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## Federal Income Tax—Section 302(b)(3) Applies to Series of Corporate Redemptions Even Though Redemption Plan Is Not Contractually Binding. *Bleily & Collishaw, Inc. v. Commissioner*, 72 T.C. 751 (1979)

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The Court concluded that Pershing Redevelopment Corporation and its parent corporation<sup>50</sup> were private entities despite the grant of eminent domain; thus, their acquisitions of real property were exempt from URA.<sup>51</sup> Because the developer acted as a private entity, the City's receipt of federal funds was insufficient to invoke URA benefits.<sup>52</sup>

*Young* limits the available theories under which URA benefits might otherwise apply. *Young* permits some municipal participation, with federal financial assistance, in a redevelopment program without corresponding URA coverage.<sup>53</sup> The extent of municipal participation needed to invoke URA benefits remains undefined, although the minimum level of involvement must be significant.<sup>54</sup>

*Young's* balancing test, which weighs the grant of eminent domain against the private nature of the development,<sup>55</sup> is a new judicial tool in URA analysis. The Eighth Circuit, however, failed to articulate clearly the factors involved in the test. The Eighth Circuit should forcefully address these issues when it next examines the Act. Additionally, the court in *Young* allowed frustration of the congressional policy behind URA. Had these plaintiffs been displaced directly by the government, they would have been entitled to URA benefits. By delegating the traditional public function of eminent domain, the city thus can gain the benefits of urban redevelopment, but avoid the compensatory costs of URA.

TAXATION—FEDERAL INCOME TAX—SECTION 302(b)(3) APPLIES TO SERIES OF CORPORATE REDEMPTIONS EVEN THOUGH REDEMPTION PLAN IS NOT CONTRACTUALLY BINDING. *Bleily & Collishaw, Inc. v. Commissioner*, 72 T.C. 751 (1979). Petitioner, a California corporation, owned 225 shares of Maxdon Construction, Inc. (Maxdon), thirty percent of Maxdon's outstanding stock. In order to obtain sole control and

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50. See note 5 *supra* and accompanying text.

51. 599 F.2d at 878.

52. *Id.* See note 12 *supra* and accompanying text.

53. See notes 40-41 *supra* and accompanying text.

54. The City of St. Louis was extensively involved in the present case, but the court found this participation insufficient to make the project a joint undertaking. *Id.*

55. See notes 48-49 *supra* and accompanying text.

ownership of the corporation, Maxdon's president, who held the remaining 525 shares, negotiated a purchase by Maxdon of all petitioner's shares at a fixed price per share. Because the corporation lacked sufficient cash to purchase all the shares at one time, petitioner initially transferred only a portion of the shares. Both petitioner and Maxdon intended to complete the redemption of the remaining shares. Neither, however, was under any contractual or legal obligation to complete the intended transfers. During the following six months,<sup>1</sup> Maxdon completed the purchase of the remaining stock, terminating petitioner's interest in the corporation.

Petitioner reported the proceeds of the 1973 transfers as dividends on its 1973 corporate income tax return, availing itself of the eighty-five percent deduction allowed by I.R.C. § 243(a)(1)<sup>2</sup> for dividends received by a corporation.<sup>3</sup> Respondent assessed a deficiency of \$6,573 in petitioner's income tax for 1973, asserting that the redemptions constituted distributions in exchange for stock and so were taxable as capital gains. The Tax Court affirmed respondent's determination and *held*: A series of redemptions executed pursuant to a fixed plan to terminate a shareholder's interest constitute the component parts of a single sale or exchange of the entire stock interest, even though the plan does not contractually bind either the corporation or the shareholder.<sup>4</sup>

In general, a distribution of money, securities, or other property<sup>5</sup> by a corporation to a shareholder (in his capacity as shareholder<sup>6</sup>) is

1. The following six months fell within calendar years 1973 and 1974.

2. All statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years at issue.

3. *See* note 15 *infra* (discussion of certain tax advantages to corporation of treating proceeds from redemption of stock as dividends). In the instant case, it is undisputed that Maxdon has sufficient earnings and profits to treat each redemption as a dividend under I.R.C. § 316. *Bleily & Collishaw, Inc. v. Commissioner*, 72 T.C. 751, 754 & n.3 (1979).

4. 72 T.C. at 756-57.

5. I.R.C. § 317(a) ("property" is defined as money, securities and any other property, but not as stock of corporation making distribution).

6. *Treas. Reg.* § 1.301-1(c) (1960) provides that "Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such." I.R.C. §§ 301(a) and 301(c) provide that in general the amount of any distribution by a corporation to a shareholder which is treated as a dividend (within the meaning of § 316(a)) shall be included in the shareholder's gross income.

treated as a dividend.<sup>7</sup> The amount of the distribution is therefore includible in the gross income of the shareholder,<sup>8</sup> and is taxable at the rates applicable to ordinary income.<sup>9</sup> Redemption,<sup>10</sup> however, may be treated under certain circumstances as a distribution in part or full or a payment in exchange for the stock.<sup>11</sup> Section 302(b)(3), in particular, provides that "if the redemption is in complete redemption of all the stock of the corporation owned by the shareholder,"<sup>12</sup> it is an exchange. As a result of this classification, the distribution is taxed as a capital gain rather than as ordinary income.<sup>13</sup> Because of the applicability of lower rates to capital gains as compared to ordinary income,<sup>14</sup> the shareholder's tax liability will normally be substantially reduced if the redemption qualifies under section 302(b)(3).<sup>15</sup>

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7. I.R.C. §§ 301(a), (c) (requiring inclusion in shareholder's gross income of any amount received as dividend).

Section 316(a) defines dividend in relation to a corporation's current and accumulated earnings and profits.

8. *Id.* §§ 301(a), (c). See note 5 *supra*.

9. I.R.C. § 1 (individual income tax rates); *id.* § 11 (corporate income tax rates).

10. *Id.* § 317(b) provides: "(b) Redemption of Stock—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock."

11. *Id.* § 302(a) provides: "(a) General Rule—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3) or (4) of [section 302(b)] applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock." If § 302(a) is inapplicable, the distribution is taxed under the provisions of § 301. *Id.* § 302(d); see note 5 *supra*.

12. I.R.C. § 302(b)(3). The other circumstances in which a redemption of stock shall be treated as an exchange occur if (1) the redemption is not essentially equivalent to a dividend, *id.* § 302(b)(1); or (2) the redemption is "substantially disproportionate" with respect to the shareholder, *id.* § 302(b)(2) (a redemption is substantially disproportionate only if immediately after the redemption the shareholder owns less than 50% of the voting power of all classes of voting stock, *id.* § 302(b)(2)(B), and shareholder's proportionate ownership of voting stock outstanding after the redemption is less than 80% of shareholder's proportionate ownership of voting stock outstanding before the redemption, *id.* § 302(b)(2)(C)); or (3) the redemption is of certain specifically defined railroad corporation stock, *id.* § 302(b)(4).

13. See generally *id.* §§ 1201, 1202, 1221-1223 (selected capital gains provisions).

14. See notes 9, 12 *supra*.

15. The tax on a § 301 "dividend" distribution, however, may be lower than the capital gain tax on an exchange if (1) the shareholder is itself a corporation (as *Bleily*), thereby entitled to the 85% dividends received deduction of I.R.C. § 243(a)(1), see, e.g., *Pacific Vegetable Oil Corp. v. Commissioner*, 251 F.2d 682 (9th Cir. 1957) (taxpayer successfully argued that distribution from corporation was not sale resulting in long term capital gain but rather was essentially equivalent to dividend under § 115(g) of 1939 Code, predecessor of § 302(b)(1)); or (2) the redeeming corporation has no earnings and profits, in which case the distribution will be taxable only insofar as it exceeds the taxpayer's basis in all shares held prior to redemption, I.R.C. §§ 301(c)(2), (3). B.

Courts have granted taxpayers favorable 302(b)(3) treatment in cases in which the termination of the shareholder's interest in the corporation occurred through a series of redemptions rather than merely through a single exchange. In these instances, however, section 302(b)(3) treatment is predicated upon a finding that the redemptions were executed pursuant to a "firm and fixed" plan in which the various transactions had been integrated in order to effect a complete termination of the shareholder's ownership interest in the corporation.<sup>16</sup> The plan need

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BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ch. 9, ¶ 9.20 & n.1 (3d ed. 1971). Should the redemption be treated as a sale or exchange, gain apparently must be recognized only to the extent that the distribution exceeds the basis of the shares redeemed. *See generally id.*

16. *Lisle v. Commissioner*, 35 T.C.M. (CCH) 627 (1976). In *Lisle* the corporation agreed to repurchase all of shareholders' stock in installments over a period not to exceed twenty years. The court held such an agreement effectuated a complete termination of the shareholders' interest for the purpose of § 302(b)(3), notwithstanding that the corporation was obligated to repurchase shares only when doing so would not reduce its earned surplus below that required by state corporate law, and that as security for the corporate obligation the shareholder retained legal title to the unredeemed shares as well as the right to vote all such shares. *See also Estate of Mathis v. Commissioner*, 47 T.C. 248 (1966) (accrued but undeclared dividends on preferred stock, payable in installments in accordance with a binding purchase agreement in which corporation agreed to redeem all of shareholder's preferred stock, taxable as capital gain). Similarly, several cases have held that in instances in which there was a firm, fixed, integrated plan intended to effect a substantially disproportionate redemption of the shareholder's interest, a series of redemptions might be treated as a single exchange for purposes of § 302(b)(2); or in cases in which there was such a plan intended to effect a complete termination of a shareholder's interest, a series of redemptions might be treated as not essentially equivalent to a dividend, under § 302(b)(1) or § 115(g) of the Internal Revenue Code of 1939 (the statutory predecessor of § 302(b)(1) of the Internal Revenue Code of 1954). *See, e.g., Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964) (two distributions in redemption of portion of shareholder's preferred stock held not essentially equivalent to dividend under § 302(b)(1) because taxpayer's aggregate ownership interest in corporation was reduced by five percent), *rev'g* 41 T.C. 62 (1963); *Estate of Lukens v. Commissioner*, 246 F.2d 403 (3rd Cir. 1957) (capital gain treatment allowed on redemption of stock, if redemption greatly reduced taxpayer's proportionate interest in the corporation, because redemption was part of an integrated plan to terminate taxpayer's interest as shareholder, begun two years earlier via gift of some stock to his children, and completed two years later through gift of remaining stock to the children; distributions deemed not essentially equivalent to dividend under § 115(g) of Internal Revenue Code of 1939), *rev'g* 26 T.C. 900 (1956); *Rickey v. United States*, 427 F. Supp. 484 (W.D. La. 1976) (capital gain treatment allowed shareholder on redemption of stock by corporation under § 302(b)(2), in situations in which redemption and documented intention to transfer additional stock to various individuals and charitable organizations were parts of an integrated plan to reduce shareholder's stock ownership from 72% to less than 50%, since aggregate divestiture would make redemption substantially disproportionate as to the shareholder); *McDonald v. Commissioner*, 52 T.C. 82 (1969) (court granted taxpayer capital gain treatment under § 302(b)(1), holding that distribution with respect to complete redemption of taxpayer's preferred stock, followed by reorganization in which taxpayer exchanged common stock in same corporation for stock of different corporation, was not essentially equivalent to dividend since taxpayer's interest in initial

not, as the Tax Court in *Niedermeyer v. Commissioner*<sup>17</sup> stated, be written, communicated to others, or absolutely binding, but these factors do tend to show the existence of the requisite plan.<sup>18</sup>

Inability to demonstrate that a "firm and fixed" plan exists prior to the initiation of any of the challenged distributions generally results in the courts' refusal to treat the redemptions as a single exchange.<sup>19</sup> Thus, the Tax Court in *Lisle v. Commissioner*<sup>20</sup> noted that "a gentleman's agreement lacking written embodiment, communication, and contractual obligations generally will not suffice"<sup>21</sup> to establish the existence of a firm and fixed plan. Merely planning for future redemptions of all of a shareholder's stock also may be considered insufficient to demonstrate the existence of the requisite plan. Thus, the Tax Court in *Himmel v. Commissioner*<sup>22</sup> found that even though a prior arrangement existed, no firm and fixed plan existed. In *Himmel* only a small portion of the shareholder's stock had been redeemed; future redemptions were not obligatory, merely permissible, and dependent upon the corporate directors' and other shareholders' desires to proceed with the redemptions.<sup>23</sup>

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corporation was completely terminated pursuant to written, binding plan which was fixed as to its terms).

17. 62 T.C. 280 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976).

18. *Id.* at 292.

19. See *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974) (distribution in redemption of portion of shareholder's stock held to be taxable as dividend; testimony by taxpayer that at time of redemption he intended to donate all remaining shares to charity, even when supported by fact that such donation was actually made later in same taxable year, was insufficient to establish existence of firm and fixed plan for complete termination of shareholder's interest because alleged plan was not in writing and because petitioner's asserted donative intent apparently had not been communicated to anyone at time of redemption), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976); *Leleux v. Commissioner*, 54 T.C. 408 (1970) (distributions in redemption of stock held to be taxable as dividends; § 302(b)(3) not applicable upon finding that "petitioner . . . failed to prove the existence of such a plan. . . . [T]he record points to a contrary conclusion and the alleged plan appears to us to be afterthought rather than prearrangement." *Id.* at 418).

20. 35 T.C.M. (CCH) 627 (1976).

21. *Id.* at 635.

22. 41 T.C. 62 (1963), *rev'd on other grounds*, 338 F.2d 815 (2d Cir. 1964).

23. *Id.* (two distributions held taxable as dividends even though prearranged plan existed for possible future redemptions, because conditional nature of plan and wide shareholder discretion indicated that there was in fact no firm and fixed plan to eliminate shareholder from the corporation); *accord*, *Benjamin v. Commissioner*, 592 F.2d 1259 (5th Cir. 1979) ("absence of any time framework, coupled with the wide discretion in determining when the redemption was possible,

In *Bleily & Collishaw, Inc. v. Commissioner*<sup>24</sup> the Tax Court viewed the existence of a firm and fixed plan as a factual question requiring the court to focus on the substance of the transaction.<sup>25</sup> Applying this principle, the court found the requisite plan in the efforts of Maxdon's president to eliminate petitioner's ownership interest in Maxdon. The court stressed that the initiative for the redemption came from him, as the president and only other shareholder. Furthermore, the court considered the parties' agreement to redeem all of the shares at a definite purchase price and their expectations that the entire series of redemptions be completed within a few months<sup>26</sup> as indicative of a firm and fixed plan.

These factors, in the court's opinion clearly demonstrated well-defined intentions and expectations on the part of both parties. Thus, the court concluded that the ensuing redemptions were indeed component parts of an integrated plan. Citing with approval the dictum of *Niedermeyer v. Commissioner*<sup>27</sup> that a plan need not be absolutely binding in order to be firm and fixed,<sup>28</sup> the court affirmatively decided that the absence of a contractual or legal obligation to consummate the intended redemptions did not preclude a finding of a "firm and fixed" plan to terminate through a series of redemptions.<sup>29</sup>

The Tax Court in *Bleily & Collishaw, Inc.* correctly determined the existence of a firm, fixed plan for effecting the redemption of peti-

vested in the taxpayers as directors," *id.* at 1261, led to the conclusion that no firm or fixed plan actually existed), *aff'g* 66 T.C. 1084 (1976).

24. 72 T.C. 751 (1979).

25. *Id.* at 756.

26. *Id.* at 757. The significance of the fulfillment or non-fulfillment of the alleged plan prior to the time of court review is unclear, though review of the parties' actions subsequent to initiation of the purported plan has not been uncommon. Compare *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976), and *Himmel v. Commissioner*, 41 T.C. 62 (1963) (apparent failure to make any additional redemptions, after two partial redemptions consummated, was one factor supporting finding that no fixed or firm plan to terminate shareholder's entire interest in corporation actually existed), with *Lisle v. Commissioner*, 35 T.C.M. (CCH) 627 (1976) (plan to eliminate shareholders' entire interest in corporation via installment sale with 20-year payout period found to constitute firm and fixed plan when distributions made conformed to plan terms, even though at time of review much of plan was not yet fulfilled). See also *Leleux v. Commissioner*, 54 T.C. 408, 419 & n.5 (1970) (resting its decision upon other grounds, the court expressly refrained from comment upon potential application of § 302(b)(3) when shareholder had not completely terminated his interest in corporation even at time of trial).

27. 62 T.C. 280, *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976).

28. 62 T.C. at 292.

29. 72 T.C. at 756-57.

tioner's entire stock holdings. The court was similarly correct in holding that the absence of a binding obligation to complete the redemption need not prevent the finding of a firm and fixed plan, especially in cases in which the final termination of the taxpayer's interest has been completed exactly as originally contemplated.

*Bleily & Collishaw, Inc.*'s primary significance lies in its illumination of the planning pitfalls that each taxpayer may encounter in an attempt to use redemption to completely terminate an interest. The impact on those relatively few taxpayers who would benefit from having redemptive distributions taxed as dividends is clear: the mere absence of a contractually binding obligation to complete a plan of serial redemptions will not necessarily insulate the redemptions from capital gain treatment under section 302(a). Thus, additional planning is required to ensure that anticipated distributions will be taxed as dividends rather than as capital gains.

For the majority of taxpayers who seek the advantages of capital gain treatment afforded by the safe harbor provisions of section 302(b),<sup>30</sup> the significance of the case is less obvious. The decision does provide clear, direct authority for the proposition that section 302(b)(3) may be properly applied to a series of corporate redemptions, even though the redemption plan is not contractually binding, provided the firm and fixed nature of the plan is otherwise established. On the other hand, *Bleily & Collishaw, Inc.* did not overrule any previous case but merely extended prior decisions.<sup>31</sup> Thus, it is likely that redemption plans that are not contractually binding will continue to be successfully challenged in the courts by the Commissioner, and if the Commissioner prevails will result in distributions being taxed as dividends rather than as capital gains. Consequently, prudent planning for redemptions, in anticipation of insuring favorable treatment under the provisions of section 302, mandates continued use of firm and fixed plans of redemption. These plans should include binding agreements, unless non-tax factors preclude the use of a binding obligation in the particular factual situation.

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30. See note 16 and accompanying text.

31. *Id.*