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Branko J. Marusic, Jr.*

The Prohibited Interest of I.R.C. Section 302(c)(2)(A) After *Seda* and *Lynch*

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I. INTRODUCTION

When a shareholder in a family held corporation[1] decides to retire, he generally desires to obtain capital gain treatment on the exchange of his stock,[2] similar to that which a shareholder in a publicly held

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1. A family held corporation refers to a corporation in which members of a family hold exclusive stock ownership of the corporation.
2. Throughout this Article, the author assumes that the corporation has not annually distributed its yearly profits to its shareholders. The shareholder attempting the redemption desires to obtain capital gains treatment on his redemption to the extent his share of corporate earnings and profit exceeds his stock basis. There exist instances, though, in which a shareholder might desire a redemption to be

corporation would receive under similar circumstances. Unlike the publicly held corporation shareholder, the shareholder in a family owned corporation would like also to maintain exclusive corporate ownership within his family. Accordingly, the shareholder cannot sell his stock to an outsider. In addition, other family members may not have sufficient funds to purchase his interest. The family shareholder solves his dilemma by effecting a corporate redemption of his stock. A qualifying redemption[3] provides the shareholder both capital gains treatment and the continuance of exclusive, family corporate ownership.

In order to receive capital gains treatment for his redemption, the shareholder must terminate his interest in the corporation.[4] Internal Revenue Code section 302(c)(2)(A)[5] prohibits the shareholder from retaining any interest in the corporation, including holding the position of an officer, director, or employee, but excluding an interest as a creditor.[6] The confusion surrounding the interpretation of this prohibited interest has historically plagued corporate shareholders.

This Article describes the differing interpretations of the prohibited interest of section 302(c)(2)(A). It analyzes the legislative history of section 302,[7] which requires a rigorous and mechanical reading of the section. The Internal Revenue Service's view, which is generally consistent with the congressional intent behind section 302, will be compared with the Tax Court's position. Until recently, the court has held that a prohibited interest is proved by a showing of a retained financial or managerial interest.[8] The court's current position, set forth in *Seda v. Commissioner*[9] and *Lynch v. Commissioner*,[10] reflects a stricter reading of section 302(c)(2)(A). The Article concludes with a criticism of the Tax Court's most recent interpretation of a prohibited interest, which, although an advance in the direction evinced by Con-

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characterized as a § 301 dividend. A corporate shareholder, for example, might desire a redemption distribution to be treated as a dividend in order for the corporation to avail itself of the corporate 85% dividend exclusion.

3. A qualifying redemption must meet the requirements of § 302. *See infra* notes 12-29 and accompanying text (discussing the mechanics of a § 302 redemption).

4. The family shareholder must terminate his stock ownership pursuant to § 302(b)(3) and abstain from the retention of other prohibited corporate interests as described in § 302(c)(2)(A). *See infra* notes 12-29 and accompanying text (describing the interaction of these two sections).

5. All references hereinafter to "section" are to the Internal Revenue Code of 1954, as amended.

6. I.R.C. § 302(c)(2)(A)(i). *See infra* notes 12-29 and accompanying text (analyzing the mechanics of the section).

7. *See infra* notes 30-51 and accompanying text.

8. *See infra* notes 52-218 and accompanying text.

9. 82 T.C. 484 (1984).

10. 83 T.C. 597 (1984).

gress, nevertheless falls short of the statute's intended meaning.[11]

II. THE MECHANICS OF SECTION 302(c)(2)(A)

Section 302(a)[12] treats a corporate redemption[13] of a shareholder's stock as an exchange subject to capital gains treatment,[14] provided the redemption meets the requirements of section 302(b).[15] A redemption not qualifying as an exchange receives ordinary dividend treatment.[16] Accordingly, a redemption treated as an exchange results in tax treatment similar to that of a sale of stock to a third party.

The third-party sale analogy ends when a corporation redeems a shareholder's interest in a family owned corporation. The ex-shareholder, for example, might maintain a direct or indirect beneficial interest in the corporate business through the stockholdings of his relatives.[17] If so, the redemption of his shares reduces only the form of his interest in the corporation. To prevent a redemption coupled with a continuing interest from receiving capital gains treatment, the Code provides that a redeeming shareholder constructively owns, at the moment of the redemption, the remaining corporate stock held by certain members of his family.[18] Thus, absent the Section

11. *See infra* notes 164-218 and accompanying text.
12. I.R.C. § 302(a).
13. Section 317(b) defines a redemption of stock as the acquiring by the corporation of "its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." I.R.C. § 317(b).
14. Section 302(a) treats a qualifying redemption as an exchange of stock. The Code treats an exchange of stock as the sale or exchange of a capital asset. I.R.C. §§ 1221, 1222.
15. I.R.C. § 302(a). The specified requirements include: (1) redemptions not essentially equivalent to dividends; (2) substantially disproportionate redemption of stock; (3) termination of a shareholder's interest; and (4) redemption from noncorporate shareholders in partial liquidation. I.R.C. § 302(b).
16. I.R.C. § 302(d).
17. The redeeming shareholder in a family owned corporation argues for capital gain treatment similar to that which he would have received had he sold his interest to a third-party. A stock redemption, however, prevents the outside interference that would have resulted had the shareholder sold his stock outside of his family. Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 33 (1956).
18. I.R.C. § 302(c)(1). The Code provides that the attribution rules of § 318(a) shall apply. *Id.* Section 318 generally states that an individual constructively owns the stock held by certain members of his family, by partnerships and estates or trusts of which he is a partner or beneficiary, and in the amount of his proportionate ownership, and by corporations of which he is at least a 50% shareholder. I.R.C. § 318(a). The members of the individual's family, whose stock the individual is deemed to constructively own, include his spouse (unless legally separated or divorced), children, grandchildren, and parents. Stock held by the individual's siblings or grandparents is not attributed to him by § 318(a). The attribution rules of § 318, which provide an objective means of determining stock ownership, rely on the rationale that related individuals and entities will act in concert and for the

302(c)(2)(A) provisions, a redeeming shareholder in a family owned corporation would never obtain a recognized reduction of his corporate interest under the requirements of section 302(b).[19]

Section 302(c)(2)(A) provides a shareholder effecting a redemption relief from the family attribution rules. A shareholder terminating his stock interest in the corporation pursuant to section 302(b)(3)[20]

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benefit of each other. Benjamin v. Commissioner, 66 T.C. 1084, 1107 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979). The attribution rules prevent taxpayers from gaining from redemptions that transfer legal title to their stock but do not affect the true control or benefit that they exercise and enjoy through the remaining related shareholders. For example, a sole shareholder could transfer some shares to his daughter, redeem his remaining interest, and remain in control of the corporation as president by exercising influence over his daughter. In substance, no beneficial interests in the corporation have changed. Yet, without the family attribution rules, the father would obtain capital gain treatment for the full termination of his stock holdings under § 302(b)(3). Section 318(a)(1)(A) states that the father constructively owns the stock of his daughter which results in his owning 100% of the corporation's stock after the redemption. Consequently, his percentage of corporation ownership remains the same and his redemption does not receive capital gains treatment.

Although § 318(a) provides an objective test for determining stock ownership at the time of the redemption, the courts have recognized that under certain circumstances, hostile family relationships will mitigate or prevent family stock attribution under § 318(a)(1). Robin Haft Trust v. Commissioner, 510 F.2d 43, 46-48 (1st Cir. 1975). The service will not follow the *Haft* hostility exception. Rev. Rul. 80-26, 1980-1 C.B. 66. Furthermore, the Tax Court will recognize the *Haft* family hostility exception when it reviews only § 302(b)(1) "essentially equivalent to a dividend" redemptions. *See* Metzger Trust v. Commissioner, 76 T.C. 42 (1981); *see also* Niedemeyer v. Commissioner, 62 T.C. 280 (1975) (bad blood between relatives does not affect § 318(a)(1) attribution), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976). For a "legal"-family hostility twist, *see* Blount v. Commissioner, 51 T.C. 1023, *aff'd*, 425 F.2d 921 (2d Cir. 1969), which provides an analysis of the application of § 318(a)(1) rules to an installment redemption when husband and wife shareholders are married during the initial but not during the latter installments.

Trusts, estates, partnerships, and corporations may not waive attribution between their beneficiaries, partners, or shareholders. These entities may, however, generally waive the family attribution of stock to their beneficiaries to prevent a second attribution of the family owned stock to the entity. § 302(c)(2)(C).

19. *See infra* notes 30-51 and accompanying text.

20. A § 302(b)(3) redemption requires a complete termination of the shareholder's corporate stock interest. The courts have stated that § 302(b)(3) requires that a shareholder divest himself of all his equitable holdings in the corporation. Commissioner v. Brown, 380 U.S. 563 (1965); Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968). *See also* Rev. Rul. 76-524, 1976-2 C.B. 94 (stating that a stockholder may remain an officer or a director after a redemption if he has no actual or constructive stock ownership afterwards). Accordingly, the requirements of § 302(b)(3) require a complete stock holding divesture and no "de minimis" exceptions to the rule are permitted. Niedemeyer v. Commissioner, 62 T.C. 280, 290 (1975).

An equitable or proprietary interest could also include corporate indebtedness to the ex-shareholder. Thus, corporate obligations to ex-shareholders, including

and complying with section 302(c)(2)(A) will not constructively own, for purposes of the redemption, the remaining corporate stock held by his family.[21] Section 302(c)(2)(A) requires that "immediately after the distribution the distributee [have] no interest in the corporation (including an interest as officer, director, or employee), other than an interest as creditor."[22] In addition, the section requires that "the distributee . . . not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution,"[23] and that the distributee file an agreement with the Service stating that he will not obtain any such interest.[24]

The Code denies the above relief from the family attribution rules to a distributee (shareholder effecting the redemption) who acquires his redeemed stock from a related person[25] within ten years preceding the redemption and for the principal purpose of tax avoidance.[26] In addition, if a related party to the distributee holds stock at the date of redemption which he acquired from the distributee within ten years preceding the redemption, the relief is likewise denied.[27] Neither of the above reinstatements of the family attribution rules will apply when the acquisition (or disposition) of the stock by the distributee does not have as one of its principal purposes the avoidance of tax.[28] The "as one of its principal purposes" statutory language implies that a transaction may contain more than one principal purpose, therefore, "principal purpose" does not connote a predominant purpose. Generally, acquisitions or dispositions of stock for business purposes are not considered principally tax avoidance purposes.[29]

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indebtedness resulting from a redemption payment, must run the gamut of § 385 debt-versus-equity scrutiny. For an in-depth analysis of the debt versus equity problem in § 302(b)(3) redemptions, see Comment, *Complete Stock Redemption in a Family Corporation: A Warning About the Pitfalls of Two Standards*, 23 VILL. L. REV. 100 (1978). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 4.01-4.22, at 4-2 to 4-58 (4th ed. 1979).

21. I.R.C. § 302(c)(2)(A). Note that the section blocks only the *family* attribution rules of § 318(a)(1). *See supra* note 18 and accompanying text.
22. I.R.C. § 302(c)(2)(A)(i).
23. I.R.C. § 302(c)(2)(A)(ii). An ex-shareholder who utilizes § 302(b)(3) does not acquire a prohibited interest when a § 318(a) related party acquires stock in the corporation within 10 years of redemption. Rev. Rul. 71-562, 1971-2 C.B. 173.
24. I.R.C. § 302(c)(2)(A)(iii).
25. "Related person" refers to a § 318(a)(1) family member.
26. I.R.C. § 302(c)(2)(B)(i).
27. I.R.C. § 302(c)(2)(B)(ii).
28. I.R.C. § 302(c)(2)(B).
29. In Rev. Rul. 56-584, 1956-2 C.B. 179, the controlling shareholder of a family-owned corporation gave a small interest in the corporation to his son. The father hoped that the gift would increase the son's desire to participate in the corporation. Several years after the gift, the son left the corporation and redeemed all of his shares pursuant to §§ 302(b)(3) and 302(c)(2)(A).

The ruling holds that the redemption qualifies as an exchange under § 302(a)

III. LEGISLATIVE HISTORY

Prior to the 1954 Code, the law of corporate stock redemptions was marked by uncertainty.[30] Section 115(g) of the 1939 Code stated that a redemption "essentially equivalent to a dividend" would not receive capital gains treatment.[31] The related regulations utilized a "facts and circumstances" approach to determine if the redemption fell within the essentially equivalent standard.[32] Although the regulations provided little insight into this standard,[33] they were clear on the point that a corporate redemption of all the stock of a particular shareholder, resulting in the cessation of any interest in corporate affairs, would not result in a distribution essentially equivalent to a dividend.[34] Notwithstanding this full termination of stock interest test,

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because the gift to promote an interest in the corporation suffices as a bona fide business purpose and there was no plan in existence at the time of the gift to effect a redemption of the stock. The gift of stock, therefore, did not have tax avoidance as one of its principal purposes. *Id.* at 180. *See also* H.R. REP. NO. 1337, 83d Cong., 2d Sess. A76 (1954), *reprinted in* 1 B. REAMS, JR., INTERNAL REVENUE ACTS OF THE UNITED STATES: THE REVENUE ACT OF 1954 WITH LEGIS. HISTORIES AND CONG. DOCUMENTS A76 (1982) [hereinafter cited as REAMS] (providing that a taxpayer will meet the terms of § 302(c)(3)(C) when his transaction has both a bona fide business purpose and the absence of a principal purpose of tax avoidance).

30. In 1954, the Senate Committee on Finance described the ambiguities surrounding redemptions. "Under present law it is not clear when a stock redemption results in capital gain or ordinary income. Some courts have held a distribution disproportionate to the shareholders' ownership of common stock in the corporation results in capital gains treatment, but no definite test has developed." S. REP. NO. 1622, 83d Cong., 2d Sess. 44 (1954), *reprinted in* 2 REAMS, *supra* note 29, at 44. *See also* B. BITTKER & J. EUSTICE, *supra* note 20, ¶ 9.02, at 9-4 to 9-7; Murphy, *Dividend Equivalency—The End of the Beginning?*, 10 TAX L. REV. 213, 213-14 (1955).
31. Section 115(c) of the 1939 Code treats amounts distributed in partial liquidation as payments in exchange for stock of the distributing corporation. Amounts distributed in partial liquidation included distributions in cancellation or redemption by a corporation of part of its stock. I.R.C. § 115(c) (1939). Section 115(g) modified the application of § 115(c). "If a corporation cancels or redeems its stock . . . at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed . . . shall be treated as a taxable dividend." I.R.C. § 115(g) (1939). *See* Bittker, *supra* note 17, at 14-15 (describing the chronological development of the statutory language "essentially equivalent to a dividend").
32. The regulations provided, in relevant part: "The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case." Reg. 118, § 39.115(g)-1(A)(2) (1940).
33. The regulations did state that a partial corporate redemption of stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend. *Id.*
34. *Id.* Section 302(b)(3) currently reflects the "old" regulations language of a redemption of all the shareholder's stock in the corporation. The courts interpreted regulation language requiring the shareholder to cease his interest in the

shareholders attempting redemptions generally faced planning nightmares.[35]

In drafting the 1954 Code, the House Ways and Means Committee recognized the existent ambiguities in the corporate redemption area.[36] The Committee's initial proposal to revamp the redemption area discarded the "essentially equivalent to a dividend" test and the facts and circumstances inquiry that accompanied it.[37] In its place, the Committee attempted to introduce specific conditions that would enable taxpayers to enter "safe harbors" when structuring redemptions.[38]

Section 302(b)(3) of the House bill codified the full termination of a shareholder's stock interest test as one of its specific redemption conditions.[39] Under section 302(a)(3), the Committee made it clear that a

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corporation affairs as a termination of a shareholder's equity interest. *See, e.g.*, Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). *See also* Rose, *The Prohibited Interest of Section 302(c)(2)(A)*, 36 TAX L. REV. 131, 134 n.18 (1981) (Rose suggests that the "ceases to be interested" language may have been the Service's safeguard against nominal transfers of stock in form only. The safeguard permitted the Service to attribute other family members' stock to the ex-shareholder.). *But see* Bittker, *supra* note 17, at 36 n.81 (suggesting that the language was to prevent the redemption of shares through payments made exclusively from future corporate profits).

35. "Existing law with respect to corporate distributions, liquidations, and intercorporation transactions is so uncertain that it has seriously impeded transactions which are desirable both for the companies involved and for the economy." 100 CONG. REC. 3425 (1954) (statement of Rep. Reed), *reprinted in* 2 REAMS, *supra* note 29, at 3425. *See also* Bittker, *supra* note 17, at 16 ("[T]here proved to be no escape from the inquiry into all the facts and circumstances of each case, and predictions were hazardous . . . ."). In addition, the taxpayer had the burden of proving that his redemption was not essentially equivalent to a dividend. *Id.* at 15.

36. The Committee expressed concern about the "uncertainty of existing law" regarding the tax treatment of shareholders in corporate redemptions. H.R. REP. NO. 1337, *supra* note 29, at A70, *reprinted in* 1 REAMS *supra* note 29, at A70.

37.
> The approach adopted in Section 115 (g) of existing law, whereby the consequences resulting from the redemption of stock may be taxed depending upon the factual circumstances surrounding the redemption have been changed by your committee. In lieu of a factual inquiry in every case, it is intended to prescribe specific conditions from which the taxpayer may ascertain whether a given redemption will be taxable at rates applicable to the sale of assets or as a distribution of property not in redemptions of stock subject to Section 301.

Id. at A72-A73, *reprinted in* 1 REAMS, *supra* note 29, at A72-A73.

38. "Under [Sections 302(b)](3), (4), and (5), the test of factual equivalence to a dividend distribution is eliminated and definitive standards are enumerated." *Id.* at A73. "The bill [H.R. 8300] contains a complete technical overhaul of the [1939 Code section 115(g)] provisions which is designed to promote certainty and to permit legitimate and desirable transactions . . . ." 100 CONG. REC., *supra* note 35, at 3425, *reprinted in* 2 REAMS, *supra* note 29, at 3425.

39. H.R. 8300, 83d Cong., 2d Sess. § 302(b)(3), *reprinted in* 11 REAMS, *supra* note 30, at 86.

redemption of all of the stock held by a shareholder would qualify for capital gains treatment. The Committee eliminated the previous factual equivalence test[40] and opted for an objective stock ownership attribution rule that prevents a shareholder from claiming complete termination of her stock interest when related parties hold the remaining corporate stock.[41] Thus, unless the stockholder properly waived her family-stock attribution, she would not receive capital gains treatment on her redemption.[42]

The section 302(c)(2)(A) waiver of family attribution rules, applicable solely upon a complete termination of a stockholder's interest, was an additional attempt to provide clarity in the redemption area.[43] Prior to 1954, it was unclear whether and when the attribution of remaining family-held stock should apply to a family corporation redemption.[44] Proposed section 302(c)(3)(A) permitted a waiver of the family attribution rules if, immediately after the redemption, the ex-shareholder retained no interest in the corporation, including any interest as an officer, director, or employee, but excepting an interest as a creditor.[45] The Committee claimed that this section provided a definitive answer to the problem of administering the existing uncer-

40. H.R. REP. NO. 1337, *supra* note 29, at A73, *reprinted in* 1 REAMS, *supra* note 29, at A73.

41. H.R. 8300, *supra* note 39, § 302(c)(1), *reprinted in* 11 REAMS, *supra* note 29, at 86-87.

42. *Id.* The structure of §§ 302(c)(1) and 318(a) prevent the evasion of ordinary dividend treatment. *Id.* at 36; S. REP. NO. 1622, *supra* note 30, at 45, *reprinted in* 2 REAMS, *supra* note 29, at 45.

43. *See* Rose, *supra* note 34, at 136-38.

44. Prior to the 1954 Code, there were no statutory provisions mandating the constructive ownership of stock for distributions in redemption. H.R. REP. NO. 1337, *supra* note 29, at A96, *reprinted in* 1 REAMS, *supra* note 29, at A96. Consequently, the administration of I.R.C. § 115(g) (1939) became "clouded with uncertainty by reason of executive application of rules of attribution of ownership." *Id.* Notwithstanding the lack of statutory authority, both the Service and the courts at times regarded the relationships between a shareholder whose stock was redeemed and the remaining shareholders as significant. B. BITTKER & J. EUSTICE, *supra* note 20, at 9-11 n.18. *See* Rose, *supra* note 34, at 135-36 (analyzing the government's attempts prior to the 1954 Code to assert constructive stock attribution upon redemptions).

45. H.R. 8300, *supra* note 39, § 302(c)(2)(A), *reprinted in* 11 REAMS, *supra* note 29, at 87. The legislative history of § 302(c)(2)(A) fails to mention a rationale for the statutory "creditor interest" exception. Without this exception corporations would need to fund the entire shareholder redemption price as well as additional existing indebtedness to the shareholder at the time of the redemption. Accordingly, the financial strain put upon a corporation to fund this potentially large amount at one time would render a majority of redemptions impractical. In addition, many states outlaw such vast depletions of corporation assets. *See, e.g.*, MODEL BUSINESS CORP. ACT § 6 (1974) (redemption distributions may not exceed unreserved and unrestricted earned surplus). *See generally* Rose, *supra* note 34, at 159-60; Comment, *supra* note 20, at 104-05.

tainties under section 115(g) of the 1939 Code.[46] It follows, then, that the final version of section 302(c)(2)(A) reflected the Committee's general desire to introduce certainty and an easily administered standard to the redemption area.

The Senate agreed that certainty was needed in the redemption area but believed the House provisions were too restrictive.[47] Rather than completely revise the pre-1954 redemption law, the Senate opted for the "essentially equivalent to a dividend" standard as an alternative test that would qualify a redemption for capital gains treatment.[48] Thus, in some instances, taxpayers could assert that they had effected a redemption based upon the facts and circumstances surrounding their particular situation.[49] This factual inquiry, however, began and

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46. H.R. REP. NO. 1337, *supra* note 29, at A75, *reprinted in* 1 REAMS, *supra* note 29, at A75. The technical explanation of H.R. 8300 provides an example of a prohibited interest under § 302(c)(2)(A). In the example, a husband and wife each own 50% of a corporation's stock. The husband fully redeems his shares pursuant to § 302(b)(3). The example states that if the husband became an officer of the corporation nine years after receiving the redemption proceeds, he is deemed to have acquired a prohibited interest. H.R. REP. NO. 137, *supra* note 29, at A75-A76, *reprinted in* 1 REAMS, *supra* note 29, at A75-A76.

47. The Senate Committee on Finance stated: "Under present law it is not clear when a stock redemption results in capital gain or ordinary income. . . . While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive . . . ." S. REP. NO. 1622, *supra* note 30, at 44, *reprinted in* 2 REAMS, *supra* note 29, at 44.

48. The Senate Finance Committee stated:

> Your committee has substantially recast the provisions of the House bill dealing with the tax treatment of corporate distributions and adjustments . . . . It shares the belief that this part of the statute must be rewritten in order to provide a degree of certainty which is lacking in existing law. However, such certainty is not to be achieved at the expense of the legislative flexibility necessary to provide a statutory pattern which will tax, in an equitable manner, the myriad business transactions with which this area of law is concerned. The House bill . . . would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws.
>
> The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible. It has, however, not hesitated to depart from the present statute where such departure was necessary . . . .

Id. at 41-42, *reprinted in* 2 REAMS, *supra* note 29, at 41-42. The standard is codified in § 302(b)(1), which states that a redemption not essentially equivalent to a dividend will receive capital gains treatment.

49. The Senate Committee on Finance submitted that redemptions of preferred stock, which might be called by the corporation without a minority shareholder having any control over date of redemption, would constitute a distribution not essentially equivalent to a dividend to such shareholder. S. REP. NO. 1622, *supra* note 30, at 44, *reprinted in* 2 REAMS, *supra* note 29, at 44.

ended with section 302(b)(1)[50] since the Senate did not intend to promote a factual inquiry test for the definitive standards established under sections 302(b)(3) and 302(c)(2)(A) of the House bill.[51]

IV. JUDICIAL AND ADMINISTRATIVE INTERPRETATIONS

Both the Tax Court and the Service agree that a shareholder must completely sever any equitable interest in the corporation under section 302(b)(3),[52] but disagree as to what constitutes a section

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50. The Senate Committee on Finance said:

> Unlike the House bill, however, Section 302 does not provide specific statutory guides governing the tax consequences of every stock redemption. In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, *except where it is specifically provided otherwise*, upon a factual inquiry. . . .
>
> . . . .
>
> . . . In general, under this subsection your committee intends to incorporate into the bill existing law as to whether or not a reduction is essentially equivalent to a dividend under Section 115(g)(1) of the 1939 Code, *and in addition to provide three definite standards in order to provide certainty in specific instances.*

Id. at 233, *reprinted in* 2 REAMS, *supra* note 29, at 233 (emphasis added). Thus, the definitive standards intended by the House bill were agreed to and retained by the Senate.

51. *See supra* note 50. In addition, the Senate retained the House provision in § 302(c)(2)(A) requiring the ex-shareholder to refrain from acquiring or retaining a prohibited interest after this redemption in order to qualify for a waiver of the family attribution rules. The Finance Committee said:

> A distribution in complete redemption of a shareholder's stock will also result in capital gain. However, in order to prevent tax avoidance, *your committee follows the rules of the House bill* whereby, under specific circumstances, a shareholder may be considered as owning stock held by members of his family (or by partnerships, corporations, or estates, trusts in which he has an interest). If a shareholder desires to sever completely his interest in a corporation which he and his family controls [sic], the rules of family ownership are waived, *as under the House bill*, if the shareholder does not reacquire, other than by bequest or inheritance, an interest (other than an interest as a creditor), for a period of 10 years thereafter.

Id. at 45, *reprinted in* 2 REAMS, *supra* note 29, at 45 (emphasis added). Thus, the Senate version of § 302(c)(2)(A) both agreed with and incorporated the House's desire to provide an easily ascertainable standard for shareholders to waive family attribution.

52. *See, e.g.*, Rev. Rul. 56-521, 1956-2 C.B. 174 (stating that shareholder's redemption of only one of his two classes of stock in the corporation would not qualify under § 302(b)(3)); Commissioner v. Brown, 380 U.S. 563 (1965) (discussing generally the termination of interest problems of section 302(b)(3)). For a general discussion of § 302(b)(3), see B. BITTKER & J. EUSTICE, *supra* note 20, ¶ 9.23, at 9-22 to 9-24; Gardner & Randall, *Distributions in Redemption of Stock: Changing Definitions for a Termination of Interest*, 8 J. CORP. TAX'N 240, 241-44 (1981).

302(c)(2)(A) prohibited interest.[53]

The Service generally adheres to a strict interpretation of section 302(c)(2)(A), maintaining that a shareholder will have a post-redemption prohibited interest if he retains or acquires[54] a voting interest,[55] interest as an officer,[56] interest in the corporation assets,[57] or provides services to the corporation.[58] Notwithstanding this narrow reading of section 302(c)(2)(A), the Service occasionally measures the extent of the retained interest, and if it is relatively less than that of a creditor's, the service will not consider it a prohibited interest.[59]

Prior to 1984, the Tax Court had required a showing of a financial or managerial interest as a prerequisite to a finding of a prohibited interest.[60] In *Seda* and *Lynch*, however, the court established a narrower test that represents a more literal interpretation of section 302(c)(2)(A).[61]

A. Prohibited Voting Interest

Section 302(c)(2)(A) prohibits the retention of any interest in the corporation, including, as stated in its parenthetical language, an interest as officer, director or employee.[62] If a shareholder retains the power to vote any remaining stock following a section 302(b)(3) redemption, he retains an interest in the corporation.[63] This change in stock ownership is considered a change in form only and is precisely the type of interest retention that section 302(c)(2) prohibits.[64] Accordingly, in Revenue Ruling 71-426,[65] the Service stated that a shareholder's retention of his position as trustee of a voting trust for his children constituted a section 302(c)(2)(A) prohibited interest.[66]

53. *See supra* notes 12-29 and accompanying text (discussing the mechanics of the prohibited interest).
54. A shareholder cannot retain or obtain a prohibited interest within 10 years after the redemption. I.R.C. § 302(c)(2)(A).
55. *See* Rev. Rul. 71-426, 1971-2 C.B. 173.
56. *See* Rev. Rul. 75-2, 1975-1 C.B. 99.
57. *See* Rev. Rul. 56-556, 1956-2 C.B. 177.
58. *See* Rev. Rul. 70-104, 1970-1 C.B. 66.
59. *See* Rev. Rul. 77-467, 1977-2 C.B. 92.
60. Chertkof v. Commissioner, 72 T.C. 113 (1979), *aff'd*, 649 F.2d 264 (4th Cir. 1981); Estate of Lennard v. Commissioner, 61 T.C. 554 (1974) (*nonacq.*).
61. *See infra* notes 188-218 and accompanying text.
62. I.R.C. § 302(c)(2)(A)(i).
63. Although § 302(c)(2)(A) does not expressly prohibit a power to vote, the power to control the corporation's affairs falls easily within the prohibited interest term. Rose, *supra* note 34, at 158.
64. *See* Bittker, *supra* note 17, at 34 (§ 302(c)(2)(B) frustrates redemptions that are in form only and that do not terminate the stockholder's control over his family's stock interests).
65. 1971-2 C.B. 173.
66. Nor can an ex-shareholder serve within 10 years of his redemption as custodian of

The Service will permit, however, an ex-shareholder to acquire the power to vote the stock if it is acquired through bequest or inheritance. In Revenue Ruling 79-334,[67] the Service ruled that an ex-shareholder's appointment, through a will, as trustee of a voting trust did not constitute the acquiring of a prohibited interest. A similar appointment as an executor, which entails the power to vote the estate's stock, also did not violate section 302(c)(2)(A).[68] In both instances, the Service characterized the devised voting power as an "interest acquired by bequest or inheritance," a permissible interest under section 302(c)(2)(A).[69]

This analogy accurately reflects the congressional intent embodied in section 302(c)(2)(A). If a testator desires to leave outright the stock to an ex-shareholder, the ex-shareholder will not suffer adverse tax consequences under section 302(c)(2)(A).[70] The ex-shareholder's temporary voting power as executor permits the satisfaction of the testator's wishes without sacrificing a disruption of the corporate business.[71] A prohibition of this temporary voting power would likely force a testator to devise the stock either to minors not capable of running the corporation or to individuals outside the family unit.[72] Thus,

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stock given, pursuant to the Uniform Gifts to Minors Act, to his child by the remaining shareholders. Rev. Rul. 81-233, 1981-2 C.B. 83.

67. 1979-2 C.B. 127.

68. In Rev. Rul. 72-380, 1972-2 C.B. 201, two brothers who had previously effected § 302(b)(3) redemptions were appointed by their father's will as his estate executors within 10 years following their redemptions. Their positions as executors gave them the power to vote the stock of their deceased father, who had been the sole shareholder. The Service ruled that the brothers' voting power acquired as executors did not constitute a prohibited interest.

69. The receipt of a direct interest in stock through bequest or inheritance is permitted by § 302(c)(2)(A)(ii). By analogy, the receipt through bequest or inheritance of an executor or trustee position that may vote the stock is similar. Rev. Rul. 72-380, 1972-2 C.B. 201; Rev. Rul. 79-334, 1979-2 C.B. 127. *Cf.* Rev. Rul. 75-2, 1975-1 C.B. 99, (discussed *infra* notes 73-75 and accompanying text).

70. Section 302(c)(2)(A)(ii) would not prohibit an interest acquired within 10 years from the date of the redemption by bequest or inheritance.

71. While the estate is probated, the corporation's business continues. A temporary abstention of the right to vote stock during the probate proceedings could result in a lack of timely and necessary business decisions. The right to vote the stock during this period should be granted to another family member.

72. The testator will usually devise the stock into trust with its distribution withheld until the beneficiaries come of age. The trustee who has the power to vote the stock is usually the children's parent. If no other family members existed, the testator would be forced to appoint a trustee for the minors' stock from outside the family group. An outsider with a power to vote the corporation stock would disrupt the exclusive family control.

The rationale of Rev. Rul. 71-426 provides an interesting hypothetical. Suppose Father and Son *A* each own 50% of the corporation. Son *B* exchanged his stock in a corporate redemption less than 10 years ago. Father dies and leaves his stock in trust to the children of Son *B*. Father's will appoints Son *B* as trustee. Revenue Ruling 71-426 apparently would permit this arrangement. Son *A*, how-

the temporary voting power permitted by the Service is analogous to the "bequest or inheritance" exception to acquiring a prohibited interest.

The analogy fails, however, when the ex-shareholder abuses this temporary power. In Revenue Ruling 75-2,[73] two brothers, who had previously effected section 302(b)(3) redemptions, were appointed executors of their father's estate. In that capacity they had the power to vote the stock of their deceased father, who himself had been the corporation's sole shareholder. The brothers exercised their voting power and elected one of them as president of the corporation. The ruling states that the brother elected president had acquired a prohibited interest.[74]

Revenue Ruling 75-2 permits an executor to obtain a voting interest, but prohibits the executor's actual exercise of that voting interest to elect himself to corporate office. The power to vote shares that control corporate policy and choose corporate officers is commonly considered an interest greater than that of an officer. The Service's rationale may be to maintain, for administrative ease, a per se prohibition of any section 302(c)(2)(A)(ii) enumerated interest. Alternatively, the Service may regard executor voting power as temporary in nature which, once acquired, should not be exploited to gain any greater or additional interest.[75]

B. Providing Services

1. Lewis v. Commissioner

The Tax Court's prohibited interest test of a "financial or managerial stake" in the corporation initially appeared in Judge Simpson's

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ever, could act as trustee without corporate control leaving the family. Should the father be forced to bequest his corporate interest to Son *A*, who has not previously effected a § 302 redemption? One could argue that a child's parent as trustee will better provide for the child's interest. This factor alone should permit Son *B* to remain as trustee. Section 302(c)(2)(A) does not turn, however, on such interests but prevents a shareholder from obtaining an interest unless by bequest or inheritance.

73. 1975-1 C.B. 99.

74. Section 302(c)(2)(A)(i) prohibits the acquiring of an interest as an officer in the corporation. I.R.C. § 302(c)(2)(A)(i). *Cf.* Lewis v. Commissioner, 47 T.C. 129, 137-38 (1966) (The retention of positions as director and officer in title only with no compensation or duties does not constitute a prohibited interest.)

75. The Service's position may be that an executor's temporary voting power gives him a legal interest in the stock but that the equitable interest remains in the stock's intended beneficiary. The Service might view an executor's voting of himself into office as an abuse of his temporary power which is not in the best interests of the stock's intended beneficiary. If the executor in Rev. Rul. 75-2 had also been the stock's intended beneficiary, then he would have held both a legal and an equitable interest in the stock. Had the executor held both interests, the Service might have permitted the executor's election of himself into office.

concurring opinion in *Lewis v. Commissioner*.[76] In *Lewis* the petitioner incorporated his business in 1950 after operating it as a sole proprietorship for twenty-four years. From 1950 to 1956, Lewis reduced his corporate services to consulting and advising, on a limited basis, his two sons who had bought corporate stock. In 1956, at the age of sixty-nine, Lewis decided to retire to a life of farming. He resigned as president on June 11, 1956, but remained on the board of directors and was elected vice president. On July 1, 1956, the corporation entered into a redemption agreement with Lewis for his approximate one-half ownership. After July 1, the corporation discontinued Lewis' salary and he neither rendered services to the corporation nor actively exercised any powers as director or vice president. Although he attended informal directors meetings, he did not participate in any of the deliberations.[77]

In an opinion rendered by the entire Tax Court, the court held that Lewis' redemption was not "essentially equivalent to a dividend."[78] In reaching its decision, the court neither utilized section 302(b)(3) nor reached the question of whether a taxpayer's nominal retention of a position as director or officer violates section 302(c)(2)(A).[79]

In his concurring opinion, Judge Simpson agreed with the majority's result but disagreed with the court's failure to apply both the family attribution rules and the section 302(b)(3) test.[80] He stated that section 302(c)(2)(A)(i) merely provides that a prohibited interest *may* include an interest as an officer or director but does not prohibit office holding per se.[81] Lewis, according to Judge Simpson, held merely the title of officer and director, which did not amount to an interest that Congress intended to prohibit. Instead, Congress was concerned with nominal stock transfers that had no effect on corporate management and transfers in which the shareholder retained a financial stake.[82]

After *Lewis*, the Service articulated in Revenue Ruling 70-104[83] its strict view of the section 302(c)(2)(A) "interest." The Service's ruling stated that an ex-shareholder providing consulting services to the corporation after his redemption constituted a prohibited interest. In that ruling, a father effected a section 302(b)(3) redemption within a family owned corporation. After the redemption, the father entered

76. 47 T.C. 129 (1966).
77. *Id.* at 130-31.
78. *Id.* at 132-36. The majority utilized the § 302(b)(1) analysis and found that Lewis' redemption qualified for capital gains treatment. The finding of nondividend equivalency disposed of the necessity to analyze whether the taxpayer had complied with §§ 302(b)(3) and 302(c). *Id.* at 132.
79. *Id.* at 135.
80. *Id.* at 136.
81. *Id.* at 137.
82. *Id.*
83. 1970-1 C.B. 66 (1970).

into a five-year consulting agreement with the corporation. The Service maintained that the father's provision of services pursuant to the agreement was a prohibited interest under section 302(c)(2)(A).

2. *Estate of Lennard v. Commissioner*

The Tax Court analyzed Revenue Ruling 70-104 in *Estate of Lennard v. Commissioner*.[84] In *Lennard*, the petitioner had initially contributed $100,000 to Gerald Metals, a corporation formed by petitioner's son, and in return had received approximately a one-third interest. Lennard's son served as president, director and manager of the corporation. Lennard himself also served as director and secretary-treasurer and provided general accounting services for the corporation on a monthly basis. Upon his redemption in September, 1965, Lennard resigned as president and director. Following the redemption and until Lennard's death in 1970, Lennard's accounting firm provided Gerald Metals general accounting services, including annual audits in 1965 and 1966. Lennard's duties as managing partner of the Gerald Metals account included preparing Metal's tax returns and monthly audits, both requiring only a few days work. In addition to acting as trustee for Metals' pension plan since its inception in 1965, Lennard assisted in establishing a procedure to stop inventory loss in 1970. Sometime in 1965 or 1966 he advised his son regarding the acquisition of a refinery. Gerald Metals subsequently made that acquisition.[85]

The Tax Court held that Lennard provided his services to Metals in an independent capacity.[86] He acted, therefore, not in the capacity of an employee under the control of the corporation but as an independent contractor.[87] Distinguishing Revenue Ruling 70-104[88] as applying only to interests retained as employees, the court relied on the concurring opinion in *Lewis*, noting that the congressional concern behind section 302(c)(2) was a retained financial interest or a nominal stock transfer with no change in corporate management.[89] Congress,

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84. 61 T.C. 554 (1974)(*nonacq.*).
85. *Id.* at 555-59.
86. *Id.* at 560-61. The court held that Lennard acted as a partner in his accounting firm when rendering accounting services to Metals. As an accountant, he carried on an independent employment pursuant to an arrangement with Metals by which he had complete control over his accounting work and the manner of its employment. *Id.* at 561.
87. The court stated that no evidence existed indicating Lennard performed work as an employee. *Id.*
88. *See supra* note 83 and accompanying text (describing the facts of Rev. Rul. 70-104). The court stated that Lennard's performance of services was of a prescribed nature that was "far more circumscribed than the broader consultant and advisory services" rendered by the taxpayer in Rev. Rul. 70-104. Estate of Lennard v. Commissioner, 61 T.C. 554, 560 (1974) (*nonacq.*).
89. Estate of Lennard v. Commissioner, 61 T.C. 554, 561 (1974), (*nonacq.*).

the court stated, had in mind a corporate involvement greater than that of a third party providing goods or services to the corporation."[90]

3. Chertkof v. Commissioner

The Tax Court distinguished *Lennard* in *Chertkof v. Commissioner*,[91] holding that the taxpayer had retained a prohibited interest in entering into a property management contract with the corporation after the redemption. Chertkof had redeemed his approximate one-third interest in E & T Realty Co., a family owned corporation. In return for his shares, Chertkof received a one-third undivided interest in E & T's realty and remaining assets. E & T then entered into an agreement with Chertkof in which E & T agreed to manage his one-third property interest for ten years. Chertkof, after obtaining a favorable letter ruling from the Service stating that his redemption would receive capital gains treatment, resigned as an officer and director and redeemed his stock in February, 1966.[92]

In June or July of the same year, Chertkof was approached by his father's attorney, who asked Chertkof to consider managing E & T's properties since the father, an officer with E & T, could no longer oversee the properties because of his declining health. On August 31, 1966, J.O. Chertkof Co., owned eighty percent by Chertkof and twenty percent by his wife and sons, entered into a property management contract with E & T. The company had not previously managed any property. The agreement with E & T gave J.O. Chertkof Co. exclusive power to negotiate, procure, and execute all leases on behalf of E & T. Moreover, E & T authorized the company to collect rents, make expenditures, and keep records with respect to the properties.[93]

The Tax Court held that Chertkof's property management contract with E & T created a prohibited interest under section 302(c)(2)(A). Unlike the services provided by the taxpayer in *Lennard*, Chertkof's services went to the essence of the purpose for E & T's existence. Chertkof's broad and unrestrained management powers over both the properties and E & T's corporate policy made him an integral part of E & T's business.[94]

Chertkof acquired greater control over E & T under the property management contract than what he had prior to the redemption.[95]

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90. *Id.*
91. 72 T.C. 1113 (1979), *aff'd*, 649 F.2d 264 (4th Cir. 1981).
92. 72 T.C. 1117-18.
93. *Id.* at 1118-19.
94. *Id.* at 1124-25.
95. Prior to the redemption, Chertkof's father had controlled corporate policy. In fact, the redemption occurred as a result of petitioner's continual disagreement with his father's corporate policy decisions. Chertkof's powers under the property management contract were in no way limited by any corporate policy established by his father. *Id.* at 1125.

Unlike the facts of *Lennard*, E & T could not terminate Chertkof's contract at any time.[96] Thus, Chertkof stood to gain financially through his one-third property interest as a result of his own management duties.[97] After examining the "financial or managerial test" of *Lewis*, the Tax Court concluded that Chertkof had acquired a prohibited interest.

The Tax Court's required finding of a retained financial or managerial interest in the corporation by the ex-shareholder is an unwarranted interpretation of the congressional intent behind section 302(c)(2)(A). The court's prohibited interest interpretation requires the exact facts and circumstances inquiry that Congress intended to avoid.[98] Congress intended to bring certainty to the redemption area by providing definite standards through which taxpayers could construct their transactions.[99]

4. *Analysis of* Lewis, Lennard *and* Chertkof

In *Lewis*, Judge Simpson's concurring opinion stated that section 302(c)(2)(A) did not prohibit office holding per se but that it did prohibit a retained financial stake or an interest in the corporate managerial affairs.[100] While Judge Simpson recognized that the congressional intent favored a bona fide severance of the shareholder's interest in order to qualify for capital gains treatment,[101] he failed to recognize the predominant congressional concern to introduce easily ascertainable standards into the redemption area.[102] Although Congress codified the "essentially equivalent to a dividend" standard of pre-1954 law in section 302(b)(1),[103] it did not intend to include a similar individual factual inquiry in the other codified redemption standards.[104] Rather, Congress intended that section 302(c)(2)(A) provide a mechanical and

96. *Id.*
97. *Id.* at 1125-26.
98. H.R. REP. NO. 1337, *supra* note 29, at A72-A73, *reprinted in* 1 REAMS, *supra* note 29, at A72-A73.
99. *Id.* at A73, *reprinted in* 1 REAMS, *supra* note 29, at A73. *See supra* notes 36-38 and accompanying text.
100. Lewis v. Commissioner, 47 T.C. 129, 137-38 (1966).
101. *Id.* at 137.
102. *See supra* notes 36-38 and accompanying text (discussing the need for certainty in the redemption area).
103. Section 115(g) of the 1939 Code states that a redemption resulting in a corporate distribution essentially equivalent to a dividend will not qualify for capital gains treatment. The essentially equivalent to a dividend standard required an analysis of all surrounding facts and circumstances. Reg. 118, § 39.115(g)-1(a)(2) (1940). *See supra* notes 30-35 and accompanying text (discussing the uncertainties prevalent in the facts and circumstances inquiry under pre-1954 law).
104. The redemption standards available under § 302(b), other than those contained in § 302(b)(1), provide definitive and easily administered standards. H.R. REP. NO. 1337, *supra* note 29, at A72-A73, *reprinted in* 1 REAMS, *supra* note 29, at A72-A73; S. REP. NO. 1622, *supra* note 30, at 233, *reprinted in* 2 REAMS, *supra* note 29, at

objective means to waive family stock attribution.[105]

Judge Simpson, in stating that a prohibited interest required the finding of either a retained financial or managerial interest in the corporation, cited an article that proposed a similar inquiry.[106] The article stated that section 302(c)(2)(A) is not without its ambiguities[107] and explained that the Service, in interpreting pre-1954 law, had indicated in Revenue Ruling 54-408[108] that the mere performance of services after a redemption would not constitute a prohibited "interest in the affairs of the corporation."[109] This ruling, the article stated, suggests a need to find more than employment to constitute a section 302(c)(2)(A) prohibited interest.[110]

The article, however, confuses the complete termination standard of section 302(b)(3) with the prohibited interest of section 302(c)(2)(A)(i).[111] Revenue Ruling 54-408, cited by the author of the article, analyzes the post-redemption employment of an ex-shareholder by a corporation in which none of his family holds a stock interest. The family stock attribution waiver of section 302(c)(2)(A), therefore, is not applicable. In addition, the ruling utilizes a redemption standard stated in the regulations under section 115(g) of the 1939 Code.[112] This complete termination standard was codified in section 302(b)(3) of the 1954 Code.[113] In summary, the revenue ruling is not concerned with the section 302(c)(2)(A) prohibited interest factors.

Section 302(c)(2)(A) prohibits a much broader interest than does section 302(b)(3). The latter prohibits only a retained equity interest

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233. *See supra* notes 43-50 and accompanying text (discussing Congress' elimination of the facts and circumstances inquiry).

105. *See supra* notes 43-50 and accompanying text.

106. Judge Simpson cited Bittker, *supra* note 17, at 33 n.72 (1956). Lewis v. Commissioner, 47 T.C. 129, 138 n.3 (1966).

107. Bittker, *supra* note 17, at 33.

108. 1954-2 C.B. 165. The ruling states that the ex-stockholder, who was a majority shareholder prior to the redemption of all his shares, was to remain in the employ of the corporation for four years. The ex-shareholder would train key employees to assume his prior duties and would introduce them to his personal contacts. During the same period he was to receive his present salary but would sever all other corporate interests, including his positions as officer and director. The ex-shareholder had no relationships with any other shareholder and no member of his family was associated with the corporation. *Id.*

109. The regulations accompanying 1939 Code § 115(g) stated that a complete redemption of all the shareholder's stock, so that he ceases to be interested in the affairs of the corporation, qualifies for capital gain treatment. Reg. 118, § 39.115(g)-1(a)(2) (1940). The phrase "ceases to be interested in the affairs of the corporation" was interpreted as a cessation of the shareholder's equity interest. *See supra* note 34.

110. Bittker, *supra* note 17, at 33 n.72.

111. Rose, *supra* note 34, at 147-48.

112. *See supra* note 109.

113. H.R. REP. NO. 1337, *supra* note 29, at A73, *reprinted in* 1 REAMS, *supra* note 29, at A73.

in the corporation,[114] whereas section 302(c)(2)(A) prohibits an interest in the corporation, including that of an officer, shareholder, or director.[115] A waiver of family stock attribution under section 302(c)(2)(A) is available only to shareholders effecting a complete stock interest termination under section 302(b)(3).[116] Without the broader prohibited interests of section 302(c)(2)(A), the Service would face a burdensome task in determining when family attribution of stock ownership should apply. Congress intended section 302(c)(2)(A) to provide certainty in the redemption area that would create redemption "safe harbors" and in turn relieve administrative burdens of the Service.[117] A factual inquiry into the substantive financial and managerial interests retained by the ex-shareholder was not a congressional objective.

The legislative history of section 302(c)(2)(A) reflects no desire by Congress to elevate form over substance. Contrary to Judge Simpson's interpretation in *Lewis*,[118] Congress did intend to prohibit office holding per se for individuals who in fact act as officers, directors, or employees. Without this per se prohibition, section 302(c)(2)(A) would not provide a clear standard for taxpayers structuring redemptions.

In *Lennard*, the Tax Court held that the distributee had rendered services in an independent capacity that was not prohibited by section 302(c)(2)(A).[119] Utilizing the *Lewis* retained "financial or managerial interest in the corporation" standard, the *Lennard* court concluded that Congress did not intend to prohibit services equivalent to those provided by a third party.[120] In its analysis, the court neglected to address the congressional concern that shareholders should sever all ties with the corporation. Instead, the court concentrated on the nature of the accounting services provided by the petitioner and held that supplying those services did not allow him to exert control over his son.[121]

Mr. Lennard, notwithstanding his stock interest termination, had severed only a few of his ties with the corporation. He continued to provide monthly accounting services to the corporation, and advised the corporation on an inventory maintenance plan and the purchase of

114. *See supra* notes 39-42 and accompanying text.
115. *See supra* notes 43-50 and accompanying text.
116. A shareholder not completely terminating his equity interest in the corporation would fail § 302(b)(3) and never reach the prohibited interest test of § 302(c)(2)(A).
117. *See supra* notes 44-45 and accompanying text.
118. Lewis v. Commissioner, 47 T.C. 129, 137 (1966). *But see* Seda v. Commissioner, 82 T.C. 484, 491 (1984) (Whitaker, J., concurring) (Congress did intend to prohibit the retention of all employment relationships).
119. Estate of Lennard v. Commissioner, 61 T.C. 554, 560-61 (1974) (*nonacq.*).
120. *Id.* at 561.
121. *Id.* at 562.

a new refinery. Although the court emphasized that Lennard had no control over his son, who made all corporate policy decisions,[122] it failed to address the objective tests of family stock attribution expressed in the legislative history of section 302(c)(2)(A).[123]

The *Lennard* court emphasized that Lennard's independent contractor status distinguished his interest from the interest prohibited in Revenue Ruling 70-104.[124] That ruling characterized a five-year management consulting agreement between the distributee and the corporation as a prohibited interest. Neither the ruling nor the legislative history of section 302(c)(2)(A) indicates a need to distinguish between an employee and an independent contractor in determining whether a prohibited interest has been retained. However, section 302(c)(2)(A) prohibits an interest in the corporation *including* that of an officer, director, or employee.[125] The parenthetical language of section 302(c)(2)(A) does not limit the extent of the interest but merely provides examples of prohibited interests.[126] In addition, the court applied the common law test of employer control to determine if Lennard was an employee of the corporation.[127] This initial inquiry to determine whether a corporation controls an individual appears misguided in light of Congress' desire to prohibit the individual from controlling the corporation.

The *Chertkof* court also applied the *Lewis* standard of retained financial or managerial interest in the corporation.[128] Chertkof had formally agreed to manage the corporation's properties. Unlike the services provided by the taxpayer in *Lennard*, Chertkof's services were not circumscribed by the corporation.[129] The court found that these management powers provided Chertkof exclusive corporate con-

122. *Id.*
123. *See supra* notes 43-50 and accompanying text.
124. Estate of Lennard v. Commissioner, 61 T.C. 554, 560-61 (1974) (*nonacq.*). *See supra* note 83 and accompanying text (discussing Rev. Rul. 70-104).
125. I.R.C. § 302(c)(2)(A)(i).
126. The Senate report defines the § 302(c)(2)(A)(i) interest as including, but not limited to, an interest as officer, director, or employee. S. REP. NO. 1622, *supra* note 30, at 236, *reprinted in* 2 REAMS, *supra* note 29, at 236.
127. The court thought it necessary to determine the character of Lennard's employment status in order to conclude whether he fell within the parenthetical language of § 302(c)(2)(A)(i). Estate of Lennard v. Commissioner, 61 T.C. 554, 561 (1974) (*nonacq.*). The court used Employment Tax Regs. § 31.3402(c)-1(c), for guidance in determining if he was an employee of the corporation. Estate of Lennard v. Commissioner, 61 T.C. 554, 561 (1974) (*nonacq.*). The cited employment regulations utilize the common law test of control wherein all surrounding facts and circumstances are analyzed to determine if the employer controls the service provider.
128. Chertkof v. Commissioner, 72 T.C. 1113, 1126 (1979), *aff'd*, 649 F.2d 264 (4th Cir. 1981).
129. Mr. Chertkof had exclusive power to negotiate, procure, and execute all leases on behalf of the corporation. *Id.* at 1124.

trol and the ability to benefit financially from its operations.[130] Section 302(c)(2)(A) does not require an inquiry into the substance of the shareholder's retained interest, thus the *Chertkof* court could have found a prohibited interest on the mere existence of the petitioner's contract to provide services. The incomplete severance of his corporate ties constituted a prohibited interest regardless of his characterization as an employee or an independent contractor.

C. Interest Greater than that of a Creditor

Section 302(c)(2)(A) expressly exempts from prohibited interests a retained interest as a creditor.[131] The exemption prevents corporate cash flow problems by permitting corporations to exchange debt instruments in lieu of cash to fund redemption agreements.[132] In fact, the Service does not restrict the exempted creditor's interest to mere corporate indebtedness existing at, or resulting from, the redemption. On the contrary, the Service permits arm's length leasing transactions between the ex-shareholder and the corporation since these transactions create an interest in the ex-shareholder no greater than that of a creditor.[133]

The related section 302(c)(2)(A) regulations make it clear that a creditor's interest with respect to the corporation cannot include rights against the corporation broader than those necessary to enforce the creditor's claim.[134] The Service amplified this restriction in Revenue Ruling 59-119.[135] The ruling, citing the above regulations, states that a distributee cannot reserve a right to appoint a director to the

130. *Id.* at 1126.
131. I.R.C. § 302(c)(2)(A)(i).
132. The legislative history under § 302 gives no indication of Congress's rationale underlying its choice of a creditor exemption. *See supra* note 45 and accompanying text (discussing commentators' views agreeing with the corporate cash-flow problem as the rationale underlying the creditor exemption).
133. Rev. Rul. 77-467, 1977-2 C.B. 92.
134. Reg. § 1.302-4(d) reads as follows:

> Sec. 1.302-4 Termination of shareholder's interest.
>
> . . . .
>
> (d) For the purpose of Section 302(c)(2)(A)(i), a person will be considered to be a creditor only if the rights of such person with respect to the corporation are not greater or broader in scope than necessary for the enforcement of his claim. Such claim must not in any sense be proprietary and must not be subordinate to the claims of general creditors. An obligation in the form of a debt may thus constitute a proprietary interest. For example, if under the terms of the instrument the corporation may discharge the principal amount of its obligation to a person by payments, the amount or certainty of which are dependent upon the earnings of the corporation, such a person is not a creditor of the corporation. Furthermore, if under the terms of the instrument the rate of purported interest is dependent upon earnings, the holder of such instrument may not, in some cases, be a creditor.

135. Rev. Rul. 59-119, 1959-1 C.B. 68.

corporate board for the purpose of protecting his creditor interests. The Service maintains that the limiting by the remaining shareholders of the director's duties to a mere policing of his creditor's interest is immaterial[136] since section 302(c)(2)(A) makes no exceptions for directors,[137] actual or appointed.

The regulations additionally state that ex-shareholders having creditor interests that are in "any sense proprietary and subordinate to the claims of general creditors," have greater rights than necessary to enforce their claims.[138] Debt obligations, thus, may constitute proprietary interests, particularly when their repayment is directly related to corporate profits.[139] Debt repayment subject to sufficient corporate earnings is usually a factor in determining whether a debt instrument constitutes equity.[140] Section 302(c)(2)(A), which applies only to complete terminations of stock interests under section 302(b)(3), necessitates a broader reading of "proprietary interest."[141] The degree of equitable interest found in a prohibited, proprietary interest, as defined by the regulations, is less than that of an equitable interest reclassified as stock, but greater than that of a creditor's interest.

The Service has ruled that some corporate obligations, but not strict indebtedness, result in the ex-shareholder having a corporate interest no greater than that of a creditor. In Revenue Ruling 84-135,[142] the taxpayer received payments pursuant to a pre-existing, unfunded pension agreement after the full redemption of his shares in a family owned corporation. The Service ruled that the taxpayer's interest, which was no greater than that of a creditor's, was not a prohibited one. This ruling emphasizes that the pension payments were neither dependent on corporate profits nor subordinate to the claims of general creditors.[143]

Similarly, in Revenue Ruling 77-467,[144] the Service stated that a leasing transaction, bargained at arm's length, between the corporation and ex-shareholder did not constitute an interest greater than that of a creditor. The taxpayer in the ruling had entered into a ten-

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136. *Id.* at 70.
137. *Id.*
138. Reg. § 1.302-4(d).
139. *Id. See supra* note 134 (discussing Reg. § 1.302-4(d)).
140. *See generally* B. BITTKER & J. EUSTICE, *supra* note 20, ¶ 4.03, at 4-8 to 4-10.
141. In order to avail oneself of the § 302(c)(2)(A) waiver, the shareholder must have terminated his complete stock ownership pursuant to § 302(b)(3). I.R.C. § 302(c)(2)(A). The term stock ownership includes debt obligations reclassified as equity. *See supra* notes 20-24 and accompanying text.
142. Rev. Rul. 84-135, 1984-2 C.B. 80.
143. *Id.* The emphasis on corporate earnings and subordination derives from Reg. § 1.302-4(d).
144. Rev. Rul. 77-467, 1977-2 C.B. 92.

year lease of an office building to the corporation five years before his redemption. The Service warned, however, that an interest greater than that of a creditor would result if the rent payments were either dependent on corporate earnings or subordinate to future creditors.[145]

Although both the pension obligation and lease agreement resemble creditor interests, the pension obligation more closely mirrors the indebtedness anticipated and permitted by Congress in section 302(c)(2)(A).[146] Similar to redemption indebtedness or pre-existing indebtedness, the pension obligation represents a sum certain that would cause corporate solvency problems if section 302(c)(2)(A) required its full and immediate payment upon redemption,[147] whereas the lease agreement falls outside of this interpretation of exempted creditor interests and represents a continuing interest by the shareholder in the corporation.[148] A leasing transaction enables the shareholder to lease potentially necessary assets to the corporation's business. Similar to a prohibited employee relationship in which the individual provides services for a fee, the lessor provides an asset for the lessee's use for a fee.[149] Simply, any post-redemption dealings with the corporation that provide the distributee with an interest in the assets of the corporation should be prohibited. The fact that the transaction appears to have been bargained at arm's length should be irrelevant. Congress attempted to avoid the administrative problems associated with determining when one family member influences another by providing definitive standards in section 302.[150] Congress did not intend that the Service or the Courts measure the extent of the creditor's interest.

In addition to the discussion of proprietary interests, the regulations state that a distributee must not subordinate his note to a general creditor.[151] In *Lennard*, the petitioner subordinated his note to the

145. *Id.* The Service declared that it will not issue private letter rulings as to whether a rental agreement is dependent on corporate profits. Rev. Proc. 77-45, 1977-2 C.B. 579. A fixed rental agreement is not a rental agreement dependent on profits. *Id.* "Fixed rental" includes rent computed on a fixed percentage of corporate sale receipts. *Id.*

146. *See supra* note 45.

147. *See supra* note 45 (discussing the intent behind the creditor exception of § 302(c)(2)(A)).

148. *See* Rose, *supra* note 34, at 159-61. A family corporation could argue that, similar to the hardship that would result if it were forced to immediately pay off in cash all pre-existing indebtedness to the distributee, the immediate termination of the pre-existing lease could result in the loss of an essential business asset. The hardship of lease termination might parallel the funding of all pre-existing debt. The lease, especially one entered into post-redemption, provides the continuing interaction by the distributee in corporate affairs that Congress attempted to prevent.

149. Rose, *supra* note 34, at 160-61.

150. *See supra* notes 43-50 and accompanying text.

151. Reg. § 1.302-4(d).

other creditors of the corporation.[152] The court utilized a debt/equity analysis of the redemption obligation to determine if the retained interest exceeded that of a creditor's.[153] In response to the regulations, the *Lennard* court held that the regulations required both a finding of a proprietary interest and subordination for the creditor's claim to constitute a prohibited interest.[154]

A literal reading of the *Lennard* court's interpretation of Regulation section 1.302-4(d) would not result in the existence of a proprietary interest when a claim had proprietary attributes but no subordination.[155] The *Lennard* court probably intended its statement to mean that the regulations define only when the element of subordination will determine a creditor's interest as prohibited. The regulations state, however, that the claim "may not in *any sense* be proprietary . . . ."[156] Accordingly, the discovery of any proprietary element, including subordination, would render the creditor's claim prohibited. Although such a view is consistent with the congressional desire for a distributee to sever all corporate connections, it does not reflect the underlying policy for the creditor exemption—to prevent corporate solvency problems.[157]

A normal debtor-creditor relationship involves the transfer of a security interest in the debtor's property to the creditor. The security interest permits the secured party the right to control the debtor's disposition of the security. The interest and control in corporate assets is

152. Estate of Lennard v. Commissioner, 61 T.C. 554, 557-58 (1974) (*nonacq.*).
153. *Id.* at 562-63. The *Lennard* court defined a proprietary interest as a debt obligation redefined as capital as a result of its subjection to the risks of the business. *Id.* at 562. The court cited Kraft Foods Co. v. Commissioner, 232 F.2d 118, 125-26 (2d Cir. 1956), for the proposition that "debt is still debt despite subordination." The *Kraft* decision involved a debt-equity issue. The proprietary interest prohibited pursuant to § 302(c)(2)(A) is less than that of an equitable interest. *See supra* notes 138-141 and accompanying text.
154. Estate of Lennard v. Commissioner, 61 T.C. 554, 557-58 (1974) (*nonacq.*).
155. The court stated that it must conjunctively read the regulation language requiring a proprietary interest *and* subordination. *Id.*
156. Reg. § 1.302-4(d) (emphasis added).
157. If subordination alone could render a distributee's redemption debt a prohibited interest, few corporations could effect redemptions. Generally, small, family held corporations must subordinate shareholder loans in order to obtain large capital improvement loans. A financial institution generally will ask for the same subordination from an ex-shareholder. Prohibition of mere subordination of redemption obligations would thus prevent many redemptions.

The courts have permitted the subordination of debt to third-party restrictions. Thus, local law restrictions on note repayment terms, Harlan v. U.S., 409 F.2d 904, 909 (5th Cir. 1969), and the corporate charter restrictions on indebtedness repayment, Commissioner v. Union Mut. Ins. Co., 386 F.2d 974, 976-78 (1st Cir. 1967), if complied with will not generally constitute a prohibited interest. The courts focus on the need of the third party to accomplish its legitimate business objectives and the effect of furthering the creditor's interests. Dunn v. Commissioner, 70 T.C. 715, 729 (1978), *aff'd*, 615 F.2d 578 (2d Cir. 1980).

no greater than that of a normal creditor's and is consequently not a section 302(c)(2)(A) prohibited interest. Regulation section 1.302-4(e) further provides that a distributee may enforce his security interest and acquire corporate assets on an obligation default by the corporation.[158] This asset acquisition will not constitute a prohibited section 302(c)(2) interest unless corporate stock is acquired.[159] The courts have construed the regulations to prohibit the acquiring of stock but to permit *the right* to acquire the stock[160] because the pledge of stock is a condition found in normal creditor relationships.[161] However, this interpretation disregards the need for objective methods to determine if the distributee has severed corporate ties.[162] The Service, on the other hand, views the mere right to acquire stock due to claim enforcement as an interest potentially greater than that of a creditor.[163]

V. THE TAX COURT'S STRICTER STANDARD

A. *Seda v. Commissioner*

In 1984, the full Tax Court had another chance to review the prohibited interest standard. In *Seda v. Commissioner*,[164] the petitioner was the sole shareholder of a corporation, which in June, 1979, redeemed all of Seda's stock in the corporation. The corporation concurrently issued 1000 shares of common stock to Seda's son, James, whom the corporation had employed for seven years. On the date of redemption, Seda resigned as officer and director. At his son's insistence, however, Seda remained employed by the corporation at a salary of $1,000 per month.[165] In June, 1981, Seda terminated his employment

158. Reg. § 1.302-4(e).
159. *Id.*
160. Lynch v. Commissioner, 83 T.C. 597, 610 (1984).
161. *Id.*
162. Although the pledge of stock is normal in a creditor relationship, a redemption obligation from a family held corporation is not a normal debtor-creditor relationship. The general proposition is that family members will be influenced by and respectful of other family members' interests. A family held corporation might pre-arrange with the distributee to purposely default on the redemption obligation and transfer corporate control back to the distributee. Although Reg. § 1.302-4(e) prohibits a distributee from acquiring stock through the enforcement of his security interest, the courts have not yet encountered that fact situation. If the courts refused to permit the stock acquisition, then their allowance of the mere pledging of stock would be rendered meaningless. Section 302(c)(2)(A) prohibits the distributee from regaining corporate control. In addition, the administrative burden of determining whether an arms-length transaction has occurred between family members has resulted in the need for definitive standards that assure the severance of the distributee from corporate affairs.
163. Rev. Proc. 72-9, 1972-1 C.B. 719.
164. 82 T.C. 484 (1984).
165. An accountant had advised against the corporation's employment of Seda after his redemption. *Id.* at 486. The court dismissed this fact as not controlling. *Id.* at 488.

relationship with the company upon learning of the potential adverse tax consequences.[166]

The *Seda* court held that the petitioner's post-redemption employment relationship with the corporation, which continued approximately two years, constituted a retained financial stake prohibited by section 302(c)(2)(A).[167] The court did not decide if section 302(c)(2)(A) prohibited all employment relationships per se.[168] Instead, it relied on the *Lewis* financial or managerial interest test to conclude that Seda had retained a prohibited interest.[169]

In a concurring opinion, Judge Whitaker disagreed with the majority's application of the required finding of employment coupled with a financial or managerial interest standard. He stated that the legislative history of section 302(c)(2)(A) indicated that retention as an officer, director, or employee interest was prohibited per se.[170] Only when the retained interest fell outside the parenthetical language, however, was a facts and circumstances inquiry, similar to those in *Lennard* and *Chertkof*, required.[171]

B. *Lynch v. Commissioner*

Seven months after *Seda*, the Tax Court confronted another prohibited interest case in *Lynch v. Commissioner*.[172] Lynch was the sole shareholder of W.M. Lynch Company, which leased cast-in-place concrete pipe machines to building contractors. In December, 1975, petitioner gave $16,000 to his son Gilbert, which the latter used, along with $1,170 of his own money, to purchase fifty shares of stock from the Lynch Company.[173] On the same day, both Lynch and his wife resigned as officers and directors. In December, 1975, the corporation redeemed all of Lynch's 2,300 shares. Lynch received property and an installment promissory note guaranteed by Gilbert, who pledged his stock as security for the guarantee. If the corporation defaulted on the note, Gilbert's stock, and with it full control of the corporation, was to revert back to Lynch.[174]

Gilbert, who had begun to assume greater managerial responsibil-

166. *Id.* at 485-86.
167. *Id.* at 488.
168. The court, in stating that it did not decide if all retained employment relationships were prohibited per se, cited the concurring opinion in *Lewis*. *Id.* at 488 n.2.
169. *Id.* at 488.
170. *Id.* at 491. Judge Whitaker did agree with Judge Simpson's concurring opinion in *Lewis* that the retention of an officer's position in form only was not a prohibited interest.
171. *Id.*
172. 83 T.C. 597 (1984).
173. The Commissioner did not assert any gift tax liability with respect to the transfer of stock from the petitioner to Gilbert. *Id.* at 612 n.5.
174. *Id.* at 599.

ity for the corporation approximately two years before the redemption, retained his father's technical expertise on a consulting basis. Lynch's knowledge of the technical aspects of cast-in-place concrete pipe machines was extremely valuable since only two other concerns in the Western United States owned machines similar to those leased by the Lynch Company. Lynch entered into a written five-year consulting agreement with the company. The agreement provided him a monthly salary of $500 in addition to reimbursement of travel and entertainment expenses. In return, Lynch agreed to provide technical advisory services as reasonably requested by the company. Lynch also signed a covenant not to compete against the company within the borders of California.[175]

In addition to the consulting agreement, Lynch retained certain other corporate interests. First, he remained covered by the corporation's group medical insurance policy. When his coverage ended in 1980, Lynch had received a net benefit of $4,487.54 in premiums paid by the corporation. Second, he was covered by a medical reimbursement plan adopted by the corporation on the same day that Lynch and his wife resigned as officers and directors. The plan limited its annual medical reimbursement to $1,000 per plan member. The total plan reimbursements to Lynch totalled $96.05.[176]

Following the redemption, the corporation consulted Lynch on an irregular basis. In 1976, however, Lynch did assist in planning the layout of buildings and equipment at the corporation's plant. In 1976 and 1977, he advised the corporation on the renovation of thirteen pipe machines. Immediately after the redemption, the petitioner made daily trips to the office. These visits declined to only once or twice a week approximately one year after the redemption. Although he initially shared an office with Gilbert, Lynch received a private office in 1979 when the corporation moved to new office quarters. The corporation also acquired a pickup truck for Lynch in 1977, which he used, although not exclusively, for two years.[177] In February, 1977, his monthly payments pursuant to the contract were reduced to $250. Subsequently, the contracting parties terminated their agreement one year prior to its expiration. At no time did the corporation withhold payroll taxes on its monthly payments to Lynch.[178] On the date of redemption, Lynch did not subordinate his installment note to any other creditor. In May, 1976, the company received a $350,000 bank loan enabling them to purchase thirteen pipe machines. As a condition to the loan, Lynch had to subordinate his indebtedness to that of

175. *Id.* at 600. The agreement not to compete was for the duration of the consulting contract. *Id.*
176. *Id.* at 601-02.
177. *Id.* at 601.
178. *Id.*

the bank's. The bank, in connection with its loan, took a security interest in the corporation's assets which were then valued at $985,000.[179]

The Tax Court held that Lynch did not retain a section 302(c)(2)(A) prohibited interest. Judge Simpson, writing for the court, recited the retained "financial or managerial interest" standard that he utilized in *Lewis*[180] as the controlling standard in *Lynch.* He modified the standard by agreeing with the concurring opinion in *Seda,* which stated that when the interest retained is not one of an employee, officer, or director, all of the facts and circumstances must be examined to determine if a prohibited interest exists.[181]

The Commissioner argued that Lynch retained a financial interest through his employment with the corporation after the redemption. The *Lynch* court followed the *Lennard* court's common law control test and held that Lynch was not under the corporation's control and was, therefore, not an employee. The court emphasized Lynch's independence in determining when he would work for the corporation as well as his irregular attendance at the office. The court stated that his advising the corporation on the purchase of the pipe machines was within the scope of his status of an independent contractor. The court acknowledged that Lynch's continued insurance and medical plan benefits suggested an employee status, but concluded that the weight of the evidence established his status as an independent contractor.[182]

Having found that Lynch provided services as an independent contractor, the Tax Court examined all of the facts and circumstances to determine the extent of his interest. Emphasizing that the consulting payments were not geared to corporate profits and were in fact reduced in half approximately one year after the redemption, the court held that he retained neither a financial nor managerial interest. Similarly, the insurance and medical plan benefits, as well as the truck furnished by the company, were in no way contingent on corporate earnings. The court concluded that those benefits did not provide Lynch a substantial interest in the corporate business.[183]

Stressing Gilbert's control over corporate policy decisions to diversify, the Tax Court held that Lynch did not control the corporation after the redemption.[184] In addition, the court stated that merely providing advice on corporate affairs is not prohibited. The Commis-

179. *Id.* at 602.

180. *Id.* at 605.

181. *Id.* In *Seda,* Judge Simpson sided with the majority and not Judge Whitaker's concurring opinion. Seda v. Commissioner, 82 T.C. 484, 489 (1984).

182. Lynch v. Commissioner, 83 T.C. 597, 605-06 (1984).

183. *Id.* at 606.

184. Prior to the redemption, the petitioner had considered diversifying the corporation. *Id.* at 599.

sioner argued that Lynch did not control the corporation but that he had remained in a position to do so. The court responded that Lynch's de facto control was not determinative; Gilbert, both nominally and actually, controlled the corporation.[185]

The Commissioner argued next that Lynch's subordination of his note to the bank's debt indicated a retained equity interest greater than that of a creditor's. The Commissioner relied on the regulations under section 302, which prohibit a redemption indebtedness from being in any sense proprietary and subordinated to the claims of general creditors. The Tax Court, citing *Lennard*, held that subordination is only one factor to be considered in determining the creditor interest. The court stated that the regulations required the finding of both subordination *and* a proprietary interest, and thus held that its initial finding of the petitioner's lack of a retained financial or managerial interest in the corporation was also determinative in its finding of his lack of a retained proprietary interest. The court also emphasized that Lynch subordinated the note to a single creditor, the bank, and not general creditors. Lynch, the court concluded, did not retain an interest greater than that of a creditor.[186]

Finally, the Commissioner asserted that the pledge agreement between Lynch and his son demonstrated that the redemption note was similar to an equity interest prohibited by section 302(b)(3). The Commissioner relied on Regulation section 1.302-4(e), which prohibits a distributee from acquiring an interest in the corporate stock. The Tax Court noted that Lynch acquired a contingent right to acquire the stock but did not acquire the stock itself, and held that such a right is not inconsistent with the rights of a creditor.[187]

VI. ANALYSIS OF THE TAX COURT'S STANDARD

The *Seda* majority reaffirmed the *Lewis* standard of a retained "financial or managerial interest."[188] The court held that Seda's two-year term of employment with salary constituted a financial stake in the corporation prohibited by section 302(c)(2)(A).[189] The court did

185. *Id.* at 607.
186. *Id.* at 609-10.
187. *Id.* at 610. The Commissioner raised two additional objections. First, he asserted that the transfer of stock from Lynch to Gilbert was part of a scheme of which the principal purpose was tax avoidance. That finding by the Tax Court would prevent application of the § 302(c)(2)(A) family attribution waiver. The court was convinced that the sole purpose of the transaction was to transfer corporate control to Gilbert, and that no tax avoidance purpose was involved. *Id.* at 611-12. Secondly, the Commissioner argued that the redemption price was inflated. The court dismissed that argument as a new theory not presented at trial and thus not reviewable by the court. *Id.* at 612-13.
188. Seda v. Commissioner, 82 T.C. 484, 488 (1984).
189. *Id.*

not inquire further into the extent of Seda's employment relationship.[190] In fact, the court stated that the petitioners failed to show that Seda no longer controlled the corporation.

Judge Whitaker's concurring opinion stated that section 302(c)(2)(A)(i) prohibits all employment relationships per se.[191] While recognizing the congressional intent to bring clear standards to the redemption area in arriving at this conclusion,[192] the opinion falls short of establishing fully the standards expressed by Congress. Judge Whitaker's proposal, that the courts examine all of the surrounding facts and circumstances when the interest challenged is one other than that of an officer, director, or employee,[193] conflicts directly with the legislative history concerning the per se prohibition of employee relationships.[194]

Judge Whitaker stated that some of the section 302(b) and (c) rules required factual inquiries[195] while the remaining section 302 rules required application of mechanical tests.[196] He supported his statement with a reference to section 302(b)(1) redemptions (which require factual inquiries), and two law review articles stating that "Section 302(c) was enacted as a 'safe haven.' "[197]

Judge Whitaker's conclusion that section 302(c) presents a safe haven but remains subject to a facts and circumstances scrutiny is confusing. He might have meant that the parenthetical language of section 302(c)(2)(A)(i) provides a semi-safe haven or a shallow harbor that taxpayers should attempt to avoid.[198] If this is a correct interpretation, the taxpayer is still confronted with uncertainty in planning a redemption if his interest after the redemption is something other than that of an employee, officer, or director. Both the articles and

190. The court was satisfied that two years of receiving a salary of $1,000 per month constituted a prohibited interest. The opinion does not indicate the nature or extent of Seda's duties.

191. *Id.* at 490. Judge Whitaker exempted relationships in form only from the per se rule. *Id.* at 491; *see* Lewis v. Commissioner, 47 T.C. 129, 137 (1966) (Simpson, J., concurring).

192. Judge Whitaker relied on H.R. REP. NO. 1337 which articulates the precise standards whereby a shareholder, under specific circumstances, will constructively own the stock of his family. Seda v. Commissioner, 82 T.C. 484, 490 (1984).

193. *Id.* at 491.

194. *See supra* notes 43-50, 191 and accompanying text (discussing the legislative history of § 302(c)(2)(A)).

195. Seda v. Commissioner, 82 T.C. 484, 491 (1984).

196. *Id.*

197. *Id.* The articles cited by the court are Rose, *supra* note 34, at 145, and Kahn, *Stock Redemptions: The Standards for Qualifying a Purchase Under Section 302(b)*, 50 FORDHAM L. REV. (Part I) 1, 28 (1981-82).

198. In other words, a taxpayer structuring a redemption would know that an interest retained as an officer, director, or employee is definitely prohibited by § 302(c)(2)(A). If the taxpayer desires an interest outside of the "safe harbor," he subjects himself to an uncertain facts and circumstances test.

legislative history relied on by Judge Whitaker reject this view.[199] With the exception of section 302(b)(1), Congress intended to eliminate the uncertainty of pre-1954 law by providing clear redemption standards.[200]

The *Lynch* majority applied the two-step test set forth in the *Seda* concurrence. First, the court determines if an employee relationship exists. Second, if the individual is not an employee, the court inquires into the extent of his financial or managerial interest, utilizing all of the surrounding facts and circumstances.[201] Although *Lynch* recognized the importance of a retained interest as an employee, the court did not hold that an employee interest is prohibited per se.[202] The *Lynch* analysis focused on whether Lynch was an employee of the corporation or an independent contractor.[203] Similar to *Lennard*, *Lynch* utilized the common law test of control.[204] The corporation's control over the distributee has little to do with the congressional concern of a distributee retaining control over the corporation.[205] An independent contractor may control a corporation just as easily as an employee.[206]

Concluding that Lynch was an independent contractor, the court analyzed all of the facts and circumstances surrounding the extent of his interest[207] and held that Lynch retained neither a financial nor a managerial interest prohibited by section 302(c)(2)(A).[208] The court emphasized the one-half reduction in monthly fees under the contract and mitigated the importance of the medical, insurance, and truck benefits. Thus, the *Lewis* "retained financial interest" standard re-

199. Both articles conclude that the distributee should not need to subject his interest to a facts and circumstances test. Rose, *supra* note 34, at 166; Kahn, *supra* note 197, at 28-29. *See supra* notes 43-50 and accompanying text (discussing the congressional intent to eliminate the factual inquiry test and bring certainty to the family attribution rules).

200. S. REP. NO. 1622, *supra* note 30, at 41-42, *reprinted in* 2 REAMS, *supra* note 29, at 41-42.

201. Lynch v. Commissioner, 83 T.C. 597, 604-05 (1984).

202. The *Lynch* court stated that the concurring opinion in *Seda* agreed with the need for a factual inquiry if the distributee's interest fell outside the parenthetical language. *Id.* at 605 n.2.

203. *Id.* at 604-05.

204. The Employment Tax Regulations state that the employer-employee relationship exists when the person for whom the services are performed has the right to direct and control the individual who performs the services. Employment Tax Reg. 26 C.F.R. § 31.3121(d)-1(c)(2) (1985). Important factors that determine an employee relationship include supplying tools and a place to work. *Id.* The Tax Court did not address these factors in relation to Lynch's corporate-provided truck and office.

205. Congress intended a distributee to completely sever his interests in the corporation, including but not limited to those of an employee, officer, or director. *See supra* notes 43-50 and accompanying text.

206. Rose, *supra* note 34, at 150.

207. Lynch v. Commissioner, 83 T.C. 597, 605-06 (1984).

208. *Id.*

quired that the court measure the extent of Lynch's financial stake in the corporation. Congress, however, sought to eliminate such a highly subjective inquiry in the redemption area and provide instead for certainty and consistency.[209] Thus, the variables constituting a prohibited financial interest under the Tax Court's standard provide little guidance for a taxpayer planning a redemption.[210]

The Tax Court held that Lynch's son completely controlled the corporation. Yet immediately after the redemption, Lynch continued to make daily appearances at the office.[211] He also advised the corporation on the purchase of machinery and the layout scheme of a new plant. His technical input and involvement in the corporate affairs, therefore, fell short of a complete severance of corporate interests.

Although Lynch might have advised his son on corporate plans and policies, the court held that merely providing advice to a corporation is not prohibited.[212] Moreover, the court implied that Lynch would have to exert control over his son to constitute a prohibited management interest.[213] The obvious difficulties in proving Lynch's control over his son demonstrates the type of administrative burden associated with the subjective inquiries that Congress attempted to alleviate when it enacted the family stock attribution rules of section 302(c).[214] The rules provide a concise, mechanical test to determine when stock attribution applies. The court's factual inquiry into the extent of Lynch's actual control over the corporation conflicts with this congressional intent.

The Tax Court also held that Mr. Lynch's subordination of his redemption note to a secured bank loan did not constitute an interest greater than that of a creditor.[215] Citing *Lennard*, the court held that subordination by itself did not constitute a prohibited interest.[216] Subordination of shareholder notes is an unavoidable hazard of family corporations seeking large sums of credit, the prohibition of which would render most family corporation redemptions impractical.[217] Lynch's subordination of his note to a specific creditor and not to general creditors is in accordance with the family shareholder's need to

209. *See supra* notes 43-50 and accompanying text.
210. The Tax Court dismissed without explanation the $4,487.54 in life insurance premiums paid for the petitioner by the corporation. It also stressed the reduction in monthly contract payments but did not consider that the contract, as originally drafted, guaranteed the petitioner monthly payments for five years, regardless of the actual services provided.
211. Section 302(c)(2)(A)(i) prohibits an interest retained *immediately* after the distribution.
212. Lynch v. Commissioner, 83 T.C. 597, 606 (1984).
213. *Id.* at 607.
214. *See supra* notes 43-50 and accompanying text.
215. Lynch v. Commissioner, 83 T.C. 597, 609 (1984).
216. *Id.*
217. *See supra* note 157 and accompanying text.

subordinate debt. A proprietary interest under section 302(c)(2)(A), however, is much more encompassing than an equity interest.[218] Lynch's note subordination, therefore, coupled with his other proprietary interests, such as his consulting contract and his medical and insurance benefits, constituted an interest greater than that of a creditor.

VII. CONCLUSION

After *Seda* and *Lynch*, the Tax Court remains divided on whether the post-redemption retention of an interest as an officer, employee, or director constitutes a per se prohibited interest under section 302(c)(2)(A). Both decisions reflect a Tax Court policy to closely scrutinize any distributee who retains an interest listed in section 302(c)(2)(A)'s parenthetical language.

For retained interests not encompassed by the parenthetical language, the Tax Court has failed to recognize the congressional intent to bring certainty to the redemption area. The Tax Court's inquiry into the facts and circumstances surrounding the extent of the distributee's retained financial or managerial interest is inconsistent with the congressional intent surrounding section 302, an intent that shareholders sever all ties with the corporation in order to receive capital gains treatment. This complete severance of interests enables both the Service and the taxpayer to determine objectively whether the family attribution rules will apply to the proposed transaction.

Lynch also confuses the type of services that a distributee may provide the corporation. Previously, both the Service[219] and the Tax Court[220] maintained that a written contract for consulting services constituted a prohibited interest. *Lynch* permits such a contract. In addition, *Lynch* held that the factor which initially determines whether the services provided constitute a prohibited interest is not the extent of control that the distributee retains but the extent of control that the corporation exercises over the distributee.

Lynch creates confusion for taxpayers planning redemptions. A taxpayer relying upon *Lynch*[221] must closely scrutinize the facts surrounding his expected retained interest. If the retained interest includes a position with the corporation as an officer, director, or

218. *See supra* notes 138-50 and accompanying text.
219. Rev. Rul. 70-104, 1970-1 C.B. 66 (1970).
220. Chertkof v. Commissioner, 72 T.C. 1113, *aff'd*, 649 F.2d 264 (4th Cir. 1981).
221. Under the Ways and Means Committee's Proposed 1985 Tax Reform Bill (H.R. 3838), the current Internal Revenue Code's 60% capital gain deduction is reduced to 50% for tax years beginning in 1986 and 42% for tax years beginning after 1986. H.R. 3838, 99th Cong., 1st Sess. § 241 (1985). Despite the reduced deduction for capital gains, a taxpayer would continue to benefit from a redemption not treated as "essentially equivalent to a dividend."

employee, it likely will constitute a prohibited interest. The taxpayer who avoids these interests must then revert to a factual analysis to measure the extent of the retained financial or managerial interest. This procedure, however, runs afoul of Congress' explicit intent to bring certainty to the redemption area. Instead, taxpayers seeking a true safe-harbor should follow the Service's view and sever all post-redemption interests with the corporation.