Recent Interpretations of the "Meaningful Reduction" Test of I.R.C. Section 302(b)(l)

Boyd C. Randall
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A carefully planned stock redemption can often escape dividend treatment under the “safe harbor” provisions of Internal Revenue Code subsections 302(b)(2)-(4).1 If, however, the re-

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1. I.R.C. § 302(b)(2)-(4):

(b) Redemptions treated as exchanges.

(2) Substantially disproportionate redemption of stock.

(A) In general. Subsection (a) [providing sale treatment] shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation. This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions. For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder’s ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions. This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder’s interest. Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Stock issued by railroad corporations in certain reorganization
demption does not meet the requirements of any of these subsections, it still may be "not essentially equivalent to a dividend" and therefore qualify for sale treatment under section 302(b)(1) rather than dividend treatment. In spite of a large volume of case law examining the dividend equivalency issue, including the 1970 Supreme Court decision of United States v. Davis, the meaning of the section 302(b)(1) test has remained unclear. The test has therefore proved difficult to use as a planning tool. The purpose of this article is to examine recent cases and revenue rulings that suggest the probable parameters of the "dividend equivalency" test as it applies to common and preferred stock redemptions.

I. BACKGROUND

The issue of dividend equivalency originated because of the difference in tax consequences between a liquidating distribution, which is taxed as a sale (usually receiving preferential capital gain treatment), and an earnings distribution, which is taxed as a dividend (usually receiving ordinary income treatment). Before 1921, a taxpayer who wished to reduce his tax could convert a distribution of earnings into a liquidating distribution by causing the corporation to issue a nontaxable stock dividend and then to redeem the stock dividend for cash. In 1921, Congress took steps to defeat this method of tax avoidance by enacting a statute imposing a tax on the shareholder when the redemption of stock, previously issued as a dividend, was "essentially equivalent to the distribution of a taxable dividend." The statute was amended in 1924 and in 1926 in order to prevent further tax avoidance schemes. The 1926 version of the statute was codified in the

Subsection (a) shall apply if the redemption is of stock issued by a railroad corporation (as defined in section 77(m) of the Bankruptcy Act, as amended) pursuant to a plan of reorganization under section 77 of the Bankruptcy Act.

Section 302(b)(4) is too narrow to be of general planning use to the practitioner.

2. I.R.C. § 302(b)(1): "Subsection (a) [providing sale treatment] shall apply if the redemption is not essentially equivalent to a dividend."


4. See Lynch v. Turris, 247 U.S. 221 (1918). This rule is embodied in I.R.C. § 331.

5. See Lynch v. Hornby, 247 U.S. 339 (1918). This rule is part of the current statutory scheme. I.R.C. §§ 301, 316.


9. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11.

10. Taxpayers were able to circumvent the 1921 statute by first having the corporation redeem some of their stock and then having the corporation replace it by issuing new
Internal Revenue Code of 1939 as section 115(g).\textsuperscript{11} Courts interpreted the test of "dividend equivalency" to be a factual inquiry into whether or not the "net effect" of the transaction more closely resembled a dividend or a stock sale.\textsuperscript{12} Although many factors were considered in the test,\textsuperscript{13} the major consideration was whether a valid business reason existed for the redemption.\textsuperscript{14} The factual nature of the test, however, made it almost useless to taxpayers as a planning tool and produced some confusion in its interpretation by the courts.\textsuperscript{15}

In an effort to eliminate the uncertainty of the dividend equivalency test, the House of Representatives drafted a new test as part of the Internal Revenue Code of 1954.\textsuperscript{16} The House proposal eliminated the "essentially equivalent to a dividend" language and provided objective guidelines\textsuperscript{17} that now comprise subsections 302(b)(2)-(4). The Senate, however, restored the language of the 1939 Code with this explanation:

While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when

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\item stock as a dividend. The 1924 amendment closed this loophole. Finally, the 1926 amendment made distributions that were "essentially equivalent to a dividend" taxable as ordinary income regardless of whether any pre- or post-redemption stock dividend was made.
\item 11. Int. Rev. Code of 1939, ch. 1, § 115(g), 53 Stat. 48 (current version at I.R.C. § 302(b)(1)).
\item 12. See, e.g., Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940); McGuire v. Commissioner, 84 F.2d 431 (7th Cir.), cert. denied, 299 U.S. 591 (1936).
\item 13. For a listing of these factors, see Comment, Defining Dividend Equivalency Under Section 302(b)(l), 16 VILL. L. REV. 88, 89-90 (1970).
\item 17. The House report explained the change as follows:
The approach adopted in section 115(g) of existing law, whereby the consequences resulting from the redemption of stock may be taxed depending upon the factual circumstances surrounding the redemption have been changed by your committee. In lieu of a factual inquiry in every case, it is intended to prescribe specific conditions from which the taxpayer may ascertain whether a given redemption will be taxable at rates applicable to the sale of assets or as a distribution of property not in redemption of stock subject to section 301.
\end{itemize}

the redemption may take place. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. This general rule is supplemented by your committee by the rule of the House bill that a redemption which is substantially disproportionate shall also qualify so as not to be taxable as a dividend.18

As finally enacted, section 302(b)(1) of the 1954 Code contained the same "essentially equivalent to a dividend" test previously found in section 115(g) of the 1939 Code. Subsections 302(b)(2)-(4) of the new provision also contained the objective rules proposed by the House, commonly referred to as "safe harbors." In addition, section 302(c) provided that the attribution rules of section 31819 would apply in determining whether the ownership tests of section 302 were satisfied.20

In the years following enactment of section 302(b)(1), the courts struggled to define the parameters of its application.21 During this period, a conflict developed in the circuits as to whether business purpose was still a relevant consideration in determining dividend equivalency under section 302(b)(1).22 The Supreme Court, in the landmark case of United States v. Davis,23 finally resolved the issue by holding that the existence of a business purpose for the distribution was irrelevant and did not qualify the distribution as being not essentially equivalent to a dividend.24 The Court then established that in order for a distribution to be not essentially equivalent to a dividend, it must result in a "meaningful reduction of the shareholder's proportionate inter-


19. The purpose of § 318 is to "[p]rovide rules to indicate specific instances when, for purposes of preventing tax avoidance, a person shall be considered to own stock owned by a related person." S. REP. No. 1622, 83d Cong., 2d Sess. 43, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4675.

20. Although the language of I.R.C. § 302(c) does not clearly require that the attribution rules be applied in a determination of dividend equivalence under § 302(b)(1), United States v. Davis, 397 U.S. 301 (1970), held the rules to be applicable. See note 28 and accompanying text infra.


22. For a listing of the alignment of the circuits, see United States v. Davis, 397 U.S. 301, 303 n.2 (1970).

23. Id.

24. Id. at 312.
The Court also held that the attribution rules of section 318 must be used to measure ownership interest in determining dividend equivalency. Although Davis resolved the conflict surrounding the application of the business purpose test and definitely established that the section 318 attribution rules would apply to a section 302(b)(1) redemption, the courts were faced with the task of determining when a redemption would create a meaningful reduction of the shareholder's proportionate interest.

II. MEANINGFUL REDUCTION OF THE SHAREHOLDER’S PROPORTIONATE INTEREST

In determining whether the meaningful reduction test has been met, recent cases and revenue rulings have looked to the reduction of shareholder interests such as voting control, the right to current earnings, and the right to assets on liquidation. The remainder of this article will discuss which of these interests must be reduced and to what extent in order to satisfy the Davis test. Because these considerations depend primarily upon the stock ownership pattern in which the redemption occurs, the article will focus on redemptions in two general contexts, redemptions of common stock and redemptions of preferred stock.

A. Redemptions of Common Stock

1. Shareholder having complete ownership

What constitutes a meaningful reduction seems to be very clear when one shareholder is deemed to own 100 percent of a corporation's common stock. The Court in Davis concluded that...
"a redemption [of a sole shareholder's stock] is always 'essentially equivalent to a dividend' within the meaning of that phrase in §302(b)(1). . . ." Thus, there can never be a meaningful reduction of a sole shareholder's interest regardless of how much of his stock the corporation redeems. Although the redemption in Davis was of preferred stock, a review of the post-Davis cases involving redemptions of the common stock of sole shareholders reveals that the rule has been followed in every instance—including those when ownership was constructive rather than actual.

2. Shareholder having majority ownership

Almost every court that has considered the application of "meaningful reduction of the shareholder's proportionate interest" in the context of a redemption of common stock of a majority shareholder has concluded that reduction of voting power or control is the determinative factor. The language of a California federal district court in Title Insurance and Trust Co. v. United States is representative: "[T]he redemption must result in a meaningful reduction of the shareholder's proportionate interest (voting power) in the corporation . . . ." In addition, a recent revenue ruling suggests that the degree of shareholder control is the primary consideration involved in determining whether there has been such a meaningful reduction.

As previously noted, the stock attribution rules of section 318 are strictly applied in measuring whether a meaningful reduc-

30. 397 U.S. at 307 (footnote omitted).
31. If, however, the taxpayer completely redeems his interest, he may satisfy another "safe harbor" provision, I.R.C. § 302(b)(3). Note 1 supra.
36. See note 28 and accompanying text supra.
tion has occurred. Thus, even if a majority shareholder's actual stock ownership has been decreased or even terminated,37 the court will also look to whether an increase or decrease in constructive stock ownership has occurred. The principle is exemplified by *Title Insurance and Trust*. That case involved three trusts, each of which, prior to the redemption, owned stock as follows:

<table>
<thead>
<tr>
<th>Actual Ownership</th>
<th>Constructive Ownership</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>55%</td>
<td>70%</td>
</tr>
</tbody>
</table>

Each trust had all of its actual shares redeemed, but because of stock attribution, each constructively owned 100 percent of the corporation's stock following the redemption.38 The district court determined that the redemption did not result in a "meaningful reduction of the shareholder's (trusts) proportionate interest in the corporation."39 This determination was upheld on appeal to the Ninth Circuit.40 The Tax Court has also adopted the view of the Ninth Circuit that when a redemption results in an increase in the redeeming shareholder's proportionate interest in the corporation, even if due to the application of constructive ownership rules, it can never qualify for sale treatment under section 302(b)(1).41

Other decisions have indicated that a minor reduction in a majority shareholder's common stock interest will not be a meaningful reduction if the shareholder continues to exercise majority control over the corporation. In *Fehrs Finance Co. v. Commissioner*,42 the taxpayer experienced a 9.5 percent reduction in common stock ownership from 98.2 percent to 88.69 percent. Neither the Tax Court nor the Eighth Circuit viewed this reduction as meaningful because the taxpayer's control of the corporation remained essentially unaltered.43 The Tax Court, however,

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38. After the corporation redeemed the stock of each trust, the corporation was owned 100% by the parents of the trust's child beneficiaries. The parents' stock ownership was therefore attributed to each trust by virtue of I.R.C. §§ 318(a)(1)(A) and 318(a)(3)(B)(i).


40. 484 F.2d at 465.


43. The 'Tax' Court held that "a reduction in stock ownership from 98.2 to 88.69
suggested that under different circumstances a 9.5 percent reduction might be meaningful: "[T]he same percentage spread might make a great deal of difference if the initial figure was not such a very high one, and there might be unusual circumstances in which the exact percentage reduction here would be material." In *Niedermeyer v. Commissioner*, the "initial figure" was not quite as high as in *Fehrs Finance*, yet the Tax Court held that a 7.5 percent reduction from 90.49 percent to 82.96 percent was not meaningful. Again, the court suggested that the shareholder's retention of control was the disqualifying factor.

In *Jones v. United States*, a federal district court was even more explicit in holding that retention of control will disqualify a majority shareholder from sale treatment: "The Court finds as a matter of law that ownership of such a vast majority [96.1 percent] of corporate stock precludes a finding that plaintiff's attributed interest had been meaningfully reduced . . . ."

Revenue Ruling 75-502 sets forth the Commissioner's view regarding redemptions of the common stock of a majority shareholder. Before the redemption, the taxpayer estate in the ruling owned actually and constructively approximately 57 percent of the total voting rights of the corporation. After the redemption, the taxpayer had no actual ownership but owned 50 percent of the corporation by virtue of section 318 attribution. The Commissioner ruled that the redemption resulted in a meaningful reduction.

Although the ruling mentioned the right to share in the common stock does not deprive such a dominant shareholder of his ability to control the corporate activities; such a reduction does not affect the shareholder's relationship to the corporation in any significant way." *T.C. at 185. See also 487 F.2d at 187.*

44. 58 T.C. at 185.
46. *Id.* at 287-88 (footnotes omitted) (emphasis added):

We do not think a reduction in ownership of the AT&T common stock from 90.49 percent to 82.96 percent constitutes a meaningful reduction of petitioners' proportionate interest in AT&T in the instant case. With such a small change in a high percentage interest, petitioners' control and ownership of AT&T is essentially unaltered and cannot be considered to have undergone a meaningful reduction. An 82.96 percent interest clearly is sufficient to dominate and control the policies of the corporation.

*Cf.* Rev. Rul. 73-2, 1973-1 C.B. 171, 172 (suggesting in a § 304 context that a 19% reduction in ownership from 100% to 81% does not meet the test of § 302(b)(1)).
47. 72-1 U.S. Tax Cas. 84,208 (D.N.J. 1972).
48. *Id.* at 84,212 (emphasis added). The majority shareholder's common stock ownership had been reduced from 98.5% to 96.1%.
49. 1975-2 C.B. 111.
50. *Id.* at 112.
corporation's assets on liquidation and the right to share in current and accumulated earnings, it is clear that reduction of control was the most important factor. The Commissioner stated: "Moreover, the reduction of the estate's voting rights from 57 percent to 50 percent produced a situation in which the other 50 percent of the voting rights of X were held by a single unrelated shareholder." In other words, the shareholder had lost his voting control as a result of the redemption. The final paragraph of the ruling confirmed that the loss of control was the most relevant factor influencing the Commissioner's position:

If in the instant case, the stock of X held by the estate was reduced by less than 7 [percentage points] the redemption would not qualify under section 302(b)(1) because the estate would continue to have dominant voting rights in X by virtue of its ownership of more than 50 percent of the X stock.52

Two recent cases collaterally related to section 302 by virtue of section 35653 confirm that loss of majority control as a result of a redemption of common stock constitutes a meaningful reduction of a shareholder's proportionate interest. In Wright v. United States,54 a taxpayer participated in a corporate reorganization under section 368, receiving stock in the newly formed corporation. Incidental to the reorganization, the taxpayer also received a $102,002 note. The Eighth Circuit characterized the transaction as a reorganization in which the taxpayer received an 85 percent stock ownership interest in the new corporation, followed by a

51. Id.
52. Id. The Commissioner's ruling states that the estate would have had "dominant voting rights in X" had its stock ownership been reduced by less than 7 percentage points. In fact, the estate had no actual ownership following the redemption. Its voting rights were due entirely to its attributed stock. Although this position is probably consistent with Davis, see notes 26, 28 and accompanying text supra, the estate in fact may not have been able to exercise any control over the stock attributed to it. Cf. Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975) (holding that family hostility may prevent the attribution rules from applying).
53. I.R.C. § 356 outlines the tax consequences of receipt of additional consideration in certain corporate reorganizations. Section 356(a)(2) provides in part: "If an exchange . . . has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount . . . ." (emphasis added). Both the courts and the Commissioner have recognized that the redemption provisions of § 302 and § 356(a)(2) should be read in pari materia in determining whether a distribution has the "effect . . . of a dividend" under § 356(a)(2). See Wright v. United States, 482 F.2d 600, 605 (8th Cir. 1973); Hawkinson v. Commissioner, 255 F.2d 747, 751 (2d Cir. 1956); Ross v. United States, 173 F. Supp. 793, 797 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); Rev. Rul. 75-83, 1975-1 C.B. 112, 113; Rev. Rul. 74-515, 1974-2 C.B. 118, 119.
redemption of a portion of the stock in exchange for the note. After the redemption the taxpayer owned 61.7 percent of the corporation's stock.\textsuperscript{55} Even though the taxpayer was still the majority shareholder, the court held that the redemption had caused a meaningful reduction of the shareholder's interest. The court reasoned that since Arkansas state law required a two-thirds majority for certain extraordinary corporate decisions,\textsuperscript{56} the redemption had caused the taxpayer to lose voting control. The rule in \textit{Wright} is broader than the rule laid out by the Commissioner in Revenue Ruling 75-502\textsuperscript{57} because \textit{Wright} suggests that a shareholder who experiences a practical loss of voting control for any reason, whether control is defined by state law or perhaps by the articles of incorporation, may qualify for sale treatment even if he retains his status as the majority shareholder.

A more recent decision reaffirms the relative importance of a loss of voting control. In \textit{Shimberg v. United States},\textsuperscript{58} the taxpayer initially owned approximately 66 percent of the common stock of corporation A, which gave him a controlling interest in the corporation. Pursuant to a plan of merger, the shareholders of corporation A exchanged their stock for stock and cash in corporation B, a publicly held corporation listed on the New York Stock Exchange. Following the merger, the taxpayer's ownership interest in corporation B was less than 1 percent.\textsuperscript{59} The court held that the merger had resulted in a meaningful reduction of the taxpayer's interest because his voting control had been virtually extinguished.\textsuperscript{60}

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  \item This characterization was disputed by the Commissioner who argued that the exchange of stock for the note occurred prior to the merger. The reduction in ownership, therefore, should have been measured in terms of the taxpayer's ownership in the initial corporation. 482 F.2d at 607. The Commissioner has formally objected to the Eighth Circuit's characterization of the facts in \textit{Wright}. Rev. Rul. 75-83, 1975-1 C.B. 112, 113. Although the Commissioner's view of the facts in \textit{Wright} may affect the application of § 302(b)(1) in future § 356 cases, the principles established in \textit{Wright} continue to be relevant in other § 302(b)(1) cases.
  \item ARK. STAT. ANN. §§ 64-507, -703, -901 (1966).
  \item 1975-2 C.B. 111.
  \item 415 F. Supp. 832 (M.D. Fla. 1976).
  \item Id. at 836.
  \item Id.
\end{itemize}

His former rights to direct the affairs of LSC were extinguished. His interest in MGIC afforded him no control whatsoever over the destiny of the large national corporation. No longer was he the major "owner" of a successful local company operating in several Florida counties. He was then the holder of a minuscule percentage of the outstanding stock in a huge publicly-held corporation. It is clear that the merger resulted in a radical change and meaningful reduction in the nature of the Plaintiff's interest in the continuing business.
Thus, it seems clear from these recent cases and rulings that, in the case of a majority stockholder, both the Commissioner and the courts consider loss of voting control to be the determinative factor in deciding whether a meaningful reduction of a shareholder’s interest has occurred within the purview of section 302(b)(1).

3. **Shareholder having a minority interest**

The Commissioner of Internal Revenue has issued three revenue rulings setting forth his position with respect to redemptions of the common stock of minority shareholders. These rulings outline the results of a redemption where control is a significant part of a shareholder’s interest and where it is not.

a. "Control" a significant part of shareholder’s interest. In Revenue Ruling 76-364, taxpayer A had actual ownership of 27 percent of the outstanding common stock of corporation X. The remaining 73 percent was held equally by individuals B, C, and D. Thus, taxpayer A was in a position of substantial control, being able to control the corporation by forming a voting block with any one of the remaining three shareholders. After a portion of his common shares were redeemed for cash, taxpayer A owned 22.27 percent of the corporation’s stock. The Commissioner ruled that the redemption was a meaningful reduction of the shareholder’s interest. While he mentioned in his reasoning the reduction in the taxpayer’s (1) right to vote, (2) right to earnings, and (3) right to share assets in liquidation, the Commissioner seemed to place greater reliance on the fact that the reduction in taxpayer A’s voting rights from 27 percent to 22.27 percent “caused A to go from a position of holding a block of X stock that afforded A control of X if A acted in concert with only one other stockholder, to a position where such action was not possible.”

The ruling is consistent with Revenue Ruling 75-502 which held that a reduction in voting control from 57 percent to 50

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62. For purposes of this article, a minority shareholder exercising substantial control is defined as a minority shareholder who has sufficient voting rights to have a practical influence over corporate affairs. The usual example of such a shareholder exists in a closely held corporation having few shareholders, none of whom owns a majority of the stock, but all of whom may have a practical influence over corporate affairs by aligning themselves in a voting block with one or more fellow shareholders. See note 61 and accompanying text supra and notes 63-64, 97-104 and accompanying text infra.
64. Id. See also Rev. Rul. 57-353, 1957-2 C.B. 223.
percent is a meaningful reduction. The rulings suggest that whether a shareholder owns a majority of voting stock or exercises control by virtue of a minority voting interest, he must experience a practical reduction in his voting control as a result of the redemption in order to qualify for sale treatment.

b. "Control" not a part of shareholder's interest. Revenue Ruling 75-512 involved a trust that owned actually and constructively 30 percent of the common stock of a corporation controlled and managed by an unrelated taxpayer. Following a redemption of its common stock, the trust had no actual ownership but continued to own 24.3 percent of the corporation's stock through attribution. The Commissioner ruled that the redemption qualified as a sale under section 302(b)(1) because the trust took no part in the management of the corporation, and its voting rights, right to earnings, and right to share in net assets on liquidation were all reduced. The Commissioner left unresolved, however, the question of how large the reduction must be in order to qualify as meaningful. The facts presented in Revenue Ruling 75-512 involved a situation where the taxpayer's ownership was reduced by 19 percent of what it had previously been, but it is not clear whether a lesser reduction would have qualified as meaningful.

Revenue Ruling 76-385 suggests a partial answer to this question. In this ruling, the taxpayer had actual and constructive ownership of 0.0001118 percent of corporation Z's common stock prior to the redemption. Following the redemption, the taxpayer had no actual ownership and 0.0001081 percent constructive ownership. Thus, the redemption only reduced the taxpayer's ownership by 3.3 percent of its previous figure. Nevertheless, the Commissioner ruled that the reduction was meaningful and that the redemption was therefore not essentially equivalent to a dividend. In addition to citing the reduction in the taxpayer's three ownership interests as rationale for his ruling, the Commissioner stated:

One purpose for the enactment of section 302(b)(1) of the Code was to provide capital gain treatment for redemptions of stock held by certain minority shareholders, especially minority hold-

65. See notes 49-52 and accompanying text supra.
67. Id.
69. Id. at 93.
ers of preferred stock who exercise no control over corporate affairs . . .

The redemption in the instant case falls within the category of redemptions Congress intended to exclude from dividend treatment through the enactment of section 302(b)(1) of the Code since the redemption involves a minority shareholder whose relative stock interest in Z is minimal and who exercises no control over the affairs of Z. 70

Revenue Ruling 76-385 concludes by referring to Revenue Ruling 75-512 71 as another instance in which the redemption of a minority shareholder's interest was not essentially equivalent to a dividend. Although the two rulings were based on different rationales, the former on the legislative intent 72 and the latter on the meaningful reduction test, 73 the factual similarity of the rulings 74 suggests that the rationale of either ruling may be broad enough to cover them both. In this light it seems probable that a redemption of the common stock of a minority shareholder not exercising any controlling interest 75 will always qualify as a sale under section 302(b)(1) provided it results in some reduction in the stockholder's percentage ownership. 76

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70. Id. (emphasis added).
72. See note 70 and accompanying text supra.
74. Both rulings involved minority shareholders who exercised no control over the affairs of the corporation. The fact that one shareholder had only "minimal" ownership seems irrelevant when, as a practical matter, neither shareholder exercised any control.
75. For a shareholder not to exercise any controlling interest in a corporation probably requires that the shareholder have no reasonable possibility of exercising control by forming a voting block with other minority shareholders. See notes 67-70 and accompanying text supra.
76. A redemption of the common stock of a minority shareholder exercising no control is analogous to a redemption of the preferred stock of such a shareholder since in neither case is control reduced. Thus, as in the preferred stock situation, any reduction in a shareholder's interest resulting from a redemption will qualify as a sale. See notes 105-16 and accompanying text infra.

The Commissioner apparently accepted this position prior to Davis. In Rev. Rul. 56-183, 1956-1 C.B. 161, four shareholders owned a total of 11% of the common stock of the corporation prior to redemption. The redemption resulted in a reduction in their ownership to 9%. The Commissioner ruled that this reduction was not essentially equivalent to a dividend.

The Commissioner also reached this result in Rev. Rul. 56-485, 1956-2 C.B. 176. There the Commissioner was asked to rule whether a transaction that involved a redemption of 20% of the voting preferred stock of a corporation was essentially equivalent to a dividend. Although the preferred stock was owned to a large extent by the shareholders of common stock, it was not generally owned in the same proportion as the common stock. Thus, the redemption was generally non pro rata, resulting in a decrease in the proportionate interest of some shareholders and conceivably resulting in an increase in the interest of others.
B. Redemptions of Preferred Stock

In 1964, the Second Circuit in *Himmel v. Commissioner*\(^7\) established a "net effect" test of dividend equivalency applicable to preferred stock redemptions from shareholders owning both common and preferred stock. The test compared the amount actually distributed to a redeeming shareholder with the amount that would have been distributed to the shareholder had a pro rata dividend with respect to common stock been declared. If the amount of the redeeming distribution equaled or approximated this hypothetical dividend, it was taxable as a dividend; if not, the redemption was taxable as a sale.\(^7\)

Although the broad language of *Davis* clearly was intended to embrace factual situations previously governed by *Himmel*, recent decisions have struggled with whether the *Davis* test replaced the net effect test, or whether *Himmel* continues to provide a useful tool for measuring a meaningful reduction. The following section will analyze these cases and examine how they have applied section 302(b)(1) in the context of shareholders holding more than one class of stock.

1. Shareholder having complete common stock ownership

The redemption of the nonvoting preferred stock of a sole common stock shareholder is analogous to a redemption of voting common stock from a sole shareholder. In neither instance has the shareholder lost any control. The facts of *Davis* fall within this ownership pattern, and the language in *Davis* to the effect that "a redemption [of a sole shareholder's stock] is always 'essentially equivalent to a dividend'"\(^7\) is controlling. Therefore, such a redemption will never qualify for sale treatment under section 302(b)(1).

Although a sole common stock shareholder's redemption of

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\(^7\) The Commissioner ruled that the redemption was not essentially equivalent to a dividend as to each shareholder. The Commissioner noted as well that no single shareholder or family group had more than 25% of the voting power, apparently suggesting that control was not a major interest of any shareholder. *Id.*

Although the meaning of "not essentially equivalent to a dividend" has been modified significantly in the 21 years since this ruling, the Commissioner has neither modified nor reversed his position. Based on the meaningful reduction requirement, however, the Commissioner is unlikely ever to treat as a sale a redemption that results in an increase in percentage ownership.

\(^7\) 338 F.2d 815 (2d Cir. 1964).

\(^{78}\) *Id.* at 817-20.

\(^{79}\) 397 U.S. at 307.
preferred stock where unrelated shareholders own the remaining preferred shares results in a reduction of his right to dividends and right to share in liquidation proceeds, recent decisions have not considered this reduction of "net worth" to be meaningful when the sole common stock shareholder does not experience any loss of control. This appears to be the rule whether the redemption is of all or of only a portion of the preferred stock.

2. Shareholder having majority common stock ownership

Because preferred stock typically does not give the shareholder voting rights, a redemption of preferred stock can only result in a reduction of two of the three shareholder interests discussed above. Thus, it is unclear whether a redemption of preferred stock from a controlling shareholder can ever result in a meaningful reduction. Majority shareholders have made two principal arguments in an effort to receive sale treatment for redemptions of their preferred stock.

First, several taxpayers have argued that Himmel established that a non pro rata redemption could not be essentially equivalent to a dividend and that the Supreme Court accepted this position in Davis. One federal district court, in Brown v. United States, read Himmel as requiring such a result where a haphazard pattern of distributions in exchange for preferred stock was involved. The court concluded, however, that because the taxpayer's ownership percentage of preferred actually increased as a result of the redemption, the taxpayer's interest was increased as a result of the redemption, the taxpayer's interest was

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80. See Benjamin v. Commissioner, 66 T.C. 1084, 1111 (1976): "Whatever changes in net worth and participation in earnings [taxpayer] experienced as a result of the distribution, factors considered by the Second Circuit in Himmel v. Commissioner, supra, in our opinion the retention of absolute voting control in the present case outweighs any other consideration."

81. Although no recent cases involving sole shareholders have so held, this rule has governed complete redemptions of the preferred stock of majority shareholders and thus applies to sole shareholders a fortiori. See note 95 and accompanying text infra. See also Rev. Rul. 56-521, 1966-2 C.B. 174.

82. See Benjamin v. Commissioner, 66 T.C. 3459, 3481 (1976).

83. These two ownership interests are (1) the right to dividends and (2) the right to share in assets on liquidation. See note 29 and accompanying text supra.

84. 338 F.2d 815 (2d Cir. 1964).


not meaningfully reduced. The Tax Court, however, has not interpreted *Himmel* as requiring sale treatment for every non pro rata distribution, but as requiring satisfaction of a two pronged test. In addition to being disproportionate with respect to common stock, the distribution must also result in a change in the shareholder's "relative economic interest or rights of ownership." The Tax Court has also indicated that any other interpretation of *Himmel* would be in conflict with *Davis* since *Davis* requires a reduction in a shareholder's interest.

Second, taxpayers have argued that because *Himmel* lists several ownership rights, a redemption that results in a reduction of some but not of all these interests is still a meaningful reduction. The courts, however, have not been persuaded by the argument. The Tax Court has implied that in the case of a majority shareholder, the redemption must also result in a change in control. This follows from application of the *Davis* meaningful reduction test. This requirement eliminates the possibility of ever receiving sale treatment when a controlling shareholder's nonvoting preferred stock is redeemed, regardless of whether the redemption of preferred stock is partial or complete. More importantly, the inability of a controlling shareholder to achieve a meaningful reduction does not seem to depend on whether the redemption satisfies the first prong of the *Himmel* test, i.e.,

87. The district court apparently misread the net effect test of *Himmel*. The court interpreted *Himmel* as sanctioning sale treatment of any disproportionate distribution whether it increases or decreases a shareholder's proportionate interest. See 345 F. Supp. at 246-47. The Second Circuit, however, has indicated in interpreting its own test that a distribution that was disproportionate but increased the shareholder's interest could not satisfy the *Himmel* test. Rather, the disproportionate distribution must decrease the shareholder's interest. See Levin v. Commissioner, 385 F.2d 521, 527-28 (2d Cir. 1967). Therefore, the distribution in *Brown* did not satisfy the *Himmel* test. See also Grabowski Trust v. Commissioner, 58 T.C. 650, 666 (1972).


89. Id.

90. The second prong of the *Himmel* test apparently sets out the same standard as the meaningful reduction test of *Davis*.


93. Obviously, a shareholder redeeming nonvoting preferred stock will never experience a reduction in voting control.


whether it is non pro rata with respect to common stock shareholders. 96

3. Shareholder having minority common stock ownership

a. "Control" a significant part of shareholder's interest. *Miele v. Commissioner* 97 is the only recent case that has raised the question of whether a redemption of the preferred stock of a minority shareholder exercising some control can ever result in a meaningful reduction. In *Miele* five taxpayers, each with substantial control, 98 owned almost all of the outstanding stock of a small corporation. These taxpayers owned preferred stock in the same proportion as their common stock. Thus, when their preferred shares were completely redeemed, the resulting distribution was pro rata with respect to their common stockholdings. The Tax Court held that the redemption was essentially equivalent to a dividend since it did not change the relative interests or

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The only instance in which the first prong of the *Himmel* test could arguably apply is in the case of a redemption of stock from a minority shareholder exercising no control. In such a redemption, the meaningful reduction test does not require a reduction in voting rights. The Commissioner continues to require such a redemption to be non pro rata in order to receive sale treatment. The legislative history of § 302(b)(1), however, arguably does not require a non pro rata redemption. *See notes* 111-16 and accompanying text *infra*.

In the case of common stock redemptions, the first prong of *Himmel* is encompassed in the *Davis* meaningful reduction test. A common stock redemption must be non pro rata to result in a reduction in voting control, and since a reduction in voting control is required to meet the meaningful reduction test, a common stock redemption that qualifies for sale treatment will be non pro rata.


Other cases arising from the same transaction as *Miele* were La Fera Contracting Co. v. Commissioner, 30 Tax Ct. Mem. Dec. 691 (1971), aff'd mem., 475 F.2d 395 (3d Cir. 1973) and Spiniello v. Commissioner, 475 F.2d 1396 (3d Cir. 1973) (mem.).

98. For a definition of a minority shareholder having substantial control, see note 62 *supra*.

Each shareholder in *Miele* owned actually and constructively approximately one-third of the corporation's common stock. Thus, each shareholder could form a majority voting block by aligning himself with another shareholder. *Cf.* notes 61-64 and accompanying text *supra* (minority shareholder exercising substantial control redeems common stock).
rights of the stockholders. The Third Circuit upheld this determination on appeal.

Although the redemption in *Miele* was pro rata as to the shareholder's common stockholdings, it is probable that the same result would have obtained even had the distribution been non pro rata. This conclusion is supported by Revenue Ruling 76-364, which held that a minority shareholder with substantial control over corporate affairs must experience a reduction in practical control as a result of the redemption in order to qualify for sale treatment. Thus, a redemption of preferred stock of a minority shareholder exercising control may never satisfy the test of section 302(b)(1) since he will experience no reduction in practical control as a result of the redemption.

b. "Control" not a part of shareholder's interest. A redemp-

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99. 56 T.C. at 567.
100. 474 F.2d at 1338.
102. See notes 61-64 and accompanying text supra.
103. The minority shareholder exercising control is treated similarly to a majority shareholder. See notes 93-96 and accompanying text supra. Some have suggested that this strict rule which applies to both majority shareholders and minority shareholders exercising control is required to prevent tax abuse. Were it not for the rule, a shareholder could have a portion of his preferred stock redeemed at capital gain rates and subsequently declare a stock dividend to restore his preferred stock. This tax avoidance scheme is what prompted legislation of the predecessor to § 302. See notes 6-10 and accompanying text supra.

It seems more likely, however, that the result of this strict rule will be inequitable. This is the position taken by three Supreme Court Justices dissenting from a denial of certiorari in *Miele* (sub nom. Albers v. Commissioner, 414 U.S. 982 (1973) (Powell, Douglas & Blackmun, JJ., dissenting)). In *Miele*, the shareholders had issued preferred stock in order to increase the corporation's private capital so that the Federal Maritime Commission would guarantee a first mortgage loan from a bank to the corporation. When the need for the additional capital no longer existed, the corporation redeemed the preferred stock. This resulted in a taxable dividend to the shareholders in the amount of the distribution. This harsh result appears somewhat inequitable in view of the fact that if the financing had been arranged with a shareholder loan rather than preferred stock, a nontaxable return of capital would have resulted. Moreover, the taxpayers received a distribution of precisely the same amount that they had previously contributed. The dissenting Justices argued that this inequity was too high a price to pay for ease of administration. 414 U.S. at 985. The Justices also suggested that the Davis test creates a "tax trap" for the unwary and should be reconsidered. Id. at 988.

104. Although the Commissioner's current position in Rev. Rul. 76-364 suggests that a reduction in control is needed to satisfy § 302(b)(1), a different result was suggested by Rev. Rul. 55-462, 1955-2 C.B. 221. In that ruling, individuals A and B each owned 50% of the common stock of corporation M. A also owned 15 shares of preferred stock; B owned 1 share. Pursuant to a shareholder agreement to equalize their holdings, A redeemed 14 preferred shares for cash. The Commissioner ruled that the distribution was not essentially equivalent to a dividend. Although the Commissioner has neither withdrawn nor modified this ruling, it is unlikely that he will follow it in light of Rev. Rul. 76-364.
tion of the preferred stock of a minority common stock shareholder who has no control over corporate affairs seems to be clearly within the congressional intent of section 302(b)(1). Moreover, because control does not form a part of the shareholder's interest in the corporation, both the Davis and Himmel tests are satisfied if a disproportionate redemption results in a reduction of the shareholder's rights to earnings and to assets on liquidation.

In Agway, Inc. v. United States, the taxpayer held less than 6 percent of the voting stock of a farmers' cooperative. Prior to the redemption, the taxpayer also held 18.0 percent of the cooperative's outstanding preferred stock that he had received in lieu of cash patronage refunds pursuant to the cooperative's bylaws. The redemption of preferred stock, also pursuant to the cooperative's bylaws, resulted in an 11 percent reduction in taxpayer's ownership of preferred stock to 16.1 percent. The court held that the redemption should be treated as a sale rather than as a dividend. The result reached by the court seems correct in view of the reduction in the taxpayer's right to earnings and right to assets on liquidation.

Several recent revenue rulings have also suggested that the redemption of preferred stock in the case of a noncontrolling shareholder will result in sale treatment in certain circumstances. In Revenue Ruling 74-515, corporation X merged into corporation Y in a section 368 reorganization. Pursuant to the merger, the preferred stock of X was exchanged for cash. Several shareholders of X corporation held both common and preferred stock of X prior to the redemption. In reaching its decision, the Court of Claims rejected the Davis test stating: "This case is easily distinguishable from § 302(b)(1) cases involving corporations with related shareholders where 'attribution' and § 318 applies. See United States v. Davis . . . ." Id. at 1198. Since the corporation's bylaws required preferred stock to be redeemed in the same order it had been issued, any redemption by the corporation would be non pro rata. The court therefore concluded that the Himmel test was met and the redemption should be treated as a sale. Id. The reasoning of the court is somewhat dubious since the broad language of Davis was clearly intended to embrace all stock redemptions. The Davis meaningful reduction test was satisfied in this case, however, since any reduction in shareholder interest caused by the redemption of stock of a shareholder with no practical voting control is meaningful. See notes 66-76 and accompanying text supra.

105. See note 18 and accompanying text supra.
106. In the case of a minority common stock shareholder exercising no control over the corporation, a redemption of preferred stock may receive sale treatment even if it is pro rata with respect to common stock. See notes 115-16 and accompanying text infra.
107. 524 F.2d 1194 (Ct. Cl. 1975).
108. Id. at 1196-97.
109. Id.
110. In reaching its decision, the Court of Claims rejected the Davis test stating: "This case is easily distinguishable from § 302(b)(1) cases involving corporations with related shareholders where 'attribution' and § 318 applies. See United States v. Davis . . . ." Id. at 1198. Since the corporation's bylaws required preferred stock to be redeemed in the same order it had been issued, any redemption by the corporation would be non pro rata. The court therefore concluded that the Himmel test was met and the redemption should be treated as a sale. Id. The reasoning of the court is somewhat dubious since the broad language of Davis was clearly intended to embrace all stock redemptions. The Davis meaningful reduction test was satisfied in this case, however, since any reduction in shareholder interest caused by the redemption of stock of a shareholder with no practical voting control is meaningful. See notes 66-76 and accompanying text supra.
111. 1974-2 C.B. 118.
to the exchange. The Commissioner applied section 302(b)(1) to determine whether the exchange resulted in a dividend to these shareholders.\textsuperscript{112} The Commissioner concluded that the distribution was not a dividend because none of the shareholders had any form of control over X (all owned less than 1 percent)\textsuperscript{113} and the cash distribution was disproportionate with respect to the common stockholdings of the X shareholders.\textsuperscript{114}

On the other hand, the Commissioner has suggested that he will treat a pro rata redemption of preferred stock as a dividend.\textsuperscript{115} The legislative history of section 302(b)(1), however, does not support this position. Congress apparently intended minority common stock shareholders who also own preferred stock to receive the benefit of sale treatment when their preferred stock is redeemed. Their lack of control seemed to be the touchstone of the Senate amendment to the House version of section 302.\textsuperscript{116} It therefore seems irrelevant whether or not the redemption of preferred stock coincidentally is pro rata with respect to common stock ownership.

4. Shareholder having no common stock ownership

The Commissioner has suggested in Revenue Ruling 74-515\textsuperscript{117} that a complete redemption from a shareholder holding only preferred stock will result in sale treatment. In this ruling, shareholders of preferred stock in corporation X had their interests entirely terminated\textsuperscript{118} when they received cash for their shares.

\textsuperscript{112} For an explanation of why the test of § 302(b)(1) was used, see note 53 supra.
\textsuperscript{113} 1974-2 C.B. at 19-20.
\textsuperscript{114} Id. See also Rev. Rul. 56-179, 1956-1 C.B. 187.
\textsuperscript{115} In Rev. Rul. 74-515, 1974-2 C.B. 118, 119-20, the Commissioner indicated that Rev. Rul. 56-220, 1956-1 C.B. 191 (classifying pro rata cash distributions as dividends) would have controlled had the cash distribution been pro rata with respect to the common stockholdings of the taxpayers.

[The House] rules appeared unnecessarily restrictive, 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. Accordingly, your committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend.

\textsuperscript{117} 1974-2 C.B. 118.
\textsuperscript{118} Although it is unclear why § 302(b)(3) dealing with complete termination of a shareholder's interest did not apply in this instance, at least two explanations are possible: First, the shareholders may have continued to have had a forbidden interest in the corporation, or second, the shareholders may have failed to file the required waiver. See I.R.C. § 302(b)(3).
MEANINGFUL REDUCTION” TEST

pursuant to a merger between corporation X and corporation Y. The Commissioner ruled that the preferred stock shareholders receipt of cash would receive sale treatment under section 302 because it was not essentially equivalent to a dividend.119 In Cummins Diesel Sales Corp. v. United States,120 a federal district court held that sale treatment will result even if the redemption does not completely terminate the shareholder’s interest.121 Both the legislative history of section 302(b)(1)122 and the meaningful reduction test123 seem to require the results reached in the case and in the ruling.

The Commissioner might object to sale treatment, however, in certain circumstances. For example, if the preferred shareholder exercised control over the corporation as a practical matter by virtue of his holding a major financial interest in the corporation, a redemption occurring because of this control might not qualify for sale treatment.124

III. CONCLUSION

Recent cases and rulings discussing dividend equivalency under section 302(b)(1) have suggested two basic rules. If a shareholder exercises any control over the redeeming corporation (whether as a majority or minority shareholder), a redemption of his stock will receive sale treatment only if the shareholder experiences a significant reduction of whatever degree of control he previously maintained. The actual percentage reduction in voting shares is relevant only to the extent it produces a practical loss of control. This rule makes it virtually impossible for a share-

120. 323 F. Supp. 1114 (S.D. Ind. 1971), aff’d, 459 F.2d 668 (7th Cir. 1972).
121. Cummins Diesel Sales Corporation established ten local branches as sales outlets. These branches were owned by independent parties with Cummins providing major financing through ownership of preferred stock. In one such case, the independent owner did not operate successfully so Cummins reacquired the independent branch in a transaction in which Cummins had its preferred stock redeemed and also received common stock. Because Cummins received common stock subsequent to the redemption, § 302(b)(3) did not apply. The court held, however, that the redemption satisfied the provisions of § 302(b)(1). Id. at 1118.
122. See notes 18, 116 and accompanying text supra.
123. Cf. notes 71-76 and accompanying text supra (meaningful reduction in the common stock redemption context).
124. Since a reduction in control is required to satisfy the meaningful reduction test if the redeeming shareholder exercises control, the type of control, whether voting or financial, seems irrelevant. Cf. Cummins Diesel Sales Corp. v. United States, 323 F. Supp. at 1118 (court held a redemption of preferred stock to be a sale under § 302(b)(1), yet suggested that the shareholder exercised considerable control).
holder exercising control to avoid dividend treatment when his preferred stock is redeemed.

If, however, a shareholder exercises no practical control over the corporation, it appears that any redemption resulting in a reduction of the shareholder's interest should be treated as a sale. Although this rule has never been expressly stated, both legislative history and recent decisions and rulings support its validity.