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## Taxation - Stock Redemptions - The Availability of Capital Gains Treatment. *United States v. Davis*, 90 S. Ct. 1041 (1970)

W. J. Funk

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In so holding, the Court of Appeals believed that the theory of the action, whether breach of warranty or negligence, was unimportant in a "danger invites rescue" situation.<sup>31</sup> Previous litigation and the significantly different bases of liability, however, indicate that some distinction between warranty and tort theory is desirable.<sup>32</sup> Indeed, some members of this court cautioned that the holding should be limited to similar factual settings as were present in *Guarino* lest injustice result from abuse of the remedy of breach of warranty.<sup>33</sup>

WILLIAM M. MUSSER, III

**Taxation—STOCK REDEMPTIONS—THE AVAILABILITY OF CAPITAL GAINS TREATMENT.** *United States v. Davis*, 90 S. Ct. 1041 (1970).

Maclin Davis, a fifty percent stockholder in a closely held corporation,<sup>1</sup> made an additional capital contribution in exchange for preferred stock to enable the corporation to qualify for a loan.<sup>2</sup> The stock was redeemed

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*"Anti-Privity" Statute: Strict Products Liability Under the Uniform Commercial Code*, 51 VA. L. REV. 804 (1965).

31. 25 N.Y.2d at 464, 255 N.E.2d at 175, 306 N.Y.S.2d at 944.

32. The trend toward abolishing privity in warranty actions is gaining support. See *supra* note 10. As a result, the word "warranty" is no longer identified with contract law but has taken on many aspects of tort law. See RESTATEMENT (SECOND) OF TORTS § 402A, comment *m* at 9 (Tent. Draft No. 10, 1964). However, the new meaning of "warranty" causes a conflict between section 402A of the *Restatement* and the warranty provisions of the Uniform Commercial Code. The question arises when to apply section 402A and when to apply the Code. Does section 402A apply to all warranty actions or only certain types such as personal injury cases? It is this conflict which prompted Chief Justice Traynor to criticize the New Jersey Supreme Court for allowing a plaintiff to recover damages for loss of bargain on the basis of strict tort liability under section 402A of the *Restatement* in *Santor v. A & M Karagheusian, Inc.*, 44 N.J. 52, 207 A.2d 305 (1965). See *Seely v. White Motor Co.*, 63 Cal. 2d 1, 403 P.2d 145, 45 Cal. Rptr. 17 (1965). The California court stated:

The history of the doctrine of strict liability in tort indicates that it was designed, not to undermine the warranty provisions of the sales act or of the Uniform Commercial Code but, rather to govern the distinct problem of physical injuries.

403 P.2d at 149, 45 Cal. Rptr. at 21. However, Justice Peters in a strong dissent reasoned that if a defect exists, recovery should not be based on what kind of damage the defect caused. 403 P.2d at 153, 45 Cal. Rptr. at 25. See generally R. D. DUESENBERG & L. KING, SALES AND BULK TRANSACTIONS UNDER U.C.C., § 7.06[1] (1966).

33. 255 N.E.2d at 176, 306 N.Y.S.2d at 946 (Scileppi, J., concurring).

1. Davis and his wife each owned twenty-five percent of the issued common stock.

2. The company believed that it needed to present a better position on the balance sheet for the purposes of loan qualification. Once the anticipated loan was repaid, Davis was to be reimbursed via the redemption of the preferred stock.

after the loan had been repaid, at which time Davis and his family owned one hundred percent of the common stock.<sup>3</sup> In his personal income tax return for 1963, Davis reported the redemption as a return of capital.<sup>4</sup> The Commissioner determined that the stock redemption was pro-rata and "essentially equivalent" to a dividend.<sup>5</sup>

The district court<sup>6</sup> and the Court of Appeals for the Sixth Circuit<sup>7</sup> were in agreement in overruling the Commissioner's determination, holding that although the redemption was pro-rata it was not equivalent to a dividend. The redemption was based upon a course of action that had a legitimate business purpose. The Supreme Court granted certiorari and reversed, holding that the stock redemption was equivalent to a dividend.<sup>8</sup>

A stock redemption by a closely held corporation is accorded preferred treatment as a sale or exchange when it "is not essentially equivalent to a dividend."<sup>9</sup> Two basic tests, strict and flexible net effects, have been developed by the courts for determining when section 302(b)(1) of the Internal Revenue Code is applicable.<sup>10</sup> In *Levin v. Commissioner*,<sup>11</sup>

3. Prior to the stock redemption, Davis purchased the remaining fifty percent of the outstanding common stock from E. B. Bradley and caused such stock to be transferred to his son and daughter.

4. INT. REV. CODE of 1954, § 302(a) provides:

GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

Sec. 302 (b) (1) provides:

REDEMPTION NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

Davis' basis in the stock equaled the amount he received from the redemption; no gain or loss resulted. See Greene, *Tax Traps for Company and Owner Lie Hidden in Many Stock Redemption Plans*, 14 J. TAXATION 12, 14 (1961).

5. Int. Rev. Code of 1954, §§ 301, 316.

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

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

8. *United States v. Davis*, 90 S. Ct. 1041 (1970).

9. INT. REV. CODE of 1954, § 302(b)(1).

10. Under the net effect test, the court must hypothesize a situation where the corporation did not redeem any stock, but instead declared a dividend for the same amount. The court must then examine the situation after the dividend, and compare it with the actual facts of the case when the stock was redeemed. . . . The first step to be taken in making this determination is whether the redemption of stock has caused a meaningful change in the position of the shareholder with relation to his corporation and the other shareholders. In sum, it is obvious that where, subsequent to a distribution, there has been no real shift in intercorporate interest or no significant change

the second circuit adopted a strict net effect test requiring that there be a reduction in ownership as a result of the redemption before capital gains treatment is allowed. Other circuits have been more flexible, however, and have recognized that extraneous circumstances may qualify a pro-rata redemption as a return of capital.<sup>12</sup> In *Keefe v. Cote*,<sup>13</sup> the first circuit recognized that the pro-rata redemption was but an initial step in carrying out the original legitimate business purpose of improving the corporate credit position, and was not essentially equivalent to a dividend.

The Supreme Court in *United States v. Davis*<sup>14</sup> first determined that the attribution rules of section 318<sup>15</sup> are applicable to section 302(b)

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in the economic interest of the parties involved, a proclivity towards dividend equivalence usually results. . . .

1 J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 9.100, at 273-75 (1969).

Under a more flexible approach, however, "a pro-rata redemption of stock can have a business justification sufficient to overcome its resemblance to a dividend under the 'net effect' test." *Id.* See *Wolfberg, Stock Redemptions under Section 302 of the 1954 Code*, 48 *TAXES* 27, 29 (1970); see also *Kerr v. Commissioner*, 326 F.2d 225 (9th Cir. 1964).

11. 385 F.2d 521 (2d Cir. 1967). See *James F. Boyle*, 14 T.C. 1382, 1390 (1950), where the court concluded that the effect of the distribution rather than the motives and plans of the taxpayer or his corporation was the fundamental question. See also *Hasbrook v. United States*, 343 F.2d 811 (2d Cir. 1965); *Northup v. United States*, 240 F.2d 304 (2d Cir. 1957).

12. *Commissioner v. Berenbaum*, 369 F.2d 337 (10th Cir. 1966); *United States v. Fewell*, 255 F.2d 496 (5th Cir. 1958); *Davis v. United States*, 274 F.Supp. 466 (M.D. Tenn. 1967). See also *Kerr v. Commissioner*, 326 F.2d 225 (9th Cir. 1964); *Ballenger v. United States*, 301 F.2d 192 (4th Cir. 1962); *Heman v. Commissioner*, 283 F.2d 227 (8th Cir. 1960).

13. 213 F.2d 651 (1st Cir. 1954). Among the circumstances to consider are: (1) the dividend record of the corporation prior to and subsequent to the taxable year; (2) whether or not the corporation accumulated earnings and profits in years prior to and subsequent to the taxable year; (3) the motives and purposes of the corporation in acquiring its stock from its shareholders; (4) whether or not the corporation contracted or eliminated its business in any way; (5) whether or not the corporation continued to operate at a profit after the acquisition of its stock; (6) whether or not the ownership and control of the corporation was substantially altered by the acquisition of the stock; and, (7) whether there appeared to be a plan or scheme of tax evasion.

14. 90 S. Ct. at 1045.

15. INT. REV. CODE OF 1954, § 318(a) provides:

GENERAL RULE.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) MEMBERS OF FAMILY.—

(A) IN GENERAL.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance),

(1). The *Davis* case presents the classic example of a pro-rata stock redemption, as Davis was considered to be the owner of one hundred percent of the corporate stock. The Court concluded that the test under section 302(b)(1) was whether or not there existed a sale which resulted in a meaningful reduction of ownership.<sup>16</sup> Because the statutory language was unclear, the Court turned to Congressional intent<sup>17</sup> and intimated that any test other than meaningful reduction of ownership would not be consistent with that intent.<sup>18</sup> Clearly, a pro-rata redemption, whether or not coupled with the presence of a business purpose or other circumstance, can never result in a meaningful reduction in ownership.

*United States v. Davis*, while severely limiting the application of section 302(b)(1), has not eliminated its use. The section will be available to a taxpayer who, having failed to meet the disproportionate redemption and termination of interests tests under section 302(b)(2) and 302(b)(3), can still prove that the transaction resulted in a meaningful reduction of his corporate ownership.

W. J. FUNK

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and

(ii) his children, grandchildren, and parents.

See *Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967); *Commissioner v. Berenbaum*, 369 F.2d (10th Cir. 1966); *Ballenger v. United States*, 301 F.2d 192 (4th Cir. 1962); B. BITTKER & J. EUSTIS, *FEDERAL INCOME TAXATION OF CORPORATION AND STOCKHOLDERS* 292, n.32 (1966); *Wolfberg*, *supra* note 10, at 39.

16. 90 S. Ct. at 1047-48.

17. *Id.* at 1041-47.

18. *Id.* at 1047-48. The Court relied upon the Senate committee's technical evaluation of section 302(b)(1) which reported:

The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under § 115(g)(1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted 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 corporation. For this purpose the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earning or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absence of earnings and profits.

S. REP. No. 1622, 83d Cong., 2d Sess. 234 (1954), reported in 1954 U.S. CODE CONG. & AD. NEWS 4870-71 (1954).