Redemptions Not Essentially Equivalent to Dividends

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Does dividend equivalency matter? It clearly does, but many M&A Tax Report readers might have a hard time saying exactly why. First there is the question of tax rates.

If a payment is a dividend, it is subject to one set of tax rates. If a payment is proceeds of a sale or exchange, it is subject to another set of rates. Of course, many dividends today are taxed at the qualified dividend rate of 15 percent. For the moment, that is also the long-term capital gain rate. On the surface, this serendipity may make you think the distinction is unimportant.

But is it so simple? Some dividends do not qualify for the 15-percent rate. Even more obviously, if one receives sale or exchange treatment, payments can be a recovery of basis and therefore not be gain, in whole or in part.

One may even have a loss. Thus, even assuming that the same 15-percent tax rate might apply to a dividend or the proceeds on a sale or exchange there may be a considerable difference. In these and other ways, we still care about dividend equivalency.

The Road Less Traveled by

If a redemption does not qualify as substantially disproportionate under Internal Revenue Code Section ("Code Sec.") 302(b)(2) and is not in complete termination of a shareholder's interest, then the only possibility for redemption treatment is for the redemption to be "not essentially equivalent to a dividend."

It is clear that this "not essentially equivalent to a dividend" standard is to be applied without regard to whether a redemption fails to meet the tougher standards of a substantially disproportionate redemption or a complete termination of a shareholder's interest. The fact that a redemption fails to meet the more objective criteria of a substantially disproportionate redemption or complete termination of interest is irrelevant in assessing dividend equivalency. [*See* Code Sec. 302(b)(5).]

Traditionally, it was commonly asserted that the "not essentially equivalent to a dividend" standard is of relatively little planning importance. One rarely wants to rely upon this amorphous standard.

Plainly, certainty is always good. However, many redemptions, for one reason or another, cannot be structured to comply with either of the other two sets of rules. Although admitting that this is not an area of absolute certainty, it is possible to chart a course through the authorities interpreting the meaning of "dividend nonequivalency."

Readers of the M&A TAX REPORT often must confront the nonstatutory business purpose doctrine. It is nice not to need to worry about it here. The critical question is whether there is a "meaningful reduction" in the redeemed shareholder's interest. It is possible to view this meaningful reduction requirement as a more watered-down version of the same concept applicable to substantially disproportionate redemptions.

What Is Not "Essentially Equivalent"?

Is it possible to state succinctly what is *not* essentially equivalent to a dividend? If it were, there would be considerably less concern over a redemption that fails both the substantially disproportionate redemption provision and the complete termination of interest provision. Unfortunately, the regulations aren't too helpful.

In fact, they state merely that whether a distribution in redemption is not essentially equivalent to a dividend depends upon "the facts and circumstances of each case." [*See* Reg. § 1.302-2(b).] Beyond this, the regulations provide little guidance, except in stating that the Code Sec. 318 attribution rules will apply in determining dividend equivalency (as in determining the qualification of any redemption under Code Sec. 302). [*See* Reg. § 1.302-2(b).]

The early case law raised a number of questions concerning the application of the "not essentially equivalent to a dividend" standard. For example, in *A.H. Squier Est.*, 35 TC 950, Dec. 25,715 (1961), the Tax Court considered the redemptions of stock of the recently deceased president of a corporation. The court noted that it not only resulted in a substantial dislocation of relative shareholdings in the corporation, but also brought about a significant change in control.

Consequently, the redemptions were not essentially equivalent to a dividend. Conversely, in *E.D. Bradbury*, CA-1, 62-1 USTC ¶9827, 298 F2d 111 (1962), the First Circuit stated that the redemption of stock by the dominant shareholder (who was in debt to the corporation at the time) was a distribution essentially equivalent to a dividend.

The seminal case on stock redemptions which are not essentially equivalent to a dividend was decided by the Supreme Court in 1970. In *M.P. Davis*, SCt, 70-1 USTC ¶9289, 397 US 301 (1970), the High Court determined that the primary focus under this standard should be whether there has been a "meaningful reduction" in the interest of the redeemed shareholder.

The Court reiterated that a business purpose is not necessary for the redemption to be not essentially equivalent to a dividend. Indeed, the presence or absence of a business purposes is irrelevant (happy day!).

Of course, the *Davis* Court also determined that the attribution rules of Code Sec. 318 applied in determining dividend equivalency. Unfortunately, the Court did not resolve whether factors such as family hostility may then negate otherwise applicable attribution. For tax lawyers, cases about family hostility are somehow fun. But it does not appear that this notable topic is worthy of discussion here.

The final point made by the Court relates to redemptions of a sole shareholder. Under the view espoused in *Davis*, a redemption of part of the common or preferred stock of a sole shareholder will *never* be treated as not essentially equivalent to a dividend. Plainly, that makes sense. Because *Davis* focuses on whether there has been a "meaningful reduction" in the interest of the redeemed shareholder, this final proposition is unexceptional.

Davis is such an important case that it is worth revisiting its architecture. In *Davis*, the corporation redeemed preferred stock, the entire class of which was owned by the taxpayer. Yet the taxpayer also owned 25 percent of the common stock directly, and his wife and two children each owned 25 percent of the common.

Based on these facts, the *Davis* holdings follow:

- The constructive ownership rules of Code Sec. 318 apply, in this case to treat the taxpayer as the owner of all the common stock.
- A redemption of stock held by a sole shareholder (whether or not the person is treated as a sole shareholder by virtue of constructive ownership) is, by definition, essentially equivalent to a dividend.
- The existence of a business purpose is irrelevant in determining dividend equivalency (the taxpayer argued that the redemption of the preferred stock was necessary for business reasons).
- The test for dividend nonequivalency is whether there is a "meaningful reduction" in the shareholder's proportionate interest in the corporation. [*See Davis*, 397 US, at 307–13.]

Post *Davis*

The importance of *Davis* in establishing these principles cannot be overstated. Still, three Justices dissented in *Davis*, disagreeing with the notion that a valid business purpose could not help save a distribution from dividend equivalency. Shouldn't a good business purpose help? Shouldn't a *compelling* one?

The dissenters also would have left open the possibility that a redemption of stock in a corporation with only one shareholder could perhaps still qualify. Couldn't a single shareholder redemption somehow and sometimes be not essentially equivalent to a dividend?

In a later case, *J. Miele*, 56 TC 556, Dec. 30,841 (1971), *acq.* 1972-2 CB 2, *aff'd per curiam*, CA-3, 73-1 USTC ¶9379, 474 F2d 1338 (1973), *cert. denied sub nom. N.E. Albers*, SCt, 73-2 USTC ¶9730, 414 US 982 (1973), *reh. denied*, SCt, 414 US 1104 (1973), the Tax Court ruled that a business purpose for a redemption was immaterial. The Tax Court found that there had been no meaningful reduction in stock ownership when preferred stock was redeemed. The case was affirmed *per curiam* by the Third Circuit.

The *Miele* case *could* have been *Davis II.* However, the Supreme Court denied review of the *Miele* case, although three Justices dissented from the denial of *certiorari*. The dissenters felt that even a *pro rata* redemption of preferred stock could qualify for sale or exchange treatment when a substantial business purpose was served by the redemption.

Despite such early grumblings over *Davis*, its holdings now seem immune from attack. In fact, since then, many cases have applied the principle that the primary concept to be addressed in assessing dividend nonequivalency is simple. Has there been a meaningful reduction in proportionate interest?

What Is a "Meaningful Reduction"?

What do we mean by a "meaningful reduction"? We look at the proportionate interest of a shareholder. The coveted meaningful reduction in that interest entitles the shareholder to sale or exchange treatment. The lack of clarity is attributable in part to the fact that the courts have looked not solely at numerical reductions in percentage ownership, but also to other factors.

For example, a reduction in percentage interest from 57 percent to 50 percent was held to be meaningful. Why? It was primarily on the grounds that the remaining shares were held by a single, unrelated individual. That meant that the two remaining shareholders could not themselves control the corporation. [*See* Rev. Rul. 75-502, 1975-2 CB 111.]

Of course, it is worth noting that on these percentages, the redemption could not qualify for substantially disproportionate redemption treatment. Meeting numerical tests is always better than relying on the facts and circumstances. Moreover, sheer numerical reductions may be meaningful if they are large enough.

However, the IRS clearly views factors of control as more significant. In effect, the practical consequences of the reduction in percentage ownership are precisely what make the reduction "meaningful." The courts have generally followed this approach.

First, one looks to the percentage reduction, and then to the practical consequences of such a reduction. [*See B.S. Benjamin*, 66 TC 1084, Dec. 34,044 (1976).] Whether an actual loss of control is required is not clear, and I would argue that it should not be. Yet the IRS is not convinced. For example, in Rev. Rul. 78-401, 1978-2 CB 127, the IRS ruled that a reduction from 90 percent to 60 percent in stock ownership was not a meaningful reduction because control is still maintained.

Note, however, that is has been successfully argued in at least one case that a reduction in ownership was meaningful where it caused a majority shareholder to lose the control needed to independently vote for mergers, liquidations, and other events requiring a two-thirds majority under state law. [*See W.F. Wright*, CA-8, 73-2 USTC ¶9583, 482 F2d 600 (1973).] In effect, there is control, and then there is high control or super control or control that is all but absolute. Of course, in making control determination, the attribution rules are applied. [*See* Rev. Rul. 77-218, 1977-1 CB 81.]

Moreover, even where constructive ownership does not exist, the IRS has looked to the ability of the redeemed shareholder (some of whose stock is redeemed) to thereafter act in concert with the remaining shareholders. Thus, in Rev. Rul. 85-106, 1985-2 CB 116, the redeemed shareholder could still participate in the control group. However, in Rev. Rul. 76-364, 1976-2 CB 91, redemption that effected a reduction from 27 percent to 22 percent was held meaningful where the shareholder lost the power to control the corporation with agreement of only *one* other shareholder. [*See also* Rev. Rul. 75-502, 1975-2 CB 111.]

In effect, the degree of control, or rather the degree to which rights can be exercised, is impacted. Yet there is a corollary.

Vote and Power

There is considerable focus on the need for both a percentage reduction and a change in the power of the redeemed shareholder. This makes it questionable, at least in the IRS's view, whether a shareholder would *ever* have a meaningful reduction in stock when he remained a majority owner after the redemption. In Rev. Rul. 78-401, 1978-2 CB 127, a reduction from 90 percent to 60 percent was not meaningful.

However, in *Wright*, *supra*, a reduction from 85 percent to 61.7 percent was held sufficient. In that case, state law required a two-thirds vote for mergers, liquidations, *etc.* Plainly, the primary inquiry in a "meaningful reduction" analysis is based upon the percentage reduction. Yet it is relevant to consider the related effect on the shareholder's control.

Nevertheless, it is possible for a meaningful reduction to be based on other factors. Indeed, a loss of a share in dividends, liquidating dividends, *etc.* may arguably be "meaningful" without regard to control. The IRS has referred to a loss of a claim to earnings and profits and accumulated surplus. See Rev. Rul. 75-512, 1975-2 CB 112. Of course, this would seem to occur in a percentage reduction of any magnitude.

It is possible to view this meaningful reduction requirement as a more watered-down version of the same concept applicable to substantially disproportionate redemptions.

Indeed, the notion that a redemption involves a loss of a share of these attributes seems unexceptional. If a corporation has only one class of stock, how could it be otherwise? But what about the more nuanced fact pattern involving multiple classes of stock?

There, the impact of a redemption on a shareholder's rights with respect to dividends may be truly meaningful in the case of multiple classes of stock. This is so regardless of the voting rights in question. For example, suppose an issuance of preferred stock with substantial dividend rights and common stock with subordinated dividend rights. Assume there is a redemption of a significant portion of the preferred stock, along with a lesser portion of the common stock.

Plainly, this redemption will affect the redeemed shareholder's dividend and voting rights disparately. In that sense, the "meaningful reduction" concept cannot be entirely dependent upon a mere percentage reduction or upon a change in voting control. This is demonstrated by a revenue ruling in which the IRS held that a meaningful reduction had occurred when common stock was redeemed resulting in the distributee being reduced from a 0.0001118-percent interest to a 0.0001081-percent interest in the corporation. [*See* Rev. Rul. 76-385, 1976-2 CB 92.] However, a later revenue ruling seems to contradict this result. [*See* Rev. Rul. 81-289, 1981-2 CB 82.]

A "meaningful reduction" can occur where there is an alteration in rights to participate in earnings and other shareholder rights rather than in voting power. This occurred in *I. Himmel*, CA-2, 64-2 USTC ¶9877, 338 F2d 815 (1964). There, a shareholder's interest in current earnings, accumulated surplus and net assets on liquidation were reduced by virtue of a redemption.

Notably, his voting power remained unchanged, and voting power is important. Nevertheless, the Second Circuit viewed the reduction of these other rights as more important than the unchanged voting power. Therefore, the court allowed sale or exchange treatment. [*See also M.G. Roebling*, 77 TC 30, Dec. 38,039 (1981).]

Predictably, the IRS disagreed with this result, and announced that it would not follow the holding of the *Himmel* case. [*See* Rev. Rul. 85-106, 1985-2 CB 116.] More recently, the IRS issued Field Attorney Advice 20064401F (June 7, 2006), which noted that in cases involving voting stock, the effect of the redemption on the taxpayer's control of the corporation is considered the most significant factor, citing the 1985 revenue ruling.

Nevertheless, the decision clearly leaves room for the relevance of a reduction in the shareholder's right to participate in current earnings, accumulated surplus and net assets on liquidation. Of course, as a practical matter, control is considerably more important. Generally, the courts have also viewed control as the most significant factor in determining whether a meaningful reduction has occurred.

Conclusion

While little blood may have been spilled recently over the "not essentially equivalent to a dividend" category, the bleeding has been copious in the past. It is always better to avoid the uneasy solace of this inherently amorphous characterization. But if you do find yourself relying upon it, don't hesitate to look beyond the basics of strict percentage voting to other factors.

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