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UNITED STATES v. DAVIS: WHAT REMAINS OF SECTION 302(b)(1)²

Section 302(b)(1) of the Internal Revenue Code of 1954¹ provides that a distribution in redemption of stock will qualify for capital gain treatment if it is "not essentially equivalent to a dividend." Attempts to determine when a distribution coupled with a stock redemption is "essentially equivalent to a dividend" have been characterized as "vexing,"² "exasperating,"³ and "nightmarish."⁴ Most of the problems under this section have arisen in those courts which consider the business purpose of a redemption to be a relevant factor in determining dividend equivalency.⁵ The use of the business purpose test forced the courts to apply numerous factors of varying significance to the many complex fact situations presented by the financial operations of corporations. With the decision of *United States v. Davis*,⁶ the Supreme Court injected a large measure of certainty into what was once an extremely confused and tangled area of the tax law by holding that the business purpose of a stock redemption is irrelevant in determining dividend equivalency.⁷

United States v. Davis involved the redemption by Macklin Davis of non-voting preferred stock which he had purchased to enable the cor-

1. INT. REV. CODE of 1954, § 302(b)(1) [hereinafter cited as Code].

2. *Bradbury v. Comm'r*, 298 F.2d 111, 114 (1st Cir. 1962).

3. *Thomas G. Lewis*, 35 T.C. 71, 76 (1960).

4. *United States v. Fewell*, 255 F.2d 496, 499 (5th Cir. 1958).

5. Under INT. REV. CODE of 1939, § 115(g), the predecessor of section 302, the business purpose of a redemption was a factor to be considered in determining whether a distribution was essentially equivalent to a dividend. *Flanagan v. Helvering*, 116 F.2d 937 (D.C. Cir. 1940). Many courts have found that the criteria used to determine dividend equivalence under the 1939 Code are still applicable to like determinations under section 302(b)(1) of the 1954 Code. *E.g.*, *Davis v. United States*, 274 F. Supp. 466 (M.D. Tenn. 1967), *aff'd* 408 F.2d 1139 (6th Cir. 1969); *William K. Edmister*, 46 T.C. 651 (1966), *aff'd* 391 F.2d 584 (6th Cir. 1968); *Kerr v. Comm'r*, 38 T.C. 723 (1962), *aff'd* 326 F.2d 225 (9th Cir. 1964); *United States v. Carey*, 289 F.2d 531 (8th Cir. 1961). The second circuit and the leading commentator on the area have adopted the view that the business purpose of a redemption is irrelevant under section 302(b)(1). *Levin v. Comm'r*, 385 F.2d 521 (2d Cir. 1967); *Hasbrook v. United States*, 343 F.2d 811 (2d Cir. 1965); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 291 (2d ed. 1966). The strongest reason for not considering the business purpose in making a determination under section 302 is given by B. BITTKER & J. EUSTICE, *supra*, at 293. They maintain that since section 346 was enacted to cover redemption "characterized solely by what happens at the corporate level," the business purpose test is no longer applicable under section 302(b)(1).

6. 397 U.S. 301 (1970).

7. *Id.* at 312.

poration to qualify for a government loan negotiated through the Reconstruction Finance Corporation. At the time of the purchase, Davis, who owned 50 percent of the corporation's common stock, and the other 50 percent common stockholder, E. B. Bradley, agreed that the preferred stock would be redeemed when it was no longer needed. When the loan was finally paid, Davis redeemed his preferred stock for the \$25,000 purchase price. In the interim Davis had purchased Bradley's shares of common stock and had transferred 75 percent of the outstanding common shares equally among his wife, son, and daughter. Davis, in his tax return, treated the redemption as capital transaction; the Commissioner of Internal Revenue characterized it as a dividend. The district court⁸ and the Court of Appeals for the Sixth Circuit⁹ felt that the business purpose of the transaction precluded a finding of dividend equivalency. The Supreme Court reversed.

APPLICATION OF THE ATTRIBUTION RULES

As a first step in its decision, the Court held that the attribution rules of section 318 are to be applied in making a determination under section 302(b)(1)¹⁰. This holding resolved a question upon which tax lawyers and scholars had speculated for many years.¹¹ Against the position taken by the *Davis* Court it has been argued that while section 302(c)(1) states that the attribution rules of section 318 apply "in determining the ownership of stock for the purposes of this section,"¹² the intent of section 302(c)(1) is to apply attribution rules only to those subsections which contain an explicit reference to stock ownership.¹³ In reaching a contrary conclusion, the Court stated that to rule otherwise would nullify sections 302(b)(2) and 302(b)(3).¹⁴ These sections qualify for capital gain treatment those redemptions which substantially reduce a stockholder's voting power or completely terminate his interest in the corporation. The Court reasoned that "if a transaction failed to qualify under one of those sections [302(b)(2) or 302(b)(3)] solely because

8. *Davis v. United States*, 274 F. Supp. 466 (M.D. Tenn. 1967).

9. *Davis v. United States*, 408 F.2d 1139 (6th Cir. 1969).

10. 397 U.S. at 307.

11. See B. BITTKER & J. EUSTICE, *supra* note 5, at 292 n.32; Cohen, *Redemptions of Stock Under the Internal Revenue Code of 1954*, 103 U. PA. L. REV. 739, 758-59 (1955); Plowden-Wardlaw, *Constructive Ownership Under the 1954 Internal Revenue Code*, 26 FORDHAM L. REV. 441, 458-61 (1957).

12. INT. REV. CODE OF 1954, § 302(c)(1).

13. 397 U.S. at 307.

14. *Id.*

of the attribution rules, it would according to taxpayer's argument, nonetheless qualify under § 302(b)(1)."¹⁵ Since Congress expressly applied the attribution rules to the tests of disproportionate redemption and termination of interest, it could not have intended to render the effect of this attribution meaningless by not applying the same rules to section 302(b)(1). Although the position adopted by the Court has been subjected to criticism by various commentators,¹⁶ it was clearly the majority view prior to the *Davis* decision.¹⁷ After concluding that the attribution rules are to be applied in determining ownership under section 302(b)(1), the Court found that *Davis* "must be deemed the owner of all 1,000 shares of the company's common stock."¹⁸ (Emphasis supplied).

While the plain language of the statute supports the Court's holding, neither the decision nor the statute should be construed to prevent future determinations that a distribution is not equivalent to a dividend where family estrangement would make strict applications of the rules inappropriate.¹⁹

BUSINESS PURPOSE TEST

The *Davis* decision leaves no doubt that in the future the business purpose of a stock redemption will be irrelevant in determining whether the redemption is "essentially equivalent to a dividend."

The lower courts had previously adopted two basic approaches in determining the relevance of the business purpose of the questioned transaction: the strict net effect test,²⁰ under which the only relevant con-

15. *Id.*

16. Comm. on Taxation, Ass'n of the Bar of the City of New York, *Bar Association Explains Weak Spots in Corporate Sections of 1954 Code*, 2 J. TAX. 322, 324 (1955); Cohen, *supra* note 11, at 758-59; Laikin, *Stock Redemptions: Section 302 and 318*, 14th N.Y.U. ANN. INST. FED. TAX. 671, 686-87 (1956); Rasman, *Stock Redemptions Under Section 302 of the 1954 Code*, 35 TAXES 355, 362 (1957).

17. Levin v. Comm'r, 385 F.2d 521, 526-27 (2d Cir. 1967); Comm'r v. Berenbaum, 369 F.2d 337, 342 (10th Cir. 1966); Ballenger v. United States, 301 F.2d 192, 199 (4th Cir. 1962); Bradbury v. Comm'r, 298 F.2d 111, 116-117 (1st Cir. 1962). This is also the position taken by the Internal Revenue Service, Treas. Reg. § 1.302-2(b) (1960). *But see*, Perry S. Levin, 47 T.C. 129 (1966), where the Tax Court without giving a reason chose to ignore the attribution rules in a section 302(b)(1) case.

18. 397 U.S. at 307

19. *But see*, *The Supreme Court, 1969 Term*, 84 HARV. L. REV. 236 n.15 (1970) (advancing the view that *United States v. Davis* precludes an exception to attribution based on the estrangement doctrine). *See also* 2 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 24.02A(5) (1970); McAndrews, *Supreme Court's Davis Decision: Does it do away with the 302(b)(1) Redemption?*, 32 J. TAX. 328, 329 (1970).

20. *E.g.*, Hasbrook v. United States, 343 F.2d 811 (2d Cir. 1965); Himmel v. Comm'r, 338 F.2d 815 (2d Cir. 1964); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962);

sideration was whether the redemption resulted in a pro rata distribution; and the flexible net effect test,²¹ under which the courts looked to the motives of the taxpayer in order to determine whether a redemption was actually a tax avoidance scheme. In adopting the strict net effect test,²² the Court relied on legislative history which is inconclusive at best. The taxpayer argued that under the 1939 Code, business purpose was relevant in most courts²³ and the re-enactment of the statute in the 1954 Code was accompanied by a Senate Report which stated: "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)(1) of the 1939 Code."²⁴ The Government relied on a portion of the same report, which stated that the inquiry under 302(b)(1) "will be directed solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corpora-

Ferro v. Comm'r, 242 F.2d 838 (3d Cir. 1957). This is the test which the Internal Revenue Service considers the proper test under section 302(b)(1). Rev. Rul. 57-353, 1957-2 CUM. BULL. 223.

21. This test was used by a majority of the courts. *Davis v. United States*, 408 F.2d 1139 (6th Cir. 1969); *Bloch v. United States*, 386 F.2d 839 (5th Cir. 1968); *Comm'r v. Berenbaum*, 369 F.2d 337 (10th Cir. 1966); *Taberty v. Comm'r*, 354 F.2d 422 (9th Cir. 1965); *Heman v. Comm'r*, 283 F.2d 227 (8th Cir. 1960); *Keefe v. Cote*, 213 F.2d 651 (1st Cir. 1954); *Joe L. Smith, Jr.*, 49 T.C. 476 (1968).

While *Treas. Reg. § 1.302-2(b)* (1960) indicates that in the case of a pro-rata redemption the Service will not usually recognize any exception to the strict net effect test, it did acquiesce in the result of *Joe L. Smith, Jr.*, 49 T.C. 476 (1968), 1968-2 CUM. BULL. 3. In *Rev. Rul. 68-547*, 1968-2 CUM. BULL. 123; *Rev. Rul. 56-183*, 1956-1 CUM. BULL. 161; the Service noted that certain redemptions were motivated by a valid business purpose.

22. While the Court appears to adopt the strict net effect test, its requirement of a "meaningful reduction of the shareholder's proportionate interest in the corporation" may well foreclose the use of the comparative dividend test, which looks at the distribution to determine if the shareholders would have received identical payments if the redemption had been a dividend. See *Himmel v. Comm'r*, 338 F.2d 815 (2d Cir. 1954); *McGinty v. Comm'r*, 325 F.2d 820 (2d Cir. 1963); *Ballenger v. United States*, 301 F.2d 192 (4th Cir. 1962); *TAX COORDINATOR, Bi-Weekly Alert*, Mar. 26, 1970, at 7.

23. *E.g.*, *United States v. Fewell*, 255 F.2d 496 (5th Cir. 1958) (dictum); *Keefe v. Cote* 213 F.2d 651 (1st Cir. 1954); *Flanagan v. Helvering*, 116 F.2d 937 (D.C. Cir. 1940) (This was the leading case, in which Associate Justice Vinson, who later became Chief Justice of the United States, listed the absence of a tax avoidance motive as one of several factors to be considered); *Bans v. United States*, 289 F.2d 644 (Ct. Cl. 1961).

24. S. REP. No. 1622, 83d Cong., 2d Sess. 233 (1954). Judge Dawson of the Tax Court in his dissent to *J. Milton Sorem*, 40 T.C. 206, 220 (1963), *rev'd* 334 F.2d 275 (10th Cir. 1964) said that the business purpose of a redemption is the only relevant consideration under section 302(b)(1). He maintains that the legislative history of section 302(b)(1) establishes that the section is not in any sense concerned with whether a redemption is pro rata.

tion.”²⁵ The Government further argued that a sale implied a reduction of ownership and therefore the existence of such a reduction was the sole test.²⁶ The Court, while noting that the legislative history was not free from doubt,²⁷ adopted the Government’s argument that if the sole inquiry was whether the redemption could be characterized as a sale, then “Congress was apparently rejecting past court decisions that had also considered factors indicating the presence or absence of a tax-avoidance motive.”²⁸ This conclusion was supported by a statement in the Senate Report that the presence or absence of earnings was immaterial in determining whether a redemption could be characterized as a sale.²⁹ Since the absence of earnings and profits would preclude any tax liability in a transaction that is “essentially equivalent to a dividend,” obviously the presence or absence of tax avoidance motive is not material.

After deciding that Congress had not intended for the business purpose of a transaction to be a relevant factor in determining dividend equivalence under section 302(b)(1), Justice Marshall stated that “to qualify for preferred treatment under that section, a redemption must result in a meaningful reduction of the shareholder’s proportionate interest in the corporation.”³⁰ It is tautological to assert that under this test redemptions can never qualify for favorable treatment in the one-man corporation situation.

This sweeping decision, which strikes down the flexible net effect test that had been adopted by six circuits and the Tax Court,³¹ was not necessary to the resolution of the case. In keeping with its own doctrine of deciding cases on the narrowest possible grounds, the Court could have reached the same result either by denying the suitability of the business purpose of this particular transaction or by finding that the motivation for the redemption was a stockholder purpose and not a corporation purpose.³² Perhaps the most persuasive approach available to the Court, and one which it apparently discarded,³³ would have been a separation of the purpose of issuing the stock from the purpose for redeeming the

25. S. REP. NO. 1622, *supra* note 24, at 234.

26. *See* McAndrews, *supra* note 19, at 330.

27. 397 U.S. at 311.

28. *Id.*

29. S. REP. NO. 1622, *supra* note 24, at 234.

30. 397 U.S. at 313.

31. *See* cases cited note 21 *supra*.

32. *See* 2 J. RABKIN & M. JOHNSON, *supra* note 19, at § 24.02(3).

33. 397 U.S. at 307 n.9.

stock, thus allowing a finding that while the issuance had a valid business purpose there was no sufficient business purpose for the redemption.³⁴

The principal virtue in the sweeping nature of the *Davis* decision, although it is based on inconclusive and contradictory legislative history, is the simplification of an extremely confused and complex body of case law. However, this virtue will not be appreciated by Macklin Davis and others similarly situated who loaned money to corporations in the form of a stock purchase and now find that they cannot withdraw their funds without receiving their capital as dividend income.

WHAT TYPES OF REDEMPTION REMAIN UNDER SECTION 302(b)(1)?²

In his dissent to *United States v. Davis*, Justice Douglas stated that the Court's decision "effectively cancels § 302(b)(1) from the Code."³⁵ While the decision certainly will have a significant effect on the financial decisions of those owning shares in close corporations,³⁶ it has limited, but not eliminated, the opportunity to qualify a redemption under sec-

34. The fourth and tenth circuits have held that a valid business purpose for the issuance of stock cannot be converted into a valid business purpose for its redemption. *Comm'r v. Berenbaum*, 369 F.2d 337, 341 (10th Cir. 1966); *Ballenger v. United States*, 301 F.2d 192, 199 (4th Cir. 1961). However, the lower court in deciding the *Davis* case held that the redemption was simply the last contemplated step of the original business purpose. *Davis v. United States*, 408 F.2d 1139, 1144 (6th Cir. 1969). *Accord*, *Cobb v. Callan Court Co.*, 274 F.2d 532, 538 (5th Cir. 1960); *Keefe v. Core*, 213 F.2d 651, 657 (1st Cir. 1954). In *Comm'r v. Berenbaum*, *supra*, just as in *Davis* preferred stock was issued to improve the company's balance sheet, with an understanding that the stock would be redeemed when no longer needed. The court held that there was no business purpose for the redemption.

35. 397 U.S. at 314. A Tax Court decision and a Revenue Ruling shed some light on the effect *Davis* is having on stock redemptions. In *Estate of William F. Runnels*, 54 T.C. 762 (1970), the court cites *Davis* in finding a redemption equivalent to a dividend, but since the distribution was pro rata even without applying the attribution rules and there was not a valid business purpose for the redemption, the result would have been the same prior to the *Davis* decision.

However, in Rev. Rul. 70-496, 1970 INT. REV. BULL. No. 39, at 6, the elimination of any consideration of a business purpose test seems to require dividend treatment of sales of stock among corporations controlled by a common parent.

36. The redemption of stock in a public corporation is seldom pro rata; even when it is, the average stockholders' lack of control over the company's dividend policy argues against a finding of dividend equivalency.

One commentator has come up with the interesting proposal that as section 302 was intended to facilitate shifts in ownership among the shareholders of close corporations, redemptions from public corporations should always be taxed as a dividend. This would be justified by analogy to section 305(b)(1) where if a taxpayer has the option to take stock or property he is taxed as if the distribution was a dividend. Chirelstein, *Optional Redemption and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739 (1969).

tion 302(b)(1) There appear to be two situations where a redemption can still qualify under this section: a redemption that causes a "meaningful reduction in a shareholder's proportionate interest," yet does not qualify as a substantially disproportionate redemption under the provision of section 302(b)(2), and a redemption that would qualify as a meaningful reduction of interest, but for the effect of the attribution rules of section 318, if the taxpayer's situation is such that application of the attribution rules is unwarranted.

Meaningful Reduction of Interest that Fails to Qualify Under Section 302(b)(2)

As section 302(b)(5) provides that failure to qualify under section 302(b)(2) shall not affect determination under section 302(b)(1), it seems clear that a meaningful reduction under section 302(b)(1) is not the same as a section 302(b)(2) substantially disproportionate redemption.³⁷ Thus, even with the business purpose of a redemption now deemed irrelevant, those disproportionate redemptions that narrowly fail the test of section 302(b)(2) are prime candidates for qualification under section 302(b)(1) Other candidates are redemptions of preferred stock, especially when the shareholder has no control over when the redemption will occur,³⁸ and redemptions of the stock of minority shareholders which, while not substantially disproportionate, leave the shareholder with a very limited stake in the corporation.³⁹

37. INT. REV. CODE OF 1954, § 302(b)(2), entitled "Substantially Disproportionate Redemption of Stock," provides a specific objective test for determining if a redemption will qualify for capital gain treatment.

38. It was apparently this situation that caused the Senate Finance Committee to add section 302(b)(1) to the House version of the bill which, in an effort to eliminate "the considerable confusion which exists in this area," had provided the objective tests of sections 302(b)(2) and 302(b)(3) but not the "essentially equivalent to a dividend" provisions. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 35 (1954). The Senate Finance Committee report states:

While the House bill set forth definite conditions under which stock may be redeemed at capital gain rates, these rules appear 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 might 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 the stock if the redemption is not essentially equivalent to a dividend.

S. REP. NO. 1622, *supra* note 24, at 44-45.

39. Rev. Rul. 56-183, 1956-1 CUM. BULL. 161, rules that a reduction in ownership of

An important function of section 302(b)(1) should be to provide a more liberal standard for redemption of preferred stock than is available in the strict and inflexible requirements of section 302(b)(2). A preferred stock in a close corporation is normally a non-convertible claim for a fixed amount, the value of which does not reflect the value of retained earnings to the same extent as does common stock. Preferred stock does not provide the same opportunity as common stock to extract income via redemption at capital gains rates. If the redemption is pro-rata, the common stockholder can extract income and still retain his identical interest in the assets of the corporation. Thus, because of the decreased opportunity for tax avoidance, the courts would be justified in qualifying under section 302(b)(1) a redemption of preferred stock, while at the same time denying capital gain treatment to a redemption of common stock even though the reduction of proportionate interest is identical.⁴⁰

Inapplicability of Attribution Rules in a Conflict Situation

In *Davis*, the Supreme Court held that the attribution rules apply in determining whether a redemption is essentially equivalent to a dividend under section 302(b)(1).⁴¹ The Court did not comment on whether a family estrangement would create an exception to the application of these rules. Some commentators have said that *Davis* requires strict application of the attribution rules in all cases.⁴² As *Davis* did not involve any estrangement, such a conclusion is neither necessary nor warranted.

A distribution to hostile adults that is pro-rata only because of the attribution rules, is a clear example of a distribution that is "not essentially equivalent to a dividend."⁴³ There is support for this position in the legislative history of the Revenue Code, in the Treasury Regulations and in case law.

The legislative history makes it clear that the policy behind the at-

stock from 11 to 9 percent was not equivalent to a dividend as the minority position justified the characterization of the transaction as a "sale."

40. See 84 HARV. L. REV., *supra* note 19, at 240-41.

41. 397 U.S. at 307.

42. Note 19 *supra*.

43. See generally Moore, *Dividend Equivalency—Taxation of Distribution in Redemptions of Stock*, 19 TAX. L. REV. 249, 252-55 (1964); A. BERLIN & W. GOLDSTEIN, 17-3d TAX MANAGEMENT, *Corporate Stock Redemption* A-33 (1970); Note, *Stock Redemptions from Close Family Corporations Under Section 302*, 47 MINN. L. REV. 853, 867-70 (1963).

tribution rules is the prevention of tax avoidance⁴⁴ in situations where one member of a family is able to control the stock owned by the other members of the family or where a trust or estate is able to control the stock owned by its beneficiaries. The attribution rules simply assist in determining if an individual is merely a dummy stockholder⁴⁵ with no influence in the control of the corporation. Prior to the enactment of section 318, the Internal Revenue Service was occasionally successful in persuading the courts to consider the relationship of the distributee to the remaining shareholders.⁴⁶ In spite of the divorce trends, family harmony is still the normal situation and there is no reason why an individual should be able to escape adverse tax consequences merely by transferring a portion of his stock to his wife, while retaining practical control over the power of the stock. But where, as in *Herbert C. Parker*,⁴⁷ there is a history of sharp and continual disagreement between a father and son concerning the proper operation of their company and because of this conflict the son wished to buy out his father, there is no reason and no justification for applying the attribution rules. This was the reasoning of the Tax Court. Despite the fact that application of the attribution rules would have resulted in less than one-half of one percent reduction in the taxpayer's ownership, the court found that the redemption was not "essentially equivalent to a dividend."

The first circuit in 1962,⁴⁸ while attributing a daughter's stock to her father and as a result of this attribution finding dividend equivalency,

44. The Report of the House Ways and Means Committee states:

To prevent tax avoidance, but at the same time to provide a definite rule for the guidance of taxpayers, your committee has provided precise standards whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his immediate family (or by partnerships, corporations, or trusts which he controls).

H. REP. No. 1337, 83d Cong., 2d Sess. 36 (1954). The Senate Finance Committee Report states:

However, in order to prevent tax avoidance, your committee follows the rules of the House bill whereby, under specific circumstances a shareholder may be considered as owning stock held by members of his family (or by partnerships, corporations, or estates, trusts in which he has an interest).

S REP. No. 1622, 83d Cong., 2d Sess. 44 (1954). See also J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION, CODE COMMENTARY*, § 318 at 114 (J. Malon ed. 1970).

45. See *Lukens Estate v. Comm'r*, 246 F.2d 403, 407 (3d Cir. 1957) (decided under section 115(g) of the 1939 Code).

46. *William H. Grinditch*, 37 B.T.A. 402, 412 (1938). But see *Lukens Estate v. Comm'r*, 246 F.2d 403, 407 (3d Cir. 1957).

47. 20 T.C.M. 893 (1961).

48. *Bradbury v. Comm'r*, 298 F.2d 111 (1st Cir. 1962).

qualified the use of the attribution rules and approved a flexible approach. The court said:

While these attribution rules are generally applicable to section 302(b)(1), their imposition is not inflexible and if it can be demonstrated that discord exists in a family relationship which would make attribution unwarranted, they will not be applied.⁴⁹

In support of its statement the court cited *Estate of Arthur H. Squier*⁵⁰ wherein the Tax Court applied the attribution rules, but ignored their effect because the redemption caused a significant increase in a minority interest and, due to a sharp disagreement between the executor of the estate and the beneficiaries, caused the estate to lose control of the corporation. Thus, while the court applied the attribution rules, it chose to ignore their effect in a situation where it considered attribution to be unwarranted.

The argument for flexible imposition of these rules is further supported by the regulations under section 302 which provide that constructive ownership under section 318(a) is "one of the facts to be considered in making"⁵¹ a determination under section 302(b)(1)

In *Davis* the Supreme Court reversed the Court of Appeals for the Sixth Circuit by finding that the business purpose of a redemption was not a relevant factor in determining dividend equivalency. Both the lower courts⁵² had agreed that the attribution rules should apply to section 302(b)(1), however, the court of appeals indicated in a footnote that it regarded constructive ownership as merely a factor in determining whether a distribution is equivalent to a dividend.⁵³ The court indicated that in a situation involving family estrangement it might be unreasonable to apply the attribution rules in a strict fashion. The Supreme Court stated that the "taxpayer *must* be deemed the owner of all 1,000

49. *Id.* at 116-17 n.7

50. 35 T.C. 950 (1961).

51. Treas. Reg. § 1.302-2(b)(1960). Also in support of a flexible application of the attribution rules is the statement in this same section of the regulations that: "The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case."

52. *Davis v. United States*, 408 F.2d 1139, 1142-43 (6th Cir. 1969); *Davis v. United States*, 274 F. Supp. 466, 469 (M.D. Tenn. 1967).

53. 408 F.2d at 1142-43 n.6. "But, like the flexibility given to the strict net effect test, there may be situations where it would be unrealistic to apply the attribution rules in strict fashion, for instance in cases of family estrangement."

shares of the company's common stock." ⁵⁴ (emphasis supplied) However, as there was no estrangement in the Davis family, this statement can be limited to the facts of the case.

Since the first and second circuits along with the Tax Court have recognized the doctrine of estrangement on several occasions,⁵⁵ and since no other courts have expressly repudiated the doctrine, it seems to have attained some validity in precedent as well as in logic.

The very reasons that motivated the enactment of section 318 supply the strongest arguments for not applying the attribution rules in inappropriate situations. The rules rest on the assumption that one member of a family can control the stock owned by other members of the family and that it is proper to regard a member as holding all the shares possessed by his family. Where this assumption is clearly erroneous there should be no requirement to apply the attribution rules.

An inflexible application of the attribution rules in cases involving family estrangement would be a victory of form over substance, a result to which the Supreme Court has been unalterably opposed for many

54. 397 U.S. at 307

55. In *Levin v. Comm'r*, 385 F.2d 521, 527 (2d Cir. 1967), the court applied the attribution rules from a son to a mother and then stated: "We do not hold that there may not be cases in which strict application of the attribution rules may be inappropriate family estrangement may render the application of the family attribution rules unwise." *Himmel v. Comm'r*, 338 F.2d 815, 820 (2d Cir. 1964) applied the attribution rules to aid the taxpayer in a constructive dividend test that determined that a redemption was "not essentially equivalent to a dividend." However, at footnote 7 the court stated: "We think it quite proper to be aware of the effect of a distribution on significant corporate interests without strict regard to the attribution rules." *Bradbury v. Comm'r*, 298 F.2d 111 (1st Cir. 1962) (discussed at note 48 *supra*). In *Leon R. Meyer*, 46 T.C. 65, 89 (1966), the Tax Court applied the attribution rules and found dividend equivalency, but commented:

in this case there is no suggestion of a change in control or of any "sharp cleavage" between the members of the Meyer family, which might tend to diminish the significance of the attribution rules of section 318(a)(1) as a factor in the consideration of whether a redemption is "not essentially equivalent to a dividend. "

Estate of Arthur H. Squier, 35 T.C. 950 (1961) (discussed note 50 *supra*); *Herbert C. Parker*, 20 T.C.M. 893 (1961) (discussed note 47 *supra*); *Perry S. Lewis*, 47 T.C. 129, 133 (1966) (wherein while holding that the attribution rules should apply, the court ignored their effect and found a redemption not essentially equivalent to a dividend).

The Tax Court's willingness to look behind the attribution rules and see the true relationships does not always work to the taxpayer's advantage. In *Ralph L. Humphry*, 39 T.C. 199 (1962), the court chose to ignore the express requirement of section 318(a)(2)(C) that a stockholder must own 50 percent or more of the value of stock of a corporation before the ownership of stock owned by such corporation will be attributed to him, and attributed the ownership of stock owned by a corporation in which the stockholder was 44 percent owner resulting in the finding of dividend equivalency

years.⁵⁶ As Justice Frankfurter said in *Griffiths v. Commissioner*, “[w]e cannot too often reiterate that ‘taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed.’”⁵⁷

CONCLUSION

United States v. Davis has severely limited the availability of section 302(b)(1), but it has not cancelled the section from the Code. Although the case eliminates the use of a business purpose or other lack of tax avoidance motive arguments as a basis for finding a distribution “not essentially equivalent to a dividend,” the section is still available for those redemptions that fail to qualify for a safe harbor, but do cause a “meaningful reduction of a shareholder’s proportionate interest in a corporation.” In determining the effect of a redemption, there is ample authority and compelling reason to disregard the effect of the attribution rules in situations involving family estrangement or other conflicts that negate the very assumptions on which the rules are based.

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56. *Comm’r v. Hansen*, 360 U.S. 446, 461 (1959); *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Helvering v. F & R. Lazarus & Co.*, 308 U.S. 252, 255 (1939); *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 174 (1926); *Weiss v. Stearn* 265 U.S. 242, 254 (1924); *United States v. Phellis*, 257 U.S. 156, 168 (1921).

57. 308 U.S. 355, 357 (1939).