the Treasury Regulations to authorize the grant of a reasonable extension of time to file the statement if the distributee establishes reasonable cause for failing to file the agreement within the prescribed time. 112 If the failure is attributable simply to inadvertence, that will constitute reasonable cause under the Service’s present view. 113 In brief, the Service is now relatively flexible in granting extensions of time. The better practice, needless to say, is to file the prescribed statement with a timely filed return for the year in which the redemption occurs.

It is important to recognize that the ten-year look-ahead rule can be satisfied even where the redemption is from an entity, not a related individual at all. 114 Sometimes family attribution will simply be a link in a chain of attribution that ends with an entity, such as an estate, or a trust, or a partnership. If that link can be broken by the effective waiver of the family attribution rule, a redemption from the entity might clearly satisfy the complete termination test for sale or exchange treatment. Suppose, for example, that a father and son own in equal shares all of the stock of a corporation. The father dies and bequeaths all of his estate to his widow. The father’s stock cannot safely be redeemed during such time as it is owned by the estate, unless family attribution is

111 See Fehrs v. United States, 556 F.2d 1019 (Cl. Ct. 1977).
effectively waived. The son’s stock will be attributed to his mother under the family attribution rule, and from the mother to the estate under the estate-beneficiary rule.

The redemption of the estate’s stock will still leave the estate as the constructive owner of all remaining stock. But if the rule attributing the son’s stock to his mother is waived, the redemption of the estate’s stock will satisfy the complete termination test for favorable sale or exchange treatment. As indicated, the statute now clearly permits the estate, in this example, to obtain relief from family attribution. This relief is available, however, only if the entity from which the stock is redeemed, and the members (or beneficiaries) of that entity to whom some other individual’s stock is attributed under the family attribution rule, all meet the full requirements of the look-ahead rule and agree to be jointly and severally liable for any deficiency that might arise on account of a future violation of the look-ahead rule.\footnote{I.R.C. § 302(c)(2)(C)(i).} In our example, that means that both the estate and the mother must satisfy the look-ahead rule, including the signing of the indicated agreement.

The capacity of an entity to waive the family attribution rule is an important and helpful planning tool. But it has its limitations. Only family attribution may be waived. The entity to member, or member to entity, attribution may not be waived under any circumstances. The Court of Appeals for the Fifth Circuit has held differently, but the decision is simply wrong and should not be relied upon.\footnote{Rickey v. United States, 592 F.2d 1251 (5th Cir. 1979). The Conference Committee Report accompanying the 1982 amendment of the statute states that the amendment is intended to overrule Rickey. Although the statute does not precisely state that, the Rickey decision may safely be presumed dead.}

\textbf{Example:} A father and a son are equal owners of the stock of X Corporation. Father dies, and his son is one of the residuary beneficiaries of his estate. A redemption of the estate’s stock will be taxable as a dividend to it,\footnote{Except to the extent, if any, that I.R.C. § 303 is applicable. See § 9.33[3], infra.} since the son’s stock will continue to be attributed to the estate under the estate-beneficiary attribution rule. There is no way in which this attribution rule can be waived.

\textbf{[ii]—Satisfying the “ten-year look-back” rule.} The ten-year look-back rule will be satisfied if the following two facts are present:\footnote{I.R.C. § 302(c)(2)(B).}

\begin{enumerate}
\item The shareholder whose stock is redeemed did not acquire, during the ten-year period immediately preceding the redemption, any part of such stock from a person or entity whose ownership of stock at the time of the redemption would be attributable to such shareholder under any of the attribution rules of Code Section 318, and such person or entity is living or still in existence at the time of the redemption; and
\item The shareholder whose stock is redeemed did not transfer, during the ten-year period immediately preceding the redemption, any stock to a person or entity who owns stock in the corporation at the time of the redemption, which person’s or entity’s stock would be attributable to the redeeming shareholder under any of the attribution rules.\footnote{This latter requirement will be met, however,}
\end{enumerate}
or entity owns stock at the time of the redemption, this requirement will not be met even though only a small portion of the stock was acquired within the preceding ten-year period from the redeeming shareholder.

The foregoing double-barreled requirement need not be satisfied if it can be established that the particular transfer of stock or acquisition of stock did not have as one of its principal purposes the avoidance of federal income tax.\textsuperscript{120} Thus, if the absence of an income tax avoidance motive can be shown, the fact that there have been intra-family transfers during the past ten years will not preclude relief from the family attribution rules.

The difficulty with this important exception to the applicability of the ten-year look-back rule is that it depends on a particular person’s state of mind, and that can be a difficult thing to prove. Where substantial dollars are at stake, the taxpayer may want the assurance of a private ruling from the National Office before relying on this provision. The Service has for several years taken the position that it will not rule on this state of mind question unless the facts and circumstances are materially identical to those set forth in certain published rulings.\textsuperscript{121} Fortunately for taxpayers, the areas covered by the designated rulings are sufficiently broad to indicate a fairly liberal and realistic attitude at the National Office.

Perhaps most important for planning purposes is the availability of a ruling when the intra-family transfer is designed to facilitate the so-called bootstrap method of transferring ownership of a corporation from one generation to another generation that is active in the business.

Suppose, for example, that a father owns all of the stock of a corporation. His daughter is active in the business. The father wishes to transfer sole ownership to his daughter and retire completely from the business, but he is not willing to make the transfer entirely a gift. The most attractive procedure might be for the father to give or sell a small percentage of the stock directly to his daughter, and contemporaneously require the corporation to redeem the balance of his stock, perhaps for deferred installments over a period of several years. The father’s willingness to retire completely from the business makes it possible to satisfy the 10-year look-ahead rule for relief from attribution. The question is whether the sale or gift of a portion of the stock to the daughter violates the 10-year look-back rule. In Revenue Ruling 57-387, the Service ruled that a sale of a part of the stock to the active generation incident to a redemption of the balance of the stock does not violate the ten-year look-back rule.\textsuperscript{122}


Rev. Proc. 96-3 is the 1996 version of an annually updated procedural ruling that sets forth the Service’s no-ruling areas. The current version, which is traditionally the third procedural ruling in each calendar year, should be checked before proceeding with an application for a ruling.

\textsuperscript{122} See also Rev. Rul. 77-455, 1977-2 C.B. 93.

Ruling 77-293, the Service ruled that a gift of stock to an active generation incident to the redemption of the balance is also permissible. Even though the gift lessens the amount of capital gain subject to income tax, that is not the type of income tax avoidance at which the statute is directed. The purpose of the statute is to prevent a shareholder from seeking continued control, or economic interest, in the corporation through the stock given to a related person.122.1 When the evidence refutes that purpose, the ten-year look-back rule is not violated.

Similarly, a gift or sale of shares to a younger generation that is active in the business will not violate the ten-year look-back rule even though the redemption of the balance of the stock was not planned at the time of the transfer. In Revenue Ruling 56-556, the Service ruled that a later redemption of all of the transferor’s stock could safely be made. In Revenue Ruling 56-584, where the transferee was no longer employed by the corporation, the Service ruled that the corporation could safely redeem the stock given to him five years earlier by his father.

Even when a transfer of stock is designed specifically to avoid the attribution rules, and thereby to assure capital gain treatment on a planned redemption, the transfer will not invoke the ten-year look-back rule if the redemption effects a transfer of control to an actively employed family member. In Revenue Ruling 79-67, a decedent’s estate and his son owned all of the stock of a corporation. The estate distributed its stock to the sole residuary beneficiary, the widow of the decedent. The estate remained open.122.2 The purpose for the distribution was to facilitate a redemption from the widow, thereby leaving her son the sole remaining shareholder. If the redemption had been effected from the estate, no relief from family attribution would have been possible under pre-1982 law (see N. 114, supra), and the redemption would have constituted a dividend. Thus, the distribution from the estate to the widow made possible a sale or exchange transaction, rather than a dividend, with resulting income tax savings. Since, however, the motivating purpose was to enable the son to obtain complete ownership of the corporation, the National Office ruled that the avoidance of federal income tax was not one of the principal purposes of the distribution. Accordingly, the ten-year look-back rule was satisfied.123

An intra-family transfer that is designed to negate the effect of an earlier transfer is likely to obtain the approval of the National Office. In Revenue Ruling 85-19, a father made a gift of a small percentage of the corporation’s stock to his son. The son was not employed by the corporation, and the gift was not a part of a plan to shift control to the son. The son had also inherited a significant amount of shares from his grandparents. The son wanted to be bought out. Accordingly, the son sold back to the father all of the shares that he had acquired by gift from him, and the corporation redeemed all of the shares that the son had inherited from his grandparents. The

122.2 If the estate had been closed prior to the redemption, the ten-year look-back rule would have been satisfied because the entity would not have been in existence at the time of the redemption. See Ltr. Rul. 9041005.
123 See, also, Ltr. Rul. 8542072, where the same technique was favorably utilized by the distribution of stock from a marital trust to the widow-beneficiary immediately before the redemption from the widow. See, also, Ltr. Rul. 9116031.
Service ruled that the sale back to the father did not have a principal purpose of avoiding federal income tax. It simply restored the father and son to their pre-gift position, when all of the son’s inherited stock could have been redeemed without dividend consequences.

Despite the Service’s stated “no-ruling” policy with respect to the ten-year look-back rule, the indicated exceptions appear to be broad enough to encompass virtually any situation where the facts and circumstances negate an integrated plan whereby a dominant shareholder’s transfer of a part of his stock to a family member, and subsequent redemption of either his or the transferee’s shares, is designed to effect a partial bail-out of corporate earnings in a sale or exchange transaction with the transferor still maintaining control of the corporation. It should be noted, in this connection, that the Service is not likely to rule favorably where the gift or sale of stock is to the spouse. The National Office is concerned, perhaps justifiably, that the subsequent redemption of either spouse’s stock leaves too much opportunity for the transferring spouse to retain effective control after the redemption.

[3]—When the “partial liquidation” haven is available. All of the preceding discussion in Section 9.33(2) relates to those instances in which a sufficient change in the redeemed shareholder’s percentage interest in the corporation will preclude ordinary dividend tax treatment to him. An additional exception to dividend treatment applies, irrespective of any percentage changes at the shareholder level, if the redemption effects, or is attributable to, a sufficient change in business operations at the corporate level. If the change at the corporate level qualifies as a partial liquidation of the corporation, the redemption will qualify for favorable sale or exchange treatment even though the redemption meets none of the favorable tests previously discussed and, indeed, even though the redemption is pro rata among the shareholders.

[a]—What constitutes a partial liquidation. A distribution is treated as being in partial liquidation of a corporation only if it is made to a shareholder who is not a corporation. Thus, if the shareholder receiving the redemption distribution is also a corporation, the redemption simply cannot qualify as a partial liquidation. In addition, the distribution must meet the statutory definition of a “partial liquidation.” This definition will be met if the distribution

\[124\] In Ltr. Rul. 9023047, the acknowledged purpose for the gifts to nonactive children was to reduce the size of the donor’s estate, thereby effecting federal estate tax savings. These gifts were ruled not to violate the ten-year look-back rule on the subsequent redemption of all of the stock owned by both the donor and the donees. It should be noted that even though tax savings were the principal purpose for the gifts, it was not federal income tax avoidance that was the motivating purpose. See also, Ltr. Rul. 9116031.


\[125\] I.R.C. §§ 302(b)(4) and 302(e), added in 1982. As indicated, a pro rata redemption will qualify for favorable sale or exchange tax treatment if it constitutes a partial liquidation. But, clearly, the redemption does not have to be pro rata; a disproportionate redemption at the shareholder level may also qualify as a partial liquidation. Rev. Rul. 82–187, 1982–2 Cum. Bull. 80.

\[126\] I.R.C. § 302(b)(4)(A), added in 1982. With respect to partial liquidations effected prior to September 1, 1982, the partial liquidation characterization was not limited to noncorporate shareholders.

(1) is not essentially equivalent to a dividend, determined at the corporate level rather than at the shareholder level; and

(2) is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.\(^\text{127}\)

In addition to the technical requirements that the redemption be pursuant to a “plan,” and that it be effected within a certain time period, the operative language requires simply that the distribution not be essentially equivalent to a dividend, determined at the corporate level rather than at the shareholder level. It is clear, under longstanding Treasury Regulations, that this broad and imprecise language means that the distribution must be incident to a substantial contraction of the corporate business.\(^\text{128}\)

The Treasury Regulations give an example in which a fire destroys a substantial part of a corporation’s physical plant. The corporation receives insurance proceeds on account of the fire loss. Instead of using the insurance proceeds to rebuild the plant, the corporation decides to cut down the scope of its activities and to distribute the insurance proceeds to its shareholders in pro rata redemption of a part of its stock. The distribution qualifies as a partial liquidation since there is a contraction of the business activities at the corporate level.\(^\text{129}\) Although the Regulations do not so state, it is clear that a voluntary contraction of the corporate business can give rise to a partial liquidation just as can a contraction induced by a casualty loss.\(^\text{130}\) But, whether voluntary or involuntary, the contraction of the scope of the business must be meaningful and substantial. A decrease of inventory without a corresponding substantial decrease in the scope of the business, or a distribution of investment assets which constitute a large portion of the corporation’s total net worth,\(^\text{131}\) or a distribution of any other asset (or proceeds of sale thereof) which does not result in a substantial contraction of business, will not qualify.\(^\text{132}\) In the view of the National Office, which is all-important if the assurance of an advance ruling is sought, a contraction of business is sufficiently substantial to constitute a partial liquidation if it is incident to a reduction of at least 20 percent in all of (i) gross revenue, (ii) net fair market value of assets, and (iii) employees.\(^\text{133}\) If the corporate business has been sufficiently contracted to qualify a distribution as a partial liquidation, the distribution may include cash equal to the working capital reasonably attributable to the discontinued activities.\(^\text{134}\)

A distribution in partial liquidation of a corporation is one form of tax-favored redemption, and a redemption is effected only when the issuing corporation reacquires a portion of its outstanding stock.\(^\text{135}\) Since, however, the characterization of a partial

\(^{127}\) I.R.C. § 302(e)(1).

\(^{128}\) Treas. Reg. § 1.346–1(a). Prior to the 1982 Tax Act, the relevant definition of a partial liquidation appeared in I.R.C. § 346. The cited Treasury Regulation was issued under Section 346. Although the definition is now contained in I.R.C. Section 302(e), the substance is the same, and the Regulations cited in this text under Section 346 are still valid.

\(^{129}\) Treas. Reg. § 1.346–1(a).


\(^{135}\) I.R.C. § 346(a)(2), which applied to partial
liquidation is determined solely at the corporate level, without regard to any change in the shareholders’ proportionate interest, an actual physical redemption of stock may be a meaningless act. For that reason, both the courts and the Service agree that under certain circumstances a redemption will be deemed to have occurred even though no physical transfer of stock is made. This will be true where there is only one shareholder. 136 It will also generally be true when there are several shareholders and the distribution is pro rata. 137 But if the partial liquidating distribution is not pro rata, a physical redemption of stock is essential. 138 In addition, pending further study, the National Office will not presently issue a favorable ruling, even where the distribution is seemingly pro rata, if either (i) the corporation has outstanding more than one class of stock and there are priorities in dividend or liquidating distributions or any other differences in the rights of each class, or (ii) either under the terms of the stock or by contract there are any rights affecting the corporation’s stock, such as warrants, options, convertibility, shareholder agreements, or rights of first refusal. 139 If any of these factors is present counsel should insist upon an appropriate redemption of shares.

[b]—How the “two business” rule may lead to automatic qualification as a partial liquidation. In many cases it will be difficult to conclude, absent an advance favorable ruling from Washington, that a proposed contraction of the corporate business will be sufficiently significant in scope to give rise to a partial-liquidation distribution within the meaning of the Internal Revenue Code. If, however, the so-called two-business rule as set out in the Code is satisfied, the distribution will be treated as satisfying the general definition of a partial liquidation, and will thereby give rise to favorable sale or exchange treatment by the shareholders. 140 The satisfaction of the two-business rule requires that

1. the distribution to shareholders be attributable to the corporation’s ceasing to conduct, or consist of the assets of, a trade or business; 140a

2. such trade or business must have been actively conducted for the five-year period immediately preceding the distribution; and

136 Fowler Hosiery Co. v. Commissioner, 301 F.2d 394 (7th Cir. 1962).
140 I.R.C. § 302(e)(2).
140a The proper interpretation of the statute seems to be that the corporation may not retain some of the assets of the separate business, or some of the proceeds of sale of those assets. Apparently, all of the assets of the separate business, or all of the proceeds of sale of those assets, or, presumably, all of the assets not sold and all of the proceeds of sale of the balance of the assets, after the payment of debts attributable to that business, must be distributed to the shareholders. See Kenton Meadows Co. v. Commissioner, 48 T.C.M. 580 (1984), affirmed 85–2 U.S.T.C. ¶ 9489 (4th Cir. 1985).

(3) such trade or business was not acquired within the preceding five years in a transaction in which gain or loss was recognized in whole or in part,\(^\text{141}\) and

(4) the corporation immediately after the distribution must be engaged in the active conduct of a trade or business, which trade or business has been actively conducted for the five-year period immediately preceding the date of the distribution and was not acquired by the corporation in a taxable transaction during such period.

The operation of the two-business rule may be illustrated by the following example: Suppose a corporation operates both a shoe store and a drug store, and it has operated both such businesses continuously for the last five years or more. The corporation sells all the assets attributable to the shoe store and forthwith distributes the proceeds pro rata to its shareholders in redemption of an appropriate portion of its shares. The distribution will be treated as being received by the shareholders in a sale or exchange of a portion of their stock.\(^\text{142}\)

The satisfaction of the two-business rule satisfies simply the requirement that the distribution not be essentially equivalent to a dividend. The other, more technical, requirements of a redemption of stock, a plan, and time limitations of the distribution, must still be satisfied, at least under the Service’s view.\(^\text{143}\) Under the Service’s view, by way of example, a postponement of the distribution beyond the taxable year following the taxable year in which the plan of partial liquidation is adopted will disqualify the transaction as a partial liquidation. In that event, the distribution will be tested under the shareholder exceptions to ordinary dividend treatment, discussed in Section 9.33[2], above.

[c]—Interrelationship of partial liquidation with other Section 302 redemptions. It should be noted that a corporate distribution in redemption of a part of its stock need satisfy only one of the four exceptions set forth in Code Section 302(b) in order to avoid ordinary dividend treatment. In situations where it is clear that a partial liquidation will be effected, the parties need not concern themselves with the difficult limitations applicable to the other exceptions set forth in Section 302. In this connection, it must be emphasized that the important distinction between the first three exceptions set forth in Section 302 and a partial liquidation is that a partial liquidation is effected only if there is a sufficient contraction of activities at the corporate level. If, as is usually true, the redemption of stock is not attributable to

\(^{141}\) If such business was acquired by the corporation within the five-year period in a transaction which was wholly tax-free, the period of operation by the predecessor owner is counted in determining whether the five-year rule is satisfied.

\(^{142}\) In addition to distributing the proceeds of sale of tangible assets, the corporation may also distribute a proportionate part of its working capital. See N. 115, supra. But it may not, in lieu of distributing the proceeds of sale, distribute other assets equal in value to the proceeds of sale, at least in the opinion of the National Office. Rev. Rul. 79–275, 1979–2 C.B. 137.


a cut down in the scope of the corporation’s activities, favorable sale or exchange

treatment will apply only if one of the favorable tests of Section 302, with all of its

attribution of ownership implications, is met, or if the redemption satisfies the favorable

rules of Section 303 (discussed in the next succeeding subdivision).

[4]—How the post-death stock redemption haven can be availed of. A unique opportunity is often available upon the death of a shareholder in a closely

held corporation to bail cash out of the corporation at little or no tax cost whatever
to the recipient. Furthermore, this opportunity can be availed of without concern over whether the proportionate interests of the shareholders are significantly altered,144

without any analysis as to the impact of the attribution of ownership rules,145 and

without regard to whether there is a cut down in the scope of the corporation’s

activities.146

[a]—Purpose and effect of liberal rule relating to certain post-death
redemptions. A post-death stock redemption which meets the requirements of
Section 303 of the Internal Revenue Code will give rise to favorable sale or exchange

treatment. Since stock which is includable in a decedent’s estate for federal estate tax

purposes will ordinarily obtain a basis equal to its fair market value at the date of death,
or at the election of the estate, six months after the date of death, a redemption shortly
after death which is treated as a sale or exchange is likely to involve little or no gain.

One caveat is worth noting. If the agreement to sell stock provides that the purchase
price covers not only the stock but also other ordinary income entitlements of the

decedent, then the portion allocable to the ordinary income will be taxable to the estate

as ordinary income in respect of the decedent.146.1

The purpose of this liberal provision is to enable the estates of shareholders in certain

closely held corporations to pay death taxes and administration expenses without having
to dispose of stock in closely held corporations to outsiders at a possible financial

sacrifice. As will shortly be observed, however, the effect of this liberal provision is

considerably broader than is necessary to meet its purpose.

[b]—Satisfying the stockholding requirement. The important and unique

opportunity under Section 303 of the Code is available if the value for federal estate tax

purposes of all the stock in the particular corporation included in the decedent’s

gross estate is more than 35 percent of the decedent’s gross estate, reduced only by

the debts of the decedent and the expenses of administering the estate.147 This is a

relatively high proportion of the total estate, and is the single most limiting requirement

for this special treatment.

Example: A decedent’s gross estate is $800,000, his debts are $50,000, and the

expenses of administering his estate are $30,000. The value of his stock in X
corporation, includable in his gross estate, is $225,000. The special rule under

144 See § 9.33[2][a] supra.
146.1 I.R.C. § 691. Estate of Robert E. Cartwright
 v. Commissioner, 183 F.3d 1034 (9th Cir. 1999).
Section 303 will not be available since the value of his stock is not more than 35 percent of $720,000, the value of his gross estate less his debts and the expenses of administration. If the value of his stock were more than $252,000, and the other statistics were the same, Section 303 would be applicable.

It is important to note that ordinarily the stock of one single corporation must satisfy the 35-percent test in order for Section 303 to be available.\(^\text{148}\) If, however, 20 percent or more in value of all of the outstanding stock of two or more corporations is includable in the decedent’s gross estate for federal estate tax purposes, the stock in those corporations which meet the 20-percent includability test can be aggregated for the purpose of applying the 35-percent valuation test.\(^\text{149}\) In addition, stock owned by the surviving spouse with the decedent as community property, joint tenants, as tenants by the entireties or as tenants in common, is treated as being includable in the decedent’s estate for the purpose of applying the 20-percent aggregation rule. But no other attribution of ownership rule applies. If stock is owned by another family member, and is not includable in the decedent’s gross estate, or if the stock is of a subsidiary of a corporation whose stock is includable in the decedent’s estate, it may not be counted in determining whether the 20-percent or 35-percent test is met.\(^\text{150}\)

[c]—The dollar limitations on availability of liberal rule. If the stockholding requirement is met, the corporation (or corporations, if two or more corporations qualify under the 20-percent test) may distribute in redemption of a portion of the decedent’s stock an amount which is not in excess of all death taxes (both state and federal) payable on account of the decedent’s death, and all funeral and administration expenses allowable as estate tax deductions, including the executor’s commission and the attorney’s fee.\(^\text{151}\) Although the amount of the distribution is limited to the aggregate of the aforesaid taxes and expenses, it is not necessary that the estate or the beneficiaries actually use the redemption distribution for those purposes, or, indeed, that the estate or the beneficiaries even need corporate funds for such purposes. In view of the fact that it is unnecessary to trace the redemption distribution to the payment of taxes and other expenses, the opportunity offered by Section 303 is far more attractive than merely providing a source of cash to an otherwise nonliquid estate. It is fair to say that, if the amount of gain on a Section 303 redemption will be fairly modest, then whether or not the estate needs cash to meet its various taxes and expenses, the opportunity to bail cash out of the corporation at little or no income tax cost should virtually never be passed up. There is no other situation under the federal income tax laws in which cash may be bailed out of a corporation and into

\(^{148}\) Even if two corporations in which the decedent owned stock at the time of his death are merged after his death, and before the expiration of the optional valuation date, they count as two separate corporations for this purpose. If the stock of one corporation alone is insufficient to meet the minimum valuation requirement, Section 303 is ordinarily unavailable. Rev. Rul. 69–594, 1969–2 Cum. Bull. 44.

\(^{149}\) I.R.C. § 303(b)(2)(B).

\(^{150}\) Estate of Byrd v. Commissioner, 388 F.2d 223 (5th Cir. 1967).

\(^{151}\) I.R.C. § 303(a).

The distribution may cover the indicated funeral and administration expenses even though a part or all of such expenses are elected to be taken as income tax deductions rather than estate tax deductions (I.R.C. § 642(g)). Rev. Rul. 56–449, 1956–2 Cum. Bull. 180.
the hands of a shareholder with so few technical qualifications and with such favorable
tax consequences.

Suppose, by way of example, that a husband and wife each own 50 percent of the
outstanding stock of a corporation. The husband dies and his stock interest qualifies
for a Section 303 redemption. His will leaves all of his stock to his wife. The stock
is distributed to the wife and the estate is closed. During the permissible time period,
that portion of the stock derived from the husband is redeemed from the wife as is
equal in value to death taxes and funeral and administration expenses attributable to
the husband’s death. The redemption will be treated as a sale or exchange, even though
the redemption of a part only of the stock owned by a sole shareholder (the wife) would
clearly not qualify for sale or exchange treatment under any of the favorable tests set
forth in the general redemption provisions.\[152\]

\[d\]—From whom the redemptions may be made. Although redemptions
under Section 303 will ordinarily be made from a decedent’s estate, they need not
be. The favor of Section 303 extends to any stock which is includable in the decedent’s
gross estate for federal estate tax purposes to the extent that the holder’s interest in
the estate is reduced by the payment of death taxes and funeral and administration
expenses.\[153\] Unless the effective terms of the decedent’s will, or a trust, or a binding
obligation, makes some other person or entity liable, the decedent’s residuary estate
will be fully liable for these taxes and expenses. And, ordinarily, the stock will be owned
by the decedent’s residuary estate at the time of the redemption. If these factors
coincide, no problem will be presented. But if the redemption is made from a legatee
of the stock, the favor of Section 303 will apply only to the extent that his interest
in the estate was reduced by the taxes and expenses.\[154\]

Example: The death taxes and funeral and administration expenses attributable to
A’s death are $105,000. The burden of these taxes and expenses falls on A’s residuary
estate. His three children are the residuary beneficiaries of his estate, but his will
requires that his son’s one-third interest in the residuary estate be first satisfied with
stock in X corporation. The son accordingly inherits $150,000 worth of X corporation
stock. A’s holdings in X corporation qualify for Section 303 treatment. Subsequently,
within the permissible time period, $50,000 in value of X corporation stock is re-
deemed from the son. Since the son’s interest in A’s estate was reduced by only
$35,000 on account of death taxes and funeral and administration expenses, the favor
of Section 303 extends to the redemption only to that extent. The characterization
of the balance of the redemption will be governed by the tests of Section 302.

\[152\] § 9.33[2][a] supra.
\[153\] I.R.C. § 303(b)(3).
\[154\] Prior to the Tax Reform Act of 1976, the law
permitted a redemption from a much wider choice of
persons or entities. With respect to decedents dying
before 1977, Section 303 applied without the limitation
that the holder’s interest in the estate must have
been reduced by the payment of death taxes and
funeral and administration expenses. Thus, the favor
of Section 303 extended to a person to whom the stock
was specifically bequeathed, to a surviving joint
tenant, or an appointee of assets, or a trust created and
funded by a decedent during his lifetime the corpus
of which was includable in his estate for federal estate
tax purposes, or to a person who received the stock
as a gift made in contemplation of death.

Unless the terms of a will, or a trust, or a binding contract provide otherwise, the interest of a surviving joint tenant, a specific legatee, an appointee of trust assets or a taker in default of appointment, a trust which was funded during the decedent's lifetime, or a donee who received the stock by a gift made in contemplation of death, will not be affected by the amount of death taxes and funeral and administration expenses paid by reason of the decedent's death. Thus, ordinarily, the favor of Section 303 will not extend to redemptions from those persons or entities. This particular limitation is perhaps more likely to be a trap for the unwary where the decedent, during his lifetime, transfers his stock in the relevant corporation to a revocable living trust. Even though the corpus of the trust is still includable in the decedent's gross estate for federal estate tax purposes, Section 303 will not extend to a redemption from the trust unless (i) the will, or the trust instrument, or a binding contract obligates the trust to bear a part or all of the taxes and expenses, in which event Section 303 will apply to that extent, or (ii) the decedent's residuary estate pours over to the same trust, in which event the trust's interest in the estate will have been reduced by the taxes and expenses paid or payable by the residuary estate.

The redemptions may be effected at different times and from two or more persons. If, however, several redemptions which qualify for Section 303 treatment result in aggregate distributions which exceed the dollar limitations, the favor of Section 303 will be applied on a “first come, first serve” basis. Even if the earlier redemption would clearly qualify for sale or exchange treatment under the rule of Section 302, the amount distributed in that redemption must be applied against the maximum dollar limitations of Section 303.

[e]—The time limitation on post-death redemptions. In order to qualify under Section 303, the redemptions must be effected within the time period set forth in the statute. Generally, the redemptions must be effected within the period of limitations for the assessment of the federal estate tax, or within ninety days after the expiration of such period. If, however, a petition is timely filed in the Tax Court for the redetermination of a deficiency in estate tax, the redemption distribution need be effected within sixty days after the decision of the Tax Court becomes final.

In addition to this usual time limitation, a Section 303 redemption may validly be made under extended time limitations if certain additional requirements are met. If the estate elects to pay a part of the federal estate tax over the 15-year period authorized by the Internal Revenue Code under certain conditions, the favor of Section 303

156 Treas. Reg. § 1.303–2(g).

The relevant period of limitations is three years after the estate tax return is due, if a return is timely filed on or before the date. I.R.C. § 6501(a). The due date for filing the estate tax return is nine months after the decedent’s death. I.R.C. § 6075(a). If an estate tax return is filed late, the redemption under § 303 may be effected within three years, plus ninety days, from the date of actual filing. Rev. Rul. 73–204, 1973–1 Cum. Bull. 170.

Where stock is redeemed in exchange for the corporation’s note, the redemption takes place when the note is distributed, not at the later time when the note is paid. Rev. Rul. 65–289, 1965–2 Cum. Bull. 86.

159 See I.R.C. § 6166 for the conditions and limitations relating to the 15-year installment payment of estate tax.
is similarly extended for that period of time.\textsuperscript{160} If, however, a redemption is effected later than the time allowed under the limitation discussed in the preceding paragraph (that is, later than four years after the decedent’s death), the favor of Section 303 will apply only to the extent of the lesser of (i) the amount of death taxes (including interest thereon) and funeral and administration expenses which remain unpaid immediately before the redemption, or (ii) the amount of those taxes and expenses which are in fact paid during the one-year period beginning with the distribution in redemption of stock.\textsuperscript{161} In effect, a modified tracing of redemption proceeds is required in order to qualify under the extended time limitations. This is to be contrasted with Section 303 redemptions made within the initial time limitation, where there is no correlation whatever between a need for funds for death taxes and funeral and administration expenses and the availability of Section 303 protection.

\textbf{[f]—How proportionate control can be retained notwithstanding a post-death redemption.} The feasibility of taking advantage of the unique post-death opportunity to bail cash out of a corporation is greatly enhanced by the fact that any type of stock interest, voting or nonvoting, common or preferred, can be redeemed under Section 303. Furthermore, a limited-participation type of stock can be issued even after the decedent-stockholder’s death in order to be utilized in a Section 303 redemption. For example, suppose that decedent was one of several shareholders in a corporation which has outstanding only one class of common stock. Decedent’s stock interest qualifies under Section 303. If a portion of decedent’s stock is redeemed, however, the interest of the family in the voting power and future growth of the corporation will be proportionately reduced. That reduction might make a redemption unfeasible. If, however, a class of preferred stock is authorized, and distributed as a tax-free stock dividend,\textsuperscript{162} the preferred stock may be used by the estate or its beneficiaries to effect the redemption under Section 303.\textsuperscript{163} With care, and perhaps with the cooperation of the surviving shareholders, the common stock interest of the decedent’s family need not be reduced. In appropriate instances, moreover, proper advance planning will result in the issuance of the preferred stock dividend prior to death.

\textbf{§ 9.34—How to use insurance to fund stock redemption.} When an agreement is entered into for the redemption of corporate stock upon the death of a shareholder, it will sometimes be desirable for the corporation to fund its future purchase obligation with the purchase of life insurance on the shareholder’s life. In this respect, the objective is the same as it is with respect to the use of insurance

\footnotesize{
\begin{itemize}
  \item I.R.C. § 303(b)(1)(C).
  \item I.R.C. § 303(b)(4).
  \item See § 9.23[3][a] supra.
  \item I.R.C. § 303(c).
  
  See Rev. Rul. 87-132, 1987-2 Cum. Bull. 82. Although this ruling corroborates the favorable conclusion with respect to the estate or its beneficiaries, it adds a stark reminder that the co-shareholders who receive and retain additional stock may have taxable income by virtue of I.R.C. § 305. In Ltr. Rul. 9110052, however, the Service ruled, in precisely this situation, that the co-shareholders who receive and retain preferred stock do not have taxable income by virtue of Section 305. This latter conclusion is more appropriate; it will, it is hoped, become the subject of a published ruling.
\end{itemize}
}
to fund a death buy-sell agreement at the shareholder level: to provide funds to the purchaser so that he will be able to carry through with his commitment.\textsuperscript{164} Since in a shareholder buy-sell arrangement, the surviving shareholders will be the purchasers, the insurance is owned by and payable to the shareholders. By contrast, in a redemption arrangement the corporation will purchase the shares and, accordingly, the corporation should be the owner and beneficiary of the insurance.

\textbf{[1]}—\textit{How corporate insurance affects the applicability of the accumulations penalty tax.} Except in the rare instance where a corporation purchases term insurance to fund a death redemption agreement, the insurance owned by the corporation will build up a cash surrender value. One of the least fruitful debates of the past two decades or so has centered around the question of whether or not the corporation’s accumulation of a cash surrender fund makes the corporation vulnerable to attack by the Internal Revenue Service under the accumulations penalty tax provisions.\textsuperscript{165} Although case authority on this point is inconclusive, it is not likely that a corporation will refrain from embarking on a desired and well-conceived insurance program simply on account of this area of uncertainty.\textsuperscript{166}

Perhaps the most significant practical moral which can be derived from the uncertainty in this area is that wherever a low-premium type of insurance policy—such as ordinary life insurance—will serve the particular purpose for which the insurance is carried just as adequately as a high-premium type of insurance—such as a limited pay life or an endowment type policy—then the low-premium type insurance policy should be used. If the corporation can prove a probable need for substantial cash upon the death of a shareholder-insured, it is not likely that the IRS will be able to successfully assert the accumulations penalty tax on account of the insurance, particularly if a low-premium type policy, with its minimal buildup of cash surrender values, is used.

\textbf{[2]}—\textit{The usual tax treatment of corporate-owned insurance.} The proceeds of life insurance received by a corporation are not includible in the

\textsuperscript{164} See § 9.22 supra.
\textsuperscript{165} See § 1.13[2] supra.
\textsuperscript{166} In Emeloid Co., Inc. v. Commissioner, 189 F.2d 230 (3d Cir. 1951), the court indicated that corporate insurance on the life of a shareholder-officer serves a legitimate business function, but the case does not involve the accumulations penalty tax. In Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958), the court indicated that an accumulation for the purpose of redeeming a majority shareholder’s stock is improper within the meaning of the accumulations penalty tax, at least where no contractual commitment makes the redemption mandatory, but the case does not involve insurance. But see Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), rev’d 18 T.C.M. 306 (1959). In Oman Construction Co. v. Commissioner, 24 T.C.M. 1799 (1965), the court held that the retention of insurance proceeds to redeem the stock of a deceased officer served a reasonable business need. Although the case did not involve the vulnerability of accumulating a cash surrender value, the same favorable holding should presumably be applicable in this latter situation. In A.T. Williams Oil Co. v. Commissioner, 42 T.C.M. 851 (1981), the Tax Court held that the cash surrender value of life insurance policies should not be considered a liquid asset for the purpose of determining whether the corporation’s net liquid—assets were in excess of its reasonable business needs. The holding is favorable on the point discussed in the text, but it was not analyzed in depth in the memorandum decision of the Tax Court.
corporation’s gross income. Similarly, where the corporation is directly or indirectly the beneficiary of the insurance, the premiums paid by it are not deductible for income tax purposes. The portion of the premium which increases the cash surrender value of the policy constitutes the cost of an asset and, to that extent, is not an expense. The portion, if any, of the insurance premium which exceeds the addition to cash surrender value is an expense which is chargeable from an accounting standpoint to earned surplus, but is nevertheless not a deductible expense for federal income tax purposes.

If the insured has no beneficial interest in the insurance, the payment of premiums by the corporation does not constitute income to him. When the insured is also a substantial shareholder, however, care should be taken in setting up the insurance program and in drafting the redemption agreement to avoid any basis for an allegation that the insurance really benefits the insured shareholder and not the corporation. In some instances where insurance was taken out and carried in a manner which indicated an alarming disregard for the legal separateness of a corporation and its shareholders, the IRS successfully contended in the trial court that the premiums paid by the corporation were taxable income to the shareholder-insured. Although the trial court decisions in those cases were reversed favorably to the taxpayers, and the IRS thereafter announced a rather liberal policy in this area, the practical moral is clear: Inadequate care in setting up corporate-owned insurance on the lives of shareholders may result in litigation and the possible includability of the premium payment in the taxable income of the insured. From the tax standpoint, the necessary care should be directed towards making certain that the shareholder is not the real owner or beneficiary of the insurance.

[3]—Suggestions and precautions in using insurance to fund death redemption. Unless careful attention is given to the setting up of insurance in connection with a death redemption agreement, two adverse results may follow: (1)
The shareholder-insured may have to include the premium in his taxable income, and (2) the surviving shareholders may be enriched at the expense of the deceased shareholder, or the deceased shareholder may be enriched at the expense of the surviving shareholders. The following suggestions and precautions will ordinarily be relevant in this connection.

\[ \text{a)—Corporation must own the insurance.} \] The corporation should be the owner and the beneficiary of the insurance. No arrangement should be made that might enable the IRS to argue that the owner or the beneficiary of the insurance is one of the shareholders.

\[ \text{b)—Insurance proceeds should not be minimum price.} \] The insurance proceeds should not be set as the minimum price to be paid for the decedent shareholder’s stock. Quite apart from income tax implications, such a provision might result in an excessive payment for the decedent shareholder’s stock and, to that extent, be unfair to the surviving shareholders. From an income tax standpoint, such a provision is some indication that the insurance was taken out by the corporation not primarily to fund its own redemption obligation, but rather to benefit the decedent’s family by giving it a minimum amount of insurance which is paid for by the corporation.

\[ \text{c)—Determining whether insurance proceeds should increase price of stock.} \] Although the insurance proceeds should not be set as the minimum price to be paid for the decedent stockholder’s interest (Subsection [b] above), the parties will sometimes want to take the proceeds into account in determining the price to be paid by the corporation for the decedent’s stock. This will sometimes be their desire, not from a tax standpoint, but from the standpoint of simple equity. Since the insurance proceeds will enrich the corporation, the decedent’s estate should as an equitable matter be entitled to receive its proportionate share of that enrichment. Suppose, by way of example, that immediately before a shareholder’s death, a corporation has no debts and has assets with a book value of $100,000, including $10,000 represented by the cash surrender value of its insurance policies on the life of such shareholder. The death proceeds of the insurance policies are $50,000, so that immediately after the shareholder’s death the corporation’s book value has been increased by $40,000, to a total of $140,000. If the corporation has two equal shareholders, and if the decedent shareholder’s estate is entitled to the book value of his stock computed without regard to the insurance proceeds, the decedent’s estate will be entitled only to $50,000; the surviving shareholder will have a corporate

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174 See [2], above.
175 In Rev. Rul. 59–184, 1959–1 C.B. 65, the IRS ruled that the corporate payment of premiums does not constitute income to the shareholder-insured even though the shareholder has the right to designate the beneficiary, provided that the beneficiary’s right to the proceeds is conditioned on a surrender to the corporation of the decedent’s stock.
176 It has been held that where the contract is ambiguous in this respect, the insurance proceeds will be taken into account. Land & Simmons Co. v. Arcenci, 223 Md. 204, 162 A.2d 478 (1960).
177 See § 9.21 for a discussion of the various methods commonly employed in determining the purchase price of shares in a closely held corporation.
business with a book value of $90,000.\textsuperscript{178} In effect, the entire excess of the insurance proceeds over the cash surrender value immediately prior to death will inure to the benefit of the surviving shareholder. If, on the other hand, the increased value of the corporation on account of the receipt of insurance proceeds is taken into account in determining the purchase price of the decedent’s stock, the decedent’s estate in our example will receive $70,000 and the surviving shareholder will have a corporate business with a book value of $70,000.

Taking into account the insurance proceeds for this purpose will increase the financial burden on the corporation in connection with the redemption. For this reason, some business owners will choose to ignore the insurance proceeds in determining the price, or the formula for determining the price, to be embodied in the contract. Other owners will accept this additional burden in order to avoid a substantially disproportionate treatment between the decedent and the surviving shareholders. The business advisor’s chore is to point out the differing impact of including or excluding the insurance proceeds in the price determination; the decision should properly be left to the client.

\textbf{[4]—Dealing with an excessive alternative minimum tax.} Although life insurance proceeds are not includable in a corporation’s taxable income for regular tax purposes, they are likely to add to the base on which a C corporation’s alternative minimum tax is computed. In many instances this will not be a significant problem. Thus, during the lifetime of the insured shareholders the basis of the policies will gradually increase; only the excess of the death proceeds over the basis immediately prior to death adds to the alternative minimum taxable income.\textsuperscript{178a} The amount of the excess may not be unduly burdensome. This, when combined with the lower alternative minimum tax rate of 20 percent and the possible availability of a $40,000 exemption,\textsuperscript{178b} may make the alternative minimum tax an insignificant threat. But the alternative minimum tax will not always be insignificant. In some instances the corporation will gradually build up the amount of its insurance on a major shareholder’s life to the point at which hundreds of thousands, or even millions, of dollars will ultimately be received. If so, the alternative minimum tax may be a substantial deterrent.

The easiest and most effective answer is for the corporation to elect S status. Insurance proceeds do not add to the alternative minimum tax base of an S corporation. When S status is feasible and available, the corporate advisor should seriously consider this easy and effective solution.\textsuperscript{178c}

If an S election is not an available or appropriate solution, the corporate advisor might consider the possibility of converting the buy-sell arrangement from a

\textsuperscript{178} A similar disproportion may result from the typical cross-insurance funding of a shareholder buy-sell agreement. See § 9.22. In connection with the shareholder cross-insurance arrangement, however, the cash surrender value of the policy owned by the decedent on the survivor’s life will decrease the disproportion. No such partial equalizing factor will be present when the insurance is owned by the corporation.

\textsuperscript{178a} See ch. 1, \textit{Preincorporation Planning and Procedure}.

\textsuperscript{178b} See I.R.C. § 55(b), (d).

\textsuperscript{178c} See ch. 3, \textit{Making the Most of Subchapter S}. 

(Ref.48—5/05 Pub.400)
redemption by the corporation to a cross-purchase among the individual shareholders. 178d If the redemption agreement is cancelled, and a shareholder cross-purchase agreement is substituted, no income taxes will be payable on the transaction. However, the parties normally will want to transfer the corporate-owned life insurance to the individual shareholders so that it can be used by the individual shareholders to help fund their individual obligations to purchase a decedent’s stock. The transfer of the policies may result in disastrous tax consequences. The tax problem stems from the fact that the transfer of the policies from the corporation to the shareholders may invoke the “transfer for value” rule. Under this rule, the death proceeds are taxable to the transferee’s actual cost for the policies, including the premiums paid by the transferee. 178e The tax cost to the beneficiary of the policy is likely to be substantially greater than the alternative minimum tax that the corporation would otherwise have paid.

The transfer of the policies to the shareholders will almost certainly be for value. Thus, if a shareholder buys a policy for its cash surrender value, or takes a policy subject to the policy loan incurred in paying the premiums, the transfer is clearly for value. Even if the corporation merely distributes the policy as a dividend to the shareholders, the corporation’s release from its future obligation to redeem its stock almost certainly constitutes “value” for purposes of the “transfer for value” rule.

There are, however, certain exceptions to the application of the transfer for value rule, and it is one of these exceptions that must be met in order to make the transfer feasible. One method of excluding a policy from the transfer for value rule is to fund a shareholder cross-purchase arrangement in which the co-shareholders of the insured shareholder, and not the insured shareholder, become the owners and beneficiaries of the policies on the insured shareholder’s life. 178f

Another exception applies when the transfer is to a partner of the insured or to a partnership in which the insured is a partner. 178g It is this exception that has proven to be helpful in solving this problem. Thus, if the shareholders happen to be partners in an existing partnership, the IRS has ruled that the purchase of the policies by the individual partners/shareholders, or by the partnership followed by a distribution from the partnership to the individual partners, does not invoke the transfer for value rule. 178h

In most instances, however, the shareholders will not also be partners in a partnership. But even here the IRS has come to the aid of the corporation and its shareholders. The IRS has ruled that a new partnership may be created solely for the purpose of receiving and holding the life insurance policies on the lives of the shareholders, simply to facilitate the conversion of a redemption arrangement to a cross-purchase arrangement, and the partnership exception to the transfer for value rule will be invoked. 178i

178d See § 9.2.
178e I.R.C. § 101(a)(2).
178f See § 9.22.
178g I.R.C. § 101(a)(2)(B).
178h Ltr. Ruls. 9239033, 9328010.
178i Ltr. Rul. 9309021. The ruling is unexpectedly liberal; the IRS could have taken the position that a new partnership with no business purpose other than to facilitate a move that will avoid the future imposition of the alternative minimum tax will be ignored.
§ 9.35—Avoiding dividend dangers to remaining shareholders.

The Internal Revenue Code contains detailed rules relating to the tax treatment of the shareholder whose shares are purchased by the corporation.\textsuperscript{179} We now turn to a discussion of tax dangers to the remaining shareholders, persons who do not receive any part of the redemption payment but whose percentage interest in the corporation is increased by virtue of the redemption from others. In this area, our concern is with judicial, nonstatutory law; the very few statutory rules are neither a material hindrance nor a material aid.\textsuperscript{180}

The dividend dangers to the remaining shareholders can perhaps best be understood by the following examples:

(1) Suppose that A and B are equal shareholders in X Corporation. B purchases all of A’s shares and then immediately sells to the corporation the shares acquired from A. In this example, X Corporation has redeemed a portion of B’s shares, leaving him after the redemption in sole control of the corporation just as he was immediately prior to the redemption. B actually receives the redemption distribution, his proportionate ownership is not affected, and the distribution will be treated as a dividend distribution to him.\textsuperscript{181} This result will follow because B actually receives a distribution from the corporation which, under the circumstances, is characterized as a dividend distribution.\textsuperscript{182}

The result would then be that the transfer of policies is treated as being from the corporation to the insured’s co-shareholder, a transfer that is subject to the transfer for value rule. The ruling is very helpful as a guide to the National Office’s apparent ruling policy on this question. Unless and until the favorable conclusion of this letter ruling is embodied in a published ruling or a definitive case, the corporate advisor is well-advised to obtain a private letter ruling in advance of utilizing this technique.

\textsuperscript{179} See § 9.33.

\textsuperscript{180} The statutory rules that could, conceivably, have a bearing on this question are contained in subdivisions of I.R.C. § 305 (b) and (c). In all likelihood, however, these statutory rules are relevant only to redemption distributions which are treated as ordinary dividend distributions to the redeemed shareholders, not sales or exchanges. The type of redemption which is our concern in this chapter—a redemption which is designed to shift shareholder control—should always be planned to result in sale or exchange treatment to the redeeming shareholder.

\textsuperscript{181} Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); Television Indus., Inc. v. Commissioner, 32 T.C. 1297 (1959); Edmister v. Commissioner, 46 T.C. 651 (1966), aff’d per curiam, 391 F.2d 584 (6th Cir. 1966).

\textsuperscript{182} But even in this seemingly clearly adverse situation for the remaining shareholders, if they can make a convincing case that a redemption, not a shareholder purchase, was planned and intended all along, but that for reasons largely outside their control a shareholder purchase had to be effected to satisfy the seller or a lending institution or, presumably, to accomplish some other important business purpose, the contemporaneous or near-contemporaneous redemption from the purchasing shareholders might still be treated as a redemption directly from the other shareholder, with no dividend consequence to the remaining shareholders. See Bennett v. Commissioner, 58 T.C. 381 (1972), acq. 1972-2 C.B. 1; Bunton v. Commissioner, 27 T.C.M. 9 (1968); T.A.M. 9401001. But compare Adams v. Commissioner, 594 F.2d 657 (8th Cir. 1979), and Skyline Memorial Gardens, Inc. v. Commissioner, 50 T.C.M. 360 (1985), in which the taxpayer was unable to convince the court that he was acting as an agent for the corporation to effect a redemption of the corporation’s stock from the selling shareholders. Relying on the approach upheld in Bennett and Bunton is precarious.
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(2) Suppose that instead of B purchasing A's shares and then having them redeemed by the corporation, B acquires A's shares and causes X Corporation to pay A directly the purchase price. Although B receives no distribution from the corporation, the payment by X to A may be treated as a constructive distribution to B on the ground that the corporation has used its funds to purchase an asset (A's shares) for B.\textsuperscript{183}

(3) Suppose that B obligates himself to purchase A's shares but at the final closing B causes the corporation directly to redeem A's shares and to pay A the purchase price. In this example, no asset is purchased by the corporation for B, inasmuch as B never receives A's shares. Notwithstanding, the corporation makes a payment to A which relieves B of a liability previously contracted by him; in line with the usual rule whereby a shareholder is treated as being in constructive receipt of a distribution when a corporation discharges his obligation,\textsuperscript{184} this transaction will be treated as a distribution to B.\textsuperscript{185} But B must be unconditionally and unqualifiedly obligated to purchase the shares in order for this unfavorable rule to apply. If B is obligated either to purchase the shares or to find a buyer for them, the purchase of the shares by the corporation will not be a dividend to B.\textsuperscript{186} Nor will a redemption be taxable as a dividend to the remaining shareholder simply because he would have become obligated to purchase the shares if the corporation had chosen not to do so.\textsuperscript{187} Similarly, if shareholders A and B have an agreement that upon the death of the first of them to die the survivor will personally purchase the decedent's shares, but the agreement is rescinded during their joint lifetimes, a subsequent redemption from the first decedent will not constitute a dividend to the survivor.\textsuperscript{188} But if the attempted rescission of the original agreement is effected after the death of the first of them to die, after the survivor has become unconditionally and unqualifiedly obligated to purchase the shares, the redemption will be taxed as a dividend to the survivor.\textsuperscript{189}

(4) Suppose that B does not obligate himself to purchase A's shares; instead, he acquires an option to purchase them. B later assigns his option to the corporation which exercises it and purchases A's shares. In this example, it cannot be said that

\textsuperscript{183} Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958); Miles v. Commissioner, 25 T.C.M. 1278 (1966); O'Reilly v. Commissioner, 27 T.C.M. 1543 (1968).

\textsuperscript{184} Cf. Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954).

\textsuperscript{185} See ch. 7, Dividends: Tax and Nontax Problems.

\textsuperscript{186} See ch. 7, Dividends: Tax and Nontax Problems.


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B actually received the distribution from the corporation (Example (1) above), or that he received A’s shares (Example (2) above) or that he was relieved from a liability by virtue of the corporate purchase from A (Example (3) above). It would be difficult on these facts to justify taxing B simply by virtue of the corporate purchase from A. On similar facts, a divided Court of Appeals for the Third Circuit held that the remaining shareholder was not taxed.190

(5) Suppose that B does not obligate himself to purchase A’s shares and does not acquire an option on the shares. In a transaction solely between A and the corporation, the corporation redeems A’s shares. In view of the favorable conclusion indicated in Example (4) above, it should clearly follow that in this “clean” deal, no tax could be imposed upon the remaining shareholder simply by virtue of the corporate purchase from A.

In each of Examples (4) and (5), the percentage ownership of the remaining shareholder is increased. But the benefit of increased ownership is not in itself a sufficiently direct benefit on which to base a tax under our present income tax laws. The fact is that for a tax to lie against the remaining shareholders they must receive the distribution from the corporation (as in Example (1) above), or receive a new asset paid for by the corporation (as in Example (2) above), or be relieved of an obligation (as in Example (3) above). The present position of the IRS is in accord with the foregoing.191 If the remaining shareholders do not receive the corporate distribution, do not receive a new asset, and are not relieved from a personal liability, the redemption will not ordinarily give rise to tax consequences to them. If, however, the price paid to the selling shareholder is less than the fair market value of his shares, the IRS takes the position that the redemption may constitute a gift or compensation to the remaining shareholders.192 The IRS position in this respect appears to be legally sound. It should be noted that the IRS’s position presumably does not mean that a disproportionately low price necessarily results in gift or compensation treatment to the remaining shareholders. The disproportionately low price must presumably be associated with a donative intent by the selling shareholder or with circumstances justifying compensation treatment for the unfavorable tax characterization to apply.

Most important, for planning purposes, it can safely be assumed that the redemption of one shareholder’s stock will not give rise to tax consequences to the remaining shareholders if

(i) the remaining shareholders do not receive the redemption distribution,
(ii) they do not receive the shares directly from the selling shareholders,
(iii) they are not relieved from an unconditional and unqualified personal obligation by virtue of the redemption, and
(iv) the redemption is for a fair price.

192 Rev. Rul. 58–614, 1958–2 C.B. 920. Similarly, if the price paid to the selling shareholder is higher than fair market value of the shares, the remaining shareholders may have made a gift, or paid compensation, to the seller.
§ 9.36—The problem presented by a divorce settlement.

When one or both spouses own a controlling interest in a closely held corporation, a divorce may motivate the parties to have a portion of that stock redeemed. A redemption may be desirable for any number of reasons: the spouse active in the business may want the other spouse out of the corporation; the inactive spouse may insist on getting out; or the corporation may be a better source of cash for a divorce settlement than the dominant shareholder. Whatever the specific motivation, a redemption of stock is likely to be a part of the divorce proceedings.

It would seem, at first blush, that the presence of a divorce settlement should not change any of the prevailing rules. The spouse whose stock is redeemed should have a taxable event with no tax consequence to the non-redeeming spouse, unless the redemption discharges a primary and unconditional obligation of the non-redeemed spouse to purchase that stock. Thus, for example, if Husband (H) and Wife (W) both own stock in Corporation X, and they agree that X will redeem the stock owned by W, the redemption will be treated as a sale or exchange by W and she will be taxed on any gain realized by her. If, however, they agree that H will purchase her stock and H causes X to redeem the stock, W will still have a taxable sale or exchange and H will also be treated as receiving a dividend from X, taxable in full as ordinary income.

Comment: If the corporation is an S corporation, the characterization of dividend treatment to H is not likely to be nearly as onerous as indicated above. This is particularly true if the corporation has no accumulated earnings and profits. In this event, the distribution will be treated as a tax-free recovery of H’s basis in his stock and a sale or exchange to the extent of any excess over basis. If the S corporation has accumulated earnings and profits, see § 3.12[2] for the proper tax treatment to H.

An element of doubt with respect to the proper treatment of the redemption is attributable to I.R.C. Section 1041 and the Temporary Regulations thereunder. Section 1041 was enacted in 1984 in order to facilitate transfers of appreciated property between spouses incident to a divorce. Under Section 1041, a transfer of property between spouses incident to a divorce is treated as a gift, even though the transferee pays valuable consideration. The transferor does not recognize taxable gain, and the transferee takes a carry-over basis.

The purpose and effect of Section 1041 is to postpone the recognition of a taxable event until such time as the transferee spouse disposes of the property. The Temporary Regulations under Section 1041 expand the literal scope of the statute by stating that under certain circumstances a transfer of property by one spouse to a third party “on behalf of” the other spouse will be treated as a nontaxable transfer to the other spouse followed by a taxable transfer by the other spouse to the third party. Clearly, for example, if, incident to a divorce settlement, W transfers appreciated property to a bank to discharge a debt owed by H to the bank, the transfer will be treated as a nontaxable gift from W to H and a taxable sale by H to the bank. The direct transfer by W to the bank is clearly “on behalf of” H. But

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193 See § 9.35 supra.
194 I.R.C. § 1041(b); Temp. Treas. Reg. § 1.1041-1T(d), Question and Answer 10 and 11. The Temporary Regulations were issued in 1984, shortly after the enactment of I.R.C. § 1041.
what does “on behalf of” mean in the context of a redemption of stock incident to a divorce?

In *Arnes v. United States*, the Court of Appeals for the Ninth Circuit interpreted the “on behalf of” language very broadly, probably too broadly. In *Arnes*, H and W jointly owned all of the stock of X Corporation. Pursuant to a divorce agreement, H and W agreed that X would redeem all of W’s stock and that H would personally guarantee X’s obligation. It should be noted that H did not personally obligate himself to purchase W’s stock, only to personally guarantee X’s payment obligation. The redemption was effected, and W reported the gain and paid the tax. She then sued for a refund. Both the district court and the court of appeals held that she was entitled to the refund. The court of appeals apparently reasoned that since the redemption was a part of the settlement agreement, H benefitted from the redemption, and since he benefitted from the redemption it was made on his behalf, within the meaning of the Temporary Regulations. Therefore, W made a tax-free constrictive transfer of the stock to H, and H, presumably, made a taxable transfer of the stock to X.

The reasoning of the Ninth Circuit in *Arnes* is not at all persuasive. Clearly, the Tax Court rejects it.

In the second *Arnes* case, decided in the Tax Court, and involving the husband’s tax liability, the Tax Court refused to follow the Ninth Circuit’s reasoning and held that the husband was not taxable on the redemption because he did not have a primary obligation to purchase his wife’s stock. In effect, the Tax Court interprets the Temporary Regulations to mean that a redemption is “on behalf of” the non-redeeming spouse only when the settlement agreement, or the divorce decree, imposes a primary liability on the non-redeeming spouse to purchase the stock, and that liability is discharged by a redemption.

The Tax Court’s position is also that of the Internal Revenue Service, as expressed in a Technical Advice Memoranda, and implicit in a Letter Ruling. It is the correct position.

However, in the *Craven* case, a district court adopted the position of the Ninth Circuit in the first *Arnes* case. In *Craven*, the redeemed wife argued that her sale of a 47-percent stock interest to the corporation was tax-free under Section 1041 because it was on behalf of her husband, the 51-percent stockholder, who had personally guaranteed the corporation’s payment. The Service responded that because the husband was not primarily liable for the purchase, Section 1041 did not apply. The court agreed with the wife.

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195 981 F.2d 456 (9th Cir. 1992).
197 In *Hayes v. Commissioner*, 101 T.C. 593 (1993), the Tax Court held that the nonredeeming spouse was in constructive receipt of a dividend because he was personally obligated to purchase the stock of the redeemed spouse. In *Blatt v. Commissioner*, 102 T.C. 77 (1994), the Tax Court held that the redeemed spouse was taxable on the redemption because the other spouse was not personally obligated to purchase the stock, nor did the non-redeeming spouse personally guarantee the corporation’s payment.
198 T.A.M. 9046004.
199 Ltr. Rul. 9427009.
§ 9.37  MICHIGAN CORPORATION LAW

It is to be hoped that the final regulations under Section 1041 will clarify the proper tax treatment of redemptions incident to a divorce. Meanwhile, practitioners and their clients may proceed cautiously, outside the Ninth Circuit, on the basis that intrusion of a divorce does not change the rules developed by the cases, summarized most helpfully in Revenue Ruling 69-608, and discussed in some detail in Section 9.35, above. If the parties want the tax burden to fall on the redeemed shareholder, which will usually be the case, they must be careful not to impose a primary obligation on the remaining shareholder to personally purchase the stock. Even better, the parties should avoid requiring a personal guarantee from the non-redeeming spouse.

§ 9.37—The tax effect to the redeeming corporation.

When a corporation pays for its own stock with cash or its promissory note, it is not disposing of any asset on which a gain is realized, so necessarily there is no taxable gain that can be recognized. Even when it pays for the redeemed stock by transferring an asset which has a value greater than its basis to the corporation, it can be argued that the corporation, by reacquiring its own stock, receives nothing that is of value to it. Consequently, the argument might be, the corporation cannot realize a gain. Indeed, for many years the general rule was predicated on that analysis. With certain statutory and judicial exceptions a corporation did not recognize gain when it distributed an asset in redemption of its stock. The current law is exactly the opposite. With respect to redemptions effected after 1986, the rule is clear and unambiguous; namely, when a corporation distributes an asset in redemption of its stock, it recognizes gain just as though it had sold that asset for an amount equal to its fair market value. In no event, however, is a loss recognized to the corporation when it distributes, in redemption of stock, an asset that is worth less than its basis to the corporation. In addition, any expense incurred by the corporation in connection with the redemption, including legal fees, is not deductible. If the corporation borrows money in order to effect the redemption, the interest expense is clearly deductible. But the courts are not in agreement as to the deductibility of the expenses of obtaining the loan. The interest expense incurred on the debt has been expressly allowed as a deduction, but until the Small Business Job Protection Act of 1996, expenses incurred to obtain the loan appeared to be unambiguously not deductible. Courts were split on their reading of the statute, so the

199.2 However, another federal district court has followed the Ninth Circuit in a case similar to Arnes. Craven v. United States, 70 F. Supp. 2d 1323 (N.D. Ga. 1999).

200 See ch. 7 for a very brief history of the so-called “General Utilities doctrine.”

201 I.R.C. § 311(b). This rule does not apply to a redemption of stock by a regulated investment company if the redemption is made upon the demand of the shareholder. I.R.C. § 852(b).

202 I.R.C. § 311(a).

203 I.R.C. § 162(k). This is true even if the redemption is essential to the survival of the corporate business. Frederick Weisman Co. v. Commissioner, 97 T.C. 563 (1991). The Tax Court in Weisman rejected a Fifth Circuit decision in Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966). Five Star is almost certainly wrong under the present provisions of I.R.C. § 162(k).


205 Former I.R.C. § 162(k).

206 In United States v. Kroy (Europe) Ltd., 27 F.3d 367 (9th Cir. 1994), the Ninth Circuit held that the borrowing is a separate event from the redemption.
statute was retroactively amended by the 1996 Act. Under current law, these expenses are now amortizable over the life of the loan.\textsuperscript{207}

If the redemption is accompanied by something else, such as a contractual promise to not compete or to not purchase the corporation’s stock for some period of time (referred to politely as greenmail), an allocation for part of the redemption price to such a promise might be amortizable even though not immediately deductible.\textsuperscript{208}

\section*{§ 9.4—How To Make a Death Buy-Out Agreement Controlling for Estate Tax Purposes.}

\subsection*{§ 9.41—Introduction—a brief history.}

When a shareholder transfers a part or all of his stock, by gift or sale, to another person, he will ordinarily expect that the transferred stock will not be a part of his estate for federal estate tax purposes. Similarly, if the shareholders of a corporation enter into an agreement with the corporation pursuant to which the estate of the first of the shareholders to die agrees to sell, and the corporation agrees to buy, the stock owned by the first decedent at a specified price, the parties will expect that the contract price will be the value of the stock for federal estate tax purposes. If this expectation proves to be wrong, the result can be catastrophic. Suppose, for example, that A owns all of the stock of X Corporation. He has three children, only one of whom, B, is active in the business. In order to assure that B will end up with sole ownership of the business and that the other children will inherit a fair share of unrelated assets, A makes a gift to B of a 30 percent stock interest in X at a time when the entire corporation is worth $1,000,000. At the same time, A, B, and X enter into an agreement that obligates A’s estate to sell, and X to buy, the balance of A’s stock at the then present fair value of $700,000. At A’s later death, X is worth $5,000,000. A’s estate is obligated to sell its 70 percent interest for $700,000, and that constitutes the bulk of A’s estate which is left to the other children. If the contract price is not controlling for federal estate tax purposes, A’s 70 percent interest will be valued at $3,500,000 even though his estate is obligated to sell it for only $700,000. A’s actual estate will be confiscated for the payment of estate taxes.

Before 1988, a well-drafted contract could make it reasonably certain that the contract price would control estate tax valuation even though the contract price turned out to be very substantially less than the fair market value of the stock at the time of the decedent’s death. In 1987, Congress enacted the short-lived I.R.C. Section 2036(c) in order to kill all of the various techniques for freezing the value of a decedent’s estate. Section 2036(c) in effect invalidated any buy-sell agreement that favored family members unless the agreement provided for a buy-out price that equaled the fair

and allowed the deduction of the fees and expenses of obtaining the loan. The Tax Court rejected the Ninth Circuit’s holding in \textit{Fort Howard Corp. v. Commissioner}, 103 T.C. 345 (1994), but issued a new opinion in that case to acknowledge the retroactive effect of the 1996 statutory amendment. \textit{Fort Howard Corp. v. Commissioner}, 107 T.C. 187 (Oct. 22, 1996).


\textsuperscript{208} \textit{Wrangler Apparel Corp. v. United States}, 931 F. Supp. 420 (M.D.N.C. 1996).
market value of the stock at the time of the future sale. The impact of Section 2036(c) on buy-sell agreements and other techniques for shifting ownership of closely held corporations was so severe that it was bitterly attacked by many small business organizations. As a result, it was repealed retroactively in 1990. At the same time, Congress enacted I.R.C. Section 2703 which is a modified approach to buy-sell agreements. Under current, post-1990 law, the rules in this area are very different, depending on whether the contract was entered into prior to October 9, 1990, or after October 8, 1990.


If a buy-sell agreement was entered into before October 9, 1990, careful drafting could make reasonably certain that the purchase price payable to the decedent's estate would be the proper valuation of the decedent's stock for federal estate tax purposes. If the contract fails to satisfy three tests set forth in the cases and Treasury Regulations, however, it is possible that the decedent’s estate will, as a matter of contract law, be entitled only to the purchase price set forth in the contract, but would, as a matter of federal estate tax law, be obliged to pay death taxes based on a considerably higher value.

[1]—Price must be fair when contract entered into. The contract price must represent a fair price at the time when the contract was executed. This does not necessarily mean that the contract price must be at least as high as the amount for which the shareholder could then have sold his or her interest to an outsider. The understandable desire of shareholders of a closely held corporation to keep ownership within a defined group may result in a contract price that is favorable to the survivors. So long as the price indicates that the agreement was entered into as a bona fide business arrangement and not as a substitute for a bequest to a close family member, this requirement will be met. A redemption formula which effectively makes a bequest to an unrelated third party will probably control for estate tax purposes.

[2]—Lifetime disposition of stock must be restricted. The decedent must not have been able during his or her lifetime to dispose of his or her stock interest free and clear of the obligation to sell. The contract might prohibit the shareholder

§ 9.4

1 Commissioner v. Bensel, 100 F.2d 639 (3d Cir. 1938); see Treas. Reg. § 20.2031-2(h).
2 May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Weil v. Commissioner, 22 T.C. 1267 (1954), acq. 1955-2 C.B. 10; Estate of Littick v. Commissioner, 31 T.C. 181 (1958), acq. 1959-2 C.B. 5, acq. withdrawn in result only substituted, 1984-2 C.B. 1; Fiorito v. Commissioner, 33 T.C. 440 (1959), acq. 1960-1 C.B. 4; Estate of Seltzer v. Commissioner, 50 T.C.M. 1250 (1985); Compare Estate of Laufer v. Commissioner, 64 T.C.M. 1643 (1992), in which the cavalier method by which the contract price was established was an important factor in the court’s decision that the contract was a substitute for a bequest and was, therefore, not controlling for federal estate tax purposes. See also Cameron W. Bommer Revocable Trust v. Commissioner, 74 T.C.M. 346 (1997), in which the contract price was not binding, in part because it was lower than what the taxpayers had stipulated in other relatively contemporaneous transactions.
3 Treas. Reg. § 20.2031-2(h); Giannini v. Commissioner, 148 F.2d 285 (9th Cir. 1945); Matthews v. Commissioner, 3 T.C. 525 (1944), acq. 1944 C.B. 19.
from making any disposition by way of gift during his or her lifetime and, in addition,
give the corporation or the remaining shareholders a right of first refusal to purchase
at the same price as specified for a sale at death, in the event that the shareholder
desired to sell the stock during his or her lifetime. Or the agreement might not prohibit
lifetime transfers but, instead, might make clear that any such transfer would be subject
to the agreement; upon the death of the original shareholder, the shares owned by
him at the time the contract was executed would have to be sold by the then owner
to the corporation or to the remaining shareholders at the predetermined price. 5 In
brief, in order for the contract price to control for estate tax valuation purposes, the
decedent could not have been in a position to vitiate the contract during his or her
lifetime simply by giving away or selling the shares.

Similarly, the decedent should not have been in a position to unilaterally amend
the agreement restricting his stock. In one case the decedent owned 86 percent of
the corporation’s stock and the shareholders agreement required an 87.5 percent vote
to amend. The court held that the decedent had the power to amend the agreement
because his wife owned 1.9 percent of the stock. The wife was not active in the business
and was presumed by the court to have deferred to her husband. 5.1 This presumption
of deference from a family member is potentially dangerous precedent. The tax
practitioner must be alert.

[3]—Estate may not have option to refuse to sell. The contract must
obligate the decedent’s estate to sell the shares, or give the surviving shareholders or
the corporation (without the consent of the decedent’s estate) the option to purchase
the decedent’s stock at the predetermined price (or pursuant to a predetermined
formula for determining price). If the estate or the decedent’s beneficiaries reserves
the right to refuse to sell, or if for some other reason the agreement is unenforceable
against the decedent’s estate, the agreement will be ineffective for estate tax valuation
purposes. 6

[4]—Contract must not have been substantially modified after Octo-
ber 8, 1990. An agreement entered into before October 9, 1990, that meets the
indicated requirements and is not substantially modified after October 8, 1990, is clearly
grandfathered from the application of current law. 7 The regulations are helpful in
defining “substantially modified.” 8 Under the regulations the following modifications
may be made to a pre-October 9, 1990, agreement without bringing the current law
into effect:

(1) The addition of a family member as a party to the agreement if the addition
is required by the terms of the agreement. Thus, if the agreement requires
that a new shareholder must become a party to the agreement as a condition

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4 [Reserved].
5 An illustration of the failure to meet this require-
ment is provided by Estate of Obering v. Commis-
5.1 Cameron W. Bommer Revocable Trust v. Com-
missoner, 74 T.C.M. 346 (1997).
6 See, for example, Weil v. Commissioner, 22 T.C.
7 Revenue Reconciliation Act of 1990,
§ 11602(e)(1). See also Treas. Reg. § 25.2703-1(d).
8 Treas. Reg. § 25.2703-1(c).

(Rel.48—505  Pub.400)
of becoming a shareholder, that addition would seem to be permissible even though the new shareholder is a close family member. If the addition of the family member is not required by the terms of the agreement, the addition is a substantial modification.\textsuperscript{8.1} If, however, the added family member is of the same or higher generation than the lowest generation of individuals who are already parties to the agreement, the addition of that family member to the agreement, even though voluntary, will not be a substantial modification. Thus, if A and A’s daughter, B, are parties to a pre-October 9, 1990, agreement that effectively freezes the future price to be paid for a decedent’s stock, and B’s sibling becomes a party to the agreement in 1992, that addition will not be a substantial modification of the agreement.

(2) If the terms of the agreement require a periodic updating of the purchase price, the updating is not a substantial modification. This is clearly true if the modification results in a price that more closely approximates the fair market value of the stock.\textsuperscript{9} Suppose, however, that the update lowers the price to be paid to a point significantly below its fair market value, and that this lowering is permissible under the terms of the agreement. The proposed regulations do not address this specific question. It is difficult to believe, however, that such a change would not constitute a substantial modification.

(3) A modification of the agreement that results in only a \textit{de minimis} change to the quality, value, or timing of the restriction is not a substantial modification.

(4) An amendment, even though voluntary (that is, it is not required by the terms of the agreement), that brings the price more closely in line with the fair market value of the stock is not a substantial modification.

\section*{\textsection 9.43—Agreement entered into after October 8, 1990.}

An agreement that is entered into after October 8, 1990, or is substantially modified after that date, will have no depressing effect on the estate tax valuation of the affected stock unless the agreement meets all of the following requirements:\textsuperscript{10}

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer the stock to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms length transaction.

Both the legislative history behind this 1990 statutory change and the regulations emphasize that each of these three requirements is independent of the others.\textsuperscript{11} Thus, with respect to the first two requirements, the regulations state that a mere showing that a restriction is a bona fide business arrangement is not sufficient to establish the absence of a device to transfer property for less than full and adequate consideration.

\begin{itemize}
  \item [8.1] See Ltr. Rul. 9324018.
  \item [10] I.R.C. \textsection 2703.
\end{itemize}
PROCEEDURES IN SHIFTING SHAREHOLDER CONTROL § 9.43

This approach must be contrasted with pre-1990 case law, where a showing that a purchase price favorable to the survivors was motivated by the understandable desire to keep the ownership of a closely held corporation within a defined group supported both the presence of a business purpose and the absence of a device to substitute for a testamentary bequest.\(^\text{12}\) It may be difficult for the courts to separate these two requirements, despite this attempt by both the Congress and the IRS. The fact is that evidence negating the presence of a device is relevant to establishing a business purpose, and evidence establishing a business purpose is relevant to establishing the absence of a device. The courts may continue to be sympathetic to taxpayers on this point under the first two requirements of the 1990 statute.

The third requirement, which mandates a comparison to arms length transactions, will almost certainly lead to a stricter approach than was taken by the courts under pre-1990 law, at least where one or more close family members are the surviving shareholders.\(^\text{13}\) The regulations take the position that this requirement will be met if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business. A “fair bargain” is one that conforms with the general practice of unrelated parties under negotiated agreements in the same business.\(^\text{14}\) In the real world, a dominant shareholder will occasionally give a deliberate and substantial bargain price to unrelated key employees, but that is certainly not the general practice. Under current law, an acceptable formula for valuing the shares under a buy-sell agreement among persons who are the natural objects of each others’ bounty must be one that demonstrates an adequate degree of self-interest on the part of the decedent. An important exception to these restrictive rules is created by regulations. The regulations take the favorable position that each of the three statutory requirements is considered to be met if more than 50 percent in value of the stock that is subject to the agreement is owned by individuals who are not members of the transferor’s (i.e., decedent’s) family, provided that the stock owned by the unrelated individuals is subject to the restrictions to the same extent as the stock owned by the transferor. For the purpose of this favorable exception, the transferor’s family is very broadly defined. It includes (in addition to ancestors and descendants) siblings, nieces and nephews, and any other individual who is a natural object of the transferor’s bounty.\(^\text{15}\)

A buy-sell agreement, even among close family members, is still an important part of close corporation planning, in order to assure that ownership will continue with family members who are employed by the corporation, and in order to provide an assured market for the sale of the decedent’s shares. But the old days, when the agreement could also freeze the purchase price at the value at the time the agreement was signed, are over. The practitioner must now make a conscientious effort to devise a formula that is generally accepted in the particular industry.

\(^\text{12}\) See e.g., Angela Fiorito, N. 2, above.

\(^\text{13}\) Although the statute literally applies whether or not the parties to the agreement are related, the proposed regulations take the favorable position that each of the three statutory requirements is considered to be met if the agreement is exclusively among persons who are not the natural objects of each others’ bounty.


\(^\text{15}\) Treas. Reg. § 25.2703-1(b)(3).
§ 9.5—Shifting Control Through Purchase of Shares by an ESOP.

One intriguing method of shifting control involves the use of an employee stock ownership plan ("ESOP"). An ESOP is a qualified retirement plan which acquires stock in the employer corporation and allocates this stock to the accounts of its employee participants.¹

An ESOP may be adopted by a C corporation, and since the Small Job Protection Act of 1996, by an S corporation. However, there are some subtle differences between C corporation and S corporation ESOPs.

An ESOP will effect a purchase of stock by borrowing money, usually from a bank but sometimes from the employer corporation which itself borrows the money from a bank. The ESOP then services its debt with the annual qualified plan contributions paid by the employer corporation. As with any qualified retirement plan, there is a limit on the amount the employer corporation can contribute annually to an ESOP on a deductible basis, but the limitation is far less in the case of an ESOP than other plans.

Stock held by an ESOP is either allocated to specific employee participant accounts or held in suspense until so allocated. Special voting rules apply depending upon the status of such shares.

When a participant retires, or otherwise becomes entitled to a distribution from the ESOP, he or she may demand that he or she receive a distribution of the employer corporation’s stock, and he or she can require the corporation to redeem these shares at an independently appraised fair market value.

In the context of the closely held corporation, the adoption of an ESOP is typically motivated by a desire to have substantial shareholders bought out in a tax-advantaged way. In fact, to provide incentive for distributing stock ownership among employees, Congress has offered substantial benefits to the employer corporation and the selling shareholders, if they permit ESOPs to acquire stock.

An ESOP can also be used by a third party to assist its acquisition of the employer corporation, or it can be used by an employer corporation to raise additional capital. Still, however, its most common use will continue to be as a substitute for the redemption or typical cross-purchase of a substantial shareholder’s stock. The advantages and disadvantages of its use as a substitute are discussed below.

§ 9.51—The advantages of using an ESOP.

[1]—Use of pre-tax dollars to purchase stock. The purchase of stock is almost always a non-deductible and non-amortizable capital expenditure. Whether a

¹ An ESOP is subject generally to the requirements applicable to other qualified plans, as described in ch. 5, Methods of Compensating the Executive. However, there are some important technical distinctions between ESOPs and other qualified plans, which are beyond the scope of this treatise. For a more detailed discussion of the peculiar requirements pertaining to ESOPs, see Frutkin, Tax Planning for Executive Compensation, § 4.03[1][f].
corporation purchases stock in a redemption or a shareholder purchases stock in a cross-purchase, the purchaser typically pays for the stock with after-tax dollars. If the purchaser is an individual in a 39.6 percent tax bracket, he or she must earn $1.65 of taxable income to buy one dollar’s worth of stock. If the purchaser is a corporation in a 35 percent tax bracket, it must earn $1.54 of taxable income to redeem one dollar’s worth of stock.

In favorable contrast is a purchase of stock by an ESOP. Since an ESOP is funded by deductible qualified plan contributions, its purchase of stock is financed by pre-tax dollars. That is, the employer corporation must earn only $1.00 of taxable income to permit an ESOP to purchase one dollar’s worth of stock.\(^2\)

\[2\]—Availability of low interest loan to finance purchase of stock. Congress has provided several sweeteners to induce the transfer of stock ownership to ESOPs.\(^2.1\) One major inducement is the availability of low-interest financing. For certain institutions which lent money to finance an ESOP’s acquisition of stock before the enactment of the Small Business Job Protection Act of 1996, gross income does not include half of the interest received, provided that the ESOP owns more than one-half of the stock of the employer.\(^3\) This meant that a lender in a 35 percent tax bracket could offer a 20 percent discount off the fully taxable interest rate it would otherwise charge. For example, an 8 percent interest rate could be reduced to 6.4 percent. Obviously, this sort of bargain could make some unaffordable deals affordable.

Though this bargain is not available for ESOP loans made after the enactment of the Small Business Job Protection Act of 1996, it is still available for ESOP loans made before the enactment, and for post-enactment loans which refinance pre-enactment loans.\(^3.1\)

\[3\]—Sale or exchange treatment for seller without the complexity of Section 302. As explained earlier in this chapter, sometimes a corporation’s redemption of stock from a shareholder results in ordinary dividend treatment to the selling shareholder.\(^4\) To avoid this result, one of the tests in Section 302 of the Code must be satisfied, but Section 302, with its intricate attribution rules, is not always easy to apply, let alone satisfy. Selling to an ESOP circumvents this obstacle. Since the sale

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\(^2\) Of course, since the corporation may be obligated to repurchase the same shares at some future date, the current bargain may not be a bargain in the long run. See § 9.52[2] below.

\(^2.1\) However, ESOPs are not as sweet as they once were. Congress repealed such former tax benefits as the opportunity for the selling shareholder to reduce or eliminate his or her estate tax, the ability of an ESOP to pay for a decedent’s stock by assuming (and deferring) part or all of the decedent’s estate tax liability, the possible avoidance of Section 382 limitations on the deductibility of NOL carryovers, and the deductibility by the lender of half the interest income received by the lender from an ESOP. On the other hand, after the enactment of the Small Business Job Protection Act of 1996, ESOPs can now be shareholders of S corporations, and be allocated flow-through income exempt from the tax on unrelated business taxable income. I.R.C. § 512(c)(3).

\(^3\) I.R.C. § 133, repealed by the Small Business Job Protection Act of 1996, for ESOP loans made after the date of enactment.

\(^3.1\) Ltr. Ruls. 9712030, 9722023, 9803010.

\(^4\) See § 9.33.
to an ESOP is not a redemption, Section 302 is not relevant and the seller is entitled to sale or exchange treatment.  

[4]—Opportunity for seller to defer or eliminate income tax. A shareholder of a C corporation may sell shares to an ESOP and defer tax on the capital gain realized from the sale, so long as the ESOP owns at least 30 percent of the stock of the employer corporation immediately after the transaction (excluding for this purpose certain pure preferred stock), and the selling shareholder reinvests the proceeds in certain qualifying debt or equity securities during the 15-month period beginning three months before the transaction and ending 12 months after the transaction. In order for the shareholder to be eligible for this special treatment, he or she must have owned the shares for a period of three years prior to selling the shares to the ESOP. If the shareholder qualifies for the deferral, only when the replacement securities are later sold will the capital gain be taxable. If the replacement securities are held until death, the capital gain will never be recognized. It is this opportunity to defer and even eliminate the income tax which is usually most compelling to selling shareholders. The ability to defer gain is not available to shareholders of an S corporation.

The selling shareholder will usually wish to invest in a diversified portfolio of publicly-traded securities. But the shareholder could simply form a new corporation to operate a new business and use his sale proceeds to capitalize the new corporation in exchange for stock. The stock is “qualified replacement property” under Section 1042.

[5]—Deductibility of dividends paid to an ESOP. Dividends paid to a C corporation ESOP on stock owned by the ESOP are deductible to the payor corporation if the dividends are either used to pay principal or interest on an ESOP loan or are passed through to the participants. In the view of the IRS, the dividends paid must

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5 The IRS might argue that the sale to an ESOP should be treated as a corporate distribution if the selling shareholder and his or her relatives have more than a 20 percent beneficial interest in the ESOP. See Rev. Proc. 77-30, 1977-2 C.B. 539.

6 I.R.C. § 1042. The benefits of Section 1042 are available only if the selling shareholder properly makes an election and files certain statements under Section 1042. Failure to file the election, despite an obvious intent to do so, may be fatal. Ltr. Rul. 9733001. Substantial compliance, however, may be enough. Ltr. Ruls. 9735046, 9821022, 9927003. The tax practitioner must be alert to one additional technical caveat: Non-recognition treatment is not available if any stock acquired by the ESOP from the seller is allocated to (1) the seller, (2) any person who is related to the seller in one of the ways described in I.R.C. § 267(b), or (3) any other person who owns (after application of the attribution rules of I.R.C. § 318(a)) more than 25 percent of any class of outstanding stock of the employer corporation or any class of stock of certain related corporations.

6.1 The transfer of replacement property to a charitable remainder trust does not trigger gain recognition. Ltr. Rul. 9715040.

6.2 I.R.C. § 1042(c)(1)(A). Fortunately, a shareholder can sell to a C corporation ESOP and make the tax-deferred reinvestment, and then the corporation can convert to an S corporation.

6.3 Ltr. Ruls. 9720026, 9801053, 9801054, 9801055.

7 I.R.C. § 404(k). However, dividends are not deductible for alternative minimum tax purposes. Treas. Reg. § 1.56(g)-1(d)(3)(iii)(E), which was approved by the Tax Court in Snap-Drape, Inc. v. Commissioner, 105 T.C. 16 (1995), aff’d, 98 F.3d 194 (5th Cir. 1996) and Schuler Industries, Inc. v. United States, 109 F.3d 753 (Fed Cir. 1997).
be reasonable in amount in order to be deductible. For this purpose a “reasonable”
dividend is one at a rate that is normally paid in the ordinary course of business and
that can reasonably be expected to be paid on a recurring or continuing basis.\footnote{Tech. Adv. Memo. 9304003 (Sept. 30, 1992).}

[6]—Accumulation of earnings in an S corporation ESOP. Normally an
S corporation distributes at least enough cash to its shareholders to permit them to
pay their income taxes on the flow-through liability. If an S corporation is 100-percent
owned by an ESOP, then there will be no flow-through tax liability, so the S corporation
may retain that cash.

\section{9.52—Disadvantages of using an ESOP.}

[1]—Distribution of shareholder rights to employees. Often when
controlling shareholders of a closely held corporation choose not to implement an
ESOP, the compelling reason is their concern that employees will acquire certain
shareholder rights. This concern is not unfounded. Although ESOP participants cannot
direct how the shares allocated to their accounts are voted in an election of directors,
they can direct the voting of their shares with respect to approval or disapproval of
any corporate merger or consolidation, recapitalization, reclassification, liquidation,
dissolution, or sale of substantially all assets of a trade or business.\footnote{I.R.C. § 409(e)(3).}

Potentially more worrisome than whatever voting power the employees may wield
is the possibility that participants may have a right to demand certain information about
the corporation, such as its financial statements. Whether the participants have the
right to demand information directly from the corporation or the right only to demand
that the ESOP fiduciary demand such information on their behalf is not yet settled.
But no matter how the demand rises, controlling shareholders are understandably wary
of revealing to employees the full extent of corporate profits or executive compensation.

[2]—Obligation to repurchase stock. An employee participant who becomes
entitled to receive a distribution from a C corporation ESOP may demand that his
or her benefit be distributed in the form of the employer corporation’s stock. (An S
corporation ESOP may require participants to accept cash rather than stock, to ensure
that the 75-shareholder cap for S corporations not be exceeded.)\footnote{I.R.C. § 409(h). The put option must be exercisable
for at least 60 days after the distribution is made, and if not exercised during this initial period, then it must be exercisable for at least one more 60-day period during the next plan year. I.R.C. § 409(h)(4). Payment of the put option price must be made over not more than five years and must be adequately secured. I.R.C. § 409(h)(5).}

The participant also has a put option to require the corporation to repurchase his or her stock at an
independently appraised fair market value.\footnote{I.R.C. § 409(h)(2).}\footnote{The put option cannot bind the ESOP to repurchase the shares, but the ESOP may be permitted to purchase the stock tendered to the corporation. Treas. Reg. § 54.4975-7(b)(10). If the ESOP repurchases the stock, the acquisition would again be tax-advantaged, but someday in the future another distributee will have a put option with respect to the same shares.} This means, in effect, that the corporation
which finances an ESOP’s initial acquisition of stock on a tax-advantaged basis, may
later have to repurchase the same shares without tax advantage.\footnote{I.R.C. § 409(h).}

Thus, in the long
run, a corporation may end up effectively purchasing the same shares two or more times. Depending upon the actuarial statistics of the employee population, this future obligation may or may not be burdensome. If all of the participants are 25 years old at the time of the acquisition, the future obligation would probably be distant enough and spread out enough to attenuate the pain caused by the repurchase liability. On the other hand, if all the participants are 55 years old, the future obligation could be disastrously close to being a current obligation.

[3]—Complexity and cost of implementation and maintenance. Since an ESOP is a qualified plan, the hypertechnical requirements applicable generally to qualified plans apply also to ESOPs. A written plan and trust must be drafted. A favorable IRS determination letter should be obtained. Employees and the Department of Labor should be properly notified. It is an expensive process. And the cost does not end upon implementation. Annual reports are required and independent appraisals of the corporation’s stock will probably be required yearly. For many closely held corporations, these costs will in fact be prohibitive. And for many of the rest, the prospect of these costs will be more than slightly discouraging.

[4]—Balance sheet liability. Usually an ESOP loan is either guaranteed by the employer corporation or covered by the employer corporation’s commitment to make qualified plan contributions sufficient to service the ESOP’s debt. From an accounting standpoint, the corporation’s obligation may have to be reported as a liability on its balance sheet, without an offsetting asset or reduction in outstanding shares. Consequently, an ESOP’s acquisition of stock may lower the book value per share of the employer corporation’s stock. Since book value per share is such a common yardstick, whether for purposes of a shareholder redemption agreement, a loan covenant agreement, a collateral security agreement, or some other contractual arrangement, this diminution in book value can have complex and distressing implications.