Volume 42 | Number 2 Article 16

2-1-1964

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highly desirable solution as it would favor various local policies while redressing the violations of the federally created right.

From a practical standpoint, *Borak* seems to be the more desirable of the two decisions. If *Dann* is followed, the state courts could still refuse to take jurisdiction by holding that in determining the consequent effects of invalid proxies, they would be enforcing a liability created by the federal law, in contravention of the exclusive jurisdiction provision of section 27.[45] Furthermore, even if the state courts did take jurisdiction to decide the "state law" aspects of the action, two actions would be necessary before relief could be granted. Besides the time and money lost in this litigation, plaintiff would also lose the benefits of liberal venue and nationwide service of process available under section 27.[46]

Moreover, *Borak* carries out the purpose of section 14(a), protecting investors in securities, to a much greater degree than *Dann*. The very fact that the private action exists in addition to the enforcement by the Commission adds to the protection afforded by the act.[47] The decision also serves as a warning that any advantage obtained through illegal solicitation may be taken away in a private action after the vote. As such, it is a psychological weapon against those who would make use of such methods.

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Liability of Continuing Shareholder for Constructive Dividend

When a closely held corporation redeems the shares of one stockholder, the threat of a constructive dividend may present tax problems for the continuing shareholder. The problem arises when one major shareholder has decided to leave the corporation and another wishes to remain. Basically, there are two ways for the continuing shareholder to acquire complete ownership of the corporation: (1) the continuing shareholder may use his personal funds to

[45] State courts have so far refused to hear any claim or defense based upon § 14(a) because of § 27. *E.g.*, Investments Associates, Inc. v. Standard Power & Light Corp., 29 Del. Ch. 225, 48 A.2d 501 (Ch. 1946), *aff'd*, 29 Del. Ch. 593, 51 A.2d 572 (Sup. Ct. 1947); Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A.2d 862 (Ch. 1952), *aff'd per curiam*, 12 N.J. 467, 97 A.2d 437 (1953).

[46] See these provisions of § 27 in note 16 *supra*.

[47] Brief for the SEC as Amicus Curiae, p. 21, Borak v. J. I. Case Co., 317 F.2d 838 (7th Cir. 1963).

purchase the shares of the retiring stockholder, or (2) the corporation may use its funds to redeem the shares of the retiring stockholder.

There is at least one persuasive reason for having the corporation redeem the shares rather than having the remaining shareholder make the purchase. The remaining shareholder's personal funds may be insufficient to purchase the shares of the departing shareholder, and he may have to look to the corporation itself for the funds needed to purchase the retiring shareholder's interest. If the continuing stockholder takes corporate funds into his own hands in order to purchase the shares of the retiring stockholder, there must be a dividend declared to him; and, therefore, a personal income tax will be precipitated at the shareholder level. The consequence of this tax may leave the continuing shareholder with insufficient funds to purchase the shares of the retiring stockholder. It thus becomes a matter of tax economy[1] (and often a matter of economic necessity) that the continuing shareholder so arrange the transaction that no dividend need be declared to him, and that no constructive dividend may be imputed to him. The desire for such a use of corporate funds—a redemption by the corporation free of dividend tax dangers to the continuing stockholder—brought about the transactions in two recent cases.

In one decision,[2] the remaining shareholder made a contract to purchase the shares of the other stockholder. Unable to perform due to a lack of funds, the remaining shareholder assigned his contract to a third party. The third party purchased the shares from the retiring shareholder, and they were subsequently redeemed by the corporation from the third party. The Commissioner argued that the effect of these transactions constituted a constructive dividend to the remaining shareholder. The grounds were that the

[1] A simple illustration shows the economics of the situation: *X* and *Y* each own fifty per cent of the corporation, and they agree that on the death of either, the remaining shareholder will purchase the other's stock for $50,000, the fair market value of the stock at the time of the agreement. When *Y* dies, the corporation is worth $200,000. Assuming that *X* is in the fifty per cent tax bracket, he will have to declare a dividend of $100,000 from the corporation to himself in order to obtain the purchase price of $50,000. This would leave *X* with a corporation worth $100,000. However, if a redemption is provided for, the corporation will pay $50,000 and *X* will then be the sole owner of a corporation worth $150,000.

[2] Milton F. Priester, 38 T.C. 316 (1962).

corporation had satisfied the remaining shareholder's obligation to purchase the stock, and that the third party was merely used as a "straw man" to effect this purpose. Rejecting this line of reasoning, the Tax Court held that there was no constructive dividend. The third party was not merely a "straw"; rather, the facts indicated that he was an independent businessman acting for his own interests.[3]

The taxpayer was not as fortunate in another instance.[4] There the remaining shareholder also contracted to purchase the retiring shareholder's interest. Through necessity, or choice, the taxpayer borrowed money from the corporation and made the purchase himself. The shares were subsequently redeemed from the remaining stockholder, the consideration being a cancellation of his debt to the corporation.[5] It was held that the discharge of the debt was essentially equivalent to a dividend to the extent of available earnings and profits in the corporation.[6]

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[3] *Id.* at 325.

[4] Aloysius McGinty, 38 T.C. 882 (1962).

[5] From a technical point of view, the continuing shareholder received a dividend by failing to come within the provisions of INT. REV. CODE OF 1954, § 302 which allows certain redemptions to be treated as capital exchanges rather than as dividends.

In Hargleroad v. United States, 202 F. Supp. 92 (D.C. Neb. 1962), the continuing shareholder received the shares from the retiring shareholder and had them redeemed himself. The court disregarded the circuitous means used to effect the redemption, and looked at the net effect of the transaction, construing that there was only a redemption and that there was no constructive dividend to the remaining shareholder. But compare Neff v. United States, 305 F.2d 455 (Ct. Cl. 1962) where a different approach was used. The sole shareholder had the corporation redeem his shares in order that the corporation could resell the shares and obtain additional working capital. On resale of the shares, the corporation made a large profit. But the court refused to look at the net effect of the transaction and held the redemption to be a dividend to the remaining shareholder because it failed to qualify under INT. REV. CODE OF 1954, § 302. The court felt that the business purpose involved was subservient to the code provisions which in effect provide that where a redemption of stock of a sole shareholder occurs, it will be considered a dividend to the extent of available corporate earnings and profits, rather than payment in exchange for the stock which would obtain sale or exchange treatment. In order to obtain sale or exchange treatment, the payments must meet the redemption qualifications in INT. REV. CODE OF 1954, § 302. If not, the payment will be treated as a dividend under INT. REV. CODE OF 1954, §§ 301(c), 316(a).

[6] The 1954 Code treats disbursements to the retiring shareholders fairly explicitly, however, there are no express provisions concerning the taxability of the remaining shareholders where the corporation redeems the shares of a retiring stockholder. Case law has developed in this field under INT. REV. CODE OF 1939, § 115(g) and subsequently under INT. REV. CODE OF 1954, § 302(b)(1). Under those provisions, the question is this: "Was the pay-

The historical development of the law in regard to the continuing shareholder's liability for a constructive dividend can be traced in the following manner:

The first group of cases concerned facts similar to those involved in the *McGinty* case.[7] The rule was established that where corporate funds were used to satisfy the remaining shareholder's *obligation* to purchase, then he would be deemed to have received the equivalent of a taxable dividend.[8]

The next important case involved an individual who had an *option* to purchase the remaining shares of a corporation in which he had a substantial interest.[9] He assigned his option to the corporation and the shares were redeemed. The Tax Court held that this was clearly a constructive dividend to the taxpayer because no corporate purpose was served and because the net effect was that the corporation made the purchase for the remaining shareholder. This ruling was reversed on appeal.[10] The taxpayer was never

ment to the retiring shareholder 'essentially equivalent to a dividend' to the remaining shareholder?" See Graham, *Redemption Problems: The Holsey and Zipp Cases,* 36 TAXES 925 (1958).

[7] See note 4 *supra* and accompanying text.

[8] Two of the leading cases establishing liability for constructive dividends where the corporation assumes the taxpayer's obligation to purchase are Wall v. United States, 164 F.2d 462 (4th Cir. 1947) and Thomas J. French, 26 T.C. 263 (1956). In the *Wall* case the taxpayer had given notes to purchase shares in the corporation. He surrendered the stock to the corporation and the corporation agreed to pay the note. In *French,* the taxpayer borrowed money from the corporation itself. He subsequently surrendered part of the stock and the corporation cancelled the outstanding debt. In both cases it was held that the satisfaction of the taxpayer's obligation was essentially the equivalent of a taxable dividend. See also, Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958); Ferro v. Commissioner, 242 F.2d 838 (3d Cir. 1957); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955); Lowenthal v. Commissioner, 169 F.2d 694 (7th Cir. 1948); Edgar S. Idol, 38 T.C. 444 (1962); George M. Hancock, 18 T.C. 210 (1952).

[9] Holsey v. Commissioner, 28 T.C. 962 (1957), *rev'd,* 258 F.2d 865 (3d Cir. 1958). For a discussion of this case and subsequent revenue rulings, see Ward v. Rountree, 193 F. Supp. 154 (M.D. Tenn. 1961), where two shareholders each owned fifty per cent of two different corporations. One corporation redeemed the stock of one shareholder, and the other corporation redeemed the shares of the other shareholder. It was held that the remaining shareholder(s) did not receive a constructive dividend as a result of the redemption(s).

[10] Holsey v. Commissioner, 258 F.2d 865, 869 (3d Cir. 1958). The court disregarded the arguments as to whether there had been a business purpose for the redemption. It was stated that the effect of the redemption rather than its purpose was the controlling factor in determining whether the redemption was equivalent to a dividend.

"obligated" to purchase the shares and the shares never came into his possession. Therefore, there was a straight redemption and no constructive dividend to the remaining shareholder.[11] The Commissioner agreed to follow this decision.[12]

A subsequent revenue ruling seems to depart somewhat from the "obligation" test.[13] The taxpayer was obligated either to purchase the shares or to vote his stock for liquidation of the corporation. Instead of pursuing either alternative under the contract, the shareholder caused the corporation to redeem the shares for book value and for a valid business purpose. It would seem that the corporation had clearly satisfied the continuing shareholder's obligation (and certainly the corporation expended funds to render that obligation moot), but it was ruled that there was no constructive dividend. The "obligation" cases were distinguished because here the taxpayer never bought the shares for himself, nor did he obligate himself to do so, except in the alternative. In the prior "obligation" cases, the shareholder had either actually purchased the shares before the corporation redeemed, or he was obligated to do so without express reference to any corporate redemption.

It is apparent that the decided cases put a premium on the drafting of the agreement. If the parties provide for corporate redemption, the continuing shareholder is saved from the constructive dividend, because he was at no time obligated to purchase the shares.[14]

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[11] Ray Edenfield, 19 T.C. 13 (1952), is another example of an unsuccessful attack by the Commissioner where the taxpayer was not obligated to purchase the shares. The taxpayers bought a portion of the retiring shareholder's stock and had the corporation issue its notes to the retiring shareholder in redemption of the remainder of the stock. The Commissioner argued that when the notes were paid off, the remaining shareholders received the equivalent of a dividend, because the corporation was paying the debt *for* the remaining shareholders. The court did not follow this theory because the debt was solely that of the corporation. The continuing shareholder was never obligated.

[12] REV. RUL. 58-614, 1958-2 CUM. BULL. 920. The ruling warns that if the stock is surrendered to the corporation for less or more than fair market value, it may be treated as a gift to or from the retiring shareholder.

[13] REV. RUL. 59-286, 1959-2 CUM. BULL. 103.

[14] The remaining shareholder may not want the working capital of the corporation to be diminished by the redemption cost. In such a case, he could take over the corporation's obligation to purchase the stock, since the retiring shareholder probably would not object. There is, however, some danger in this approach. The redemption price could be less than the fair market value of the stock. When the corporation assigns the contract to the shareholder who is to remain, what will be the result? No case law concerning this type arrangement has been found. The assignment could be

The same result could be obtained if the corporation were obligated to purchase the shares, contingent on the continuing shareholder's not having previously exercised an option to buy the shares for himself.[15] This agreement would be more flexible in that the remaining shareholder could use either his own or corporate funds. Thus the shareholder's needs and the needs of the corporation at the time of redemption or purchase could both be considered in determining which course to follow.

It seems questionable that the continuing shareholder should ever be taxed as having received a constructive dividend where the action taken has the same effect as a straight redemption. Since redemptions are allowed, it is somewhat unjust to penalize a shareholder who discovers, after he has obligated himself, that he would be better off having the corporation redeem. Also, the whole theory behind the "obligation" cases seems somewhat illogical. If a shareholder's *obligation* to purchase is assigned to a third party, the shareholder would never be taxed for the *benefits* accruing to that third party as a result of the assignment. Admittedly, the result in such an instance may differ where the assignment is made to the corporation, in that the assignor receives the benefits of the contract because he becomes the sole owner of the corporation. But this is not the complete consequence. The corporation which the remaining shareholder now owns in its entirety is diminished by the amount of the redemption price.[16] When the shareholder makes the assignment, he not only assigns his obligation, but he also assigns the benefits which would otherwise flow to him. Since there has been a loss of benefit as well as obligation, why should there be a constructive dividend?[17]

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treated as a gift to the remaining shareholder of the excess over fair market value. But this possible threat might be avoided by allowing the corporation to redeem and by contributing more capital at the time of redemption.

[15] This clause in the agreement should be very carefully worded in order to avoid the construction that the shareholder was obligated to purchase the shares. For instance, the following type clause should be avoided: "At such time, the remaining shareholder will purchase, or the corporation will redeem, such shares."

[16] Assume *X* and *Y* are equal shareholders in a corporation whose shares are worth $200,000. If *X* buys the shares, he becomes the sole owner of a corporation valued at $200,000. On the other hand, if the corporation redeems *Y's* stock for $100,000, then *X* becomes the sole owner of a corporation worth only $100,000.

[17] Erickson v. United States, 189 F. Supp. 521 (S.D. Ill. 1960) lends support to this argument. In this case, the obligation theory was not followed.

Moreover, if the continuing shareholder is to be taxed at all, as having received a constructive dividend, why should the results be dependent on whether the shareholder "obligated" himself to buy the shares? For policy reasons, some sort of "business purpose" test would seem more consistent. For example, it would seem logical to tax the continuing shareholder where the corporation had a real need for working capital but nevertheless used the needed funds to redeem at a price which was no bargain, for the sole purpose of accommodating the remaining shareholder. On the other hand, it would seem illogical to tax the continuing shareholder when the corporation had excessive funds on hand to use for redemption at a price which was a bargain. Under the obligation test, however, these factors would not be considered.

Under the present state of the law, it seems unlikely that the Commissioner will attack again where there is no obligation on the remaining shareholder to purchase the shares, regardless of whether there was any business purpose whatever for the redemption. It would seem even more unlikely that the courts would rule for the Commissioner should he take such action. Until some change is effected concerning the "obligation" theory, the drafters of the purchase or redemption contract should beware the constructive dividend.

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The stockholder borrowed money from a third party to purchase the shares from the estate of a deceased shareholder, in agreement with the other remaining shareholders. The corporation, when it became financially able, paid off the stockholder's debt to the third party and cancelled the shares. Although it would seem that the shareholder's obligation was satisfied, it was held that there was no dividend. The court stated that in reality there had been merely a redemption by the corporation from the deceased shareholder's estate. The form of the transaction was regarded as being merely a temporary expedient which would enable the corporation to retire the shares without overextending its financial position at the time.

The taxpayer in effect assigned his benefits under the contract, as well as his obligation, to the corporation. Consequently, he received no constructive dividend.

If the continuing shareholder were never taxed on a constructive dividend where the net effect of the transaction was that of a redemption, the substance of the transaction would be controlling, rather than its form.