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## COMMENTS

# ATTRIBUTION RULES' EFFECT ON STOCK REDEMPTIONS WHEN FAMILY HOSTILITY EXISTS

by *Lawrence Stern*

**A** CORPORATE stock redemption is a taxable event to a shareholder.<sup>1</sup> The tax treatment of this event has long been a highly contested issue between the Internal Revenue Service and shareholders. Individual shareholders would prefer to have the redemption treated as a sale or exchange of property to take advantage of capital gain tax rates.<sup>2</sup> To qualify for this treatment, a shareholder must meet the requirements of Internal Revenue Code section 302(b).<sup>3</sup> If the redemption

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Editor's Note: Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended, which is codified in title 26 of the United States Code. Internal Revenue Code sections are cited to the 1982 permanent edition of the United States Code, if therein. Otherwise, code sections are cited to the main edition and/or current supplement of the United States Code Annotated, published by West Publishing Company. All Treasury Regulations are cited by section number and may be found in 26 C.F.R. (1983) unless otherwise indicated.

1. A stock redemption is defined as a corporation's acquisition of "its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b) (1982). Stock redemptions are taxable under I.R.C. §§ 301, 302 (1982).

2. Individuals may deduct 60% of the excess of their net long-term capital gain over their net short-term capital loss. *Id.* §§ 1202, 1222. As a result, only 40% of any proceeds qualifying for capital gain treatment is taxable, whereas ordinary income, including dividends, is fully taxable. *Id.* § 301(c).

3. *Id.* § 302 provides:

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock.*—

(A) *In general.*—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation.*—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

does not qualify for capital gain treatment, the proceeds will be considered a dividend distribution,<sup>4</sup> which is taxable at ordinary income rates.<sup>5</sup> Section 302(b) sets out three situations in which a stock redemption will be treated as a sale or exchange: first, when the redemption is not essentially equivalent to a dividend;<sup>6</sup> second, when the redemption is substantially disproportionate;<sup>7</sup> and third, when the redemption completely terminates a shareholder's interest in a corporation.<sup>8</sup>

A shareholder's stock ownership in a corporation must be determined to apply the three criteria of section 302(b) to a redemption situation. In determining a redeeming shareholder's stock ownership for purposes of that section, section 302(c) requires that the attribution rules in Code section 318(a)<sup>9</sup> be applied.<sup>10</sup> Only in limited cases may these attribution rules be

(C) *Definitions.*—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions.*—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) *Termination of shareholder's interest.*—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account.

4. A dividend distribution is defined as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits." *Id.* § 316(a).

5. *See id.* § 301(c)(1). Section 301(c)(1) provides that a distribution constituting a dividend is includable in gross income. The type of corporate distribution that is considered a dividend is determined under I.R.C. § 316(a) (1982).

6. *Id.* § 302(b)(1).

7. *Id.* § 302(b)(2).

8. *Id.* § 302(b)(3).

9. *Id.* § 318(a). The attribution rules are technical rules under which specific entity and individual corporate shareholders, as a result of their relationship with other shareholders, will be deemed to constructively own stock of the other shareholders. *Id.* The rationale behind the attribution rules is that certain relationships are likely to encompass a community of economic interest, in which individuals and entities will act to benefit the entire community. Therefore, when one community member reduces his interest in a corporation, this event will have little impact on corporate control if other community members retain an interest in the corporation. *See Reilly, An Approach to the Simplification and Standardization*

waived.<sup>11</sup>

One specific area of controversy in the redemption field is the impact that family hostility should have in alleviating the harsh results of applying attribution rules to stock redemptions. When more than one family member owns stock in a corporation and hostility exists between these members, a stock redemption is one method used to resolve the discord, since an unhappy family member can thereby terminate his interest in the corporation.<sup>12</sup> The Internal Revenue Service has taken the position that the constructive ownership rules of section 318 must be mechanically applied to a shareholder who has actually terminated his interest in the corporation.<sup>13</sup> The service asserts that particular facts and circumstances may not circumvent the application of the family attribution rules.<sup>14</sup> Judicial decisions, however, have tended to disregard the attribution rules when family discord has been present.<sup>15</sup>

Closely related to this family hostility issue is the question of whether the statutory waiver of the attribution rules under section 302(c)(2) may be extended to trusts and estates. A waiver can provide significant benefits to redeeming shareholders when family hostility exists. The Internal Revenue Service has maintained that an entity may not waive the application of section 318(a) to stock redemptions, contending that the privilege belongs exclusively to individuals.<sup>16</sup> Case law, however, has expanded the scope of the statutory waiver beyond individuals to trusts and estates.<sup>17</sup>

These divergent IRS and judicial positions regarding family hostility and an entity's ability to waive the attribution rules led to the litigation of these issues in a recent Fifth Circuit case, *Metzger Trust v. Commissioner*.<sup>18</sup> Disregarding the holdings reached in other courts,<sup>19</sup> the Fifth Circuit sup-

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of the Concepts of "The Family," "Related Parties," "Control," and "Attribution of Ownership," 15 TAX L. REV. 253, 255 (1960).

10. I.R.C. § 302(c)(1) (1982).

11. See *id.* § 302(c)(2)(A); *infra* text accompanying notes 41-47.

12. Other methods feuding family members might use to resolve their dispute is to have one member sell his stock directly to another member instead of to the corporation, or to have all family members terminate their interests in the corporation through a sale to an unrelated party. See Cohen, *Corporate Liquidations Under the Internal Revenue Code of 1954*, 55 COLUM. L. REV. 37 *passim* (1955).

13. Rev. Rul. 80-26, 1980-1 C.B. 67.

14. *Id.* at 66, 67.

15. See *Haft Trust v. Commissioner*, 510 F.2d 43, 46-48 (1st Cir. 1975); *Parker v. Commissioner*, 20 T.C.M. (CCH) 893, 900-01 (1961); *Estate of Squier v. Commissioner*, 35 T.C. 950, 955-56 (1961), *acq.* 1961-2 C.B. 5, *acq. withdrawn and nonacq. substituted* 1978-2 C.B. 5.

16. See Rev. Rul. 68-388, 1968-2 C.B. 122, 123; Rev. Rul. 59-233, 1959-2 C.B. 106, 107.

17. *Johnson Trust v. Commissioner*, 71 T.C. 941, 955 (1979) (scope of statutory waivers expanded to include trusts); *Crawford v. Commissioner*, 59 T.C. 830, 835-37 (1972), *nonacq.* 1974-2 C.B. 5 (scope of statutory waivers expanded to include estates). The passage of § 228 of the Tax Equity and Fiscal Responsibility Act of 1982 statutorily mandated this expanded scope. Tax Equity and Fiscal Responsibility Act of 1982 [hereinafter cited as TEFRA], Pub. L. No. 97-248, § 228, 96 Stat. 493, 515 (amending I.R.C. § 302(c)(2)(C)).

18. 693 F.2d 459 (5th Cir. 1982), *cert. denied*, 103 S. Ct. 3537, 77 L. Ed. 2d 1388 (1983).

19. See *Haft Trust v. Commissioner*, 510 F.2d 43, 46-48 (1st Cir. 1975); *Parker v. Commissioner*, 20 T.C.M. (CCH) 893, 900-01 (1961); *Estate of Squier v. Commissioner*, 35 T.C. 950, 955-56 (1961), *acq.* 1961-2 C.B. 5, *acq. withdrawn and nonacq. substituted* 1978-2 C.B. 5 (existence of family hostility allowed to mitigate application of attribution rules).

ported the IRS view that family hostility should not mitigate the application of attribution rules<sup>20</sup> and that a trust could not waive the attribution rules.<sup>21</sup> The court recognized, however, that its decision would not have a lasting effect on the law<sup>22</sup> because Congress had recently passed section 228 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which amended the scope of statutory waivers under section 302(c).<sup>23</sup> The amended section allows an entity to waive the family attribution rules, provided that all related persons can also be induced to waive the rules.<sup>24</sup>

This Comment will discuss the relevance of family hostility and an entity's ability to waive the attribution rules on the tax treatment afforded a shareholder involved in a stock redemption. First, the pertinent provisions of Code sections 302 and 318 are outlined and their legislative history examined. The recent case law relating to family hostility and entity waivers is then discussed. Finally, the effect of the TEFRA amendment to section 302(c) on the tax treatment of future stock redemptions is analyzed.

## I. STOCK REDEMPTIONS AND FAMILY ATTRIBUTION RULES IN GENERAL

### A. Code Provisions

Code sections 302 and 318 are crucial to the understanding of how family hostility and entity waiver of family attribution rules can affect a shareholder's tax treatment of a stock redemption. For a stock redemption to be treated as an exchange of property, under section 302(a), section 302(b) mandates that the transaction must be either not essentially equivalent to a dividend, a substantially disproportionate redemption, or a complete termination of the shareholder's interest.<sup>25</sup> If the redemption does not meet any of these tests, it is treated as a distribution of property to which section 301 applies.<sup>26</sup> Under section 301(c), a distribution from a corporation's

20. 693 F.2d at 465-68.

21. *Id.* at 470.

22. *Id.* at 468.

23. TEFRA, Pub. L. No. 97-248, § 228, 95 Stat. 493, 515 (amending I.R.C. § 302(c)(2)(C)). This amendment became effective as section 302(c)(2)(C) after August 31, 1982. *Id.* The *Metzger Trust* opinion was delivered on December 13, 1982. Although the court in *Metzger Trust* properly concluded that § 228 of TEFRA amended the scope of statutory waivers, the court was actually incorrect in assuming that its decision would not have a lasting effect on the law. The trust in *Metzger Trust* was not attempting to waive the family attribution rules, but rather the entity attribution rules. See H.R. REP. NO. 760, 97th Cong., 2d Sess. 545, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1391.

24. I.R.C. § 302(c)(2)(C) (1982) provides in part:

(C) Special Rule for Waivers by Entities.—

(i) In General.—Subparagraph (A) shall not apply to a distribution to any entity unless—

(I) such entity and each related person meet the requirements of clauses (i), (ii), and (iii) of subparagraph (A), and

(II) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

25. I.R.C. § 302(b)(1)-(3) (1982). For complete text of § 302, see *supra* note 3.

26. I.R.C. § 302(d) (1982).

earnings and profits is considered a dividend taxable at ordinary tax rates.<sup>27</sup> A distribution in excess of the dividend amount reduces a shareholder's basis in the stock,<sup>28</sup> and any amount in excess of the basis is treated as a gain from the exchange of property.<sup>29</sup>

The first test in section 302(b) provides that a redemption will be treated as an exchange if the redemption is not essentially equivalent to a dividend.<sup>30</sup> The Code itself does not clarify this criterion; the Treasury Regulations, however, do provide some guidance. The regulations state that whether a distribution in redemption of a shareholder's stock is essentially equivalent to a dividend depends on the facts and circumstances of each case.<sup>31</sup> One of the facts to be considered is the application of the constructive ownership rules under section 318(a) to the shareholder.<sup>32</sup> The indefiniteness of this first test under section 302(b) has made it the center of varying judicial interpretations and conflict. The presence of family hostility, one of the facts used to determine dividend equivalence, has in effect helped cause this judicial confusion.<sup>33</sup>

The second test in section 302(b) permits exchange treatment if the redemption results in a substantially disproportionate reduction of a shareholder's stock in a corporation.<sup>34</sup> A redemption qualifies under this test if: (1) the shareholder owns less than fifty percent of the total combined voting power of all classes of voting stock immediately after the redemption;<sup>35</sup> (2) the shareholder's percentage of voting stock owned after the redemption is less than eighty percent of the shareholder's percentage of voting stock owned before the redemption;<sup>36</sup> and (3) the shareholder's percentage of common stock, voting and nonvoting combined, owned after the redemption is less than eighty percent of the shareholder's percentage of common stock owned before the redemption.<sup>37</sup> This standard will not apply to any redemption that is part of a planned series of redemptions that fails to be substantially disproportionate to the shareholders when considered in the aggregate.<sup>38</sup>

The third test allows a redemption to be treated as an exchange if made in complete redemption of all of a shareholder's stock in the corporation.<sup>39</sup> A shareholder therefore must completely terminate his interest in a corporation to qualify for exchange treatment under this criterion. Although this standard does not seem to cover any situation not already covered by

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27. *Id.* § 301(c)(1).

28. *Id.* § 301(c)(2).

29. *Id.* § 301(c)(3).

30. *Id.* § 302(b)(1).

31. Treas. Reg. § 1.302-2(b) (1955).

32. *Id.*

33. See *infra* notes 97-138 and accompanying text.

34. I.R.C. § 302(b)(2) (1982).

35. *Id.* § 302(b)(2)(B).

36. *Id.* § 302(b)(2)(C).

37. *Id.* § 302(b)(2)(C) (last paragraph).

38. *Id.* § 302(b)(2)(D).

39. *Id.* § 302(b)(3).

the substantially disproportionate test, section 302(c) makes this criterion more useful when family members continue to own shares in a corporation after a complete redemption. Again, family hostility and an entity's ability to waive the family attribution rules have been controversial judicial considerations when this third test has been applied to stock redemptions.<sup>40</sup>

Section 302(c) requires that the constructive ownership rules of section 318(a) must be applied in determining a shareholder's stock ownership.<sup>41</sup> When determining whether a shareholder has completely terminated his interest, however, the family attribution rules in section 318(a)(1) will be waived if: (1) immediately after the distribution the distributee retains no interest in the corporation, except that of a creditor;<sup>42</sup> (2) the distributee acquires no interest within ten years of the redemption date unless by bequest or inheritance;<sup>43</sup> and (3) the distributee files an agreement with the IRS to notify it of any acquisition of a prohibited interest during a ten-year period after the redemption.<sup>44</sup> Even if a distributee meets the above three requirements, he will not be able to waive the attribution rules in section 318(a)(1) if: (1) any of the redeemed stock was acquired by the distributee within a ten-year period prior to the redemption from a person whose stock would be attributed to the distributee under the attribution rules;<sup>45</sup> or (2) any person within the scope of the attribution rules acquired stock from the distributee within a ten-year period prior to the redemption, unless that stock was redeemed in the same transaction.<sup>46</sup> These two conditions will apply only if one of the principal purposes of the transaction was the avoidance of federal income tax.<sup>47</sup>

The constructive ownership rules in section 318(a) can have a significant effect upon the tax treatment afforded a taxpayer in a stock redemption.<sup>48</sup> The relationships that require attribution are those that Congress viewed as likely to encompass a community of economic interest among the parties such that one party's stock reduction would not be a significant economic event if other community members continued to hold stock in the same corporation.<sup>49</sup> The types of attribution in section 318(a) can be di-

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40. See *Metzger Trust v. Commissioner*, 693 F.2d 459, 463-67 (5th Cir. 1982) (attribution rules must be mechanically applied even when family hostility exists), *cert. denied*, 103 S. Ct. 3537, 77 L. Ed. 2d 1388 (1983); *Johnson Trust v. Commissioner*, 71 T.C. 941, 955 (1979) (trusts may waive the family attribution rules under § 302(c)).

41. I.R.C. § 302(c)(1) (1982).

42. *Id.* § 302(c)(2)(A)(i).

43. *Id.* § 302(c)(2)(A)(ii).

44. *Id.* § 302(c)(2)(A)(iii).

45. *Id.* § 302(c)(2)(B)(i).

46. *Id.* § 302(c)(2)(B)(ii).

47. *Id.* § 302(c)(2)(B) (last paragraph).

48. For discussions of the attribution rules, see Goldstein, *Bringing the Attribution Rules into Sharper Focus; How and Where They Apply*, 26 J. TAX'N 280 (1967); Reilly, *supra* note 9; Ringel, Surrey & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209 (1958); Winston, *Attribution of Stock Ownership From Stock Options Under the Internal Revenue Code*, 44 U. CHI. L. REV. 482 (1977).

49. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 36, *reprinted in* 1954 U.S. CONG. & AD. NEWS 4025, 4061:

At the present time a possible opportunity for tax avoidance results where

vided into four categories. Stock can be attributed from one family member to another,<sup>50</sup> from entities to those who hold a beneficial interest in them,<sup>51</sup> to entities from those who hold a beneficial interest in them,<sup>52</sup> and to those who hold options to acquire stock.<sup>53</sup>

Under the family attribution rules an individual is considered to own stock that is owned directly or indirectly by his spouse, children, grandchildren, and parents.<sup>54</sup> Once stock is attributed from one family member to another, this stock may not be reattributed from the latter to other family members.<sup>55</sup> Only these family attribution rules may be waived in a complete stock redemption under section 302(b).<sup>56</sup>

Under section 318(a)(2), stock owned directly or indirectly by partnerships, estates, trusts, and corporations will be attributed to those who hold a beneficial interest in them.<sup>57</sup> Stock owned by a partnership or estate is attributed proportionately to the partners or estate beneficiaries.<sup>58</sup> Stock owned by a trust is attributed to its beneficiaries in proportion to their actuarial interest in the trust.<sup>59</sup> Finally stock owned by a corporation is attributed proportionately to stockholders owning at least fifty percent of the corporation's stock.<sup>60</sup> Likewise, under section 318(a)(3) stock owned directly or indirectly by individuals is attributed to the entities in which they hold a beneficial interest.<sup>61</sup> Stock owned by a partner, estate beneficiary, or shareholder owning at least fifty percent of a corporation's stock is fully attributed to the respective entity.<sup>62</sup> Stock owned by a trust benefi-

redemptions are effected in the case of family-owned corporations. To prevent tax avoidance, but at the same time to provide definite rules for the guidance of taxpayers, your committee has provided precise standards whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his immediate family (or by partnerships, corporations, or trusts which he controls).

. . . [T]he family attribution rules will be applied to insure a bona fide severance of a particular shareholder's interest in an enterprise. . . .

50. I.R.C. § 318(a)(1) (1982). These attribution rules are referred to as the family attribution rules. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 9.21, at 9-13 to -14 (4th ed. 1979).

51. I.R.C. § 318(a)(2) (1982).

52. *Id.* § 318(a)(3). The attribution rules in §§ 318(a)(2) and 318(a)(3) between entities and individuals are referred to as the entity attribution rules. See B. BITTKER & J. EUSTICE, *supra* note 50, ¶ 9.21, at 9-14 to -15.

53. I.R.C. § 318(a)(4) (1982).

54. *Id.* § 318(a)(1)(A). A spouse who is legally separated from the taxpayer under a divorce decree or separate maintenance decree will not be treated as a spouse for purposes of § 318(a)(1). *Id.* § 318(a)(1)(A)(i). Also, Congress apparently did not view siblings as belonging to the same community of economic interest, since they are not included in the definition of family members. See *id.* Stock will not be attributed directly from one brother or sister to another. McCaffrey, *Post-Mortem Section 302 Redemptions and the Attribution Rules*, 15 INST. ON EST. PLAN. ¶ 1204.2, at 12-11 (1981).

55. I.R.C. § 318(a)(5)(B) (1982).

56. See *supra* notes 41-47 and accompanying text.

57. I.R.C. § 318(a)(2) (1982).

58. *Id.* § 318(a)(2)(A)-(C).

59. *Id.* § 318(a)(2)(B)(i).

60. *Id.* § 318(a)(2)(C).

61. *Id.* § 318(a)(3).

62. *Id.* § 318(a)(3)(A)-(C).



ary is fully attributed to the trust, unless the beneficiary has only a remote, contingent interest in the trust.<sup>63</sup> As with the family attribution rules, once stock is attributed to one of the above entities, this stock may not be reattributed to another who holds a beneficial interest in the entity.<sup>64</sup>

Section 318(a)(4) provides that if an individual has an option to acquire stock, that stock should be attributed to that person.<sup>65</sup> In a situation in which both the option and family attribution rules can apply, the option attribution rule will take precedence.<sup>66</sup> Thus, contrary to the family attribution rules, optioned stock attributed to a family member may be reattributed to another member of the option holder's family.<sup>67</sup>

Although at first glance these attribution rules seem easy to apply, the notion of reattribution increases their complexity.<sup>68</sup> Reattribution often will not apply; however, stock attributed by an entity to one holding a beneficial interest in the entity may be reattributed from the beneficial interest holder to members of his family. Conversely, stock attributed from

63. *Id.* § 318(a)(3)(B)(i). This section provides that a contingent interest is considered remote if, in the trustee's discretion, the value of the interest, computed actuarially, is five percent or less of the value of the trust property. *Id.*

64. *Id.* § 318(a)(5)(C).

65. *Id.* § 318(a)(4).

66. *Id.* § 318(a)(5)(D).

67. *Id.* § 318(a)(5)(A).

68. The following examples illustrate the complexity involved in applying the attribution rules:

[(1)] X Corporation's 100 shares of stock are owned as follows: Twenty shares by A, B, and C, who are brothers, and forty shares by a trust, in which the interests of A, B, and C, computed actuarially, are 50 percent, 20 percent, and 30 percent, respectively. The trust is considered to own all of the stock in X, whereas A, B, and C, in addition to the 20 shares each owns directly, own 20, 8, and 12 shares constructively, respectively.

If C's interest in the trust were both "remote" (i.e., worth 5 percent or less) and contingent, his stock would not be attributed to the trust, but its stock would be attributed proportionately to him.

B. BITTKER & J. EUSTICE, *supra* note 50, ¶ 9.21, at 9-17.

Under section 318(a)(3)(B), all stock owned indirectly by a trust beneficiary will be attributed to the trust unless the value of the beneficiary's interest, actuarially computed, is worth 5% or less of the trust's property. Thus, in the above example all of the shares owned by A, B, and C must be attributed to the trust, creating the 100% ownership.

[(2)] X Corporation's 100 shares are owned 30 shares by W, 20 shares by S (the son of W), and 50 shares by E, an estate (W is the life beneficiary of the property being administered by the estate, and S the remainderman). E owns 100 shares of X, 30 of which are attributed from W, and 20 from S to W (by family attribution) and thence from W to E (by beneficiary to estate attribution). W also owns 100 shares of X (all of the estate's 50 shares, since W, rather than S, is considered as the sole beneficiary since she has the direct present interest in estate assets or income) and 20 from S by family attribution. S likewise owns 100 shares of X (30 from W, and 50 from E to W to S).

If S and W were unrelated, however, the estate would own only 80 shares of X (those owned directly, plus those attributed from W, S not being a beneficiary), as would W; S would own only 20 shares, the amount owned directly, since he is not a beneficiary of the estate in view of his "future" interest.

*Id.* ¶ 9.21, at 9-17 to -18.

The above example demonstrates the effect of reattribution in determining the stock ownership of both an individual and entity.

one family member to another may be reattributed to an entity.<sup>69</sup> As a result of these reattribution rules, a stock redemption might not qualify for exchange treatment under the strict tests of section 302(b).

The ramifications of an entity's ability to waive these attribution rules thus can be important. If a trust or estate is allowed to waive the family attribution rules under section 302(c)(2), a more beneficial tax treatment will be afforded a stock redemption.<sup>70</sup> If family hostility exists, it might be a fact or circumstance that allows a stock redemption to be treated as not essentially equivalent to a dividend, thus affording it exchange treatment.<sup>71</sup>

### B. Legislative History of Section 302

A review of the legislative history of section 302 is necessary to understand recent judicial decisions involving the tax treatment of stock redemptions. As evidenced by this legislative history, stock redemption complications are not new problems. Congress, in an attempt to prevent abusive distributions of corporate earnings, first established rules governing the tax treatment of stock redemptions in 1921.<sup>72</sup>

Congress enacted these rules in response to a 1920 Supreme Court case, *Eisner v. Macomber*.<sup>73</sup> Prior to this decision, shareholders were taxed immediately upon receipt of a stock dividend.<sup>74</sup> The Supreme Court concluded in *Eisner*, however, that the receipt of a stock dividend by a shareholder was not in itself a taxable event.<sup>75</sup> The court reasoned that a stock dividend neither took anything away from a corporation's property nor added to a shareholder's property.<sup>76</sup> The shareholders, therefore, had not received any taxable income within the meaning of the sixteenth amendment.<sup>77</sup> This holding made it possible for a corporation with accumulated earnings to issue a stock dividend to a shareholder and then redeem the shares for cash. The shareholder could thus avoid the ordinary tax rate treatment applicable to cash dividends and treat the transaction as a stock redemption that qualified for the capital gain tax rates.

Congress, recognizing this possibility of abuse, enacted section 201(d) of the Revenue Act of 1921, which provided that a stock redemption preceded by a stock dividend could be taxed as a dividend if the transaction

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69. I.R.C. § 318(a)(5)(A) (1982).

70. See *infra* notes 147-58 and accompanying text.

71. See Treas. Reg. § 1.302-2(b) (1955); *infra* notes 97-138 and accompanying text.

72. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 227 (amended 1924) (current version at I.R.C. §§ 302, 305 (1982)).

73. 252 U.S. 189 (1920).

74. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757 (repealed 1921) (current version at I.R.C. § 305 (1982)).

75. 252 U.S. at 211-12.

76. *Id.*

77. *Id.* at 212. The sixteenth amendment states that "[t]he Congress shall have power to lay and collect taxes on incomes, from whatever source derived." U.S. CONST. amend. XVI.

was essentially equivalent to the distribution of a taxable dividend.<sup>78</sup> Only redemptions that occurred after a stock dividend were subject to this dividend equivalence test under section 201(d). Shareholders could, therefore, first redeem shares for cash to be taxed at capital gain rates and then have the corporation issue a stock dividend equal to the number of shares redeemed. Through this reversal of the stock dividend and redemption, shareholders avoided the consequences of section 201(d). This abuse was corrected in 1924 when Congress enacted section 201(f) of the Revenue Act of 1924.<sup>79</sup> Section 201(f) provided that a stock redemption could be treated as a dividend regardless of whether the transaction occurred before or after a stock dividend.

Two years later Congress again amended this provision by including section 201(g).<sup>80</sup> Under this section the question of whether a stock redemption preceded or followed a stock dividend was irrelevant. Whenever a stock redemption occurred it was to be treated as a taxable dividend if the redemption was essentially equivalent to such a dividend.<sup>81</sup> This provision removed any possibility for manipulative timing of stock dividends and redemptions to obtain more favorable tax treatment.

Section 201(f) was ultimately reenacted as section 115(g) of the Internal Revenue Code of 1939.<sup>82</sup> Since no objective standards were presented in the Code to determine whether a redemption was essentially equivalent to a dividend under section 115(g), courts created their own vague standards. Each case involving the tax treatment of a stock redemption required a court to inquire into the characteristics of the distribution to determine

78. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 227 (amended 1924) (current version at I.R.C. §§ 302, 305 (1982)) stated:

A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation . . . .

79. Revenue Act of 1924, ch. 234, § 201(f), 43 Stat. 253 (amended 1926) (current version at I.R.C. §§ 302, 305 (1982)) stated:

A stock dividend shall not be subject to tax, but if *before or after* the distribution of any such dividend the corporation proceeds to cancel or redeem 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 taxable dividend.

(Emphasis added.)

80. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11 (current version at I.R.C. § 302 (1982)).

81. *Id.*

82. Internal Revenue Code of 1939, ch. 1, § 115(g), 53 Stat. 48 (current version at I.R.C. § 302 (1982)) provided:

If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) 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 in redemption or cancellation of the stock . . . shall be treated as a taxable dividend.

whether it more closely approximated a dividend or an exchange of stock.<sup>83</sup> The characteristics upon which the courts based their decisions included: (1) whether a sufficient surplus had accumulated to fund a distribution;<sup>84</sup> (2) whether the redemption was made for a legitimate business purpose;<sup>85</sup> (3) whether the corporation had routinely paid dividends;<sup>86</sup> (4) whether the corporation or the shareholders initiated the redemption;<sup>87</sup> (5) whether the redemption was a pro rata distribution;<sup>88</sup> and (6) whether the redemption materially altered the corporate ownership.<sup>89</sup> Because courts considered so many different characteristics to be significant in determining the tax treatment of stock redemptions, divergent case law developed and section 115(g) could not be relied on in shareholder tax planning.

This situation provided the background for the congressional enactment of section 302 of the Internal Revenue Code of 1954. To eliminate the discord caused by prior statutes, the House of Representatives proposed two objective standards under which stock redemptions would be taxed at capital gain rates.<sup>90</sup> The House expressly noted that its rationale for this new approach was to eliminate the factual inquiry needed in every stock

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83. See, e.g., *Flanagan v. Helvering*, 116 F.2d 937, 939 (D.C. Cir. 1940); *McGuire v. Commissioner*, 84 F.2d 431, 432-33 (7th Cir.), cert. denied, 299 U.S. 591 (1936).

84. *Hirsch v. Commissioner*, 124 F.2d 24, 29 (9th Cir. 1941); *Flanagan v. Helvering*, 116 F.2d 937, 940 (D.C. Cir. 1940); *Brown v. Commissioner*, 79 F.2d 73, 75 (3d Cir. 1935); *Hill v. Commissioner*, 66 F.2d 45, 47 (4th Cir. 1933).

85. *Commissioner v. Quackenbos*, 78 F.2d 156, 158 (2d Cir. 1935); *Commissioner v. Champion*, 78 F.2d 513, 514-15 (6th Cir. 1935); *Commissioner v. Babson*, 70 F.2d 304, 305-07 (7th Cir.), cert. denied, 293 U.S. 571 (1934); *L.M. Lockhart*, 8 T.C. 436, 440-42 (1947); *Samuel A. Upham*, 4 T.C. 1120, 1127-28 (1945); *H.F. Asmussen*, 36 B.T.A. 878, 883-84 (1937); *Alfred E. Fuhlage*, 32 B.T.A. 222, 227-29 (1935); see also *Bittker & Redlich, Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 468 (1950) (existence of legitimate business purpose termed the most important standard used by the courts to determine dividend equivalence under § 115(g) of the 1939 Code).

86. Some courts have concluded that where a corporation with a poor dividend history suddenly redeems stock, this transaction in reality is a concealed dividend. *Goldstein v. Commissioner*, 113 F.2d 363, 364 (7th Cir. 1940); *E.M. Peet*, 43 B.T.A. 852, 858-59 (1941); *J. Natwick*, 36 B.T.A. 866, 875-77 (1937). *Contra Joseph W. Imler*, 11 T.C. 836, 840-41 (1948).

87. *Flanagan v. Helvering*, 116 F.2d 937, 939 (D.C. Cir. 1940); *Robinson v. Commissioner*, 69 F.2d 972, 973 (5th Cir. 1934); *R.W. Creech*, 46 B.T.A. 93, 103 (1942).

88. *Flanagan v. Helvering*, 116 F.2d 937, 939 (D.C. Cir. 1940); *Bona Allen, Jr.*, 41 B.T.A. 206, 210-11 (1940).

89. *Hirsch v. Commissioner*, 124 F.2d 24, 29 (9th Cir. 1941); *Flanagan v. Helvering*, 116 F.2d 937, 939 (D.C. Cir. 1940); *J. Natwick*, 36 B.T.A. 866, 876 (1937).

90. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 35-36, reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4025, 4060-61 states:

In general, because of the considerable confusion which exists in this area, taxpayers have been faced with potential dividend-tax liability in many cases where such result is unwarranted, and in other cases have avoided such liability where the redemption was the equivalent of a dividend.

Your committee's bill sets forth definite conditions under which stock may be redeemed at capital-gain rates. . . . [Y]our committee has defined when a substantially disproportionate redemption of a shareholder's stock will qualify so as not to be taxable as a dividend; namely, that a particular shareholder's holdings of participating stock after the distribution be less than 80 percent of his holdings before the distribution.

A distribution in complete redemption of a shareholder's stock will also result in a capital gain.

redemption case to determine if the redemption was not essentially equivalent to a dividend under section 115(g).<sup>91</sup> These House proposals became the current substantially disproportionate test under section 302(b)(2) and the complete termination test under section 302(b)(3). The House also noted the opportunity for tax avoidance in redemptions involving family owned corporations. To prevent this possible abuse and to provide guidance in tax planning, the House version of section 302 provided that the attribution rules should be applied when determining the tax treatment afforded stock redemptions.<sup>92</sup>

The Senate left the section 302 provisions adopted by the House intact, but reenacted the language of section 115(g) that allowed exchange treatment for stock redemptions not essentially equivalent to a dividend. The purpose of this reinstatement was to ameliorate the restrictiveness of the House's definite criteria, which could create inequities.<sup>93</sup> The Senate also indicated that a factual inquiry like that employed under section 115(g) was still to be applied under the standard that is currently section 302(b)(1).<sup>94</sup> The House proposals along with the Senate amendment became section 302 of the Internal Revenue Code of 1954. This section, which was to have added certainty to the tax laws and eliminated confusion among courts and taxpayers, only created additional controversy.

## II. FAMILY HOSTILITY AND SECTION 302

### A. Early Judicial Developments

Code sections 302 and 318 provide no guidelines for determining what effect the presence of family hostility should have on the tax treatment of stock redemptions. Section 302(c) requires that the attribution rules must

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91. *Id.* at A72-73, reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4025, 4210.

92. *See supra* note 49 and accompanying text.

93. S. REP. NO. 1622, 83d Cong., 2d Sess. 44, reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4629, 4675 states:

While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend.

94. *Id.* at 233-34, reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4629, 4870 states:

In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry.

. . . In general, under this subsection your committee intends to incorporate into the bill existing law as to whether or not a redemption is essentially equivalent to a dividend under section 115(g)(1) of the 1939 Code. . . .

. . . The test intended to be incorporated in the interpretation of [section 302(b)(1)] is in general that currently employed under section 115(g)(1) of the 1939 Code.

be applied to all stock redemptions.<sup>95</sup> On the other hand, though, the determination of whether a stock redemption is not essentially equivalent to a dividend under section 302(b)(1) requires that a factual inquiry be employed.<sup>96</sup> The application of the attribution rules to stock redemptions when family hostility exists has been addressed in several recent judicial decisions.

This controversy was first recognized in a 1961 Tax Court case, *Estate of Squier v. Commissioner*.<sup>97</sup> The decedent, Squier, directly owned 50.09% of the stock of Squier, Schilling, and Skiff, Inc., and had an additional 13.21% through attribution from his wife and grandchild. After Squier's death, friction developed between the chief trust officer of the bank handling his estate and family members.<sup>98</sup> Squier's executor elected to exercise an option to redeem a portion of Squier's stock. After the redemption the estate owned 41.27% of the corporation's stock directly and 15.55% through attribution from the hostile family members who were the estate's beneficiaries. The executor claimed that the redemption was not essentially equivalent to a dividend and should qualify for capital gain treatment. The IRS argued that the distribution should be taxed as a dividend.

In its holding the tax court first recognized that hostility existed between the executor and the family members who owned the corporation's stock.<sup>99</sup> Thus, despite the attribution rules, the redemption did actually result in a reduction of the estate's control over the corporation. Taking these facts into account, the court concluded that even after applying the attribution rules, the redemption was not essentially equivalent to a dividend.<sup>100</sup>

Later in the same year that *Squier* was decided, the Tax Court decided *Parker v. Commissioner*,<sup>101</sup> another case involving the family hostility issue. In *Parker* differences of opinion arose between a father and his son concerning the corporation in which they were majority shareholders. The father owned 49.7% of the corporation's stock and the son owned 47.4%. As a result of their differences, the father agreed to redeem a portion of his shares so that his son could obtain control of the corporation. Although the father treated this redemption as an exchange under section 302(b)(1), the IRS disagreed, contending that the attribution rules required the redemption to be taxed as a dividend. The Tax Court noted, as it had in *Squier*, that substantial controversy regarding the company's operation ex-

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95. I.R.C. § 302(c)(1) (1982).

96. See Treas. Reg. § 1.302-2(b) (1960); S. REP. NO. 1622, 83d Cong., 2d Sess. 233-34, reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4629, 4870.

97. 35 T.C. 950 (1961), *acq.* 1961-2 C.B. 5, *acq. withdrawn and nonacq. substituted* 1978-2 C.B. 4, 5.

98. The trust officer was elected to serve in Squier's place on the corporation's board of directors. Later Squier's widow demanded that this officer, acting as the estate's executor with a majority interest in the corporation, name her son-in-law as the new corporation president. The bank officer refused to accede to this demand.

99. 35 T.C. at 955-56.

100. *Id.* at 956.

101. 20 T.C.M. (CCH) 893 (1961).

isted between Parker and his son prior to the redemption.<sup>102</sup> The result of the redemption, then, was to transfer effective control of the corporation from one family member to another.<sup>103</sup> After reviewing all the facts, including the family relationship involved and the history of continuing disagreement, the court ruled that the redemption should be afforded capital gain treatment.<sup>104</sup> The IRS acquiesced in the Tax Court's position in *Squier*,<sup>105</sup> and the issue of how the presence of family hostility should affect stock redemptions appeared to be decided.

The family hostility issue arose again in the 1970 Supreme Court decision in *United States v. Davis*.<sup>106</sup> Although family discord was not actually present in *Davis*, the decision had important implications for determining whether a redemption was not essentially equivalent to a dividend. In 1945 Davis and an unrelated person formed a corporation in which he and his wife each owned twenty-five percent of the common stock. Subsequently, Davis contributed an additional \$25,000 to the corporation in return for 1000 shares of preferred stock. The purpose of this transaction was to increase the company's working capital to enable the company to qualify for a loan. The corporation was to redeem the preferred stock when the loan was repaid. Meanwhile, Davis purchased all of the unrelated stockholder's shares and divided them between his son and daughter. In 1963 the loan was fully repaid, and the company redeemed the preferred stock for \$25,000. Davis treated the redemption as a capital gain transaction for which he recognized no income in his 1963 tax return. The IRS, however, contended that the redemption was essentially equivalent to a dividend and, thus, taxable as ordinary income.

Davis first argued that the attribution rules in section 318(a) did not apply when considering whether a redemption is essentially equivalent to a dividend. The Court concluded, however, that the plain language in section 302(c) indicated that the attribution rules were applicable in determining stock ownership for purposes of that section.<sup>107</sup> In support of its position, the Court noted that courts of appeals' decisions,<sup>108</sup> Treasury Regulations,<sup>109</sup> opinions of leading commentators,<sup>110</sup> and the legislative history of section 302 all concurred with this view.<sup>111</sup>

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102. *Id.* at 900.

103. *Id.* at 899-900.

104. *Id.* at 901.

105. 1961-2 C.B. 5. IRS policy is to announce in the Internal Revenue Bulletin whether the Commissioner will acquiesce or not acquiesce in a Tax Court decision that disallows a tax deficiency determined to be due by the IRS. An acquiescence in a decision means that the IRS accepts the conclusion reached, but does not necessarily approve of the reasons given by the court for its conclusion. 1982-2 C.B. 1.

106. 397 U.S. 301 (1970).

107. *Id.* at 306-07.

108. *Id.* at 306 (citing *Levin v. Commissioner*, 385 F.2d 521, 526-27 (2d Cir. 1967); *Commissioner v. Berenbaum*, 369 F.2d 337, 342 (10th Cir. 1966); *Ballenger v. United States*, 301 F.2d 192, 199 (4th Cir. 1962); *Bradbury v. Commissioner*, 298 F.2d 111, 116-17 (1st Cir. 1962)).

109. 397 U.S. at 306 (citing *Treas. Reg. 1.302-2(b)* (1960)).

110. 397 U.S. at 306 (citing *B. BITTKER & J. EUSTICE*, *supra* note 50, at 292 n.32).

111. 397 U.S. at 306-07.

Davis further argued that even if the attribution rules were applicable to redemptions under section 302(b)(1), this redemption was still not essentially equivalent to a dividend. The Court again rejected Davis's argument, holding that the motivation for the redemption should be disregarded when applying the dividend equivalency test.<sup>112</sup> The Court concluded that for a redemption to qualify for exchange treatment under section 302(b)(1), it must represent "a meaningful reduction of a shareholder's proportionate interest in the corporation."<sup>113</sup> The effect of the *Davis* holding on the family hostility issue was unclear from the outset. Although the Court clearly stated that the attribution rules must be applied in all stock redemptions, the Court failed to address the question of how to determine a meaningful reduction of a shareholder's interest after application of the attribution rules.

### B. *Aftermath of United States v. Davis*

Subsequent to the *Davis* decision, the IRS developed a new administrative stance toward stock redemptions and family hostility, evidenced by both its withdrawal of the earlier acquiescence to the *Squier* decision and its replacement with a nonacquiescence.<sup>114</sup> The IRS finally instituted a rigid, mechanical approach towards the application of family attribution rules to stock redemptions.<sup>115</sup> The courts, on the other hand, did not directly address the family hostility issue immediately following *Davis*. Support for the position that the existence of family hostility still did mitigate the effect of the attribution rules on stock redemptions, however, appeared in *Title Insurance & Trust Co. v. United States*.<sup>116</sup> In that case the court noted that the assumption of family unity integral to the attribution rules may "prove awkward or unfair in cases where families do not behave as the rules assume they will, and inter-family disputes exist as to who should control and how."<sup>117</sup> Family hostility was not present in this case, however, so the statement was a mere dictum.

The first chance after *Davis* for a definite holding by the courts on the family hostility argument came in a First Circuit case, *Haft Trust v. Commissioner*.<sup>118</sup> The case involved four trusts created by a grandfather for

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112. *Id.* at 312-13.

113. *Id.* at 313.

114. 1978-2 C.B. 4, 5.

115. *See* Rev. Rul. 80-26, 1980-1 C.B. 66.

116. 484 F.2d 462 (9th Cir. 1973); *see also* B. BITTKER & J. EUSTICE, *supra* note 50, ¶ 9.24, at 9-33 n.73 ("The *Davis* decision . . . weakens, but does not eliminate, the 'family fight' argument in mitigation of § 318 attribution under § 302(b)(1) . . ."); Boyd & Boyd, *Family Discord May Negate Attribution Rules and Allow Capital Gain Treatment of a Redemption*, 15 TAX'N FOR ACCT. 362, 364 (1975) (a meaningful reduction of interest occurs when a substantial family controversy eliminates control that redeeming shareholders have over other family shareholders); Comment, *Defining Dividend Equivalency under Section 302(b)(1)*, 16 VILL. L. REV. 88, 104 (1970) (circumstances surrounding redemption should be examined to determine whether family relationship has deteriorated such that attribution is a fiction, thereby creating meaningful reduction of shareholder's interest.).

117. 484 F.2d at 465 n.4.

118. 510 F.2d 43 (1st Cir. 1975).



each of his four grandchildren. The grandfather transferred into each of the trusts 25,000 shares of Haft-Gaines Corporation stock. After a bitter divorce the parents decided to terminate the trusts' financial involvement in the corporation and the trusts' stockholdings were redeemed by the corporation. After applying the attribution rules, each trust owned thirty-one and two-thirds percent of the corporation's stock prior to the redemption and thirty-three and one-third percent after the redemption.<sup>119</sup> This unique situation indicated no significant shift in control of the corporation, although the trusts no longer actually owned any stock. In their 1967 federal income tax returns, the trusts treated the proceeds from the stock redemption as a long-term capital gain. If the attribution rules were mechanically applied, however, as the IRS argued, the redemption would be considered essentially equivalent to a dividend and taxable as ordinary income. The issue before the court was thus whether, after *United States v. Davis*, the presence of family hostility mitigated the application of the constructive ownership rules of Code section 318 in determining dividend equivalence under section 302(b)(1).<sup>120</sup>

Relying on the statement in *Davis* that section 302(b)(1) requires a meaningful reduction of the shareholder's proportionate interest in the corporation,<sup>121</sup> the court held that the language permitted, if not mandated, an examination of the facts and circumstances of a stock redemption, rather than a mechanical application of the attribution rules.<sup>122</sup> In a futile attempt to support its purely objective test, however, the IRS argued that a judicial inquiry into the presence of family hostility would lead to a legal quagmire.<sup>123</sup> The court responded that in retaining section 302(b)(1) in the Code, Congress was willing to tolerate some administrative inconvenience for the sake of equity.<sup>124</sup> The court concluded, therefore, that the effect of family attribution rules could be mitigated in determining dividend equivalence, depending on the facts and circumstances of a stock redemption.<sup>125</sup> The case was then remanded to the Tax Court for a consideration of the effects of family hostility in negating the presumption that the trusts would continue to exert control over the corporation.<sup>126</sup> Before the Tax Court could receive the case, however, it was settled out of court. As a result, *Haft Trust* could not be relied on as a clear precedent that the attribution rules should be mitigated by family hostility.<sup>127</sup>

Despite the *Haft Trust* decision, the IRS issued Revenue Ruling 80-26,<sup>128</sup> which directly conflicted with the holding. On facts identical to

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119. See *id.* at 46 n.2 for explanation of this result.

120. *Id.* at 44-45.

121. *Davis*, 397 U.S. at 313.

122. 510 F.2d at 48.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. See Englebrecht & DeCelles, *Family Discord and Section 302 Stock Redemptions: A Review and Analysis*, 58 TAXES 43, 49 (1980).

128. Rev. Rul. 80-26, 1980-1 C.B. 66.

those in *Haft Trust* the IRS held that the facts and circumstances of a particular stock redemption could not contradict the mechanical application of the attribution rules in determining the amount of stock that a shareholder owned.<sup>129</sup> This series of holdings thus set the stage for a definite decision on the family hostility issue, and the recent Fifth Circuit case *Metzger Trust v. Commissioner*<sup>130</sup> provided the opportunity.

In *Metzger Trust* David Metzger created a trust with his wife as a life beneficiary and his three children, Jacob, Catherine, and Cecelia, as holders of one-third remainder interests. Four years later David incorporated the family business as Metzger Dairies, Inc., and the trust became a shareholder. When David died in 1953, Jacob assumed control of the corporation, and his two sisters became corporate directors. During the 1960s corporate earnings declined and dividends were not distributed. As a result, quarreling among the siblings escalated into open animosity. Disagreements arose over the management of the corporation and other issues unrelated to business. This hostility continued to a point of such discord that finally in 1972 Jacob, Catherine, and Cecelia concluded that their joint ownership in the corporation must terminate. The siblings decided that the corporation would redeem the stock directly owned by Catherine and Cecelia and the stock owned by the trust in which they held a beneficial interest. Prior to the redemption, the trust, after applying the attribution rules, owned 100% of the corporation's stock. After the redemption, the trust still constructively owned 100% of the stock, although Catherine and Cecelia no longer had any ownership interest in the corporation.

The trust treated the proceeds from the stock redemption as a capital gain on its 1973 tax return, and the IRS assessed a deficiency, claiming that the proceeds were essentially equivalent to a dividend and taxable at ordinary income rates. The issues before the court included the question of whether the section 318 attribution rules must be applied when family discord is present in determining whether a redemption is not essentially equivalent to a dividend.<sup>131</sup> In response to the trust's first argument that the attribution rules were inapplicable since the family could not function as an economic unit, the court held that in view of the *Davis* decision the attribution rules may not be treated as a rebuttable presumption, but must be applied in all stock redemptions when determining dividend equivalence.<sup>132</sup> Relying on *Haft Trust*, the trust next argued that although 100% stock ownership was attributed to it before and after the redemption, the redemption was still not essentially equivalent to a dividend because of the

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129. *Id.* at 67. The IRS concluded that it would not follow the First Circuit's decision in *Haft Trust*. *Id.*

130. 693 F.2d 459 (5th Cir. 1982), *cert. denied*, 103 S. Ct. 3537, 77 L. Ed. 2d 1388 (1983).

131. 693 F.2d at 460. Other issues before the court were whether a trust may waive the attribution rules by filing a waiver agreement and whether the § 267(c) attribution rules must be applied to interest payments between hostile family members. *Id.* The latter issue was before the court because of an appeal by the corporation and is unrelated to the family hostility issues discussed in this Comment.

132. *Id.* at 463-64.

family hostility present.<sup>133</sup> The court stated that even though some commentators and courts indicated that *Davis* did not foreclose arguments for capital gain treatment based on family hostility,<sup>134</sup> their interpretations were not persuasive.<sup>135</sup> Convinced by the *Davis* court's observation that Congress designed the attribution rules to provide a clear answer to what would otherwise be a difficult tax question, the court concluded that the attribution rules could not be mitigated.<sup>136</sup> Thus, family discord should not be taken into account, but rather an inquiry into only the structure of the stockholdings should be made to determine whether a meaningful reduction has occurred in the shareholder's proportionate interest.<sup>137</sup> If after applying the attribution rules the resulting corporate structure has virtually the same incidents of ownership as before the redemption, the redemption proceeds must be essentially equivalent to a dividend.<sup>138</sup>

The *Metzger Trust* decision represents an abrupt shift in the judicial interpretation of the family hostility issue. Even though *Davis* may have weakened previous court decisions, no court before *Metzger* had specifically held that the presence of family hostility would not mitigate the application of the attribution rules in stock redemptions. Unfortunately the only conclusion that can be drawn from these conflicting judicial opinions is that the confusion surrounding the dividend equivalence test under section 302(b)(1) has yet to be eliminated. Instead, further judicial inquiry into the family hostility issue and the effect of the *Davis* decision is necessary.

### III. ENTITY WAIVER OF FAMILY ATTRIBUTION RULES

#### A. Extension of Waiver Beyond Individuals

Closely related to the family hostility issue is the question of whether the statutory waiver of the attribution rules under section 302(c)(2) may be extended to trusts and estates. As is evident by the foregoing discussion of the family hostility issue, a judicial controversy has arisen only when the IRS questioned the tax treatment afforded a stock redemption by an estate or trust. If the requirements for a waiver under section 302(c)(2) can be met, a family dispute could be settled through a stock redemption that terminates the shareholder's interest in the corporation. The shareholder need not qualify for exchange treatment under the dividend equivalence test of section 302(b)(1). Instead, under section 302(b)(3) the proceeds would be taxed at capital gain rates.<sup>139</sup> When the redeeming shareholder

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133. *Id.* at 463.

134. *Id.* at 465-66 (citing *Robin Haft Trust v. Commissioner*, 510 F.2d 43, 48 (1st Cir. 1975); B. BITTKER & J. EUSTICE, *supra* note 50, ¶ 9.24, at n.73; O'Dell & Boyd, *Family Hostility and Stock Redemptions: Revenue Ruling 80-26 Revives the Controversy*, 59 TAXES 153, 156-60 (1981)).

135. 693 F.2d at 466.

136. *Id.*

137. *Id.* at 467-68.

138. *Id.*

139. See *supra* notes 39 & 40 and accompanying text.

is an individual, this settlement creates no tax problems. When the redeeming shareholder is a trust or estate, however, the tax treatment afforded the redemption is a subject of controversy.

The IRS has continually maintained that section 302(c)(2) applies only to redemptions from individuals. Revenue Ruling 59-233 presented the IRS's initial attack on an entity's right to avail itself of the statutory waiver.<sup>140</sup> This ruling involved a corporation owned jointly by an individual and a trust created for the benefit of the individual's children. The trust redeemed its stock and attempted to qualify for exchange treatment under section 302(b)(3) by filing the statutory waiver under section 302(c)(2).<sup>141</sup> The purpose of the filing was to waive the family attribution from the father to his children.<sup>142</sup> If this waiver was deemed ineffective, the shares attributed to the children could be reattributed to the trust under section 318(a)(2),<sup>143</sup> rendering section 302(b)(3) inapplicable. The IRS denied the trust this privilege, noting that the legislative history of section 302(c)(2) clearly limited the waiver of family attribution rules to a distributee who would be considered to own stock subsequent to the redemption only by application of section 318(a)(1).<sup>144</sup> Since section 318(a)(1) covers only family members, the IRS concluded, a trust was ineligible to file the statutory waiver.<sup>145</sup> The IRS reiterated this conclusion and extended it to estates in Revenue Ruling 68-388.<sup>146</sup>

In 1973 the Tax Court in *Crawford v. Commissioner*<sup>147</sup> rejected the IRS's position that a "distributee" under section 302(c)(2) meant only an individual and not an entity. The corporation in *Crawford* was owned by an estate, the decedent's wife, who was also the estate's sole beneficiary, and her two sons. The estate and Mrs. Crawford, pursuant to a stock purchase agreement, concurrently redeemed all of their stock and filed waiver agreements. The IRS maintained, as in their prior revenue rulings, that subsequent to the redemption the estate still constructively owned 100% of the stock and, not being an individual, could not waive the family attribution

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140. Rev. Rul. 59-233, 1959-2 C.B. 106.

141. *Id.* at 106.

142. *See supra* notes 54 & 55 and accompanying text. Section 302(c)(2) allows only the distributee to file a waiver of the family attribution rules. Thus, since the trust alone was a distributee in the redemption, only the trust, and not its beneficiaries, could even attempt to qualify for the statutory waiver. *See* I.R.C. § 302(c)(2) (1982).

143. *See supra* note 69 and accompanying text.

144. Rev. Rul. 59-233, 1959-2 C.B. at 107.

145. *Id.*

146. Rev. Rul. 68-388, 1968-2 C.B. 122. This ruling involved a corporation owned jointly by an individual and an estate whose sole beneficiary was the individual's mother. To avoid the problem encountered in Revenue Ruling 59-233, the estate proposed first to transfer its stock to the mother, who would then pay for the stock with the proceeds from a simultaneous redemption by the corporation. The IRS labeled this proposal as transitory and without economic substance, saying that in reality the corporation would be redeeming stock from the estate. *Id.* at 122. Thus a waiver filed by the mother would be ineffective, because Revenue Ruling 59-233 had established that only a distributee who was an individual could file a waiver.

147. 59 T.C. 830, 834 (1973), *nonacq.* 1974-2 C.B. 5.

rules. The proceeds received by the estate would, therefore, be taxed as a dividend.

The court, however, disagreed with the IRS, noting that in drafting section 302(c)(2), Congress scrupulously avoided the use of terms referring specifically to a person.<sup>148</sup> The court concluded that Congress's choice of the word "distributee" throughout section 302(c)(2) was not inadvertent, but rather was intended to avoid limitation of the statutory waiver to individuals.<sup>149</sup> In response to this conclusion, the IRS contended that permitting an estate to avail itself of the waiver provision would lead to abuses, because the waiver filed by an estate would not prevent the beneficiaries from acquiring an interest in the distributing corporation within ten years after the redemption. The court conceded that this potential for abuse did exist, but stated that the remedy proposed by the IRS would lead to a nonsensical result.<sup>150</sup> This concession by the court was actually unnecessary. Under section 318(a)(3)(A), a reacquisition by an estate beneficiary would constitute a prohibited reacquisition by the estate, and the beneficiary would, in effect, be bound by the terms of the estate's waiver.<sup>151</sup> This principle was approved by the IRS in Revenue Ruling 71-562.<sup>152</sup>

The *Crawford* rationale was extended to trusts in a subsequent Tax Court case, *Rodgers P. Johnson Trust*.<sup>153</sup> In *Johnson Trust* a decedent's trust owned approximately five percent of a corporation's stock. The decedent's son, who had a 96.14% actuarial interest in the trust, owned no stock. His mother owned approximately forty percent of the corporation's stock, but her actuarial interest in the trust was not sufficient under section 318(a)(3)(B)(i) to directly attribute her stock to the trust.<sup>154</sup> The mother's shares were attributed through her son to the trust, and the trust redeemed its stock and filed the statutory waiver of the family attribution rules under section 302(c)(2). The case centered on whether the trust was eligible to file a waiver that cut out the attribution between the mother and son.<sup>155</sup> In addition to concluding that Congress did not intend waivers to be filed only by family members,<sup>156</sup> the court explained that adverse consequences could result from a restrictive interpretation of the term "distributee" when a trust held non-income-producing, closely held stock that the trustee wished to replace with income-producing assets.<sup>157</sup> Unless the attribution rules could be waived to allow a redemption in which the proceeds could be used to acquire productive assets, the court concluded, the trustee might

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148. 59 T.C. at 834.

149. *Id.* at 836.

150. *Id.*

151. McCaffrey, *supra* note 54, ¶ 1206.3, at 12-34.

152. *See* Rev. Rul. 71-562, 1971-2 C.B. 173.

153. 71 T.C. 941 (1979).

154. *See supra* note 63.

155. 71 T.C. at 948.

156. *Id.* at 950-51. The court focused again on Congress's use of "distributee," rather than "person," in the statute. *See* I.R.C. § 302(c)(2) (1982).

157. 71 T.C. at 954.

have to retain the nonproductive stock.<sup>158</sup>

*B. Extension of Waiver Beyond Family Attribution Rules*

A 1979 Fifth Circuit case, *Rickey v. United States*,<sup>159</sup> extended the Tax Court's holdings in *Crawford* and *Johnson Trust*. In *Rickey* an estate owned approximately fifty-seven percent of the corporation's stock prior to the redemption. The decedent's three children, who were the estate's only beneficiaries, owned approximately thirty-four percent of the corporation's stock. Under the terms of the decedent's will all of the estate's stock was required to be redeemed by the corporation, pursuant to a purchase agreement. In an attempt to qualify for exchange treatment under section 302(b)(3), the estate filed a waiver agreement.

The situation in *Rickey* was unlike that in both *Crawford* and *Johnson Trust*. In the latter cases the purpose of filing was to avoid the family attribution rules. The specific terms of section 302(c)(2) allow a distributee to waive these rules only as outlined in section 318(a)(1). In *Rickey*, however, the estate filed the waiver to avoid the entity attribution rules under section 318(a)(3).<sup>160</sup> In *Crawford* and *Johnson Trust* neither the entities nor their beneficiaries still directly owned stock in the corporation after the redemption, but in *Rickey* the estate beneficiaries still owned a thirty-four percent interest in the corporation.

While acknowledging this situation, the court rejected a "slavish" interpretation of the Code in order to obtain results more in line with the congressional intent in enacting the attribution and waiver sections of the Code.<sup>161</sup> The court stated that the Code should not be given a "crabbed reading" when, because the rationale behind a section is absent, applying the section leads to unnecessarily harsh results.<sup>162</sup> Instead, the court was convinced that Congress intended enforcement of the Code to be accompanied by common sense and basic principles of fairness.<sup>163</sup> Thus the court concluded that an estate could waive the entity attribution rules of section 318(a)(3) to qualify for exchange treatment under section 302(b)(3).<sup>164</sup>

The *Rickey* decision has received much criticism,<sup>165</sup> primarily because

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158. *Id.*

159. 592 F.2d 1251 (5th Cir. 1979).

160. *Id.* at 1258.

161. *Id.* at 1257-58.

162. *Id.* at 1258.

163. *Id.*

164. *Id.*

165. See, e.g., Karzon, *No Smooth Sailing for Fiduciaries Waiving Attribution in Stock Redemptions*, 59 TAXES 3, 6 (1981); Phillips & Kelly, *Waiver of Attribution Rules in Internal Revenue Code Section 302 Redemptions from Estates*, 5 J. CORP. L. 241, 255-59 (1980); Wilens, *Recent Decisions Open the Way for Trusts and Estates to Waive Stock Attribution*, 51 J. TAX'N 208, 210 (1979); Comment, *Estate Waiver of the Estate-Beneficiary Attribution Rule in Nonliquidating Redemptions under Section 302 and Related Matters: The Rickey Case in the Fifth Circuit*, 55 TAX L. REV. 147, 162-63 (1979); Comment, *Stock Redemptions and the Estate Attribution Rules*, 128 U. PA. L. REV. 650, 666-69 (1980).

the decision allegedly contradicts the plain language of section 302(c)(2)<sup>166</sup> and because no administrative or judicial foundation exists to support the conclusion.<sup>167</sup> *Rickey*, however, could be considered a logical extension of the judicial trend, as seen progressively in *Squier*, *Haft Trust*, *Crawford*, and *Johnson Trust*, to examine the congressional intent in enacting the attribution rules and to disregard these rules when their mechanical application produces inequitable results. The courts have seemed willing, when family hostility was present and a trust or estate was the redeeming shareholder, to allow the redemption to qualify for capital gain treatment under section 301(b)(3) upon the filing of a waiver under section 302(c)(2), even though the IRS has consistently objected.

One question remained open after *Rickey*: whether the holding would be extended to trusts, so that trusts involved in a redemption also could waive the entity attribution rules to resolve family discord and thereby qualify for capital gain treatment. This issue was addressed by the court in *Metzger Trust v. Commissioner*.<sup>168</sup> The trust in *Metzger Trust* maintained that, in light of the Fifth Circuit's earlier decision in *Rickey*, the waiver it filed was also effective to waive the trust-beneficiary attribution rules of section 318(a)(3). Without the waiver, 100% stock ownership was attributed to the trust through its beneficiary, Jacob, even though Jacob's sisters, who were involved in the family dispute, no longer owned any stock.<sup>169</sup> The court disagreed with the trust's argument, noting that it was not obligated to extend the *Rickey* decision and that sufficient differences existed between a waiver by an estate and a waiver by a trust to justify different rules.<sup>170</sup> The court reasoned that section 302(c)(2) was designed to permit one family member to turn control of a close corporation over to another family member and receive capital gain treatment only once in a ten-year period.<sup>171</sup> Allowing the transfer of control to occur through an estate after the first family member's death was, the court stated, consistent with this rationale. Conversely, the court concluded that permitting a waiver by trusts would run contrary to the purpose of section 302(c)(2).<sup>172</sup> Since trusts are artificial entities and any number of them can be created, if a trust could waive the entity attribution rules, nothing could prevent the beneficiaries or a new trust with the same beneficiaries from acquiring the same interest in the corporation.<sup>173</sup> Although the parties stipulated that the redemption was motivated by a desire to settle a family dispute and not to avoid taxes, the court held that this motive did not guarantee that the par-

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166. Willens, *supra* note 165, at 210.

167. Karzon, *supra* note 165, at 6.

168. 693 F.2d 459, 460 (5th Cir. 1982), *cert. denied*, 103 S. Ct. 3537, 77 L. Ed. 2d 1388 (1983). The first question covered in *Metzger Trust* was the family hostility issue, which is discussed *supra* notes 130-38 and accompanying text.

169. For a discussion of the facts of *Metzger Trust*, see *supra* text accompanying notes 130 & 131.

170. 693 F.2d at 469.

171. *Id.*

172. *Id.*

173. *Id.*

ties who had their stock redeemed would not reacquire an interest in the corporation at a later date.<sup>174</sup> The court therefore concluded that a trust may not file an effective waiver agreement under section 302(c)(2).<sup>175</sup>

The Fifth Circuit's decision in *Metzger Trust* regarding trust waivers, as with the court's ruling regarding the family hostility issue, represents a sudden shift in the previous judicial trend expanding the scope of section 302(c). The *Metzger Trust* decision signals a warning by the courts that future controversies involving family hostility and entity waiver may be decided in accordance with the IRS's position.<sup>176</sup> Without further legislative action, taxpayer planning in stock redemptions will remain in a confused state and the litigation of these redemptions will continue.

#### IV. TEFRA IMPLICATIONS FOR STOCK REDEMPTIONS

Congress, aware of the conflicting positions of the courts and the IRS, passed TEFRA section 228 a few months before the *Metzger Trust* decision.<sup>177</sup> This section amended Code section 302(c)(2). Although this amendment was passed prior to *Metzger Trust*, the court was unable to apply the new law in *Metzger Trust* since the redemption involved in the controversy occurred prior to the passage of TEFRA.<sup>178</sup>

Under amended section 302(c)(2) an entity is allowed to waive the family attribution rules of section 318(a)(1), provided that the entity and each related person meets the requirements specified in section 302(c)(2)(C)(i)(I), which provides that no interest in the corporation may be acquired within ten years after the redemption.<sup>179</sup> For purposes of the section, "entity" includes estates, trusts, partnerships, and corporations.<sup>180</sup> A "related person" means any person to whom a corporation's stock is attributed under section 318(a)(1), if that stock can be further attributed to the entity under section 318(a)(3).<sup>181</sup> Each related person must agree to be held equally liable along with other related persons for any deficiency resulting from an acquisition by either the entity or the related person of a corporate interest within ten years after the redemption.<sup>182</sup>

Congress thus mandated the position taken by the courts in *Crawford* and *Johnson Trust*. Contrary to the IRS's long-maintained stance, the term "distributee" in amended section 302(c)(2) now applies to both individuals and entities. Congress did respond favorably, however, to the IRS's concern in *Crawford* that potential for abuse of the tax laws existed

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174. *Id.* at 469-70.

175. *Id.* at 470.

176. *See supra* notes 140-46 and accompanying text.

177. TEFRA, Pub. L. No. 97-248, § 228, 96 Stat. 493, 515 (amending I.R.C. § 302(c)(2)(C)).

178. The court noted that, because of the passage of TEFRA § 228, its resolution of the controversy's issues would not have a lasting effect on the law. 693 F.2d at 468. *But see supra* note 23.

179. I.R.C. § 302(c)(2)(C)(i)(I) (1982); for the text of this provision, *see supra* note 24.

180. I.R.C. § 302(c)(2)(C)(ii)(I) (1982).

181. *Id.* § 302(c)(2)(C)(ii)(II).

182. *Id.* § 302(c)(2)(C)(i)(II).



because the waiver filed by an entity would not prevent beneficiaries from acquiring a subsequent interest in the corporation. The new law holds both the entity and the beneficiary liable for any acquisition within ten years after the redemption.

As outlined in TEFRA section 228 and previously required by section 302(c)(2), an entity may waive only the family attribution rules of section 318(a)(1).<sup>183</sup> Congress has, therefore, overruled the position taken by the Fifth Circuit in *Rickey*.<sup>184</sup> An entity may file a waiver agreement only when both the entity and its beneficiaries own no corporate stock immediately following the redemption, and the beneficiaries must join the entity in filing the required waiver agreement.<sup>185</sup> As a result, the new law makes it impossible for an entity to waive the entity attribution rules since this would require that the entity's beneficiaries still own corporate stock.<sup>186</sup> This congressional action should appease the critics of the *Rickey* decision.

TEFRA has supplied some answers regarding the effect that section 302(c)(2), as amended, will have on the tax treatment afforded stock redemptions when family hostility is the motivating factor for the redemption. Since prior to the enactment of TEFRA only a redeeming individual shareholder could apply the section 302(c)(2) waiver provisions, the enactment of TEFRA has added a new dimension of certainty in areas in which the courts and the IRS conflicted. Now, in certain situations, when the redeeming shareholder is an entity and family discord exists, a redemption that settles the dispute as in *Haft Trust* can also qualify for capital gain treatment under section 302(b)(3) without the need for judicial determination. An entity will no longer need to argue subjectively under *Davis* that the redemption resulted in a meaningful reduction in corporate control in order to qualify for the ambiguous dividend equivalence test under section 302(b)(1).<sup>187</sup> This opportunity, however, is available only when both the entity and its beneficiaries own no corporate stock following the redemption. Thus, in settling a family dispute, an entity may qualify for exchange treatment under section 302(b)(3) only if all the corporate stock owned by an entity and all of its beneficiaries is redeemed.<sup>188</sup> On the other hand, if a beneficiary owns any stock after the redemption, this stock will be attributed to the entity under section 318(a)(3). The entity no longer will have the option to waive these shares attributable to it, but must instead attempt to qualify for capital gain treatment under section 302(b)(1).<sup>189</sup>

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183. *Id.* §§ 302(c)(2)(C)(i), 302(c)(2)(A).

184. See H.R. REP. NO. 760, 97th Cong., 2d Sess. 545, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1319-20, which expressly states that the waiver rules do not extend to entities and their beneficiaries and that *Rickey v. United States* is intentionally overruled.

185. I.R.C. § 302(c)(2)(C)(i) (last paragraph) (1982).

186. See *supra* notes 51 & 52 and accompanying text.

187. See *Haft Trust v. Commissioner*, 510 F.2d 43, 48 (1st Cir. 1975).

188. The factual situation in *Haft Trust* followed this pattern. See *supra* text accompanying notes 118-20.

189. The facts presented in *Metzger Trust* followed this pattern. See *supra* text accompanying notes 130 & 131.

One final question, however, remains even after the passage of TEFRA: when family hostility is the motive for a redemption involving an entity and related persons, one of whom retains a corporate interest after the redemption, will the redemption qualify for exchange treatment under the dividend equivalence test of section 302(b)(1)? Unfortunately, no answer can be drawn from the conflicting judicial opinions. Consistent with the *Haft Trust* decision, however, evidence that family hostility exists in the above fact situation should be sufficient to qualify a redemption as not essentially equivalent to a dividend under section 302(b)(1).

As stated by Congress, the rationale behind the attribution rules is that certain relationships are evidence of a community of economic interest.<sup>190</sup> Individuals within these relationships will act in a manner to benefit the community as a whole. As a result, when one community member's interest in an entity is reduced, this event will not have a significant impact on the control of the entity if the other community members retain an interest in the same entity.<sup>191</sup> This rationale is inapplicable when families are divided by hostility since no concern exists that the individual members will act to benefit the family as a whole. Therefore, the attribution rules should not be applied to deny exchange treatment to redemptions necessitated by family hostility. As the IRS argued in *Haft Trust*, this approach may lead to abuses if family disputes are fabricated to allow redemption proceeds to be taxed at capital gain rates. This potential abuse, however, is no excuse for injustice when family hostility clearly does exist.

Allowing a redemption exchange treatment when family hostility is its motivating force is also consistent with interpretations of the meaningful reduction test in *Davis*.<sup>192</sup> As a result of the *Davis* decision, a redemption must result in a meaningful reduction of a shareholder's proportionate interest in a corporation to qualify for exchange treatment under section 302(b)(1).<sup>193</sup> This test is necessary to prevent a shareholder from redeeming only a portion of his stock interest and still treating the redemption as an exchange, claiming only that family hostility existed. To qualify as a meaningful reduction an actual shift in corporate control must occur.<sup>194</sup> As the critics and subsequent court opinions have suggested, the meaningful reduction test permits an inquiry into the facts surrounding a stock redemption, even after a mechanical application of the attribution rules. This view has even been promulgated in the IRS's Treasury Regula-

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190. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 36, reprinted in 1954 U.S. CODE CONG. & AD. NEWS, 4025, 4061.

191. *Id.*

192. See, e.g., *Haft Trust v. Commissioner*, 510 F.2d 43, 48 (1st Cir. 1975) ("Section 302(b)(1) requires a 'meaningful reduction' of the shareholder's proportionate interest in the corporation' . . . . This language certainly seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction . . . ." (Emphasis added.)); Comment, *supra* note 116, at 104 (circumstances surrounding redemption should be examined to determine whether in fact a meaningful reduction has occurred and whether control is mere fiction).

193. *Davis*, 397 U.S. at 313.

194. Cf. *Parker v. Commissioner*, 20 T.C.M. (CCH) 893, 899-900 (1961) (father redeemed portion of stock interest in order to transfer effective control of corporation to son).

tions.<sup>195</sup> Thus, *Davis* would allow a redemption to be afforded capital gain treatment when family hostility exists and a shift in corporate control occurs.

Furthermore, although amended section 302(c)(2) does not apply directly to the situation in which family hostility motivates the stock redemption by an entity and a beneficiary of the entity retains a stock interest, Congress's passage of the amended section tends to support the position that this redemption should be afforded capital gain tax treatment. Amended section 302(c)(2) clearly broadens the scope under which redeeming shareholders may file a statutory waiver. In effect, the section also broadens the ability of feuding family members to settle disputes through a stock redemption that is afforded capital gain treatment. Some certainty as to the tax treatment of stock redemptions has been created by this new law, enabling shareholders to resolve family discord based on objective criteria as to the tax consequences. As a logical extension of this section, though, allowing a redemption necessitated by family hostility exchange treatment under section 302(b)(1) would create further certainty. Taxpayers in this situation, knowing the tax consequences of the redemption, could effectively plan for these consequences and need not fear that the IRS might subsequently tax the redemption proceeds at higher ordinary income rates. Some critics might argue that this approach will actually create less certain tax results because of possible problems in defining the nature of the hostility necessary to afford a redemption exchange treatment. After a few judicial decisions and IRS clarifications, however, the type of discord necessary for a redemption to be afforded exchange treatment should be well-defined.

Conclusive resolution of the family hostility issue by allowing redemption exchange treatment under the dividend equivalence test is consistent with recent judicial and legislative trends that expand the scope of stock redemptions that might qualify for capital gain treatment. The *Metzger Trust* decision is a lone exception. Further judicial and congressional inquiry, however, is still necessary ultimately to resolve the effect of family hostility on stock redemptions.

## V. CONCLUSION

Confusion regarding the tax treatment of stock redemptions has existed since income tax laws were first enacted. When the redemption has been motivated by the presence of family hostility, persistent controversy has prevailed between taxpayers and the IRS. The complexity of Code sections 302 and 318, which provide the criteria for determining when a redemption will qualify for exchange treatment, has only fueled this controversy. Prior to *Metzger Trust*, the judicial trend in this litigation was to allow redemption proceeds to be taxed at capital gain tax rates when the

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195. Treas. Reg. § 1.302-2(b) (1955) ("The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case.").

redemption was motivated by family hostility. Other judicial decisions, consistent with the trend, have broadened the class of shareholders that could waive the family attribution rules, thus creating objective criteria upon which more favorable tax treatment could be afforded to some redemptions motivated by family hostility. The recent passage of TEFRA section 228 ultimately mandated the courts' position taken in these opinions, but this new law did not go far enough to resolve the family hostility issue conclusively. Until the conflicting judicial decisions are resolved or further legislative action is taken, confusion surrounding the effect of family discord upon the dividend equivalence test of section 302(b)(1) will continue. This confusion must be eliminated; it creates ineffective tax planning and unnecessarily prolongs family hostility.

