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CASES NOTED

TAX COURT ABROGATES CONTROVERSIAL ATTRIBUTION RULING

Decedent's estate was comprised primarily of stock in two family-owned corporations. Decedent and his wife owned, as community property,¹ one-third of the stock of each corporation. The remaining two-thirds of the stock was owned by their two sons in equal shares. At decedent's death, pursuant to stock purchase agreements, each corporation redeemed² its respective shares from the estate and the widow, who was the sole beneficiary.³ The estate and the widow treated the redemptions as distributions in exchange for stock under section 302(a) of the Internal Revenue Code of 1954,⁴ which resulted in the proceeds being treated as capital gains and not as ordinary dividends. They asserted that the redemptions completely terminated their interests in the corporations as required by section 302(b)(3).⁵ In order to prevent application of the stock attribution rules of section 318(a)(1), which apply to section 302(b)(3) distributions,⁶ the executor of the estate and the widow filed the appropriate waiver agreements as provided in section 302(c)(2)(A)(iii).⁷ The Commissioner conceded that

1. The parties were residents of the state of California. Rev. Rul. 71-138, 1971-1 CUM. BULL. 109 requires both a husband and wife to file a section 302(c)(2)(A)(iii) agreement in cases where community property is being redeemed.

2. Section 317(b) of the Internal Revenue Code defines "redemption" as a corporate acquisition of its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired or held as treasury stock. See also Estate of Mathis, 47 T.C. 248 (1966), *acquiesced in* 1967-2 CUM. BULL. 3.

3. As to the definition of a beneficiary of an estate, see Treas. Reg. § 1.318-3(a) (1960).

4. All statutory references are to the Internal Revenue Code of 1954, as amended [hereinafter cited by section only].

5. Other subparagraphs of section 302 can also qualify a redemption as a sale or exchange. Section 302(b)(1) affords such treatment if the transaction is not essentially equivalent to a taxable dividend and section 302(b)(2) is applied where the redemption is substantially disproportionate with respect to the shareholder. These subparagraphs are seldom used in light of the Supreme Court's decision in *United States v. Davis*, 397 U.S. 301 (1970), which held that neither the absence of a tax avoidance motive nor the existence of a bona fide business purpose would avoid ordinary dividend treatment of the redemption proceeds when such a redemption does not change the relative rights or economic interests of the shareholders. For considerations of "termination of interest" in general, see *Bryant v. Comm'r.*, 399 F.2d 800 (5th Cir. 1968); *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Gordon Erickson*, 56 T.C. 1112 (1971).

6. The attribution rules under section 302 serve to attribute stock to distributee, not away from him to other shareholders. *Friend v. United States*, 345 F.2d 761 (1st Cir. 1965).

7. The constructive ownership rules of section 318(a) apply to any stock redemption done under section 302(b). However, a special exception under section 302(c)(2) provides that section 318(a) will not apply in section 302(b)(3) cases if three conditions of section 302(c)(2) are satisfied:

- (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,
- (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and
- (iii) the distributee, at such time and in such manner as the Secretary or his delegate by

the widow's redemption qualified under section 302(b)(3), but claimed the estate would not be considered a distributee eligible to file the necessary agreement. It was the Services' contention that only individuals, not estates or trusts, could file waiver agreements.⁸ Accordingly, as a result of the attribution rules of section 318(a)(1) being applied to the redemption of the estate's stock, no termination of interest occurred and the estate was deemed to own 100% of the stock of both corporations, constructively and actually, both before and after the redemptions.⁹ The Commissioner concluded that the entire distribution was to be treated as a taxable dividend, not as a sale or exchange of stock. Contrary to the Commissioner's position, the United States Tax Court, on petition by the widow and the estate, *held*: An estate can be considered a distributee under section 302(b)(3), thereby making it eligible to waive the attribution rules of section 318(a)(1) upon filing of section 302(c)(2) agreements. *Lillian M. Crawford*, 59 T.C. 830 (1973).

The crux of the case dealt with the "distributee" issue and was the first court test of the Commissioner's position on this matter.¹⁰ Section 302(c)(2) refers to a "distributee" as the person who is eligible to file a waiver agreement as provided in that code section. In *Crawford*, the Commissioner, basing his position on Revenue Ruling 59-233,¹¹ asserted that the estate was not within the purview of this definition, and therefore could not file an effective agreement. The factual situation of Revenue Ruling 59-233 involved the redemption of corporate stock from a testamentary trust created by a deceased mother for her children. The balance of the corporation's stock was owned by the father. The Commissioner concluded that the trust was deemed to own constructively all of the stock of the corporation,¹² despite the timely filing of a section 302(c)(2) waiver agreement.¹³ The ruling limited the appli-

regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

8. Rev. Rul. 59-233, 1959-2 CUM. BULL. 106. *Accord*, Rev. Rul. 72-472, 1972-2 CUM. BULL. 202, which holds that a trust cannot utilize the waiver provisions of section 302(c)(2). *See also* Rev. Rul. 72-471, 1972-2 CUM. BULL. 201 (regarding grantor trusts).

9. If the section 302(c)(2) agreements were ineffective, section 318(a)(1) would attribute the sons' shares of both corporations to their widowed mother and section 318(a)(3)(A) would reattribute all the shares to the estate since she was the sole beneficiary. *See also* Stanley F. Grabowski Trust, 58 T.C. 650 (1972); *Webber v. United States*, 263 F. Supp. 703 (E.D. Ky. 1967), *aff'd*, 404 F.2d 411 (6th Cir. 1968); Rev. Rul. 67-24, 1967-1 CUM. BULL. 75; Rev. Rul. 71-211, 1971-1 CUM. BULL. 112; Rev. Rul. 71-262, 1971-1 CUM. BULL. 110.

10. One author has questioned the Commissioner's wisdom in selecting *Crawford* as a test case for the distributee issue. *See* Covey, *Estate, Gift and Income Taxation—1973 Developments*, U. MIAMI 8TH INST. ON EST. PLAN. ch. 74-1 (1974).

11. 1959-2 CUM. BULL. 106.

12. *See* section 318(a)(3)(B)(i).

13. There are a number of cases regarding a late filing of the agreement and the provision relating to the statute of limitations. These problems are not considered in conjunction with the case at hand since both parties' agreements were timely filed. However, for contrasting decisions in this area, *see* Robin Haft Trust, 61 T.C. 398 (1973) (where each redeemed shareholder was a

cation of agreements to those circumstances where a shareholder as an individual was involved. If an entity, such as a trust or an estate, was the distributee, its filing of a section 302(c)(2) agreement was deemed ineffective in waiving the family attribution rules.¹⁴

The effects of this ruling create potential problem situations where a buy-sell agreement is involved in a corporate redemption. Under entity buy-sell agreements, the corporation usually purchases the stock held by the estate of the deceased shareholder. In closely held corporations where the surviving shareholders are family members, the transaction entails the risk of triggering the attribution rules, thereby preventing a redemption of the estate's stock from qualifying under section 302(b)(3).¹⁵ The promulgation of Rev. Rul. 59-233 consequently made this area of estate planning very difficult since it was impossible to predict a shareholder's status regarding family attribution at the time of his death.

In this ruling and in *Crawford*, the Commissioner reviewed the legislative history of section 302(c)(2)¹⁶ and claimed that a strict literal interpretation should be applied to the semantic terminology "distributee." The Tax Court summarized this contention with the following discussion:

[The Commissioner] contends that "distributee" refers to the family members described in section 318(a)(1) and that the waiver is applicable only to the redemption of the stock of a family member and not to the redemption of the stock held by an entity like an estate. Happily, respondent has not tried to persuade us that the exclusive reference of "distributee" to family members is contained in either the language or the syntax of the statute because we are fairly confident that no such reference could be found therein. Respondent does contend that his position is "clear" from the legislative history of section 302(c)(2).¹⁷

The court rejected this approach as it was clearly in contravention of the intent of Congress. The court refused to "slavishly apply the literal language of a statute"¹⁸ even though the Commissioner urged the tribunal to "eschew literality in determining which 'distributees' may avail themselves of Section 302(c)(2) . . ."¹⁹ The Commissioner further

family trust); *Fehrs Fin. Co.*, 58 T.C. 174 (1972), *aff'd* 487 F.2d 184 (8th Cir. 1973); *Georgie S. Cary*, 41 T.C. 214 (1963), *nonacquiesced in* 1964-2 CUM. BULL. 8; *Archbold v. United States*, 201 F. Supp. 329 (D.N.J. 1962), *aff'd per curiam*, 311 F.2d 228 (3d Cir. 1963); *Van Keppel v. United States*, 206 F. Supp. 42 (D. Kan. 1962), *aff'd* 321 F.2d 717 (10th Cir. 1963).

14. Rev. Rul. 59-233, 1959-2 CUM. BULL. 106 applies to estates, trusts, corporations or partnerships which are shareholders in the distributing company.

15. See Rev. Rul. 69-562, 1969-2 CUM. BULL. 7.

16. See S. REP. NO. 1622, 83d Cong., 2d Sess. 44 (1954); H.R. REP. NO. 1337, 83d Cong., 2d Sess. 35 (1954).

17. 59 T.C. at 835.

18. *Id.* at 836. See *International Trading Co.*, 57 T.C. 455, 461 (1971).

19. 59 T.C. at 836.

claimed that permitting an estate to avail itself of this waiver of attribution provision would lead to abuses.²⁰ Although acknowledging the potential for abuse, the Court reasoned that:

Our decision here rests solely upon the effectiveness of the waiver agreement filed by petitioner . . . [W]e are concerned that the positions taken by respondent will prevent a family member who receives his interest in a corporation through inheritance from terminating this interest in a redemption qualifying under § 302(b)(3) unless the stock is first distributed to him by the estate. Even if it were possible for estates to distribute the stock in all instances prior to the redemption, respondent's positions merely put a premium on tax planning and set a trap for the unwary.²¹

The Tax Court buttressed its opinion by noting that the actual wording of section 302(c)(2) uses the neutral term "distributee" instead of personal pronouns. It therefore concluded that Congress did not intend exclusive application of the term "distributee" to persons, thereby allowing entities such as estates or trusts to be included in this definition.

An interesting aspect of the opinion concerns its failure to discuss the consequences of situations other than simultaneous redemptions by an estate and a beneficiary. This omission from the court's discussion creates a potential for abuse which the Commissioner fully recognized. In the case, the Commissioner argued that permitting an estate to avail itself of the waiver provision would lead to abuse, as the agreement filed by the estate would not prevent the beneficiaries from subsequently acquiring an interest in the corporation within the forbidden ten year period.²² A reacquisition by a beneficiary in such a situation would not affect an estate's redemption under section 302(b)(3) and yet would still permit ownership of a prohibited stock interest in the corporation by blocking the chain of attribution.²³ Imposition of transferee liability on the beneficiary is unsuccessful because in order to impose such liability, the distributee, the estate, must first be in violation of the code limitations, which, as a result of *Crawford*, it is not. The court apparently thought that this collateral result of its ruling was not an overriding consideration and bluntly stated that "[w]hile such a potential for abuse does exist, the particular remedy proposed by respondent [disqualification of the estate's waiver agreement] will itself lead to a nonsensical result in this and other cases."²⁴

20. *Id.*

21. *Id.* at 837.

22. See section 302(c)(2)(A)(ii).

23. For an analysis of examples before and after *Crawford*, see Hull, *Review of the Recent Tax Court Decision in Crawford v. Commissioner*, 37 CONN. CPA 22 (Sept. 1973).

24. 59 T.C. at 836.

This reasoning is indicative of the court's efforts in this case to avoid the creation of any additional tax traps. However, one point is not clearly resolved. The opinion accepts the petitioner's contention that an estate can utilize section 302(c)(2) agreements in cases where the beneficiaries have also executed and filed the waiver agreement in a simultaneous redemption, but does not consider a situation where only the stock of the estate is to be redeemed. It should be noted that *Crawford* deals with an estate and a sole beneficiary simultaneously executing the section 302(c)(2) agreements.²⁵ The decision did not state whether the filing of the waiver by an estate alone would block family attribution to the entity. Although the answer is not evident from the opinion, a careful reading infers that the court will treat estate or trust entities as separate parties when determining whether a complete termination of interest has occurred by the filing of a section 302(c)(2) agreement by the particular entity.

It is obvious that *Crawford* will have a highly significant effect in the field of estate planning for three important reasons: (1) an estate or trust, through its fiduciary, can now execute section 302(c)(2) waiver agreements and avert the family attribution rules; (2) stock owned by an estate or trust in a family corporation may be redeemed without the redemption being treated as a dividend; and (3) once an entity has executed the waiver agreement, a beneficiary may reacquire stock in the corporation within the forbidden ten year period without any consequence to the estate.²⁶ These factors must be viewed as broad rejections by the Tax Court of the potential problems once posed by Rev. Rul. 59-233.

The holding of the instant case leaves no doubts that the Commissioner's prior position was without merit. Although it is unfortunate that almost fifteen years elapsed before the matter was subjected to judicial review, it is evident as a result of the *Crawford* decision that section 302(c)(2) agreements filed by entities will now be afforded the same effectiveness as those executed by individuals in their application to section 302(b)(3) redemptions.

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25. See Rev. Rul. 68-388, 1968-2 CUM. BULL. 122, where an estate failed to block the attribution rules by conducting a simultaneous redemption and sale of the corporate stock with the sole beneficiary. The situation involved the distribution of stock to the beneficiary who then redeemed his shares for cash. The beneficiary subsequently repurchased the stock from the corporation. The repurchase was disallowed as an unpermissible disguised redemption from the estate.

26. This was also previously possible under certain circumstances. See, e.g., Rev. Rul. 71-562, 1971-2 CUM. BULL. 173 (holding that an acquisition by a son of the distributee within the ten year period does not violate section 302(c)(2)(A)(ii)); Rev. Rul. 72-380, 1972-2 CUM. BULL. 201 (permitting distributees, as executors, to vote stock of an estate without triggering the attribution rules). For a general discussion regarding estate planning in this area, see Rabin, *Section 302 and 303 Redemptions and Disasters*, U. MIAMI 2ND INST. ON EST. PLAN. ch. 68-16, ¶ 68.1600 (1968).