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by Peter Richman

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VIEWPOINT

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A Regulatory Proposal for Stock Buybacks

by Peter Richman

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In this article, Richman proposes regulatory and subregulatory reforms to improve the federal income tax treatment of corporate stock buybacks.

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I. Introduction

The taxation of corporate stock redemptions — commonly known as buybacks — has received significant attention in recent years, particularly in light of the dramatic increase in buyback activity following passage of the so-called Tax Cuts and Jobs Act.[1] Since then, President Biden and lawmakers in both chambers of Congress have proposed a federal excise tax on buybacks.[2] Practitioners have dissected these proposals with technical analysis and commentary,[3] and academics and politicians alike have suggested various alternative legislative reforms more directly targeted at the federal income tax consequences of buybacks.[4]

Lurking beneath much of this policy activity is the premise that redemptions by publicly traded corporations (public redemptions) almost always result in capital gains or losses[5] for the redeemed shareholders (that is, and not dividends). In many cases this outcome is mandated by the IRC, which details several mechanical tests that provide redeemed shareholders with capital gains. But the code does not prescribe this result in all cases. On the contrary, the meaning of section 302(b)(1) — one of the principal gateways to capital gain treatment — is relatively unclear from the terms of the statute.

In Rev. Rul. 76-385, 1976-2 C.B. 92, Treasury and the IRS interpreted this provision in a manner that ensures that virtually all public redemptions yield capital gains. However, the ruling rests on misinterpretations of both legislative history and relevant case law. Moreover, its holding promotes questionable policy by contributing to the divergent federal income tax treatment of redemptions and pro rata distributions, two transactions that generally are — or at least can be — economically equivalent.[6] This article reviews the history of section 302(b)(1) and its interpretation by the Supreme Court in *Davis*[7] before analyzing Rev. Rul. 76-385 and its legal

[1] *See, e.g.*, Thomas Heath, "A Year After Their Tax Cuts, How Have Corporations Spent The Windfall?" *The Washington Post*, Dec. 14, 2018; Senate Committee on Finance, "Wyden Launches Investigation of Abbott Tax, Stock Buyback Practices" (May 18, 2022).

[2] *See* White House, "The Build Back Better Framework"; H.R. 5376, the Build Back Better Act (as passed by the House Nov. 19, 2021); S. 2758, the Stock Buyback Accountability Act; *see also* Nancy Cook and Laura Davison, "Biden Ally Floats 21% Surtax on Oil Profits to Blunt Inflation," Bloomberg, June 14, 2022 (Senate Finance Committee Chair Ron Wyden, D-Ore., would "impose a 25 percent stock buyback tax for oil and gas companies . . . with at least $1 billion in revenue.").

[3] *See* Adam Murphy, Maury I. Passman, and Jeffrey L. Vogel, "Stock Repurchases Under the Build Back Better Act's Excise Tax," *Tax Notes Federal*, May 9, 2022, p. 865; Thomas F. Wood et al., "Proposed Excise Tax on Stock Repurchases Has Far-Reaching Implications for Corporate Transactions," Skadden, Arps, Slate, Meagher & Flom LLP, Nov. 5, 2021; *see also* Andrew Velarde, "Stock Buyback Tax Could Cause Taxpayer Headaches," *Tax Notes Federal*, Nov. 22, 2021, p. 1149.

[4] *See* Daniel J. Hemel and Gregg D. Polsky, "Taxing Buybacks," 38 *Yale J. on Reg.* 246 (2021); Reuven S. Avi-Yonah, "A Different Way to Tax Stock Buybacks," *Tax Notes Federal*, Nov. 22, 2021, p. 1107; Marco Rubio, "America Needs to Restore Dignity of Work," *The Atlantic*, Dec. 13, 2018 (previewing a plan to "end the tax code's favoritism for companies that spend their tax cuts on stock buybacks"); Senate Committee on Small Business and Entrepreneurship, "Made in China 2025 and the Future of American Industry," at 73-74 (Feb. 12, 2019) (similar).

[5] If a redemption is treated as a sale or exchange (as explained in Part II.A), it may result in either capital gains or capital losses for the redeemed shareholder. For ease, the remainder of this article refers only to capital gains.

[6] *See infra* note 76.

[7] *United States v. Davis*, 397 U.S. 301 (1970).

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rationale. It then recommends that Treasury and the IRS revoke the revenue ruling and propose new regulations providing that more public redemptions result in dividend treatment.[8]

II. Background

A. Overview of Section 302

Corporations transfer earnings to their shareholders by either making pro rata distributions or redeeming outstanding shares.[9] Assuming the corporation has sufficient earnings and profits, a pro rata distribution is treated as a dividend.[10] A redemption, on the other hand, may result in either dividends or capital gains, depending on whether it is characterized as a pro rata distribution or a sale or exchange. The engine that drives this sorting exercise is section 302(b), which identifies five tests for determining whether a redemption will be characterized as a sale or exchange.[11] If sale or exchange treatment applies, the redeemed shareholder computes its gains on the redemption under section 1001.[12] If none of the five tests of section 302(b) apply, the redemption is treated as a pro rata distribution,[13] typically yielding dividend treatment to the redeemed shareholder.[14]

Four of the tests of section 302(b) — those described in paragraphs (2) through (5) — are relatively mechanical.[15] By contrast, section 302(b)(1), which provides that a redemption is treated as a sale or exchange if it is "not essentially equivalent to a dividend," is more open to interpretation. Over the last 100 years, Congress, Treasury, the IRS, and the Supreme Court have each weighed in on the meaning of this phrase. Before considering the application of section 302(b)(1) to public redemptions today, this article reviews pertinent aspects of that history.

B. Legislative History of Section 302(b)(1)

Section 302(b)(1) can be traced to the inappropriate tax planning opportunities resulting from the Supreme Court's decision in *Macomber*,[16] which held that a shareholder's receipt of a stock dividend does not result in taxable income.[17] Under *Macomber*, a corporation could transfer earnings to shareholders without creating taxable income by distributing its stock and then redeeming the distributed stock with cash.[18] In response, Congress enacted section 201(d) of the Revenue Act of 1921, which addressed situations in which, after a stock dividend, "the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend."[19] In those cases, the amounts received by the shareholder in the redemption or cancellation would be treated as a dividend.[20]

Creative taxpayers quickly found ways to circumvent this provision, which prompted several amendments by Congress. By 1926 the law applied regardless of whether the redeemed stock was previously issued as a stock dividend; instead, any cancelation or redemption of stock would be treated as a taxable dividend if it was made "at such time and in such manner" as to render it dividend equivalent.[21] However, because of this broader application, the rule became the

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[8] *See* Tax Law Center at NYU Law, "Recommendations for the 2022-2023 Priority Guidance Plan," at 4 (June 2, 2022) (making the same recommendation).

[9] Corporations may also use these transactions to transfer borrowing proceeds or the proceeds of an initial public offering to their shareholders.

[10] *See* sections 301(c)(1) and 316.

[11] *See* section 302(a) and (b).

[12] The redeemed shareholder's gains will be treated as capital because the redeemed stock is a capital asset. *See* section 1221(a).

[13] *See* section 302(d).

[14] *See supra* note 10. To the extent that a redemption that is treated as a pro rata distribution exceeds the redeeming corporation's E&P, it results in basis recovery or capital gains. *See* section 301(c)(2) and (3).

[15] Section 302(b)(2) applies if the redemption is "substantially disproportionate with respect to" the redeemed shareholder based on a mathematical formula. Section 302(b)(3) applies if the redemption completely terminates the redeemed shareholder's interest in the redeeming corporation. Section 302(b)(4), which is less mechanical than section 302(b)(2) and (3), applies in the case of a partial liquidation. Section 302(b)(5) applies to some redemptions made by regulated investment companies (*e.g.*, mutual funds). Also, section 303 generally provides for sale or exchange treatment for a redemption of stock that is included in a decedent's gross estate.

[16] *Eisner v. Macomber*, 252 U.S. 189 (1920).

[17] *See Davis*, 397 U.S. at 308; Philip F. Postlewaite and Susan Rogers Finneran, "Section 302(b)(1): The Expanding Minnow," 64(4) *Va. L. Rev.* 561, 565 (1978).

[18] *See id.*

[19] Revenue Act of 1921, section 201(d).

[20] *See id.*

[21] Revenue Act of 1926, section 201(g).

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source of "much confusion in the tax law,"[22] with courts considering a wide range of facts and circumstances to test for dividend equivalence.[23]

In 1954 the House of Representatives sought to resolve this confusion by eliminating the "not essentially equivalent to a dividend" standard in favor of purely mechanical tests.[24] However, the Senate Finance Committee resurrected it, finding the House bill to be "unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place."[25] The Senate Finance Committee did not identify any other situations in which section 302(b)(1) might apply, but it did provide that "the inquiry [should] be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation."[26] Thus, despite the House's push for bright-line rules, the question of whether a redemption is essentially equivalent to a dividend found new life in the Internal Revenue Code of 1954.

C. Reg. Section 1.302-2

In 1955, one year after the enactment of section 302(b)(1), Treasury and the IRS published a sweeping guidance package addressing subchapter C of the 1954 code.[27] Because personnel from Treasury and the IRS Office of Chief Counsel were closely involved in drafting the 1954 legislation,[28] many of the regulations in this package were similar to the explanations and examples found in the legislative history. Indeed, this is the case for the regulations interpreting section 302(b)(1).

The relevant rules issued in 1955 are still in reg. section 1.302-2 today.[29] They repeat the example in the Senate report about the application of section 302(b)(1) to a mandatory redemption of preferred stock, although they clarify that the preferred stock is nonvoting.[30] They also repeat the statement from the Senate report that whether the redeeming corporation has E&P is immaterial to a finding of dividend equivalence.[31] The regulations do provide one reference point not contained in the legislative history, which is that "the question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case."[32] Reg. section 1.302-2 does not further elucidate the analysis required under section 302(b)(1).

D. *Davis*

Perhaps unsurprisingly, neither the enactment of section 302(b)(1) nor the issuance of reg. section 1.302-2 eliminated the enduring uncertainty regarding the application of the dividend-equivalent standard. In particular, courts struggled with whether a redemption required a business purpose to be considered not essentially equivalent to a dividend.[33] In 1970 the Supreme Court considered the issue and rejected any need for a business purpose, instead offering the interpretation that continues to guide section 302(b)(1) today.

The facts of *Davis* were straightforward. Maclin P. Davis Jr. owned 250 of the 1,000 outstanding common shares and all the outstanding preferred shares of a closely held corporation; his wife and children, collectively,

[22] *See Davis*, 397 U.S. at 309.

[23] *See* Postlewaite and Finneran, *supra* note 17, at 566.

[24] *See* H.R. Rep. No. 83-1337, at A72-A73 (1954) ("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 redemption of stock subject to section 301.").

[25] *See* S. Rep. No. 83-1622, at 44 (1954) (the Senate report).

[26] *See id*. at 234. The Senate report also stated that whether the corporation has E&P is immaterial to a finding of dividend equivalence. *See id.*

[27] *See* T.D. 6152.

[28] *See* Leonard L. Silverstein, "An Introduction to the Internal Revenue Code of 1954," N.Y.U. 13th Inst. on Fed. Tax. 7, 8-9 (1955); Norris Darrell, "Internal Revenue Code of 1954 — A Striking Example of the Legislative Process in Action," 1955 So. Calif. Tax Inst. 1, 8-9.

[29] *Compare* reg. section 1.302-2, *with* reg. section 1.302-2 in T.D. 6152. *Cf.* T.D. 9264 (updates for filing requirements and some cross-references); T.D. 9329 (similar).

[30] *See* reg. section 1.302-2(a).

[31] *See id.*

[32] *See* reg. section 1.302-2(b)(1). The regulations also provide that constructive ownership of stock under section 318(a) is to be taken into account. *See id.*

[33] *See* Postlewaite and Finneran, *supra* note 17, at 568-570.

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owned the remaining 750 outstanding common shares. In 1963 the corporation redeemed all of Davis's preferred shares. He reported the redemption as a sale or exchange with no resulting capital gains because of his high basis in the redeemed stock.

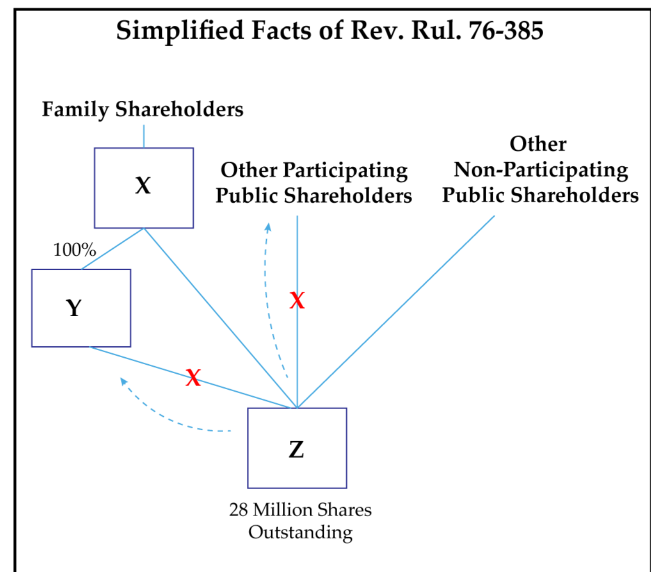
The IRS disagreed with Davis's characterization, and the case made its way to the Supreme Court. As an initial matter, the Court treated Davis as the sole shareholder of the redeeming corporation, as the 750 shares owned by his wife and children were attributed to him by reason of section 318. After reviewing the legislative history of section 302(b)(1), the Court interpreted the language "not essentially equivalent to a dividend" as a matter of substance over form, stating:

> If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the stockholders. Where a redemption has that same effect, it cannot be said to have satisfied the "not essentially equivalent to a dividend" requirement of section 302(b)(1). Rather, to qualify for preferred treatment under that section, a redemption must result in a *meaningful reduction* of the shareholder's proportionate interest in the corporation.[34] [Emphasis added.]

Because the redemption did not meaningfully reduce Davis's interest in the corporation, it was essentially equivalent to a dividend (and thus not treated as a sale or exchange). Stated differently, the Court ruled that a redemption is not essentially equivalent to a dividend if it results in a meaningful reduction (the meaningful reduction rule). While the Court limited its analysis to redemptions by closely held corporations with a single shareholder,[35] many lower court cases have since applied the meaningful reduction rule to closely held corporations with multiple shareholders.[36]

E. Rev. Rul. 76-385

In Rev. Rul. 76-385, Treasury and the IRS considered a redemption by publicly traded corporation Z that was required to divest some assets under a settlement of federal antitrust litigation. The ruling focuses on two corporate shareholders of Z: X, and its wholly owned subsidiary, Y.[37] Y participated in the redemption, but X did not. Thus, after the redemption, even though Y no longer directly owned shares in Z, it was attributed the shares owned by its sole shareholder, X, by reason of section 318. Accordingly, the redemption reduced Y's interest in Z from 0.0001118 percent to 0.0001081 percent.



The ruling concludes that the redemption of Y's interest in Z was not essentially equivalent to a dividend, but it is vague about the precise

[34] *See Davis*, 397 U.S. at 313; *see also id.* ("It was clearly proper for Congress to treat distributions generally as taxable dividends when made out of earnings and profits and then to prevent avoidance of that result without regard to motivation where the distribution is in exchange for redeemed stock.").

[35] *See Davis*, 397 U.S. at 307 ("This case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation."). As described above, Davis was attributed the stock owned by his wife and children.

[36] *See, e.g.*, *Coates Trust v. Commissioner*, 55 T.C. 501 (1970), *aff'd*, 480 F.2d 468 (9th Cir. 1973); *Sawelson v. Commissioner*, 61 T.C. 109 (1973).

[37] Dividend treatment is often more attractive than capital gains to corporate shareholders, who may be eligible for a dividends received deduction. *See* sections 243, 245, and 245A. However, there is no indication that this consideration factored into Rev. Rul. 76-385.

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rationale. Citing legislative history, the ruling describes one of the purposes of section 302(b)(1) as providing preferential capital gains treatment for minority shareholders that "exercise no control over corporate affairs."[38] Because Y's interest in Z was minimal, and Y did not control Z, Treasury and the IRS viewed the redemption as consistent with legislative intent in enacting section 302(b)(1).[39] Also, the ruling describes the meaningful reduction rule before noting that Y experienced a reduction of its voting, dividend, and liquidation rights (collectively, its "*Himmel* rights"[40]). However, the ruling offers no analysis or even mention of whether the reduction was meaningful.[41] Despite this ambiguity, the conclusion of Rev. Rul. 76-385 is clear. Z's redemption of Y's interest — and by extension virtually any public redemption that does not satisfy paragraph (2), (3), (4), or (5) of section 302(b) — is considered not essentially equivalent to a dividend and therefore results in capital gains.

F. Rev. Rul. 81-289

In Rev. Rul. 81-289, 1981-2 CB 82, Treasury and the IRS addressed a rare situation in which a public redemption may be considered essentially equivalent to a dividend. In that ruling, a shareholder tendered 2 percent of its stock in a public redemption in which the redeeming corporation redeemed 2 percent of its total outstanding stock. Thus, because of the simultaneous participation by other shareholders, the redeemed shareholder's proportionate interest in the corporation remained the same. Citing Rev. Rul. 76-385 for the proposition that the meaningful reduction rule applies to publicly traded corporations,[42] the ruling concludes that the redemption was dividend equivalent regarding the redeemed shareholder because that shareholder experienced no reduction (and therefore no *meaningful* reduction) in its *Himmel* rights. Thus, while the two rulings reach different outcomes, the analysis of Rev. Rul. 81-289, which suggests that dividend equivalence in a public redemption requires dividend exactitude, relies on the same underlying rationale as Rev. Rul. 76-385.

III. Reexamining Rev. Rul. 76-385

It is unclear whether Rev. Rul. 76-385 involves two legal theories or one. The ruling could be read as presenting one argument based on legislative history and a separate argument based on *Davis*. Alternatively, it may be that Treasury and the IRS developed a single legal theory that subsumes both the legislative history and *Davis*. The latter explanation accords more closely with the text of the ruling, but in either case, the legal reasoning is questionable. Moreover, the conclusion of the ruling, which is compelled by neither the legislative history nor *Davis*, produces a result that is difficult to reconcile with the terms of the statute.

A. Legislative History

The legislative history of section 302(b)(1) offers some indications — but few clear directives — about what Congress intended in enacting the provision. Indeed, the Court noted in *Davis* that the "intended scope of section 302(b)(1) as revealed by this legislative history is certainly not free from doubt."[43] However, the Senate report was clear that in reviving the dividend-equivalent standard, the only specific transaction lawmakers

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[38]Rev. Rul. 76-385 (citing the Senate report at 44-45); *see also supra* notes 25-26 and accompanying text.

[39]This analysis was not novel at the time. For example, after *Davis* but before the issuance of Rev. Rul. 76-385, one commentator wrote that "the redemption of stock in a public corporation is seldom pro rata; even when it is, the average stockholders' lack of control over the company's dividend policy argues against a finding of dividend equivalency." *See* Fred K. Morrison, "*United States v. Davis*: What Remains of Section 302(b)(1)?" 13 *Wm. & Mary L. Rev.* 202, 207, at n.36 (1971).

[40]In *Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964), the court analyzed the application of section 302(b)(1) to a redemption of preferred stock based on its "net effect" on the redeemed shareholder's right to (1) vote, (2) participate in corporate earnings (*i.e.*, receive dividends), and (3) receive proceeds upon a corporate liquidation.

[41]By contrast, some roughly contemporaneous revenue rulings offered more careful analysis of the meaningful reduction rule in the context of redemptions by closely held corporations. *See* Rev. Rul. 75-502, 1975-2 C.B. 111 (focusing on the redeemed shareholder's loss of majority control); Rev. Rul. 76-364, 1976-2 C.B. 91 (focusing on the redeemed shareholder's loss of the ability to control the corporation by acting jointly with only one other shareholder). *But see* Rev. Rul. 75-512, 1975-2 C.B. 112 (applying the meaningful reduction rule without analyzing why the reduction was meaningful).

[42]The ruling incorrectly asserts that "the United States Tax Court applied the meaningful reduction standard in a situation involving a publicly held corporation." *See id*. The ruling cites *Sawelson*, which involved a redemption by a closely held corporation. *See Sawelson*, 61 T.C. at 110.

[43]*See Davis*, 397 U.S. at 311.

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had in mind was a redemption of preferred stock held by a minority shareholder that has no control over if and when the redemption might take place.[44]

In Rev. Rul. 76-385, Treasury and the IRS misinterpret this background to justify expanding section 302(b)(1) well beyond the reach envisioned by the drafters of the 1954 code. The ruling states that Congress intended to afford capital gains treatment to any "minority shareholder whose relative stock interest in [the corporation] is minimal and who exercises no control over the affairs of [the corporation]."[45] That assertion is not supported by the legislative history cited in the ruling.[46] Indeed, the example described in the Senate report differs from the facts of Rev. Rul. 76-385 in two critical respects. Whereas the Senate report described a redemption of preferred stock, the ruling involves a redemption of common stock. Also, whereas the Senate report described a mandatory redemption over which the redeemed shareholder has no control, the redeemed shareholder in the ruling voluntarily participates in the redemption. Thus, the ruling's claim about legislative intent is simply unfounded.

Moreover, the distinctions between the example in the Senate report and the facts of Rev. Rul. 76-385 do not just foreclose the argument that the legislative history supports the ruling's conclusion; they suggest the opposite. Because preferred stock is typically nonvoting,[47] a redemption of preferred stock generally cannot qualify under the mechanical test of section 302(b)(2), which requires a reduction to the redeemed shareholder's voting power.[48] Thus, not only is the shareholder forced into the transaction, but its pathways for accessing capital gains are diminished.[49] There is no reason to think the Senate Finance Committee intended to extend its sympathy beyond this "narrow hardship"[50] to the broader class of minority shareholders who voluntarily participate in a public redemption.

B. Meaningful Reduction Rule

Rev. Rul. 76-385 recounts the holding of *Davis* before stating that "as a result of the redemption, Y experienced a *reduction* of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in net assets on liquidation" (emphasis added).[51] On its face, this statement is purely observational; virtually every non-pro-rata redemption results in a reduction to the redeemed shareholders' *Himmel* rights.[52] But the statement is not presented as factual background — it is included in the ruling's conclusion as the penultimate sentence to the holding. This location suggests that the statement factors into the ruling's legal theory. What that theory might be, however, depends on the significance attached to the ruling's conspicuous omission of the word "meaningful."

Some commentators simply read past the omission to conclude that Treasury and the IRS considered the redemption to satisfy the meaningful reduction rule.[53] Others, however, assert that Rev. Rul. 76-385 "used the legislative history of section 302(b)(1) to create a broad 'de minimis' exception" to the meaningful reduction rule.[54] Under this view, the failure to describe the redemption of Y's interest as "meaningful" indicates that it was not meaningful, but Treasury and the IRS nevertheless believed that the legislative history of section 302(b)(1) supported

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[44] *See supra* note 25.

[45] *See* Rev. Rul. 76-385.

[46] The ruling cites the Senate report at 44-45. *See also* Postlewaite and Finneran, *supra* note 17, at 594 (quoting the ruling's misinterpretation of legislative history before stating that "the drafters of section 302(b)(1) neither mandated nor intended this result.").

[47] *See generally supra* notes 28 and 30 and accompanying text; Postlewaite and Finneran, *supra* note 17, at 595, n.188.

[48] *See* reg. section 1.302-3(a) ("Section 302(b)(2) does not apply to the redemption solely of nonvoting stock (common or preferred)."). However, a redemption of nonvoting stock may piggyback on a simultaneous redemption of voting stock to which section 302(b)(2) applies. *See id.*; Rev. Rul. 77-237, 1977-2 C.B. 88.

[49] *See* Postlewaite and Finneran, *supra* note 17, at 596.

[50] *Id.*

[51] *See* Rev. Rul. 76-385.

[52] *But see* Rev. Rul. 81-289.

[53] *See* Boyd C. Randall, "Recent Interpretations of the Meaningful Reduction Test of I.R.C. Section 302(b)(1)," 1977(2) *BYU L. Rev.* 253, 264 ("the Commissioner ruled [in Rev. Rul. 76-385] that the reduction was meaningful"); Matthew J. Zinn and Mark J. Silverman, "Redemptions of Stock Under Section 302(b)(1)," 32(1) *The Tax Lawyer* 91, 95, at n.14 (1978) (describing Rev. Rul. 76-385 as finding "a meaningful reduction within the meaning of *Davis*"); Hemel and Polsky, *supra* note 4, at 261 (citing Rev. Rul. 76-385 for the assertion that "the IRS generously has determined that any reduction in percentage ownership interest by a non-controlling shareholder qualifies as a meaningful reduction"). *See also* GCM 38357.

[54] *See* Postlewaite and Finneran, *supra* note 17, at 586.

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an exception to the meaningful reduction rule for the facts in the ruling. While it is unclear which of these interpretations is correct, under either theory, the ruling's rationale is untenable.

In analyzing the potential application of the meaningful reduction rule to Rev. Rul. 76-385, the pertinent question is not whether the redeemed shareholder's *Himmel* rights have been reduced, but whether they have been sufficiently reduced so as to render the transaction qualitatively distinguishable from (that is, nonequivalent to) a dividend. In this regard, treating the redemption in Rev. Rul. 76-385 as satisfying the meaningful reduction rule compels a finding of non-dividend equivalence in all public redemptions so long as there is any reduction in the redeemed shareholder's interest.[55] While that has generally been the outcome of Rev. Rul. 76-385, as a doctrinal matter — and a syntactical one — that is not what the meaningful reduction rule provides.[56] There is no basis for ignoring the word "meaningful" when applying *Davis* to public redemptions.

This incompatibility is the reason for the alternative theory about a de minimis exception. If the holding of Rev. Rul. 76-385 cannot be reconciled with the meaningful reduction rule, then it must represent a carveout. If one accepts the ruling's analysis at face value, there may be no better way to reconcile the discussion of *Davis* and legislative history with the ruling's failure to describe the reduction as meaningful.[57] However the de minimis theory leads to the implausible conclusion that a public redemption that cannot satisfy the meaningful reduction rule is simply excepted from that rule's application. Nothing in the legislative history supports, let alone necessitates, such an exception.

C. GCM 38357

The IRS Office of Chief Counsel revisited the rationale of Rev. Rul. 76-385 a few years after its issuance in a lengthy 1980 general counsel memorandum.[58] In describing the meaningful reduction rule, the memorandum acknowledges the truism that not every reduction is meaningful.[59] It then explains Rev. Rul. 76-385 as follows:

> It is true that the ruling does not expressly state that that reduction was meaningful. It can be inferred by the reader, however, that the Service was taking into consideration the cumulative effect of the fact that there was a reduction as well as the fact that the redemption was from a minority shareholder who had no control over the corporation. Under such circumstances one might infer that any reduction in proportionate interest was meaningful since the shareholder had a relatively meaningless interest to begin with.

This excerpt suggests that the ruling involves a single legal theory. But in contrast to the de minimis theory, which posits that the ruling relied on legislative history to create an exception to the meaningful reduction rule, this view asserts that the legislative history transforms "any reduction" into a meaningful one, as long as the redeemed shareholder's pre-redemption interest is "relatively meaningless." However, the memorandum fails to explain the basic physics of how something that is meaningless can be reduced in a way that is meaningful.[60] Moreover, as with the de minimis theory, this explanation of the ruling relies on a misinterpretation of legislative history.

D. *Conopco*

In *Conopco*,[61] the U.S. District Court for the District of New Jersey further revealed the weaknesses of Rev. Rul. 76-385. The case involved

[55] *But see Conopco Inc. v. United States*, No. 2:04-cv-06025 (D.N.J. 2007).

[56] *But see* GCM 38357, *infra* note 58.

[57] This interpretation is also more consistent with the view that a public redemption that is neither substantially disproportionate nor a complete redemption is not "meaningful" in terms of its underlying economics or effect on corporate governance. *See* Part IV.A.

[58] *See* GCM 38357, issued in connection with the development of Rev. Rul. 81-289.

[59] *See id.* ("Where the shareholder's proportionate interest has been reduced the courts, following *Davis*, have concluded that the reduction must be meaningful before the distributions will be treated as an exchange.").

[60] The drafters of the memorandum hint at this unresolved issue, noting that Rev. Rul. 76-385 "may highlight some of the problems of applying the 'meaningful reduction' test of *Davis* in the context of a publicly traded corporation." *See id.*

[61] *Conopco*, No. 2:04-cv-06025.

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a public redemption that reduced the interest of an employee stock ownership plan in Conopco, the redeeming corporation, from 2.7884 percent to 2.7809 percent.[62] The IRS relied on Rev. Rul. 76-385 to argue that the reduction was meaningful, but the court rejected this contention, finding that under this "interpretation of Revenue Ruling 76-385, the word 'meaningful' would be read completely out of the Supreme Court's test in *Davis*."[63] The court determined that, because Rev. Rul. 76-385 involved a redeemed shareholder whose pre-redemption interest was "relatively meaningless," the ruling did not apply to the redemption of the ESOP, whose pre-redemption interest of 2.7884 percent was more meaningful.[64] Instead, the court found that the reduction, which represented 0.0075 percent of Conopco's total pre-redemption interest, was "so minor that it did not constitute a meaningful reduction" and was therefore treated as a pro rata distribution.[65]

By focusing on the size of the redeemed shareholder's pre-redemption interest, the court chips away at Rev. Rul. 76-385 to adopt a more sensible approach for at least some public redemptions. But this distinction only highlights the deficiencies of Rev. Rul. 76-385, even with a limited scope. If the pre-redemption interest is meaningful, the reduction must be meaningful to satisfy the meaningful reduction rule; but if the pre-redemption interest is meaningless, any reduction will suffice. As described above, this double standard is a departure from legislative history, Supreme Court interpretation, and a plain reading of section 302(b)(1).

IV. Consequences of Capital Gain Treatment

Rev. Rul. 76-385 is the principal reason why virtually all public redemptions that are not described in paragraphs (2) through (5) of section 302(b) yield capital gains for the redeemed shareholders. Much of the history of section 302 dates to earlier eras in federal income taxation when dividends were taxed at substantially higher rates than capital gains. However, even under the current unified rate regime in which both qualified dividends and long-term capital gains of U.S. taxpayers are subject to a maximum rate of 23.8 percent,[66] whether a public redemption yields dividends or capital gains determines several material federal income tax consequences.

- *Foreign shareholders*: Foreign shareholders' dividend income is generally subject to withholding tax at a rate of 30 percent (or lower by treaty).[67] Foreign shareholders' capital gains, on the other hand, are not subject to federal income tax because they are generally sourced to the residence of the seller.
- *Basis recovery*: Dividends are included in gross income dollar-for-dollar,[68] but capital gains allow the redeemed shareholder to recover its adjusted basis in the redeemed stock.[69]
- *Capital losses*: While noncorporate taxpayers' dividends may be offset by no more than $3,000 of capital losses in a given tax year, their capital gains may be offset by capital losses without limit.[70]

The large dollar amount of public redemptions in recent years[71] suggests that this divergent treatment of dividends and capital gains has significant consequences for both

[62] Interestingly, this case originated from the tax consequences to the redeeming corporation, and not to the redeemed shareholder. Section 404(k) generally allows a deduction for amounts paid as dividends to an ESOP. Conopco sought to characterize the redemption as a pro rata distribution that yielded dividend treatment to benefit from this dividends paid deduction.

[63] *See Conopco*, No. 2:04-cv-06025, slip op. at 15.

[64] *See id.* In any event, the court would not have been bound to follow the position of a revenue ruling. *See generally* Rev. Proc. 89-14, 1989-1 C.B. 814 ("Revenue rulings . . . do not have the force and effect of Treasury Department regulations"); *see also* Internal Revenue Manual section 32.2.2.10(1) (same).

[65] *See Conopco*, No. 2:04-cv-06025, slip op. at 13.

[66] *See* sections 1(h) and 1411.

[67] *See* sections 1441 and 1442. *See also* sections 871 and 881.

[68] *See* section 301(c)(1).

[69] *See* section 1001(a).

[70] *See* section 1211(b).

[71] In 2018 through 2021 S&P 500 companies repurchased $806.4 billion, $728.7 billion, $519.7 billion, and $881.7 billion, respectively, of their own stock. *See* S&P Dow Jones Indices, "S&P 500 Q4 2018 Buybacks Set 4th Consecutive Quarterly Record at $223 Billion; 2018 Sets Record $806 Billion," March 25, 2019; S&P Dow Jones Indices, "S&P 500 Buybacks Up 3.2% in Q4 2019; Full Year 2019 Down 9.6% From Record 2018, as Companies Brace for a More Volatile 2020," March 24, 2020; S&P Dow Jones Indices, "S&P 500 Buybacks Increase 28.2% in Q4 2020 From Q3 2020; Full Year 2020 Down 28.7% From 2019," March 24, 2021; S&P Global, "S&P 500 Buybacks Set Quarterly and Annual Record," Mar. 15, 2022.

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taxpayers and the fisc. But critically, each of these relevant consequences is downstream from the initial characterization of the transaction. Given the pressure placed on this analysis, it is somewhat surprising that the regulations interpreting section 302(b)(1) have not been substantively updated since 1955.[72] However, in light of the shortcomings of Rev. Rul. 76-385, the paucity of recent regulatory guidance presents Treasury and the IRS a critical opportunity to revisit the federal income tax treatment of public redemptions.

V. Proposal

A. Reason for Change

Section 302(b)(1) and its predecessors reflect congressional intent that redemptions be taxed in accordance with their substance rather than their form.[73] Stated differently, the provision encapsulates what might be viewed as transactional horizontal equity — that is, a policy that economically similar transactions be taxed similarly. By effectively requiring dividend exactitude for public redemptions, Rev. Rul. 76-385 imposes an inappropriately strict standard on section 302(b)(1).[74] Rather, the proper application of that provision to public redemptions requires a more qualitative assessment of the essential equivalence of the transaction to a pro rata distribution. Indeed, that is the general view adopted by Treasury and the IRS in the regulations issued in 1955, which provide that "whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case."[75]

Commentators have long recognized that public redemptions and pro rata distributions are — or at least can be — economically equivalent.[76] In each case, the corporation transfers earnings to its shareholders. From a shareholder perspective, this economic equivalence is particularly acute for redemptions governed (under current law) by section 302(b)(1). If the shareholder continues its interest after the redemption (and thus fails to satisfy section 302(b)(3)) and the redemption is not large enough to qualify as "substantially disproportionate" (and thus fails to satisfy section 302(b)(2)), the redeemed shareholder is left in substantially the same position as it would have been after a pro rata distribution.

Of course, a public redemption will typically cause some reduction in the redeemed shareholders' *Himmel* rights.[77] Whether that reduction renders the redemption essentially different from a pro rata distribution, however, is ultimately a matter of judgment. A full examination of the literature on *Himmel* rights and publicly traded corporations is beyond the scope of this article. But Rev. Rul. 76-385's description of Y as exercising "no control over the affairs of Z" before its *Himmel* rights were reduced appears emblematic of the typical minority shareholder. When the redeemed shareholder's rights have no more practical significance before the transaction than they do after, the better interpretation of the statute suggests the redemption should be treated as dividend equivalent.[78]

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[72] *See supra* note 29.

[73] *See supra* note 34 and accompanying text.

[74] The Senate report confirms that dividend exactitude is not required for a finding of dividend equivalence by noting that whether the corporation has E&P (a prerequisite for dividend treatment) is not material to an analysis under section 302(b)(1). Also, while an ordinary dividend results from a pro rata distribution, many cases and subregulatory authorities have found dividend equivalence in the case of a non-pro-rata distribution. *See, e.g., Furr v. Commissioner*, T.C. Memo. 1975-85; *Coates Trust*, 55 T.C. 501; *Grabowski Trust v. Commissioner*, 58 T.C. 650 (1972); Rev. Rul. 66-37, 1966-1 C.B. 209; Rev. Rul. 57-353, 1957-2 C.B. 223. *See also* Postlewaite and Finneran, *supra* note 17, at 572 (noting that *Davis* "did not change prior interpretations that had held a distribution need not be identical to a dividend in order to preclude capital gains treatment").

[75] *See* reg. section 1.302-2(b)(1).

[76] *See* Marvin A. Chirelstein, "Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares," 78 *Yale L.J.* 739, 741 (1969) ("Analysis suggests that share repurchasing and ordinary dividend payments are largely interchangeable from an economic standpoint, although considerations of management self-interest may occasionally lead to a preference for the former"); *id.* at 746 ("Share repurchases and dividends are perfect substitutes for each other as long as income tax distinctions are disregarded"); Hemel and Polsky, *supra* note 4, at 252-253 ("Two transactions — one denominated a buyback, the other characterized as a cash dividend — can achieve economically identical results both for the corporation and for its shareholders.").

[77] *Cf.* Rev. Rul. 81-289.

[78] Various legislative proposals over the years similarly demonstrate that rationalizing the treatment of public redemptions and pro rata distributions is sound tax policy. *See supra* note 76; George K. Yin, "A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax," 78 *Geo. L.J.* 1837 (1990); Ethan Yale, "Corporate Distributions Tax Reform: Exploring the Alternatives," 29 *Va. Tax. Rev.* 329 (2009).

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B. Options for Guidance

Treasury should consider (1) revoking[79] Rev. Rul. 76-385, (2) revoking or modifying[80] Rev. Rul. 81-289, and (3) publishing prospectively applicable[81] regulatory guidance that treats most public redemptions as essentially equivalent to a dividend.[82] That guidance may take one of the following approaches:

- *Option 1*: With the revocation of Rev. Rul. 76-385 (along with the revocation or modification of Rev. Rul. 81-289), Treasury and the IRS could distinguish public redemptions from *Davis*, which the Court limited to redemptions by closely held corporations.[83] Accordingly, regulations under section 302(b)(1) could provide that any public redemption is considered essentially equivalent to a dividend.[84] This option could also be structured as a default rule (or rebuttable presumption) applicable to less-than-5-percent shareholders, with a more flexible analysis reserved for significant shareholders. Option 1 is likely to be simpler than Option 2.
- *Option 2*: Treasury and the IRS could define the term "meaningful reduction" for purposes of public redemptions. This approach could reach generally similar results to Option 1 by providing, for example, that a meaningful reduction in a public redemption requires a specific threshold reduction in a shareholder's *Himmel* rights. This option could also be structured as a default rule (or rebuttable presumption) that treats a redemption of a less-than-5-percent shareholder as not resulting in a meaningful reduction.

C. Other Considerations

1. Authority.

Treasury and the IRS's interpretation of section 302(b)(1) is long-standing, but only under subregulatory guidance. The regulations interpreting this provision are sparse and have not been substantively updated since 1955.[85] Also, while there is little meaningful judicial authority in the context of public redemptions, the case law that does exist supports the view that not all public redemptions should result in capital gains.[86] Finally, the Supreme Court has acknowledged that the meaning of the phrase "not essentially equivalent to a dividend" is ambiguous.[87] It is well within Treasury's authority to revoke previously issued revenue rulings and publish regulatory guidance that addresses this ambiguity.

2. Scope of impact.

The proposal would affect all public redemptions that would otherwise be governed, in whole or in part, by section 302(b)(1). In 2021

[79] *See* IRM section 32.2.2.8.1(5) ("*Revoked* is used when the position in a previous publication is not correct and the correct position is being stated in a new publication.").

[80] *See* IRM section 32.2.2.8.1(4) ("*Modified* is used when the substance of a previously published position is being changed.").

[81] Any regulations issued under section 302(b)(1) would be governed by section 7805(b) as in effect before its amendment in 1996. *See* Taxpayer Bill of Rights 2, section 1101(b). Old section 7805(b) provided that tax regulations applied retroactively, except as otherwise provided. *See generally TBL Licensing v. Commissioner*, 158 T.C. No. 1, n.10 (2022). Thus, new regulations under section 302(b)(1) could be issued with retroactive applicability to 1954 (if not earlier), although concerns regarding fairness, compliance, and administrability would likely dictate that they only be applied prospectively.

[82] This guidance would not change the federal income tax treatment of redemptions described in paragraphs (2) through (5) of section 302(b). *See supra* note 15.

[83] Lower courts have generally held that *Davis* is not limited to closely held corporations with a single shareholder. *See supra* note 36. *But see* GCM 38357 (stating that *Davis* should be applied to public redemptions, even though "Rev. Rul. 76-385 may highlight some of the problems of applying the [meaningful reduction rule] in the context of a publicly traded corporation").

[84] There may be a concern that the Court's interpretation of section 302(b)(1) in *Davis* applies to public redemptions and cannot be supplanted by Treasury and the IRS. *See National Cable & Telecommunications Association v. Brand X Internet Services*, 545 U.S. 967, 982 (2005) ("[A] court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute"); *see also United States v. Home Concrete & Supply LLC*, 566 U.S. 478 (2012). However, this argument fails to account for the fact that *Davis* is explicitly limited to redemptions by closely held corporations. *See Davis*, 397 U.S. at 303-304. Also, the *Davis* Court did not hold that its construction followed from the unambiguous terms of the statute. *See id*. at 311.

[85] *See supra* note 29.

[86] In *Conopco*, the court found that a non-pro-rata public redemption was "so minor that it did not constitute a meaningful reduction." *See supra* note 65. Separately, in *Brown v. United States*, 345 F. Supp. 241 (S.D. Ohio 1972), *aff'd without opinion*, 477 F.2d 599 (6th Cir.), *cert. denied*, 414 U.S. 1011 (1973), the court considered a redemption by a corporation of preferred stock held by a family that controlled 99.3 percent of the vote of the corporation. While the facts are unclear, it appears that some of the preferred stock of the corporation was held by the public. The court found that a 1 percent reduction in the redeemed shareholders' proportionate interest was not meaningful.

[87] *See Davis*, 397 U.S. at 311.

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corporations in the S&P 500 redeemed approximately $881 billion of stock.[88] While virtually all these redemptions should have resulted in capital gain for the redeemed shareholders, it is unclear what percentage of these redemptions were governed by section 302(b)(1) (i.e., as opposed to paragraphs (2), (3), (4), or (5) of section 302(b)). For the public redemptions affected by this proposal, foreign shareholders would generally become subject to 30 percent withholding (or lower by treaty).[89] Also, taxable U.S. shareholders would be treated as receiving dividends instead of capital gains.[90]

3. Closely held vs. publicly traded.

GCM 38357 expresses concern about adopting different standards under section 302(b)(1) for closely held and publicly traded corporations based on the legislative history of the tax-free reorganization provisions in the 1954 code. The memorandum cites to the Senate report, which explains that the House believed reorganizations undertaken by closely held corporations presented a greater potential for abuse than those undertaken by publicly traded corporations and should thus be subject to stricter requirements.[91] The Senate rejected this distinction because of the practical difficulty of separately defining closely held and publicly traded corporations, as well as a sense that it would be unfair to impose greater restrictions on "a class of corporations which is ordinarily small than on their larger competitors."[92] Citing these reasons, GCM 38357 argues that "the standard for determining dividend equivalency should be the same for 'closely held' and 'publicly held' corporations."

However, to the extent this legislative history has any bearing on section 302(b)(1) today, it suggests the opposite conclusion. Treasury and the IRS have defined (or otherwise identified) publicly traded corporations in many instances that could be leveraged for this regulatory proposal.[93] In addition, Rev. Rul. 76-385 guarantees the very policy outcome the Senate sought to avoid by ensuring that public redemptions yield capital gains, while redemptions by closely held corporations are offered no such certainty. Thus, the memorandum's argument is not persuasive – at least not from a contemporary perspective. On the contrary, lawmakers' current focus on public redemptions indicates wider acknowledgment that different standards are, indeed, warranted.[94]

4. Shareholder intent.

Redeemed shareholders may argue that dividend treatment is inappropriate because in many instances they are unaware that they are participating in a buyback. Most public redemptions are implemented as open market repurchase programs through a broker that executes the repurchases over time.[95] In those cases, a shareholder that opts to sell its stock has no visibility into who is buying the shares. Thus, there may be a concern about basing the shareholder's tax consequences on the identity of a counterparty that is unknown (and unknowable) at the time of the transaction.

This argument, however, strays from the core inquiry of section 302(b)(1). The determination of whether a redemption is essentially equivalent to a dividend does not depend on the shareholder's intent; rather, the focus is on whether the effect of the redemption "is to transfer the property from the company to its shareholders without a change in the relative economic interests or rights of the stockholders."[96] Indeed, in *Davis*, the Court ruled that the redeeming corporation's purpose for entering into the transaction is irrelevant to the analysis,[97] suggesting a similar role for the shareholder's purpose. Moreover, to the extent that the shareholder's intent is considered, one could argue that, at least for corporations with

[88] *See supra* note 71.

[89] Analysts estimate that approximately 40 percent of the stock in domestic corporations is owned by foreign shareholders. *See* Steve Rosenthal and Theo Burke, "Who's Left to Tax? U.S. Taxation of Corporations and Their Shareholders," Fall 2020 NYU Tax Policy Colloquium, Oct. 27, 2020.

[90] Analysts estimate that approximately 25 percent of the stock in domestic corporations is owned by taxable U.S. shareholders. *See id.*

[91] *See* GCM 38357 (citing the Senate report at 42).

[92] *Id.*

[93] *See, e.g.*, reg. sections 1.897-1(m), 1.1297-1(f)(7), and 1.7704-1(b); *see also* New York State Bar Association, "Report No. 1445 – Report on Section 304 in Public M&A Transactions," 11-13 (Nov. 19, 2020) (the NYSBA report).

[94] *See supra* note 2.

[95] *See* 87 F.R. 8443, 8444 (Feb. 15, 2022).

[96] *See Davis*, 397 U.S. at 313.

[97] *See Davis*, 397 U.S. at 312.

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sizable open market repurchase programs, the shareholder should be presumed to have intended to sell the shares back to the redeeming corporation. Either argument, however, would attach undue significance to the shareholder's knowledge (or lack thereof) of the counterparty's identity. Instead, the application of section 302(b)(1) fundamentally depends on the transaction's economic and legal effect.

5. Implementation.

While, as a doctrinal matter, the shareholder's knowledge of the purchaser's identity should not dictate the characterization of the transaction, the mechanics of an open market repurchase program do raise implementation challenges for this regulatory proposal.[98] Specifically, the redeemed shareholder's sale must ultimately be tied to the redeeming corporation's purchase in order for the parties to comply with their obligations. In theory, this issue could be addressed by requiring brokerage firms to identify when shares have been sold to a redeeming corporation. However, directly tracing the transaction through the open market would introduce significant administrative complexity.[99] Alternatively, Treasury and the IRS could provide permissible assumptions that allow a brokerage to relate a selling shareholder's sale to a redeeming corporation's purchase based on publicly available data. For a given period, brokerages could calculate a ratio equal to the volume of a corporation's buyback activity over total trading volume in that corporation's stock.[100] That ratio could then be applied to each share sold in the given period as a proxy for directly identifying which shares were sold to the redeeming corporation. Such an approach would be consistent with other administrative efforts to reconcile certain legal requirements applicable to publicly traded corporations with the practical difficulties of identifying their shareholders.[101] As the New York State Bar Association recently noted in a comparable context, "Treasury has exercised its regulatory authority in the past to address issues of administrative practicality and to implement Treasury's view of the policy motivating statutory text."[102]

6. Section 305(c).

Section 305(c) and the regulations thereunder construct a deemed taxable stock dividend in several situations, including some instances in which a redemption that is treated as a dividend increases the proportionate interest of the non-redeemed shareholders in the E&P or assets of the redeeming corporation.[103] An example in the regulations suggests that a public redemption will not trigger the application of section 305(c) under current law, provided it is not undertaken "pursuant to a plan to increase the proportionate interest of some shareholders and distribute property to other shareholders."[104] It does not appear likely that the IRS would argue that a typical public redemption is made under such a plan. Still, if this proposal is pursued, Treasury

[98] *Cf.* Rev. Rul. 99-58, 1999-2 IRB 701 (finding that a public redemption by an acquiring corporation after a potential reorganization does not adversely affect satisfaction of the continuity of interest requirement because of the mechanics of the open market repurchase program).

[99] Brokerage firms might respond to this complexity by assuming that any shares of a redeeming corporation sold during the course of an open market repurchase program were purchased by the redeeming corporation. *See generally* NYSBA report, at 10 (noting the prevalence of taxpayers and withholding agents assuming that section 304 applies to a transaction when the shareholder data necessary to make a more conclusive determination is unavailable).

[100] Corporations are required to disclose their buyback activity by month under Item 703 of Regulation S-K, but a recent proposal from the SEC would require disclosure by day. *See* 87 F.R. 8443.

[101] *See* reg. section 1.382-2T(k)(1)(i) (allowing some simplifying assumptions about public shareholders based on available data) and Rev. Proc. 2011-35, 2011-25 IRB 890 (providing methods for an acquiring corporation to establish its basis in the stock of a target corporation acquired in a nonrecognition transaction). *See also* LTR 202141005 (July 16, 2021) (allowing certain estimates about public shareholders based on available data for purposes of section 304); LTR 201910004 (Dec. 6, 2018) (similar but for purposes of section 355(e)); LTR 201817001 (Jan. 26, 2018) (same).

[102] *See* NYSBA report, at 16. *See also* Mark R. Hoffenberg, Stephen M. Marencik, and Adam Murphy, "Determining Control in Public M&A Transactions," *Tax Notes Federal*, Dec. 13, 2021, p. 1501, nn.59-60 and accompanying text (discussing the principle derived from *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) and its progeny that, when relevant underlying information is unavailable, taxpayers may develop reasonable methods for making estimates).

[103] *See* reg. section 1.305-3 and -7(a); section 305(b)(2).

[104] *See* reg. section 1.305-3(e), Example 13. By raising the prospect that section 305(c) could apply, the example assumes that the public redemption was treated, at least partially, as a pro rata distribution (given that section 305(c) could not apply if the public redemption was treated entirely as a sale or exchange). Thus, the example appears inconsistent with Rev. Rul. 76-385. *See* GCM 38357.

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and the IRS should consider whether changes to the section 305 regulations are appropriate.[105]

7. Behavioral response.

If feasible, affected shareholders may seek to avoid application of the proposal by increasing their participation in the public redemption (that is, exchanging more shares) to avail themselves of section 302(b)(2) or (3). Alternatively, affected shareholders may simply decline to participate in public redemptions and instead exclusively sell their shares to third parties to ensure that they receive sale or exchange treatment.[106] And theoretically, redeeming corporations could restructure their public redemptions as pro rata distributions, avoiding the application of section 302 altogether. In each of these scenarios, the proposal would advance the goal of ensuring that capital gain treatment is only provided to transactions that are not economically equivalent to a dividend.

8. Proposed excise tax.

The Build Back Better Act would levy a 1 percent excise tax on public redemptions.[107] In contrast to the regulatory proposal, which would primarily directly affect redeemed shareholders,[108] the proposed excise tax would be levied on the redeeming corporation. Still, the regulatory proposal could interact with the proposed excise tax, particularly if either one prompts shareholders or redeeming corporations to change their behavior. Also, because redemptions that are treated as dividends are excluded from the proposed excise tax,[109] its base could be affected by this proposal. However, this exclusion suggests that the policy objectives of the proposed excise tax do not extend to redemptions that are treated as dividends.[110] Thus, this proposal should be viewed as consistent with, and complementary to, the proposed excise tax.

VI. Conclusion

Despite the substantial attention paid to buybacks by lawmakers, commentators, and the media, Treasury and the IRS's role in regulating the federal income tax consequences of these transactions has attracted little notice. Perhaps this is because the statute is clear regarding the proper treatment of those public redemptions described in paragraphs (2) through (5) of section 302(b), and long-standing subregulatory guidance addresses those left to section 302(b)(1). Even still, as other federal agencies respond to the recent increase in buyback activity,[111] it is imperative that Treasury and the IRS ensure that their prior interpretations reflect sound legal reasoning and promote appropriate policy outcomes.

Unfortunately, the legal rationale of Rev. Rul. 76-385 does not withstand scrutiny. As an initial matter, the legal theory proffered in support of the ruling is unclear. Moreover, the various pathways that might explain the ruling's rationale rest on incorrect interpretations of legislative history or *Davis* (or both). If these flaws were simply a matter of legal doctrine, they might be left alone in a dusty corner of subchapter C. But that is not the case. These arguments are used to support a holding that virtually guarantees the application of section 302(b)(1) to public redemptions,[112] effectively replacing the standard of dividend

[105] There are policy arguments in favor of applying section 305(c) more broadly than under current law to address the ability of some shareholders to eschew participation in public redemptions and thereby avoid the receipt of taxable income altogether. *See generally* Chirelstein, *supra* note 76; Hemel and Polsky, *supra* note 4; *see also* Richard L. Bacon, "Share Redemptions by Publicly Held Companies," 26 *Tax L. Rev.* 283, 293 (1971) (in enacting section 305(c), "Congress accepted the basic idea that a redemption can be viewed as providing a choice between cash or equity and can be treated as a currently taxable event to nonredeeming shareholders.").

[106] For public redemptions implemented through open market repurchase programs, this would presumably require brokerage firms to offer shareholders the option to avoid selling shares to the redeeming corporation.

[107] The proposed excise tax would generally apply to "repurchases," which are defined to include redemptions. *See* proposed section 4501(c) in the Build Back Better Act.

[108] The regulatory proposal would have some effect on the redeeming corporation. For example, the reduction to the redeeming corporation's E&P depends on whether the redemption is classified as a pro rata distribution or a sale or exchange. *See* section 312(a) and (n)(7). *See also supra* note 62.

[109] *See* proposed section 4501(e)(6) in the Build Back Better Act.

[110] Indeed, one of the policy objectives of the proposed excise tax may be to encourage corporations to distribute more earnings to shareholders as dividends. *See* Hemel, "Testimony Before the House Committee on Ways and Means, Subcommittee on Oversight: The Pandora Papers and Hidden Wealth" (Dec. 8, 2021) ("The 1 percent excise tax on stock buybacks in the Build Back Better Act is a first step in the right direction [toward] propelling a move back to dividends.").

[111] The SEC, for example, recently proposed guidance to improve corporate disclosure requirements arising from some redemptions. *See supra* note 100.

[112] *Cf. Davis*, 391 U.S. at 314 (dissent expressing concern that the majority's opinion "effectively cancels section 302(b)(1) from the Code").

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equivalence with one of dividend exactitude. While Rev. Rul. 76-385 has been outstanding for more than four decades,[113] the growing trend toward public redemptions calls for its reconsideration, and the weakness of the ruling's legal rationale calls for its revocation.

In its place, Treasury and the IRS should exercise their regulatory authority to generally treat that subset of public redemptions that would otherwise be governed by section 302(b)(1) as pro rata distributions. This guidance would be consistent with both the legislative intent behind section 302(b)(1) from 1954 and the growing recognition of the tax system's inappropriate bias in favor of redemptions.[114] Moreover, this guidance would give effect to the common understanding of the language of the statute, which prescribes that transactions that carry all the hallmarks of a dividend — that is, those that are essentially equivalent to a dividend — be taxed in the same manner as an actual dividend. ■

[113] The ruling was criticized soon after its issuance. *See* Postlewaite and Finneran, *supra* note 17, at 591 ("The generosity of [Rev. Rul. 76-385] is startling in light of the historical perspective of the continual efforts of Congress, the courts, and the Service to narrow the escape from dividend treatment under section 302(b)(1) and its predecessors.").

[114] *See supra* notes 2, 4, and 76.

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