

# VALUATION OBSERVATIONS

*Some practical observations from a practicing  
business appraiser.*

VLC

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## UNINTENDED CONSEQUENCES

### *Corporate Redemptions vs Marital Property Division*

Corporate redemptions of stock are governed by IRC §302. However, the redemption is subject to the constructive ownership (aka family attribution) rules of IRC §318. If these aspects of the tax code are not reviewed carefully, the transaction could produce very expensive tax consequences. Here's what happened:

#### Fact Pattern

Harry and Wilma each own 300 shares of common stock of a C corporation. There are no other shareholders. They enter into a stock redemption agreement whereby Corporation purchases (redeems) Wilma's 300 shares for \$500,000 (based on the agreed company value of \$1 million). Six months later, Wilma files for divorce.

#### Relevant Law

For purposes of applying the tests for determining whether a redemption is treated as a sale or exchange, or as a corporate distribution that is taxed as a dividend to the extent of the redeeming corporation's earnings and profits, the shareholder whose stock is being redeemed may be treated as owning stock that is actually owned by another person under the rules described below.

Family attribution defined – an individual is treated as owning stock owned, directly or indirectly, by or for his spouse, children, grandchildren and parents. For this purpose, a legally adopted child of an individual is considered to be his child, but a person who is legally separated from another person under a decree of divorce or separate maintenance is not considered to be a spouse. An individual is not treated as owning stock owned by his grandparents, stepchildren (unless legally adopted), brothers, sisters, aunts, uncles, nephews, nieces, cousins or more distant relatives.

The Supreme Court confirmed in *U.S. v. Davis*, 397 U.S. 301 (197) that the constructive ownership rules of IRC §318(a) apply for purposes of determining whether a distribution in redemption of stock is not essentially equivalent to a dividend under §302(b)(1). In the case of the family attribution rules, however, there is a question whether the existence of family hostility justifies disregard of the constructive ownership of stock.

In decisions rendered before *Davis*, the Tax Court held that family discord could negate the “community-of-interest” rationale of the attribution rules and would be relevant to a determination of dividend equivalence under § 302(b)(1).

The First Circuit, in *Haft Trust v. Comr.*, 510 F. 2d 43, 48 (1<sup>st</sup> Cir. 1975) found that the existence of family hostility could have a bearing on the question whether the taxpayers continued to exert control over the corporation after the redemption. The IRS indicated in Rev. Rul. 80-26 that it will not take into account family hostility in determining whether a redemption results in a meaningful reduction in the shareholder's interest under §302(b)(1) and that it, consequently, will not follow the First Circuit's decision in *Haft Trust*.

The Fifth Circuit, in *Metzger Trust v. Comr.*, 693 F.2<sup>d</sup> 459 (5<sup>th</sup> Cir. 1982), *aff'g* 76 T.C. 42 (1981) held that the attribution rules are to be applied without regard to family hostility. After *Metzger Trust* rejected the Tax Court's suggestion that family hostility could be relevant in the case of a § 302(b)(1) redemption, the Tax Court announced in another decision a three-step analysis for testing § 302(b)(1) dividend equivalency when family discord is present. It held that it will (1) apply the attribution rules straightforwardly, (2) make a determination whether there has been a reduction in the shareholder's proportionate interest, and (3) (if there has been a reduction) examine all facts and circumstances, including family hostility, to determine whether the reduction was meaningful, *Cerone v. Comr*, 87 T.C. 1 (1986).

The split in approaches is demonstrated by Rev. Rul. 80-26 and the Fifth Circuit's decision in *Metzger Trust*, which held that family hostility is not to be considered in determining whether there was a meaningful reduction in the shareholder's proportionate interest under §302(b)(1), and by the Tax Court in *Cerone* and the First Circuit in *Haft Trust*, which held that it may be appropriate under certain circumstances to consider whether family hostility supports a finding of a meaningful reduction in interest.

The IRS declines to recognize any exceptions to the application of §318 to §302(b)(1). In CCA 200409001, for instance, a family owned corporation redeemed stock held by the corporation's primary shareholders to pay gift and income taxes on the primary shareholders' transfers of stock of the same corporation to trusts for their children, which stock was then transferred to a voting trust. Examining the transfers and redemptions as a single transaction, the Chief Counsel's Office advised that the redemption was essentially equivalent to a dividend because there was no meaningful reduction in the primary shareholders' proportionate interests in the corporation as a result of the transfers and redemptions. The Chief Counsel's Office, citing *Davis*, stated that the §318(a) rules apply to gifts and redemptions. Therefore, the children's trusts constructively owned the stock in the voting trust, the children constructively owned the stock in the children's trusts, and the children's ownership of the stock was attributed to their parents, the primary shareholders. Referring to the IRS's nonacquiescence in *Squier Est. v. Comr*, 35 T.C. 950 (1961), *nonacq*, 1978-2 C.B. 4 and citing *Haft Trust*, the Chief Counsel's Office reiterated that there can be no mitigating circumstances (including family hostility or the transfer of a family business) in the application of the constructive ownership rules to the determination of whether a redemption is essentially equivalent to a dividend.

#### Implications to Fact Pattern:

Because H and W were married at the time of the redemption, and current law does not recognize a hostility exception, Family Attribution rules apply. As such, W does not have a complete termination of interest in C. Therefore, the redemption transaction is treated as a dividend taxed at ordinary income rates rather than the preferred capital gains rates. Furthermore, the basis to be deducted from the proceeds in calculating capital gains is not applicable. See below for a comparison of the two treatments.

<u>Treatment</u>	<u>Capital Gain</u>	<u>Ordinary</u>
Proceeds	\$ 500,000	\$ 500,000
Basis	(100,000)	not applicable
Taxable gain/income	\$ 400,000	\$ 500,000
Tax rate	15%	35%
Tax	\$ 60,000	\$ 175,000

As you can see from the above discussion, W will not be eligible to benefit from the preferred tax treatment of capital gains. The detriment of redemption during marriage in this fact pattern is extensive.

Further complication would arise if the corporation was an S-corporation. S-corps require that distributions (i.e. dividends) be proportionate to ownership. When Wilma's redemption distribution is reclassified as a dividend due to family attribution, the proportionate distribution rule is violated and the company loses its S-corp status.

Alternatives to Fact Pattern Presented:

IRC §1041 provides that no gain or loss is recognized on the transfer of property from an individual to a spouse, or if incident to a divorce, then former spouse. H and W should consider transferring W's stock to H in exchange for either cash or other property as part of the property division inherent in the divorce. If the parties prefer the cash alternative, H can borrow the funds from C at the federal mid-term (payout between 3 and 9 years) interest rate (currently at 2.18%), which is less expensive than the bank's prime rate. However, an analysis of the marital estate may reveal a more effective settlement division.

If the parties terminate their marriage by way of dissolution, they may agree on the value of the stock, and utilize that agreed upon value in the property division analysis. If the divorce is litigated, the Court will require an appropriate valuation of the Company.

If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

Member of:

**Terri**

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors and sits on the Board of Trustees of the Center for Principled Family Advocacy.