

STOCK REDEMPTIONS IN CLOSE CORPORATIONS: A PLAN FOR TAXATION*

Stock redemptions enable shareholders to gain control of close corporations without suffering cash outlay or tax incidence.¹ Shareholders whose stock is redeemed are, of course, exposed to taxation.² However, the surviving shareholders may escape tax consequence despite the increase in their proportionate interests and even though they would have been taxed if they received the redemption funds in a distribution and subsequently purchased the redeemed shareholder's equity.³ The redemption mechanism may be utilized to transfer control in various fashions. For example, a third party can assume control through purchase of a partial interest of the controlling shareholder and a subsequent redemption by the corporation of the seller's remaining equity.⁴ Or, a corporation may redeem the stock of one shareholder at his death or retirement, thereby leaving another as sole owner.⁵ To the extent corporate funds provide the consideration for the redeemed stock in these instances, the

*Joseph R. Holsey, CCH TAX CT. REP. ¶ 22522 (Aug. 8, 1957).

1. See, generally, 1 MERTENS, FEDERAL INCOME TAXATION § 9.104 (Supp. 1957); Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13 (1956); First, *Use of Corporate Funds to Buy Out Shareholders—Acquisitions by Third Parties*, N.Y.U. 12TH INST. ON FED. TAX. 191 (1954); Harnett, *Buying Out the Disputatious Shareholder*, N.Y.U. 11TH INST. ON FED. TAX. 393 (1953); Raum, *Stock Purchase Agreements Among Stockholders of Close Corporations*, N.Y.U. 8TH INST. ON FED. TAX. 702 (1950); Notes, *Income Tax Problems in the Use of Stock Redemptions to Purchase a Corporation out of Future Earnings*, 67 HARV. L. REV. 1387 (1954), 40 VA. L. REV. 43 (1954).

Most jurisdictions permit corporations to purchase shares only out of surplus. BALLANTINE, CORPORATIONS §§ 256-58 (rev. ed. 1946). Some allow repurchase out of capital when no prejudice to other shareholders or creditors results. Note, 59 YALE L.J. 1177 (1950). Only two states have an absolute prohibition against such corporate action. *Id.* at 1182.

2. See note 7 *infra* and accompanying text.

3. See text at notes 19-22 *infra*. Dividend income may be utilized to effect a transfer in corporate control. Grayck, *Taxing Income that Is Applied Against the Purchase Price*, 12 TAX L. REV. 381 (1957). Where, pursuant to an agreement of sale, dividends on stock held in escrow are to be applied against the purchase price, such dividends are taxable income to the buyer. *Miller v. Commissioner*, 57-2 U.S.T.C. ¶ 9813 (7th Cir. July 9, 1957); *Northern Trust Co. v. United States*, 193 F.2d 127 (7th Cir.), *cert. denied*, 343 U.S. 956 (1952). The buyer is deemed to enjoy the beneficial use, if not the legal title, of the stock. *Estate of Arthur L. Hobson*, 17 T.C. 854 (1951), *acq.*, 1952-1 CUM. BULL. 2; Rev. Rul. 153, 1956-1 CUM. BULL. 166.

For discussion of the tax consequences of alternative means of employing corporate funds to effect control, see Lurie, *Checklist for Stockholder Buy-Outs With Corporate Funds Under 1954 Code*, J. Taxation, Nov. 1954, p. 7.

4. See Ray Edenfield, 19 T.C. 13 (1952), *acq.*, 1953-1 CUM. BULL. 4; Richardson, *Buying Corporation With Large Earned Surplus; Two Types of Transactions*, 4 J. TAXATION 334 (1956).

5. See *Pelton Steel Casting Co.*, 28 T.C. No. 20 (April 25, 1957), *appeal docketed*, 4 P-H 1957 FED. TAX SERV. ¶ 71109 (7th Cir. July 5, 1957) (No. 50455).

surviving shareholder may be subject to an ordinary income tax.⁶ For a redemption "essentially equivalent to a dividend" yields constructive income to a shareholder whose interest in the corporation survives the redemption.⁷ But since

6. See notes 15-18 *infra* and accompanying text.

The Commissioner has announced that stock redemptions will be examined to determine whether any payments by the corporation have the effect of a dividend to the shareholders who remain interested in the corporation. See Rev. Rul. 458, 1954-2 CUM. BULL. 167, applicable under the 1954 Code, Rev. Rul. 745, 1955-2 CUM. BULL. 223.

7. INT. REV. CODE OF 1954, § 302(b) (1) (formerly Int. Rev. Code of 1939, § 115(g), as amended, 65 STAT. 498 (1951)). Stock is "redeemed" when acquired by a corporation from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired or held as treasury stock. INT. REV. CODE OF 1954, § 317(b). Funds received in redemption of stock will be treated as in part or full payment for the stock, and thus be entitled to capital gains treatment if the redemption is not essentially equivalent to a dividend, is substantially disproportionate, or terminates a shareholder's interest. INT. REV. CODE OF 1954, § 302. Redemptions failing to satisfy any of these criteria are considered distributions of property and taxed as dividends to the extent derived from earnings and profits. INT. REV. CODE OF 1954, § 302(d); see INT. REV. CODE OF 1954, §§ 301, 316; Wren, *The Income Taxation of Corporate Distributions Under the Internal Revenue Code of 1954*, 43 CALIF. L. REV. 268 (1955), 44 CALIF. L. REV. 105 (1956); Bittker, *Stock Dividends, Distributions in Kind, Redemptions and Liquidations Under the 1954 Code*, 1955 U. SO. CALIF. TAX INST. 349. Distributions not derived from earnings and profits will reduce the adjusted basis of the stock. INT. REV. CODE OF 1954, § 301(c)(2). Any amount in excess of basis will then be treated as a gain from the sale or exchange of property. *Ibid.*

Whether or not a redemption is equivalent to a dividend is a question of fact. See 1 MERTENS, FEDERAL INCOME TAXATION § 9.100 & nn.39-66 (Supp. 1957). Relevant factors under the 1939 Code included: existence of a business purpose; corporation or shareholder initiation of the redemption; past dividend record; special circumstances existing at time of distribution; extent of change in control of the corporation; subsequent contraction of corporate activities. See, e.g., Earle v. Woodlaw, 245 F.2d 119 (9th Cir.), cert. denied, 77 Sup. Ct. 1400 (1957); Chandler v. Commissioner, 228 F.2d 909 (6th Cir. 1955); Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954); J. Natwick, 36 B.T.A. 866 (1937); Treusch, *Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code*, 32 TAXES 1023, 1037 (1954). Ordinarily no single factor is dispositive; courts consider the "net effect" in determining whether the redemption is equivalent to a dividend. See Pacific Vegetable Oil Co. v. Commissioner, Civil No. 15273, 9th Cir., July 8, 1957; Flanagan v. Helvering, 116 F.2d 937, 939-40 (D.C. Cir. 1940); Rockwell Spring & Axle Co. v. Granger, 140 F. Supp. 390 (W.D. Pa. 1956).

Congress may have intended to apply the 1939 criteria to the 1954 Code. See S. REP. No. 1622, 83d Cong., 2d Sess. 233-34 (1954) (committee intention to incorporate case law as to when a redemption is essentially equivalent to a dividend); Young, *Extreme Care Needed Today to Avoid Dividend Treatment of Stock Redemptions*, 7 J. TAXATION 66 (1957); Laikin, *Stock Redemptions: Sections 302 and 318*, N.Y.U. 14TH INST. ON FED. TAX. 671, 685-86 (1956). But see Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 41-43 (1956) (§ 302(b) (1) intended to apply only to redemptions not pro rata among shareholders).

Redemption of all of a seller's stock will ordinarily result in capital gains treatment, since it terminates his interest in the corporation. INT. REV. CODE OF 1954, § 302(b) (3); Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Auto Finance Co. v. Commissioner, 24 T.C. 416 (1955), *aff'd per curiam*, 229 F.2d 318 (4th Cir. 1956). However, the rules of constructive ownership apply. See INT. REV. CODE OF 1954, §§ 302(c), 318. Thus, a re-

existing law hinges this finding on the formalities rather than effect of the redemption, tax incidence may be easily avoided.⁸

The formalities incident to a stock redemption failed to relieve the surviving shareholder from tax liability in the recent case of *Joseph R. Holsey*.⁹ Ownership in the corporation, an Oldsmobile dealership, was equally shared by the taxpayer and G company, a Chevrolet dealership. The taxpayer had acquired his half-interest in the corporation pursuant to an option granted him by G company. Subsequent revision of the option permitted him or a corporation in which he owned at least fifty per cent of the common stock to purchase the remaining shares. The option was assigned to the corporation, which later purchased the stock. Reasoning that constructive receipt is geared to benefit and that the taxpayer's sole ownership was effected without expenditure on his part, the court found the stock redemption essentially equivalent to a dividend.¹⁰

In addition, *Holsey* implicitly rejected corporate purpose as a factor limiting tax liability in stock redemptions. The corporation's dealership contract was its most significant asset.¹¹ And the manufacturer's policy precluded ownership by competing dealers.¹² By eliminating the objectionable competitor interest, the redemption of G company's stock served a corporate end apparently as legitimate as those honored by prior case law.¹³ Yet the court held that a

demption of all of a shareholder's stock would not terminate his interest in the corporation within § 302(b) (3) if he constructively owned the stock of a surviving shareholder. Wolfman, *Some of the Attribution-of-Ownership Problems Involved in the Redemption of Stock Under the 1954 Code*, 33 TAXES 382 (1955). But family relationship will induce constructive ownership only under limited circumstances. INT. REV. CODE OF 1954, § 302 (c) (2); see Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 31 (1956).

8. "It is true that the [taxpayers] could have achieved their objective, yet completely avoided the tax liability here imposed That being so, it can be argued that to permit the decision of the Tax Court to stand is to permit form to triumph over substance. Yet, to the extent here implied, it is form which often must prevail, when the delicate question involved is whether the extraction of a corporation's earned surplus has been accomplished at less than the rates taxed upon ordinary income. . . . 'If a taxpayer has two legal methods by which he may attain a desired result, the method pursued is determinative for tax purposes without regard to the fact that different tax results would have attached if the alternative procedure had been followed.'" *Woodworth v. Commissioner*, 218 F.2d 719, 724 (6th Cir. 1955). See note 29 *infra* and accompanying text.

9. *Joseph R. Holsey*, CCH TAX CT. REP. ¶ 22522 (Aug. 8, 1957).

10. The court applied § 115(g) of the 1939 Code, which taxed distributions incident to stock redemptions if they were made at such time and in such manner as to be essentially equivalent to a dividend. Int. Rev. Code of 1939, § 115(g), as amended, 65 STAT. 498 (1951) (now INT. REV. CODE OF 1954, § 302(b) (1)). The court need not have resorted to this section, particularly since the shares of the taxpayer, the surviving shareholder, were not redeemed. The redemption could have been held a disguised dividend taxable under Int. Rev. Code of 1939, § 22(a), as amended, 53 STAT. 574 (1939) (now INT. REV. CODE OF 1954, § 61). See Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 37 n.86 (1956).

11. CCH TAX CT. REP. ¶ 22522, at 2883-84.

12. *Ibid.*

13. See, *e.g.*, *Tucker v. Commissioner*, 226 F.2d 177 (8th Cir. 1955) (preservation of dealership franchise); *Commissioner v. Snite*, 177 F.2d 819 (7th Cir. 1949) (providing stock

transfer of ownership which could have been effected without a corporate act does not constitute a proper corporate aim.¹⁴ Since any transfer can be achieved by sale between shareholders, this holding necessarily labels immaterial the effect of corporate purpose on the taxability of stock redemptions.

In overlooking the formalities of a stock redemption and rejecting corporate purpose as a limitation on tax liability, *Holsey* represents a complete departure from existing law. Formerly, taxation turned on the corporation's assuming an obligation of the surviving shareholder.¹⁵ Thus taxation awaited the share-

for sale to key employees); Giles E. Bullock, 26 T.C. No. 35 (1956) (repurchase of long outstanding preferred); Marjory K. Hatch, P-H 1954 T.C. Mem. Dec. ¶ 54114 (enabling managing shareholder to acquire voting control); A. C. Monk, P-H 1947 T.C. Mem. Dec. ¶ 47247 (improving credit standing of corporation); Bona Allen, 41 B.T.A. 206 (1940) (same); H. F. Asmussen, 36 B.T.A. 878 (1937) (furnishing stock for sale to young executives). See, generally, Brown, *How to Plan and Draft a Stock Purchase Agreement Relating to the Death of a Shareholder in a Closely Held Corporation*, U. So. CALIF. ST. TAX INST. 519 (1956). See text at notes 19, 20 *infra*.

14. CCH TAX CT. REP. ¶ 22522, at 2881.

Holsey is an application of an earlier tax court rationale taxing surviving shareholders when a corporate payment caused a transfer of corporate control. In *Tucker v. Commissioner*, 23 T.C. 115 (1954), *rev'd*, 226 F.2d 177 (8th Cir. 1955), the tax court refused to characterize corporate payments to a former minority shareholder as pursuant to a corporate purpose even though, absent the payments, the corporation would have lost its dealership franchise. See also *Emeloid Co.*, 14 T.C. 1295 (1950), *rev'd*, 189 F.2d 230 (3d Cir. 1951) (loan to purchase insurance for stock retirement agreement not primarily serving a business purpose); Steinberg, *Funding Stock Redemption Agreements with Life Insurance*, 35 TAXES 669, 673-74 (1957); Friedman, *Buy and Sell Agreements: A Review and a New Look*, N.Y.U. 15TH INST. ON FED. TAX. 1053, 1059 (1957). The court generally considered that such payments were intended to benefit the corporation only incidentally. *Tucker v. Commissioner*, *supra* at 125-26; *cf.* Jackson Howell, 26 T.C. 846 (1956), *aff'd sub nom.* Phelps v. Commissioner, Civil No. 15386, 9th Cir., July 24, 1957 (redemption taxed although designed to eliminate shareholder undesirable to supplier of corporation). The attitude that stock redemptions intended to transfer control are not designed for corporate purposes is suggested by recent tax court decisions involving insurance. These cases taxed shareholders on corporate premium payments for insurance to fund a stock retirement agreement. See Henry E. Prunier, CCH TAX CT. REP. ¶ 22327 (April 12, 1957); *Sanders v. Fox*, 149 F. Supp. 942 (D. Utah 1957). Compare *Casale v. Commissioner*, Civil No. 24476, 2d Cir., Sept. 5, 1957. See, generally, Lawthers, *Prunier Offers No Threat to a Sound Insured Buyout Plan*, 7 J. TAXATION 2 (1957). In each case, the corporation was committed to use the proceeds solely to effect the retirement agreement. Henry E. Prunier, *supra* ¶ 22327, at 2296; *Sanders v. Fox*, *supra* at 944. In finding this limitation insufficient to insulate the shareholders from income tax to the extent of the premium payments, the court evidently viewed stock retirement agreements as serving the shareholders more than the corporation. See Brief for Government, *Sanders v. Fox*, *supra*; Mannheim and Friedman, *Stock-Retirement Agreements—The Prunier and Sanders Cases*, 35 TAXES 567 (1957) (while continuity of management is of incidental benefit to corporation, shareholders are ultimate beneficiaries).

For criticism of the use of the corporate purpose doctrine in stock redemption cases, see Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 468 (1950).

15. *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947), 46 MICH. L. REV. 1002 (1948); *Woodworth v. Commissioner*, 218 F.2d 719 (6th Cir. 1955); *Lowenthal v. Com-*

holder who purchased another's interest with a promissory note and received the corporation's assumption of his obligation in exchange for redemption of the stock so purchased.¹⁶ While this result might be rationalized on the ground that the surviving and redeeming shareholders were in fact the same person, assumption of obligation cases need not involve such identity. Alternatively, a third party might contract to buy all the stock of a sole shareholder, half upon execution of the agreement and half within a year. After the initial purchase and before the expiration of a year, the corporation might redeem the stock of the seller and thus extinguish the buyer's contractual liability. Courts considered corporate payment of such "debts" gratuitous unless the taxpayer surrendered equity in the corporation sufficient to deprive him of a controlling interest.¹⁷

missioner, 169 F.2d 694 (7th Cir. 1948); Rev. Rul. 265, 1956-1 CUM. BULL. 156; Harnett, *supra* note 1, at 394-96; *cf.* Ruphane B. Iverson, 29 B.T.A. 863 (1934) (corporation under legal incapacity to redeem and received no consideration on assuming obligation). *But see* James Kay, 28 B.T.A. 331, 334 (1933) (dictum).

16. See, e.g., *Wall v. United States*, *supra* note 15.

Transactions taxable to a buyer because the corporation pays his purchase price for stock may assume a variety of forms. A corporation may cancel the indebtedness which a buyer previously incurred to purchase stock. *Lowenthal v. Commissioner*, *supra* note 15; *Floyd W. Bell*, 15 CCH Tax Ct. Mem. 1004 (1956); *Frank P. Holloway*, 10 CCH Tax Ct. Mem. 1257 (1951), *aff'd per curiam*, 203 F.2d 566 (6th Cir. 1953). Or, if a "strawman" is utilized by a buyer to borrow from a corporation to purchase shares, a subsequent redemption of the strawman's shares and discharge of indebtedness will be taxable to the buyer. *Fred C. Niederkrome*, 15 CCH Tax Ct. Mem. 1312 (Nov. 16, 1956), *appeal docketed*, 4 P-H 1957 FED. TAX SERV. ¶ 71109 (5th & 9th Cir. July 1, 1957) (Nos. 51491, 51526-9, 51531, 51533). Furthermore, a buyer will be taxed if a corporation redeems shares from a seller returned to him by the buyer in satisfaction of the buyer's debt. *Ferro v. Commissioner*, 242 F.2d 838 (3d Cir. 1957).

However, a valid promise to repay the funds borrowed from a corporation will insulate a buyer from ordinary income taxation. *George D. Mann*, 33 B.T.A. 281 (1935), *nonacq.*, XV-1 CUM. BULL. 37 (1936).

17. *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947) (no consideration where same proportionate interest before and after redemption); *Ferro v. Commissioner*, *supra* note 16 (same); *Pacific Vegetable Oil Co. v. Commissioner*, Civil No. 15273, 9th Cir., July 8, 1957 (redemption produced small change in interest); *Commissioner v. Roberts*, 203 F.2d 304, 305 (4th Cir. 1953); *Boyle v. Commissioner*, 187 F.2d 557, 560 (3d Cir.), *cert. denied*, 342 U.S. 817 (1951); *Pullman, Inc.*, 8 T.C. 292 (1947); Rev. Rul. 182, 1956-1 CUM. BULL. 157.

If a shareholder owns (directly and constructively) less than 50% of the total outstanding voting stock immediately after a redemption, and such shares do not exceed 80% of his prior percentage holdings, his receipts from the redemption will automatically be taxed as capital gain. INT. REV. CODE OF 1954, § 302(b)(2). Even if these statutory mathematical requirements are not met, the redemption may be treated as an exchange if a shareholder's proportionate interest is substantially decreased, and he controls less than 50% of the voting stock. See INT. REV. CODE OF 1954, § 302(b)(5) (fact that redemption fails to meet specific tests does not require finding of dividend income); S. REP. NO. 1622, 83d Cong., 2d Sess. 233-34 (1954) (incorporation of prior case law into 1954 Code); *Ferris v. United States*, 133 Ct. Cl. 257, 135 F. Supp. 286 (1955) (redemption substantially reduced shareholder's proportionate interest); *Smith v. United States*, 131 Ct. Cl. 748, 130 F. Supp. 586 (1955).

And gratuitous payment was regularly held the tax equivalent of a dividend.¹⁸ However, believing that corporate acts primarily intended to benefit the corporation should not impose tax liability on shareholders, courts generally did not allow redemptions subserving legitimate corporate aims to generate dividend income.¹⁹ Corporate purpose insulated the surviving shareholder even when the corporation had assumed his debt upon redemption.²⁰

Although functionally identical to a redemption in which the surviving shareholder's personal obligation was assumed, redemption absent an assumption did not produce ordinary income.²¹ Such transactions were considered arrangements between the corporation and the seller which affected the surviving shareholder only by giving him a greater interest in a smaller corporation.²² Under-

See also 1 MERTENS, FEDERAL INCOME TAXATION § 9.101 (Supp. 1957); Rasman, *Stock Redemptions Under Section 302 of the 1954 Code*, 35 TAXES 355, 358 (1957).

Presumably the treatment of substantially disproportionate redemptions stems from the recognition of the significance of control in the context of close corporations. To be characterized as a sale or exchange and therefore eligible for capital gains treatment, a transaction must manifest a mutual transfer of valuable property. See Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13 (1956). A redemption in which the corporation's cash is exchanged for the shareholder's certificates only embodies such characteristics when the certificates represent some real value, namely control.

18. See note 16 *supra*.

19. Tucker v. Commissioner, 226 F.2d 177, 179 (8th Cir. 1955), *reversing* 23 T.C. 115 (1954) (preserving dealership franchise), 42 VA. L. REV. 235 (1956); Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954) (improving credit position of corporation); Leake v. Jones, 4 P-H 1955 FED. TAX SERV. ¶ 72814 (W.D. Okla.) (same); Fred F. Fischer, 6 CCH Tax Ct. Mem. 520, 525-26 (1947) (preventing litigation, possible receivership proceedings).

20. Fewell v. United States, 4 P-H 1957 FED. TAX SERV. ¶ 72752 (S.D. Fla. May 8, 1957) (improving credit position of corporation); Smith v. United States, 131 Ct. Cl. 748, 130 F. Supp. 586 (1955) (obtaining stock for later sale to key employees).

21. Ray Edenfield, 19 T.C. 13 (1952), *acq.*, 1953-1 CUM. BULL. 4, 53 COLUM. L. REV. 881 (1953); Revenue Service Letter Ruling, March 28, 1956, on file in Yale Law Library (surviving shareholder assigned option to purchase shares of decedent to corporation; redemption by corporation did not result in a dividend to survivor).

22. Ray Edenfield, *supra* note 21, at 20; Ruphane B. Iverson, 29 B.T.A. 863, 870-71 (1934) (dissenting opinion); First, *supra* note 1, at 197.

If a buyer can prove that he is only the corporation's agent in purchasing a seller's shares, subsequent redemption of the purchased stock will not be treated as a dividend to him. Fox v. Harrison, 145 F.2d 521 (7th Cir. 1944); Nicholson, *Corporate Assistance in Sale of Stock*, 32 TAXES 644 (1954). The redemption is considered one of the seller's equity interest, not the buyer's. Fox v. Harrison, *supra* at 522. But proof that surviving shareholders expected the corporation to provide some of the required funds does not support an assertion that the corporation was a party to the agreement. Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948). Furthermore, without corporate authorization or ratification, a corporate check indicates only that a purchaser is using corporate funds to pay a personal debt. Mendle Silverman, 13 CCH Tax Ct. Mem. 527 (1954); Frank P. Holloway, 10 CCH Tax Ct. Mem. 1257 (1951), *aff'd per curiam*, 203 F.2d 566 (6th Cir. 1953). And the Commissioner may be able to frustrate the attempted conversion of a shareholder obligation into a corporate debt. George M. Hancock, 18 T.C. 210 (1952)

lying this rationalization may have been a presumption that redemptions not directly involving the surviving shareholder must be designed for a corporate purpose and therefore do not evoke constructive dividends.²³ Such a view shifts the function of corporate purpose from a ground for insulating otherwise taxable transactions to a basis for denying taxation in the first instance. In any event, whether or not an obligation is assumed, the surviving shareholder increases his proportionate interest without personal expenditure, the cost to the corporation is identical and the departing shareholder's receipts and taxes are the same.²⁴

As a departure from existing law, *Holsey* should be construed to embody these considerations and to require taxation of all shareholders whose proportionate interests are increased by stock redemptions. Whether the surviving shareholder purchases his increased interest from the retiring shareholder with corporate funds received in a taxable distribution or the corporation uses the same funds as consideration for redemption, the parties occupy identical positions after the transaction. The sole relevant economic distinction between these methods of transferring control lies in the relief from taxation arbitrarily granted or denied by present law.²⁵ And the existence of an assumption of obligation is functionally immaterial.²⁶ Moreover, the assumption of obligation rationale may be internally inconsistent. To the extent the shareholder whose liability was assumed contemplated subsequent redemption, the obligation may be viewed as constructively that of the corporation in the first instance.²⁷ This

(under *Court Holding* doctrine, sale by one party cannot be transformed for tax purposes into sale by another); see Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 38 (1956).

A corporation may reissue redeemed stock as a stock dividend without tax consequence to the shareholders. *Schmitt v. Commissioner*, 208 F.2d 819 (3d Cir. 1954), 67 HARV. L. REV. 1266 (1954); see Pavenstedt, *Use of Corporate Funds to Buy Out a Stockholder—The Schmitt Case and Its Ramifications*, N.Y.U. 12TH INST. ON FED. TAX. 203 (1954). The distribution of common on common is not a taxable event unless it changes the proportionate interests of the shareholders. *Schmitt v. Commissioner*, *supra* at 820. Moreover, the shareholders will be immune from tax as surety endorsers on the primary obligation of a corporation to redeem stock. *Estate of Edward L. Koepenick*, 2 CCH Tax Ct. Mem. 143 (1943). Although one court has held that a redemption of a seller's stock is not a dividend to a buyer who has agreed to purchase, or cause to be purchased, such stock from the seller, *S. K. Ames, Inc.*, 46 B.T.A. 1020 (1942), the decision is weak authority because of its confusing rationale and implied rejection by *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947). See Harnett, *supra* note 1, at 398-99.

23. See *Fox v. Harrison*, 145 F.2d 521 (7th Cir. 1944).

24. Compare, e.g., *Ray Edenfield*, 19 T.C. 13 (1952), with, e.g., *Woodworth v. Commissioner*, 218 F.2d 719 (6th Cir. 1955).

25. See 1 MERTENS, FEDERAL INCOME TAXATION § 9.104 (Supp. 1957).

26. Of course, the creditor's economic position is altered by the corporation's assumption of his debtor's obligation. But this factor is irrelevant in determining whether or not the debtor received a dividend.

27. But cf. *Lowenthal v. Commissioner*, 169 F.2d 694 (7th Cir. 1948) (discussed in note 22 *supra*).

approach would suggest denial rather than imposition of taxation.²⁸ Nevertheless, shareholders in a close corporation can generally structure a transaction to avoid the obligation rule,²⁹ and the problem of increased interest without cash outlay or tax consequence remains. In imposing a tax despite the presence of a corporate purpose and the absence of an assumed obligation, *Holsey* offers a sensible plan for taxation of stock redemptions—a plan cognizant of the functional equivalence between redemptions and shareholder sales.³⁰

Adoption of the *Holsey* plan for taxation would not inequitably impede transfers of control designed to promote legitimate corporate objectives. Stock redemptions facilitate transfers of ownership incident to the operation of close corporations. Agreements often provide for redeeming the equity of retired or deceased shareholders to permit continuation of harmonious management. The surviving shareholder may operate the corporation as an individual endeavor or, by sale of the redeemed stock, introduce third parties who are sympathetic to prior corporate policy.³¹ Such agreements further prevent separation of ownership from management by precluding the introduction of inactive parties against the will of the surviving shareholder.³² Redemptions may also be utilized to provide stock for sale to key employees in order to align their interests more closely with those of the corporation.³³ Before *Holsey*, the form of the redemption determined whether these ends could be accomplished without the use of funds against which a personal, ordinary income tax had been levied. But since such transfers are inevitably motivated by the advantage to be gained from shifts in shareholder control, considering corporate funds used to effect them as constructive dividends to the surviving shareholder does not seem unreasonable.³⁴ Transfers of ownership in the analogous business unit, the partnership,

28. If the obligation were in fact that of the corporation, the rationale for taxation would disappear.

29. See *Higgins v. Smith*, 308 U.S. 473, 475-76 (1940); Rabkin, *The Close Corporation—Through the Looking Glass*, N.Y.U. 8TH INST. ON FED. TAX. 664 (1950).

30. That redemptions intended to transfer control are tax-avoiding substitutes for equally available sales between shareholders, see *The Emeloid Co.*, 14 T.C. 1295 (1950), *rev'd*, 189 F.2d 230 (3d Cir. 1951); Steinberg, *supra* note 14, at 676; 53 COLUM. L. REV. 881, 882 (1953).

31. Mannheimer, *Insurance to Fund Stock-Retirement and Buy-and-Sell Agreements*, 29 TAXES 393, 395 (1951); Rappoport, *Corporation Stock-Purchase-Insurance Trust Agreement*, 29 TAXES 835 (1951).

32. Mannheimer & Friedman, *Stock-Retirement Agreements*, 28 TAXES 423, 425 (1950).

33. Brown, *supra* note 13.

34. However, if a redemption is taxed as a dividend, the basis of the remaining stock should reflect the distribution. For example, if *A* purchases all the stock of *X* corporation for \$100,000 and one half of the stock is later redeemed for \$150,000 in a taxable transaction, *A* should keep a cost basis of \$100,000 as he would in the case of an ordinary dividend distribution. See Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 54-55 (1956); Nicholson, *supra* note 22, at 649. Concomitantly, if a corporate redemption is treated as a dividend to surviving shareholders, the amount of the distribution so taxed should be added to the basis of their original stock. This basis would be the same as if they had purchased the shares of the

must be effected with property subjected to an ordinary income tax, and no reason appears for favoring corporate structure in this context.³⁵ Moreover, third parties will still be able to gain control without incurring ordinary income taxation. Instead of purchasing a partial interest and awaiting redemption of the remaining shares, a third party could acquire the business assets after they had been distributed at capital gains rates in complete liquidation.³⁶ He could then, in a tax-free transaction, exchange such assets for stock in a newly organized corporation.³⁷ The *Holsey* approach only prevents third parties from avoiding taxation while retaining the business and tax benefits inherent in continued existence of the original corporation.³⁸ *Holsey* may, however, impose

retiring shareholder. And the tax imposed would be the same as if they had received the funds used to make such purchase in a taxable distribution. See text at note 3 *supra*.

From the corporation's viewpoint, earnings accumulated to fund a stock retirement agreement might not be encompassed by the reasonably anticipated needs of the business to the extent that redemptions shifting control cannot be rationalized as serving a corporate purpose, and therefore might evoke the accumulated earnings tax. See INT. REV. CODE OF 1954, §§ 531, 533 (accumulations for purpose of avoiding surtax on shareholders subject to penalty tax; accumulations beyond the reasonable needs of the business shall be determinative of purpose to avoid the income tax with respect to shareholders, unless the corporation proves the contrary by a preponderance of evidence). Although the accumulations could not be designed to avoid the surtax on the corporation's shareholders indefinitely, since the *Holsey* approach would tax at the time of redemption, these funds would permit the corporation to shift its shareholders' income to periods most beneficial to them and thereby subject the accumulations to the penalty tax. See *Pelton Steel Casting Co.*, 28 T.C. No. 20 (April 25, 1957), *appeal docketed*, 4 P-H 1957 FED. TAX SERV. ¶ 71109 (7th Cir. July 5, 1957) (No. 50455) (accumulation to fund redemption subject to penalty); *Hedberg-Friedheim Contracting Co.*, 15 CCH Tax Ct. Mem. 1433 (Dec. 13, 1956), *appeal docketed*, 4 P-H 1957 FED. TAX SERV. ¶ 71109 (8th Cir. July 1, 1957) (No. 53629-30) (same). Compare *Gazette Pub. Co. v. Self*, 103 F. Supp. 779 (E.D. Ark. 1952) (funds used to redeem stock originally accumulated for valid corporate purpose).

35. Income earned by a partnership is taxed each year to the individual partners according to their distributive shares. INT. REV. CODE OF 1954, §§ 701, 702.

36. INT. REV. CODE OF 1954, § 331.

37. INT. REV. CODE OF 1954, § 351.

38. Formation of a new corporation will result in loss of any tax benefits incidental to the liquidated corporation's "tax history." Thus, the net operating loss deduction of the liquidated corporation will not be available to the new corporation. See INT. REV. CODE OF 1954, §§ 172, 381; Friedman & Silbert, *Acquisition of Corporate Business*, N.Y.U. 15TH INST. ON FED. TAX. 659, 660 (1957). And the business assets will take on a new basis for purposes of determining gain or loss on a subsequent sale and computing depreciation. First, *supra* note 1, at 197-98. This basis, and that of the shares in the new corporation exchanged for the assets, will be the same as the fair market value of the assets when received in complete liquidation of the old corporation, INT. REV. CODE OF 1954, §§ 351, 358, or the price paid in acquiring such assets, INT. REV. CODE OF 1954, § 1012, which presumably will be the same figure.

In addition, business disadvantages may attend liquidation of the old corporation. For example, any licenses of the liquidated unit would have to be reacquired by the new corporation. Expenses would be incurred in obtaining a new, and necessary, corporate franchise. And stamp taxes, both state and federal, would be imposed on the issuance of shares by the new corporation. Moreover, assignment of old contracts may present legal difficulties. BALLANTINE, CORPORATIONS § 293 (rev. ed. 1946).

increased taxation on shareholders desiring to gain control and continue the business. The treasury regulations provide that distributions in complete liquidation may generate dividend income when assets of the original corporation are transferred to another corporation.³⁹ Accordingly, the complete liquidation and new organization technique could result in greater taxation of shareholders than the redemption mechanism in the absence of *Holsey*. Nevertheless, the *Holsey* refinement seems justified. Just as third parties must exchange tax liability for continued corporate existence, shareholders must yield tax immunity for continued employment of the same business assets.

39. U.S. Treas. Reg. § 1.331-1(c) (1955).