Purchase by Redemption – A Proposed Solution for the Taxation of the Remaining Shareholder

Herbert Odell

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PURCHASE BY REDEMPTION—A PROPOSED SOLUTION FOR THE TAXATION OF THE REMAINING SHAREHOLDER

HERBERT ODELL*

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I. INTRODUCTION

Many frustrations result as a consequence of a legal system which is composed of many adjudicatory tribunals that consistently reach diverse conclusions about similar problems. If these problems are not of sufficient importance in the total complex of societal transactions to warrant a single authoritative determination by either the Supreme Court or the Congress, then the necessity that the inferior tribunals find some common rationale becomes magnified. And in addition, if the area in which the problem is found is one in which planning of future activity at the primary stage may depend on the conclusions reached by a court in reference to the legal effect of the transaction, the problem becomes acute. This appears to be the present situation in those cases in which a buyer or group of buyers uses a close corporation to pay the purchase price of the corporate business entity.

Anomaly Incorporated is owned by Harold Grab and Sidney Gimme. Each owns fifty of the one hundred shares of outstanding capital.

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stock of the corporation. The corporation produces abusives. That it has been quite successful in this endeavor is indicated by the following financial statements:

**BALANCE SHEET**
As of December 31, 1963

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>OWNERS' EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 50,000</td>
<td>Capital Stock $1,000</td>
</tr>
<tr>
<td>Machinery 50,000</td>
<td>Earned Surplus 99,000</td>
</tr>
<tr>
<td><strong>Total Assets $100,000</strong></td>
<td><strong>Total Owners' Equity $100,000</strong></td>
</tr>
</tbody>
</table>

**ANNUAL PROFITS AND LOSSES FROM THE DATE OF INCORPORATION**

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1959</td>
<td>$9,000</td>
</tr>
<tr>
<td>1960</td>
<td>22,500</td>
</tr>
<tr>
<td>1961</td>
<td>22,500</td>
</tr>
<tr>
<td>1962</td>
<td>22,500</td>
</tr>
<tr>
<td>1963</td>
<td>22,500</td>
</tr>
</tbody>
</table>

After five years of being together Grab and Gimmee are having difficulties. They cannot decide whether to sell the business to Samson Friendly or whether one of them should sell his interest to the other. The difficulty with either solution is that Friendly, Grab and Gimmee have no personal funds with which to make the purchase. Therefore, they are considering the possibility of having the corporation buy them out through a stock redemption. They are aware of the favorable tax consequences that will devolve upon the party whose shares are redeemed if he terminates his entire interest in the corporation. However, they are not quite certain what tax effect the transaction will have on the remaining or purchasing shareholder. An effort will be made in this paper to set forth rational lines of demarcation as to the federal tax consequences to the remaining shareholder or shareholders in transactions of this nature.

A. The Alternatives

There are several basic approaches to the solution of the Grab-Gimmee problem. The book value of the stock is 1,000 dollars per

---

1. Generally, the corporate codes permit a corporation to redeem its own shares out of "surplus." Although difficulties arise as to what constitutes "surplus," in the situation presented there is sufficient earned surplus from which the redemption can be made. It is generally recognized that earned surplus is one of the components of "surplus." E.g., ABA-ALI Model Bus. Corp. Act § 5 (1961).

2. Int. Rev. Code of 1954, § 302(b)(3) [hereinafter all references to sections shall be to sections in the Internal Revenue Code of 1954, unless otherwise indicated]. Assuming, of course, that the stock was a capital asset in the hands of the shareholder.

3. The shareholder who owns stock in the corporation after the completion of the purchase will be denominated as the purchasing (buying) or remaining shareholder throughout this paper.

4. There are various methods in which the transaction may be effected. See, e.g., First, Use of Corporate Funds to Buy Out Shareholders—Acquisitions by Third Parties, N.Y.U.
share. The approximate average earnings of the corporation is 20,000 dollars per year. Capitalized at a conservative rate of twenty per cent, the business is worth 100,000 dollars.\(^5\) It is unlikely that there is a substantial market for the stock, so that fair market value would be difficult, if not impossible, to ascertain on the basis of a going price for the corporate shares. It would appear reasonable to conclude that fifty shares of stock are worth 50,000 dollars.

Assuming that Grab decided to buy out Gimmee he could accomplish this in several ways, depending, of course, upon Gimmee's acquiescence in the plan.

(1) The simplest approach would appear to be to have the corporation redeem Gimmee's stock for 50,000 dollars. Gimmee would have his interest in the corporation completely terminated by the redemption and would therefore recognize capital gain on the transaction.\(^6\)

(2) The corporation could redeem the stock owned by Gimmee for a total price of 50,000 dollars, but instead of paying cash it could give its own notes, payable annually from 1964; the face amount of each note would be 10,000 dollars with interest at five per cent. Assuming that the fair market value of the notes was 50,000 dollars, Gimmee would realize capital gain to the extent of the difference between his basis in the stock and the purchase price.\(^7\)

If Grab and Gimmee decided to sell the business to Friendly they could accomplish this by:

(3) selling Friendly five shares of stock for 5,000 dollars and then having the corporation redeem the remainder of their stock for 95,000 dollars. Because the corporation has only 50,000 dollars in cash, it would have to borrow the additional 45,000 dollars from either the vendors or an independent source. It could pay Grab and Gimmee 50,000 dollars and give them notes for the remaining 45,000 dollar balance payable annually; each note would have a face value of 9,000 dollars and would bear a five per cent interest rate. The first payment would be due in December 1964.

(4) The corporation could borrow 45,000 dollars from a bank with repayment to be made annually at the rate of 9,000 dollars a year; the notes would bear a five per cent interest rate with the first payment due in December 1964.

---

\(^5\) 12TH INST. ON FED. TAX 191 (1954); Redlich, *The Sale of a Closely-Held Corporate Business*, 9 TAX L. REV. 354 (1954); Note, 67 YALE L.J. 112 (1957). However, the methods discussed in this section are limited to those which will help illustrate the basic thesis presented in this article.


\(^7\) See note 2 *supra*.  

Ibid. See generally 4 CCH 1963 STAND. FED. TAX REP. ¶ 4400.
In examples three and four the vendors would obtain capital gain treatment on the difference between the basis of their shares and the total purchase price received.\(^8\)

Assuming that the sales and redemptions in all four cases were completed in December 1963, the vendors would realize capital gain for that taxable year. The differences in the transactions would not alter their federal tax consequences. The problem that remains is whether the transactions should give rise to any taxable income to the remaining or purchasing shareholders in any of the four cases. And if so, which ones, to what extent and why?

II. THE EXISTING STATE OF THE LAW

This section of the article will be devoted to a consideration of what the law appears to be at present with reference to the tax liability of the remaining or purchasing shareholders. This is intended to afford a backdrop to a later discussion of what the law ought to be.

A. The "Obligation" Criterion

The most completely developed area relating to the tax liability of the remaining or purchasing shareholders can be found in those situations in which the purchaser or remaining shareholder has obligated himself in his personal capacity for the price of the shares being sold. Once he has taken this step he seems to be headed down a path of doom. If the shareholder has the corporation redeem stock from him so that he can use the funds to pay the obligation he has incurred for the price of the shares, the distribution he receives will be considered "essentially equivalent to a dividend."\(^9\) Prior to the passage of the Internal Revenue Code of 1954, this transaction presented no complications with reference to the statutory language, because the Internal Revenue Code of 1939 merely provided that distributions in redemption of stock, if essentially equivalent to a dividend, were to be taxed as a dividend.\(^10\) However, the 1954 Code has raised some new problems in that the statute provides that if its specific requirements are met\(^11\) the distribution in redemption is to be treated as one "in exchange" for the stock.\(^12\) Thus, the distribution could lose its dividend equivalence even though in payment of an obligation of the shareholder.\(^13\)

---

8. In example (3) the sale of the stock to Friendly would give rise to capital gains and the redemption would also produce capital gains. The same would be true for example (4). See §§ 1222, 302(b)(3).
9. Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Thomas J. French, 26 T.C. 263 (1956); George M. Hancock, 18 T.C. 210 (1952).
10. INT. REV. CODE OF 1939, § 115(g), ch. 2, 53 Stat. 48 (1939) [hereinafter all references to § 115(g) are to the INTERNAL REVENUE CODE OF 1939].
11. E.g., § 302(b)(3).
12. Section 302(a).
13. See II(A)(2) of this article's text infra.
Dividend consequences may devolve upon the shareholder-purchaser if he: (1) borrows money from the corporation to pay the purchase price of the stock he has acquired and then has some of his stock redeemed in return for a cancellation of his indebtedness; or (2) if he assigns his rights under the contract of purchase to the corporation and thereby has the corporation redeem the seller's stock directly. It would seem, at first blush, that the considerations which would predicate dividend equivalence should be different depending on which of the methods was adopted. Thus, if there was a redemption of stock and a cancellation of indebtedness, the determination would revolve around the criteria which have developed in determining whether a redemption is essentially equivalent to a dividend. If the shareholder assigned his rights in the contract of sale and had the corporation assume the obligation to pay for the purchased shares, factors other than those pertinent to redemptions should, at least, be considered in the first instance. When a shareholder assigns to a corporation his right to an asset and the corporation assumes the debt on the asset, the payments do not necessarily constitute dividend income to the shareholder. Admittedly, there is an easy distinction between the situation in which a shareholder assigns his right in an asset to the corporation and the assignment of the right to acquire the stock of the assignee-corporation. Further, the court may be looking through the transaction in which the shareholder assigns his right to purchase the corporate stock, so that what it would see after the bubble has burst is nothing more than a redemption by the corporation from the purchasing shareholder. This situation would make the same criteria relevant, whether the transaction was a cancellation of indebtedness with a redemption, or an assignment of a contract right to purchase the corporate stock with an assumption of the liability which arose under the contract. However, even though there is a plausible theory which supports a finding of dividend income in both situations, the courts have failed to consider the problem, or if they have, it has been done sub rosa.

16. If the transaction was under the Internal Revenue Code of 1939, the applicable section would be 115(g), whereas under the Internal Revenue Code of 1954, § 302 would control. If the transaction fell within § 302(b)(1), then the criteria for determining dividend equivalence would be similar to those applied under § 115(g). Thomas G. Lewis, 35 T.C. 71 (1960). For a discussion of these criteria see Nolan, The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal, 65 Harv. L. Rev. 255 (1951).
17. Stout v. Commissioner, 273 F.2d 345 (4th Cir. 1959). In this case there was an assignment of stock in a corporation wholly owned by the shareholders of the assignee-corporation. The stock was not fully paid at the time of the assignment. Payment by the assignee did not constitute a distribution to the assignor-shareholders. See also Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961) (one of the alternative arguments considered by the court).
18. The treasury stock of a close corporation should not be considered an asset. But see Schalk Chem. Co., 32 T.C. 879 (1959). When a corporation makes payments on an obligation incurred to purchase a piece of equipment it is building an equity in that equipment; when it makes payments on treasury stock it is building nothing of value to itself.
Although the broad proposition, that there are dividend consequences to remaining shareholders when the corporation satisfies their obligations on the purchase price of the corporate stock, is simple to state, an understanding of its application by the courts is somewhat more difficult. Sometimes the courts seem preoccupied with the substance of the transaction—Was the net effect a redemption of the corporate stock? At other times there is a preoccupation with the formalities—Did the purchaser obligate himself to purchase the stock? The answer may depend on the question; and there seems to be no consistency as to which question will be asked.19

1. THE DEFENSES

The remaining shareholder has attempted to establish various counter-arguments to a finding of dividend income in those transactions in which he was foolish enough, or at times compelled by circumstances, to obligate himself to pay the purchase price of the selling shareholder's stock.

a. The Conduit Theory

If the remaining shareholder can establish to the satisfaction of the finder of fact that in obligating himself to purchase the selling shareholder's stock he was acting only as an agent for the corporation, and that in reality it was the corporation that was redeeming the stock from the seller, he will not incur dividend income when the corporation subsequently pays his obligation by redemption of the stock.20 This transaction presents itself in two basic forms. Suppose that Grab and Gimmee decide that the corporation should buy Gimmee's shares. Gimmee wants the cash immediately, but the corporation does not have sufficient surplus to buy its own stock.21 Grab may either obligate himself for the purchase price and pay a part in cash, giving notes for the remainder, or he may borrow the necessary funds or use his own resources to make an immediate cash payment. Subsequently the corporation earns a sufficient surplus from which it can redeem the Gimmee-stock, now owned by Grab. In the first case Grab will assign his rights under the contract of purchase and the corporation will assume his obligation on the notes. In the second case the corporation will redeem the purchased shares from Grab and Grab will use the funds to replenish his own resources or


[A] closer scrutiny of the case will show nothing more than an awkward attempt between two honest but uninformed men, acting under poor advice, to sever the joint ownership of property which their toil had built up, in a way to leave each in possession and ownership of his own part. A superficial view of the case shows only the method used by them; a deeper view discloses the true intent and purpose to do that which no statute ever intended or attempted to tax. Ruphane B. Iverson, supra at 870.


21. See note 1 supra.
to pay the debt he incurred when he made the purchase. In either case if the court finds as a fact that he was acting only as an agent for the corporation when he made the purchase, he will be considered as having received no income when the redemption takes place.  

Many taxpayers have attempted to make use of this theory as an afterthought. Generally, their efforts have been of no avail. In order to establish that the remaining shareholder was acting only as an agent for the corporation he should, at least, be able to prove that: (1) prior to the transaction there was formal authorization by the corporation for the shareholder to act in its behalf; (2) if there was no prior authorization there was at least a subsequent ratification by the corporation of the purchase of the shares in its behalf; (3) if he used some of his own funds in payment of part of the purchase price there is a corporate liability to him for this amount; (4) the corporation was a party to the contract of sale; and (5) the corporate minutes reflect that the purchase was made on behalf of the corporation. At best this is a dangerous defense to rely upon and because it appears relatively easy to avoid the consequences of obligating oneself to purchase the selling shareholder's stock, it is not a sound planning device.

The taxpayer has proved successful in a recent decision in the Tax Court in which the government sought to use the conduit theory as a sword. In *Milton F. Priester*, the taxpayer was one of two shareholders of a corporation. He entered into a contract with the other shareholder to purchase her entire interest. The total purchase price was 100,000 dollars. He could not meet the obligation on the contract when it came due. In order to avoid a breach, he contacted a third party who was willing to buy the stock if he could be assured that it would be redeemed at 113,000 dollars in not less than six months. The seller agreed to allow the third party to take over the taxpayer's obligation and the third party then purchased the shares for 100,000 dollars. As part of the transaction the taxpayer agreed that the corporation would redeem within the stipulated period. The taxpayer pledged his own shares as security for the guaranty of redemption. When the corporation redeemed the stock the government contended that this was a constructive dividend to the taxpayers argued that they were acting in behalf of the corporation notwithstanding the fact that pursuant to a trust agreement they could not act for the corporation.


23. Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); E. H. Stolz, 30 T.C. 530 (1958); Thomas J. French, 26 T.C. 263 (1956).

24. Mendle Silverman, 13 CCH Tax Ct. Mem. 527 (1954) (the distribution was found to be essentially equivalent to a dividend). See also Schalk Chem. Co., 32 T.C. 879 (1959). The taxpayers argued that they were acting in behalf of the corporation notwithstanding the fact that pursuant to a trust agreement they could not act for the corporation.

25. See George M. Hancock, 18 T.C. 210 (1952).


The Tax Court, however, held that there were no dividend consequences to the taxpayer. They rationalized this conclusion on the ground that the third party was not an agent of the taxpayer. The distribution did not relieve the taxpayer of his obligation on the prior contract of sale, because the seller had relieved him of this obligation when the third party agreed to make the purchase. This reasoning seems to overlook the fact that the third party only agreed to purchase on the condition that the corporation would redeem within a certain period of time. The ratio decidendi of the dissent is more in accord with the realities of the transaction:

[Taxpayer] certainly received financial and economic benefits measured by the corporate funds used to relieve him of his obligation to [the vendor] . . . despite the interposition of . . . [the third party]. The net effect was a taxable dividend to . . . [the taxpayer].

Thus, although the conduit theory may not be a very effective shield for the taxpayer, particularly when it is nothing more than an afterthought, it does not appear to be much of a sword for the government. The Priester decision seems to afford an easy solution to the difficulties confronting the taxpayer who obligates himself to purchase the shares of another shareholder, when he later decides to have the corporation pay for the purchase. So long as he can find somebody willing to earn a gross interest rate and, in addition, who only has to pay tax at a capital gains rate on the money earned, he should be in a position to accomplish a result similar to that in Priester.

Again, however, this type of transaction could be avoided at the inception if the purchaser does not obligate himself to pay the purchase price. This is the best path to pursue. The use of a third party to overcome the dividend consequences of the assumption or payment of the remaining shareholder's obligation for the purchase price of stock is a dangerous technique.

29. In the Priester case, assuming the money was borrowed for a year, the corporation paid interest at the rate of 13%.
30. Since the transaction was given the effect the parties intended, the third party had his entire interest in the corporation terminated. Thus, he met the requisite of § 302(b)(3) and, therefore, the redemption was an "exchange" within § 302(a). If the stock was a capital asset in his hands he would receive capital gain treatment on the transaction.
31. Cf. Edgar S. Idol, 38 T.C. No. 47 (June 27, 1962). In this case the taxpayer had agreed to purchase all the corporate stock. He was obligated for the purchase price of $112,500. C corporation wished to purchase some of the assets of the corporation. The taxpayer sold C corporation some of his stock. As part of the contract it was agreed that the corporation would redeem this stock in exchange for the assets that C corporation sought to purchase. The taxpayer used the money he received for his stock from C corporation to pay part of the obligation he owed on the $112,500 purchase price. The Tax Court held that C corporation, in effect, purchased the assets from the corporation and that the corporation distributed the cash received to the taxpayer. This distribution constituted a
b. The Interposition of a Corporation to Avoid the Consequences of the Obligation Theory

A taxpayer who desires to purchase the stock of a corporation, but who is without sufficient personal funds, may be able to borrow the funds and have the purchased corporation repay the loan without incurring the dividend consequences inherent in this type of transaction.82 But this approach seems unlikely. An alternative would be to incorporate and have the new corporation borrow sufficient funds to make the purchase. The new corporation can then be merged by statute into the purchased corporation. The purchased corporation will assume all the obligations of the constituent corporation.83 The question then raised is whether subsequent payments on the loans incurred to make the purchase create dividend consequences to the taxpayer. This appears to be nothing more than a circuitous route to avoid having the purchased corporation assume the obligation of the purchaser-taxpayer. However, if the new corporation is bona fide and not created as a sham to avoid the implications of the assumption of obligation theory, there will be no dividend income to the taxpayer.84 The new corporation should: (1) adhere to all the formalities of corporate existence; (2) engage in some business activity other than that of a holding company; and (3) remain in existence for a period of time longer than it takes to go through the procedure of incorporation and merger, i.e., at least one year. In addition, the taxpayer should avoid making himself unconditionally liable as an accommodation party on the obligations of the new corporation.85 By using this technique the taxpayer would be putting himself in a vulnerable position, because the question of whether the corporation is a sham is one of fact. Further, it may be difficult to find a business in which the new corporation may engage other than that of holding the purchased corporation’s stock.

taxable dividend. See also Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957) (discussion of this case can be found in the text accompanying note 41 infra).

32. See II(A)(1)(a) of this article’s text supra.

33. The corporate merger statute may force the surviving corporation to assume the acquired corporation’s obligation as a matter of law. See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 69(e) (1961).


35. In Arthur J. Kobacker, supra note 34, one of the taxpayers had signed a corporate obligation as an accommodation party in the following manner: “By this endorsement I hereby guarantee payment of any unpaid balance of the within note plus accrued interest on maturity date.” (Emphasis added.) The court assumed this was a conditional liability and, therefore, held that the purchased corporation had not assumed the taxpayer’s obligation. This overlooks the fact that if this indorsement made him a guarantor of payment his obligation would be the same as the unconditional obligation of the corporation. Thus, if a transaction similar to the one in Kobacker is being planned it would be best to make sure that the taxpayer was no more than a guarantor of collection on any of the corporation’s obligations. See Annot., 84 A.L.R. 289 (1933); 24 AM. JUR. Guaranty §§ 16, 17 (1939).
c. Liquidated Damages Theory

A contract of purchase may provide that the purchaser will pay 25,000 dollars immediately and the remaining 20,000 dollars due on the purchase price of the stock at some future date; if the purchaser fails to pay the remainder he shall forfeit the 25,000 dollars down payment and lose his right to the shares. Suppose the purchaser then assigns to the corporation his right to receive the stock and the corporation assumes his obligation to pay the 20,000 dollars he still owes. Does a subsequent payment of this obligation by the corporation constitute a dividend to him? The Tax Court has held that it does. This type of provision does not give the purchaser an option to purchase; it merely restricts the remedy for breach of the agreement. Thus, the obligation to pay the remainder of the purchase price was binding on the purchaser. Since the corporation paid his obligation, the payment constitutes a constructive dividend.

However, the Internal Revenue Service has ruled that when an agreement provides that upon the death of one of two shareholders, the other must purchase his stock at its fair market value or vote a dissolution of the corporation within six months, a subsequent redemption of the stock of one of the shareholders after his demise does not relieve the remaining shareholder of an obligation. "[A]t no time did . . . [the remaining shareholder] purchase the redeemed shares or obligate himself to do so . . . ." Thus, there were no dividend consequences to the remaining shareholder. This rationale seems to suggest that if there is a liquidated damages provision in the contract the purchaser will be considered obligated nonetheless. But if the agreement provides in the alternative that the purchaser must buy the shares or perform some other act, even if it be a requirement that he dissolve the corporation, he will not be considered obligated to purchase the shares. Certainly when he has a choice of purchase or liquidation, he is obligated to do one or the other. The fact that he did neither without breaching the agreement would suggest that his obligation was satisfied from another source. Why then should the satisfaction not constitute a dividend to him?

d. The “Indian Giver”

A unique situation was presented in Ferro v. Commissioner. Pursuant to a plan of liquidation, the three shareholders surrendered all the stock to the corporation. In order that the business might continue to

39. Id. at 104.
40. See Lloyd H. Diehl, 1 T.C. 139 (1942).
41. 242 F.2d 838 (3d Cir. 1957).
operate, they agreed to allow the taxpayer, who was one of the shareholders, to purchase all of the stock from the corporation. Because one of the other former shareholders had surrendered a substantial ownership, the taxpayer agreed to compensate him for his interest. When the corporation began to prosper, the former shareholder agreed to accept 20,000 dollars as satisfaction of the taxpayer's debt. The taxpayer conveyed stock of the corporation worth 20,000 dollars to the former shareholder. This stock was immediately redeemed by the corporation. Viewing the transaction as a whole, the court found that the taxpayer was the sole shareholder both before and after the transaction, thereby resulting in the proportionate interests remaining unchanged. Corporate money having been used to discharge an obligation of the taxpayer, the effect was essentially equivalent to a dividend.

2. A SPECIAL PROBLEM CREATED BY THE 1954 CODE

Section 302(b)(2) of the Internal Revenue Code of 1954 may make it difficult for the courts to find a constructive dividend when there is a cancellation of indebtedness (rather than an assumption of the purchaser's obligation) by the corporation on a loan made to the taxpayer to enable him to pay for purchased shares. Assume that A owns ten shares and B owns ninety shares of the outstanding stock of a corporation. Because A has been devoting more time to the business it is agreed that A's percentage interest should be increased to one-third. However, at this time the corporation does not have sufficient surplus out of which to redeem a part of B's shares. Therefore, A enters into a contract to purchase forty shares from B. He borrows sufficient cash from the corporation to pay for twenty-five shares and uses his own funds to pay for the other fifteen shares. When the corporation earns a sufficient surplus, it redeems twenty-five shares from A in return for a cancellation of his debt. This redemption would meet the specific requirements of section 302(b)(2) and, therefore, it would be considered "in exchange" for A's stock. Because the shares were exchanged at a price equal to their adjusted basis there would be no gain recognized on the exchange. Even if gain were to be recognized it would be taxed at capital gains rates. A would now own one-third of the corporation. Admittedly, this device could not be used if the two shareholders wished to equalize their ownership, but there may be situations, such as this one, where equalization is not desired.

Under section 115(g) of the 1939 Code, there were no specific criteria for determining how disproportionate a redemption had to be for it to

42. See note 1 supra.
43. Section 302(a); cf. Rev. Rul. 57-353, 1957-2 CUM. BUL. 223.
44. A has just purchased the 25 shares from B. He borrowed enough from the corporation to pay the purchase price of these shares. His debt to the corporation, therefore, equals the basis of his stock. Thus, there will be no gain on the redemption.
45. Section 302(b)(2)(B).
qualify as not equivalent to a dividend.\textsuperscript{46} Thus, the above illustration could create dividend consequences under section 115(g) without doing violence to the statutory language. However, the 1954 Code created a new problem. A transaction within section 302(b)(2) would certainly force the courts to face the problem of whether a redemption in cancellation of an indebtedness presents considerations that differ materially from those involved in an assumption of a purchaser’s liability on a contract to purchase the corporate stock. Prior to the 1954 Code the courts could state blithely that the distribution was essentially equivalent to a dividend without considering whether the transaction was a cancellation of indebtedness or an assumption of the obligation to purchase. This lackadaisical approach is no longer available. The courts are now faced with a decision as to whether to draw a dichotomy between the transactions or to rationalize them on similar grounds by disregarding their form. The Internal Revenue Service has indicated that the cancellation of indebtedness may be viewed as an assumption of the shareholder’s obligation.\textsuperscript{47} Thus, the two situations are drawn under one theoretical umbrella. However, query—is this rationalization proper in light of the express wording of the statute?

B. \textit{Declaration of Dividends to the Seller—Are They Part of the Purchase Price?}

The question arises as to whether a dividend declared in connection with a sale of stock, and paid to the seller because he is the holder of title on the designated date, is a part of the purchase price received by the seller or a distribution of a dividend. If it is a part of the purchase price,

\begin{itemize}
\item \textsuperscript{46} In Television Indus., Inc., 32 T.C. 1297 (1959), \textit{aff’d}, 284 F.2d 322 (2d Cir. 1960), the shareholder owned 950 of the 1,000 outstanding shares at the time of the redemption of 260 of the corporate shares. The corporation cancelled a debt that had been incurred by the shareholder to enable it to purchase the stock of the redeeming corporation. The court held that the payment for the redemption by cancellation of the debt constituted a dividend within the meaning of § 115(g). Under the 1954 Code this transaction would not fall within one of the definitive subsections of § 302, and, therefore, the question would be similar to the one presented under § 115(g), \textit{i.e.}, whether the distribution was essentially equivalent to a dividend. Section 302(b)(1).

\item \textsuperscript{47} Rev. Rul. 57-353, \textit{1957-2 CUM. BULL. 223}. Two shareholders contracted to buy out a third. When they found that they could not make the payments on the contract they had the corporation redeem stock from them and they used the funds to pay their obligations. There was a fourth shareholder and this made the redemption from the two disproportionate. However, it was not disproportionate enough to meet the criteria of § 302(b)(2). The ruling found the redemption equivalent to a dividend and, thus, not within § 302(b)(1). However, the Service stated:

While the transaction described is viewed as a redemption of stock from \(B\) and \(C\), it would, nevertheless, be a dividend to them if it were viewed instead as a direct purchase by the corporation from \(A\) since the effect of such a purchase would be the assumption of \(B\)'s and \(C\)'s liabilities to \(A\) by the corporation. Such an assumption of the liabilities of stockholders is a distribution to them under section 301 of the Code. \textit{Id.} at 225.

Thus, this ruling assumes that the redemption transaction can be viewed as though it were an assumption of the obligation of the shareholder.
\end{itemize}
the seller will only have to pay a capital gains tax on any gain on the sale; if the distribution is a dividend to him he will have to pay an ordinary income tax for the total distribution to the extent of the earnings and profits of the corporation. The buyer will have no income from the distribution if it is a dividend to the seller. But if the distribution is a part of the payment of the purchase price it may constitute a dividend to him to the extent of earnings and profits.

The principle seems to be that if the dividend reduces the amount paid by the buyer on the total agreed-upon purchase price, then the distribution is income to him, taxed at ordinary rates. Analogically, if the distribution does not affect the agreed-upon purchase price then it is income to the seller.

The difficulty lies in determining whether the dividend affects the agreed-upon purchase price. Apparently, if there is a dividend declared after an informal agreement as to the purchase price, which becomes formalized subsequent to the dividend declaration, the dividend is considered a distribution to the seller. This is so even though the informally agreed-upon purchase price is reduced by the amount of the dividend to determine the final price. When the agreed-upon price is not altered by a subsequent dividend declaration, the dividend is not considered as affecting the purchase price. This result obtains even though the parties, when contracting for the sale, took the dividend to be declared into account in determining the price.

Although, generally, the seller would prefer to treat the dividend as part of the purchase price, thereby subjecting himself to a capital gains tax only on the amount of the gain, there is one situation in which this is not the most desirable result. This situation would encompass a transaction in which the shareholder is a corporation. In this instance, if the distribution is a dividend to the seller, the shareholder-corporation will be entitled to an eighty-five per cent dividends received deduction.

49. Sam E. Wilson, Jr., 27 T.C. 976 (1957).
51. Ibid.
52. Merrill C. Gilmore, 25 T.C. 1321 (1956); Loyld H. Diehl, 1 T.C. 139 (1942), aff'd, 142 F.2d 449 (6th Cir. 1944).
53. Sam E. Wilson, Jr., 27 T.C. 976 (1957).
54. See note 52 supra.
56. Section 243.
Thus, the total tax on the distribution, at most, would be approximately seven and one-half per cent.\(^{57}\)

C. The Effect of a Redemption from the Selling Shareholder

The basic arrangement to be considered in this section is one in which Grab and Gimmee sell their entire interest to Friendly.\(^{58}\) In the past the Tax Court held that a sale by Grab and Gimmee of part of their stock with a subsequent redemption of the remainder of their stock by the corporation did not cause dividend consequences to the remaining shareholder, Friendly, if he was not personally obligated to purchase.\(^{59}\) This result obtained even though Grab and Gimmee were paid in corporate notes, payment to be made over a period of years.\(^{60}\) It would seem, a fortiori, if the payment were made immediately by the corporation out of past accumulations there would be no dividend consequences to the remaining shareholder.\(^{61}\)

Of course, if Friendly agrees to buy the corporate stock and has it redeemed after he has made the purchase, he will be subject to dividend consequences,\(^{62}\) unless the redemption is one not essentially equivalent to a dividend or meets one of the specific criteria of section 302.\(^{63}\)

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\(^{57}\) Of course, if there would be no gain on the sale the seller would prefer the distribution to constitute payment of part of the purchase price, whether or not the seller was a corporate body. If the distribution was a dividend there would be a tax liability to the extent of the distributing corporation's earnings and profits. Whereas, if the distribution was part of the purchase price there would be no gain and, thus, no income subject to tax.

\(^{58}\) See text following note 7 supra.

\(^{59}\) Ray Edenfield, 19 T.C. 13 (1952).

\(^{60}\) *Ibid.* In Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954), it was held that a redemption of the remainder of the selling shareholder's stock was an "exchange" and, therefore, he was only subject to a capital gains tax on the gain derived from the redemption. The Internal Revenue Service has ruled that it will follow *Zenz* in cases arising under the 1939 Code, Rev. Rul. 54-458, 1954-2 *CUM. BULL.* 167, and also in those arising under the 1954 Code, Rev. Rul. 55-745, 1955-2 *CUM. BULL.* 223. There was no specific requirement under § 115(g) that there be a termination of interest for the redemption to qualify for "exchange" treatment. However, the Service in Treas. Reg. 101, Art. 115-9, 4 Fed. Reg. 729 (1939), formulated the following as one test for non-dividend equivalence: "[A] cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder *ceases to be interested in the affairs of the corporation*, does not affect a distribution of a taxable dividend." (Emphasis added.) Under § 302(b)(3) of the 1954 Code, if there is a termination of the shareholder's interest this will automatically qualify the redemption for "exchange" treatment. The court did not consider what might constitute a termination of interest in *Zenz*. It merely concluded that if all the shares of the particular shareholder were redeemed there was a termination of interest. However, in *Zenz* the obligation of the purchasers to pay the price of the shares acquired from the seller was secured by a pledge of the stock they acquired. May this negate a termination of the seller's interest? If so, the seller could have dividend consequences upon a redemption of the remainder of his shares.

\(^{61}\) Cf. *Zenz* v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). See text following note 120 *infra*.

\(^{62}\) Bell v. Commissioner, 248 F.2d 947 (6th Cir. 1957); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955); Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); Edgar S. Idol, 38 T.C. No. 47 (June 27, 1962); Frank P. Holloway, 10 CCH Tax Ct. Mem. 1257 (1951), *aff'd mem.*, 203 F.2d 566 (6th Cir. 1953). See II(A) of this article's text *supra*.

\(^{63}\) See II(A)(2) of this article's text *supra*. 
If the transaction is arranged so that first the seller has part of his stock redeemed by the corporation and thereafter sells the remainder of his shares to the purchaser, the distribution to the seller will not be considered equivalent to a dividend if: (1) a complete termination of the seller's interest was contemplated from the beginning; and (2) the redemption was the first step in the plan. Attempting the transaction in this fashion does leave the seller vulnerable. He might suffer dividend consequences even though he intended a sale of his entire interest, if the court refuses to consider the steps as integral to the total plan. The wisest procedure for the seller would be to sell some of his shares first and then have the corporation redeem the remainder. This would place his side of the transaction clearly within the terms of the section entitling him to treat the redemption as an exchange.

In a later decision the Tax Court held that when corporate earnings produced after the taxpayer agreed to purchase were used to pay the purchase price of stock redeemed from the seller, the payments constituted constructive dividends to the remaining shareholder. The court did not declare the actual payments to be the dividends, but said rather that the total transaction, when completed by a stock dividend of the redeemed shares, constituted a dividend in the year the stock dividend was distributed. The decision was reversed on appeal. The rationale of the Tax Court had been that the entire transaction was a sham and that, in effect, the corporation purchased the shares for the remaining shareholders. The court of appeals, however, reasoned that the stock dividend was not a taxable transaction. This left the question open as to whether the actual payments constituted dividends in the year in which they were made.

Subsequently, the Court of Appeals for the Sixth Circuit held that if, as a matter of fact, a corporation purchases stock, directly or indirectly,

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65. See the opinion of the Tax Court in Irwin G. Lukens, 26 T.C. 900 (1956). This was reversed in Lukens v. Commissioner, 246 F.2d 403 (3d Cir. 1957).
66. Section 302(b)(3). See note 60 supra.
67. Joseph P. Schmitt, 20 T.C. 352 (1953). The total earnings for the period during which the stock was being redeemed exceeded the purchase price although for any given year the earnings might not have been sufficient to cover the payment for the stock.
68. Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954). The facts were even stronger in Schmitt than they were in Robert Deutsch, 38 T.C. 118 (1962), to support dividend consequences to the remaining shareholders. In Schmitt there were two other minority shareholders whom the taxpayers persuaded to sell their shares to the taxpayers while the corporation was paying for the purchase of the shares being redeemed. This was to prevent any questioning of the transaction by minority shareholders. In effect, corporate funds were being used for the personal benefit of the taxpayers. See Note, Buying Out Insurgent Shareholders With Corporate Funds, 70 Yale L.J. 308 (1960). Thus, in Schmitt it is clearly shown that the taxpayers were using the corporate earnings for their personal benefit. However, in Schmitt the government sought to tax a stock dividend made up of the redeemed shares, rather than the actual redemption payments. The circuit court seized this innocuous event as the essence of the case and held that there were no tax consequences from the distribution of a pro rata stock dividend.
from the seller for the remaining shareholders and they receive the stock, the payment is a constructive distribution to the remaining shareholders.\textsuperscript{60} The important factor is that the government attempts to tax the distribution and not the transaction through which the remaining shareholders receive the stock. Thus, if the remaining shareholders end up with the shares that were being sold, the fact that they acquired the shares through a stock dividend would seem to be of little significance so long as the government was attempting to focus on the payment as the income producing event, rather than the dividend.

Recently, the Tax Court decided a case, apparently on an assumption of obligation theory, but with more profound implications.\textsuperscript{70} The taxpayer purchased a few shares of corporate stock from the sole shareholder and agreed to purchase or cause the corporation to purchase the remaining shares over a period of time. The contract provided that from its inception, the purchaser would be in control of the corporation. He could vote the stock and was entitled to receive all dividends as long as he was not in default on the contract. The payments were made by the corporation. They were held to be dividend distributions to the purchaser.\textsuperscript{71} The court attempted to rationalize its holding on alternative theories: (1) that the payments were made in discharge of an obligation of the taxpayer; or (2) that the taxpayer owned the stock at the time the payments were made and therefore his stock was being redeemed and not the stock of the seller. Under this construction, the taxpayer, in effect, owned one hundred per cent of the stock both before and after the redemption and therefore the redemption was essentially equivalent to a dividend.\textsuperscript{72}

The first theory clearly appears to be in conflict with prior interpretations of agreements of this type both by the Tax Court\textsuperscript{73} and the Internal Revenue Service.\textsuperscript{74} It has been held that when the taxpayer has

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\textsuperscript{61} If the stock is in reality purchased by a remaining shareholder and paid for by the corporation, then, regardless of the form of this transaction, the payment will be considered a dividend to the shareholders who make the purchase. Rev. Rul. 58-614, 1958-2 Cum. Bull. 920. But see Earle F. Tucker, 23 T.C. 115 (1954), rev'd, 226 F.2d 177 (8th Cir. 1955).

\textsuperscript{70} Robert Deutsch, 38 T.C. 118 (1962).

\textsuperscript{71} Since some payments were made before the 1954 Code went into effect and some were made after the effective date, the distributions were held to be dividends under both § 115(a) of the Int. Rev. Code of 1939, as amended, ch. 144, § 2, 61 Stat. 179 (1947), as amended, and § 316(a) of the Int. Rev. Code of 1954.

\textsuperscript{72} This result would obtain under either § 115(g) or § 302(a). See Nolan, The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal, 65 Harv. L. Rev. 255 (1951).

\textsuperscript{73} Lloyd H. Diehl, 1 T.C. 139 (1942).

the alternative of purchasing or causing the corporation to purchase the stock, a purchase by the corporation is not in fulfillment of the taxpayer's obligation. The second ground for the decision seems more plausible. However, the proper focal point of the decision, it is suggested, should be the fact that the purchaser was paying for his acquisition from accumulations the corporation would earn after he had entered into the agreement. In effect, he was using the business entity he had acquired to earn funds to pay for the purchase.

D. Redemption from One of the Present Shareholders to Transfer Ownership to the Remaining Shareholders

In this transaction Grab decides to purchase Gimmee's shares. He can accomplish this by having the corporation redeem Gimmee's entire interest. Grab exercises particular care to avoid any personal obligation to purchase these shares. If the redemption is from past accumulated earnings, whether more or less than book value is paid for the shares, there are no resultant dividend consequences to the remaining shareholder. If the redemption is in kind, a similar result will obtain.

Further, a redemption from earnings to be acquired after the transaction will not produce dividend consequences to the remaining shareholder. Tucker v. Commissioner carried this view to the furthest extreme. The taxpayer sought to acquire shares of the corporation

76. See text following note 120 infra.
79. This is assuming that fair market value and book value are approximately the same. This appears to be reasonable for a close corporation that has no active market for its shares.
82. Earle F. Tucker, 23 T.C. 115 (1954), rev'd, 226 F.2d 177 (8th Cir. 1955). The Tax Court recently implied this conclusion in Milton F. Priester, 38 T.C. No. 36 (May 29, 1962). In that case the agreement was entered into in 1953. However, substantial payments were not to be made until 1957, 1958 and 1959. This apparently was to give the corporation sufficient time to earn enough funds for the taxpayer to have available for payments on the purchase agreement. The court held that a redemption from a third party who had purchased the shares in place of the taxpayer did not produce a constructive dividend to the taxpayer. The court made this finding after it first had decided that the corporation had not paid the taxpayer's obligation. See text accompanying note 27 supra. Cf. Ruphane B. Iverson, 29 B.T.A. 863 (1934) (dividend consequences based on corporation paying shareholder's obligation).
83. 226 F.2d 177 (8th Cir. 1955).
owned by a third party. As part of the consideration for the acquisition, the corporation agreed to pay twenty per cent of its earnings for the next five years. The formality of a redemption was not observed. The stock was transferred directly to the taxpayer. The court held:

We think that to treat the payments made by the Company to . . . [the third party] during the years in suit, as income constructively received by . . . [the taxpayer] was carrying the doctrine of constructive dividends too far.85

E. Redemption by the Corporation for the Purpose of Immediate Resale

A method of shifting control or making stock available for purchase when the purchaser does not have funds presently available, is a corporate redemption in contemplation of a resale. Generally, this method has been held not to give rise to dividend consequences under either section 115(g) of the 1939 Code or section 302 of the 1954 Code, even though the redemption is pro rata.86 Thus, if three stockholders wish to provide stock for their employees they may have the corporation redeem some of their stock pro rata to keep available for purchase by the employees. The redemption will not be considered essentially equivalent to a dividend. Apparently, this is the counterpart of the "conduit theory."87 In this situation it is the corporation that is the conduit. The courts seem to consider the transaction as a sale of the stock to the employees or third parties rather than a redemption.88

Admittedly, in these transactions the sale can be made directly between the buyer and seller without the intervention of the corporation. However, when the shares redeemed are immediately resold the redemption is innocuous. The difficulty arises when there is no immediate resale or there is only a resale of part of the redeemed shares. In these situations the shareholder has obtained corporate funds at capital gains rates while still maintaining his percentage interest in the corporation, or, at least, the change in his interest is not sufficiently disproportionate for the distribution to be other than a dividend.89 The rationale offered

84. The taxpayer was not the only remaining shareholder. However, the corporation could have redeemed the shares and distributed them in a non-pro rata stock dividend to the taxpayer. The other shareholder wanted the taxpayer to acquire the shares and, therefore, he would have consented to this.

85. Tucker v. Commissioner, 226 F.2d 177, 179 (8th Cir. 1955). This reasoning clearly shows that the only things being carried too far are the anomalous results in situations of this type. See note 69 supra and accompanying text.


87. See II(A)(1)(a) of this article's text supra.


in support of treating the transaction as an exchange is that the redeemed stock is more akin to an asset when there is a contemplated resale. Therefore, the transaction is more like a purchase than a dividend distribution.\(^90\)

III. A PROPOSED CHANGE IN THE LAW

A. How Is It To Be Accomplished?

A proposed change in the law will be suggested in this section. It is set forth as a modification through legislation. However, the reason for the method suggested is that the courts have shown a reluctance to change prior formulations. The use of this technique should not be taken as an indication that the changes cannot be made with all propriety by judicial decision. In fact, this would seem to be the preferable method.

The statutory proposal is not intended to be completely definitive. Rather, it is the framework for a new section. Its wording indicates leeway for the courts in interpreting its applicability.\(^91\) This suggests that if the judiciary should refuse to take the horse by the bit in the first instance, the legislation will not necessarily make its job easier. Also, certain rigid lines have been drawn.\(^92\) To alleviate an inappropriate application of this rigidity, exceptions and presumptions had to be made, thereby creating some uncertainty.\(^93\) This approach indicates that decision on a case-by-case basis is not outweighed by the need for certainty. It is hoped that the following discussion of the legislation and its application will show by force of reason that the changes suggested readily fit into the present statutory framework and that they can be reasonably adopted by the decisional process.\(^94\)

B. The Proposal

Sec. 316x. Except as provided in subparagraph two (2):

(1) When a corporation redeems shares of its corporate stock,

(a) in the context of a purchase of the corporation by the remaining shareholders, and

(b) payment for the redeemed stock is made by the

\(^90\) From the standpoint of the company, by adjusting its book entries this could be made to appear the same as the distribution of a dividend. This would require reducing the accumulated earnings and undivided profits by the amounts paid out for the stock and not entering the treasury stock as an asset. However, this would be somewhat unrealistic in view of the fact that the company has since realized over $75,000 from the sale of this stock to key employees. John A. Decker, 32 T.C. 326, 332 (1959).

\(^91\) Section 316x(1)(a). [References to §§ 316x & 301x are to the proposed legislation found in III(B) of this article's text infra.]

\(^92\) Section 316x(2).

\(^93\) Ibid.

corporation in the taxable year or years succeeding the year of purchase,
(i) out of earnings and profits accumulated subsequent to the year of purchase,
(c) the payment for the redeemed stock shall constitute a "dividend" to the remaining shareholders in the year in which the payment is made.
(i) Remaining shareholders include not only those who were shareholders prior to the redemption, but any shareholder who owns stock in the corporation immediately after the redemption has occurred.
(ii) Under paragraph (b) of this subparagraph payment will be considered as being made in accordance with this subparagraph if the corporation borrows money or property with which it pays for the redemption and repays the loan out of earnings and profits accumulated in taxable years succeeding the year of redemption.

(2) If there are more than ten (10) remaining shareholders after the redemption then subparagraph one (1) is not applicable, unless the government can sustain the burden of proof that each shareholder consented to the redemption for the purpose of purchasing the corporation.

(3) If subparagraph one (1) of this subsection is applicable to a transaction, then the basis of the shares of stock owned by the remaining shareholders shall be increased, pro rata, by the amount of the distribution taxable to them as a dividend under subparagraph one (1).

(4) Whenever a redemption is found to be within this subsection then section 302 shall not be applicable to the redemption and the effect on the redemptionee shall be as though he sold his stock to the remaining shareholders.

Sec. 301x.

(1) When a corporation redeems its corporate stock,
(a) in the context of a purchase of the corporation by the remaining shareholders,
(2) the payment for the redeemed stock shall constitute a distribution of property to the remaining shareholders within section 301(a) in the year or years in which the payment or payments are made.

At the outset it should be noted that the proposed changes are set within sections 316 and 301 of the 1954 Code. In the past, in attempting
to find constructive dividends to remaining shareholders after a redemption from selling shareholders, the courts had applied the redemption section of the 1939 Code. This was an inappropriate use of that section. The basic purpose of the section was to provide dividend treatment for a shareholder whose stock was redeemed when the distribution he received was tantamount to a dividend. The section was not intended to be used as a weapon against a shareholder whose stock was not redeemed. In order to find a constructive dividend under the 1939 Code, therefore, the general dividend section should have been the one applied. This error has been remedied in some cases under the 1954 Code, as the courts have considered the general dividend sections appropriate in determining whether the remaining shareholders have received constructive dividends upon the redemption of the selling shareholder's stock.

It has been argued that if the redemption comes within the literal wording of section 302, it cannot also be considered a dividend to the remaining shareholders. If it is in exchange for the retirement of stock, it cannot also be in payment for the purchase. However, this overlooks the fact that the arrangement is in reality, a purchase by the corporation for the buyer cast in the form of a redemption. Merely because the arrangement literally fits within the redemption section should not cloud the effect of the transaction.

The basic premise underlying the proposed change is that there should be dividend consequences to a purchaser of a close corporate entity when the corporation is used to produce the income that pays for the purchase. In a close corporation there are no independent controls on the use of the corporation by the shareholders for their personal benefit. Thus, the use of the corporation as a separate taxable entity

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99. Sections 301, 316.
100. Robert Deutsch, 38 T.C. 118 (1962).
102. If there is more than one shareholder, this assumes that the others are in accord with the proposed transaction. This common accord is more readily obtainable in a situation in which there are only a few parties. In a large corporation in which there are many stockholders, total consent to a plan that will not directly benefit all the stockholders is difficult to obtain. Therefore, with these corporations the independent control is the probability of a minority shareholder's suit if the directors of the corporation cause it to repurchase its stock without a proper business reason. Compare Anderson v. Albert & J. M. Anderson Mfg. Co., 325 Mass. 343, 90 N.E.2d 541 (1950), and Bennett v. Propp, 187 A.2d 405 (Del. 1962), with Kors v. Carey, 158 A.2d 136 (Del. Ch. 1960).

Directors cannot take advantage of their official position to manipulate the issue and purchase of shares of the stock of the corporation in order to secure for
is subjected all the more readily to abuse. It is conceded that if a corporation increases its wealth through productivity, this alone is not sufficient to create taxable income to the shareholders under the present statutory scheme.\textsuperscript{108} But the situation is different when corporate funds are used to purchase treasury stock so that the remaining shareholder or shareholders obtain complete ownership of the corporation.\textsuperscript{104} The reason generally espoused by the courts as to why there are no dividend consequences to the remaining shareholder is that there is no realizable event.\textsuperscript{106} However, this clearly overlooks the fact that there was a corporate distribution. This is the necessary event for a dividend, assuming there are sufficient earnings and profits.

The question that remains is why this distribution should be attributed to the remaining shareholder. Certainly, it will not be contended that merely because it was not received by the remaining shareholder, it cannot be considered as income to him.\textsuperscript{106} If Grab owned an apartment house on which he borrowed extensively, the mere fact that the tenants paid their monthly rent to the mortgagee would not alter the fact that Grab had to include this rent as part of his income.\textsuperscript{107} Now the following cry will be heard: "But in the situation being considered there is no ownership of the corporate entity as such; it is a distinct person for tax purposes. When it receives income it pays tax on that income."\textsuperscript{108} Therefore, when it enters into a contract to purchase its own stock, even

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  themselves the control of the corporation and then to place the ownership of the stock in such a position as will perpetuate that control. Such action constitutes a breach of their fiduciary obligations to the corporation and a wilful disregard of the rights of other stockholders. Anderson v. Albert & J. M. Anderson Mfg. Co., supra at 346-47, 90 N.E.2d at 544. See generally Note, Buying Out Insurgent Shareholders with Corporate Funds, 70 YALE L.J. 308 (1960); 6A FLETCHER, CYCLOPEDIA CORPORATIONS §§ 2845-61 (1950).

  It may be contended that the creditors in a close corporation may prevent corporate action solely for the benefit of a shareholder. However, in a redemption transaction there seems to be very little a creditor can do if there is sufficient surplus from which the redemption is to be made. "[C]reditors are not injured where the corporation has assets largely in excess of its indebtedness at the time of the purchase; and insolvency of the corporation at some later time is immaterial." 6A FLETCHER, op. cit. supra § 2854, at 402-03.

  103. Consider the ratio decidendi of Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958).

  104. See, e.g., Sneed, A Defense of the Tax Court's Result in Prunier and Casale, 43 CORNELL L.Q. 339, 352 (1958): [A] mere enhancement in the value of shares owned by a shareholder because of corporate business profits should not be taxed to the shareholder because this eliminates a distinction, albeit perhaps not a wise one, deeply rooted in the Code itself. On the other hand, the corporate structure should not be used to shield from the income tax the shareholder who derives benefits, distinct from those normally flowing to a shareholder because of the success of the trade or business of the corporation, through accumulation and investment of the corporate earnings. 105. See, e.g., Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954).

  106. See, e.g., Illinois Agricultural Holding Co., 46 B.T.A. 1, af'd, 131 F.2d 583 (7th Cir. 1942) (dictum).

  107. See, e.g., 1 CCH 1963 STAND. FED. TAX REP. ¶ 202.02.

  108. Section 11; but see § 1372.
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though it is for the purpose of giving the remaining shareholders complete ownership, there is no distribution to these shareholders. This entity, independent of the shareholder for tax purposes, merely made a purchase."

It is conceded that the corporation is a separate entity and that every activity in which it engages which is beneficial to the shareholders does not give rise to a distribution to them. If the corporation buys a machine, its payments on the machine do not constitute income to the shareholders. Even if there be only one shareholder it is not income to him. Why then in this case when the corporation purchases its own stock should the payments constitute income to the shareholders? The answer is relatively simple. Because a close corporation and its shareholders when acting in concert to acquire the ownership of the corporate entity for the remaining shareholders should be considered one for tax purposes.

In the first place, in this type transaction no meaningful distinction can be drawn between corporate and shareholder motive. Of course, the following type argument may be made: the corporation, in order to maintain its franchise, has to get rid of shareholder X. Therefore, it redeems his stock and complete control is vested in shareholder Y. Thus, the motivation for the redemption came at the corporate level. But is this argument sound? After the transaction shareholder Y is the only individual left with an equity interest in the corporation. If the corporation loses its franchise, he as well as the corporation will suffer. Instead of having the corporation redeem the stock he could have purchased it himself. If he had no funds he could have borrowed them from the corporation, or from an independent source if that were possible. But instead he chose to allow the corporation to redeem. What difference could it make to him? There were no other shareholders to contest the use of the corporate funds. The act of redemption was innocuous. Whether the corporation obtained the shares as treasury stock or he obtained them, the result would be the same. He would have complete ownership. Thus, rationally, it is impossible to separate corporate and shareholder purpose in this situation.

Secondly, what is the corporation acquiring when it purchases its

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110. See Sneed, A Defense of the Tax Court's Result in Prunier and Casale, 43 CORNELL L.Q. 339, 370 (1958):

Nowhere is the deceptive nature of the "benefit" analysis better revealed than in this case [Tucker, Note 111, infra]. Expenditures which directly serve the investment interest always further, to some extent, the group's ability to carry on the business for which they joined together. In that sense they always provide a benefit to the corporation, but the immediate and primary objective is to affect the investment the shareholder has in the business. To repeat, this cannot be fully grasped so long as "the weighing of benefits" occupies the court's attention.
own stock? In a close corporation where there is no ready market for the corporate shares, the stock certainly cannot be considered an asset.\textsuperscript{112} In addition, in a situation in which the remaining shareholders cause the redemption so as to acquire the corporation, they would have no intention of permitting the corporation to subsequently resell the acquired stock.\textsuperscript{118} Therefore, in this situation treasury stock has very little in common with an asset. At best, the corporation is making payments and receiving nothing in return to advance corporate and shareholder motives which are indistinguishable. Further, there usually is no corporate motive for the redemption. In this situation you have the corporation paying a consideration and receiving nothing in return.\textsuperscript{114} Thus, it is proper to consider the corporation and the shareholder as one in these instances. In effect, the payments are being earned by a producing entity, like any other investment, and going directly to a third party for the benefit of the shareholders. Therefore, the payments should be included in the shareholders' income.\textsuperscript{116}

It has been suggested by some writers that to tax the distributions to the remaining shareholders would subvert the redemption sections of the Code.\textsuperscript{116} Their argument appears to be that by creating dividend consequences for the buyer upon a redemption by the seller, there will not be as much incentive to use the redemption provisions. However, the only transactions in which there would be dividend treatment are those in which there is a contemplated purchase of a close corporation. Further, the argument overlooks a basic fact: the redemption sections were not passed originally to alleviate the tax burden, but to add to it by providing ordinary income consequences when a redemption is

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  \item \textsuperscript{112} See \textit{Accountant's Handbook} § 21.32-33 (4th ed. Wixon 1956). "The vast majority of accounting authorities do not recognize any logical basis for showing treasury shares as an asset." But see II(E) of this article's text supra.
  \item \textsuperscript{113} Compare John A. Decker, 32 T.C. 326 (1959), \textit{aff'd per curiam}, 286 F.2d 427 (6th Cir. 1960).
  \item \textsuperscript{114} See, e.g., Robert Deutsch, 38 T.C. 118 (1962); Television Indus., Inc., 32 T.C. 1297 (1959), \textit{aff'd}, 284 F.2d 322 (2d Cir. 1960); Joseph P. Schmitt, 20 T.C. 352 (1953), \textit{rev'd}, 208 F.2d 819 (3d Cir. 1954); Ray Edenfield, 19 T.C. 13 (1952).
  \item \textsuperscript{115} Professor Sneed has offered a rationale similar to this one although he does not consider it necessary to pierce the corporate veil. His basic position is:
  \begin{quote}
    A shareholder should be considered as having realized accumulated earnings and profits of the corporation in the form of dividends when such gains in an ascertainable amount are primarily devoted to purposes which serve interests of the shareholder distinct from his interest as a proprietor of the business conducted by the corporation. Sneed, \textit{A Defense of the Tax Court's Result in Prunier and Casale}, 43 \textit{Cornell L.Q.} 339, 353 (1958) (Italics omitted.).
  \end{quote}
  He then divides the interests of the shareholder into three categories: (1) his interest in the business activity of the corporation; (2) his interest in the investment represented by the stock; and (3) his personal interests. If the expenditure was for either interest (2) or (3), the distribution should be taxable to the shareholder.
  \item \textsuperscript{116} Smith, \textit{Recent Developments in the Field of Corporate Business Purchase Agreements}, 14 \textit{Tax L. Rev.} 413 (1959); Graham, \textit{Redemption Problems—The Holsey and Zipp Cases}, 36 \textit{Taxes} 925 (1958).
\end{itemize}
equivalent to a dividend.117 The provisions in the 1954 Code made it more certain, to an extent, when a redemption is to receive exchange treatment.118 But basically, the sections have been and still are preventive.

Also, the redemption sections are concerned with the seller's side of the transaction. The seller will have a sale or exchange whether the transaction is cast as a redemption not equivalent to a dividend or as a purchase by the remaining shareholders.119 Therefore, as far as the seller is concerned, treating the redemption as a distribution to the remaining shareholders will not affect his tax incidents. Finally, the argument fails to consider that by releasing these conjured frustrations of section 302, the court is permitting a more ruinous result, i.e., it is overriding the basic scheme of corporate distributions by permitting this distribution of corporate funds to be tax free to the remaining shareholders.

The proposed section seeks to tax as a dividend only those payments made for the redemption of the seller's stock out of earnings accumulated subsequent to the date of purchase.120 The section as worded establishes the date of purchase as the last day of the taxable year in which the transaction took place by creating dividend consequences only for those payments made in the succeeding taxable years.121 This is not to imply that it would be unreasonable to assume that the parties may agree upon the transfer of control in January and use the earnings of that taxable year to pay for the redemption.122 Rather, it is to avoid the difficulties inherent in a factual determination of when the purchase actually occurred. This problem is particularly acute in those situations in which the transactions are accomplished informally. Thus, all payments that are to be made in taxable years succeeding the year of the transaction are susceptible to dividend treatment.

117. Section 115(g) was itself couched in terms providing that it was to create dividend consequences in certain situations, not absolve one from this type treatment:

If a corporation cancels or redeems its stock . . . at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed . . . shall be treated as a dividend.

See, e.g., S. REP. No. 1631, 77th Cong., 2d Sess. 116 (1942):

It is believed that the proper application of section 115(g) will prove adequate to prevent taxable dividends disguised as liquidations from receiving capital-gain treatment.


In lieu of a factual inquiry in every case it [§ 302] is intended to prescribe specific conditions from which the taxpayer may ascertain whether a given redemption will be taxable at rates applicable to the sale of assets or as a distribution of property not in redemption of stock subject to section 301.

119. See §§ 302(a), 1222.

120. Section 316x(1)(b)(i).

121. Section 316x(1)(b).

Further, it is also provided that if the corporation borrows money to pay for the redemption immediately, but is to repay the loan from funds earned subsequent to the year of purchase, these payments on the loan will also give rise to possible dividend treatment. Otherwise, the effect of the proposal easily could be avoided by having the corporation borrow the necessary funds for the redemption and pay for the redeemed stock in the year of the purchase. In both cases: (1) when the corporation agrees to pay for the stock over a period of years; or (2) when the corporation borrows funds to pay for the redeemed stock immediately with repayments on the loan to be made in future years, the same result is achieved. The corporation is paying for the purchase from funds earned subsequent to the purchase. The mere fact that the form is different should not affect the result. The cases are not logically distinguishable. If one type of transaction gives rise to dividend consequences, so should the other.

Two fundamental criticisms have been levelled at this approach of finding dividend consequences to the buyer only when payments are made from future earnings. It has been suggested that there is no real difference with reference to the remaining shareholder, whether future earnings are used to pay for the redemption or payment is made out of past accumulations and future earnings used to rebuild the net worth to its pre-redemption level. Thus, why tax one and not the other distribution to the remaining shareholder?

There is a basic distinction between the two situations. Consider the first alternative presented in the Grab-Gimmee transaction. By having the corporation redeem Gimmee's stock for cash, Grab would be acquiring a corporation with a value of 50,000 dollars. That was what his interest was worth prior to the redemption. Thus, in effect, he acquired no more than he had. Or consider the case in which Grab and Gimmee decide to sell to Friendly. Assume that the corporation was entirely liquid and that Grab and Gimmee were paid 95,000 dollars in cash immediately. Friendly would have acquired a corporation for 5,000 dollars. However, that is all the corporation would have been worth. The payment for the redemption should not give rise to dividend income to the buyer, even though future earnings are used to rebuild the corporation back to its former position. The situation is simply that Friendly bought or acquired an asset for which he paid full value; the asset subsequently earned income and that income has not been distributed. Because the asset is a corporation the buyer does not have to recognize the income until it is distributed to him. But when the corpo-

123. Section 316x(1)(c)(ii).
125. See I(A) of this article's text supra.
126. Ibid.
ration redeems Gimmee's stock by giving him notes for 50,000 dollars payable annually, the situation is different.\textsuperscript{127} Grab begins by owning an enterprise worth 100,000 dollars, not 50,000 dollars. He has the complete benefit of an enterprise double the size of the one he would have had if the corporation had paid for the redemption immediately. Thus, he is acquiring a corporate entity of 100,000 dollars with the use of his interest, which is worth only 50,000 dollars. The future earnings of the corporation are used to pay for his purchase. He started with an enterprise owning producing assets double the value of his interest, having paid nothing for the additional value.

Similarly, consider the sale to Friendly.\textsuperscript{128} He could pay 5,000 dollars for five shares of stock and have the corporation redeem the remainder by paying Grab and Gimmee over a period of years. Friendly would have acquired a 100,000 dollar corporation for 5,000 dollars. He would have the \textit{full investment value} of the entity for a minimal price. This entity would then pay for the purchase out of its earnings. Thus, the situation in which the redemption is financed from past accumulations is quite different from the buyer's point of view from the purchase made out of future earnings.

Consider also, that in the transactions in which the redemption is made from past accumulations, the buyer is starting with a smaller investment. That is, he only has the earning capacity of a 50,000 dollar or 5,000 dollar enterprise. He paid the value of this entity when he made the purchase, or in Grab's case he owned that much of the investment originally. However, when the redemption is from future earnings the buyer has a 100,000 dollar enterprise for which he has only paid 5,000 dollars; or in Grab's case he had a prior investment of 50,000 dollars. From the buyer's view the distinction is substantial between redemptions made out of past as contrasted with future earnings.

Secondly, it has been suggested that payment out of future earnings "is nothing more than the typical case of one shareholder starting out on a shoestring, investing relatively small amounts of capital, and having the corporation issue large amounts of bonds to others which are later redeemed as the corporation earns money."\textsuperscript{129} The payment on these bonds apparently would not give rise to a taxable event.\textsuperscript{130} Thus, why should payment for the redeemed stock be anything different than payment of other corporate indebtedness when a shareholder starts a corporation on "a shoestring"?

There is a difference and it is very real. When a corporation is begun on a shoestring it borrows money to acquire assets. This is some-

\begin{itemize}
  \item \textsuperscript{127} Ibid.
  \item \textsuperscript{128} Ibid.
  \item \textsuperscript{129} Note, 67 Harv. L. Rev. 1387, 1389 (1954). (Footnotes omitted.)
  \item \textsuperscript{130} This is assuming that there are no problems concerning "thin incorporations."
\end{itemize}
thing of value to the corporation independent of any value it may have to the shareholders. The payments on the loans are, therefore, in essence, payments for the purchase of assets. However, when the corporation borrows to redeem stock, what is it acquiring? The stock is not an asset. It has no real value to the corporation. Of course, the selling shareholder could effect a redemption in kind and then have the corporation repurchase the assets. However, this would not change the nature of the transaction. In effect, it would be nothing more than a sham. The corporation would be paying for something it had previously owned. There would be no valid reason for the distribution and the immediate repurchase. The corporation would not be acquiring an asset. In substance, it would be acquiring its own stock. Therefore, there is a substantial difference between a transaction in which there is borrowing to finance a corporation begun on "a shoestring" and borrowing to redeem a seller's stock in the context of a purchase of the corporation. This distinction affords the basis for the difference in treatment between the transactions.

The proposed section is limited to those situations in which the redemption is made to effectuate a purchase of the corporation. This approach limits the applicability of the proposal and leaves uninhibited other redemptions falling within the confines of section 302. As written, the section requires the transaction to be "in the context of a purchase of the corporation." This provision is aimed at those transactions in which the seller's interest is completely terminated. The seller would therefore be entitled to exchange treatment under section 302(b)(3), unless the attribution rules were applicable. For example: if a father and son owned a corporation and the father wished to sell his interest in the corporation to the son, a redemption of the father's stock, payment to be made out of future earnings, might give rise to dividend consequences to the father as a redemption essentially equivalent to a dividend. In addition, the proposed section 316x would also be applicable. This would create the anomaly of having one distribution create double dividend consequences. To avoid this result, section 316x(5) was added. Thus, if the transaction is viewed as a sale, the son would have dividend income and the father would have a capital gain on the sale.

The section is not intended to encompass those transactions in which a redemption is used to effect a shift in control or a partial sale

131. See note 112 supra and accompanying text.
132. Section 316x(1)(a).
133. Of course, to avoid application of the section, the parties could agree that the seller retain a nominal amount of stock. It is hoped that the courts would look through this agreement and find the section applicable. Whether there has been a complete termination of interest should depend on the facts and not on perfunctory criteria.
134. Section 318(a).
135. This is assuming that the requisites of § 302(c)(2) are not met.
of the seller's interest. These transactions do not contemplate a purchase by the remaining shareholders as the seller still has an interest in the corporation. The remaining shareholders have not acquired the entire corporation. Presumably the corporate entity will not be abused for the benefit of the remaining shareholders when the seller retains an interest in the corporate affairs. Therefore, there is no pressing reason to pierce the corporate veil in this instance.

The proposed section is limited to close corporations. The statute defines a close corporation as one consisting of not more than ten shareholders. This numerical figure was based on pragmatic grounds after a consideration of the majority of cases in this area. The number of shareholders, rather than assets or earning power, was made a determinative criterion because the crux of the problem is the abusive tactics of a small number of shareholders. The important facet of the transaction is the agreement of the shareholders to use the corporation as the vehicle of purchase. Thus, the number of shareholders becomes important. However, the number is not limited in all instances to ten. The section creates a presumption that it is not applicable if there are more than ten shareholders. But if the government can prove in any given case, in which the number of shareholders is in excess of ten, that all the shareholders consented to purchase the corporation from the seller by a redemption from future earnings, then the section will be applicable. This is to prevent an easy avoidance of the section by using any number of shareholders in excess of ten to make the purchase.

The purpose of the shareholder limitation is to avoid the problem of presumptive dividend consequences to the remaining shareholders of a corporation which has a large number of shareholders (e.g., one thousand), and which redeems the stock of one shareholder out of future earnings. It has been suggested that there is no rational basis for limiting the dividend treatment to shareholders of close corporations. This distinction, it is submitted, is not only rational but proper. As was suggested before, it is only in close corporations that complete agreement among the remaining shareholders can readily be achieved. Thus, there is no substantial control on the use of the corporation to make the purchase. However, with a larger corporation, in which complete agreement is difficult if not impossible to obtain, the directors will be subject to the scrutiny of minority shareholders. They will not be willing to use, indiscriminately, corporate funds solely for the benefit of a majority which

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136. But see note 133 supra.
137. Section 316x(2).
138. The consequences are only presumptive, because it still has to be shown that the redemption was in the context of a purchase. Section 316x(1)(a).
desires the purchase. Thus, it is the small corporation that should be pierced in the purchase-by-redemption situations as it is the one most susceptible to abuse.

If the transaction falls within section 316x, the buyer will not have dividend income attributed to him until the year that the payments are made. This result obtains whether or not the corporation gives the seller notes in exchange for his stock. If the notes have a fair market value this result might appear to be contrary to general dividend concepts. The view has been expressed that if the notes are considered as given on behalf of the buyer, he should have to recognize income in the year they are given. However, the proposed section is concerned with the buyer's side of the transaction. From his (reconstructed) point of view he is receiving a distribution which he then uses to pay for the stock. Even though the notes have been given by the corporation they are more akin to notes of the buyer or remaining shareholder. It is not until the corporation as an entity makes a payment that it is doing something that should create dividend consequences for the buyer. The important event is not the giving of the notes, but the corporation earning income subsequent to the sale—income, the use of which is employed to effect the purchase. Only when the income has been earned and payment made is there a distribution of future earnings. If the corporation earns no income and must make a payment on the notes out of past accumulations, from the buyer's point of view this is a payment from capital and he has received no income. This underlies the concept that dividends to the remaining shareholders should be recognized only when payments are made from future earnings. Thus, even though notes have been given by the corporation, the remaining shareholder may not have to recognize income if there are no subsequent earnings. The giving of the notes is of no importance to the buyer within the concept of the proposal and, therefore, it is not the taxable event.

Upon the receipt of a dividend under the proposed section, the remaining shareholder adds the amount of the dividend to the basis of the stock he owns in the corporation. This is in harmony with the rationale of the proposal. Although he has not received additional shares in form, the remaining shareholder has paid for the seller's interest when he has the payment for the redemption from future earnings attributed to him.

141. See note 102 supra.
142. Section 316x(1) (c).
143. If notes are given and they have a fair market value, their value is dividend income in the year they are received rather than in the year they are paid. See generally 2 P-H 1963 FED. TAX SERV. ¶ 9178, and particularly 2 P-H 1963 FED. TAX SERV. ¶ 9179-B.
145. Section 316x(3). This has been suggested in dicta by the Tax Court in The Gray Processes Corp., 43 B.T.A. 624, aff'd per curiam, 122 F.2d 1021 (3d Cir. 1941). See also Note, 67 YALE L.J. 112, 119 n.34 (1957); cf. Sneed, A Defense of the Tax Court's Result in Prunier and Casale, 43 CORNELL L.Q. 339, 344 n.11 (1958).
Thus, the additional cost of his new interest is added to the basis of his stock. Of course, if the corporation makes a payment from past accumulations, there is no dividend to the remaining shareholder and nothing is added to the basis of the stock for this distribution.

A problem arises when one of the remaining shareholders sells his stock prior to the time that the corporation has made full payment for the redemption. At this point he may have had to recognize some dividend income and he thereby would have increased his basis, but not to the full extent of the price (not yet fully paid) for the redeemed stock. One of two approaches may be taken.

First, a provision could have been added to the section which would have required the remaining shareholder to recognize his gain from the sale as ordinary income to the extent of his undistributed pro rata share of the remainder of the payments. Or, secondly, the dividend treatment could follow the shares. That is, whoever bought the stock would be subject to dividend income upon payment of the price for the redeemed shares, if payment was made out of future earnings. The fact that the buyer might be subject to this income would probably be reflected in the price he would be willing to pay for the stock. In effect, the theory would be that the purchaser bought stock that was not fully paid for and the corporation was making payments on the balance due.

The second suggestion seems the appropriate one. It may be argued, however, that the purchaser was not a party to the transaction in which the purchase was agreed upon. The theory underlying the proposed section is that the corporate entity should be pierced because of the

146. Section 316x(1)(b).
147. Only the amount of the distribution taxable to the remaining shareholders under § 316x is added to the basis of the stock. Section 316x(3). The distribution will reduce the basis of the stock. See the text following note 151 infra.
148. E.g., a section something like this:
If stock is sold by a remaining shareholder before complete payment has been made for the redemption by the corporation, then the amount of money or property received in excess of the basis of the stock shall constitute ordinary income to the extent of the shareholder's pro rata share of the distribution that would be attributed to him under subparagraph (1) [of § 316x] (assuming all payments were made out of future earnings) had he held the stock until the full redemption price was paid. Any excess over this amount shall be considered in exchange for the stock. Of course, this penalizes the remaining shareholder who sells his stock, because he has ordinary income even though subsequently the payments are made out of past rather than future accumulations. A provision could be added giving him a deduction from income in subsequent years if payments are from past accumulations. But this would require him to keep in contact with the operations of a corporation in which he has no interest. It could be provided that he only has to recognize ordinary income to the extent of future earnings in the year of the sale. This would provide, at least, a formal escape for those seeking to avoid the section. They could have a third party buy the stock; there would then be a redemption of the seller's stock. The third party would then sell the stock to the party who really sought to purchase the shares. This would be done before there were any future accumulations. Unless the court pierced the transaction, the applicability of the section would be avoided. Compare generally § 306 with the provision suggested above.
agreement among the remaining shareholders to use corporate earnings to make the purchase. The buyer was never a party to this agreement and, therefore, why should he and the corporation be considered as one?

The contrary argument is that the buyer is being attributed with dividends not because he was a party to the agreement, but rather, because the tax incidents created by his vendor's activities attach to the stock. He is buying, in reality, stock that has not been fully paid for and, therefore, he is subject to dividend income when the corporation makes payments on the unpaid balance.

There is no specific provision in the proposed section to effectuate this suggested result. This is partly due to the fact that the author is not fully convinced of the second alternative, and in part to the author's hope that the courts would reach this conclusion on their own. That is, that a reasoned analysis in the context of the proposed section would in proper situations, require this result.

Finally, what effect will the application of the section have on earnings and profits? Section 301x brings distributions made in redemption of stock in a purchase context within the general dividend section of the Code. The distribution would, therefore, come within the general rule of section 312, and earnings and profits would be reduced accordingly. Because the distribution is in the form of a payment for a redemption, this would not require any additional deduction from earnings and profits pursuant to section 312(e). This result is strengthened by the provision in section 316x(5), which provides that when a redemption is found to be within its confines, section 302 shall not be applicable. Thus, there would not be two deductions from earnings and profits since the distribution already was given dividend treatment.

Further, by bringing the distribution in payment of the stock within section 301, the basis of the remaining shareholder's stock would be reduced by any payments out of past rather than future earnings. This is in harmony with the concept of the proposal as the distribution out of past accumulations would be a partial liquidation of the remaining shareholder's investment. Any distribution not out of future earnings in excess of basis would be treated as gain from a sale or exchange of property.

149. Section 301.
150. Section 312(a).
151. There apparently would be no difficulty on the corporate level if the distribution was in kind. That is, whether the transaction was viewed as a redemption or a dividend, the corporation would not have to recognize gain or loss on the distribution. Section 311; Treas. Reg. § 1.311-1(a) (1955).
152. Section 301(c)(2).
153. Section 301(c)(3)(A).
C. The Accumulated Earnings Tax

The 1954 Code does provide another method of taxing the funds used to redeem the stock acquired in a purchase transaction. An accumulated earnings tax is imposed on a corporation "availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being . . . distributed." This provision, when applicable, would tax the accumulation of earnings used to purchase the redeemed stock at the corporate rather than the shareholder level. The treatment in individual cases of funds accumulated to redeem a selling shareholder's stock in a close corporation has not been clearly delineated. However, if the distribution of future earnings is attributed to the remaining shareholder in accordance with the proposed statutory section, there would be no basis for an application of the accumulated earnings tax to these funds as they could not be considered as having been used to avoid the tax to the shareholders on dividends.

IV. CONCLUSION

The tax incidents to the remaining shareholders in the examples set forth in the introduction to this article will be considered in reference to the proposed section and the present state of the law.

In the first example, the redemption of Gimmee's stock would be from earnings accumulated prior to the redemption. Thus, under the proposed section, Grab would have no dividend consequences upon payment for the stock. According to the present state of the law, again, Grab would have no dividend consequences.

155. Sections 531-37.
156. Section 531.
158. Herwitz, supra note 157. The author distinguishes between accumulations in anticipation of the redemption and accumulations subsequent to the redemption to pay the obligations incurred in making the redemption. His position is that the subsequent accumulations present a stronger case against finding the earnings accumulated for the proscribed purpose. Pursuant to the approach suggested in this article, the payment for the redemption from subsequently accumulated earnings would give rise to dividends to the remaining shareholders. However, the problems and considerations involved in each question are, to some extent, different. For the purpose of the accumulated earnings tax the corporation keeps its separate existence, i.e., the corporation is being availed of to avoid the surtax on shareholders. Whereas in the approach suggested in this article the corporation loses its independent status as the corporate veil is pierced. When this occurs there will be a distribution to the remaining shareholders. Thus, the shareholders will pay tax on the dividend income, but the corporation will not have to pay the penalty tax on improper accumulations.
159. See I(A) of this article's text supra.
160. See II(D) of this article's text supra.
In example two, in which Gimmee is paid for his stock in notes of the corporation, Grab would have dividend income in the years that payments were made on the notes to the extent of the income earned subsequent to the 1963, taxable year.\textsuperscript{161} Under present law it would appear that there would be no dividend income to Grab in this situation.\textsuperscript{162}

In the transaction in which Grab and Gimmee sell the corporation to Friendly, there would be dividend income to Friendly, to the extent of 45,000 dollars, assuming that there were sufficient earnings subsequent to 1963. Thus, in examples three and four, the remaining shareholder would have dividend income under the proposed section in the year in which payments were made on the notes whether or not the payments were to Grab and Gimmee or to independent creditors. Under the present state of the law the apparent result would be that Friendly would have no dividend income as a result of the transaction.\textsuperscript{163}

\textsuperscript{161} This assumes that the agreement to purchase and the redemption took place in 1963.
\textsuperscript{162} See II(D) of this article's text \textit{supra}; but see Robert Deutsch, 38 T.C. 118 (1962).
\textsuperscript{163} See II(C) of this article's text \textit{supra}. The Tax Court's recent decision in the Deutsch case throws some doubt on this. See discussion following note 70 in this article's text \textit{supra}. 