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Stock Redemptions and the Family-Owned Corporation: Tax Traps on the Path to Capital Gain Treatment

Scott E. Copple*

The recent enactment of the new capital gains exclusion1 has raised the stakes in planning for the redemption of corporate stock. This article discusses the tax problems confronting a shareholder in a family-owned corporation when the shareholder enters into an agreement for the redemption of his or her stock.

I. INTRODUCTION

In a transaction involving the redemption of corporate stock, whether a shareholder is treated as the recipient of a dividend distribution or the seller of stock has important federal income tax ramifications. If the redemption is treated as a dividend, the distribution to the shareholder is taxed as ordinary income. On the other hand, if the redemption is treated as a sale, the shareholder recognizes a capital gain based on the excess of the amount of the distribution over the basis in the stock redeemed. Assuming a taxpayer receives a distribution of $1,000,000 in exchange for his or her stock, the taxpayer could pay an additional $256,000 in federal income tax if the transaction is treated as a dividend distribution.2

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* Assistant Professor of Accountancy, College of Business Administration, University of Nebraska at Omaha. J.D., College of William and Mary's Marshall-Wythe School of Law; LL.M., Denver University College of Law; C.P.A. (inactive). The author was employed as a tax manager by Grant Thornton, CPAs, primarily in the areas of tax planning and I.R.S. appeals. He currently teaches undergraduate and graduate tax courses at the University of Nebraska at Omaha.


2. A shareholder in the 39.6% marginal tax bracket would pay $396,000 in federal income tax on the distribution if it were taxed as a dividend. See id. § 1(a). Assuming the redemption were treated as a sale and that the gain qualified for the partial exclusion under I.R.C. § 1202, only $500,000 of the gain (assuming no basis in the stock) would be taxed at a rate of 28%, resulting in a federal income tax liability of $140,000 on the redemption. See id. §§ 1(h), 1202.
The adverse tax consequences associated with a failed stock redemption require careful planning on the part of a shareholder in a family-owned corporation. A shareholder in a family-owned corporation may confront several problems in achieving capital gain treatment on the redemption of his or her stock. For example, if the corporation's stock is held in trust for the benefit of family members, the redemption may be recast as a dividend distribution. In addition, a shareholder who provides postredemption services to the corporation may jeopardize the sale treatment that would otherwise characterize the transaction. Finally, if the redeemed shareholder, in an effort to accommodate the corporation's need for additional financing, allows an installment note received in the redemption to be subordinated to the claims of other corporate creditors, the Internal Revenue Service ("the Service") may attempt to recast the sale as a dividend distribution.

This paper examines case law and administrative interpretations in an effort to demonstrate the extent to which a shareholder may, through proper tax planning, avoid these problems. In addition, whether these judicial and administrative interpretations support the policies underlying the rules surrounding stock redemptions in the case of family-owned corporations is examined.

II. BACKGROUND

The tax consequences to a shareholder receiving a nonliquidating distribution from his or her subchapter C corporation are governed primarily by §§ 301 and 302. Under § 301, a shareholder recognizes ordinary income upon the receipt of a distribution from his or her corporation to the extent of the shareholder's share of the corporation's earnings and profits. On the other hand, if a shareholder's stock is redeemed by the corporation and the transaction meets the requirements found in § 302, the distribution by the corporation is treated as an amount realized on the sale of stock by the shareholder. The shareholder recognizes capital characterization of redistribution as a dividend would almost certainly result in an even larger tax differential since the shareholder's gain would be reduced by the tax basis in the stock redeemed.

3. Id. §§ 301, 302.
4. See id. §§ 301(c), 316(a).
5. Id. § 302(a).
gain or loss based on the difference between the amount realized and the adjusted basis of the stock redeemed.  

Prior to the enactment of § 302, the courts determined the tax consequences of a corporate redemption by examining the facts and circumstances surrounding the distribution. If the facts and circumstances indicated a distribution was essentially equivalent to a dividend, the shareholder was treated as though a dividend distribution had been made, even though the shareholder actually surrendered stock to the corporation.

In enacting § 302, Congress sought to provide certainty so that shareholders in closely held corporations would know the tax treatment for a distribution pursuant to a proposed redemption transaction. Although the “dividend equivalence” test of prior law found its way into § 302, three mechanical tests were also enacted to provide the certainty Congress intended for shareholders planning stock redemption transactions. Two of the mechanical tests found in § 302 deal with determining the degree of change in the shareholder’s ownership in the redeeming corporation. Under § 302(b)(2), a shareholder will receive sale treatment for a redemption transaction, if after the redemption the shareholder owns less than 50% of the voting power of the corporation and if his percentage ownership in the outstanding voting stock (as well as all common stock) is reduced by more than 20%. Such a redemption is referred to as a “substantially disproportionate redemption.” Under § 302(b)(3), a shareholder will receive sale treatment if all the stock owned by the shareholder is redeemed by the corporation. Such a redemption is referred to as a “complete redemption.”

6. Id. § 1001(a).
8. Id. at 647.
11. Id. § 302(b)(2)-(4).
12. Id. § 302(b)(2).
13. Id.
14. Id. § 302(b)(3). The third mechanical test deals with a redemption of stock pursuant to a partial liquidation of the corporation and is not relevant to the issues addressed in this paper. See id. § 302(b)(4).
15. Id.
The stock attribution rules of §318 are made applicable to redemption transactions of §302.\textsuperscript{16} Without the application of these stock attribution rules, a shareholder seeking to receive a distribution from his or her corporation could transfer stock to a related party, such as a spouse or a wholly owned corporation, and after the transfer enter into a redemption transaction meeting the requirements of §302(b)(2) or (b)(3). Under the stock attribution rules of §318, a shareholder is treated as the owner of stock actually owned by certain related parties for purposes of determining if there has been, in substance as well as in form, a substantially disproportionate distribution or a complete redemption.\textsuperscript{17}

In general, for purposes of the redemption tests in §302, the family stock attribution rules applicable to stock redemptions provide that stock owned by certain family members is attributed to the shareholder whose stock is redeemed.\textsuperscript{18} Application of the family attribution rules makes it extremely difficult for a shareholder in a family-owned corporation to receive sale treatment on a redemption of stock. After the redemption, the shareholder is treated as owning any stock held by family members. Even bona fide redemptions flunk the tests of §302 since all stock owned by family members after the redemption are treated as the shareholder’s stock, thus precluding a substantially disproportionate distribution and a complete redemption.

Congress intended to allow a family member engaging in a bona fide stock redemption to receive capital gain treatment.\textsuperscript{19} Consequently, §302(c)(2) provides an exception to the application of the family stock attribution rules.\textsuperscript{20} A taxpayer

\textsuperscript{16} Id. § 302(c)(1).
\textsuperscript{17} Id. § 318.
\textsuperscript{18} Id.
\textsuperscript{20} I.R.C. § 302(c)(2). Section 302(c)(2)(A) provides in part:

(A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and
who enters into a redemption agreement with his or her family-owned corporation can be assured of sale treatment as long as all the stock of the corporation held by the taxpayer is redeemed; there are no related parties, as set forth in § 318, other than family members who own stock in the corporation; and the taxpayer has no interest in the corporation for a ten-year period after the redemption.\textsuperscript{21} It is the application of the stock attribution rules, and the conditions that must be met in order to waive the family stock attribution rules, that create the problems confronting a shareholder of a family-owned corporation who seeks sale treatment on the redemption of his or her stock.

III. \textsc{Application of Stock Attribution Rules When Stock is Held in Trust}

A. \textit{The Problem with Stock Held in Trust}

Stock in a family-owned corporation may be owned by several family members. In addition, corporate stock may be held by a testamentary trust as a result of the death of a shareholder whose assets pass to a marital or nonmarital trust pursuant to prudent estate planning. In most cases, the testamentary trust provides income to the surviving spouse and/or younger family members. The trust principal may be distributable to younger family members upon the death of the surviving spouse or the trust may give to the surviving spouse a power of appointment over the trust principal.\textsuperscript{22} In addition, depending on the estate planning objectives of the decedent, the trustee may be given the power to make discretionary distributions to the surviving spouse or younger family members.

Younger family members may have divergent business philosophies. Some family members may work for the corporation while others show little interest in the corporation's affairs. Family members may simply not get along. For whatever reason, one or more shareholders may seek to terminate their

\textsuperscript{21} Id. § 302(c)(2). It is only the family stock attribution rules that can be waived under I.R.C. § 302(c)(2).

\textsuperscript{22} See id. § 2056(b)(5), (7).
interest in the corporation and invest their stock redemption proceeds elsewhere.

The use of trusts to hold stock in a family-owned corporation can create a problem if a family member who is a trust beneficiary decides to terminate his or her interest in the corporation pursuant to a stock redemption transaction. The redeemed shareholder may be treated as a continuing shareholder due to his or her beneficial interest in the trust, no matter how remote the beneficial interest.23 This deemed continuing ownership interest in the redeeming corporation may cause the redemption to be recast, for federal income tax purposes, as a dividend distribution.

B. The Application of the Stock Attribution Rules

Originally, some confusion existed over exactly who might waive the family stock attribution rules in redemption transactions. The Service took the position that only individual taxpayers could waive these rules.24 This position prevented a trust from achieving capital gain treatment on a stock redemption when its beneficiaries were related to other shareholders in such a way that the shareholders’ interests were attributed to the trust beneficiaries. For example, if a surviving spouse was the beneficiary of a testamentary trust, and the trust received a distribution from the corporation in exchange for all the corporate stock held by the trust, the Service treated the distribution to the trust as a dividend if children of the surviving spouse also owned stock in the corporation. Fortunately for taxpayers, the courts did not necessarily agree with the Service.

In Crawford v. Commissioner,25 the Tax Court held that a trust could utilize the § 302(c)(2) family stock attribution waiver and treat the redemption of all the trust’s stock as a complete termination under § 302(b)(3). Capital gain treatment was allowed even though the trust beneficiary was related to other shareholders under the family stock attribution rule of § 318(a)(1). Other courts held for trusts on facts similar to those of Crawford.26 The holding in Crawford was later codi-

23. Id. § 318(a)(2)(B).
fied in 1982 as part of the Tax Equity and Fiscal Responsibility Act.\textsuperscript{27}

The waiver of the family stock attribution rule made available to trusts under § 302(c)(2)(C) allows a trust to treat a redemption of stock as a sale but does not address the problem an individual taxpayer may face when he or she seeks capital gain treatment on the redemption of all his or her stock. If the shareholder is also a beneficiary of a trust, the shareholder will be deemed to own stock held by the trust.\textsuperscript{28} This deemed stock ownership will likely cause the redemption to be treated as a dividend distribution.

To illustrate, suppose a deceased shareholder, under the terms of his or her will, transfers stock in a family-owned corporation to a trust. The trust provides that income is to be distributed to the surviving spouse. The trustee is given the power to make discretionary distributions of trust income or corpus to the surviving spouse or to the children of the decedent. The surviving spouse is given a special power of appointment over the trust corpus. Absent an exercise of the power of appointment, upon the death of the surviving spouse the trust corpus is to be distributed to the three children, A, B, and C, of the deceased shareholder and the surviving spouse. The re-

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(i) In general.—[The waiver of the family stock attribution rule (subparagraph (A))] shall not apply to a distribution to any entity unless—

(I) such entity and each related person meet the requirements of clauses (i), (ii), and (iii) of subparagraph (A), and

(ii) each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition described in clause (ii) of subparagraph (A).

In any case to which the preceding sentence applies, the second sentence of subparagraph (A) and subparagraph (B)(ii) shall be applied by substituting “distributee or any related person” for “distributee” each place it appears.

(ii) Definitions.—For purposes of this subparagraph—

(I) the term “entity” means a partnership, estate, trust, or corporation; and

(II) the term “related person” means any person to whom ownership of stock in the corporation is (at the time of the distribution) attributable under section 318(a)(1) if such stock is further attributable to the entity under section 318(a)(3).

28. I.R.C. § 318(a)(2)(B). Section 302(c)(2)(C) addresses the waiver of family attribution when a trust’s stock is redeemed, not the waiver of the trust-beneficiary attribution rules.
maining stock in the corporation is owned by the surviving spouse and the three children. The surviving spouse alone, through direct stock ownership and through the stock attributed to her through her beneficial interest in the trust, owns or is deemed to own more than 50% of the total outstanding stock.

In addition, suppose that acrimony develops after the shareholder's death, largely due to the fact that A and B, who are not active in the affairs of the corporation, distrust C, who is the corporation's president. To resolve the conflict, the family proposes that A and B sell their stock to the corporation and invest the sale proceeds elsewhere.

Unless the redemption qualifies as a complete termination under § 302(b)(3), the redeemed shareholders, A and B, must treat the amounts received as dividend income. Since the redeemed shareholders are treated as owning the surviving spouse's stock in all cases other than a complete termination, each would be deemed to own more than 50% of the corporation's outstanding stock. This deemed stock ownership would cause their redemption to fail the disproportionate distribution test under § 302(b)(2) and almost certainly the dividend equivalency test under § 302(b)(1), which requires a showing that the distribution was not essentially equivalent to a dividend.

Assuming each redeemed shareholder makes an election under § 302(c)(2)(A)(iii) and files the necessary information with the Service, however, the stock of the surviving spouse will not be attributed to them. Their sibling's, C's, stock will not be attributed to them either since brothers and sisters are not considered related parties. Further, the stock held by the trust and attributed to the surviving spouse will not be attributed through the surviving spouse to the children since the family stock attribution waiver applies to the stock attributable to the spouse through the trust. However, there is no specific statutory provision preventing the stock held by the trust from being attributed to the children as trust beneficiaries under § 318(a)(2)(B)(i).

Will the redeemed shareholder's con-

29. Id. § 518(a)(1).
30. Id. § 302(c)(2).
31. Id. § 318(a)(1).
33. Only the family stock attribution rules are waived under I.R.C. § 302(c)(2). The other stock attribution rules of § 318 apply in determining whether a redeemed shareholder has terminated his or her interest in the corporation un-
tingent remainder interests therefore cause the redemption to be treated as a dividend distribution?

The statutory language offers little hope to the redeemed shareholder. Section 318(a)(2)(B)(i) provides that beneficiaries of a trust are treated as owning stock held by the trust in an amount relative to their actuarial interest in the trust. Section 318(a)(3)(B)(i), which states that stock owned by a trust beneficiary will be attributed to the trust, also provides that no attribution to the trust is made if the beneficiary holds only a remote, contingent interest in the trust. Section 318(a)(2)(B)(i) does not provide a similar exclusion for remote, contingent interests in the case of trust-to-beneficiary attribution. No court decisions have dealt specifically with the question of whether a de minimis rule similar to that found in § 318(a)(3)(B)(i) should be read into § 318(a)(2)(B)(i). Treasury regulations do not address the issue either. However, the Service has addressed the issue, albeit not in the context of a stock redemption. Revenue Procedure 77-37, which sets forth operating rules relating to the issuance of letter rulings, provides guidelines for taxpayers requesting a ruling regarding corporate reorganizations. Section 3.05 of Revenue Procedure 77-37 states:

In determining stock ownership to be attributed to a trust or from a trust under the rules of sections 318(a)(2)(B)(i) and 313(a)(3)(B)(i) of the Code in those cases where a surviving spouse is entitled to all the income for life from the trust and also holds a power of appointment over the corpus of the trust, and in default of the exercise of the power the property held by the trust is to pass to the children of the surviving spouse, attribution will be computed as if the surviving spouse has exercised the power in favor of his or her children, so that they will be considered beneficiaries in the absence of evidence that the power has been differently exercised.

der § 302(b)(3). See supra note 21.
34. I.R.C. § 318(a)(2)(B)(ii) provides that stock held by a trust will be attributed to a taxpayer who is considered the owner of the trust under the grantor trust rules in I.R.C. §§ 671-679 (1988). Therefore, if the surviving spouse is given a general power of appointment over the trust corpus, and is treated as the owner of the trust property under I.R.C. § 678, then the stock held by the trust would be treated as owned by the surviving spouse and the waiver of the family attribution rules would apply to the stock held by the trust. See Priv. Ltr. Rul. 90-35-038 (June 1, 1990).
It appears, from section 3.05, that the Service will treat a contingent trust beneficiary as the owner of his or her proportionate share of the stock held by the trust. Without a relaxation of the application of the trust-to-beneficiary stock attribution rule, even a remote, contingent remainderman will not be able to treat the redemption of his or her stock as a complete termination. A and B in the example set forth above would thus be required to treat the amount received for their stock as dividend distributions.

This is a harsh result for the redeeming shareholder. As a remote, contingent remainderman of the trust, the shareholder has no control over the stock held in trust. If another (the surviving spouse in the example set forth above) has a power of appointment over the trust property, the shareholder may never receive his or her remainder interest. As a practical matter, such a shareholder has no more an interest in the stock held in trust than the same shareholder has in stock held outright by a related party whose will provides for the transfer of such stock to the shareholder.

The position taken in Revenue Procedure 77-37 is particularly harsh when one considers that after a complete redemption of a shareholder’s stock, the shareholder is allowed to inherit stock from a decedent without affecting the characterization of the prior distribution as a redemption transaction. That same shareholder would be denied sale treatment if, prior to the related shareholder’s death, the related shareholder held a special power of appointment over stock held in trust and if a redeeming shareholder possessed at the time of the stock redemption only a remote, contingent interest in the trust. Congress should consider amending § 318(a)(2)(B)(i), at least as it applies to stock redemptions, to include a de minimis rule similar to the rule provided in § 318(a)(3)(B)(i) to prevent stock attribution to remote, contingent beneficiaries.

C. Possible Solutions to the Problem

Absent congressional action, a shareholder could renounce his or her interest in the trust and thereby avoid the trust to beneficiary stock attribution rule. However, this may be an impractical and expensive alternative. First, the shareholder

may be treated as making a gift subject to federal gift tax upon renunciation.\textsuperscript{39} Second, the taxpayer may be denied the opportunity to share in the estate of his or her parents, since the trust assets will ultimately be distributed to the remaining trust beneficiaries. Finally, the renouncing shareholder/beneficiary may see trust property go to the very family member who is the cause of his or her desire to enter into the stock redemption agreement in the first place. He or she may be forced to remain a disgruntled shareholder to avoid such a distasteful result.

The trust to beneficiary attribution rule could also be avoided if the surviving spouse exercised his or her power of appointment and directed the trust to make a distribution to the redeeming shareholder in an amount equal to the intended disposition of the trust property upon the death of the surviving spouse. The redeemed shareholder could then renounce his or her interest in the trust, having received his or her “share” of trust property, and thereby attain sale treatment on the redemption. However, the surviving spouse may be unwilling to authorize such a distribution due to concern over the loss of control over the property to be distributed. The surviving spouse may be reluctant to do anything that might alter the intent of the deceased spouse regarding when and to whom his or her assets should ultimately be distributed.

Perhaps the most palatable solution to the problem caused by the trust-to-beneficiary stock attribution rule would be to distribute the stock held by the trust to the surviving spouse. Such a distribution would not create adverse tax consequences for the surviving spouse or the trust and would result in stock being held only by family members. In the example set forth above the trustee could exercise his or her power to distribute the stock from the trust to the surviving spouse. Additionally, the surviving spouse could transfer all the stock received to a newly created trust in which A and B had no interest. A and B would receive sale treatment on the redemption since the family stock attribution waiver provision would allow the redemption to qualify as a complete termination under § 302(b)(3).

This solution presupposes the ability to transfer the stock held in trust to trust beneficiaries. The power to transfer may be held by the surviving spouse as a power of appointment over

\textsuperscript{39} I.R.C. § 2503.
the trust property or by the trustee as a power to distribute trust property to trust beneficiaries. The power need not be plenary. The terms of the trust may give the surviving spouse the right to income only and prevent the trustee from making discretionary distributions of trust property. Without the power to distribute the stock held by the trust, the redeeming shareholder will face the hard choice between renouncing his or her interest in the trust and risking dividend treatment on the redemption transaction.

D. Summary

Closely held business owners and their tax advisors should exercise caution in planning for the disposition of stock in a family-owned corporation. Placing the stock of a family-owned corporation in trust is a dangerous proposition when no provision is made for the distribution of such stock. Family hostility may erupt after the death of the first spouse and could cause the corporation to suffer, as feuding shareholders, unwilling to renounce and incur distribution tax treatment, fail to focus on the operation of the corporation's business.

IV. POST-REDEMPTION SERVICES PROVIDED BY THE REDEEMED SHAREHOLDER

The retiring shareholder of a closely held corporation may have a particular expertise that was gained through formal education or through years of experience in the corporation's business. Perhaps the retiring shareholder holds a professional degree in accounting or law and has developed a special expertise in some aspect of his or her profession relating to the business of the corporation. Or perhaps the retiring shareholder is an engineer with a special expertise related to the products developed and sold by the corporation.

Younger family members may want to retain the retiring shareholder for the expertise he or she has developed. To that end the corporation and the redeemed shareholder may enter into an employment or consulting contract, or the corporation may engage the redeemed shareholder from time to time after the redemption to provide consulting services to the corporation. Will such an agreement for postredemption services be considered a prohibited "interest" in the corporation under § 302(c)(2)(A) and therefore cause the family attribution rules
to apply in determining whether the taxpayer was completely redeemed?

A. Analysis of Primary Authority

In *Lewis v. Commissioner*, the taxpayer received a distribution from his family-owned corporation in exchange for all his stock in the corporation. The taxpayer, who formed the corporation to operate his retail automobile dealership, initially owned all the stock but had transferred stock to his sons over a period of years so that at the date of redemption he owned 495 of the 1,000 shares outstanding. Although the taxpayer did not work for the corporation after the redemption, he did hold the title of vice president and was an inactive member of the board of directors.

The Tax Court majority held that the redemption transaction was not essentially equivalent to a dividend and therefore qualified for sale or exchange treatment under § 302(b)(1). One might question the holding of the Tax Court given the fact that had the stock attribution rules been applied, the taxpayer would have been treated as owning 100% of the corporation’s stock. However, the significance of *Lewis* is not in its holding but rather in its concurring opinion, which discusses application of the waiver of the family attribution rules provided by § 302(c)(2) to the facts of the case.

The concurring opinion concluded that the taxpayer met the requirements of § 302(c)(2), including the prohibition against having a prohibited interest in the corporation, despite the fact that the taxpayer held the positions of vice president and member of the board of directors:

The purpose of section 302(c)(2) is to provide that when there is a bona fide severance of the shareholder’s interest, he will receive capital gains treatment. On the other hand, although there is no direct judicial authority or statement in the legislative history of section 302(c)(2), I believe that Congress did not intend us to hold that an officer or director who performs no duties, receives no compensation, and exercises no influ-

40. 47 T.C. 129 (1966).
41. Id. at 130.
42. Id. at 131.
43. Id. at 135.
44. See id.; I.R.C. § 318.
45. 47 T.C. at 136 (Simpson, J., concurring).
ence has retained an interest in the corporation. It is a fair inference from the section as a whole and from its legislative history that Congress was concerned with the situation in which there was a nominal transfer of stock in a family corporation, although the transferor continued to control the corporation and benefit by its operations. . . . Finally, I believe that form should not be placed above substance, that in substance this petitioner did not retain an interest in the corporation, and that accordingly he has met the condition of section 302(c)(2)(A)(i). 46

In short, the concurrence concluded that the parenthetical language in § 302(c)(2)(A)(i) does not prohibit every officer or director from waiving the family attribution rules. While a retained interest may include an interest as an officer or director, every officer or director does not necessarily hold an interest in the corporation. 47 Whether an officer or director retains an interest in the corporation should be determined by examining the substance, rather than the form, of the relationship between the redeemed shareholder and the redeeming corporation. 48

The Tax Court first addressed the issue of whether a consulting agreement constitutes an interest in the corporation under § 302(c)(2)(A)(i) in Lennard v. Commissioner. 49 In Lennard, the taxpayer’s one-third interest in a corporation originally formed by his son and an unrelated third party was redeemed, and the taxpayer simultaneously resigned his positions as director and secretary-treasurer. 50 The taxpayer, a C.P.A., continued to perform accounting services for the corporation, for which he was compensated as an independent contractor. 51 There was no continuing consulting contract between the corporation and the taxpayer. After the redemption, and a subsequent stock acquisition, the taxpayer’s son owned two-thirds of the stock in the corporation.

The Service argued that due to the consulting services performed for the corporation, the taxpayer had an interest in the corporation after the stock redemption and sought to char-

46. Id. at 137-38 (footnotes omitted).
47. Id. at 137.
48. Id. at 138.
49. 61 T.C. 554 (1974).
50. Id. at 555, 557.
51. Id. at 557.
acterize the amount received from the corporation as a dividend.\textsuperscript{52} The Service cited Revenue Ruling 70-104\textsuperscript{53} in support of its position.\textsuperscript{54} In Revenue Ruling 70-104, a father, who with his children owned a corporation engaged in the retail jewelry business, entered into an agreement with the corporation for the redemption of all his stock. In addition, the corporation and the father entered into a five-year consulting agreement by which the father would provide consulting services to the corporation.\textsuperscript{55} The Service held that the consulting agreement constituted an "interest in the corporation" under § 302(c)(2)(A)(i) so that the waiver of the family stock attribution rules was not available to the father.\textsuperscript{56} His stock redemption was therefore treated as a dividend.\textsuperscript{57}

The Tax Court rejected the argument made by the Service. While recognizing that the revenue ruling represented the position of the Service, the court distinguished the facts of the case from the facts presented in the ruling:

Even if the revenue ruling were controlling, which it is not, we think the facts of this case are different. [The taxpayer] performed monthly accounting services for the corporation as a certified public accountant and member of an independent accounting partnership. The services were of a prescribed nature and were far more circumscribed than the broader consultant and advisory services rendered by the taxpayer in the revenue ruling. There was no employment contract involved here so that the relationship between [the corporation] and the accounting firm could have been terminated at any time. Moreover, we do not have here a father who is attempting to transfer his business to his son and continue to retain control of its operation. Rather, we have a situation where a son has established a successful business with the financial cooperation of his father, and the father is in a position to provide services to the corporation in an independent capacity after his stock ownership and interest therein have been severed.\textsuperscript{58}

\textsuperscript{52} Id. at 560.
\textsuperscript{53} 1970-1 C.B. 66.
\textsuperscript{54} Lennard, 61 T.C. at 560.
\textsuperscript{56} Id.
\textsuperscript{57} Id.
\textsuperscript{58} Lennard, 61 T.C. at 560-61.
Citing Lewis, the Tax Court reasoned that Congress did not intend to include an independent contractor with no financial stake in the corporation as one possessing an interest in the corporation for purposes of the attribution waiver rules.\(^{59}\) According to the Tax Court, in enacting § 302(c)(2), Congress was primarily concerned with redemption transactions in which the redeemed shareholder retained a financial stake in the corporation or continued to control and benefit from the corporation's operations following the redemption. The Tax Court concluded that:

It is apparent that by the use of the word "interest" [in § 302(c)(2)(A)(i)], Congress had in mind a corporate involvement greater than that attributable to a third party providing goods or services to the corporation. In fact, the statute specifically excludes creditor interests from those prohibited by the attribution waiver rules contained in section 302(c).\(^{60}\)

The Tax Court found that the services performed by the taxpayer were no more substantial than those that might have been performed by any accountant.\(^{61}\) The taxpayer had no influence over the operations of the corporation and the fees received by the taxpayer did not amount to a financial stake in the corporation.\(^{62}\) The court therefore characterized the taxpayer's interest in the corporation as no greater than a creditor's interest.\(^{63}\)

Other Tax Court cases have similarly dealt with a redeemed shareholder's continuing interest in the redeeming corporation. In these cases, the taxpayer's continuing status as an employee, rather than an independent contractor, has generally been the critical fact that has caused the court to apply the family attribution rules and characterize the redemption transaction as a dividend.\(^{64}\) However, two circuit court cases have also dealt with the issue presented in Lennard, with mixed results.

\(^{59}\) Id. at 561.
\(^{60}\) Id. at 561-62.
\(^{61}\) Id. at 562.
\(^{62}\) Id.
\(^{63}\) Id.
\(^{64}\) See, e.g., Seda v. Commissioner, 82 T.C. 484, 488 (1984); Cerone v. Commissioner, 87 T.C. 1, 33 (1986).
In *Chertkof v. Commissioner*, the taxpayer and his father owned all the stock in a corporation (E & T Realty Company) which constructed, owned, and leased a shopping center. The taxpayer's one-third interest in the corporation was redeemed in exchange for a one-third interest in the shopping center. Less than one year after the redemption the corporation entered into a management agreement with the taxpayer and a new management corporation (Chertkof Co.) owned by the taxpayer. The agreement, which was not terminable for two years, gave the taxpayer's corporation the exclusive power to determine rents, negotiate and execute leases, and set aside money for repairs and insurance. The fee charged by the taxpayer's corporation was below customary rates for similar management contracts.

The Service challenged the taxpayer's treatment of the redemption transaction. The Tax Court upheld the Service's position that through the management agreement the taxpayer acquired an interest in the corporation within the meaning of § 302(c)(2)(A)(ii). Because the Tax Court concluded that the taxpayer could not waive the family attribution rules, the stock held by the taxpayer's father was attributed to the taxpayer and the redemption proceeds were treated as a dividend.

The Court of Appeals for the Fourth Circuit upheld the decision of the Tax Court. The Fourth Circuit agreed with the Tax Court that the management contract should properly be treated as between the taxpayer and the redeeming corporation:

It is true that Chertkof Co. is a bona fide corporation. Its essential purpose, however, is engineering; it had never before managed property or engaged in the kind of commercial activity required by the maintenance contract. Taxpayer, on the other hand, was experienced in commercial property management. It is obvious from the sequence of events that it was his

65. 649 F.2d 264 (4th Cir. 1981).
66. Id. at 265.
67. Id.
68. Id.
69. Id.
70. Id.
72. Chertkof, 72 T.C. at 1126.
personal expertise that was acquired by the maintenance contract...

... It would take a simplistic view of the intrafamily business dealings reflected by the record to hold other than the Tax Court held—that the maintenance contract was in reality a contract between E & T and Taxpayer.  

The Fourth Circuit did not specifically address the issue of whether a former shareholder has a prohibited interest per se when retained as an independent contractor. However, language in the opinion suggests that the Fourth Circuit accepts the Tax Court's analysis in determining whether a shareholder has a prohibited interest. That analysis requires a finding that the redeemed shareholder maintains a financial or control interest in the corporation:

The Tax Court upheld the Commissioner's determination that the Taxpayer retained stock interest after the attempted redemption because he did not comply with subsection (ii) above in that through the maintenance contract between Chertkof Co. and E & T, Taxpayer maintained a financial and control interest in E & T. It is the correctness of this holding that is in issue.

After analyzing the facts, the Fourth Circuit concluded, "The maintenance contract in effect gave complete control over E & T to Taxpayer (who had absolute control of Chertkof Co.), and with it power to use E & T in many ways which could inure to him financially." In using this financial and control interest test, the Fourth Circuit indicated that it does not consider an independent contractor to hold a prohibited interest, per se.

In Lynch v. Commissioner, the Court of Appeals for the Ninth Circuit reached a contrary result, holding that a taxpayer who provides services as an independent contractor to a corporation after a complete redemption of stock has an interest in the corporation prohibited by § 302(c)(2)(A)(i). The Ninth Circuit, in overruling a Tax Court decision that the re-

74. Id.
75. Id.
76. Id.
77. 801 F.2d 1176 (9th Cir. 1986).
78. Id. at 1179.
deemed shareholder did not have an interest in the corporation, did not attempt to distinguish the facts involved in Lynch from the facts present in Lennard. Rather, the court disagreed with the rationale in Lennard and argued that any relationship with the corporation, other than a creditor relationship, is a prohibited interest under § 302(c)(2)(A)(i).79

The taxpayer in Lynch was the sole shareholder of a corporation involved in the leasing of cast-in-place concrete pipe machines.80 The taxpayer owned the machines individually, but leased them to his corporation.81 The taxpayer sold a small amount of stock to his son and shortly thereafter the corporation redeemed his remaining stock.82 The taxpayer's son, seeking to retain his father's expertise in the specialized machinery, entered into a consulting agreement on behalf of the corporation.83 The agreement between the taxpayer and the corporation provided for payments of $500 per month for five years, plus reimbursement of all business related expenses.84 In return the taxpayer agreed to render technical consulting services as the corporation might reasonably request.85 In addition, the taxpayer was covered by the corporation's group medical insurance policy and medical reimbursement plan.86

The Tax Court found that the services provided by the taxpayer did not amount to a prohibited interest in the corporation.87 After determining that the taxpayer was an independent contractor rather than an employee, the Tax Court analyzed the facts and circumstances to determine whether the taxpayer had a financial stake in the corporation or managerial control after the redemption.88 Since the consulting agreement was not linked to the future profitability of the corporation and there was no evidence that the taxpayer exerted any control over the corporation, the Tax Court determined that the taxpayer did not have an interest prohibited by § 302(c)(2)(A)(i).89

79. Id. at 1181.
80. Id. at 1176-77.
81. Id. at 1177.
82. Id.
83. Id.
84. Id.
85. Id.
86. Id.
88. Id. at 606.
89. Id. at 608.
The Ninth Circuit rejected the Tax Court's "individualized determination of whether a taxpayer has retained a financial stake or continued to control the corporation." Citing language from § 302's legislative history, the Ninth Circuit concluded that its holding "comports with the plain language of § 302 and its legislative history."

**B. The Tax Court Analysis is the Better Approach**

Despite the assertion in Lynch that the plain meaning of the statute and the legislative history demand that an independent contractor be treated as holding a prohibited interest in the redeeming corporation, a more careful reading of the statute and its legislative history favor the analysis adopted by the Tax Court in Lennard.

The relevant statutory language in § 302 requires that the family stock attribution rules be waived if, *inter alia*, "immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor." In order to avoid the application of the family attribution rules, the redeemed shareholder cannot have an "interest" in the corporation, other than as a creditor, following the redemption.

One of the basic rules of statutory construction is that a term used in a statute is given its common meaning unless circumstances indicate otherwise. Black's Law Dictionary defines "interest" as "[t]he most general term that can be employed to denote a right, claim, title, or legal share in something. . . . More particularly it means a right to have the advantage accruing from anything; any right in the nature of property, but less than title." Generally, an independent contractor cannot be said to have a right, claim, title, or legal share in a corporation to which he or she provides services, other than as a creditor for services already performed.

Notwithstanding the argument in Lynch that inquiring into the facts and circumstances surrounding a consulting agreement creates uncertainty in the application of § 302,
without examining the facts and circumstances it is impossible to determine whether a redeemed shareholder has an interest in the corporation. One must wonder why, if it is appropriate to look at the facts and circumstances to determine whether a redeemed shareholder is a creditor or an owner, it is not appropriate to examine the facts and circumstances to determine whether a shareholder, through a consulting agreement with the corporation, has an interest in the corporation. Whether a former shareholder is a creditor or an interest holder depends on the definition of those terms under § 302(c)(2)(A)(i), and an examination of the facts is necessary to reach a conclusion. The Ninth Circuit would have us believe that Congress intended to make no distinction, in determining the tax treatment of a redemption transaction, between a redeemed shareholder who enters into a contract to remove snow from the company parking lot and a redeemed shareholder who enters into a contract giving the redeemed shareholder complete authority to manage the corporation’s business activities. Interpreting the statute to include any independent contractor as one holding an interest in the corporation simply does not comply with the basic rule of statutory construction ascribing the common meaning to terms used in a statute.

According to the Ninth Circuit, “[t]he parenthetical language in section 302(c)(2)(A)(i) merely provides a subset of prohibited interests from the universe of such interests, and in no way limits us from finding that an independent contractor retains a prohibited interest.” The Ninth Circuit is correct. However, the fact that Congress decided to make clear that an officer, director, or employee could be treated as holding an interest in the corporation does not mandate that all independent contractors be deemed to hold an interest in the corporation within the meaning of § 302(c)(2)(A)(i). Even though an officer, director, or employee may not normally be considered to hold a “right, claim, title or legal share” in his or her corporation, Congress determined that because of the potential for an officer, director, or employee to control the corporation’s operations, the statute should make clear that one in a position to control the corporation has an interest in the corporation within the meaning of § 302(c)(2)(A)(i). If we ascribe the common

96. See, e.g., Lennard v. Commissioner, 61 T.C. 554, 562 (1974); Dunn v. Commissioner, 615 F.2d 578, 584-85 (2d Cir. 1980).
97. Lynch v. Commissioner, 801 F.2d 1176, 1180-81 (9th Cir. 1986).
meaning to the term "interest," it is more logical to conclude that by the inclusion of officers, directors, and employees Congress was attempting to make clear that taxpayers in a position to control the operations of the corporation are treated as holding an interest in the corporation. This interpretation of the statute is supported by the policy underlying § 302(c)(2), that taxpayers who, after a stock redemption transaction, continue to control the family-owned corporation or maintain a financial stake in it should not obtain the benefit of sale treatment on the redemption.99 It is this underlying policy that requires an examination of the facts and circumstances to determine whether a particular consulting agreement gives a redeemed shareholder the ability to control the operations of the corporation or to benefit financially in a manner similar to a shareholder with an ownership interest.

The Ninth Circuit relies on legislative history to conclude that examining the facts and circumstances surrounding a consulting agreement creates uncertainty that Congress sought to eliminate when it enacted § 302.100 The court's reliance on the legislative history is misplaced.

The uncertainty that concerned Congress resulted from the dividend equivalency test used by the courts prior to the enactment of § 302. Under the dividend equivalency test, payments from a corporation that are not essentially equivalent to a dividend are taxed as capital gains.101 The facts and circumstances surrounding the transaction are examined to determine whether the distribution by the corporation is essentially equivalent to a dividend. The Ninth Circuit102 cited the following language from the House Committee Report:

In lieu of a factual inquiry in every case, [§ 302] 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 301.103

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99. S. REP. NO. 1622, supra note 9, at 45, reprinted in 1954 U.S.C.C.A.N. at 4676. Even the Ninth Circuit agrees that this is the policy underlying § 302(c)(2). See Lynch, 801 F.2d at 1181 n.7.
100. Lynch, 801 F.2d at 1179.
102. Lynch, 801 F.2d at 1179.
The factual inquiry referred to relates to the dividend equivalency test, not whether a shareholder retains an interest under § 302(c)(2)(A), and the specific conditions referred to relate to the redemption tests found in § 302(b)(2), (b)(3), and (b)(4). The legislative history of § 302(c)(2) contains no implication that a factual inquiry into whether a shareholder retains an interest in the corporation is improper. The legislative history cited by the Ninth Circuit is inapposite.

The approach of the Tax Court, as set forth in Lewis, Lennard, and Lynch, and the apparent approach of the Fourth Circuit discussed in Chertkof support the policy underlying § 302(c)(2). That policy is to allow sale or exchange treatment on the redemption of a family-owned corporation's stock only when the shareholder has retained no control or financial stake in the corporation's affairs. The Tax Court's approach also comports with the plain meaning of the statute. The statute states that no interest, other than an interest as a creditor, can be retained by a shareholder seeking to waive the family stock attribution rule. The statute specifically includes employee, officer, and director as relationships that can be seen as an interest in the corporation. However, an independent contractor is not specifically mentioned and the question becomes whether an independent contractor has an interest in the corporation within the meaning of § 302(c)(2)(A). Based on the plain meaning of the term "interest," an independent contractor would generally not be considered to have an interest in the corporation, except perhaps as a creditor for services rendered. However, if the facts and circumstances show that the shareholder, through a consulting agreement, has retained control over the corporation or a financial stake akin to ownership, the shareholder's status as an independent contractor should be treated as an interest in the corporation under § 302(c)(2)(A).

at 4210.

104. In general, under [§ 302(b)] your committee intends to incorporate into the bill existing law as to whether or not a reduction is essentially equivalent to a dividend under section 115(g)(a) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances.

C. Summary

A shareholder in a family-owned corporation should carefully plan for the redemption of his or her stock. Due to the application of the family stock attribution rules in all but complete redemption transactions, it is only when all of his or her stock is redeemed that the redeemed shareholder will obtain capital gain treatment. Younger family members may want to retain the redeemed shareholder's services as a consultant, especially when the redeemed shareholder has some technical expertise applicable to the corporation's business. Although the case law is in conflict over the issue of whether a consulting agreement, per se, constitutes an interest in a corporation, the Service's view is that any such agreement between a redeemed shareholder and his or her corporation is a prohibited interest that prevents the redeemed shareholder from waiving the family attribution rules. Although the Tax Court and the Fourth Circuit Court analyze the facts and circumstances to determine whether a particular consulting agreement constitutes a prohibited interest, the Ninth Circuit has adopted the view of the Service. The analysis adopted by the Tax Court and apparently the Fourth Circuit is supported by the statutory language and the policy underlying § 302(c)(2). However, cautious taxpayers who reside outside the Fourth Circuit may decide to avoid postredemption consulting agreements. Other taxpayers need to exercise care in drafting postredemption consulting agreements. An agreement providing the redeemed shareholder with de facto control of the corporation's operations or a compensation formula tied to the success of the corporation's business may be held to be an interest in the corporation and turn a valid sale into a dividend.

V. SUBORDINATED INSTALLMENT OBLIGATIONS

A. The Problem of Subordinated Debt and the Waiver of Family Stock Attribution

When a retiring shareholder enters into a redemption agreement with his or her closely held family corporation, the corporation may not have the necessary liquidity to pay the purchase price in cash. Perhaps the retiring shareholder may want to spread the gain to be recognized on the sale over a period of years. Consequently, the retiring shareholder may enter into a redemption agreement calling for an installment
sale of his or her stock. The installment note may be a significant liability on the corporation's financial statements.

Younger family members may wish to expand the corporation's business and need to finance the expansion with corporate debt. Obtaining such financing may be difficult due to the large installment note payable to the retired shareholder. The retiring shareholder may be willing to subordinate his or her installment note in an effort to assist the corporation in securing additional financing.

By subordinating the corporation’s installment obligation to the claims of other corporate creditors, the retiring shareholder may unwittingly put the characterization of his or her stock redemption at risk since the Service views the subordination of an installment note received in a stock redemption as creating a noncreditor “interest in the corporation” prohibited by § 302(c)(2)(A)(i) and (ii).\(^{105}\) Having a noncreditor interest in the corporation, the retiring shareholder cannot take advantage of the family stock attribution waiver. Without the attribution waiver, the redemption is taxed as a dividend distribution.\(^{106}\)

**B. Analysis of Authority**

The position of the Service is expressed in Treasury Regulation § 1.302-4(d), which states:

> For the purpose of section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation.\(^{107}\)

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106. For the treatment of the receipt of an installment obligation in a transaction characterized as a dividend distribution, see Cox v. Commissioner, 78 T.C. 1021 (1982). The value of the obligation is taxed in the year of receipt. *Id.* at 1028.
The Service requires that taxpayers seeking a ruling regarding the tax treatment of a proposed stock redemption under § 302(b)(3) (complete termination) represent that any note received by the taxpayer in connection with the redemption is not subordinated to the claims of general creditors.108

The position of the Service, as expressed in the regulation quoted above, makes it extremely difficult for a redeeming shareholder to structure the installment note in a way that would facilitate a corporation obtaining outside financing without raising the ire of the Service. Fortunately, case law is not as inflexible as the Service in determining whether a redeemed shareholder holds an interest only as a creditor under § 302(c)(2)(A).

In Lennard v. Commissioner,109 the Tax Court addressed the issue of whether the taxpayer, after the redemption of all his stock, retained a prohibited interest in the corporation because the note issued to him in exchange for his stock was subordinated to the corporation's other debts. The Tax Court found that mere subordination did not make the taxpayer's installment note a prohibited interest within the meaning of § 302(c)(2)(A)(i).110

According to the Tax Court, the Service's prohibition against subordination arises only when other factors indicate that a debt instrument may, in substance, constitute a proprietary interest.111 Rather than question the validity of Treasury Regulation § 1.302-4(d), the Tax Court chose to interpret the regulation as requiring more than debt subordination before a note will be treated as a prohibited interest under § 302(c)(2)(A).112 The Tax Court concluded that the other facts and circumstances in Lennard were indicative of a creditor interest so that the subordination of the note did not cause the taxpayer's interest in the corporation to be anything other than a creditor's interest.113

110. Id. at 563.
111. Id.
112. Id.
113. Id. The Tax Court's interpretation of Treasury Regulation § 1.302-4(d) is peculiar when one considers that in Lennard the Service was litigating a case in which the installment note had no indicia of ownership other than subordination.
In Dunn v. Commissioner,\(^{114}\) which also addressed the subordination scenario, the taxpayer entered into a stock redemption agreement with her closely held family corporation. The agreement provided that a portion of the purchase price would be paid in installments. The corporation operated a Chevrolet dealership and the terms of the franchise agreement with General Motors required the corporation to “maintain a certain ‘Owned Net Working Capital’ in order to retain the dealership.”\(^{115}\) The installment sale agreement between the taxpayer and the corporation provided that if the making of an installment payment would cause the corporation to be in violation of the “owned net working capital” requirement and would prevent the corporation from retaining 50% of its net after tax profits, then the payment would be postponed until the payment would not result in a violation of the franchise requirement.\(^{116}\)

The Service argued that the taxpayer held an interest in the corporation other than as a creditor due to the provision in the installment agreement providing for postponement of payments, and cited its regulation defining a creditor interest in the context of § 302(c)(2)(A) in support of its position.\(^{117}\) Thus, the Second Circuit Court of Appeals, affirming a decision of the Tax Court,\(^{118}\) held that the installment sale agreement created only a creditor interest, despite the payment restriction.\(^{119}\) The Second Circuit found Treasury Regulation § 1.302-4(d) to be concerned with the redeeming shareholder’s status as a holder of a proprietary interest in the corporation.\(^{120}\) The Treasury Regulation prohibits a redeeming shareholder from retaining rights broader or greater than those of a creditor (e.g., voting rights or rights to convert his or her claim into stock).\(^{121}\) The Treasury Regulation also prohibits a shareholder from retaining a proprietary interest by structuring the debt to resemble an equity interest.\(^{122}\) According to the Second

\(^{114}\) Dunn v. Commissioner, 615 F.2d 578 (2d Cir. 1980).
\(^{115}\) Id. at 580.
\(^{116}\) Id.
\(^{117}\) Id. at 582.
\(^{118}\) Dunn v. Commissioner, 70 T.C. 715 (1978), aff’d, 615 F.2d 578 (2d Cir. 1980).
\(^{119}\) Dunn v. Commissioner, 615 F.2d 578 (2d Cir. 1980)
\(^{120}\) Id. at 582.
\(^{121}\) Treas. Reg. § 1.302-4(d).
\(^{122}\) Id.
Circuit, the prohibition in the regulation against subordinating the redeeming shareholder's installment payment to the claims of general creditors is an attempt to address the equity aspect of a proprietary interest, not the nature of a subordinated interest.123

In addition to claiming that the taxpayer had a noncreditor interest in the corporation, the Service argued that the terms of the taxpayer's redemption agreement restricting the timing of the corporation's payments amounted to debt subordination.124 In response, the Second Circuit did not hold, as the Tax Court concluded in Lennard, that mere subordination fails to convert an otherwise valid debt into an equity interest under § 302(c)(2)(A).125 Rather, the Court determined that the terms of the redemption agreement did not amount to debt subordination:

Nothing in the agreement affects the rank of the taxpayer's claim as against general creditors, and there is nothing in the Agreement that, if [the corporation] had been put into liquidation, would have given any creditor a basis for arguing that he should be paid before the taxpayer was paid.126

Finally, the Service argued that the taxpayer retained a prohibited interest since, under Treasury Regulation § 1.302-4(d), a redeemed shareholder is not considered merely a creditor if "under the terms of the instrument the corporation may discharge the principal amount of its obligation [to the redeemed shareholder] by payments, 'the amount or certainty of which are dependent upon the earnings of the corporation."127 The Court found that the restriction regarding payments on the installment note affected only the timing of the payment and not the amount or certainty of payment so that the regulation was inapplicable to the facts:

The regulation, then, does not support the Commissioner's position, for the instrument under review does not exhibit a single one of the characteristics given significance by the regulation. What is more important, the obligation here, to the extent that it differs from the classic debt

123. Dunn, 615 F.2d at 582.
124. Id.
125. See supra text accompanying note 110.
126. Dunn, 615 F.2d at 582-83.
127. Id. at 583.
of fixed amount and inexorable due date, does not differ in
the direction of being a proprietary or equity type of interest,
but differs simply in being unmistakably debt, but of a seem-
ingly somewhat inferior quality because of the postponement
clause.128

The Second Circuit, having determined that the regulation
cited by the Service was inapplicable to the facts of the case,
turned its attention to the question of how to determine if a
instrument is debt or equity. Although dicta, language in Dunn
suggests that the Second Circuit agrees with the Tax Court
that mere subordination of a debt does not create an interest
other than the interest as a creditor.129

In Duerr v. Commissioner,130 the taxpayer received bonds
in a redemption transaction treated by the taxpayer as a com-
plete termination of interest under § 302(b)(3). Interest on the
bonds received was payable at a fixed rate, but payable out of
income only.131 No subrogation clause was included in the
sales agreement. The Tax Court observed that the terms of
payment on the bonds were, in substance, no different than the
terms of the preferred stock redeemed in the transaction.132
The Tax Court found the bonds to be a prohibited interest,
resulting in dividend treatment on the amount received by the
taxpayer and originally treated as sales proceeds from the
redemption transaction.133

A close reading of Lennard and Dunn reveals that neither
case actually rejects the Service's apparent position that a
redeeming shareholder who subordinates his or her installment
note to the claims of creditors has retained a prohibited inter-
est under § 302(c)(2)(A). In Lennard, the Tax Court interpreted
Treasury Regulation § 1.302-4(d) as requiring more than mere
subordination before a debt will be treated as a prohibited
interest.134 In Dunn, the Second Circuit avoided confronting
the issue of whether mere subordination creates a prohibited
interest by finding that the terms of the redemption agreement
did not amount to debt subordination.135 However, the discus-

128. Id.
129. See id. at 584.
130. 30 T.C. 944 (1958).
131. Id. at 946.
132. Id. at 945.
133. Id. at 948.
134. See supra text accompanying note 110.
135. See supra text accompanying note 124.
sion in each case regarding what constitutes debt and what constitutes equity indicates that mere subordination of an installment note received in the complete redemption of a shareholder's stock will not cause the redeemed shareholder to be treated as retaining a prohibited interest.136

Lennard and Dunn appear to adopt, for purposes of § 302(c)(2)(A), the analysis underlying § 385 of the Code.137 Section 385 requires an examination of several factors to determine if an instrument is debt or equity.138 This analysis is consistent with the purpose underlying § 302(c)(2) to allow sale treatment to a bona fide redemption of stock from a shareholder of family-owned corporation where the shareholder has not retained the incidents of shareholder status, namely, a proprietary interest in the corporation or the ability to control the corporation's affairs. This approach to analyzing debt in the context of redemption transactions involving family-owned corporations is likewise reflected in Duerr, in which the payment to the shareholder, dependent on corporate earnings, was akin to a proprietary interest.

C. Summary

A shareholder who receives an installment obligation and agrees to subordinate the obligation to the claims of general creditors risks a challenge from the Service. Although the cases dealing with this issue have not specifically invalidated the regulation relied on by the Service, they do indicate that mere subordination of an installment note will not cause an otherwise valid stock redemption to be recast as a dividend distribution. Intrepid shareholders may choose to risk litigation with the Service in an effort to assist the family-owned corporation in obtaining outside financing. This may be a better alternative than personally guaranteeing corporate debt.

VI. CONCLUSION

Achieving capital gain treatment is the tax objective of a shareholder planning the redemption of stock by his or her family-owned corporation. However, a shareholder may have nontax objectives as well, such as continuing to provide impor-

136. Dunn, 615 F.2d at 584; Lennard, 61 T.C. at 563.
138. Id. § 385(b).
tant services to the corporation after the redemption, or accommodating the corporation's desire to obtain additional financing. Due to the possible application of the family stock attribution rules and consequent dividend treatment, taxpayers need to recognize the potential pitfalls on the path to obtaining capital gain treatment.

A redeeming shareholder needs to address the problem presented when a trust of which the shareholder is a beneficiary owns stock in the corporation, even if the shareholder's interest in the trust is remote and contingent. Unless the trust allows for the distribution of the stock to trust beneficiaries the redeeming shareholder may be put to a hard choice among remaining a shareholder, paying tax at ordinary income rates on the amount distributed by the corporation in exchange for the shareholder's stock, and renouncing his or her interest in the trust in order to obtain capital gain treatment.

Providing postredemption consulting services to the redeeming corporation can create problems for a redeeming shareholder as well. The Service and the Ninth Circuit Court of Appeals hold that any agreement to provide postredemption consulting services creates a prohibited interest that causes a redemption to be treated as a dividend. The Tax Court holds that not all postredemption services taint an otherwise valid sale transaction. Only when the terms of the consulting agreement give the former shareholder a financial stake in the corporation or control over its operations will the Tax Court recast a redemption as a dividend distribution. The Fourth Circuit Court of Appeals appears to agree with the Tax Court. Shareholders who provide postredemption services to the family-owned corporation risk litigation. If the nature of their consulting agreement gives the shareholder control over the corporation's affairs or if the payments to be made to the shareholder are tied to the success of the corporation, the redemption will be treated as a dividend distribution.

Finally, subordinating an installment note received by the retiring shareholder may cause the redemption to be challenged by the Service. Although case law appears to reject the Service's position that mere subordination of an installment note to the claims of general creditors is fatal to sale treatment, taxpayers need to be cautious in drafting the subordination agreement to avoid other indicia of equity ownership that might suggest that the shareholder has more than a creditor's interest in the redeeming corporation.
A family-owned corporation presents unique planning problems for the redeeming shareholder. Avoiding the obstacles discussed above may be difficult, but taxpayers need to recognize that failing to adequately plan the redemption transaction can be financially devastating. A shareholder who thought he or she completed a valid stock redemption may discover that the transaction will be taxed as a dividend.