

March 1962

## §304 of the Internal Revenue Code of 1954: Redemptions by Related Corporations

Thomas D. Terry

Follow this and additional works at: <https://scholarship.law.wm.edu/wmlr>



Part of the [Business Organizations Law Commons](#), and the [Tax Law Commons](#)

---

### Repository Citation

Thomas D. Terry, *§304 of the Internal Revenue Code of 1954: Redemptions by Related Corporations*, 3 Wm. & Mary L. Rev. 457 (1962), <https://scholarship.law.wm.edu/wmlr/vol3/iss2/15>

§ 304 OF THE INTERNAL REVENUE  
CODE OF 1954:  
REDEMPTIONS BY RELATED CORPORATIONS

THOMAS D. TERRY

I.

*Introduction*

The primary object of this study is an analysis of § 304 of the Internal Revenue Code of 1954 which deals with a specific device designed to insure that certain transactions which are entered into by a taxpayer with a corporation produce tax consequences which depend upon the substance of the transaction rather than mere form. Specifically, § 304 is concerned with sales of stock of a controlled corporation by a shareholder to another corporation which he also controls and the sale of the stock of a parent corporation to its controlled subsidiary.

Before the detailed provisions of § 304 are examined, a more general topic is treated for the purpose of developing background on the reason for creating multiple corporations, and briefly indicating what factors may influence the choice of one form of multiple corporate alignment over another. Since § 304 applies different rules in the case of parent subsidiary corporations as compared with corporations which are not related through intercorporate stockholdings but which are controlled by the same taxpayers, it is relevant to examine the reasons why one form is selected over another.

II.

*Multiple Corporation Alignment—Brother-Sister or Parent  
Subsidiary?*

There are various circumstances which may suggest the utilization of brother-sister corporations<sup>1</sup> as a means of sepa-

---

<sup>1</sup> The Internal Revenue Code does not use the term "brother-sister corporation." In § 304(a)(1), the expression "... related corporation (other than subsidiary)" is used to describe the situation where "one or more persons are in control of each of two corporations." The Committee Reports on the 1954 Code with regard to § 304 do refer to the corporation under common control as "brother-sister corporations," however. See S. Rep. No. 1622, 83rd Cong., 2d Sess.

rating the total business activities of a single individual or group of individuals acting together. These circumstances may arise when an entrepreneur who is in control of an established corporation desires to enter into a new business venture or when the controlling interest of an established corporation desire to divide the corporation into two or more legal entities. Generally, the reasons for separating the investment into two or more corporations are based upon the distinct advantages which arise when two or more legal entities are utilized rather than a mere branch of an existing corporation. For example, the following considerations favor the multiple corporation structure over a branch operation:

(1) A separate corporation is more likely to acquire a "local personality" than a branch of an existing corporation geographically located elsewhere. In addition to the more intangible effects which this situation produces, there are some very tangible immediate benefits, *e.g.*, the foreign corporation is not "present" in the jurisdiction where the newly created corporation is now operating (assuming there is no other substantial relationship between the foreign corporation and the jurisdiction) and hence not subject to regulatory or tax requirements of that jurisdiction.

(2) The two corporations are entitled to their own \$25,000 surtax exemption and \$100,000 accumulated earnings credit under § 11 and § 531 of the Internal Revenue Code.<sup>2</sup>

(3) Hazardous enterprises may be carried on by separate corporations without subjecting the investment in one corporation to the risks of the other.<sup>3</sup>

It will be observed that these examples are illustrative of the type of advantages which accrue to multi-corporate investment regardless of whether the separate legal entities are directly related in a parent-subsidiary pattern or whether they are con-

---

<sup>2</sup> Assuming that the creation and subsequent inter-corporate relationship does not invoke § 269, § 482 or § 1551, which deny the advantages here referred to, under specified circumstances.

<sup>3</sup> This, too, is subject to an exception in extreme circumstances. See *Taylor v. Standard Gas & Electric Company*, 59 Sup. Ct. 543 (1939) ["The Deep Rock Doctrine"].

trolled by the same interests and thus take on a brother-sister relationship.<sup>4</sup> There are tax factors, however, which may make the selection of a brother-sister arrangement the wiser of the two possibilities, however:

(1) If the new enterprise is expected to have a limited life and immediate prospects of earnings, the stockholders will be able to completely liquidate the new corporation under § 331(a)(1) of the Internal Revenue Code at capital gain rates (assuming the corporation is not collapsible within the meaning of § 341). Hence, the brother-sister arrangement would permit recoupment of the assets devoted to the new undertaking with a minimum of tax trouble. On the other hand in order for the beneficial owners (stockholders of the parent corporation) to recapture the assets of a subsidiary which is once-removed from the controlling shareholder by virtue of the intervening parent corporation, it will be necessary to travel the more cumbersome and uncertain route of § 355 division<sup>5</sup> followed by a liquidation of the original subsidiary corporation. This is by far the most cogent reason for considering the brother-sister type of organization when a new investment is contemplated.<sup>6</sup>

(2) If the existing corporation is closely held and its gross income is of the nature described in § 542(a)(1) and thereby is subject to the special tax imposed on "personal holding com-

<sup>4</sup> It should be noted here that brother-sister corporations and parent-sub-sidiary corporations may be subjected to different "tests" in order to determine whether they have achieved the necessary independence to qualify for the three advantages listed in the text, but once that hurdle is cleared, the results are the same. See, for example, the discussion of McCowan, *Brother-Sister Corporations: Some Operational Problems*, 16 N.Y.U. Inst. on Fed. Taxation 305 (1958) to the effect that the power given to the Commissioner under § 482 to allocate income and deductions among taxpayers should have no application as between brother-sister corporations but should apply to parent-sub-sidiary relationships. On the other hand, the test of "ordinary and necessary" under § 61 should be applied to brother-sister intercorporate dealings.

<sup>5</sup> The requirements of § 355 may be bothersome in such a situation, e.g., 355(a)(1)(A)(ii) requiring the parent (distributing) corporation to own at least 80% of the voting stock and 80% of the total number of shares of all other classes of stock; 355(b)(2)(B) requiring the active conduct of a trade or business by the subsidiary (acquired) corporation for the 5 year period ending on the date of distribution.

<sup>6</sup> See Kahn, *Parent-Subsidiary Corporation*, 16 N.Y.U. Inst. on Fed. Taxation (1958) 315, 337 ff; Driscoll, *Incorporating in Multi-Corporate Form, an Existing Business*, *Id.* at 260.

panies," it will be necessary to avoid the parent-subsidary relationship and, thus, the brother-sister situation is indicated.<sup>7</sup>

(3) Under the provisions of Subchapter S of the 1954 Code,<sup>7a</sup> a domestic corporation which does not have more than 10 shareholders (*all of whom must be either individuals or estates*) may be entitled to elect not to be taxed as a corporation. If it is desired to take advantage of this election with regard to the new corporation to be created by the investors, a parent-subsidary arrangement would frustrate their plan.

In addition to the above considerations which are of importance when the new investment opportunity is first recognized, brother and sister corporations are often created as the *result* of the division of a single corporation into two or more corporations. This may be desirable or required for any of the following general business reasons:

(1) A division of an existing corporation may be required to comply with an anti-trust decree.

(2) A state law requiring that a corporation doing a local business be required to have a certain percentage of local stockholders.

(3) To separate a regulated enterprise from an unregulated one.

Assuming that for these or other reasons the stockholders of a single corporation decide to divide their investment into two or more corporations, they may either create subsidiary corporations (which will, no doubt, qualify for non-recognition of gain or loss under § 351) or they may employ a type "D" corporate reorganization under § 368(a)(1) (D) and thus be required to qualify the transaction under § 355. The normal

---

<sup>7</sup> There are special rules applicable, however, when the "personal holding company" parent files a consolidated return with its subsidiary. See § 542(b).

<sup>7a</sup> Int. Rev. Code of 1954, §§ 1371-1377.

operation<sup>8</sup> of a § 355 tax free division will produce brother-sister corporations. In so far as tax planning is concerned, there are generally different factors bearing on the choice of brother-sister versus parent-subsidary corporations when a portion of the assets of a controlled corporation are to be used to supply the capital for the new corporation than when the corporations were to be independently created. This is primarily due to the fact that the division of a single corporation, although legally feasible, will probably require "direct communication" between the two new entities for some period of time. These "communications" may entail inter-corporate transfer of assets, after the corporations have attained a separate legal status, and it is not unlikely that any future expansion of the newly created corporation will require the financial assistance of the original controlled corporation. On its face it would certainly not seem to be an unreasonable hypothesis that when a single corporation is divided into two or more corporations there is more likelihood of an interdependence between the old and the new than would be the case if the two corporations were independently created. It is at this point that the advantages of the parent-subsidary form seem to outweigh the brother-sister possibility most distinctly:

(1) In the case of brother-sister corporations, assets would have to be transferred at "arms length" prices or the stockholders would have to secure the assets from one of the corporations and transfer them, in their individual capacities, to the other entity. Such maneuvers are subject to close administrative and judicial scrutiny, with possible dividend consequences of considerable amounts to the stockholder. Communication between parent and subsidiary is not subject to these same "disguised dividend" risks because the parent may directly contribute to the capital of its subsidiary and, in the other direction, dividends declared by the subsidiary to the

---

<sup>8</sup> It is possible under the 1954 Code to divide an existing corporation into two or more corporations under § 355 without the necessity of a pro-rata distribution of the stock of the controlled corporation to the stockholders of the distributing corporation (§ 355(a)(2)). Thus, a § 355 division will not always result in the creation of brother-sister corporations. The effect of a non-pro-rata distribution as a result of a "split up" or "split-off" was uncertain under § 112(g)(1)(0) of the 1939 Code. See BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (1959) 343.

parent will qualify under § 243 for the 85% dividends received deduction.

(2) Assuming the requirements of §§ 1501, 1504 are met, a parent may enjoy the advantages of consolidating its income with the subsidiary. In the case of substantial anticipated losses in the formative years of the new corporation's existence, this advantage may outweigh all others.<sup>9</sup>

(3) If, for any reason, the two corporations anticipate a return to their old status of a single corporation in the future, a parent-subsidiary relationship will offer the possibility of a liquidation of the subsidiary into the parent, with tax advantages. Under § 381, the parent will inherit most of the favorable tax attributes of the subsidiary.<sup>10</sup>

Other advantages of the parent-subsidiary relationship which are not directly related to the "communication" problem, discussed above, include:

(1) The tax benefits available to employees and, thus, the ability of a corporation to compete for managerial talent may be materially aided by the implementation of a stock option plan under § 421. For purposes of § 421, if a parent-subsidiary relationship exists between two corporations (a 50% ownership test applies), one corporation may grant an option to its employees or the employees of its parent or subsidiary. The option so granted may be in the stock of the granting corporation, its parent, or its subsidiaries. The applicable Code provisions require an "unbroken chain of ownership" between the corporations. Therefore, related corporations would not be entitled to this very desirable flexibility.

(2) For estate planning purposes, § 303 permitting the redemption of stock of a corporation to qualify for exchange

<sup>9</sup> It should be noted here that if the new corporation is formed as the "brother" of a pre-existing corporation, it may still be possible to take advantage of early losses of the new corporation by qualifying the new corporation under Subchapter S, §§ 1371-1377, and by virtue of § 1374, "passing through" the loss to the shareholders. Of course, this plan is beneficial only to the extent that shareholders have income in their individual capacities while a consolidated return will serve to offset profits of the affiliated corporations, directly.

<sup>10</sup> Section 381 is, by its terms, specifically inapplicable to a Kimbell-Diamond liquidation of the subsidiary under § 334(b)(2).

treatment without compliance with the conditions of § 302(b), is often a most important factor. Section 303(b)(2)(B) provides a special rule to the effect that if the decedent owns 75% or more of the stock of two or more corporations, such holdings shall be treated as the stock of a single corporation for purposes of meeting the percentage requirements of § 303(b)(2)(A). This rule places a tax premium on a multiple corporate arrangement in which the decedent concentrates his interests in a single corporation. If he creates related "brother-sister" corporations and he does not own at least 75% of each of these entities, he will have difficulty in meeting the percentage requirements of § 303(b)(2)(A). He may still obtain the advantages of separate corporations by the use of a parent-subsidary group, however, and increase his estates' chances of qualifying for a § 303 redemption.

By way of summary, there would not appear to be a great variety of circumstances which suggest the use of brother-sister corporations when a parent subsidiary alignment is also a possibility. In the great majority of business situations, about the most that can be said is that, given certain conditions, brother-sister corporations may do the job "just as well." One restricted situation does bear emphasis, however, and that is the case of a corporation which is capable of independent existence from the standpoint of immediate capital needs and funds for future expansion and for which the creators contemplate a rather limited life. Here, the use of brother-sister corporations will minimize the inherent tax risks of all multiple corporate plans and permit the liquidation of the corporations with a minimum of complication.

### III.

#### *The Legislative and Judicial History of § 304 of the 1954 Code*

Section 304 of the 1954 Code is a legislative solution to a particular phase of the never-ending quest of stockholders to take down the earnings and profits of their closely-held corporations without the realization of ordinary income and without releasing their interest in the corporation's affairs. Since the Supreme Court decided *Eisner v. Macomber*<sup>11</sup> in 1920, Congress

---

<sup>11</sup> 40 Sup. Ct. 189 (1920).



has recognized that the redemption by a corporation of its own stock could be used for purposes of avoiding ordinary income tax consequences although the substance of the transaction was no different from the receipt of a dividend taxable at ordinary income rates. Therefore, the legislative history of § 304 has its genesis in the rules which were originally developed to combat this practice.

After *Eisner v. Macomber*, Congress moved swiftly to prevent the tax free receipt of a stock dividend and the subsequent redemption of the shares at capital gains rates.<sup>12</sup> By the time the 1939 Code was enacted, it was clear that the declaration of a stock dividend was not an essential step in a plan by stockholders to avoid the results of a §301 distribution. Any redemption of stock by a corporation which was "essentially equivalent to a dividend" was detrimental to the general pattern of the tax law on corporate distributions and, therefore, § 155(g) of the 1939 Code was not restricted to a redemption which was preceded or followed by a tax-free stock dividend. In the early decisions under the 1939 Code the courts readily accepted the realities of "dividend equivalency" when stockholders of a closely held corporation effected a pro-rata redemption of their stock and thus stood in exactly the same position after the redemption in terms of their interests in the corporation.<sup>13</sup> In 1949, however, § 115(g) was held to be limited to the situation where a corporation acquired its *own* stock although, through the use of parent and subsidiary corporations, the acquisition of the stock of the parent by the subsidiary was "essentially equivalent to a dividend." In *Trustees of John Wanamaker v. Commissioner*,<sup>14</sup> stock of the parent corporation (John Wanamaker of Philadelphia) was sold to two wholly owned subsidiaries (John Wanamaker of New York and A. T. Stewart Realty Co.) with the net result that the trustee taxpayers acquired accumulated earnings and profits of the subsidiary corporations without any relinquish-

<sup>12</sup> Revenue Act of 1921, ch. 136, § 201 (d), 42 Stat. 277.

<sup>13</sup> See *Goldstein v. Commissioner*, 113 F.2d 363 (7th Cir. 1940); *Smith v. U. S.*, 34 F. Supp. 947 (D.C. Del. 1941), *aff'd* 121 F.2d 692 (3rd Cir. 1941) (redemption of sole stockholders preferred stock which was previously issued in part as a stock dividend); *E. M. Peet et al*, 43 B.T.A. 852 (1941).

<sup>14</sup> 11 T.C. 365, *aff'd* 178 F.2d 10 (3rd Cir. 1949).

ment of their control over the two subsidiaries. The Commissioner argued that the "dividend equivalency" test was met and that § 115(g) was designed to insure dividend consequences on the facts presented. The taxpayer relied on the Third Circuit's decision in *Mead Corporation v. Commissioner*<sup>15</sup> to support his argument that the language of § 115(g) was specifically limited to a corporation's acquisition of "its" stock and thus to preclude its application of the "dividend equivalency" formula where a subsidiary acquired the stock of its parent. The Tax Court held for the taxpayer and issued the familiar judicial invitation for legislative amendment of the statute if the result was contrary to the general pattern of the taxation of redemption proceeds.

The Congress, again, moved quickly to plug the gap opened by the *Wanamaker* decision and in the Revenue Act of 1950 set out to revise § 115(g) accordingly. The House Ways and Means Committee<sup>16</sup> apparently saw two tax avoidance possibilities as a result of the *Wanamaker* case. Since in *Wanamaker* there was a parent corporation and two subsidiaries, the Ways and Means Committee was concerned not only with what the taxpayer actually did in that case (viz., selling the stock of the parent to one of the subsidiaries), but what might have been achieved had the stock of one of the subsidiaries been sold to the other. The House Committee felt that neither of these plans should escape ordinary income treatment, assuming the net effect was "essentially equivalent to a dividend." Therefore, the House version of the bill was broken down into two parts, one establishing the test of dividend equivalency when the stock of the parent was sold to a subsidiary and the other applying the same test when stock of a corporation was sold to another "related" corporation.<sup>17</sup> For purposes of the second part of the House version of the bill, "related corporations" was defined to include corporations controlled by the same interests other than parent-subsidiary corporations. Significantly, it is believed, the House Committee did not attempt to differentiate between the two situa-

<sup>15</sup> 116 F.2d 187 (3rd Cir. 1940), *rev'g* 38 B.T.A. 687.

<sup>16</sup> See H. Rep. No. 2319, 81st Cong., 2d Sess., 1950-2 C.B. 420, 444.

<sup>17</sup> The text of the Ways and Means Committee proposals may be found in SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS, Vol. I (1954) 1724.

tions when they described what they considered the realities of the transactions to be. In both situations, the House bill provided that for purposes of applying the "dividend equivalency" tests, and, incidentally, the determination of which corporation's earning and profits were to be considered in order to measure dividend consequences, the transactions were to be viewed as if the corporation which initially issued the stock had subsequently redeemed it. In the case of the redemption of the parent's stock by a subsidiary, the House suggested that the "realities" of the transaction required that the redemption be viewed as if the subsidiary had distributed assets to the parent, and the parent had used these assets to acquire its own stock. In the case of other "related" corporations the House viewed the redemption as "if such amount had been distributed by the issuing corporation in redemption of the stock and the stock thereafter had been sold by it to the acquiring corporation." The Senate accepted the House plan in so far as it reached the situation where the taxpayer sold the stock of a parent corporation to its subsidiary, but refused to endorse the other situation which the House bill covered. In rejecting the portion of the House bill dealing with corporations related by common ownership, the Senate in the Committee Reports<sup>18</sup> stated only that it was not clear that redemption by related corporations should involve dividend consequences to the common owner. Although the Committee reports do not state the basis for the Senate Finance Committee's decision, the failure of the House to differentiate between the parent-subsidiary redemption and redemption by related corporations with regard to which corporation earnings and profits were involved for purposes of measuring dividend consequences, was no doubt an important factor. It is difficult to justify imposing dividend consequences on a taxpayer when, for instance, the corporation which purchases stock from the taxpayer has no earnings and profits available for dividends and has no readily available channel to acquire assets from another "related corporation" except through the taxpayer himself or through purchase of assets from the other corporations. This problem of supplying the appropriate "fiction" in order to justify ordinary income treatment when one related corporation acquired the stock of another plus the fact

---

<sup>18</sup> S. Rep. No. 2375, 81st Cong., 2d Sess., 1950-2 C.B. 514, 541.

that the *Wanamaker* case did not pass on the tax consequences of such a redemption, probably explains the Senate's hesitancy to accept the House's version of the bill. In Conference, the House receded in the Senate's version of the bill, and the Congress did not further consider the matter until the 1954 Code was enacted.

In the period of time between the action of Congress on the 1950 Revenue Act and the enactment of the 1954 Code, two developments occurred which supported the Ways and Means Committee's position in regard to the advisability of expanding § 115(g) to include redemptions by related corporations. In 1953, the Tax Court decided that § 115(g) (prior to the 1950 amendment of that section) did not reach redemptions by related corporations<sup>19</sup> and thus served notice on the Congress that any hopes which the Senate Finance Committee might have had in 1950 regarding a possible judicial solution of the problem, independent of statutory specificity, was misplaced. Secondly, the American Law Institute's proposed income tax statute released shortly before the Congress acted on the 1954 Code endorsed the general theory of the House Ways and Means Committee on redemptions by related corporations.<sup>20</sup> The American Law Institute draft statute, however, did not solve the problem which concerned the Senate in 1950—regarding the treatment of earnings and profits of the related corporation and a consistent theoretical justification for imposing ordinary income treatment in such a case. Moreover, the American Law Institute plan was limited to apply to redemptions by related corporations only when *one* stockholder was in control of both the acquiring and issuing corporation.

When the Congress considered the matter of redemption of stock by related corporations in preparation for the 1954 revision, it was decided that the new 1954 Code section should attempt to meet the problem of "brother-sister" redemptions and § 304(a)(1) entitled "Acquisition by related corporations (other than subsidiary)" was the product. A detailed examination of § 304 will be the concern of the final section of this

<sup>19</sup> *Emma Cramer*, 20 T.C. 679 (1953).

<sup>20</sup> Sec. X532, A.L.I. Federal Income Tax Statute, Feb. 1954, Draft, Vol. II, 30-31, 273-274.

paper, but before leaving the legislative history preceding the enactment of § 304 it seems appropriate to discuss the post-1954 interpretations of § 115(g) in order to complete the picture under the 1939 Code.

The Internal Revenue Service issued the first revenue ruling pertaining to "brother-sister" redemptions in 1955.<sup>21</sup> In Ruling 55-15 the Service took the position, contrary to the *Cramer* case, that a sale made by a sole shareholder of all his stock in one corporation to another corporation wholly owned by him in order to eliminate the administrative expense and to simplify the dual operation was devoid of "economic reality" insofar as any relinquishment of the interest in the first corporation was concerned. The Service therefore ruled that payments received from such sale represented cash distributions to the taxpayer taxable as dividends under § 115(a)<sup>22</sup> of the Internal Revenue Code of 1939. It is to be noted that the Service did not rely on § 115(g) in issuing the ruling. The theory implicit in the Commissioner's position was that a sale of stock of one corporation to another could not constitute a "redemption or cancellation" within the meaning of § 115(g) of the 1939 Code regardless of the fact of common control and, therefore, the only issue presented was whether the transaction constituted a "sale" or a corporate "distribution" within the meaning of § 115(a) of the 1939 Code. Further, since the purported "sale" did not alter the status of the shareholder as sole owner of the two corporations, the relinquishment of any paper shares was without substance and should be disregarded in determining tax consequences. The Service did not refer to 1950 amendments which added 115(g)(2) nor to the fact that the Senate Finance Committee had expressly rejected a statutory amendment which would specifically cover the facts presented by the ruling. Since *Cramer* was the only outstanding authority against the Commissioner at the time of the ruling, his decision was apparently based on the hope that the courts would eventually accept the proposition that no specific statutory language was necessary in the brother-sister cases while § 115(g)(2) dealing with parent-subsidiary redemptions, was

<sup>21</sup> Rev. Rul. 55-15, 1955-1 Cum. Bull. 361.

<sup>22</sup> Section 115(a) of the 1939 Code contained the basic definition of a dividend comparable to the function of § 301 and § 316 of the 1954 Code.

necessary due to the *Wanamaker* decision. His position was not to be sustained, however.

In 1957 two cases<sup>23</sup> which originated in the Tax Court were decided against the Commissioner's position in Revenue Ruling 55-15. In both cases the courts took the position that the legislative history of § 115(g)(2) was controlling. In the absence of special statutory treatment as was the case for parent-subsidiary redemptions under 115(g)(2), the Court held that the two different legal entities (although related by common ownership) were to be respected for tax purposes.

In the face of the First Circuit's affirmance in *Westerhaus* and *Pope* and the Tax Court's earlier decision in *Cramer*, the Commissioner conceded the issue in Revenue Ruling 59-97.<sup>24</sup> Of course, the Commissioner was guarded by § 304(a)(1) for cases arising after the enactment of the 1954 Code. Also, in Ruling 59-97 one note of warning was added after *Westerhaus*, *Pope* and *Cramer* were approved:

. . . However, capital gain treatment will continue to be denied in cases where and to the extent that, the stock is sold at a price in excess of its fair market value, and in cases where there exist other factors indicating that the true import of the transaction is the receipt of ordinary income, by way of dividend or otherwise, rather than sale of stock. See, *Gold* T.C. Memo 58-2 and *Tiddon* 22 T.C. 1220 rev. and rem. on other grounds, 230 F.2d 304, *cert. den.*, 352 U.S. 824.

This caution hardly seems necessary since there is nothing in the *Gold* and *Tiddon* cases cited by the Commissioner which suggests that the brother-sister relationship between the corporations involved there controlled the result. That is to say, there simply was not an arm's length sale of stock in these cases, and the principle of a "constructive dividend" has always been available to the Commissioner under such circumstances whether brother-sister corporations are involved or not.<sup>25</sup>

<sup>23</sup> *Westerhaus Co. et al*, T.C. Memo 1957-213 (1957); *Commissioner v. Pope*, 1956-41 (1956), *aff'd* 239 F.2d 881 (1st Cir. 1957).

<sup>24</sup> Rev. Rul. 59-97, 1959-1 Cum. Bull. 684.

<sup>25</sup> Compare the argument of the taxpayer in *U. S. v. Collins*, 193 F. Supp. 602, rev'd —, F.2d — (1st Cir. 1962), 9 A.F.T.R.2d 1113.

A. *The General Scope of § 304 Under the 1954 Code*

Section 304 of the 1954 Code is designed to continue the rules of § 115(g)(2) of the 1939 Code relating to parent-sub-sidiary redemptions and, in addition, to provide new statutory rules for brother-sister redemptions. Section 304 does not state that all redemptions of stock by related corporations will result in dividend treatment to the redeeming shareholder. In order to determine whether dividend consequences will result, it is necessary to refer to the provisions of § 302 which specifically describe those situations in which redemptions are not equivalent to dividends.<sup>26</sup> Also, § 304 is dependent upon § 303 dealing with distributions in redemption of stock to pay death taxes. Therefore, the real function of § 304 is to provide positive statutory authority for the recasting of stockholders' dealings with two or more separate legal entities in order to insure that tax consequences are a matter of substance and not merely form. Once the facts are recast according to the economic realities of the transaction, the rules of § 302 and § 303 should be applied to determine proper tax results.

Section 304(a)(1) provides the 1954 Code rules in the case of brother-sister redemptions. Entitled "Acquisition by related corporation (other than subsidiary)" this subsection defines the required relationship strictly on the basis of common control by one or more persons of each of two corporations. Section 304(a)(1) states, by way of parenthetical reference to the parent-sub-sidiary rules of § 304(a)(2), that in the event of overlap between the provisions of § 304(a)(1) and § 304(a)(2) that the rules of § 304(a)(2) shall govern. Assuming then that the definitional requirements of § 304(a)(1) are met, if one of the corporations under common control acquires stock of the other corporation in return for property from the person (or persons) so in control, such property shall be treated as a distribution in redemption of the stock of the corporation *acquir-*

<sup>26</sup> Section 302(b) specifies the following types of redemptions as qualifying for "exchange" treatment: § 302(b)(1)—redemptions not equivalent to dividends; § 302(b)(2)—substantially disproportionate redemption of stock; § 302(b)(3)—termination of shareholder's interest; § 302(b)(4)—stock issued by railroad corporations in certain reorganizations. Section 302(a) actually is the operative section with respect to the definitions supplied by § 302(b). Section 302(a) declares any redemption described in § 302(b) "shall be treated as a distribution in part or full payment in exchange for the stock."

*ing* such stock.<sup>27</sup> Also, § 304(a)(1) describes the effects which the "redemption treatment" shall have upon the stock in the hands in the acquiring corporation. The statute provides that the stock shall be treated as a contribution to capital of the acquiring corporation.

Section 304(a)(2) treats the case of a parent-subsidary redemption by simply stating that if the issuing corporation controls the acquiring corporation, the acquisition of the parent's stock by the subsidiary from a shareholder of the parent shall be treated as a distribution in redemption of the stock of the *parent* corporation.

Section 304(b) which is applicable to both parent-subsidary and brother-sister redemptions provides that for purposes of testing the transaction under § 302(b) the reference should be to the situation of the *issuing* corporation's stock before and after the redemption. Also, § 304(b) states that in applying § 318(a) (relating to constructive ownership of stock) with respect to § 302(b) for purposes of this subsection, § 318(a)(2)(C) shall be applied without regard to the fifty percent limitation contained therein.

Section 304(c) describes the earning and profits rules which shall be applicable for purposes of determining the extent to which a distribution (resulting from an application of § 302(d) and § 301 by virtue of the operation of § 304 shall constitute a dividend. In the case of a brother-sister redemption, the determination is to be made solely by reference to the earnings and profits of the acquiring corporation. However, in the case of the parent-subsidary redemption the determination shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation. The latter rule is the same rule which prevailed under § 115(g)(2) of the 1939 Code as noted previously.

Section 304(c) defines "control" for purposes of this section. Since the material immediately following will discuss

---

<sup>27</sup> For purposes of applying the tests of § 302(b), however, it is the stockholder's position with respect to the issuing corporation which is controlling. See the text discussion of § 304(b).



these provisions in some detail, the Code provisions will not be paraphrased here.

B. *The Specific Requirements of § 304 and Problem Areas*

1. Control.

Section 304(c) defines "control" consistently in the brother-sister and parent-subsidiary situations. In both § 304(a)(1) and § 304 (a)(2) "control" is defined as the ownership of stock possessing at least fifty percent of the total combined voting power of all classes of stock entitled to vote, or at least fifty percent of the total value of all classes of stock. In the case of the parent-subsidiary relationship, of course, the "control" definition applies to the parent's ownership of the subsidiary's stock while in the brother-sister situation the "control" test must be applied to each of the two corporations under common ownership for purposes of determining the applicability of § 304. It should also be noted that the control definition applies where a person (or persons) is in "control" (per the 50 per cent test just given) of a corporation which in turn controls (applying the same test) another corporation, then the persons controlling the parent are also considered to control the subsidiary.<sup>28</sup> Therefore, it is possible to have § 304 applying to a redemption between corporations collaterally related at the "second generation" level.

Perhaps the most important single feature of the control test is the application of the constructive ownership rules of § 318 without the 50% limitation described in § 318(a)(2)(C). This feature of the statute has been the subject of considerable comment<sup>29</sup> and is primarily responsible for the most serious technical defect in the law. Due to the operation of the attribution rules of § 318 without the fifty percent limitation, a strict application of those rules would result in every brother-sister pair of corporations being subject to the parent-subsidiary

<sup>28</sup> A recent example of the application of this rule may be found in *Radnitz v. U. S.*, 187 F. Supp. 952, *aff'd* 294 F.2d 577 (2nd Cir. 1961).

<sup>29</sup> See for example, the discussions in Lanahan, *Redemptions Through Use of Related Corporations*, 18 N.Y.U. INST. ON FED. TAXATION 741, 744 (1960) and Diamond, "Brother-Sister Corporations"—*Sale of Stock or Other Assets and Other Problems*, 1959 SO. CALIF. TAX INST. 109, 118.

treatment. An example will best describe this strange situation:<sup>30</sup>

Assume that A, B, C and D each own 25% of the outstanding stock of Corporation X and Y. If Corporation Y purchases two shares of Corporation X's stock from A (assuming X and Y each have 100 shares of stock outstanding), § 304(a)(1) has no application to the transaction. This is because applying the attribution rules of § 318 (disregarding the 50% limitation of § 318(a)(2)(C)) A owns 25% of the stock of X Corporation directly, and since Corporation Y is deemed to own the shares of X held by B, C and D, A constructively owns 25% of the shares of X which Corporation Y is deemed to own. Therefore since A only owns a total of approximately 44% of Corporation X's stock (25% directly plus 25% of 75% or 19% constructively) he is not in "control" of Corporation X within the meaning of § 304(a)(1). But, applying the same constructive ownership rules, it is also a correct application of the statute to attribute all the stock of Corporation X's shareholders to Corporation X. Therefore, Corporation X is in control of 100% of the stock of Corporation Y before A transfers his two shares of Corporation X to Corporation Y. Now, since Corporation Y is controlled by Corporation X, a parent-subsidiary relationship exists between X and Y and § 304(a)(2) would seem to be applicable.

The effect of the latter interpretation would be to eliminate the brother-sister rules entirely—certainly a result completely at odds with Congress's purpose in enacting § 304. It is interesting to note that it will be to Commissioner's advantage in practically all cases if the parent-subsidiary rules are applied rather than the brother-sister rules. Since a parent-subsidiary redemption will result in dividend income when *either* the parent or subsidiary has earnings and profits under § 304(b)(2)(B), while in brother-sister cases under § 304(b)(2)(A) only the earnings and profits of the acquiring corporation are taken into consideration, a parent-subsidiary redemption is more likely to create dividend income rather than return of capital.

Aside from the peculiar results which are described above, there is a highly unrealistic flavor to the attribution rules of § 318 when the 50% limitation is ignored. Assume individual

<sup>30</sup> This example is suggested by Lanahan, *id.* at 753.

A owns one share American Telephone and Telegraph and also is in control of a closely held family corporation. By virtue of § 318 minus the 50% limitation, American Telephone and Telegraph is constructively in control of A's family corporation.

One further result of the § 318 rules bears attention. In the brother-sister redemption situation it would seem to be impossible for a common shareholder to achieve a complete termination of his interest in the issuing corporation within the meaning of § 302(b)(3) unless he completely divested himself of his shares in both the acquiring as well as the issuing corporation.<sup>31</sup> Since he would be the constructive owner of shares held by the acquiring corporation to the extent of his proportional interest in the acquiring corporation, he would not seem to meet the requirements of § 302(b)(3) even if he disposed of all his shares in the issuing corporation to the acquiring corporation. On the other hand, there seems to be no logical reason why a shareholder who is subject to the rules of § 304(a)(1) only because a member of his family owns a controlling interest in another corporation (assuming no other relationship exists between the two corporations) could not sell the shares of his own controlled corporation to the other corporation controlled by a relative and rely on the "waiver of family attribution rules" of § 302(c)(2). If so, a § 302(b)(3) "complete termination" would seem to be possible in this rather limited situation.<sup>32</sup> In 1959, the Subchapter C Advisory Group recommended to the Congress that the control definition in § 304(c) be amended by substituting a 5% limitation in lieu of the 50% limitation now in § 318(a)(2)(C). The Advisory Group does not clearly state in its report submitted to Congress the reasons for the suggested change. However, it is clear that the recommendation basically endorses the approach of the 1954 Code with the 5% limitation added merely to eliminate the *de minimis* cases. In this regard, the Advisory Group also recommended an amendment to the basic attribution section itself, § 318, and a 5% rule was recommended in lieu

<sup>31</sup> In case of a parent-subsidiary redemption, a § 302(b)(3) would be possible. See Regs. 1.304-3(b), Example.

<sup>32</sup> Section 304, by its terms, is not restricted to 302(b) considerations alone. Both sections 304(a)(1) and 304(a)(2) are introduced by the phrase "For purposes of sections 302 and 303 . . .". There is, therefore, no apparent reason why § 302(c)(2) should not apply.

of the present 50% rule in that section, as well.<sup>33</sup> The explanation which is offered for the basic § 318 proposed amendment would seem equally applicable to the § 304 recommendation:

It is recommended, however, that a 5 percent limitation be inserted in all cases. This will eliminate *de minimis* computations so that persons having small interests in corporations, partnerships, trusts, and estates can ignore the attribution computations.<sup>34</sup>

The Advisory Group also recommended a definite statement in § 304 to eliminate the possibility, discussed above, that all brother-sister corporations might be regarded as parent-subsidiary groups by virtue of the attribution rules.<sup>35</sup> Since the Advisory Group did not recommend a fundamental departure from the present rules of attribution, such a statement would be necessary to eliminate the problem.

## 2. Earnings and Profits.

In the case of parent-subsidiary redemptions, if either the issuing parent or the acquiring subsidiary has accumulated current earnings and profits, the effect of the fictional distribution by the acquiring subsidiary to the issuing parent followed by a "deemed" redemption by the parent of its own stock, will produce a dividend to the shareholder. In the case of brother-sister redemptions, the accumulated and current earnings and profits of the issuing corporation are disregarded. The Subchapter C Advisory Group has taken the position that this situation opens the door to tax avoidance in the case of brother-sister redemptions. The Advisory Group illustrates the point by the use of the following example:

---

<sup>33</sup> Hearings Before the Committee on Ways and Means, House of Representatives, on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, 86th Cong., 1st Sess., at 491 (1959).

<sup>34</sup> *Id.* at 504.

<sup>35</sup> The Advisory Group suggests the following sentence in their proposed section: "In the case of a transaction which subsection (a)(1) of this section applies and to which subsection (a)(2) also applies by reason of the application of section 318(a), the determination of whether the distribution shall be treated as in part or full payment in exchange for the stock redeemed shall be made only under the rules of subsection (a)(1)." *Id.* at 577, 578.

Assume, for example, that individual A owning all the stock of the X Corporation creates the Y Corporation. Y corporation then borrows money from outside sources to purchase all the stock of the X Corporation from individual A. If the X Corporation is then liquidated into the Y Corporation and its assets used to pay off the loan, such a transaction may be generally described as a reorganization accompanied by a distribution of boot. However, if the X Corporation is not liquidated but merely pays out dividends to the Y Corporation to satisfy the loan payments, the transaction would appear to be beyond the scope of the literal language of § 304.<sup>36</sup>

Under the proposed amendment of the Advisory Group, the determination of the amount which is a dividend would be made as if the property were distributed by the issuing corporation to the acquiring corporation and immediately thereafter distributed by the acquiring corporation.<sup>37</sup> The result of the proposal would be to insure dividend consequences if earnings and profits were present in either the acquiring or the issuing corporations in brother-sister cases.

It has been suggested that the distinction drawn in the 1954 Code between the "fictional" distribution in parent and subsidiary redemptions and the absence of such a fictional approach in brother-sister redemptions is due to the fact that only in the parent-subsidiary case could such a hypothetical intercorporate distribution occur, because only in that case are there intercorporate stockholdings.<sup>38</sup> It will be recalled that this is the same theoretical argument which probably influenced the Senate Finance Committee when it rejected provisions in the House version of the 1950 Revenue Act covering brother-sister redemptions.

### 3. Basis Considerations

Section 304(a)(1) and the regulations thereunder prescribe<sup>39</sup> in some detail the basis adjustments which must be

<sup>36</sup> *Id.* at 491.

<sup>37</sup> *Ibid.*

<sup>38</sup> BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (1959) 236.

<sup>39</sup> Regs. 1.304-2(a).

made as a result of a brother-sister redemption. These rules may be summarized as follows:

(a) The transferee (acquiring) corporation shall treat the stock acquired as a contribution to its capital. Therefore the rules of § 362(a)<sup>40</sup> apply in order to determine the basis of the stock in the hands of the transferor. This rule applies whether the distribution by the corporation results in dividend consequences to the shareholder under § 302(d) or whether § 302(a) applies.

(b) The transferor shareholder, on the other hand, must make different basis adjustments to his stock in the transferee (acquiring) corporation depending upon whether the distribution by the transferee (acquiring) corporation falls under § 302(d) (with dividend consequences to the shareholder) or § 302(a).

(1) If § 302(d) applies to the surrender of stock by the shareholder, his basis for his stock in the acquiring corporation shall not be reduced except according to the rules of § 301. Therefore, to the extent the acquiring corporation has accumulated earnings and profits the shareholder will realize dividend income to the extent of the cash or fair market value of the property received<sup>41</sup> and there will be no basis adjustment necessary under § 301. If the acquiring corporation does not have earnings and profits available for dividends, the result will be a pro-rata reduction in the basis of the stock of the acquiring corporation retained by the shareholder as required by § 301(a).

(2) If § 302(d) does not apply, the property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under § 302(a), which

---

<sup>40</sup> Section 362 provides that if property is acquired by a corporation as a contribution to capital "then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer."

<sup>41</sup> Assuming in the case of the property distribution that the distributee is an individual. If the distributee is a corporation, § 301(b)(1)(B) applies which provides that the "amount" of a distribution to such a distributee is the property's fair market value (determined as of the time of distribution) or its adjusted basis in the hands of the distributing corporation, whichever is the lesser.

stock has a basis equal to the amount by which the stockholder's basis for his stock in the acquiring corporation was increased on account of the contribution to capital. Accordingly, the basis of the shareholder's stock in the acquiring corporation shall now be reduced by the amount which is deemed to be received in exchange for the "contribution to capital".

Of course, the net effect of the above upward and downward adjustments is to leave the basis of the stock of the acquiring corporation in the hands of the shareholder unchanged and achieve the same result as if the stock of the issuing corporation were considered to be "sold" to the acquiring corporation in an ordinary sale transaction. The reason for these verbal gymnastics is that the Congressional language in the last sentence of § 304(a)(1) *requires* that the transfer of stock be treated as a "contribution to capital" of the acquiring corporation without differentiating between transfers subject to 302(a) or 302(d). The Commissioner, therefore, is required to give effect to the language of the statute even though the "contribution to capital" theory simply does not fit the situation when § 302(a) applies. When the Commissioner first issued his regulation under § 304, he took the position that there was no distinction between a § 302(a) and § 302(d) distribution for basis purposes.<sup>42</sup> However, in a 1958 ruling<sup>43</sup> when the facts presented demonstrated the illogical result which obtains when a distribution subject to § 302(a) does not result in a "cost" basis to the shareholder as would be the case in an ordinary sale, the Commissioner retreated from his original position taken in the regulations. Accordingly, the regulations were amended<sup>44</sup> and the method of an upward basis adjustment of the shareholders' stock in the acquiring corporation (to comply with statutory mandate that the "contribution to capital" rules shall apply) followed by an equal downward adjustment (to achieve ordinary "sale" results) was utilized. This is certainly a fascinating example of administrative ingenuity designed to "cover up" for a legislative oversight.

---

<sup>42</sup> Regs. 1.304-2(c) Ex. 2, T.D. 6152 (1955) (amended by T.D. 6533, 1961).

<sup>43</sup> Rev. Rul. 58-79, 1958-1 Cum. Bull. 177.

<sup>44</sup> Regs. 1.304-2(a) and 1.304-2(c) Ex. 2, T.D. 6533 (1961).

The Advisory Group on Subchapter C recommended in its 1959 report that the statute itself be amended to state clearly the rules which the Commissioner is presently applying by virtue of the amended regulations.<sup>45</sup> As the Advisory Group points out, the amendment of the law is desirable because for purposes of other sections of the Code, it may be of considerable importance to the acquiring corporation whether the basis of the stock acquired is "cost" or "determined by reference to the basis in the transferor's hands."

The problem of the basis of the properties exchange in the brother-sister redemption situation discussed above is not present in the parent-subsidiary case. The statute does not specify rules in the parent-subsidiary case and, therefore, the basis rules will follow the distinction between a § 302(a) and a § 302 (d) redemption. Hence, if a § 302(a) exchange is made by a stockholder of the parent and the subsidiary, the basis of the parent's stock in the hands of the subsidiary and the basis of any property received by the shareholder of the parent will be determined under § 1012 (cost). Conversely, if a § 302(d) distribution is involved, the entire amount of the distribution by the subsidiary will be treated as dividend income (assuming sufficient earnings and profits in the parent or subsidiary) and the stockholder of the parent will increase the basis of his retained stock in the parent by his basis for the stock of the parent which he has relinquished in the exchange. To complete the picture, the basis of the parent's stock in the hands of the subsidiary should be a carryover basis from the stockholder who transferred the stock.<sup>46</sup>

#### 4. Judicial decisions interpreting § 304

Unfortunately, the cases which have arisen under the 1954 Code to this point have not presented any important questions under § 304. Two cases dealing with brother-sister redemptions are noteworthy, however, primarily because the taxpayer's argument completely misinterprets the function of § 304 and the courts have reached the correct result by reasoning in accord with the purpose of the statute.

---

<sup>45</sup> Hearing Before the Committee on Ways and Means, *op. cit. supra* note 33, at 491, 492.

<sup>46</sup> See Regs. 1.304-3 (b), Example.



The taxpayer's principal argument in the cases of *Radnitz v. U. S.*<sup>47</sup> and *U. S. v. Collins*<sup>48</sup> may be summarized by the following extract from the First Circuit's opinion in the *Collins* case, where the First Circuit refers to the decision below in the District Court:<sup>49</sup>

In its enumeration of the countervailing considerations to dividend equivalence the district court, after noting the initial necessity of a corporation having earnings or profits available for distribution before Section 302 would be applicable, stated: 'but it is also essential that these earnings or profits should have been distributed, and thus that there should have been an actual reduction of the corporation surplus.' In concluding that the transaction had produced no reduction in surplus so far as the Collins Company [the acquiring corporation] was concerned, the court stated: 'The corporation received stock of Perman [the issuing corporation] which was actually worth the \$15,000 paid for it. It paid out \$15,000 in cash but received assets worth at least \$15,000. Conversely the individual shareholders received the cash but parted with property of equal value. Hence there was no real distribution to them of any of the earned surplus of the corporation and hence no dividend.'

The First Circuit quite properly disposed of this argument by pointing out that the court's emphasis below on the *quid pro quo* of the transaction was entirely misplaced. The economic consequences to the taxpayer are no different, the First Circuit said, than if the acquiring corporation had distributed property to him without requiring the surrender of stock, except for the fact (usually devoid of practical consequences) that the acquiring corporation now holds the stock of the issuing corporation. Perhaps the most surprising thing about these two cases is that the District Court in *Collins* accepted the taxpayer's argument!

### C. *An Appraisal of § 304*

Although § 304, on its face, appears to be one of the least complex provisions in Subchapter C, this simplicity is mis-

<sup>47</sup> *Op. cit. supra*, note 38.

<sup>48</sup> *Op. cit. supra*, note 25.

<sup>49</sup> *Id.* at 9 A.F.T.R. 2d 1119.

leading. It is not at all clear that the Congress, the Revenue Service, tax practitioners in general nor the Subchapter C Advisory Group have developed a satisfactory theoretical basis for dividend consequences in brother-sister redemption cases. Ever since the Senate Finance Committee took the position in 1950 that it was not clear that brother-sister redemptions were the equivalent of dividends, there seems to have been a cautious approach to the mechanics of the statute. It is submitted that this cautious attitude is the result of the absence of any consistent, clear-out theory on what are "the economic realities" of brother-sister redemptions. The fact that the statute as drafted in 1954 contained at least two technical flaws, since brought to light, indicates that § 304 was not the most carefully thought out provision in the 1954 Code. It is not conceivable that Congress intended the statute to be susceptible of a construction which would convert every brother-sister redemption case into a parent-subsidiary redemption case and yet, as previously discussed, the statute may be so construed. Also, with regard to the basis for the stock of the issuing corporation in the hands of the acquiring corporation, the drafters of § 304 in requiring the stock to be treated as a "contribution to capital" neglected the possibility that §302(a) and not § 302 (d) might be applicable.

The Subchapter C Advisory Group recommends the amendment of the statute in certain respects including a recommendation that dividend consequences are to be determined in the case of brother-sister redemptions, by reference to a fictional distribution from the issuing corporation to the acquiring corporation and an assumed distribution by the acquiring corporation to the shareholder. The avowed purpose of this recommendation is to eliminate one possible method of avoiding the present provisions of § 304<sup>50</sup> and is justified according to the Advisory Group for the purposes of general application, because "the acquiring corporation will become a substantial stockholder of the issuing corporation—if not its actual parent corporation." On the other hand, the Advisory Group recommends that a positive statement be placed in § 304 which will serve to preserve the brother-sister relationship from possible conversion into parent-subsidiary corpora-

<sup>50</sup> See the example given by the Advisory Group in its report to illustrate this tax avoidance possibility, *supra*.

tion by virtue of the application of the constructive ownership rules of § 318. Why is it so necessary to insure that the constructive ownership rules do not destroy the separate treatment of brother-sister redemption and parent-subsidiary redemptions when the most important distinction between the treatment of the two situations is to be obliterated?<sup>51</sup> Moreover, if the application of the constructive ownership rules of § 318(a) do result in every brother-sister pattern being converted into parent and subsidiary *without* the special statement recommended by the Advisory Group, does a statement negating the normal operation of those rules really meet the heart of the problem? If the economic justification for treating the redemption of stock of the issuing corporation by the acquiring corporation where both corporations are under common control is to prevent the legal distinction of two separate corporate entities from controlling tax consequences, it is submitted that the controlling theory should be that the two corporations are one and the same. This means that the Advisory Group approach in recommending no essential difference between the earnings and profits rules in the brother-sister and parent-subsidiary cases is consistent with the basic justification for the statute. Since the parent-subsidiary rules of § 304(a)(2) are based upon exactly the same justification, it is not dangerous nor even surprising that the constructive ownership rules of § 318(a) might convert brother-sister corporations into parent and subsidiary. In other words, why take pains to identify two types of redemptions by related corporations when, in fact, the results of the two sets of rules are exactly the same? If one single definition of "related corporations" could be devised which would embrace both types of "controlled corporations" now treated separately in §§ 304(a)(1) and 304(a)(2), the statute would be simplified and the definition of "control", the proper earnings and profits considerations and the basis provisions, could be stated in short order. The result should be conducive to the development of rules which are consistent with the basic theory underlying redemptions by related corporations—the theory that the existence of two or more corporations "as legal entities should be disregarded for tax purposes in the case of redemptions by related corporations."

<sup>51</sup> The distinction referred to in the text are the varying rules for determining earnings and profits for dividend purposes under § 304(a)(1) and § 304(a)(2), discussed previously.