NORTH CAROLINA LAW REVIEW

Volume 43 | Number 1 Article 10

12-1-1964

Distributions Essentially Equivalent to a Dividend -- Understanding the Equation

Paul F. Mickey

James P. Holden

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation

Paul F. Mickey & James P. Holden, *Distributions Essentially Equivalent to a Dividend -- Understanding the Equation*, 43 N.C. L. Rev. 32 (1964).

Available at: http://scholarship.law.unc.edu/nclr/vol43/iss1/10

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

DISTRIBUTIONS ESSENTIALLY EQUIVALENT TO A DIVIDEND—UNDERSTANDING THE EQUATION

PAUL F. MICKEY AND JAMES P. HOLDEN*

I. THE NATURE OF THE PROBLEM

Although appreciation in value of corporate stock is generally taxed as capital gain when the stock is sold, a different result may obtain where the stock is sold to the issuing corporation. If stock is transferred to the issuing corporation as a step in complete liquidation, the transfer is properly regarded as a sale.[1] Similarly, when a shareholder sells all of his stock to the issuing corporation, sale treatment is appropriate even though the corporation is not liquidated.[2] In either case, the corporate-shareholder relationship has been terminated and a final calculation of profit on the surrendered shares is proper.

But when a sole shareholder "sells" a single share of stock to his wholly-owned corporation, has anything occurred which justifies a final calculation of profit on the surrendered share? It seems not, for the shareholder remains the sole owner of the corporation, and there has been no meaningful change in his position, except to the extent that he has more cash and the corporation has less. Nor is the effect different if there are two shareholders, each owning fifty per cent and each receiving an equal amount of cash in exchange for a few shares. Nor is it different if there are a thousand shareholders, each receiving his pro rata share of the distribution and surrendering a pro rata portion of his stock. In these instances, the distribution is more akin to a withdrawal of profits by a dividend than to a realization of profit through a sale of stock.

Congress has provided a rather brief set of statutory rules to distinguish those distributions which are entitled to be treated as sales from those which must be regarded as dividends. These rules apply to the fields of stock redemption,[3] partial liquidation,[4] and

---

* Members of the District of Columbia Bar.

[1] INT. REV. CODE OF 1954, § 331.

[2] INT. REV. CODE OF 1954, § 302(b)(3).

[3] INT. REV. CODE OF 1954, § 302.

[4] INT. REV. CODE OF 1954, §§ 331(a)(2), 346.

reorganization.[5] The problem of distinguishing dividends from sales or exchanges in the field of reorganizations is peculiar to that field, being governed largely by the Supreme Court's decision in *Estate of Bedford*.[6] But in the areas of stock redemption and partial liquidation, the problem is very much alive and very much in need of clarification. It is with the stock redemption and partial liquidation rules that this article is concerned.

II. The Origin of the Dividend Equivalence Test

After the Supreme Court in 1920 established the principle that stock dividends are not income,[7] Congress found it necessary to deal with the tax avoidance device whereby stock distributed as a nontaxable dividend was promptly redeemed with the benefit of capital gain treatment.[8] It did so by providing in the Revenue Act of 1921 that the payment in redemption might be taxed as a dividend rather than as a payment in exchange for the stock if it was "essentially equivalent to a dividend":

> A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend . . . .[9]

---

[5] Int. Rev. Code of 1954, § 356(a)(2).

[6] Commissioner v. Estate of Bedford, 325 U.S. 283 (1945).

[7] Eisner v. Macomber, 252 U.S. 189 (1920).

[8] Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 228. During debate in the Senate on this provision, the following remarks were made by Senator McCumber:

> Mr. President, nothing has developed at the present time to necessitate this proposed amendment, but conditions are ripening, I think, among a number of corporations for them to declare stock dividends which, under the late decision of the Supreme Court, would not be taxable, and then, we will say in a month or a short time thereafter, to redeem the stock, in other words, cancel the stock. In that way, under the law as it now stands, and under the Supreme Court decision, a stockholder would not be compelled to pay a tax upon the income so derived. The amendment is for the purpose of preventing the provision relating to the exemption of stock dividends from being used for a fraudulent purpose where the dividend is simply declared and then the stock taken up or traded back again in some way so that the stockholder will be free from the tax.

61 Cong. Rec. 7507 (1921) (remarks of Senator McCumber).

[9] Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 228.

This statute was amended in 1924 to operate whether the redemption preceded or followed the stock dividend.[10] The Revenue Act of 1926 eliminated altogether the necessity for a stock dividend, extending the rule to all stock redemptions:

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock . . . shall be treated as a taxable dividend.[11]

This dividend equivalence test was later embodied in section 115(g) of the Internal Revenue Code of 1939,[12] and it survives today in the forms discussed below.

Under the Internal Revenue Code of 1954, distributions in redemption of stock (other than those occurring during the course of complete liquidation) are governed either by section 302 or by section 346.[13] The tax status of distributions governed by section 302 is determined by their effect at the shareholder level, and the tax status of those governed by section 346 is determined by their effect at the corporate level. Although both technically involve distributions in redemption of stock, those in the former category are here referred to as "stock redemptions" while those in the second category are referred to as "partial liquidations."

A stock redemption under section 302 may escape dividend classification by satisfying any one of three tests. Two[14] of these tests employ precise mathematical computations, having made their appearance in the 1954 Code as a product of the widespread de-

---

[10] Revenue Act of 1924, ch. 234, § 201(f), 43 Stat. 255.

[11] Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11. Both of the committee reports make it clear that the concern of Congress was with tax avoidance through the redemption of a pro rata portion of the stock of each shareholder, resulting in a distribution of cash but no alteration in corporate ownership. H.R. REP. No. 1, 69th Cong., 1st Sess. 5 (1926); S. REP. No. 52, 69th Cong., 1st Sess. 15 (1926). The history of the redemption provisions of the Internal Revenue Code is reviewed in Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. PA. L. REV. 907 (1941).

[12] Int. Rev. Code of 1939, ch. 289, § 115(g), 52 Stat. 497 (now INT. REV. CODE OF 1954, §§ 302(b)(1), 346(a)(2)).

[13] See also INT. REV. CODE OF 1954, § 303, which relates to distributions in redemption of stock to pay death taxes.

[14] INT. REV. CODE OF 1954, §§ 302(b)(2) (substantially disproportionate), 302(b)(3) (complete termination of shareholder's interest).

sire for certainty. The third test[15] simply requires that the distribution not be "essentially equivalent" to a dividend and is the legatee of the dividend equivalence test of earlier statutes.

A partial liquidation under section 346 finds its escape from dividend classification by satisfying either of two tests. One is mechanical,[16] having its genesis also in the 1954 search for certainty. The other[17] is the general dividend equivalence standard which requires that the distribution not be "essentially equivalent" to a dividend.

III. The Judicial Approach to Dividend Equivalence

In the economic sense, a dividend is a distribution of cash or property which does not alter the respective interests of shareholders in the corporation.[18] Logically then, a distribution of cash or property to shareholders is essentially equivalent to a dividend if it results in essentially no alteration in their respective interests. But the courts generally have not approached the problem with strict logic.

Instead they have applied criteria which are largely irrelevant, studiously avoiding a definitive conclusion that one need look merely to the pro rata character of the distribution. The result is confusion and uncertainty, leading even the courts to refer to the decisions as a "morass"[19] and to the inquiry as a "most exasperating task,"[20] "a nightmarish problem,"[21] and a "vexing question."[22] The statutory standard has been termed "a Delphic proscription"[23] and a "vague negative test."[24] The Sixth Circuit states characteristically: "The . . . language of §115(g) has been in the revenue

---

[15] Int. Rev. Code of 1954, § 302(b)(1).

[16] Int. Rev. Code of 1954, § 346(b) (termination of business).

[17] Int. Rev. Code of 1954, § 346(a)(2).

[18] Pullman, Inc., 8 T.C. 292 (1947). See Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 Tax L. Rev. 437, 476 (1950). Although the distribution must be out of current or accumulated earnings in order to constitute a "dividend" within the meaning of section 316 of the Int. Rev. Code of 1954, the matter is of little moment in assessing the economic effect (as opposed to the ultimate tax treatment) upon the shareholder and the corporation.

[19] Ballenger v. United States, 301 F.2d 192, 196 (4th Cir. 1962).

[20] Thomas G. Lewis, 35 T.C. 71, 76 (1960).

[21] Wilson v. United States, 154 F. Supp. 341, 342 (N.D.N.Y. 1957).

[22] Bradbury v. Commissioner, 298 F.2d 111, 114 (1st Cir. 1962).

[23] J. Milton Sorem, 40 T.C. 206, 218 (1963) (dissenting opinion), *rev'd*, 334 F.2d 275 (10th Cir. 1964).

[24] Ballenger v. United States, 301 F.2d 192, 194 (4th Cir. 1962).

statutes since 1926; and over the years the courts have searched for some sure touchstone . . . . The search has been in vain."[25]

A. The Judicial Criteria

The criteria employed by the courts in an attempt to identify dividend distributions include such factors as whether the distribution was motivated by a valid business purpose, whether the transaction resulted in a shift in proportionate ownership, whether the distribution was initiated by the corporation or by its shareholders, whether the corporation has a history of paying dividends, and whether the corporate business was contracted as a consequence of the distribution. As the following discussion will indicate, only the inquiry as to shift in proportional ownership is truly relevant in distinguishing dividends from sales or exchanges.

The most frequently enunciated test applied by the courts is the so-called "net effect" test, which had its birth in the following passage from *Flanagan v. Helvering.*[26] After listing the above criteria, the court concluded: "But the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering § 115(g) [section 302(b)(1) of the 1954 Code]."[27] The "net effect" test has resulted in confusion because of the uncertain meaning of the term. Some courts quote *Flanagan* for the proposition that "net effect" rather than "motives and plans" governs, and then proceed immediately into an examination of criteria involving motive and purpose, such as the business purpose of the distribution and other similar factors.[28] Other courts believe that the "net effect" test requires elimination from consideration of such factors as business purpose.[29] Some, consciously or unconsciously hedging the issue, state that business purpose is irrelevant, but add that they are unable to find one anyway.[30] Some courts rationalize the result by stating that there are two versions of the net effect test, the strict which admits of no factors such as business purpose and the not-so-strict which permits such inquiry.[31]

[25] Woodworth v. Commissioner, 218 F.2d 719, 723 (6th Cir. 1955).
[26] 116 F.2d 937 (D.C. Cir. 1940).
[27] *Id.* at 939-40.
[28] *E.g.,* Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954).
[29] *E.g.,* Northup v. United States, 240 F.2d 304 (2d Cir. 1957).
[30] *E.g.,* Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962)
[31] *Ibid.*

All of this is interesting, but unhelpful. The truth, of course, is that "net effect" has no independent meaning. That it is a mere paraphrase of the statutory term "essentially equivalent" has been stated well by the Court of Appeals for the Fifth Circuit:

> "Net effect" is a paraphrase for "essentially equivalent." It is just as if the statute read: "If a corporation redeems its stock in whole or in part, so that the net effect of the transaction is the same as the payment of a taxable dividend, the amount so distributed shall be treated as a taxable dividend." The net effect test is not a test but an attractive abbreviation of the statute, as to which we shall be on safer ground if we stick to the words of the statute: essentially equivalent.[32]

The lengthy discussions of the various gradients and ingredients of the net effect test come more clearly into focus when it is remembered that these are but gradients and ingredients of the "essentially equivalent" test. The cause of clarity would be served if the term "net effect" were dropped and the statutory phrase reinstated.

Although the standard criteria listed above are frequently applied by the courts, the relevance of most of them is subject to question. They serve no logical function in distinguishing distributions which are essentially and realistically a division of profits from those which are essentially and realistically in payment for retired stock. They will not stand analysis.

At one time, it was felt that the existence of a legitimate business purpose would absolve even a pro rata distribution from dividend equivalence.[33] This reasoning leads to an absurd result—if the existence of a business purpose will rescue a distribution from being treated as a dividend, it must be true that dividend distributions are not motivated by legitimate business purposes. This is obviously incorrect. The existence of a legitimate business purpose is as consistent with a dividend as with a sale.

Among the types of business purpose frequently advanced are the elimination of debt owing from shareholders to the corporation and consequent improvement of the corporate balance sheet,[34] the

---

[32] Commissioner v. Sullivan, 210 F.2d 607, 609-10 (5th Cir. 1954).

[33] Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954). See Treusch, *Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code,* 32 TAXES 1023, 1036-40 (1954). A listing of the types of business purpose advanced in the cases is found in 17-2d T.M., CORPORATE STOCK REDEMPTION at A-23 -28 (1964).

[34] This argument has been advanced in many cases, among them Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); Estate of Lukens v.

reduction in value of stock to facilitate purchase by new investors,[35] and the desire to make stock available for purchase by employees.[36] Aside from the basic fact that the existence of a business purpose simply does not serve to distinguish a dividend from a sale, these arguments are seldom logically persuasive. Debts owing from shareholders to the corporation may be discharged by a dividend distribution equally as well as by a redemption of stock. The value of stock may be reduced as effectively by a dividend distribution as by a redemption of stock. Though the desire to sell stock to employees may be laudatory, it would not appear to justify a redemption from existing shareholders, for there certainly are other equally available sources of stock.[37]

Business purpose would be relevant if motive were at issue, but dividend treatment does not flow from the existence of a tax avoidance motive.[38] It flows instead from dividend equivalence, a status rather than a state of mind. A transfer of stock to the issuing corporation with the clear purpose of obtaining a favorable tax result is nevertheless a sale, if the transaction is not essentially equivalent to a dividend. Although the business purpose inquiry does not preoccupy the courts to the extent that it formerly did, the reluctance of the courts to discard the business purpose inquiry sometimes leads to misconceptions concerning the relevance of intent as an issue.[39] However, a majority of appellate courts now

Commissioner, 246 F.2d 403 (3d Cir. 1957); Hirsch v. Commissioner, 124 F.2d 24 (9th Cir. 1941). For discussion of this motivation and of the desire to make stock available for sale to others, see Moore, *Dividend Equivalence—Taxation of Distributions in Redemption of Stock,* 19 TAX L. REV. 249 (1964).

[35] United States v. Carey, 289 F.2d 531 (8th Cir. 1961).

[36] Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949).

[37] In Commissioner v. Snite, *supra* note 36, the purpose of obtaining stock for resale to employees was advanced to justify the redemption of 3,500 shares at a time when the corporation had available 15,000 authorized but unissued shares.

[38] "Neither artifice, subterfuge, or bad faith need be present to bring a transaction within the meaning of the statute here involved, for as we read the law a taxpayer may well act with the utmost good purpose and without evil intent and yet his transactions may in effect be the equivalent of the distribution of a taxable dividend." McGuire v. Commissioner, 84 F.2d 431, 432 (7th Cir. 1936).

[39] See, *e.g.,* Ballenger v. United States, 301 F.2d 192, 198 (4th Cir. 1962), where the court states that tax avoidance is always assumed to be a purpose of a pro rata redemption under the approach of courts which consider proof of business purpose irrelevant. This statement seems to assume that tax avoidance is an essential ingredient for dividend equivalence and that even those courts which will not accept proof on the issue of bona

recognize that the existence of a single bona fide business purpose will not preclude a finding of dividend equivalence.[40]

The courts have applied various other criteria in their quest for a dividend equivalence standard. The resulting absurdity is amply illustrated by one court's assertion that "not only is the legitimacy of the business objective to be achieved a factor to be considered" but in addition other criteria must be applied to determine the "purity of the motive for the redemption."[41]

One of the criteria is "initiative"—if the distribution is initiated by the shareholders rather than the corporation, it is thought to resemble a dividend. This is, in reality, merely a redundant statement of the business purpose factor, for its only object is to seek the origin of the motivation. It is difficult to see why shareholder initiation is indicative of a dividend as distinguished from a sale. If a shareholder desires to sell his stock, is it not quite appropriate for him to initiate negotiations? Even if the locus of initiative were thought relevant, how could the initiative of shareholders be distinguished realistically from that of management in the close corporation?[42] This standard has served largely as a makeweight;[43] it is unhelpful and merely obscures the true issue.

The dividend history of the corporation and its accumulation of earnings are frequently considered. It is said, though the premise is at best questionable, that a redemption by a company with a poor dividend history or a large accumulation of earnings is more suspect than is a redemption by a less affluent corporation. This criterion also bears only on motive or purpose and does not assist with the ultimate question of whether a particular distribution is or is not essentially equivalent to a dividend. And there is little reason to allow a company having a generous dividend record greater leeway in purchasing stock than a company with a niggardly record.[44] It has been recognized that the criterion of dividend his-

fides assume the existence of a tax avoidance motive where the distribution is pro rata. It is difficult to accept the validity of the court's position.

[40] Bradbury v. Commissioner, 298 F.2d 111, 118 (1st Cir. 1962); Heman v. Commissioner, 283 F.2d 227, 231 (8th Cir. 1960); United States v. Fewell, 255 F.2d 496, 500 (5th Cir. 1958); Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957); Northup v. United States, 240 F.2d 304, 307 (2d Cir. 1957); Neff v. United States, 157 Ct. Cl. 322, 327, 305 F.2d 455, 457 (1962), *cert. denied,* 372 U.S. 913 (1963).

[41] Ballenger v. United States, 301 F.2d 192, 197 (4th Cir. 1962).

[42] Keefe v. Cote, 213 F.2d 651, 657 (1st Cir. 1954).

[43] Bittker & Redlich, *supra* note 18, at 469-70.

[44] *Id.* at 473.

tory is of little help,[45] and it should be eliminated from consideration. The presence of accumulated earnings has been stated to be irrelevant by the Senate Finance Committee,[46] and the regulations now provide that the determination shall be made without regard to accumulated earnings.[47]

Other criteria are the contraction of the corporate business and continued profitable operation of the business. There were some logical difficulties with the contraction factor under the 1939 Code,[48] and the 1954 revision appears to have limited its influence to the area of partial liquidation.[49] Corporate contraction is discussed below in relation to that particular subject.[50]

B. The Pro Rata Standard

A distribution is, by its nature, essentially equivalent to a dividend if it is essentially pro rata. This criterion is unique in its relevance. If courts adhered to it, the opinions in the area of dividend equivalence would be vastly more meaningful.

Recognition of the pro rata criterion as the exclusive test would alter the result in few cases, for the courts, with a surprising degree of consistency, find dividend equivalence in the case of pro rata distributions and fail to find it in the case of non-pro rata distributions. The appellate decisions are nearly uniform in result, with almost all pro rata (or essentially pro rata) distributions treated

[45] United States v. Collins, 300 F.2d 821, 825 (1st Cir. 1962).

[46] S. REP. No. 1622, 83d Cong., 2d Sess. 234 (1954).

[47] Treas. Reg. § 1.302-2(a) (1955).

[48] See Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954), where a pro rata distribution of corporate assets to shareholders was held not essentially equivalent to a dividend because it resulted in a contraction of the corporate business. A similar result obtained in Joseph Imler, 11 T.C. 836 (1948), where the proceeds of fire insurance were distributed. A pro rata distribution is not logically any less a dividend simply because it is accompanied by a contraction of business. Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1 (1952). There the authors state that "we should not be moved by the emotional case in which cash results from an 'involuntary conversion' of a part of the business . . . . Such proceeds are simply cash profits being distributed." *Id.* at 38.

[49] Since the tax consequences of stock redemptions are, under the 1954 Code, to be determined by reference to events at the shareholder level, S. REP. No. 1622, 83d Cong., 2d Sess. 49 (1954), the contraction factor appears clearly irrelevant to stock redemptions and the logical problem of its effect on dividend equivalence is thus eliminated. The area of partial liquidations, in which the contraction factor enjoys increased rather than diminished prominence, is discussed in Section V of the text.

[50] See Section V of the text.

as dividends[51] and non-pro rata distributions treated as sales.[52] There are, however, five appellate opinions in which pro rata distributions were accorded sale treatment.[53]

The first,[54] decided by the First Circuit Court of Appeals, must be considered an anomaly, as that court later retreated.[55] In the second,[56] the court held that the distribution was not pro rata, which seems erroneous. But since the court was proceeding on a finding that it was not pro rata, the result springs from a questionable finding of fact rather than a difference in approach. In the third,[57] a pro rata distribution was treated as a sale because the corporate business had been contracted. This case raises the special problem which is now limited to partial liquidations.[58] The fourth and fifth cases[59] offer no easy solution, and if the pro rata standard is ac-

[51] Pro rata (or nearly pro rata) distributions were held, despite a considerable struggle in some cases, essentially equivalent to dividends in the following representative appellate opinions: Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); United States v. Collins, 300 F.2d 821 (1st Cir. 1962); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); Heman v. Commissioner, 283 F.2d 227 (8th Cir. 1960); Pacific Vegetable Oil Corp. v. Commissioner, 251 F.2d 682 (9th Cir. 1957); Bell v. Commissioner, 248 F.2d 947 (6th Cir. 1957); Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957); Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957); Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955); Commissioner v. Roberts, 203 F.2d 304 (4th Cir. 1954); Boyle v. Commissioner, 187 F.2d 557 (3d Cir. 1951); Kirschenbaum v. Commissioner, 155 F.2d 23 (2d Cir. 1946); Hirsch v. Commissioner, 124 F.2d 24 (9th Cir. 1941); Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940); McGuire v. Commissioner, 84 F.2d 431 (7th Cir. 1936).

[52] Estate of Lukens v. Commissioner, 246 F.2d 403 (3d Cir. 1957); Northup v. United States, 240 F.2d 304 (2d Cir. 1957).

[53] United States v. Carey, 289 F.2d 531 (8th Cir. 1961); Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954); Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954); Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949); Bains v. United States, 151 Ct. Cl. 599, 289 F.2d 644 (1961).

[54] Keefe v. Cote, *supra* note 53, where the court strained to uphold a jury verdict in favor of the taxpayer despite the pro rata character of the distribution.

[55] Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).

[56] Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949), where stock was redeemed for the purpose of resale to employees. All of the stock of the corporation was owned by a husband and wife and trusts for their children.

[57] Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954), where the corporation distributed operating assets pro rata to its shareholders.

[58] See Section V of the text.

[59] United States v. Carey, 289 F.2d 531 (8th Cir. 1961); Bains v. United States, 151 Ct. Cl. 599, 289 F.2d 644 (1961). In both of these cases, a pro rata distribution was followed by the elimination of a shareholder, and the main question was the status of the continuing shareholder. In both cases, the distribution actually received by the continuing shareholder was held to be not equivalent to a dividend. This result seems clearly erroneous.

cepted as the governing rule, they must be viewed as wrongly decided.

Thus, among the numerous appellate court opinions, there appear to be only two[60] in which both result and reasoning are at odds with the pro rata standard of dividend equivalence. Adherence to the pro rata standard would not cause any revolution of result, but it would substitute logic and clarity for irrelevance and confusion in dealing with the problem at both administrative and judicial levels.

IV. The Effect of the 1954 Code on the Pro Rata Standard of Dividend Equivalence

If the proper standard for measuring dividend equivalence is the pro rata standard, have the mechanical tests of the 1954 Code pre-empted the area, making the general test unnecessary? In effect, the substantially disproportionate test[61] and the complete termination of interest test[62] provide precise guides as to when an alteration in the corporate-shareholder relation is significant enough to justify treating the distribution as a sale. As a consequence, some observers have predicted that little litigation will arise under the general test of section 302(b)(1).[63] But this prediction has not proven accurate.[64]

Both cases are criticized in Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962).

[60] United States v. Carey, *supra* note 59; Bains v. United States, *supra* note 59.

[61] Int. Rev. Code of 1954, § 302(b)(2). See text accompanying notes 86 & 87 *infra*.

[62] Int. Rev. Code of 1954, §§ 302(b)(3), 346(b).

[63] Roeder, *Distributions in Redemption of Stock*, N.Y.U. 15th Inst. on Fed. Tax 475, 484-85 (1957); Wilson, *Stock Redemptions as Dividends*, 32 Taxes 718, 719 (1954).

[64] Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964); Kerr v. Commissioner, 326 F.2d 225 (9th Cir.), *cert. denied*, 377 U.S. 963 (1964); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); United States v. Collins, 300 F.2d 821 (1st Cir. 1962); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); United States v. Carey, 289 F.2d 531 (8th Cir. 1961); Hasbrook v. United States, 64-2 U.S. Tax Cas. ¶ 9715 (D. Vt. 1964); Friend v. United States, 64-1 U.S. Tax Cas. ¶ 9296 (D. Mass. 1964); Archbold v. United States, 201 F. Supp. 329 (D.N.J. 1962), *aff'd per curiam*, 311 F.2d 228 (3d Cir. 1963); Sullivan v. Bookwalter, 63-1 U.S. Tax Cas. ¶ 9151 (W.D. Mo. 1962); Cohron v. United States, 62-1 U.S. Tax Cas. ¶ 9398 (S.D. Ala. 1962); Radnitz v. United States, 187 F. Supp. 952 (S.D.N.Y. 1960), *aff'd per curiam*, 294 F.2d 577 (2d Cir. 1961); Colvin v. United States, 175 F. Supp. 877 (S.D. Cal. 1959); Tate v. United States, 59-1 U.S. Tax Cas. ¶ 9464 (E.D. Ky. 1959); Neff v. United States, 157 Ct. Cl. 322, 305 F.2d 455 (1962), *cert. denied*, 372 U.S. 913 (1963);

There are a number of areas in which the general dividend equivalence test continues to function. Since distributions which are pro rata do not qualify as sales under the mechanical tests, the general test continues to be the hoped-for haven in such cases. In them, the courts continue to hear and write of business purpose, initiative, dividend history, etc.[65] These cases probably would not come to litigation if the pro rata standard had been unequivocally established in the past; they will continue until the courts so establish that standard.

Aside from the pro rata cases, the general dividend equivalence test of section 302(b)(1) will operate where (1) the distribution would be non-pro rata and thus qualify under the mechanical tests but for the constructive ownership rules, (2) where the distribution, though not pro rata, falls short of satisfying the mechanical tests, and (3) where the special problem of preferred stock is involved.

A. Distributions Which Fail the Mechanical Tests Because of Constructive Ownership

Section 302(c) provides that the constructive ownership rules of section 318[66] shall apply "in determining the ownership of stock for purposes of this section."[67] Both of the mechanical tests embodied in sections 302(b)(2) and 302(b)(3) refer to ownership of stock, and the constructive ownership rules clearly operate in the application of those tests. But section 302(b)(1) speaks merely in terms of dividend equivalence and does not refer to stock ownership. Accordingly, there has been much discussion as to whether the constructive ownership rules must be applied in deter-

---

Presley W. Moore, P-H TAX CT. REP. & MEM. DEC. (33 P-H Tax Ct. Mem.) ¶ 64020 (Jan. 30, 1964); Robert H. Herzog, 32 P-H Tax Ct. Mem. 1815 (1963); Isidore Himmel, 41 T.C. 62 (1963); Estate of Herman Silverman, 32 P-H Tax Ct. Mem. 787 (1963); J. Milton Sorem, 40 T.C. 206 (1963), *rev'd*, 334 F.2d 275 (10th Cir. 1964); Ralph L. Humphrey, 39 T.C. 199 (1962); Estate of Arthur Squier, 35 T.C. 950 (1961), *acq.*, 1961-2 CUM. BULL. 5; Herbert C. Parker, 30 P-H Tax Ct. Mem. 976 (1961); Charles J. Simon, 30 P-H Tax Ct. Mem. 119 (1961); Thomas G. Lewis, 35 T.C. 71 (1960).

[65] See, *e.g.*, Neff v. United States, 157 Ct. Cl. 322, 305 F.2d 455 (1962), *cert. denied*, 372 U.S. 913 (1963); Presley W. Moore, P-H TAX CT. REP. & MEM. DEC. (33 P-H Tax Ct. Mem.) ¶ 64020 (Jan. 30, 1964).

[66] Int. Rev. Code of 1954, § 318(a), added by ch. 736, 68A Stat. 99 (1954), as amended, Pub. L. No. 554, 88th Cong., 2d Sess. § 5(a) (Aug. 31, 1964).

[67] INT. REV. CODE OF 1954, § 302(c)(1).

mining dividend equivalence under section 302(b)(1),[68] *i.e.*, must a distribution which is non-pro rata on the basis of legal ownership be considered pro rata because of attributed ownership?

In the first case to present this issue, the Tax Court concluded that it was required to attribute to an estate stock held by its beneficiaries, thus making the estate the sole shareholder and the conclusion of dividend equivalence unavoidable with respect to a redemption from the estate.[69] But the Tax Court appeared to retreat from this position shortly thereafter,[70] and subsequently to reject it altogether.[71] This result is altogether desirable. The function of the constructive ownership rules is to aggregate the holdings of persons within a presumed community of interest in order to

---

[68] Some commentators appear to conclude that the constructive ownership rules have automatic application in dividend equivalence cases. See, *e.g.*, Winton & Hoffman, *A Case Study of Stock Redemptions Under Sections 302 and 318 of the New Code*, 10 TAX L. REV. 363, 366 n.13 (1955). More generally they favor a flexible approach, giving weight, though not controlling weight, to relationships among shareholders. See Gratch, *How to Redeem a Shareholder's Stock*, 39 TAXES 169, 176 (1961); Laikin, *Stock Redemptions: Sections 302 and 318*, N.Y.U. 14TH INST. ON FED. TAX 671, 686-87 (1956); Ringle, Surrey & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209, 224 (1958); Sutter, *Corporate Distributions of Property, Stock and Stock Rights—Dividend or Redemption?* 39 TAXES 982, 983-85 (1961). The reluctance to import constructive ownership rules into dividend equivalence cases stems from strong feeling respecting the operation of these rules:

> Here, again, the mind is staggered by that Pandora's box of a section, 318. Back and forth one goes, 'round and 'round one goes, like the mating dance of the scorpions photographed in "The Living Desert." It would be entirely ludicrous if it were not so important.

Owen, *Stock Redemptions and Partial Liquidations Under the 1954 Code*, 32 TAXES 979, 988 (1954).

It will be observed that the Treasury Department regulations take the position that section 318(a) applies to all redemptions under section 302. Treas. Reg. § 1.302-1(a) (1955). The regulations further provide that constructive ownership under section 318 is one of the facts to be considered when making dividend equivalence determinations under section 302(b)(1). Treas. Reg. § 1.302-2(b) (1955).

[69] Thomas G. Lewis, 35 T.C. 71 (1960).

[70] See Estate of Arthur Squier, 35 T.C. 950 (1961), *acq.*, 1961-2 CUM. BULL. 5.

[71] See Herbert C. Parker, 30 P-H Tax Ct. Mem. 976 (1961). *But see* Samuel M. Levy, P-H TAX CT. REP. & MEM. DEC. (33 P-H Tax Ct. Mem.) ¶ 64131 (May 11, 1964), where the Tax Court unquestioningly attributed a husband's stock to his wife. Although the result might not differ with selective application, the approach certainly would. See also Bradbury v. Commissioner, 298 F.2d 111, 116-17 n.7 (1st Cir. 1962), where the court, although accepting the applicability of section 318, states that the imposition of the attribution rules is "not inflexible" and that a showing of discord may overcome their application.

achieve a more realistic measure of ownership. But those rules are only approximations of probabilities and may well be at variance with actual facts.[72] If the presumed community of interest does not in fact exist,[73] there is little reason to deny capital gain treatment merely on the basis of arbitrary rules. It is the function of section 302(b)(1) to provide a vehicle for factual inquiry,[74] and conclusive presumptions of ownership are inconsistent with such an inquiry.

The Subchapter C Advisory Group recommended that section 302 be amended to provide that the constructive ownership rules do not apply under section 302(b)(1) but that the relationships described in section 318 may be considered along with all the other facts and circumstances.[75] The Group understands this to be the intent of the existing statute.[76] The same amendment has been recommended by the American Bar Association Section of Taxation.[77]

The Senate Finance Committee report on the 1954 Code, in discussing the mechanical tests, expressly states that the constructive ownership rules apply to those tests.[78] It does not make the same statement with respect to the dividend equivalence test, and the exclusion of section 302(b)(1) from the following discussion seems intended:

> Paragraph (1) [of 302(c)] provides that the rules for constructive ownership of stock of section 318(a) shall apply for purposes of this section generally. For example, if an individual owns half of the stock of a corporation, and a trust of which such individual is the sole beneficiary, owns the other half of such stock, a redemption of all of the stock of the corporation owned indi-

[72] For example, Pub. L. No. 554, 88th Cong., 2d Sess. § 5(a) (Aug. 31, 1964), amended section 318 to eliminate so-called "sidewise attribution," effective with respect to redemptions occurring on or after the date of enactment. The arbitrary action of the rules is thus obvious; one community of interest might be presumed to exist on the day before enactment and an altogether different one on the day after.

[73] The community of interest would not in fact exist under circumstances such as estrangement of husband and wife, bad feelings between executor and beneficiary, and geographical separation of children from father's business.

[74] S. Rep. No. 1622, 83d Cong., 2d Sess. 233 (1954).

[75] Subchapter C Advisory Group, Revised Report on Corporate Distributions and Adjustments 5-6 (1958).

[76] *Ibid.*

[77] ABA Taxation Section, Annual Report 35-37 (1961).

[78] S. Rep. No. 1622, 83d Cong., 2d Sess. 234-35 (1954).

vidually would not qualify *under paragraph (2) or (3) of subsection (b)*.[79]

This language seems to indicate that the Committee had no thought that the constructive ownership rules would apply under the general test.

Although it is sometimes said that attribution was not considered under the dividend equivalence test of earlier revenue acts,[80] the better view seems to be that relationship was a factor to be considered.[81] Most of the cases cited to sustain the proposition that attribution was not a factor do not actually discuss the issue.[82]

Even though there is no sound basis for a conclusion that attribution is mandatory in section 302(b)(1) cases, it is highly desirable that the section be amended in accordance with the Advisory Group's proposal.[83] The inquiry in dividend equivalence cases should be whether or not the distribution is in fact pro rata, and in this inquiry the court should not be constrained by hard and fast constructive ownership rules, although it should take into consideration the effect of relationships which are involved.[84] Indeed, if factually justified, the court might properly take into account relationships beyond those expressed in section 318,[85] for in the court's

[79] *Id.* at 235. (Emphasis added.)

[80] See Thomas G. Lewis, 35 T.C. 71, 77 (1960), where attribution in dividend equivalence cases is described as "a new dimension."

[81] Estate of Ray Blauner, 30 P-H Tax Ct. Mem. 1400, 1406 (1961). See Dean, *The New Section 115(g) Regulations*, N.Y.U. 11TH INST. ON FED. TAX 587 (1953). In discussing a proposed amendment to Treas. Reg. 111, § 29.115-9 (1943), which would have established relationships as a factor to be considered in dividend equivalence cases, the author states that the "amendment would add nothing to the substantive law underlying that redemption provision." Dean, *supra* at 609. The proposed amendment, 16 Fed. Reg. 10312 (1951), was never adopted.

[82] See, *e.g.*, Summerfield v. United States, 145 F. Supp. 104 (E.D. Mich. 1956), *aff'd per curiam*, 249 F.2d 446 (6th Cir. 1957); Jackson Howell, 26 T.C. 846 (1956), *aff'd sub nom.* Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957); Giles E. Bullock, 26 T.C. 276 (1956), *aff'd per curiam*, 253 F.2d 715 (2d Cir. 1958); Ada Murphy McFarlane, 23 P-H Tax Ct. Mem. 468 (1954); Trust for Rosemary C. Weir, 21 P-H Tax Ct. Mem. 571 (1952); Estate of Henry V. Foster, 13 P-H Tax Ct. Mem. 290 (1944). *But cf.* Estate of Lukens v. Commissioner, 246 F.2d 403 (3d Cir. 1957); Estate of Ira F. Searle, 19 P-H Tax Ct. Mem. 874 (1950). In *Searle* the court expressly refused to attribute ownership of stock.

[83] SUBCHAPTER C ADVISORY GROUP, *op. cit. supra* note 75, at 5-6.

[84] In Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964), the court, in a dividend equivalence inquiry, ignored sidewise attribution through a partnership but applied the family attribution rule.

[85] As, for example, where mother, daughter, and son-in-law own stock, the son-in-law's ownership might well be attributed to the mother if peace

factual evaluation of dividend equivalence, section 318 should inhibit neither the Government nor the taxpayer.

B. Distributions Which Fail to Meet the Mathematical Limitations of the Mechanical Tests

A distribution is substantially disproportionate within the meaning of section 302(b)(2) only if two conditions are met. The first is that "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."[86] The second is that

> (i) the ratio which the voting stock of the corporation owned by the share holder 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.[87]

While this rule provides a reasonable guideline for determining when a distribution is not pro rata, it certainly is not an exclusive standard, and a distribution which misses qualification may still be tested for dividend equivalence under the general standard.

The mechanical test is clearly arbitrary. In fact, there exists some sympathy for the elimination of the fifty per cent requirement.[88] Although the requirement that a shareholder own less than fifty per cent of the stock after redemption insures either that he will lose control or that he did not have it at the outset, there is no particular magic in this. The substantial reduction, even of a controlling shareholder's interest, which is required by the eighty per cent calculation, would appear to make the distribution sufficiently non-pro rata to eliminate dividend equivalence. Thus, it may be that a distribution which would fail to qualify as substantially disproportionate under section 302(b)(2) because of failure to satisfy the fifty per cent test may yet qualify under section 302(b)(1) as not essentially equivalent to a dividend.

---

and tranquility reign within the family group. *Cf.* Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962), where the court stopped short of this mark.

[86] INT. REV. CODE OF 1954, § 302(b)(2)(B).

[87] INT. REV. CODE OF 1954, § 302(b)(2)(C).

[88] Surrey, *Income Tax Problems of Corporations and Shareholders,* 14 TAX L. REV. 1, 4 (1958).

Also, there is the question of determining at what precise point a distribution ceases to be essentially non-pro rata and becomes pro rata. Since section 302(b)(2) provides that the post-redemption percentage may not be more than eighty per cent of the pre-redemption percentage, we may assume that a twenty per cent reduction of interest will generally qualify also as non-pro rata under the general test of section 302(b)(1). If, on the other hand, there is no reduction of the shareholder's interest, the distribution is obviously pro rata. Somewhere between these figures of zero reduction and twenty per cent reduction lies the penumbra of dividend equivalence.[89] Although we may speculate that the point of dividend equivalence lies closer to twenty per cent than to zero, thus permitting only narrow misses of the mechanical test, this will remain a problem for judicial inquiry and analysis.

C. The Special Problem of Preferred Stock

In explaining why it continued the flexible dividend equivalence test of prior law, the Senate Finance Committee said this was true particularly "in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place."[90] The redemption of preferred stock does present special problems, but it is doubtful whether the emotional appeal of a shareholder's having little control over the redemption is a proper consideration. Just as in the case of common stock, initiative has little to do with the problem. Instead, it is necessary to focus on the nature of the distribution rather than the motives or purposes of the parties.

Stock which is nonvoting and limited and preferred as to dividends and in liquidation is closely akin to a debt security.[91] Debt capital, assuming no problem of thin capitalization,[92] may generally

[89] See Sorem v. Commissioner, 334 F.2d 275 (10th Cir. 1964), where one shareholder's 50% interest dropped to 43.77%, slightly more than the 40% which would be permitted under the substantially disproportionate test of section 302(b)(2). The percentage reduction in this case was 12.46%. Nevertheless, the distribution was held not essentially equivalent to a dividend under section 302(b)(1).

[90] S. REP. No. 1622, 83d Cong., 2d Sess. 44 (1954).

[91] "Obviously, the line drawn between preferred stock and bonds may in some instances come very close to one of form if the participation of the preferred stock in earnings and assets is a limited one and the stock is non-voting." SURREY & WARREN, FEDERAL INCOME TAXATION 1551 (1960).

[92] See BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 114-17 (1959). In Isidore Himmel, 41 T.C. 62 (1963), it

be repaid free of tax regardless of the pro rata character of the payment.

1. *A new policy.*—The basic policy question is whether the retirement of preferred stock should not be governed by the same principles as the repayment of debt, *i.e.,* should the tax-free recovery of invested principal be permitted? Present law is inadequate because the dividend equivalence test really does not operate with efficiency in the case of preferred stock and neither of the mechanical tests is applicable.

Whether a distribution in redemption of preferred stock is pro rata with respect to the preferred stock alone has generally been thought irrelevant. Instead, attention has been focused on whether common and preferred are held in substantially the same percentages.[93] If so, a distribution in redemption of preferred is thought to be a dividend;[94] if not, a sale is generally held to have occurred.[95]

But there is no reason to assume that preferred stock is permanent capital—indeed, it generally is not. It may originate because the incorporators find the credit position of the company will be enhanced if their temporary capital investment takes the form of preferred stock rather than debt.[96] Or preferred stock may be issued in discharge of a debt owing to a shareholder in order to improve the corporate credit position.[97] In either case, the preferred may well be temporary capital, and if the proper safeguards are employed, the redemption of such preferred stock should have the same consequences as the repayment of temporary capital in the form of debt.[98]

---

was found that alleged debt for which preferred stock was issued was in fact equity capital. Thus, the return of capital argument by the taxpayer was rejected.

[93] Treas. Reg. § 1.302-2(a) (1955).

[94] *E.g.,* Robert H. Herzog, 32 P-H Tax Ct. Mem. 1815 (1963).

[95] *E.g.,* Northup v. United States, 240 F.2d 304 (2d Cir. 1957).

[96] Samuel M. Levy, P-H TAX CT. REP. & MEM. DEC. (33 P-H Tax Ct. Mem.) ¶ 64131 (May 11, 1964).

[97] *E.g.,* Robert H. Herzog, 32 P-H Tax Ct. Mem. 1815 (1963); Henry A. Golwynne, 26 T.C. 1209 (1956).

[98] See Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders,* 52 COLUM. L. REV. 1, 26-27 (1952), where the authors reject the proposition that capital invested in preferred stock should be recoverable in the same manner as debt. This position is based on the assumed facts that the same rule would have to be extended to common stock and that it could not be restricted to new enterprises. These assumed facts appear erroneous. Capital invested in common stock is not recoverable as debt because it is in all respects equity money. The proposed treatment of pre-

Safeguards are obviously necessary to control the possibility of tax avoidance, but these are not difficult to formulate. H.R. 3394,[99] introduced by Representative Curtis, seeks to amend section 302 by adding a new subsection (b)(5). This subsection would, in general, provide that a distribution in redemption of preferred stock (*i.e.,* nonvoting stock limited and preferred as to dividends and in liquidation) qualifies as a sale to the extent of paid-in consideration if when such preferred was issued the total paid in for preferred stock and for debt owed to shareholders did not exceed the value of the common stock.

This amendment incorporates some basic safeguards. First, preferred stock qualifying for its benefits must be nonvoting and limited and preferred as to dividends and in liquidation. Thus, hybrid forms of stock falling between common and such preferred would remain subject to the existing rules. Second, the preferred must be issued for a consideration and not as a dividend; sale treatment is extended only to the recovery of the paid-in investment. This is appropriate by analogy to debt, for only the recovery of the sum lent is there permitted free of tax. Third, by limiting the ratio of preferred stock and debt to common stock, excessive investment in temporary capital is prevented. The one-to-one ratio seems appropriate, but it would seem more realistic if the common stock measure were the amount actually paid in rather than the fair market value of the common at the time of measurement. Fair market value of unlisted stock is always troublesome. Moreover, if the paid-in permanent capital is so low that it is exceeded by paid-in temporary capital, the capital structure is sufficiently "thin" to raise questions. Furthermore, the measurement should be made both upon issuance of the preferred stock and at the time of redemption to prevent avoidance of the limitation by timing the creation of shareholder debt to follow rather than precede issuance of the preferred stock.

An amendment in the nature of that embodied in H.R. 3394 would permit shareholders to utilize either preferred stock or debt for temporary capital so long as they remain within the limits of the thin capitalization theory. Their financing decisions would not

ferred is premised on the fundamental difference in the nature of the investment. There is no reason, under the approach taken herein, to confine the proposed policy to new enterprises any more than there is reason to confine tax-free debt recovery to new enterprises.

[99] H.R. 3394, 88th Cong., 1st Sess. (1963). Adverse report by Treasury Department, June 8, 1964.

have to be colored by tax problems inherent in the ultimate recovery of capital.

2. *Cases not within the amendment.*—This amendment would not necessarily solve the problem of shareholders of large, publicly-held companies redeeming preferred stock. The shareholders of such companies usually acquire their stock in the public market, unaware of the niceties of its issuance and the state of the issuing corporation's capitalization. If such a redemption fell without the proposed amendment, it would continue to be governed by the general dividend equivalence test of section 302(b)(1).

The dividend equivalence test can operate efficiently in this limited area, for preferred stocks of large, publicly-held companies are seldom held in proportion to the common stock of the same company. Consequently, distributions in redemption of preferred stock seldom are pro rata with respect to common stock. Even if a shareholder of such a company fortuitously holds the same percentage of common and preferred, a distribution in redemption of preferred should not be viewed as essentially equivalent to a dividend on his common stock if it in fact reduces his proportionate equity in preferred stock.

3. *The status of the pro rata standard in preferred stock redemptions.*—In the foregoing discussion of the judicial approach to dividend equivalence, the authors postulated that the pro rata standard of dividend equivalence was the only relevant standard. This position must be modified in the area of preferred stock redemptions where the pro rata factor is not necessarily indicative. If the right of the preferred shareholder to receive dividends is fixed and limited, it is difficult to say that a distribution outside the confines of these limitations, even though pro rata with respect to preferred shareholders, is equivalent to a dividend. Moreover, the redemption of a pro rata portion of a shareholder's preferred stock has implications not present in the case of a pro rata redemption of common —*i.e.*, the shareholder's right to recover invested principal and to receive preferred dividends is pro tanto reduced. Thus, the mere fact that a distribution in redemption of preferred is pro rata with respect to preferred is not an indicator of dividend equivalence.

If the distribution in redemption of preferred is pro rata with respect to the common stock, as where common and preferred are held in identical proportions, a factual question is presented. Is the

preferred redemption actually a distribution in retirement of preferred? Or is it a disguised dividend on the common stock? Logically, the issue should be determined by considerations inherent in the philosophy of H.R. 3394. If the preferred stock represents temporary capital in a reasonable amount, the distribution should be considered in retirement of all or a portion of that capital. On the other hand, if the preferred is not truly temporary capital, as where it is participating, or if it is excessive in relation to permanent equity capital, the redemption may be in reality a pro rata distribution on common and (under the pro rata standard of dividend equivalence) essentially equivalent to a dividend on the common.

When the preferred stock redemption issue is thus framed, cases such as *Henry A. Golwynne*[100] assume their proper significance. There a sole shareholder received a note in lieu of his salary because of the corporation's weak cash position. On his individual return, he reported and paid tax on the salary represented by the note. In order to improve the corporate balance sheet, he later permitted the note to be converted to preferred stock. Upon the subsequent redemption of that stock the Tax Court held that the distribution was not essentially equivalent to a dividend. This case is frequently explained by the emotional appeal of the shareholder's having already paid tax on the amount of his salary. To tax him again on its ultimate withdrawal would supposedly be unfair. But this rationale is nonsense, for most investments in stock are made with tax-paid funds. If the tax-paid nature of the funds will permit their withdrawal without dividend consequences, the redemption rules are for naught. The true inquiry in *Golwynne* was whether the shareholder was converting his temporary investment represented by a note into permanent capital when he accepted preferred stock. It must have seemed obvious to the court that a continuing temporary investment was intended. The amount of such investment not being excessive, the natural result was a holding that the distribution was in fact in retirement of preferred stock rather than a pro rata distribution in redemption of common stock.

V. The Effect of the 1954 Code on Dividend Equivalence in Partial Liquidations

In the above discussion, it has been ventured that a distribution with respect to common stock which is pro rata is per se equivalent

[100] 26 T.C. 1209 (1956).

to a dividend. Is this also true with respect to the dividend equivalence test of section 346 (a)(2), relating to partial liquidations? Here it appears that an altogether different standard is necessary, for distributions in partial liquidation may well be pro rata.[101] Nonetheless, if they occur during the course of a corporate contraction, they are not essentially equivalent to dividends.

The Senate Finance Committee report leaves little doubt that the governing standard of section 346 is intended to be corporate contraction, whether of the general variety conceived by the courts under the dividend equivalence test of former law[102] or the specific variety now set forth in the statute.[103] Thus, instead of examining the pro rata character of the distribution at the shareholder level, we must look to the contraction of corporate activities to differentiate between sales of stock and dividends in the area of partial liquidation.

The student will have some difficulty perceiving a logical link between diminishing corporate activity and lack of dividend equivalence. If the distribution is pro rata among shareholders it is equivalent to a dividend, and the fact that the corporation restricts its scope of activity hardly makes it less than equivalent.

Some area of capital gain taxation for liquidating distributions short of complete liquidation is probably desirable,[104] although this may be debatable.[105] In any event, Congress has established such an area and has indicated that corporate contraction is to be the standard used in defining the limits of that area. The problem is that the test enunciated in the statute, lack of dividend equivalence, is not helpful in ascertaining whether a contraction has occurred. It would seem appropriate to replace the dividend equivalence test with one more appropriate to the inquiry. Such a test might require that "the distribution be attributable to a bona fide contraction of a trade or business actively conducted by the distributing corpora-

---

[101] See, *e.g.*, Fowler Hosiery Co., 36 T.C. 201 (1961), *aff'd*, 301 F.2d 394 (7th Cir. 1962).

[102] The report cites Joseph Imler, 11 T.C. 836 (1948), involving distribution of fire insurance proceeds. S. REP. No. 1622, 83d Cong., 2d Sess. 262 (1954).

[103] "Primarily, this definition [section 346(a)] involves the concept of 'corporate contraction' as developed under existing law." *Ibid.*

[104] See Surrey, *supra* note 88, at 5-8.

[105] See Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 472 (1950); Chommie, *Section 346(a)(2): The Contraction Theory*, 11 TAX L. REV. 407 (1956).

tion" and that "such contraction was not undertaken principally as a device for the distribution of the earnings and profits of the distributing corporation." Thus, two standards would be employed in this test, a general contraction standard and a general "anti-device" standard similar to that of section 355(a)(1)(B). At least there is a logical relevance between these standards and corporate contraction, a link which is missing between lack of dividend equivalence and corporate contraction.

VI. Conclusion

Distributions which are pro rata among shareholders are logically the equivalent of dividends; those which are essentially pro rata are essentially the equivalent of dividends. The uniform application of this standard would produce clarity and consistency while yet retaining the flexibility naturally inherent in a general standard. The principal inquiry would be whether or not the distribution was in fact pro rata, or essentially pro rata, and this inquiry should be aided by a selective application of the constructive ownership rules.

A new legislative standard should be established for preferred stock, with the recognition that certain forms of preferred stock are closely akin to debt and may be entitled upon redemption to similar treatment.

A reappraisal of the dividend equivalence test in the area of partial liquidations should be made to determine whether an express corporate contraction test might better be substituted.