It would be convenient for tax practitioners if one set of attribution rules applied across the board for federal income tax purposes. In fact, though, nine Internal Revenue Code sections contain specific stock attribution rules. The applicable attribution rule depends on the situation. If the question involves the grant of an incentive stock option under section 422, a special rule applies to shareholders with more than 10 percent under sections 422(b)(6) and 422(c)(5). What stock is counted in determining whether the grantee has more than 10 percent? Section 424(d) attributes to the grantee the stock owned by the individual’s family -- and defines family as “brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.”

For almost all purposes under the corporate provisions of subchapter C, attribution rules start with those of section 318 -- although those rules may be modified, as when the family attribution rules of section 318(a)(1) are waived under section 302(c) in connection with some complete redemptions under section 302(b). Even when it applies, section 318(a)(1), unlike section 424(b), does not attribute stock owned by siblings to each other. Not considering the stock owned by a taxpayer’s brothers or sisters as being owned by the taxpayer, and vice versa, is often helpful to the taxpayer, as when a stock redemption is being tested under section 302(b) for substantial disproportionality. But the provision that saves one taxpayer from a tax problem is often the same provision that proves the tax undoing of another. So it was with Garber Industries of Lafayette, La.

Two Taxpayers or One?

In Garber Industries Holding Co. Inc. v. Commissioner, 124 T.C. No. 1, Doc 2005-1549, 2005 TNT 16-8 (2005), the question was the availability to Garber, a C corporation, of its net operating loss carryovers from 1996 and before to offset $808,935 of its taxable income for 1998 (and $728,041 of its alternative minimum tax income). The IRS had reduced the NOL amount, both for regular tax purposes and for AMT purposes, to $121,258 on the grounds that the section 382(b)(1) limitations on NOLs had been triggered by a combination of transactions in 1996 and 1998 in which Charles M. Garber Sr. had his ownership of Garber Industries reduced from 68 percent to zero while his brother, Kenneth R. Garber Sr., had his ownership increased from 26 percent to 84 percent. That change, argued the IRS, meant that an “ownership change” had occurred as defined by section 382(g). 1

Such a change is generally deemed to have occurred if, on any given date, the percentage ownership of one or more shareholders holding 5 percent is more than 50 percentage points greater than the lowest percentage ownership of the same shareholder(s) during the immediately preceding three-year period. Kenneth’s ownership had been 26 percent until July 10, 1996, and increased to 84 percent on April 1, 1998. That

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1 Spouses, children, and other siblings of the Garber brothers owned the other 16 percent.

2 See ILM 200245006, Doc 2002-24976, 2002 TNT 218-16, for an IRS legal advice memorandum apparently dealing with this case.
was more than a 50-point change, and July 1996 to April 1998 is far shorter than three years.

Family Members -- Up and Down the Family Tree

The corporation argued that Charles and Kenneth were members of the same family. Therefore, the stock owned by the family group had not changed as a result of the sale from one brother to another. As support, it cited section 382(l)(3)(A)(I), which provides that “an individual and all members of his family described in paragraph (1) of section 318(a) shall be treated as one individual for purposes of applying this section.” The IRS’s response was to point to the language of section 318(a)(1)(A), defining members of a family as including (i) an individual’s “spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and (ii) his children, grandchildren, and parents.” That does not include “brothers and sisters,” the IRS said.

Garber Industries admitted that, at first glance, the IRS might appear to be correct. But closer analysis, the corporation suggested, would show that:

although siblings are not family members described in section 318(a)(1), Charles and Kenneth are nonetheless members of the same family when such determination is made by reference to their parents and grandparents. That is, as sons, they are both members of each family consisting of a parent and that parent’s family members. . . . Accordingly, . . . Charles and Kenneth are treated as one individual under section 382(l)(3)(A)(I), with the result that transactions between them are disregarded for purposes of section 382.

Even if that analysis were valid, responded the IRS, it still would apply only with reference to living individuals. None of the Garber parents or grandparents had been alive at any time during the three-year testing period, so there was no living individual during that time whose family members could be treated as including both Charles and Kenneth.

Tax Court Judge James S. Halpern admitted that the application of section 318 to brothers in the context of section 382 was “a matter of first impression for this Court.” He conceded early in his opinion that:

the language of section 382(l)(3)(A)(I) can variably (and reasonably) be interpreted as being consistent with each party’s position in this case. That is, there is nothing in the language of the statute that would make either party’s position patently untenable. . . . Because the answer to our inquiry is not apparent from the face of the statute, we may look beyond the language of section 382(l)(3)(A)(I) for interpretive guidance.

The current section 382 structure was created in the Tax Reform Act of 1986. That legislation, as in other areas of the law, introduced new concepts and approaches to eliminate the marketing of corporate net operating losses and other tax attributes. Thus, Judge Halpern could find little help in the history of the prior section 382.

Reductio Ad Absurdum

What about the practical consequences if the taxpayer’s interpretation was accepted? Judge Halpern found it difficult to believe that Congress, without any mention of such an objective, intended by the language it used in section 382 to expand the concept of the family of an individual from not only his spouse, children, grandchildren, and
parents to his siblings, nephews, nieces, in-laws, great-grandchildren, aunts, uncles, first cousins, and great-grandparents. In a footnote, Judge Halpern explained:

As a member of each parent’s family (i.e., in his capacity as a child of those parents), an individual would be aggregated with his parents’ children (his siblings), grandchildren (his nephews and nieces), and parents (his grandparents). As a member of his spouse’s family (i.e., in his capacity as her spouse), an individual would be aggregated with his spouse’s parents (his mother- and father-in-law). As a member of each child’s family (i.e., in his capacity as a parent of those children), an individual would be aggregated with each child’s spouse (his sons- and daughters-in-law) and grandchildren (his great-grandchildren). As a member of each grandparent’s family (i.e., in his capacity as a grandchild of those grandparents), an individual would be aggregated with his grandparents’ children (his aunts and uncles), grandchildren (his first cousins), and parents (his great-grandparents). See secs. 382(l)(3)(A)(i), 318(a)(1).

And while Judge Halpern found such an expansion of “family” difficult to accept, he found even more difficult the implications of the IRS’s position that the focus had to be on living individuals:

First, it has the potential for being just as expansive as petitioner’s interpretation. More importantly, respondent’s interpretation leads to arbitrary distinctions. As relevant to this case, respondent would have us believe that the ability of siblings to sell loss corporation shares among themselves without any section 382 consequences is wholly dependent on the continued good health of their parents. We see no rational basis for Congress’s having drawn a distinction in this context between siblings whose parents happen to be living and those whose parents happen to be deceased; the former are no more related than the latter.

The Third Way

Neither interpretation made sense, concluded Judge Halpern. Therefore he came up with a third approach that put the family group focus solely on individuals who are shareholders of the loss corporation:

Congress intended individuals to be aggregated with the same family members to whom their shares would otherwise be attributed under section 318(a)(1), which in turn suggests that Congress intended the family aggregation rule to apply from the perspective of individuals who are shareholders of the loss corporation. . . . In other words, composite shareholders are to be constructed only around individuals who directly or indirectly (through an entity or by means of an option) own shares of the loss corporation.

Because neither the parents nor the grandparents of the two Garber brothers had ever been shareholders in Garber Industries, that scuttled the argument that Kenneth and Charles were members of one family group that owned most or all of the stock at all relevant times for section 382 ownership change purposes. Therefore, there was an ownership change and the IRS was correct in its calculation of the limited amount of the NOL available to the corporation in tax year 1998.  

Practitioners concerned about the possibility of artificial ownership increases for section 382 purposes as the result solely of changes in family status (marriage, divorce, death) should note that ownership change problems from gifts, death, and divorce get handled by section 382(l)(3)(B) treating stock with basis determined under sections 1014 (death), 1015 (gift), or 1041(b)(2) (divorce) as having a
Sibling Conflict and Attribution Rules

The idea of attribution, of course, is that the economic interests of some taxpayers are closely aligned with other taxpayers. For that reason, an individual is generally deemed to own the stock owned by a corporation of which he or she owns more than 50 percent and is deemed to own proportionately the stock owned by her or his partnership. Hence the family attribution rules. While members of the family are assumed to operate in the best interests of the family, the reality is that family discord is as old as the family itself. Thus, taxpayers have occasionally argued that the family attribution rules are a useful presumption, but that tax law deals with realities and an erroneous assumption can and should be rebuttable by strong evidence of family discord.

Metzger Trust v. Commissioner, 693 F.2d 459 (5th Cir. 1982), 95 TNT 38-245, illustrates that situation. Circuit Judge Patrick E. Higginbotham introduced the opinion of the three-judge panel by saying:

We decide today a story driven by tensions as old as Genesis but told in the modern lexicon of the tax law. It is the story of David who built a business and left it in the charge of his eldest son Jacob to be shared with Jacob’s two sisters Catherine and Cecelia, of their alienation and resulting quarrel with the tax collectors.

The IRS did not dispute that there was discord, perhaps even hatred, between the siblings. It did not dispute that the stock redemptions at issue were not intended to distribute the earnings of Metzger Dairies but were to end an untenable business relationship in that closely held corporation. But all that was irrelevant, said the IRS. The only question was whether the statutory requirements of section 302(c)(1) had been met so that the family attribution rules of section 318(a)(1) could be waived. The IRS concluded that they had not.

The trust argued that the existence of family discord can negate application of the family attribution rules in determining whether a redemption distribution is the equivalent of a dividend when the facts also show that there was no objective of distributing corporate earnings. Judge Higginbotham explained the trust’s position:

First, it argues that because it is undisputed here that the family cannot function as an economic unit, the attribution rules, built as they are upon that premise, are inapplicable. Second, the Trust argues that even if the Trust by virtue of attribution is virtually the sole shareholder before and after, the redemption was nonetheless not essentially equivalent to a dividend. The argument continues that this follows from the undisputed purpose of the redemption. That is, the purpose not being to bail out corporate earnings, the central base for application of nonequivalency has been touched.

The Supreme Court’s Davis Decision

Judge Higginbotham saw no ambiguity in the statute, and read the unambiguous statute as making no exceptions to the section 318 holding period that includes the time the stock was owned by the person from whom it was acquired. For other changes, such as marriage, read Judge Halpern’s discussion at E-2-b and E-5 of his opinion, including his related footnotes. The tiebreaker rule of the regulations, which he discusses, seems to handle most such situations.
attribution rules for family discord. That said, however, there remained the dividend equivalency test of section 302(b)(1). It provides that redemption treatment shall apply “if the redemption is not essentially equivalent to a dividend.” Section 302(b)(2) provides that redemption treatment shall apply “if the distribution is substantially disproportionate with respect to the shareholder” and if after the redemption the shareholder in question owns less than 50 percent of the voting power of the corporation. Those are two separate tests, contended the trust, and the question of attribution is relevant only for the substantially disproportionate test and not for the dividend equivalency test.

The problem with that interpretation of the statute was that it conflicted with the Supreme Court’s opinion in United States v. Davis et ux., 397 U.S. 301 (1970). “In Davis,” explained Judge Higginbotham, “the Court held that the attribution rules of Section 318(a) must be applied before determining dividend equivalency.” He continued, “In its first step it held that the attribution rules had to be applied in determining dividend equivalency under Section 302(b)(1). Second, the Court held that the presence or absence of a tax-avoidance motive could not be considered in determining dividend equivalency under Section 302(b)(1).” In the language of the Supreme Court,

After application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation. We conclude that such a redemption is always “essentially equal to a dividend” within the meaning of that phrase in Section 302(b)(1).

There was a short dissent, written by Justice William O. Douglas, in the 6-3 Davis decision. In it, he pointed out that the majority opinion effectively cancels section 302(b)(1) from the Code. This result is not a matter of conjecture, for the Court says that in the case of closely held or one-man corporations a redemption of stock is “always” equivalent to a dividend. I would leave such revision to the Congress.

While we would agree with Justice Douglas on this, that is not what the Court majority decided, with the result that the Metzger Trust had ordinary dividend income rather than capital gain.

Conclusion

The issue of dividend equivalency versus capital gain is less significant than in the past. Most dividends are now taxed at the same 15 percent rate as security capital gains. Thus, the difference between dividend and redemption treatment consists of the use of tax basis to offset the amount received in the stock redemption situation and full taxation of the amount received, to the extent of earnings and profits, in the dividend alternative.

But the issue of stock attribution is not as easily ignored elsewhere. Tax practitioners need to be aware of it in a wide range of situations. Garber Industries, for example, might have been able to avoid the section 382 problem if it had been conscious of the effect of the 1998 sale of stock from Kenneth to Charles. In a closely held business, the three-year window can often be managed so that there is never a 50-percentage-point change in any three-year period.

If there had been no Garber Industries case, however, we would not have deepened our understanding of the interaction between sections 318 and 382. We knew that section 382 focused on a family group being treated as one individual for change of ownership purposes. However, we
did not fully appreciate the difference in results if that individual was an ancestor, thus rendering siblings part of the family group despite section 318(a)(1); or if that focal member of the family group was alive or not throughout the testing period; or if that person was or was not directly a stockholder. Now we know. We believe the Solomonic approach taken by Judge Halpern should stand up on appeal. Tax practitioners should henceforth be able to advise on intrafamily stock transfers with a better grasp of their effect on NOL carryovers of the family corporation.