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STOCK REDEMPTIONS

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The problem posed by R. H. Brown, Jr., is not an uncommon one today. That problem was how to get cash from a closely held corporation in order to pay the estate tax due on his father's estate without having the cash received taxed as a dividend to the estate.

R. H. Brown, Sr. had been a natural born salesman, who, with two associates and his son, had taken over an almost defunct automobile agency in 1941. The business had prospered and the end result was a nice little business for his son to carry on, but right now the main worry was how to get cash to pay the estato tax. There was some insurance but that was payable to Mrs. Brown in installments. The real estate consisted of an apartment building in which Mrs. Brown lived and they wanted to keep that for her security and for additional income to her. The will left one-half of the estate to Mrs. Brown and the remainder to R. H. Brown, Jr., and it had been intended that the interest in the automobile agency would go to the son. But now the estate needed $30,000 for estate tax, and the only practical source of those funds was the corporation.

Of course the estate might sell some of the stock of the corporation. This would be ideal from the income tax standpoint since there would be little, if any, tax involved because

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of the stepped-up basis of the stock to the estate. But it would be difficult to find a purchaser, and the other stockholders would prefer not to take in an outsider anyway. The next logical purchaser would be the corporation since such a purchase would not add any new stockholders. The problem then is whether we can sell some or all of the stock to the corporation the same as we might sell the stock to another individual.

With a sketchy idea of the problem involved, we asked for a recent balance sheet of the corporation, a list of stockholders, and a statement of dividend policy of the corporation down to date, and were supplied with the following:

BROWN MOTORS, INC.
Balance Sheet—6-30-47

Assets

Cash	$ 60,000
Accounts Receivable	35,000
Inventory	60,000
Land and Building	60,000
Miscellaneous	6,000
	$221,000

Liabilities

Accounts Payable	$ 12,000
Federal Taxes (last installment)	2,000
Reserve for Taxes	7,000
Capital Stock	
Preferred (500 shares)	50,000
Common (1,000 shares)	100,000
Surplus	50,000
	$221,000

Stock Ownership

	Common	Preferred
Brown Estate	300	200
R. H. Brown, Jr.	100	100
V. Blue	300	100
W. Black	300	100

Dividend Policy

		Earnings after taxes	Dividends Common	Dividends Preferred
1941	Corp. organized 3/10/41	6,000	—0—	1,250
1942		10,000	—0—	2,500
1943		12,500	—0—	2,500
1944		14,000	—0—	2,500
1945		10,000	4,000	2,500

1946	16,000	6,000	2,500
1947 Estimated to 6/30/47	6,500	—0—	1,250
	75,000	10,000	15,000

The preferred stock has a call value of $100 a share and is callable at any time upon vote of the directors. The common stock has a book value of $150 a share, and the estate would be willing to turn in some or all of its stock at this figure. We are told that the corporation could spare as much as $50,000 in carrying out any plan which we might devise.

Being mindful of the danger that any distribution from the corporation might be taxed as a dividend regardless of what we call it, we look first for other possible solutions. The executor might borrow the $30,000 from the corporation and have R. H. Brown, Jr., who will inherit the stock, pay this back to the corporation at a later date. This would, of course, merely postpone the evil day and is a temporary solution at best. In addition, there is the danger of incurring liability under §102 of the Internal Revenue Code whenever a corporation, by lending funds to a stockholder, demonstrates that it has surplus funds which are not being paid out as dividends.

The safest procedure from the standpoint of the estate would be to completely liquidate the corporation. This, however, would cause the other stockholders to incur a tax on liquidation in order to accommodate the estate. Then if they proceeded immediately to organize a new corporation with the same proportionate holdings, there is the possibility that the liquidation and reorganization might be disregarded and the retained cash treated merely as the distribution of a dividend. If the steckholders wished to conduct the business as a partnership, this danger would be eliminated. But it would prove difficult, if not impossible, to have the estate carry on the business as a partner, and the other stockholders prefer to carry on the business in corporate form anyway.

That leaves a partial liquidation as the only practical solution if indeed that can be worked in such a manner that the redemption of stock of the corporation will not be treated as the distribution of a taxable dividend. If $30,000 were distributed to the estate and were held to be taxable income, the estate would not have the needed $30,000 with which to pay the estate tax after settling the income tax liability.

Such a result is more than a mere possibility when we start with the basic proposition that all corporate distributions are regarded as dividends under §115(a) unless some specific exception is found elsewhere in the Code. Thus any amount paid by the corporation to the estate would be a distribution by the corporation to a stockholder, and some special provision is needed to prevent that distribution being taxed as a dividend.

A special dispensation is granted by §115(c), which provides that distributions in complete or partial liquidation shall be treated as in part or full payment in exchange for the stock. Section 115(i) provides that "amounts distributed in partial liquidation" means a distribution in complete cancellation or redemption of a part of the stock of a corporation or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. These two provisions standing alone would seem to solve our problem. We could very easily arrange to have a part of the stock of all the stockholders, or a substantial portion or all of the stock of the Brown Estate redeemed so as to comply with §115(i) and thereby seemingly qualify ourselves for the special treatment accorded by §115(c).

However, tax lawyers have long ago learned that when a perfectly easy and reasonable solution presents itself they should always *cherchez la catch.* We do not have far to look in this instance before we discover §115(g) rearing its head in a very ugly way. That section in effect holds that even where you have a cancellation or redemption of stock so as to seemingly qualify as a partial liquidation, the amounts distributed may, nevertheless, be taxed as a dividend. Our problem then is to analyze the legislative history of those provisions and the court decisions so as to determine what, if anything, we can do in order that the distribution of cash to one or more of the stockholders of Brown Motors, Inc. will be treated as a distribution in partial liquidation and not as a distribution essentially equivalent to a taxable dividend.

PARTIAL LIQUIDATIONS

The definition of a partial liquidation as contained in §115(i) was first enacted in 1924 and has not been changed down to the present time. Actually the provision is a restrictive one and confines partial liquidations to those situations where stock has been redeemed or where the distri-

bution is part of a plan of complete liquidation. Since that time, apart from distributions in complete liquidation, there must be a redemption of stock before the distribution has a chance of being treated as a partial liquidation.[1]

When the definition of partial liquidations was first enacted, such distributions were treated as amounts received on the sale of the stock redeemed. They had been treated in that manner since the 1918 Act, and that treatment was continued down to the 1934 Act, which made the gain fully taxable. In the 1938 Act distributions in partial liquidation were treated as giving rise to short-term gains or losses which was about the most adverse treatment which could have been accorded within the ambit of the statute. At the same time, the sale of stock to other stockholders gave rise to capital gains and losses, and, if the stock had been held the required time, entitled the stockholder to very definite advantages. This arbitrary classification gave rise to a great deal of litigation and gross inequities based upon pure technicalities. If stock was to be redeemed and the stockholder merely turned in his stock, any gain would be taxed as ordinary income. On the other hand, if he sold his stock to a third party who subsequently redeemed it, the gain to the first stockholder would be taxed as a capital gain.

To cure this incongruous result, the 1942 Act taxed amounts received in partial liquidation in the same manner as amounts received on the sale of the stock. This seemed to open the gates to tax avoidance by permitting the corporation to dispose of its cash through redemption of its stock rather than by the payment of dividends, thereby having corporate earnings taxed at capital gains rates when distributed to the stockholders. The Ways and Means Committee was aware of this danger, but voiced the hope that any tax avoidance as a result of the more liberal treatment of distributions in partial liquidation could be stopped by the application of §115(g) to those distributions which were essentially equivalent to dividends.[2]

1. Jones v. Dawson, 148 F.2d 87 (C.C.A. 10th 1945); Edward S. Kraus, Jr., 6 T.C. 105 (1946); A. J. Long, Jr., 5 T.C. 327 (1945).
2. Sen. Rep. No. 1631, 77th Cong., 2nd Sess. 116 (1942): "Under existing law the gain realized from a distribution in partial liquidation is treated, despite the provisions of section 117, as a short-term capital gain. This treatment was occasioned by the facility with which ordinary dividends may be distributed under the guise of distributions in partial liquidation, although section

DISTRIBUTIONS ESSENTIALLY EQUIVALENT TO DIVIDENDS

Sometimes statutory provisions, like people, rise above their early surroundings and background, to an importance wholly unpredictable from their humble origin. That is true of §115(g), and that is one reason why many who are most familiar with its legislative history are apt to underestimate the full effect of that statutory provision as it is today construed by the courts. This is one strange instance where the legislative history needs to be explained away instead of lending itself to an understanding of the statutory provision.

After the Supreme Court had held stock dividends to be non-taxable, Congress became worried over the tax avoidance possibilities incident to a corporation issuing stock dividends and subsequently redeeming the stock, giving the stockholders the equivalent of cash dividends without payment of the ordinary income tax. So a provision was included in the Revenue Act of 1921 to the effect that a stock dividend should not be subject to tax, but if after the distribution of such a dividend the corporation proceeded to cancel or redeem its stock in such manner as to make the distribution essentially equivalent to a taxable dividend, the amount received in redemption or cancellation of the stock should be treated as a taxable dividend to the extent of the earnings or profits accumulated after February 28, 1913. In the 1924 Act, Congress made an amendment to include redemptions or cancellations before the distribution of a stock dividend as well as after. It was in the 1926 Act that the present §115(g) was first enacted to include redemptions and cancellations of any stock whether or not it was issued as a stock dividend. But while the language then enacted is the same as that in force today, with the exception of one minor amendment relating to depletion reserves, it has taken the

115(g) makes explicit provision for the treatment of such distributions as ordinary dividends. Inequality results, however, under the existing law in the case of unquestionable bona fide redemptions of stock not equivalent in any way to the distribution of a taxable dividend. It is believed that the proper application of section 115(g) will prove adequate to prevent taxable dividends disguised as liquidations from receiving capital-gain treatment. Accordingly, this section of the bill eliminates the provision requiring the gain from a partial liquidation to be treated as a short-term capital gain."

courts twenty years to clear away the historical background and apply the section according to its literal meaning.

BASIC PRINCIPLES

There are then three basic principles which we gather from a reading of the Code provisions relating to corporate distributions:

1. All corporate distributions are ordinary dividends under §115(a) and (b) unless they qualify as liquidating distributions under §115(c).
2. There must be a cancellation or redemption of stock to qualify a distribution as being in partial liquidation regardless of intent [§115(i)].
3. There is no magic in redeeming or cancelling stock as prescribed in §115(i). Such a redemption may be a liquidating distribution under §115(c), but it is equally apt to be taxed as a distribution essentially equivalent to a dividend under §115(g).

GLITTERING GENERALITIES

Almost all the basic provisions of the Code have undergone a substantial change in interpretation during recent years and this has resulted in considerable confusion. That general confusion has been unusually great with respect to the statutory provisions relating to partial liquidations because of the fact that the original historical purpose of § 115(g) continued to haunt the courts long after the original provisions had been interred and more vital language had been substituted to prevent the new tax avoidance schemes envisioned by Congress. Thus, although Congress more than twenty years ago had eliminated the original limiting language restricting §115(g) to situations involving stock dividends, it was only a year ago that some of our courts finally decided that the manner of the issuance of the redeemed stock was no longer determinative of the application of §115(g).[3]

Then there were the many cases involving years prior to 1942 where the only issue was whether stock had been redeemed as a part of a partial liquidation, or whether it had been sold to the corporation. Many of those cases held that the redemption was in partial liquidation under circumstances which are quite encouraging to those seeking to have

3. Kirschenbaum v. Comm'r., 155 F.2d 23 (C.C.A. 2d 1946).

a distribution today taxed as a partial liquidation instead of as a dividend.[4] In deciding whether a distribution was in partial liquidation or was a purchase of stock by the corporation, a redemption and cancellation of the stock might well be determinative. But when §115(g) enters the picture and the question is whether the distribution is in partial liquidation or is essentially equivalent to a dividend, mere redemption is not determinative since the redemption may be either in partial liquidation or equivalent to a dividend.[5]

Once we recognize that it is the character of the distribution in redemption of the stock and not the nature of the original issuance of the stock redeemed which is determinative, and when we further eliminate the many cases involving partial liquidations in which the application of §115(g) was not at issue, the scene becomes much clearer and a fairly workable pattern becomes apparent.

Where all of the stock of a shareholder is redeemed there is no real question as to the application of §115(g). The Regulations correctly provide that such a distribution is in partial liquidation if the shareholder thereby parts with all of his interest in the corporation. It is not the nature of an ordinary dividend to cause a shareholder to be without further interest in the corporation so that such a distribution could only be treated as a partial liquidation.

Where less than all of the stock of a shareholder is redeemed, then the courts require a showing that the distribution was motivated by corporate purposes if it is to be treated as a liquidating dividend. If the distribution is primarily for the benefit of stockholders, then it will be treated as essentially equivalent to a dividend. Thus the courts have found the distribution to be in partial liquidation where there was an actual contraction of business activities[6] and where there was found a corporate purpose for reducing capital.[7] But the courts have found the distribution to be es-

4. Stern v. Harrison, 152 F.2d 321 (C.C.A. 7th 1945); Gladys C. Blum, 5 T.C. 303 (1945); Abner J. Tower, 5 T.C. 383 (1945).

5. The Tax Court failed to make such a distinction in the cases it cited in Georgia P. Johnson, P-H 1947 TC Mem. Dec. Serv. ¶47,152 (1947), although the result reached could be justified on other grounds.

6. Samuel A. Upham, 4 T.C. 1120 (1945); Heber Scowcroft Inv. Co., P-H 1945 TC Mem. Dec. Serv. ¶45,235 (1945).

7. Harry A. Koch, 26 B.T.A. 1025 (1932). But see Dunton v. Clauston, 67 F. Supp. 839 (S.D.Me. 1946).

sentially equivalent to a dividend where the corporation continued to operate as previously and showed no policy of contraction,[8] where the distribution was induced by needs of the stockholders rather than by any corporate purpose,[9] and where the corporation had accumulated a substantial surplus while not paying out liberal dividends.[10] Let us apply these rather vague generalities to our problem and cite more specifically the applicable authorities which will assist us in the selection of the best method of solving our problem.

POSSIBLE DISTRIBUTIONS

There are seven feasible methods of redeeming stock so as to get the required amount of cash into the Brown Estate:

1. Pro rata redemption of common stock.
2. Redemption of all preferred stock.
3. Redemption of all preferred stock of the Brown Estate and R. H. Brown, Jr.
4. Redemption of all of the common stock of the Brown Estate.
5. Redemption of all stock owned by the Brown Estate, using notes to supplement cash.
6. Sale of 200 shares of common stock by the Brown Estate to other stockholders and subsequent redemption of all remaining stock in the Brown Estate.
7. Redemption of all of the stock of R. H. Brown, Jr. and purchase by him of assets of the estate.

The above possibilities are set out in the order of their appeal to R. H. Brown, Jr., disregarding for the moment the impact of federal income taxes. But the tax consequences of the distribution are a major item and may require a sacrifice of other desirable ends. So we proceed to examine the tax consequences of each possible distribution to determine which, if any, may prove to be the lucky one of the seven possibilities.

I. PRO RATA REDEMPTION OF COMMON STOCK

The pro rata redemption of common stock would leave

8. Flanagan v. Helvering, 116 F.2d 937 (App. D.C. 1940); Pullman, Inc., 8 T.C. 292 (1947).
9. Rheinstrom v. Comm'r., 125 F.2d 790 (C.C.A. 6th 1942).
10. Goldstein v. Comm'r., 113 F.2d 363 (C.C.A. 7th 1940). A liberal dividend policy apparently saved the day for the stockholder in A. C. Monk, P-H 1947 TC Mem. Dec. Serv. ¶47,247 (1947).

the equity interests of the present stockholders undisturbed, which has a particular appeal to them. It would not only get funds into the Brown Estate but it would also let the other stockholders participate in the distribution, and everyone would wind up owning the same relative interest in the enterprise. There would not be sufficient cash, but the corporation could use notes for some of the stockholders who were not in as great need for cash as is the Brown Estate.

But a pro rata redemption of common stock in this case is the most certain method of having the distribution taxed as a dividend under §115(g). It is the particular evil which was mentioned at the time of the enactment of that section, and the Regulations expressly cite it as an example of the type of redemption which will be taxed as the distribution of a dividend.[11] The mere fact that stock was originally issued for value will not deter the taxation of the distribution in redemption as a dividend, and the fact that funds are needed by the estate is not an alleviating factor. In *Flanagan v. Helvering*,[12] the executor had the corporation redeem an equal amount of the stock of the two sole stockholders in order to get funds to meet administration expenses. Had the distribution been made as a dividend to the estate, the amount would have gone to the heirs, and the estate would not have had the funds to meet expenses. The court held that notwithstanding the extraneous factors which required the distribution of these amounts by way of redemption, the net effect to the stockholders was the same as though the amounts had been distributed as dividends, and hence, the distribution was taxable under §115(g).

However, a pro rata redemption of common stock may fall without the ambit of §115(g) if the distribution is actually in partial liquidation of the corporation. If there is a curtailment of corporate activities and an intent to wind up one part of the business and distribute the unneeded assets,

11. Treas. Reg. 111, §115-9 (1939): "A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend."

12. 116 F.2d 937 (App. D.C. 1940).

then the distribution may be taxed as a liquidating dividend rather than an ordinary dividend. In order to get this favored treatment the facts must be somewhat unusual.

Samuel A. Upham was one of the principal stockholders of a paper company that had been in existence since 1893, during which time it had increased its capital from $18,000 to $1,000,000 by means of stock dividends. In 1938, Mr. Upham and another stockholder discussed plans for turning over the business to employees, and Mr. Upham wrote a letter outlining the plan to the trust company that had been designated as his executor. Under the plan, the stockholders were to receive $160 a share either in cash or 3% bonds, the employees were to form a new corporation and acquire the assets of the old corporation upon assuming the obligation to pay the stockholders the $160 per share. Pursuant to this plan, the corporation redeemed 40% of the outstanding stock pro rata at $160 a share. The Tax Court held that the purpose of the redemption was the ultimate liquidation of the corporation, and that there was also the intent to contract business activities of the company, so that the distribution was taxable to the shareholders as a distribution in partial liquidation rather than as an ordinary dividend under § 115(g).[13]

Whatever may be the status of dividends in actual liquidation of a corporation, the principle will not be of assistance in this case since there is no intention on the part of the surviving stockholders to curtail corporate activities, nor are there any unneeded corporate assets other than cash which might be spared to carry out the redemption. The distribution of unneeded cash is obviously not a curtailment of corporate activities even if the cash not needed in the business has been invested in securities. In *Edward L. Krauss, Jr. Trust*,[14] the corporation was in the business of manufacturing school slates and had acquired substantial security investments. The corporation sold these securities and distributed

13. Samuel A. Upham, 4 T.C. 1120 (1945). A similar result was reached in Dana v. Sheehan, 66 F. Supp. 47 (E.D.Mo. 1946), L. M. Lockhart, 8 T.C. 436 (1947) and Heber Scowcroft Inv. Co., P-H 1945 TC Mem. Dec. Serv. ¶45,235 (1945). However the Tax Court stated in Pullman, Inc., 8 T.C. 292 (1947), that the doctrine of these cases has been weakened by the decision of the Supreme Court in Comm'r v. Estate of Bedford, 325 U.S. 283 (1945).

14. 6 T.C. 105 (1946).

the proceeds to the stockholders, cancelling some of its stock two years later on account of the distribution. The court held that the distribution was not a partial liquidation in the absence of a contemporaneous cancellation of stock, but went on to say that even if it were to be regarded as a distribution in redemption of a part of its stock, the pro rata distribution would be taxable under §115(g) since there was no intent to reduce operations other than to eliminate the securities investment, which could not be regarded as one of the corporate purposes.

II. REDEMPTION OF ALL PREFERRED STOCK

A redemption of all the outstanding preferred stock would require the distribution of $50,000 by the corporation, of which the estate would receive $20,000 and R. H. Brown, Jr. $10,000. This latter amount could be used to purchase assets from the estate so as to make available the required amount of cash. The common stock interests of the parties would remain unchanged, which would make this method particularly appealing to all parties if we can have the transaction treated as a partial liquidation. In that event there would be no tax to any of the stockholders as they would be getting back their original investment.

The preferred stock is not held in the same proportion as the common stock, so that its redemption would not be quite as close to an actual dividend as would the pro rata redemption of common stock. Also the stock was originally issued for money or property paid in at the time of incorporation, and it could be contended that the stockholders were receiving merely a return of capital. But neither of these factors is determinative. It is not essential that ordinary dividend be paid pro rata in order to be taxable as a dividend to the stockholder, and the contention that a stockholder is merely receiving a return of his investment upon the redemption of a portion of his stock is not sufficient to preclude the application of §115(g).

In Stein v. U.S.,[15] Mrs. Stein had some Class B preferred stock redeemed pursuant to the provisions of the stock certificates which required only action by the board of directors. The stock had been issued at the time of incorporation for cash paid in by the subscribers. The court held that the

15. 62 F. Supp. 568 (Ct.Cl. 1945).

distribution received by Mrs. Stein on redemption of a portion of her preferred stock was taxable as an ordinary dividend. Mrs. Stein had at one time owned common, and it was not proven at the trial that she was still the owner of common stock at the time of the redemption. The court held that if her ownership of common had changed, the burden was upon her to prove it, and in the absence of such proof, the redemption of the preferred stock would be taxed as the distribution of a taxable dividend.

Bertram Meyer formed a real estate holding corporation and transferred certain properties in return for common stock and two classes of preferred. By resolution of the board of directors no dividends were payable on the common stock or on the noncumulative preferred until the first preferred stock was completely redeemed. Pursuant to this resolution and the provisions of the first preferred stock certificates no dividends were paid, and the first preferred stock was redeemed as rapidly as possible. In *Bertram Meyer*,[16] the Tax Court held that the redemption of the preferred stock was essentially equivalent te the distribution of a taxable dividend since the corporation was apparently organized in such manner as to purport to allow the holder of all its stock to obtain a return of his investment tax-free from the earnings and profits of the corporation.

It is possible to have the redemption of preferred stock taxable as a liquidating dividend under proper circumstances. Georgia P. Johnson had some preferred stock redeemed which had been issued to her in a merger involving three newspaper companies. One of the merging companies had a substantial debt which the successor corporation was required to assume. In order that the ultimate equity interests of the parties should not be too much affected by this assumption of indebtedness, stockholders of the other two merging corporations were given preferred stock in addition to their common stock, with the intention that this preferred stock would be redeemed as the assumed indebtedness was paid off. Hence, upon the payment of the assumed indebtedness and the retirement of preferred stock, the common stockholdings of the three principal groups of stockholders would bear the desired ratio. Pursuant to this plan, some of the stock of Georgia

16. Bertram Meyer, 5 T.C. 165 (1945), reversed and remanded 154 F.2d 55 (C.C.A. 3rd 1946), rehearing 7 T.C. 1381 (1946).

P. Johnson was redeemed, and the Tax Court in *Georgia P. Johnson*[17] held that since the cancellation of the preferred stock came within the definition of partial liquidation in § 115(i), the distribution was taxable as a liquidating dividend under §115(c). The reasoning of the court is difficult to reconcile with decisions of the court in other cases; however, the result was doubtless substantially affected by the fact that the redemption of the preferred stock merely counter-balanced the payments on the indebtedness of another stockholder which had been assumed as a part of the merger.

There are no special factors in our case that warrant any hope for better treatment than the court accorded the redemptions in case of Mrs. Stein and Mr. Meyer. The dividend policy of Brown Motors, Inc. has not been liberal, and the main reason for the distribution is found in the need of one of the stockholders. The distribution in redemption of all of the preferred stock would probably be held to be essentially equivalent to a taxable dividend.

III. REDEMPTION OF PREFERRED STOCK OF THE BROWN ESTATE AND R. H. BROWN, JR.

The only real difference between redeeming all of the outstanding preferred stock and redeeming only that owned by the estate and R. H. Brown, Jr. lies in the fact that in the latter instance the distribution would not be to all stockholders. There is no magic in this arrangement, although a distribution to only a portion of the stockholders does not so nearly represent the ordinary dividend distribution. Another factor in favor of this procedure is that those who presumably are not in need of the cash would not be running the risk of tax in order that the estate might receive needed funds.

In *R. W. Creech*,[18] two of the principal stockholders were indebted to the corporation in a large amount. One of the stockholders died, and in order to discharge the debt to the corporation, the two principal stockholders each turned in 285 shares of stock out of a total number of 2000 shares outstanding, and the debt of each stockholder was cancelled by the corporation. In holding that the cancellation of the debt was not essentially equivalent to the distribution of a taxable dividend, the Board of Tax Appeals stressed the

17. Georgia P. Johnson, P-H 1947 TC Mem. Dec. Serv. ¶47,152 (1947).
18. 46 B.T.A. 93 (1942).

fact that the distribution had not been pro rata among all of the stockholders. The Board recognized the cases in which it had held that the distribution need not be pro rata in order for it to be taxable as a dividend but found in this particular case that the distribution in question should not be so regarded, and noted as other factors the cash dividends paid by the corporation and the fact that the stock in question had not been issued as a stock dividend.

Since the *Creech* case, we have had the *Stein* and *Meyer* decisions taxing as dividends the distributions in redemption of preferred stock under circumstances more nearly like those in the present case. The *Creech* case is still cited, but we decide that the mere fact that the distribution in redemption is not to all stockholders is not a sufficient bulwark against the assertion of a tax in this case.

IV. REDEMPTION OF ALL OF THE COMMON STOCK OF THE BROWN ESTATE

Redemption of all of the common stock of the Brown Estato would require a distribution of $45,000 to the estate if the stock were redeemed at book value. This is more cash than is needed by the estate, and such redemption would considerably reduce the ultimate interest of R. H. Brown, Jr., who had hoped to emerge as the principal stockholder by virtue of the inheritance from his father. Believing, however, that the stockholders might be able to subsequently shift their interests so as to keep the relative position which they desired, we explore the tax potentialities of this course.

The Regulations provide that if all of the stock of a single shareholder is redeemed so that he has no continuing interest in the business, then such redemption is not to be treated as the distribution of a taxable dividend.[19] After the redemption of the common stock of the Brown Estate there would be a continuing interest in the corporation represented by the ownership of preferred stock. Is this such an interest as would make a redemption of the common stock essentially equivalent to the distribution of a taxable dividend?

If the preferred stock owned by the estate is to be regarded as a continuing interest in the corporation sufficient to justify the taxing of the entire amount paid in

19. Treas. Reg. 111, §115-9 (1939).

redemption of the common stock as the distribution of a dividend, then you would have the anomalous situation of a $45,000 dividend on a $20,000 par value 5% preferred stock. Since the determination of whether a distribution is essentially equivalent to a taxable dividend is basically one of fact, it would seem that the facts would not be present here to justify the taxing of the entire amount distributed as a dividend. The continuing interest referred to in the Regulations should be an interest which would enable the taxpayer to continue to share in the prosperity of the corporation. But where a stockholder is left with only preferred stock of a fixed dividend and liquidating value, he is certainly not in the same relative position as he would have been had he retained his common stock and received a dividend thereon. While the courts will overlook minor adjustments in the relative standing of stockholders, no decisions to date have indicated a philosophy which would lead to the conclusion that the amount received in the redemption of the common stock of the Brown Estate would be treated as the distribution of a dividend.

We should not, however, be lulled into a false sense of security by the fact that there are no court decisions to date blocking this path. The Commissioner would certainly question such a redemption and attempt to tax it as the distribution of a dividend, and there are situations where such a contention might be upheld. Suppose, for example, that the common stock were practically valueless and the preferred was worth only twenty cents on each dollar of its par value. Then a redemption of the common might be construed as essentially equivalent to a distribution of a dividend on the preferred since the preferred stock retained would still entitle the stockholder to participate in his full share of the remaining corporate assets, and he would have received the distribution in addition. In such a case, the preferred stock really represents the equity in the corporation and the retention of preferred stock might be held to be the type of continuing interest which would make the distribution taxable under the Regulations.

If the Commissioner were to obtain a favorable decision in the above type of case, we would then be faced with the problem of distinguishing between preferred stock in a prosperous corporation and preferred stock in a deficit corpora-

tion, arguing that preferred stock of a deficit corporation represented a continuing interest under the Regulations whereas preferred stock of a prosperous corporation would not. Without attempting to resolve the issue at this time, we recognize that by this method we would be stepping into almost certain litigation.

V. REDEMPTION OF ALL STOCK OWNED BY THE BROWN ESTATE

The redemption of all the stock of the Brown Estate presents considerable practical difficulties. In the first place, it would require more cash than the corporation can spare, and in the second place, it would considerably reduce the ultimate common stockholdings of R. H. Brown, Jr., as we have previously discussed.

If the corporation were to redeem all of the stock of the Brown Estate for cash and notes, the tax problem would be whether the notes would constitute a continuing interest in the corporation within the meaning of the Regulations. Certainly a noteholder has an interest in the corporation, but it is doubtful if that is the type of interest intended as that term is used in the Regulations. In all probability the notes in this case would have to be made junior to the claims of general creditors in order to maintain the credit position of the corporation, and this would make the notes more nearly like preferred stock. And since the notes would ultimately be held by a stockholder, it would be easier to find a merging of the creditor and stockholder interests. But in any event, apart from practical difficulties, this method of redemption, even using notes to supplement cash, should present a more favorable alternative from the tax standpoint than the redemption of the common stock leaving the estate owning preferred.

In order to avoid the retention by the estate of any interest in the corporation, we could have R. H. Brown, Jr. purchase the preferred stock and then have the corporation redeem the common stock from the estate. Since R. H. Brown, Jr. does not have the cash to buy the preferred stock, he could give a note to the estate for the stock, and then receive his own note upon the distribution of his share of the estate.

This all merely points up the close relationship between

R. H. Brown, Jr. and the estate, and raises the question as to whether the estate will be regarded as a separate stockholder for the purpose of determining whether there is a continuing interest of the stockholder after redemption. The relationship would be even closer if R. H. Brown, Jr. were the sole stockholder. Suppose, for example, that all of the common stock of the corporation were owned by an estate and an individual stockholder who was the sole heir of the estate. The redemption of the common stock owned by the estate would have no ultimate effect upon the common stock interest of the heir, provided there were assets in the estate sufficient so that the stock owned by the estate would have passed on to the heir. In either event, the heir would be the owner of 100% of the outstanding common stock. While such a contention could be made in some cases, and while it is believed that the Commissioner would question a redemption under those circumstances, it is to be hoped that the courts will not indulge him in his contentions, for the ramifications of such a doctrine would be most difficult to foresee. Logically, the doctrine could be applicable to the redemption of the stock of a father whose son owned the remaining stock, even before the death of the father.

In our case, it makes a very substantial difference to R. H. Brown, Jr. whether the common stock of the estate is redeemed since his ultimate share in the ownership of the corporation will be directly affected. His chance of receiving the stock from the estate, subject to the intervening rights of creditors, should not be a continuing interest so as to make the redemption of stock of the estate essentially equivalent to a taxable dividend. This should be particularly true since he is not the sole legatee, and under the will is no more entitled to receive the stock or the proceeds, than is his mother. The practical difficulties constitute the chief objection to this method.

VI. SALE OF 200 SHARES OF COMMON STOCK BY BROWN ESTATE AND REDEMPTION OF REMAINDER

In many cases it is necessary for the surviving stockholders and the corporation to combine in furnishing sufficient funds to a deceased stockholder's estate. In such a case, the surviving stockholders would buy some of the stock and the corporation would redeem the remainder. No question has

been raised as to the validity of this transaction with respect to the estate of the deceased stockholder. Apparently the sale of some stock and redemption of all the remainder qualifies as a distribution in partial liquidation, and the amount distributed by the corporation is not taxable as an ordinary dividend. In most cases, however, the stockholders who have put up the money will want to get their money returned to them by having the corporation subsequently redeem the stock which they have purchased.

In *Fox v. Harrison*,[20] a principal stockholder wanted to liquidate the corporation so as to get needed cash and other assets. In order to prevent liquidation of the corporation, the minority stockholder arranged for the corporation to redeem some of the stock, and the minority stockholder borrowed money to purchase the remainder with the understanding that he would sell it to the corporation at cost. Later, 1,000 shares of the 1,424 shares so purchased were redeemed by the corporation, and the check was used by the minority stockholder to pay off the loan which he had negotiated in order to purchase the stock. The court held that the redemption of this stock was not the equivalent of the distribution of a taxable dividend since the minority stockholder was merely acting for the corporation in purchasing the stock, and there was no gain to him through the receipt of the check from the corporation and the use of the check to pay the bank loan which he had incurred in order to purchase the stock.

Since that decision, other taxpayer-stockholders have sought to establish their status as agents of the corporation in the acquisition of stock which was subsequently redeemed, but in each instance they have failed.

The most recent case is *E. R. Lowenthal*,[21] wherein the majority stockholder decided to take over the business then being conducted by a subsidiary. He exchanged a portion of his stock with the corporation for all of the stock of the subsidiary, and then the other stockholders purchased his remaining interest. In order to obtain needed funds to complete the purchase the stockholders borrowed money from the corporation, and the indebtedness so incurred was subse-

20. 145 F.2d 521 (C.C.A. 7th 1944).
21. P-H 1947 TC Mem. Dec. Serv. ¶47,169 (1947).

quently cancelled by the corporation in return for the redemption of the stock which had been purchased from the retiring stockholder. The Tax Court held that there was no showing that the stockholders were acting in behalf of the corporation. Since the amount distributed in redemption of the stock was about equal to the dividends paid during a similar previous period, the indebtedness which was so cancelled should be taxed as a dividend.

In *Wall v. United States*[22] the estate of a stockholder sold its entire interest to a competitor. The surviving stockholder bought the stock from the competitor on installments, and later had the corporation take over his liability on these installments, giving the corporation the right to the stock on completing the payments. The court held that payment of the installment obligations by the corporation amounted to the distribution of a taxable dividend to the stockholder who was liable on those installment obligations since that stockholder owned all of the remaining stock of the corporation.

This raises a question as to the possible liability of stockholders whose stock is not redeemed, where there have been prior negotiations for the purchase of the redeemed stock by such stockholders. Suppose a minority stockholder wishes to dispose of his stock and enters into negotiations with the majority stockholder for its sale to him. After they have agreed upon a price, the majority stockholder arranges for the corporation to purchase the stock from the minority stockholder. If the negotiations had led to a binding obligation for the purchase of the stock, then the redemption of stock of the minority stockholder would amount to the distribution of a taxable dividend to the majority stockholder under the *Wall* case. But if there was no binding contract, yet the stock was ultimately redeemed by the corporation at the price which the parties had mentioned during their negotiations, could the redemption of stock by the corporation be made equivalent of the carrying out of the contract which could have been entered into by the majority stockholder, so as to make him taxable on the amount distributed in redemption of all the stock of the minority stockholder?

22. 164 F.2d 462 (C.C.A. 4th 1947).

VIII. REDEMPTION OF ALL OF THE STOCK OF R. H. BROWN, JR.

Since R. H. Brown, Jr. will inherit all of the stock of the Brown Estate, it will make no difference in the long run whether we redeem the stock of the estate or of R. H. Brown, Jr. This, of course, is the weakness of any plan for the redemption of all of the stock of either R. H. Brown, Jr. or the estate, but it is a weakness that simply cannot be avoided. Consequently, we may as well make the most of it and redeem the stock of that party which will prove most advantageous from a practical standpoint.

The common stock has a book value of $150 a share, and the earnings record of the corporation will not justify a much higher value considering the nature of the business. Consequently, R. H. Brown, Jr. would receive on redemption $15,000 for his common stock and $10,000 for his preferred stock, making a total of approximately the amount needed by the estate. Thus we could redeem the stock of R. H. Brown, Jr. by a distribution of cash from the corporation without the necessity of resorting to notes as we would have to do if we redeemed all of the stock of the estate. This would satisfy the requirements of the Regulations for the redemption of all of the stock of a single stockholder, leaving him no continuing interest in the corporation, unless Brown's right to inherit from his father's estate be regarded as such a continuing right.

The courts would have to go a long way to find such a redemption the equivalent of a distribution of a taxable dividend to R. H. Brown, Jr. Since that question is essentially a question of fact, the dangers incident to such a course would likewise be dependent upon the facts. If R. H. Brown, Jr. used the redemption money to buy a part of the stock of the estate, then it would be easier for a court to find that as a part of a plan for the redemption of a part of the stock of the estate, R. H. Brown, Jr. acted merely as a conduit for the passing of the redemption money from the corporation to the estate. If, however, the estate is in the early process of administration, and R. H. Brown, Jr. uses the redemption money to purchase other assets of the estate, and the Brown Motors, Inc. stock remains in the estate subject to claims of crediters and subject to administration for a period of time thereafter, the proposed procedure would seem to be about

as safe as any that could be devised for this particular problem.

In this case, the redemption of the stock of R. H. Brown, Jr. would be even safer if the stock owned by the estate were distributed to his mother as a part of her interest in the estate. Then you would have a situation where not only was all of the stock of a stockholder redeemed but the chance that he would get other stock simply did not materialize. However, we are not always free to do everything that would seem to make a tax situation fool-proof, and since R. H. Brown, Jr. wants the stock of the corporation and Mrs. Brown doesn't, we shall have to take the chances incident to this procedure.

SUMMARY

Naturally the methods most desirable from a practical standpoint will prove least desirable from a tax standpoint. The most desirable methods would be those which would leave the stockholders most nearly in their present relative position and those are the ones which would come nearest to being essentially equivalent to the distribution of a taxable dividend. The more nearly we approach the desirable practical goal, the more nearly we come to having the distribution taxed under §115(g).

It is not difficult to conclude in this case that pro rata distributions to all of the stockholders should be eliminated. This is true whether the plan involves the redemption of either preferred or common. Any distribution made in this case arises from the need of a stockholder and is not brought about by any corporate purpose such as the contraction of general business activities or the elimination of one branch of the business. The corporation has substantial accrued earnings and profits and its dividend record is not a liberal one, so that any pro rata distribution, regardless of how labelled, will be apt to be treated as a distribution of a taxable dividend under §115(g).

That leaves only the possibility of the redemption of all of the stock of a single stockholder in such manner as to comply with the provision in the Regulations that there is no continuing interest in that stockholder after the redemption. In this particular case, the redemption of all of the common stock of a single stockholder who also owned pre-

ferred should qualify under the Regulations although we feel it would do so only as a result of a court decision since the Commissioner would undoubtedly question it. A redemption of all of the stock of a single stockholder using notes to supplement cash, we feel, would satisfy the Regulations and probably would not be questioned by the Commissioner. The interlocking of the estate and the beneficiaries so as to constitute the group a single stockholder for purposes of determining a continuing interest after redemption is a contingency which we cannot resolve in this case. We shall have to await the outcome of litigation which undoubtedly will arise if the Commissioner follows his present course of questioning such transactions.

Since originally we listed the possible methods of getting cash into the Brown Estate in the order of their desirability from a practical standpoint, we now proceed to list the methods in the order of their desirability from a tax standpoint, eliminating the pro rata redemption of common and redemption of all preferred. We set out below the various alternatives in the order of their preference solely from a tax standpoint, setting out after each alternative the number which it bore in our list of preferences from a practical standpoint:

1. Redemption of all stock of Brown Estate, using notes to supplement cash. (5)
2. Sale of 200 shares of common stock by the Brown Estate and redemption of remainder by the corporation. (6)
3. Redemption of all of the stock of R. H. Brown, Jr. (7)
4. Redemption of all of the common stock of the Brown Estate. (4)
5. Redemption of preferred stock of the Brown Estate and R. H. Brown, Jr. (3)

If the credit of the corporation can stand the issuance of notes to supplement cash paid out in redemption of all the stock of the Brown Estate, we feel confident that this procedure would be the safest from a tax standpoint. We are reasonably certain that this will not prove feasible, and that the stockholders will decide that the stock of R. H. Brown, Jr. should be redeemed and that other practical considerations justify whatever tax risk is incident to that course.

CONCLUSION

As in so many other phases of the law, the answer which seems right is dependent upon the manner in which the problem is approached. If the taxation of distributions as dividends is regarded as one of the sacrosanct principles of our tax laws, then in determining whether a stockholder had a continuing interest there would be justification for looking beyond the particular stockholder to an estate in which he was interested or even in applying the concept of related stockholders to this problem. Certainly the redemption of the stock of a father where the son owns all of the remaining stock is not far removed as a practical matter from the redemption of the stock of an estate where the son is the sole legatee.

On the other hand, if we look at the problem from the standpoint of the taxpayer-stockholder of a small corporation, we see only an effort on his part to dispose of his stock to the only logical purchaser and wonder why he should be taxed differently from the stockholder of a large corporation whose stock is listed and whose estate can obtain needed funds on the sale of stock to third party purchasers. The difficulty confronting the estate of a stockholder of a small corporation in raising needed funds is one of the great motivating factors which is forcing owners of small corporations into combining with the larger ones.