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Michael A. Jones

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COMMENTS

SECTION 302(c)(2): OPPORTUNITIES AND PITFALLS

MICHAEL A. JONES

I. INTRODUCTION

Section 302 of the Internal Revenue Code (the Code) involves the potential tax treatment of corporate stock redemptions.¹ The

1. I.R.C. §§ 302(a)-(b) states:
   (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.
         (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 the 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.
      (4) STOCK ISSUED BY RAILROAD CORPORATIONS IN CERTAIN
general rule is that such redemptions will be characterized as stock exchanges if the conditions of section 302(a) and (b) are met. If these conditions are not met, the redemptions will be treated as dividend distributions. The classification of a stock redemption under section 302 is of vital importance to the taxpayer since characterization as an exchange paves the way for profitable capital gains treatment while categorization as a dividend distribution results in ordinary income tax liability.

Section 302 classification is complicated by the requirement that the family attribution rules of section 318(a) apply in determining stock ownership for section 302 purposes. The family attribution rules of section 318(a) specify that a redeemed shareholder will be attributed constructive ownership of any stock owned by his spouse, children and grandchildren. Under section 302(b)(3) the redeemed shareholder's interest in the corporation must be completely terminated for a stock exchange classification. The constructive ownership rule would seem to indicate that a redeemed shareholder whose family owned even one share of stock in the redeeming corporation could never meet this condition. Section 302(c)(2), however, provides an important exception to the general application of the family attribution rules. This section states that

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2. See generally I.R.C. §§ 1221-1223.
3. I.R.C. § 302(c)(1).
4. I.R.C. § 318(a)(1)(A) provides generally that an individual shall be considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren, or parents.
5. I.R.C. § 302(c) states:
   (c) CONSTRUCTIVE OWNERSHIP OF STOCK.—
   (1) IN GENERAL.—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.
   (2) FOR DETERMINING TERMINATION OF INTEREST.—
   (A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—
   (i) immediately after the distribution the distributee has
the family attribution rules are inapplicable if certain other conditions are fulfilled by the taxpayer, both prior and subsequent to the redemption.  

This comment will deal with the section 302(c)(2) exception, its conditions, and the varying constructions placed upon the exception by the courts and the Internal Revenue Service (the Service).

II. SECTION 302(c)(2)(A)(i)

Section 302(c)(2)(A) prescribes three conditions necessary to

no interest in the corporation (including an interest as officer, director, or employee), other than an interest as creditor.

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary by regulations prescribes, files an agreement to notify the Secretary of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary) notifies the Secretary of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) and such person acquired any stock in the corporation, directly or indirectly from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of federal income tax.

6. If I.R.C. § 302(c)(2)(B)(i)-(ii) requirements are not met, the stock redemption will not automatically be disqualified as a complete redemption under § 302(b)(3) if the distributee can show that the stock was not acquired, or disposed of, for the principal purpose of income tax avoidance. See, the flush language following § 302(c)(2)(B)(ii).
waive the family attribution rules of section 318(a)(1). The first condition requires the distributee to be free from any interest in the redeeming corporation immediately after the redemption. One exception is allowed. A distributee may retain an interest as a creditor after the redemption. The purpose of the creditor exception is to permit credit sales of redeemed stock, rather than requiring each redemption to be for cash.

According to section 302(c)(2)(A)(i), a distributee may not retain an interest as an officer, director, or employee. Many other types of interests, however, are discussed and prohibited in the revenue rulings and cases. For example, the Service in Revenue Ruling 70-104 held that a father's interest in a family corporation was not terminated following a stock redemption when he entered into a long-term contract to perform consultant and advisory services for the corporation. The Service stated "the performance by the father of services pursuant to the consulting agreement is an 'interest in the corporation' within the meaning of section 302(c)(2)(A)(i) of the Code." Accordingly, the termination of interest condition was not met, and the father's entire redemption was taxed as a dividend under section 301. Similarly, in Revenue Ruling 74-416, a distributee continued to hold a forbidden interest in a corporation by retaining as a trustee the right to vote corporate stock held by the trust. Finally, in Revenue Ruling 59-119, a corporation entered into a credit arrangement requiring quarterly installment payments for the redeemed stock. The distributee in that ruling wanted to appoint a voting representative to the board of directors of the corporation to insure corporate adherence to conditions of the agreement. The Service ruled that the ap-

7. I.R.C. § 302(c)(2)(A)(i) states that "immediately after the distribution the distributee [must have] no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor," while § 302(c)(2)(A)(ii) requires that the distributee not acquire such an interest within ten years after the distribution. Note that § 302(c)(2)(A)(i) looks at the interests held by the distributee immediately following the distribution.

8. See note 5 supra. See also Levin v. Commissioner, 47 T.C. 258 (1966), in which the redeeming shareholder, who was the mother of the remaining shareholders, remained as a director "out of respect and sentiment." She received a nominal $1,200 annual salary. The court found she had retained a forbidden interest and applied the family attribution rules, thus turning her stock redemption proceeds from capital gains into dividend income of over $98,000. Id. at 260.


10. Id.


13. The stock redemption agreement prescribed, among other requirements that:
pointment by the distributee of a representative to the board of directors would constitute a forbidden interest, as the nominee director would be acting solely on the distributee's behalf and would in effect be his agent.\textsuperscript{14}

In short, section 302(c)(2)(A)(i) requires a total severance of any connection with the firm's operation which might permit the distributee to protect his self-interest.\textsuperscript{16} Many court cases construing this section are inconsistent with the holdings of the revenue rulings. For example, the Tax Court distinguished \textit{Estate of Lennard v. Commissioner} from Revenue Ruling 70-104, despite the factual similarities to that ruling.\textsuperscript{18} Lennard was the founder, director, and secretary-treasurer of a metal brokerage corporation. The president and major shareholder of the corporation was Lennard's son. Lennard's redemption of his corporate stock called for the issuance of a $150,000 subordinated promissory note.\textsuperscript{17} After the redemption, Lennard joined an accounting firm as managing partner of the corporation's account. In this capacity, he continued to perform the same accounting services for the corporation as he had before the redemption.\textsuperscript{18} Despite the continuity of Lennard's connections with the corporation, the court concluded that Lennard had only retained a creditor interest.\textsuperscript{19}

Revenue Ruling 70-104 involved a parent stockholder who entered into a long-term consultant contract with the redeeming corporation. The Service held that the consulting constituted a for-

\begin{itemize}
\item \textsuperscript{14} So long as the corporation owes funds to such shareholder it will not, without first receiving the written consent of the shareholder, declare dividends; pay salaries in excess of a certain amount to officers; sell its assets except in the ordinary course of business; or engage in a reorganization, recapitalization, merger, consolidation or liquidation.
\item 1959-1 C.B. at 69.
\item 15. \textit{Id.} at 70.
\item 16. \textit{Id.} at 70.
\item 17. \textit{Petitioners claimed the note was subordinated so that the corporation would not be compelled to report the indebtedness to its bankers. It is interesting to note that of the $275,000 sales price, $125,000 was paid in cash in October 1965, and the subordinated promissory note for $150,000 was paid in January 1966, despite the fact that during the entire three-month period the corporation possessed sufficient funds to pay off the debt. Id. at 557, 563.}
\item 18. During this period, Lennard performed monthly audits, filed corporate tax returns, advised his son on a major acquisition, was named trustee of the corporation's pension plan, and worked closely with the new secretary-treasurer, who had replaced Lennard in the corporate hierarchy. After Lennard's death, the corporation did not retain an accountant to perform a monthly audit. \textit{Id.} at 558.
\item 19. \textit{Id.} at 563.
\end{itemize}
bidden interest. The *Lennard* court avoided a forbidden interest ruling by classifying Lennard as an independent contractor, whose services could be terminated at any time. Evidently, the *Lennard* court ignored the factual similarities between *Lennard* and Revenue Ruling 70-104.\footnote{20} Instead the court focused on the corporate president's ostensible autonomy, disregarding the impact that Lennard's advice may have had on his son's decisions.

In an earlier case the Tax Court had also sidestepped the revenue rulings. In *Lewis v. Commissioner*, Lewis transferred control of his automobile dealership to his sons through a series of redemptions extending over a five-year period.\footnote{21} Lewis continued to serve on the board of directors as vice president of the corporation.\footnote{22} Although Lewis "neither performed any services for the corporation nor actively exercised any powers as vice president or director," he did attend informal meetings of the board of directors and "from time to time inquired generally how business was progressing."\footnote{23} Lewis subsequently resigned as vice president and director several weeks after the last redemption was paid. The court avoided the retention of interest question by holding the redemptions were not "essentially equivalent to a dividend" under section 302(b)(1).\footnote{24} By emphasizing the five-year redemption process, instead of the resulting termination of interest, the court avoided application of section 302(b)(3) and the family attribution exception of section 302(c)(2). Had the court reached the family attribution question, it would have been hard pressed to rule that Lewis did not retain a forbidden interest under section 302(c)(2)(A)(i), which specifically prohibits retention of an interest as an officer, director, or employee.\footnote{25}

\begin{itemize}
\item \footnote{20} "It is our view that the success of the corporation was directly attributable to the efforts of [Lennard's son] rather than to the services provided by [Lennard] as accountant." \textit{Id.} at 562.
\item \footnote{21} 47 T.C. 129 (1966).
\item \footnote{22} Lewis was elected vice president at the same meeting in which he resigned as president. \textit{Id.} at 131.
\item \footnote{23} \textit{Id.}
\item \footnote{24} \textit{Id.} at 135; I.R.C. § 302(b)(1) states that a stock redemption shall be treated as an exchange, if the redemption is not essentially equivalent to a dividend. \textit{See generally, Note, I.R.C. § 302(b)(1): Dividend Equivalency After United States v. Davis, 7 Fla. St. U.L. Rev. 505 (1979).}
\item The court in *Lewis* ignored any application of the § 318 family attribution rules despite previous holdings utilizing § 318 in § 302(b)(1) cases. \textit{See, e.g., Humphrey v. Commissioner, 39 T.C. 199 (1962); Lewis v. Commissioner, 35 T.C. 71 (1960).}
\item \footnote{25} The court foresaw the problem: "At the very least, this raises the suspicion that his continuation in these posts, while he was receiving payments, had some significance." 47 T.C. at 135. \textit{But see} Judge Simpson's concurring opinion:
\end{itemize}
The lesson of *Lennard* and *Lewis* is that form can rule over substance when dealing with section 302(c)(2)(A)(i) if the court is so inclined. An alert taxpayer can meet the termination of interest requirement of section 302(c)(2)(A)(i) in spite of clear revenue rulings to the contrary or can avoid the effect of the attribution rules of section 302(c)(2)(A)(i) altogether, if: (1) enough superfluous ties are severed and job titles are changed, as in the *Lennard* case; or if (2) sufficient emphasis is shifted from the result of the redemption to the timing and type of redemption, as in the *Lewis* case.

As previously stated, a distributee may maintain a creditor interest in the redeeming corporation without risking his exemption from the family attribution rules. The only treasury regulation construing this section states "[f]or the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim." The regulation goes on to state that the claim must not be in any sense proprietary, must not be subordinated to the claims of general creditors, and that an obligation, even in the form of a debt, may sometimes constitute a proprietary interest. The relevant revenue rulings are sparse and essentially echo the treasury regulation.

As I read section 302(c)(2)(A)(i), it does not provide that every officer or director shall be treated as having retained an interest in a corporation. It provides merely that a retained interest may include an interest as an officer or director, but it does not require us to find that every officer or director has retained an interest. *Id.* at 137 (emphasis in original).

Note, however, the next year, in *Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967), the court of appeals refused to waive the family attribution rules of § 318 when the distributee, who was the mother of the remaining shareholders, continued as an officer and director at a nominal salary "out of respect."

28. "Proprietary" has yet to be defined by the Internal Revenue Service.
29. Treas. Reg. § 1.302-4(d) (1978) provides:

For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

30. *See*, e.g., Rev. Rul. 77-467, 1977-2 C.B. 92, in which a taxpayer had his stock redeemed by a family corporation, terminating his entire interest in the corporation. He then resigned as president of the corporation, but continued to receive payments, not dependent on the corporation's future earnings or subordinated to the corporation's general creditors,
Generally, Tax Court cases interpreting section 302(c)(2)(A)(i) do not reach the creditor exception issue because of the termination of interest prerequisite of section 302(b)(3). If a distributee receives an interest greater than that of a creditor, the interest is classified as an equity interest which fails the termination of interest test of section 302(b)(3). Consequently, the failure to meet the termination of interest test renders moot the question of creditor status under section 302(c)(2)(A)(i).31

Courts which have reached the creditor exception issue have encountered much difficulty in distinguishing debt from equity.32 No treasury regulation, revenue ruling, or Code section defines either debt or equity.33 Consequently, all criteria used to decide the debt or equity question comes from the courts or from academia.34

In Dunn v. Commissioner,35 Mrs. Dunn, who owned shares in a corporation which held a General Motors franchise, redeemed her shares pursuant to an agreement which provided for a twelve-year pay out of the redemption price. This agreement was subject to certain restrictions required by General Motors as a condition of the corporation retaining the franchise.36 One year after payments as rent for the corporation's use of a building owned by him. The Service found the payments represented an "arm's length charge" and did not provide the distributee with an interest greater than that of a creditor.

33. Recently the Service reduced further the flow of information. Rev. Proc. 77-45, 1977-2 C.B. 579 states that advance rulings or determination letters will not be issued on whether section 302(b) applies to a redemption of stock if after the redemption the distributing corporation uses property that is owned by the shareholder from whom the stock is redeemed and the payments by the corporation for the use of the property are dependent upon the corporation's future earnings or subordinate to the claims of the corporation's general creditors.
34. There are many cases dealing with the debt-equity question. See, e.g., Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962); Estate of Miller v. Commissioner, 239 F.2d 729 (9th Cir. 1956); Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956); Lisle v. Commissioner, 35 T.C.M. (CCH) 627 (1976); Nye v. Commissioner, 50 T.C. 203 (1968).
35. 70 T.C. 715 (1978).
36. The restrictions included: (1) the corporation would not be required to make any payment which would reduce its "owned net working capital" below whatever amount was required by its franchise agreement or would prevent the corporation from retaining 50% of the previous year's net profits after taxes; (2) if any payment of any installment would violate said provisions, the due date of such installment would be postponed until such time as
had begun, the franchise encountered financial difficulties and Mrs. Dunn was not paid any interest in that year. Over the next six years, both principal and interest payments were sometimes received late, some as late as five months after the due date. Despite the fluctuations in amounts paid and time of payment, the court held that Mrs. Dunn had met the termination of interest requirement of section 302(c)(2)(A)(i). The court disposed of the true indicators of a creditor relationship, regular principal and interest payments, in an offhand manner, noting: "The mere fact that [Mrs. Dunn] may not have been paid while other creditors were is not sufficient in and of itself to constitute subordination." Finally, the court stated that the inclusion of restrictions on payment, when imposed by an independent third party, is simply one factor to consider in determining if a distributee has retained an interest "other than an interest as a creditor." In Lennard v. Commissioner, as noted earlier, the taxpayer redeemed his stock and accepted a subordinated note as payment. The court determined that a subordinated promissory note did not destroy Lennard's creditor status because subordination was but one of several factors to be considered. The Tax Court stated that the prohibition against subordination had to be read in conjunction with the prohibition against a proprietary interest.

37. Id. at 724.
38. Id. at 729.
39. Id. at 727. "First, with the exception of the June 1971 payment, interest payments were made regularly, albeit the 1975 and 1976 payments were a few months late. Moreover, although principal payments were running about a year behind, they were being made on a fairly regular basis." Id.

The court also seemed to place great importance on the fact that some payments were made in excess of the amounts permitted by the agreement stipulated by General Motors Corporation. Id.
40. Id. at 729.
41. 61 T.C. at 554. Treas. Reg. § 1.302-4(d) (1978) states: "Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest."

Additionally, the Lennard court cites John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), a case dealing with the question of whether certain corporate payments were interest or dividends. The Supreme Court in Kelley essentially dodges the question by stating "These cases now under consideration deal with well understood words as used in the tax statutes—interest and dividends. They need no further definition. . . . The Tax Court is fitted to decide whether the annual payments under these corporation obligations are to be
The results of Dunn and Lennard allow a distributee to escape the family attribution rules without truly severing all corporate interests. Treasury Regulation section 1.302-4(d) states that interest payable should not be dependent upon the earnings of the issuing company. Dunn has applied a gloss to this regulation by holding "at least where they are imposed by an independent third party," restrictions on payment are not determinative of a disguised equity interest. Similarly, the Lennard case, from which the Commissioner recently withdrew his acquiescence, allows subordination of a note if the interest retained through that note is not "proprietary," despite a seemingly clear prohibition as to subordination in the treasury regulations. Consequently, both cases allow a transfer of stock back to the corporation that is more than a sale of stock.

Individually, the Lennard and Dunn holdings provide the opportunity for tax motivated dispositions of stock. The combination of a subordinated note with noncreditor-type restrictions on the payments, however, may constitute too many "other factors" to be ignored by the Tax Court. By carefully using the holdings of the Tax Court as a guide, section 302(b)(3) and section 302(c)(2)(A)(i) can be used to produce favorable tax consequences in business transactions.

classified as interest or dividends." Id. at 530.

Apparently under this sanction of authority, the Tax Court feels it may decide the debt-equity question without providing any standards or guidelines and without listing the determinative factors or the weights given to them.

42. (1978).
43. 70 T.C. at 729. Treas. Reg. § 1.302-4(d) (1978) provides that "if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor." Although the Commissioner has not acquiesced to the Dunn holding, Dunn provides some meaning to the "in some cases" exception of the treasury regulation.
44. 1978-2 C.B. 3. The Service did not state which relationship caused it to remove its acquiescence. Three separate grounds could have been relied upon: (1) Lennard remained as trustee of the corporation's pension plan after he redeemed his stock; (2) he continued to perform accounting services for the corporation after the stock redemption; or (3) the promissory note he received from the corporation was subordinated to general creditors. See Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS, 7-44 (Supp. 1979). "The nonacquiescence is probably a statement by the National Office that the performance of continued services for a fee, even as an independent contractor, or the subordination of a note to general creditors... precludes relief from family attribution."
46. For example, W, a wealthy individual, wishes to start his son, X, in a business, but with minimal tax implications to himself. W buys an 80% interest from Z in a widget factory and X buys an 11% interest from Z. Later, W redeems all of his shares, taking a low interest, subordinated note. X gains a controlling interest in the corporation, W pays no gift
III. Section 302(c)(2)(A)(ii)

The second requirement for suspension of the family attribution rules is provided by section 302(c)(2)(A)(ii). That section stipulates that the redeeming shareholder cannot acquire any interest in the redeeming corporation within ten years of the date of the distribution, except by bequest or inheritance.\textsuperscript{47} If the redeemed shareholder violates this requirement, the original redemption will be treated as a dividend distribution and taxed accordingly.\textsuperscript{48}

Treasury Regulation section 1.302-2(c) establishes that the ten-year rule applies to any subsequently acquired interest in the redeeming corporation.\textsuperscript{49} The purpose of the regulation is to prevent continued control of the redeeming corporation through a related corporation after redemption. The Service does not define what degree of corporate ownership is necessary to constitute a related or a subsidiary corporation.\textsuperscript{50} Additionally, the Service fails to provide any detailed definition of a successor corporation. Revenue Ruling 76-496, however, does establish general parameters for determining when a corporation is a "successor corporation."\textsuperscript{51} In that revenue ruling, the Service notes: (1) assets were sold by the redeeming corporation to the distributee at their fair market value for valid business reasons; (2) remaining business of the redeeming corporation was substantial in relation to the discontinued business; (3) no purchasers of the new division were shareholders in the redeeming corporation; and (4) none of the tax attributes of tax and has no serious tax consequences from the small interest payments of the note. X's corporation can borrow freely, as the large promissory note issued to X is subordinated and will not be a hindrance in obtaining loans. Should W decide to later forgive the indebtedness, he will have effectively delayed the imposition of gift tax.\textsuperscript{47} See note 5 supra.\textsuperscript{48}

The portion of the distribution which is paid from the corporation's "earnings and profits" is treated as a dividend and included in gross income calculations. I.R.C. § 301(a)-(c).

\textsuperscript{49} (1978).

\textsuperscript{50} The Advisory Group on Subchapter C recommended that Congress enacted a new subsection which would provide specific statutory authority for a regulation defining subsidiaries, parent corporations, and successor corporations. Additionally, the Advisory Group recommended that a subsidiary be defined as 50% owned, a parent corporation be defined as owning 50% of the redeeming corporation's stock, and a successor corporation be defined as any corporation to whom § 381(a) (dealing with the carryover of tax attributes in certain corporate acquisitions) would apply. SUBCOMMITTEE ON INTERNAL REVENUE TAXATION, COMMITTEE ON WAYS & MEANS, REVISED REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 7 (Dec. 11, 1958) [hereinafter cited as REVISED REPORT].

\textsuperscript{51} 1976-2 C.B. 93. The facts involved A, who after having all of his shares in X corporation redeemed by the corporation, purchased a division of the X corporation within ten years of the redemption. A's son retained a substantial amount of the X stock.
the redeeming corporation were carried forward with the purchased division. There is no indication that continuity of business purpose or products is an important factor. Conceivably then, if sale of a division eliminated in-house production of a unique component and caused the new corporation purchased by the redeemed shareholder to be a major supplier to the redeeming corporation, a redeemed shareholder could enjoy the advantages of the suspension of the family attribution rules and still retain a substantial, though indirect, interest in the operation of the redeeming corporation. Since the Service essentially adopts a case-by-case analysis in "successor corporation" situations, it is likely that Revenue Ruling 76-496 would not prove controlling in the hypothetical instance. It should be noted, however, that the general parameters established for a successor corporation are insufficient to preclude the hypothetical as being within the fact pattern of Revenue Ruling 76-496.

A violation of the ten-year rule of section 302(c)(2)(A)(ii) occurs when an interest in the redeeming corporation is acquired, directly or indirectly, within ten years of the stock redemption. In Revenue Ruling 75-2, a father and his sons held stock in the same corporation. The brothers redeemed their stock. After their father's death, the brothers, as executors of his estate, were allowed to vote the stock held by the estate. During the administration of the estate, one of the brothers became president of the redeeming corporation. The Service stated, in no uncertain terms, that section 302(c)(2)(A)(ii) specifically prohibits a distributee from acquiring an interest as an officer, director or employee and that the brother had violated that section. The Service noted that the length of time the offending position was held was irrelevant; section 302(c)(2)(A)(ii) would have been violated even if the brother had resigned his position as president immediately following settlement of the estate.

It is important to note that mere appointment to a trustee position will not normally violate the ten-year interest rule of section 302(c)(2)(A)(ii). In Revenue Ruling 72-380, the Service held that

52. Id. at 94.
54. Id. at 100. The inclusion of "such interest" in § 302(c)(2)(A)(ii) incorporates the language of § 302(c)(2)(A)(i) defining those interests.
55. 1975-1 C.B. at 100. The brother remained as president of the corporation after the estate had been settled and was given all of the outstanding stock of the corporation in the estate settlement. Id. at 99.
the estate executor's right to vote stock interests did not violate the requirement of section 302(c)(2)(A)(ii). The Service characterized the rights possessed by an executor as comparable to the rights allowed by the bequest or inheritance exception. Hence, although technically an executor does not acquire his interest by bequest or inheritance, the Service stated "it is reasonable to conclude that the acquisition under identical circumstances of the significantly lesser interest embodied in the limited and sharply circumscribed right of an executor to vote stock in an estate does not violate section 302(c)(2)(A)(ii) of the Code." The ten-year requirement of section 302(c)(2)(A)(ii) appears to be strictly construed by the Service. A distributee should consider carefully before accepting a position in a corporation which has redeemed his stock within the last ten years. He would be well advised to examine the duties and responsibilities, as well as the potential for discretionary action, inherent in the position. If the position is one which could affect the corporation's stock, either through ownership and voting of stock, or through control of the corporation's financial and managerial capabilities, the Service will be prone to view the position as a forbidden interest. Only the position of trustee, which still permits substantial influence to be exercised over the future of a corporation's stock, has been excepted by the Service through the revenue rulings. The Service allows this exception only because the trustee's duties and responsibilities are tightly controlled by law.

The ability to control the stock of a corporation is crucial in determining a forbidden interest under Treasury Regulation section 1.302-4(e). That section allows retention of a valid creditor interest after redemption. It stipulates that any assets of the corporation acquired in the enforcement of the creditor's rights are not considered an acquisition of an interest in the corporation. It is important to note that the same section prohibits the acquisition of the stock of the corporation, of its parent corporation, or of a subsidiary of the corporation in such circumstances. This prohibition is particularly important if the distributee receives promissory notes from a redeeming corporation experiencing financial difficul-

57. Id.
58. Undoubtedly, only a few positions, such as a trustee or a receiver in bankruptcy, would have such control over the corporation's stock while maintaining such legal standards and defined duties to make them acceptable to the Service.
ties. If the redeeming corporation applies for a reorganization, and the trustee decides to continue corporate operations, a reorganization of the capital structure will be necessary. Unfortunately, the distributee may find that the trustee suggests conversion of promissory notes into common stock. If the court accepts the trustee's plan, the distributee's promissory notes will be converted into stock. If this occurs within ten years of the redemption, the entire proceeds of the redemption will be retroactively taxed as a dividend under section 301.

Section 302(c)(2)(A)(ii) only requires that the distributee not acquire a forbidden interest within ten years of the redemption. Other family members, whose stock ownership would ordinarily be attributed to the distributee under section 318(a)(1)(A), may acquire interests in the redeeming corporation without affecting the status of the distributee. Revenue Ruling 71-562 clarifies the position of the Service in this regard. In this ruling, a father completely terminated his interest by redeeming all of his stock. His son continued as a shareholder in the redeeming corporation. The father met all the necessary conditions of section 302(c)(2) to waive the family attribution rules. Within ten years of the redemption, a second son purchased shares in the redeeming corporation. The Service held that the father did not acquire a forbidden interest by way of his son's purchase of stock from the original redeeming corporation. The Service stated that the acquisition discussed in section 302(c)(2)(A)(ii) refers to an interest as outlined in section 302(c)(2)(A)(i) and that this interest is to be determined without regard to the application of the family attribution rules of section 318(a)(1). In sum, any interest acquired in the ten-year period following the redemption, which would ordinarily be attributable to the distributee due to the family attribution rules of section 318(a)(1), is disregarded for purposes of section 302(c)(2)(A)(ii).

This interpretation of section 302(c)(2)(A)(ii) can potentially defeat the broad aim of section 302(c)(2). That aim is a total severing of any interest in the redeeming corporation to insure that the distributee will no longer have a reason or the ability to control the corporation's stock. Under Revenue Ruling 71-562, a distributee's spouse can retain a controlling stock interest in the corporation while the distributee receives capital gains treatment on his re-

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60. This would be the probable path chosen if the receiver determines that a corporation's going-concern value exceeds its liquidated value.
62. Id. at 174.
demption. Realistically, the distributee may still have substantial control over corporate policies and decisions through the spouse who remains a shareholder. For example, a husband may retain eighty percent of a corporation's stock while his spouse, who is intimate with market trends, completely redeems her shares. The husband may receive financial guidance from his wife and essentially be a conduit for her corporate control due to the closeness of the marital relationship. It should be recalled, however, that Revenue Ruling 71-562, which apparently allows this situation to occur, dealt only with a stock interest.65 The Service has yet to address the question of continued control of a corporation by a distributee through a spouse who retains a nonstock interest.66

The flush language following section 302(c)(2)(A)(iii) states that if a distributee does acquire a forbidden interest within ten years of the distribution, the statutes of limitation established in sections 6501 and 6502 are suspended.65 The Service has one year from the date it is notified by the distributee of the acquisition of the interest in which to assess and collect the tax due or to begin court proceedings to collect the tax. Since the distributee must notify the Service of the acquisition in a statement accompanying his return, the Service should have no trouble detecting a deficiency and initiating assessment and collection proceedings within the one-year period.66

63. It should follow that nonstock interests acquired by family members would also be disregarded for purposes of § 302(c)(2)(A)(ii) as § 302(c)(2)(A)(i) specifically enumerates nonstock interests and § 302(c)(2)(A)(ii) incorporates those interests by use of the phrase "any such interest." If this can be assumed, then a distributee can maintain direct control of a corporation if the spouse remains in an upper echelon corporate position, such as president or chairman of the board.

64. In 1958, however, the Advisory Group on Subchapter C recommended that a complete termination of shareholder's interest would have to include a complete termination of the interest of the shareholder's spouse:

It is felt that, because of the close relationship between husband and wife, it is not clear that the distributee ceases to have an interest in the corporation if his spouse continues as a shareholder. Frequently, he can, through the continuing stock interest of his spouse, still maintain an effective voice in the management of the corporation.

REVISED REPORT, supra note 49, at 6.

65. I.R.C. § 6501 provides generally for a three-year period of limitation on the assessment of tax by the Service. No assessment or court proceeding without assessment may be commenced outside of the three-year limitation. The section also provides further instructions and limitations for differing types of returns. I.R.C. § 6502 allows a six-year period of limitation on the collection of an assessed tax or the commencement of a court action to collect an assessed tax.

66. This flush language, allowing an extra year for assessment, places a heavy burden on the taxpayer. A forbidden interest acquired on the last day of the ten-year period may cause
IV. SECTION 302(c)(2)(A)(iii)

The third requirement necessary for suspension of family attribution rules is stipulated in section 302(c)(2)(A)(iii). This section requires that the distributee file an agreement to notify the Secretary of the Treasury of an acquisition of a forbidden interest. The Secretary is given the regulatory power to prescribe the time and manner of the filing. The regulations provide that the agreement must be a separate statement in duplicate which must be signed by the distributee and attached to the first return filed by him for the taxable year in which he terminates his interest as described in section 302(b)(3).

Although the filing requirement of 302(c)(2)(A)(iii) seems strictly procedural and rigid, the history of litigation and the treasury regulation indicate otherwise. The original regulation fleshing out the code provision did not provide for much flexibility. Treasury Decision 7535, however, added flexibility to the strict mandate of filing. This decision allows the district director to grant a reasonable time extension for filing of the agreement, provided the distributee's request for an extension is timely and the reassessment of the distributee's tax which was payable on a distribution that occurred up to eleven years earlier.

67. See note 5 supra. The section also requires the distributee to retain all records as may be necessary for the application of § 302(c)(2)(A)(iii).

68. Rev. Rul. 71-138, 1971-1 C.B. 109. In a community property state when the distribu- tee/spouse redeems stock and wishes to have the waiver of family attribution rules under § 302(c)(2) apply, both spouses must file the notification agreement specified in § 302(c)(2)(A)(iii). id. at 109.

69. Before 1979, the relevant part of the regulation read:

(a)(1) The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to the first return filed by the distributee for the taxable year in which the distribution described in section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired, other than by bequest or inheritance, any interest in the corporation (as described in section 302(c)(2)(A)(i)) since the distribution and that the distributee agrees to notify the district director for the internal revenue district in which the distributee resides of any acquisition, other than by bequest or inheritance, of such an interest in the corporation within 10 days after the acquisition, if the acquisition occurs within 10 years from the date of the distribution.

(b) The distributee who files an agreement under section 302(c)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.


70. 1978-1 C.B. 84.
utee can show a reasonable cause for failure to file the agreement. This amendment is reflected in the current treasury regulation.

Treasury Decision 7535 was issued to bring Treasury Regulation section 1.302-4(a)(1) and (2) more into line with court decisions which allowed a time extension for filing. In United States v. G.W. Van Keppel, the court held that the Director of the Internal Revenue Service abused his discretion by rejecting an agreement which was filed late due to inadvertence. The submission of the agreement with an amended return preceded the deficiency assessment. The court found the language of section 302(c)(2)(A)(iii) directory rather than mandatory and stated: "The interests of the government have not been jeopardized. The Commissioner has been neither misled nor inconvenienced."

Following the decision in Van Keppel, the courts routinely

71. Id.
72. Treas. Reg. § 1.302-4(a)(1)-(b) (1979) provides:

(a)(1) The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to the first return filed by the distributee for the taxable year in which the distribution described in section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired, other than by bequest or inheritance, any interest in the corporation (as described in section 302(c)(2)(A)(i)) since the distribution and that the distributee agrees to notify the district director for the internal revenue district in which the distributee resides of any acquisition, other than by bequest or inheritance, of such an interest in the corporation within 30 days after the acquisition, if the acquisition occurs within 10 years from the date of the distribution.

(2) If the distributee fails to file the agreement specified in section 302(c)(2)(A)(iii) at the time provided in subparagraph (1) of this paragraph, then the district director for the internal revenue district in which the distributee resided at the time of filing the first return for the taxable year in which the distribution occurred shall grant a reasonable extension of time for filing such agreement, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the agreement within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(b) The distributee who files an agreement under section 302(c)(A)(iii) shall retain copies of income tax returns and any other records indicating fully the amount of tax which would have been payable had the redemption been treated as a distribution subject to section 301.

73. Section 1.302-4(a) is amended to conform the present rules governing the time for filing an agreement with certain court decisions which have held that an untimely filing of the agreement does not preclude the distributee from applying section 302(c)(2)(A) to the redemption where reasonable cause for failure to file a timely agreement can be shown.

1978-1 C.B. at 84.
74. 321 F.2d 717 (10th Cir. 1963).
75. Id. at 720.
granted time extensions in cases where the agreement was not filed due to inadvertence.\textsuperscript{76} Similarly, the Service later issued private letter rulings allowing section 302(c)(2)(A)(iii) agreements to be filed late, some as late as four years.\textsuperscript{77} Finally, on March 14, 1978, the Service issued Treasury Decision 5735, which updated Treasury Regulation section 1.302-4(a) to its present status.

The stated purpose of the Service’s regulation amendment is to conform the regulation to the rationale of previous court holdings. The cases and private letter rulings almost uniformly have allowed a late filing of the agreement where the noncompliance was inadvertent. Similarly, the courts have rejected late filings where the filing came after an adverse court decision\textsuperscript{78} or where a change of the distributee’s plans forced a redemption to conform to a section 302(b)(3) termination of interest transaction which necessitated compliance with section 302(c)(2).\textsuperscript{79} The district director, in determining the propriety of a late filing, should look to case law as a guide for his decision. Therefore, when applying to the district director for a time extension, a distributee stands the best chance of receiving an extension if the filing deadline was inadvertently missed.\textsuperscript{80}

V. Section 302(c)(2)(B)(i)-(ii)

Section 302(c)(2)(B)(i) and (ii) impose the final requirements which must be met in order to waive the family attribution rules of


\textsuperscript{77} See also Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976), in which the Tax Court allowed an estate to file a tax agreement for the deceased distributee some five years after the stock distribution.


\textsuperscript{80} Even though under the newly amended regulation a distributee may still bring a suit charging abuse of discretion by the district director in not allowing late filing of an agreement, the amendments seem to give more credence to the decision of the district director. See Treas. Reg. § 1-302-4(a)(2) (1978). Probably only cases not dealing with an inadvertency will reach the courts. The Service will have a stronger position in appealed cases since the district director’s refusal of a time extension will come after the distributee has presented his arguments to the district director, and the regulation’s standard of “reasonableness” has been applied to the distributee’s contentions.
section 318(a)(1). Two criteria must be satisfied. First, the redeemed shareholder must not have acquired any part of the redeemed stock from a person or entity whose stock ownership would be attributable to the redeemed shareholder under the rules of section 318. This prohibition only applies to stock acquired in the ten-year period immediately before the redemption. Second, the redeeming shareholder must not have transferred any stock in the redeeming corporation to any person or entity whose stock ownership would be attributable to the redeeming shareholder under the rules of section 318, unless those shares transferred are redeemed in the same transaction. Again this prohibition only applies to stock transferred in the ten-year period immediately prior to redemption. These two criteria need not be satisfied, however, if the distributee can establish that the acquisition or transfer of stock did not have as a principal purpose the avoidance of federal income tax.

Sections 302(c)(2)(B)(i) and (ii) seek to prevent transfers in anticipation of redemption, whereby a distributee could maintain a substantial interest in and control of the corporation through the stock ownership of a family member while simultaneously receiving capital gains treatment of the redemption proceeds.

The Service adopts a practical approach to allowing certain types of stock transfers which occur within the ten-year period before redemption. In particular, the Service consistently allows a stock transfer which passes control of a corporation to a child of the redeeming stockholder, even when it occurs within the ten-year period prescribed in the Code. For example, in Revenue Ruling 56-556, a husband and wife sold a portion of their stock to their son and redeemed the remainder, thereby providing their son with a controlling interest in the family corporation. The Service held that the transfer of stock did not have as a principal purpose the avoidance of federal income tax. Consequently, the transfer to a section 318 party did not defeat the parents’ attempt to qualify under section 302(c)(2) for waiver of family attribution rules. The Service has also held that under some circumstances an acquisition by a distributee within ten years of a redemption would not defeat a section 302(c)(2) exemption attempt. In Revenue ruling 56-584, a father, the president and major shareholder of a corporation, made a gift of stock to his son five years before a redemption in order to

81. See note 5 supra.
82. 1956-2 C.B. 177.
encourage the son's interest in the business. After working for the corporation for five years, the son redeemed his stock and attempted to waive the family attribution rules under section 302(c)(2). The Service held that "because the gift of stock from father to son was made for bona fide business reasons and there was at the time of the gift no plan to effect a redemption of the stock, the avoidance of income tax was not a principal purpose of the gift." Hence, in this ruling the Service established two indicators, a bona fide business purpose and a lack of intent at the time of the transfer to effect a redemption, which it used to determine if tax avoidance was the principal purpose of the transfer.

A final indicator used to establish whether the avoidance of federal income tax was a principal purpose of the transfer was added by Revenue Ruling 57-387. In the revenue ruling, three sons acquired stock in a corporation through gifts from their parents and distributions from an estate. The sons, desiring to terminate their interest in the corporation, sold a portion of the shares to their father and had the rest redeemed by the corporation. The Service held that the transfer did not have as its principal purpose the avoidance of federal income tax and that the only purpose for the sale was to assure the termination of the sons' interests. The Service stated that the tax result would be the same regardless of how the sons' interests were terminated. The Service reasoned that similar tax results indicated the absence of a tax avoidance motive. The logic of the Service in Revenue Ruling 51-387 seems dubious at best. This reasoning assumes no tax avoidance purposes for the transfer. Clearly, if there was a motive to avoid federal income tax, the requirements of the flush language following section 302(c)(2)(B)(ii) would not be met and the redemption proceeds would be classified as dividends. Accordingly, the tax result would be dramatically different. Unfortunately, the Service chose to use circuitous reasoning by incorporating an unfounded assumption into the tax avoidance test.

83. 1956-2 C.B. 179.
84. Id. at 180.
85. 1957-2 C.B. 225.
86. Both sons also desired to waive the family attribution rules under § 302(c)(2). Id.
87. In the instant case, all of the parties to the disposition of stock are adults. The only purpose of the sale of part of the distributees' stock to their father is to assure the termination of their interest in the corporation. The same tax result will obtain regardless of how their interest is terminated, so that tax avoidance is not considered to be one of the principal purposes of the disposition.

Id. at 226.
In an apparent attempt to move away from the rigid tests enun-
ciated in past revenue rulings, the Service in 1977 issued Revenue
Ruling 77-293. This ruling dealt with the now routine procedure
whereby the shareholder makes a gift of a majority of his shares to
his child prior to redemption of his remaining shares in order to
insure transfer of corporate control to the child after redemption.
In promulgating the new ruling, the Service apparently concluded
that a case-by-case approach was better suited to determine tax
avoidance than was the three-factor method used in the past. The
Service stated: "Whether one of the principal purposes of an ac-
quision or disposition of stock is tax avoidance within the mean-
ing of section 302(c)(2)(B) of the Code can be determined only by
an analysis of all of the facts and circumstances of a particular
situation." While the transfer of stock by the distributee to the distributee’s
child, within ten years of a redemption, to effect transfer of corpo-
rate control will probably continue to be allowed by the Service, it
seems improbable that a transfer of stock to a spouse within ten
years of a redemption will be allowed. Note, however, that ac-
cording to the regulations, a transfer of stock within the ten-year
period prior to redemption will not be indicative of tax avoidance
merely because the transferee is in a lower income tax bracket
than the transferor. Rather, any ruling by the Service that a
transfer to a spouse within ten years of a redemption is for tax
avoidance purposes will be based on the possible retention of cor-
porate control by the distributee through the transferee spouse.

VI. CONCLUSION

Section 302(c)(2) is in a state of flux. Many allowances and ex-
ceptions are hidden behind the innocuous and seemingly inflexible
language of the Code. Wise use of these allowances and exceptions
can result in highly favorable tax consequences. The crucial task is
to tread the fine line between the spirit of the section and its judi-

89. Id. at 92. The only revenue ruling issued since Rev. Rul. 77-293 is Rev. Rul. 77-455,
1977-2 C.B. 357, which deals again with a transfer of stock to the distributee’s child within
ten years of the redemption to affect a transfer of control. There, the Service merely cites
Rev. Rul. 77-293 without any extensive reasoning offered for the decision. Hopefully, this
ruling does not herald a return to the Service’s original practice of issuing a ruling without
stating any substantive reasons for the holding.
cial interpretation. If this line can be found and used as a guide, the spoils of tax savings lie at the end of the journey.