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TAX LAW

THE APPELLATE DECISION IN *LYNCH*: A CONTINUING QUEST TO DEFINE THE INTEREST PROHIBITED BY SECTION 302(c)

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I. INTRODUCTION

Section 302 of the Internal Revenue Code¹ provides the statutory framework for distinguishing between corporate distributions made in redemption of the distributee corporation's stock which are to be treated as a sale or exchange by the redeeming shareholder and those which are to be less favorably treated as essentially equivalent to the distribution of an ordinary dividend.² Distributions in redemption of a corporation's stock are taxed to the redeeming shareholder as dividends³ unless the redemption satisfies one of the exceptions of section

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1. All references are to the Internal Revenue Code of 1986 unless otherwise noted.

2. Unless the redeeming shareholder is a dealer in securities, a sale or exchange will be accorded capital gain or loss treatment pursuant to I.R.C. § 1221, whereas a dividend distribution within the meaning of I.R.C. § 316 is taxed as ordinary income. Although for years after 1987, the rate differential favoring capital transactions has been repealed by the Tax Reform Act of 1986, Pub. L. 99-514, §§ 1 and 301, 100 Stat. 2085 (1986), characterization of a redemption as a sale or exchange has the continuing advantage of limiting taxable income to the excess of the redemption proceeds over the basis of the shares redeemed, as distinguished from dividend characterization which subjects the gross amount distributed to taxation.

3. I.R.C. § 302(d).

302(b).⁴ These exceptions include a reacquisition of shares which effects a complete termination of the redeeming shareholder's stock interest in the corporation.⁵ For purposes of this determination statutory rules of constructive ownership provide, in relevant part, that a redeeming shareholder is considered to own the stock owned by certain members of his family.⁶ Without more, these rules would effectively inhibit passing a wholly owned family business from one generation to another by means of a redemption transaction. For example, assume a father desires to retire from the family business and allow his son to assume control, but in order to do so needs to withdraw significant monies from the corporation to fund his retirement. A redemption of most of the father's shares for cash, with a gift of his remaining shares to the son, would accomplish these results, but unfortunately the son's shares would be attributed to the father causing the distribution in redemption to be taxed as a dividend rather than an exchange.⁷ In order that these legitimate family and

4. I.R.C. § 302(b) provides, in part, as follows:

(b) Redemptions Treated as Exchanges—

(1) Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially Disproportionate Redemption of Stock—

(A) In General— Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder. . . .

(3) Subsection(a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

I.R.C. § 302(a) provides for exchange treatment of the redemption transaction if any of the above exceptions applies.

5. I.R.C. § 302(b)(3).

6. I.R.C. § 318(a) provides, in part, as follows:

(1) Members of Family—

(A) In General— An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his 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.

7. Pursuant to the hypothetical, father owns 100% of the stock of the corporation prior to the redemption and, since the son owns all of the outstanding stock following the redemption, continues as the sole owner by virtue of attribution of the son's shares

business purposes may be achieved, without being unfairly inhibited by adverse tax consequences, the statute permits the rules of family attribution to be waived under certain limited conditions.⁸ By so providing, the retiring family member can terminate his interest and achieve capital gain treatment for the proceeds of redemption, whereas in the absence of such waiver the redemption proceeds might be taxed less favorably as the equivalent of a dividend distribution.⁹

Thus, it is extremely important to plan a redemption in a manner which satisfies the technical requirements for waiving family attribution as this is often the critical element which permits the transaction to qualify for favorable tax treatment as an exchange. Unfortunately, the tax planning necessary to achieve this end is often hindered by the uncertainties created as a result of the conflicting interpretations of the waiver requirements by the Internal Revenue Service¹⁰ and the Tax Court. A redeeming shareholder may waive family attribution provided he has not retained an "interest" in the redeeming corporation, including an interest as an employee, officer or director, which is prohibited by section 302(c)(2)(A).¹¹ The Tax Court has construed the "interest" prohibited by this section to require a retained

to him under I.R.C. § 318(a)(1). Since the father owns 100% both before and after the redemption, the transaction is treated as a dividend and not an exchange. *U.S. v. Davis*, 397 U.S. 1071 (1970).

8. These conditions are set forth in I.R.C. § 302(c)(2)(A) which provides in relevant part:

- (A) In the case of a distribution described in subsection (b) (3), section 318(a)(1) shall not apply if— (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as an officer, director or employee), other than an interest as a creditor,
- (ii) The distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and
- (iii) the distributee files an agreement to notify the Secretary of any acquisition described in clause (ii)

9. Even in the absence of a waiver of family attribution, a distributee may be entitled to exchange treatment pursuant to one of the other exceptions of I.R.C. § 302(b), as for example, the percentage tests for a disproportionate redemption of I.R.C. § 302(b)(2) or the rules of corporate contraction of I.R.C. § 302(b)(4).

10. Hereinafter referred to as the "Service."

11. *See supra* note 8. "Interest" is defined only in terms of the specifically prohibited employee, officer and director relationships and the equally specific approval of a creditor relationship. This failure to provide a more encompassing definition, at least in part, is the cause of the uncertainties of interpretation discussed subsequently.

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financial stake in future corporate profits or continued control of the redeeming corporation.¹² It has permitted the waiver of family attribution even though a shareholder has continued as an officer, director or employee of the redeeming corporation, despite the contrary language of the statute, where the specifics of that relationship were found not to constitute a financial stake or provide continuing managerial control.¹³ The Service, naturally, opts for a strict construction of the statute pursuant to which any employment relationship, including that of an independent contractor (although such status is not specifically excepted in the statute), is a per se prohibited interest.¹⁴

The uncertainty created by these differing interpretations has been exacerbated by the recent decision in *Lynch v. Commissioner*,¹⁵ in which an appellate court for the first time has overruled the Tax Court and accepted the statutory construction favored by the Service.¹⁶ This author considers both positions to be flawed. The Service and the Ninth Circuit decision in *Lynch* go too far by including all employment relationships within the per se prohibition. Similarly, the Tax Court does not go far enough in that it requires a review of the facts and circumstances in each case to determine the existence of a prohibited interest and to that extent fails to give sufficient credence to the specific language of the statute which designates status as an officer, director or employee as a prohibited interest.

A clearer and more balanced picture must be developed as to the "interest" intended to be prohibited by the statute. Not necessarily because the contradictory interpretations of the Tax Court and the Service invariably lead to differing or erroneous results, they often do not,¹⁷ but to provide more guidance where

12. *Estate of Lennard v. Commissioner*, 61 T.C. 554 (1974); *Chertkof v. Commissioner*, 72 T.C. 1113 (1979) *aff'd*, 649 F.2d 264 (4th Cir. 1981); *see also* *Lewis v. Commissioner*, 47 T.C. 129, 137 (1966) (Simpson, J., concurring).

13. *See* *Lisle v. Commissioner*, 35 T.C.M.(CCH) 627 (1976).

14. Rev. Rul. 70-104, 1970-1 C.B. 66; Rev. Rul. 59-119, 1959-1 C.B. 68; *see also* Rev. Rul. 56-556, 1956-2 C.B. 177 wherein it is stated that the reacquisition of an employee interest "with or without compensation" is prohibited. But *see* Rev. Rul. 54-408, 1954-2 C.B. 165, discussed *infra* note 49, which raises a contrary implication.

15. 801 F.2d 1176 (9th Cir. 1986), *rev'g* 83 T.C. 597 (1984).

16. *Lynch*, 801 F.2d at 1179.

17. *See* *Chertkof v. Commissioner*, 72 T.C. 1113 (1979), *aff'd*, 649 F.2d 264 (4th Cir. 1981) in which the taxpayer was held to have acquired a prohibited interest in the redeeming corporation as the result of powers granted him pursuant to a management

relationships other than employment are at issue and uncertainty rather than inconsistency hinders proper planning. This article will attempt to illustrate the excesses of both the Service and the Tax Court positions through an analysis of the *Lynch* decision; and to develop a definitional standard which not only deals effectively with the question of a shareholder's status as an officer, director or employee, but with other relationships to the redeeming corporation as well.

II. THE LYNCH CASE

A. FACTS AND COURT ANALYSIS

On December 17, 1975, William Lynch sold 50 shares of the stock of W. M. Lynch Co. to his son.¹⁸ At the same time Lynch and his wife resigned as officers and directors of the corporation.¹⁹ Two weeks later the corporation redeemed Lynch's remaining shares for a cash down payment and a promissory note leaving the son as the sole shareholder.²⁰

In the years immediately preceding the redemption the son had assumed ever increasing managerial responsibility in the corporation.²¹ Nevertheless, on assuming control he wished to retain his father's expertise in the narrow field in which the corporation conducted its business.²² Thus, on the date of the redemption, the corporation and Lynch entered into a five year consulting agreement, terminable at will by Lynch, which provided for monthly payments of \$500, and the reimbursement of business related travel, entertainment and automobile expenses.²³ The agreement was modified by mutual consent in

agreement between the redeeming corporation and a corporation 80% owned by the taxpayer. Under the Tax Court's view, the powers granted to Chertkof permitted him to control corporate policy and thereby affect his share of the income from property which he owned jointly with the redeeming corporation. This was deemed to provide Chertkof with the necessary financial stake in the redeeming corporation. A similar conclusion would undoubtedly be reached under the standard applied by the Ninth Circuit in *Lynch v. Commissioner*, 801 F.2d 1176, 1179 (9th Cir. 1986) in which any employment relationship is prohibited per se.

18. *Lynch v. Commissioner*, 801 F.2d 1176, 1177 (9th Cir. 1986).

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

February, 1977 to reduce the monthly payments to \$250 and was terminated in 1979, one year prior to its expiration date.²⁴ The corporation never withheld payroll taxes from the consulting fees paid to Lynch.²⁵

Immediately after the redemption, Lynch went to the corporation's offices daily; he shared offices with his son until 1979.²⁶ But as time went on, he went to the office less and less.²⁷ Approximately one year after the redemption, Lynch went to the office only once or twice a week, and sometimes he had no contact with the corporation for weeks at a time.²⁸ Actual consulting services were rendered only during 1976 and 1977.²⁹

In addition to the consulting agreement, Lynch remained a beneficiary under the corporation's group medical insurance policy.³⁰ Following the redemption, the corporation paid a total of \$4,487.54 in net premiums on his behalf until cancellation of his coverage under this policy on May 1, 1980.³¹ He was also covered by a medical reimbursement plan, created the day of the redemption, which provided a maximum annual payment of \$1,000 per member.³² Payments to Lynch under this plan totaled \$96.05.³³

Based on these facts, the Tax Court rejected the government's argument that the services rendered by Lynch under the consulting agreement constituted a prohibited interest.³⁴ It relied on the test developed in *Lewis v. Commissioner*,³⁵ stating:

Thus, in determining whether a prohibited interest has been retained under section 302(c)(2)(A)(i), we must look to whether the former stockholder has either retained a financial stake in the corporation or continued to control

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Lynch*, 83 T.C. at 601.

29. *Id.*

30. *Lynch*, 801 F.2d at 1177.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Lynch*, 83 T.C. at 608.

35. 47 T.C. 129, 136 (1966)(Simpson, J. concurring).

the corporation and benefit by its operations (citations omitted). In particular, where the interest retained is not that of an officer, director, or employee, we must examine the facts and circumstances to determine whether a prohibited interest has been retained³⁶

The Tax Court concluded that Lynch was not an employee but an independent contractor since the corporation did not have the right under the consulting agreement to control his actions;³⁷ and that he had not retained a financial stake in the corporation, since his consulting arrangement was not contingent on future profits.³⁸ It also found that Lynch did not exert control over corporate affairs.³⁹ As a result, the Tax Court concluded that Lynch had not retained an interest prohibited by section 302(c)(2)(A)(i).⁴⁰

On appeal, the Ninth Circuit rejected the Tax Court's standard for determining the existence of a prohibited interest.⁴¹ Based primarily on its perception that the relevant legislative history expressed Congress' intent to bring a measure of certainty to the tax consequences of corporate redemptions, the court held that a taxpayer who provides post redemption services, either as an employee or an independent contractor, holds a prohibited interest in the corporation.⁴²

The facts and circumstances test advocated by the Tax Court was viewed as a functional equal of the flexible but vague "dividend equivalence" test of prior law, which had prompted Congress to enact the definite standards of section 302(b)(2) and (3), and thereby undermined a taxpayer's ability to know the tax consequences of a redemption with certainty. The Ninth Circuit stated:

36. *Lynch*, 83 T.C. at 605.

37. Control of the means of employment is the traditional test for distinguishing employment status from that of an independent contractor. See § 31.3401(c)-1(c) of the Employment Tax Regs.

38. *Lynch*, 83 T.C. at 606.

39. *Id.* at 608.

40. See *supra* note 8.

41. *Lynch*, 801 F.2d at 1179.

42. *Id.*

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“The Tax Court’s refusal to recognize that section 302(c)(2)(A)(i) prohibits *all* noncreditor interests in the corporation creates the same uncertainty as the ‘dividend equivalence’ test.”⁴³

The court buttressed its conclusion by comparing the Tax Court’s decision in *Lynch* with that in *Seda v. Commissioner*.⁴⁴ The latter held, but only after an analysis of all the facts and circumstances, that the taxpayer had retained a financial stake, and thus a prohibited interest, in the corporation by continuing as an employee for two years at a salary of \$1,000 per month.⁴⁵ The Ninth Circuit considered this result at odds with the decision in *Lynch* where the receipt of \$500 per month was not a financial stake. It pointed to the weakness of ignoring the unequivocal language of the statute prohibiting retention of employment status per se, in favor of a facts and circumstances analysis that apparently depended on the rate of compensation and compromised the desired certainty in predicting tax results.⁴⁶

Although *Lynch* involved an independent contractor whereas *Seda* involved an employee, this factual difference was not found to be meaningful.⁴⁷ The court considered any difference in result based on the nature of the service relationship to be an unwarranted elevation of form over substance, declaring “[T]he parenthetical language in section 302(c)(2)(A)(i) merely provides a subset of prohibited interests from the universe of such interests, and in no way limits us from finding that an independent contractor retains a prohibited interest.”⁴⁸

B. CRITIQUE

The Tax Court’s reliance on a facts and circumstances test to determine whether a post redemption employment relationship provides a continuing “financial stake” in, or control of, the redeeming corporation, is an apparent attempt to interpret the parenthetical language of section 302(c)(2)(A)(i) in a manner

43. *Id.*

44. 82 T.C. 484 (1984).

45. *Id.* at 488.

46. *Lynch*, 801 F.2d at 1179.

47. *Id.* at 1180-81.

48. *Id.*

which is consistent with the broad purpose of section 302, to prevent a bailout of earnings through the conversion of an ordinary dividend distribution into a capital gain exchange.⁴⁹ The Ninth Circuit decision, on the other hand, looks to a narrower legislative purpose, the need to provide certainty in the characterization of a redemption as an ordinary dividend or capital gain exchange, and interprets the parenthetical language of section 302(c)(2)(A)(i) as requiring any employment relationship to be treated as an interest which is prohibited per se.⁵⁰ The Tax Court ignored the plain language of the statute which unequivocally declares an interest as an officer, director or employee to be prohibited, and instead required that the facts be analyzed to indicate a continuing financial stake or control. The per se test applied on appeal similarly expands the statutory language of the parenthetical exception concerning employment status to include the unspecified relationship of independent contractor as one which is prohibited per se.⁵¹ Each is over zealous in its approach.

By requiring an employment relationship of any kind to be coupled with a financial stake in the corporation, the Tax Court

49. The Tax Court position, as initially formulated by Judge Simpson in his concurring opinion in *Lewis v. Commissioner*, 47 T.C. 129, 137-38 (1966), relied upon Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 33, n. 72 which reads, in part, as follows:

Section 302(c)(2)(A)(i) does not explicitly prohibit employment or office-holding per se; it speaks of "an interest as officer, director, or employee," and this could be interpreted to mean something more than the performance of services alone. See Rev. Rul. 54-408, 1954-2 Cum. Bull. 165, implying that a majority shareholder whose stock was redeemed had ceased "to be interested in the affairs of the corporation;" within the meaning of the old regulations . . . even though he remained in the employ of the corporation for four years

The cited ruling, however, concerns characterization of a redemption under section 115(g) of the Internal Revenue Code of 1939 and the accompanying regulations which concern a cessation of interest in corporate affairs. The ruling appears more closely related to a determination as to the termination of interest requirements of I.R.C. § 302(b)(3), than the statutory restrictions imposed by I.R.C. § 302(c)(2)(A)(i), or the policy considerations underlying the imposition of those restrictions, since family attribution was not at issue. Therefore, the inference sought to be drawn from the facts of the ruling may not be justified.

50. For an extensive analysis of the legislative history in support of this position see Rose, *The Prohibited Interest of Section 302(c)(A)*, 36 TAX L. REV. 131, 134-140 (1981) and Marusic, *The Prohibited Interest of I.R.C. Section 302(c)(2)(A) After Seda and Lynch*, 65 NEB. L. REV. 486, 491-95 (1986).

51. See *Lynch*, 801 F.2d at 1179.

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ignored the transactional nature of the payment of salary for services rendered as an exchange, which if made at fair value does not create in the service provider a claim against corporate assets or earnings.⁵² Therefore, under the “financial stake” aspect of the Tax Court’s test the mere exchange of services for fair value should never be considered a prohibited interest under section 302(c)(2)(A)(i). Accordingly, the Court of Appeals in *Lynch* was correct in concluding that salary level alone was an insufficient basis to distinguish between those employment relationships which provide a prohibited interest and those that do not. Using salary as a criteria, either *Seda* or *Lynch*⁵³ would appear to represent a financial stake with a difference existing only in the amount of that stake. Recourse to the facts and circumstances as advocated by the Tax Court adds nothing to this analysis.

52. The Tax Court and the Service appear to subscribe to this formulation of what constitutes a prohibited interest founded on the existence of a financial stake. See *Lynch v. Commissioner*, 83 T.C. 597, 606 (1984) (“petitioner did not have a financial stake . . . payments . . . pursuant to the consulting agreement were in no sense contingent on the profitability or future operations of the corporation.”); *Lennard v. Commissioner*, 61 T.C. 554, 562 (1974) (“[T]here is no evidence that the fee [*sic* for consulting services payable to the redeemed shareholder] was keyed to the net profits of the corporation.”). In Rev Rul 77-467, 1977-2 C.B. 92, the Service held that a lease of property by the redeemed shareholder to the lessee corporation in exchange for fair rental value does not create a prohibited interest; it goes on, however, to state that such a relationship may constitute a prohibited interest under I.R.C. § 302(c)(2)(A)(i) “if under the terms of the agreement for the use of property the payments to the person whose stock was redeemed are dependent on the corporation’s future earnings”

53. Arguably, the cases are distinguishable on another basis. Since *Seda* involves an employee and *Lynch* an independent contractor, it might be inferred from the two decisions that the level of activity necessary to create a financial stake in the corporation differs for purposes of the facts and circumstances test as applied by the Tax Court to these differing relationships. But references to level of employment appear most appropriate to the question of the redeeming shareholder’s continued control of the corporation and not to the existence of a financial stake. See *infra* notes 81-87 and accompanying text for a discussion of how employment, as distinguished from independent contractor, status affects the redeemed shareholder’s ability to maintain management control of the redeeming corporation and favors interpreting the parenthetical language of I.R.C. § 302(c)(2)(A)(i) as a *per se* prohibited interest.

Additionally it may be argued that the Tax Court reached its decision in *Seda*, based on the combined level of activity and the failure of the taxpayer to prove “that Mr. Seda ceased to be involved in the management of the company after the redemption.” This raises the question of whether the facts and circumstances test is conjunctive rather than disjunctive, requiring both a financial stake and control in order to find the retention of a prohibited interest. However, this issue was apparently laid to rest in *Cerone v. Commissioner*, 87 T.C. 1 (1986) in which the Tax Court affirmed the test as disjunctive, requiring only a financial stake or control and not both.

However, if the level of compensation paid does exceed the value of the services rendered, a claim against, and thus a financial stake in, the earnings of the payor corporation is created. Nevertheless, this possibility does not justify the Tax Court's use of a facts and circumstances test in determining whether an employment relationship is a prohibited interest rather than relying on the specific statutory language to treat such relationship as prohibited per se. The reason underlying the parenthetical exclusion of section 302(c)(2)(A)(i) is not predicated on the continued existence or non existence of a continuing financial stake in the redeeming corporation. As the following analysis indicates, its rationale lies in limiting the ability of the redeemed shareholder to maintain control of the corporation.⁵⁴ Section 302(c)(2)(A) is designed to permit one family member to turn over control of a closely held corporation to other family members and receive exchange treatment through the waiver of family attribution which would otherwise render section 302(b)(3) inapplicable and result in the redemption proceeds being taxed as a dividend.⁵⁵ These attribution rules rest on the assumption

54. See *Committee on Taxation, Ass'n of Bar of New York, Recommendations for Revision of Internal Revenue Code 1954*, at 16 (1955) wherein it is stated:

The rule as to termination of interest is unrealistic and uncertain in its operation. If it was intended to foreclose the retiring stockholder from continuing to exercise control over corporate affairs, it will hardly succeed because in the closely held corporation designation of the retiring stockholder as an officer, director or employee is scarcely necessary. If, as seems more likely, it was intended to prevent retention of an economic interest similar to that of a stockholder, fluctuating with the welfare of the corporation, the term "interest" seems adequately descriptive. In any event, retention of the services of the former stockholder as an officer, director, or employee at a fixed salary would not seem offensive. It is recommended therefore that the parenthetical phrase "(including an interest as officer, director, or employee)" be eliminated from section 302(c)(2)(A)(i).

While it is undoubtedly true that control can be exercised without a formal employment relationship with the redeeming corporation, this comment fails to recognize that the ability to control may be enhanced if such relationships are permitted. Since, as the quoted language indicates, the parenthetical exclusion has little relationship to the retention of an economic interest similar to that of a shareholder, it seem reasonable to conclude that such language relates to the continuation of stockholder control.

55. S. Rep. No. 1622, 83d Cong., 2d Sess. 235-36 (1954). The general explanation of the Senate report says: "If a shareholder desires to sever completely his interest in a corporation which he and his family controls, the rules of family ownership are waived . . . if the shareholder does not reacquire . . . an interest (other than an interest as creditor), for a period of 10 years thereafter."

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that certain relationships often involve an economic identity of interest.⁵⁶ Thus, in the absence of a waiver of family attribution, an economic interest is presumed through attribution. To mandate a financial or economic stake as an element of a prohibited interest under section 302(c)(2)(A) would undermine that presumption by requiring such an economic stake to exist in fact before it could be imputed by attribution.⁵⁷ This would be unwarranted and leads to the conclusion that the thrust of the parenthetical language of section 302(c)(2)(A) relates to a retained interest which bears on the continued ability of the redeemed shareholder to control the corporation.

Stated differently, the general language of section 302(c)(2)(A)(i) prohibits the retention of an "interest." For purposes of statutory interpretation, "the words of statutes—including revenue statutes—should be interpreted where possible in their ordinary, everyday senses (citations omitted). Departure from a literal reading of statutory language may on occasion be indicated by relevant internal evidence of the statute itself and necessary in order to effect the legislative purpose."⁵⁸ "Interest" is defined as "the relation of being objectively concerned in something, by having a right or title to, a claim upon, or a share in."⁵⁹ This definition is consistent with the usage accorded "interest" in section 302(b)(3) where it clearly relates to a shareholder's ownership of the redeeming corporation as evidenced by his equity investment.⁶⁰ There is no need to interpret "interest" differently when used in section 302(c)(2)(A)(i) except to the extent necessary to conform that use to the more specific purpose

56. See *Rickey v. United States*, 592 F.2d 1251, 1256 (5th Cir. 1979); *Coyle v. United States*, 415 F.2d 488, 490 (4th Cir. 1968).

57. That is not to say that the existence of a financial stake or economic interest would be ignored. It would clearly constitute a prohibited interest under I.R.C. § 302(c)(2)(A). However, the existence of such an economic interest is not, and should not, be a prerequisite to such a prohibited interest.

58. *Malat v. Riddell*, 383 U.S. 569, 571-72 (1966) (citations omitted).

59. The Compact Edition of the Oxford English Dictionary, Oxford Press (1971). The secondary definition is even more to the point: "a pecuniary share or stake in, or claim upon anything, the relation of being a part-owner of property, a shareholder in a commercial or financial undertaking, or the like." *Id.*

60. The sole concern of I.R.C. § 302 is whether a change in shareholder stock ownership is sufficiently material to warrant capital gain treatment as an exchange. I.R.C. § 302(b)(3) specifically refers to the complete redemption of a shareholder's stock in the corporation as a "Termination of shareholder's interest."

of that subsection.⁶¹ The elements of continued interest prohibited by section 302(c)(2)(A)(i) should be the same as those represented by the terminated equity investment modified as necessary, to reflect that such rights are no longer delineated by stock ownership but, in appropriate circumstances, through other relationships of the redeemed shareholder to the corporation. A stock interest is recognized to have three basic elements: a claim against corporate assets, a right to corporate earnings and the power to control the corporation through election of its officers and directors.⁶² These are the elements representing an "interest" prohibited by section 302(c)(2)(A)(i). This is tacitly recognized by the Tax Court's reference to a continuing financial stake or control of the redeeming corporation.⁶³ However, an employment relationship does not ordinarily represent any right

61. Namely, to permit a waiver of family attribution in connection with a termination effected by a formal redemption of stock from being less than complete in substance because of a continuing nexus between the terminated shareholder and the corporation. *But see* Rose, *The Prohibited Interest of Section 302(c)(2)(A)*, 36 TAX L. REV. 131, 148 n. 73 (1981) in which it is stated that to give effect to the word "interest" as used in subsection 302(c)(2)(A), "it must mean something other than the "interest" referred to in subsection (b)(3). . . ."

62. *See* Himmel v. Commissioner, 338 F. 2d 815 (2d Cir. 1964). However, if "interest" as used in I.R.C. § 302(c)(2)(A)(i) is intended to embrace only the rights formerly represented by a shareholder's equity investment, a creditor interest, being an investment of a different dimension, would be excluded without the need of a specific exemption. Why then is a specific exclusion provided? The legislative history is unclear as to the purpose of the creditor exception. It has been suggested that the exception permits a redemption of shares using the installment method, thereby ameliorating the problem of funding the required redemption distribution. *See generally* Marusic, *supra* note 50, at 493 n. 45; Rose, *supra* note 50, at 159-60; Comment, *Complete Stock Redemption in a Family Corporation: A Warning About the Pitfalls of Two Standards*, 23 VILL. L. REV. 100, 104-5 (1978). While that is a pragmatic reason for a creditor exception, an explanation consonant with the intention of the statute and the plain meaning of "interest" is equally possible. As indicated, I.R.C. § 302(c)(2)(A) following the redemption of a stockholder's equity investment is intended to prohibit continuing relationships which provide similar rights to corporate assets, earnings or control. As a creditor the redeeming shareholder continues to maintain an investment entitling him to a prior claim on corporate assets and earning in the form of interest, thereby creating an investment based relationship at least ostensibly within the intended interdiction of the statute. By specifically excluding a creditor relationship, the statute affirms that a prohibited interest relates only to relationships which provide rights similar to those enjoyed through equitable ownership and not from a temporal advance of funds.

63. *Lewis v. Commissioner*, 47 T.C. 129, 137 (1966) (Simpson, J. concurring) wherein it is stated: "[I]mmediately after the enactment of the 1954 Code, it was recognized that section 302(c)(2)(A)(i) did not prohibit office holding per se, but was concerned with a retained financial stake in the corporation, such as a profit-sharing plan, or in the creation of an ostensible sale that really changed nothing so far as corporate management was concerned." As expressed in *supra* note 49, this concurring opinion is the basis for the Tax Court's interpretation of I.R.C. § 302(c)(2)(A)(i).

to assets or profits except in exchange for the value of services rendered.⁶⁴ If it bears any similarity to the rights embraced in a stock interest it is only in the ability, by virtue of the continuing relationship itself, to control corporate conduct. But even this is a lesser degree of control than that possessed by a shareholder, since a director, officer or employee can be removed by a controlling shareholder.⁶⁵ In the context of section 302(c)(2)(A)(i), however, the diluted control exercised by an officer, director, or employee may be greatly enhanced as a result of the family relationship between the redeemed shareholder and the remaining shareholders. To prevent the mischief which that continuing relationship may permit, the parenthetical language characterizes the specified employment relationships of director, officer or employee as per se prohibited interests. By so doing, a potential evil, the power to control either through the performance of one's duties or through the ability to influence other family members as a consequence of a continuing intimacy with corporate affairs, is precluded and an inquiry as to the actual exercise of such power is made unnecessary.

The Ninth Circuit, however, considers the parenthetical exception as if it "merely provides a subset of prohibited interests from the universe of such interests"⁶⁶ rather than as characterizing such employment relationships, which otherwise fall outside the intended scope of section 302(c)(2)(A)(i), as per se prohibited "interests." It is precisely here that the rationale of the Ninth Circuit decision begins to crumble, since this assumption is the foundation used to deny any distinction in treatment between the employment relationships excluded by the parenthetical language of section 302(c)(2)(A)(i) and independent contractors.⁶⁷ Rather than analyze the differences that may exist between the excluded employment relationships and an independent contractor relationship in terms of the statutory purpose of limiting the opportunity to control, the court con-

64. See *Palmer v. Commissioner*, 302 U.S. 63 (1937) in which it was held that the distribution of option rights to shareholders entitling them to purchase corporate property at its then fair market value did not constitute a dividend distribution, even though the option itself had a present value. In addition, it was held that the shareholders did not realize income on the spread between market value and option price existing at the date of exercise of the option.

65. See, e.g., DEL. CODE ANN. tit. 8, § 141(k)(1983).

66. See *Supra* text accompanying note 48.

67. *Lynch*, 801 F.2d at 1180-81.

cludes that all services are prohibited regardless of the capacity in which they are rendered.⁶⁸ That conclusion appears to be unwarranted. The search for certainty of result should not be applied to independent contractor relationships, and inferentially to all other relationships involving the rendition of services, that do not necessarily invoke the same opportunity for corporate control as assumed in the statute with respect to the parenthetical exception. As held by the Tax Court, these relationships should be prohibited, if at all, only after an inquiry into the facts and circumstances indicates the actual exercise of control rather than a presumption of control.

If a former controlling shareholder continues his employment relationship with the redeeming corporation, it is likely to be in a full time position involving decisional authority with respect to fundamental corporate policy in order to take full advantage of his extensive experience and expertise. This is precisely the situation in which the opportunity to control is greatest and in which the limitation imposed by the parenthetical language of section 302(c)(2)(A)(i) should be applied. To the contrary, the interactive possibilities between a former shareholder as independent contractor, or consultant, and the redeeming corporation are likely to be wide ranging, involving internal management services⁶⁹ as well as services ordinarily provided by third parties,⁷⁰ both full time and part time, a spectrum of relationships too broad to categorize all permutations as prohibited without benefit of an analysis of all the facts and circumstances.

The positions of officer, director and employee require the personal services of an individual, a direct rendition or involvement as it were, that in each case provides a personal opportunity to influence or affect corporate decisions that are prohibited by the statute. Personal involvement and the consequent opportunity to control is not a necessary element of all independent

68. *Id.* at 1179.

69. *See, e.g., Chertkof v. Commissioner*, 72 T.C. 1113 (1979) (taxpayer decided basic corporate policy with respect to redeeming corporation's real property interests pursuant to a contractual agreement executed by the redeeming corporation with a corporation controlled by the taxpayer).

70. *See, e.g., Lennard v. Commissioner*, 61 T.C. 554 (1974) (taxpayer continued to provide monthly and annual accounting services to the redeeming corporation as a member of a public accounting firm in which he owned a 48% interest).

contractor relationships. What if the taxpayer in *Lennard*,⁷¹ did not personally provide the required accounting services, but merely supervised? Are supervisory services requiring little or no direct contact with the redeeming corporation sufficient to constitute a prohibited interest? Should it be prohibited per se? What if only Mr. Lennard's partner provided the necessary accounting services, would Mr. Lennard nevertheless have a prohibited interest by virtue of their mutual agency relationship under partnership law?⁷² Must the partnership reject accounting work offered by the redeeming corporation in order for Mr. Lennard not to possess a prohibited interest? Does he have sufficient control of the partnership to assure such rejection? These questions, and others raised by the variety of forms assumed by consulting and other service arrangements constituting independent contractor relationships, hopefully indicate that the purposes of the statute are not always served by a per se prohibition, as control is not necessarily at issue. Whereas acceptance of employee, officer or director status always provides personal involvement and thereby the opportunity to maintain control of the redeeming corporation.⁷³ The latter is presumptively prohibited by the specific language of the statute, the former is not and should not be similarly treated.

71. *Id.* As indicated, Mr. Lennard continued to provide accounting services to the redeeming corporation after the redemption as a member of a public accounting firm of which he owned 48%.

72. An agency relationship was sufficient to constitute a prohibited interest in Rev. Rul. 59-119, 1959-1 C.B. 68 with respect to an attorney sitting as a director on the board of directors of the redeeming corporation for the sole purpose of monitoring performance of the redemption agreement.

73. This assertion may be controverted by comparing part time employee status with an independent contractor relationship involving the rendition of full time services to the redeeming corporation. The opportunity to control is greatest with respect to the independent contractor and least with respect to the part time employee, and yet if the per se prohibition, as suggested, is limited to employees, officers and directors, only the latter relationship is prohibited and not the former. However, any hard line rule creates the possibility of inequity, either real or perceived, at the point the line is drawn. Here that inequity exists in the application of a per se prohibition to part time employees who may have little influence on corporate management as compared to full time independent contractors or, for that matter, employees. But that is not sufficient reason to subject independent contractor relationships, which do not necessarily raise the issue of control, to a per se prohibition otherwise limited by the language of the statute to officers, directors and employees. To do so would merely create further inequities as to those instances in which the independent contractor relationship does not affect corporate control, and supports the application of a facts and circumstances test to prohibit only those independent contractor relationships which in fact violate the congressional intention to prevent continued control of the redeeming corporation.

III. THE *LYNCH* RATIONALE APPLIED TO OTHER RELATIONSHIPS

The *Lynch* decision is intended to provide certainty in determining the tax consequences of redemption transactions by enunciating a bright line rule prohibiting a redeemed shareholder from rendering services to the redeeming corporation in whatever capacity.⁷⁴ It appears, however, to have the opposite effect to the extent the rationale of the decision may be applied to redemption transactions involving non service oriented business relationships. Although the decision is clearly limited by its facts to the performance of services, the desire for certainty of result would appear to warrant extension of a per se prohibition to other relationships which are substantively similar to service relationships in that they also involve a bargained for exchange.

A. THE REDEEMED SHAREHOLDER AS LESSOR

If, as suggested in *Lynch*, the parenthetical exclusion of section 302(c)(2)(A)(i) is merely an example of a broader universe of prohibited interests, the publicly expressed position of the Service,⁷⁵ that a redeemed shareholder may continue to lease property to the redeeming corporation provided the lease provides for a fair market value rental which is neither contingent on corporate earnings nor subordinated to general creditors, is now suspect.⁷⁶ The ruling states that a lessor relationship "will not provide . . . an interest . . . greater than that of a creditor,"⁷⁷ and thus is not prohibited.

There is little reason, however, to differentiate a lessor relationship from a consulting arrangement save that one involves payment for the use of property and the other compensation for

74. *Lynch*, 801 F. 2d at 1179.

75. Rev. Rul. 77-467, 1977-2 C.B. 92.

76. There appears to be little to distinguish fair market value exchanges involving the rendition of personal services from transactions involving the use of property which involve a fair rental and do not contain a contingent interest in the lessor corporation's profits. The lessor/lessee relationship between the redeemed shareholder and the redeeming corporation would appear to be fully within that universe of relationships of which the parenthetical clause is considered by the Ninth Circuit to be merely an example.

77. Rev. Rul. 77-467, 1977-2 C.B. 92, 93.

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services rendered. Each is an exchange for value and it does not clarify the issue to declare one relationship to represent an interest less than that of a creditor while the other is declared to be prohibited per se. Both relationships provide rights which are less than those of a creditor: a lessor is ordinarily not entitled to payment of rent except on satisfaction of the obligation to provide quiet enjoyment of the property;⁷⁸ the consultant is ordinarily entitled to payment only with respect to services actually rendered.⁷⁹ In order to justify differing results as to the two relationships, the parenthetical exclusion must effectively be read to prohibit all service type relationships and permit those related to property. However, it is difficult to justify a selective extension of the prohibition expressed by the language of the parenthetical clause except in terms of purpose. As the subsequent discussion will indicate, that purpose does not support a distinction between property relationships and service relationships, such as those involving independent contractors, not expressly prohibited by the parenthetical prohibition.⁸⁰ It should, therefore, be rejected.

The parenthetical exclusion forecloses whatever opportunity might exist for the redeemed shareholder to continue his control through an employment relationship. In order to properly perform his duties, an officer, director or employee may be expected to have a daily,⁸¹ continuing, and often intimate, familiarity with the affairs of the corporation. Such familiarity is the basis for informed judgment and sound advice, without which it is difficult if not impossible to formulate sound policy.⁸² Thus, con-

78. See Abbott, *Housing Policy, Housing Codes and Tenant Remedies: An Integration*, 56 B.U.L. REV. 1, 6 (1976).

79. J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS*, § 11-17 at 456 (3d ed. 1987).

80. See *supra* notes 64-72 and accompanying text wherein it is argued that the purpose of the parenthetical clause is to limit the redeemed shareholder's opportunity to maintain his control of the redeeming corporation. As a consequence, consultative arrangements and similar service relationships which do not present such opportunity should be permitted in the same manner as leasing transactions under Rev. Rul. 77-467, 1977-2 C.B. 92 unless they provide a continuing economic interest in corporate profits.

81. An independent director most often will not have daily contact with the corporation; nevertheless he would ordinarily be aware of, and informed about, all important issues of corporate policy as that is the inherent responsibility of that relationship. See generally L. RIBSTEIN, *BUSINESS ASSOCIATIONS*, § 3.04 (1983)

82. See *Chertkof v. Commissioner*, 72 T.C. 1113 (1979) in which the taxpayer continued to decide basic corporate policy, although in that particular instance control was exercised pursuant to a consulting arrangement rather than as an employee.

tinuity is the touchstone of employment status that permits the redeeming shareholder to remain informed and thereby have his voice heard. It is this possibility that the statute guards against, not the reality of control.⁸³ On the other hand, a lessor relationship, although long term, does not ordinarily provide the same daily and continuing access to corporate information and affairs and, thus, does not present the same threat of continuing control.⁸⁴

The same analysis cannot be applied to distinguish the employment relationships prohibited by the parenthetical language from all independent contractor relationships. Clearly, there are those which do provide the same opportunity to exercise control as the parenthetically excluded relationships;⁸⁵ relationships in which the redeemed shareholder renders consultative services solely to the redeeming corporation on a consistent and exclusive basis is an apt example.⁸⁶ However, it should be equally clear that the ad hoc performance of service for the redeeming corporation as part of the rendition of consulting services on a broader basis to the general public, or a particular segment of the public which includes the redeeming corporation, is not an arrangement which in the ordinary course breeds continuity of information permitting an informed voice in the formulation of policy.

Since the statute does not support application of the parenthetical exclusion to all consulting arrangements, it should not be extended selectively to embrace certain of those relationships

83. See *Seda v. Commissioner*, 82 T.C. 484 (1984) in which the taxpayer's continued employment by the redeeming corporation was sufficient to prevent a waiver of family attribution as a result of I.R.C. § 302(c)(2)(A) even though no showing was made as to the scope of the taxpayer's duties. The Tax Court justified the result reached based on the existence of a financial stake in the redeeming corporation represented by the taxpayers monthly salary. The concurring opinion would have relied on the parenthetical clause of I.R.C. § 302(c)(2)(A) as providing a per se prohibition to continued employee status. *Id.* at 490-91 (Whitaker, J. concurring).

84. That is not to say that a lessor necessarily lacks influence. If the property under lease is essential to the operation of the corporation, a certain degree of economic leverage may exist in the lessor. However, the statute is apparently directed against continuing control over the formulation of corporate policy that shapes individual decisions and not at the ability to influence specific decisions on an ad hoc basis. See *Chertkof v. Commissioner*, 72 T.C. 1113, 1124-25 (1979) ("[T]hese powers over the only business asset . . . provided petitioner the wherewithal to control all . . . major policy decisions").

85. See *supra* note 82.

86. See *supra* note 82.

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while excepting other ad hoc consulting arrangements as well as property relationships. Therefore, the rationale underlying *Lynch* to the extent it implies a broader application of the parenthetical prohibition of section 302(c)(2)(A)(i) is erroneous. It should be strictly and consistently applied solely to the employment relationships therein designated. A lessor relationship such as that described in Rev. Rul. 77-467 does not present an issue of corporate control and, thus, should not be considered a prohibited interest,⁸⁷ although for reasons other than those expressed in the ruling.

B. ENGAGING IN BUSINESS WITH THE REDEEMED CORPORATION

The Service has ruled privately that a redeemed shareholder who, post redemption, is engaged as a sole proprietor in the business of goldsmithing and jewelry design may transact business with the redeeming corporation provided there are no long term contracts or commitments to do so and payments under the relationship represent fair value.⁸⁸ Similarly, the Service apparently countenances joint venture activities between a redeemed shareholder and the redeeming corporation as a relationship which does not constitute a prohibited interest under section 302(c)(2)(A).⁸⁹

These relationships clearly call into question the limits of the *Lynch* decision. The sole proprietor in Priv. Ltr. Rul.

87. The Service maintains this view; it has continued, following *Lynch* to issue private letter rulings which affirm that a redeemed shareholder's lease of property to the redeeming corporation does not constitute a prohibited interest under I.R.C. § 302(c)(2)(A)(i) or (ii). See Priv. Ltr. Ruls. 8719024 (Feb. 9, 1987); 8714059 (Jan. 7, 1987); 8711072 (Dec. 16, 1986); and 8702070 (Oct. 16, 1986).

88. Priv. Ltr. Rul. 8208164 (Nov. 30, 1981).

89. In Priv. Ltr. Rul. 8313125 (Dec. 30, 1982) the Service approved a redemption in which joint venture activities with respect to construction contracts were contemplated, but not as yet required by contract or agreement, between a redeeming corporation engaged in the business of leasing construction equipment and a second corporation wholly owned by the shareholder whose stock had been redeemed by the leasing corporation. Apart from the contemplated joint venture, the second corporation leased construction equipment from the leasing corporation at standard rates. In Priv. Ltr. Rul. 8326059 (Mar. 28, 1983), amending Priv. Ltr. Rul. 8305013 (Oct. 28, 1982), the Service approved the redeeming corporation contracting or subcontracting work to a corporation apparently controlled by the redeemed shareholder or persons whose stock would be attributable to him.

8208164 provided not only goods but goldsmithing and jewelry design services to the redeeming corporation.⁹⁰ A joint venture, depending upon the specific project in which it is engaged, also may involve both goods and services although technically both are rendered on behalf of the venture rather than the redeeming corporation.⁹¹ Pursuant to *Lynch*, these post redemption services should constitute the retention or acquisition of a prohibited interest by the redeeming shareholder under either section 302(c)(2)(A)(i) or (ii) thereby preventing an effective waiver of family attribution and causing the associated redemption to be characterized as a dividend. Since the statute requires that the redeemed shareholder have "no interest in the corporation"⁹² and does not permit the redeeming shareholder to "acquire any such interest"⁹³ the magnitude of the service element of the joint venture or product sales activities would appear to be irrelevant. This statutory language does not easily admit to an interpretation which permits de minimus services to be ignored. Will the Service apply this analysis and change its present position concerning joint venture and vendor relationships between the redeemed shareholder and the redeeming corporation or will that position be maintained despite *Lynch*? Should it be?

The sale of goods to the redeeming corporation, like the rendition of services, is an exchange of values from which neither the redeemed shareholder nor the redeeming corporation derives an unwarranted benefit or suffers an economic detriment.⁹⁴ Thus, the sale of goods is not essentially different from the leasing transaction described in Rev. Rul. 77-467,⁹⁵ except

90. See *Supra* note 88.

91. In similar situations both the Service and the courts have ignored the fact that services were rendered to the redeeming corporation by a person other than the redeeming shareholder. See Rev. Rul. 59-119, 1959-1 C.B. 68 (prohibited interest found where an attorney acting as agent of redeeming shareholder served as a director of the redeeming corporation); *Chertkof v. Commissioner*, 72 T.C. 1113 (1979) *aff'd*, 649 F.2d 264 (4th Cir. 1981)(managerial services rendered by a redeemed shareholder to the redeeming corporation through another corporation which he controlled were held to constitute a prohibited interest).

92. I.R.C. § 302(c)(2)(A)(i).

93. I. R.C. § 302(c)(2)(A)(ii). Such prohibition is for a period of ten years following the redemption.

94. See *Philadelphia Park Amusement Co. v. U.S.*, 126 F. Supp. 184 (Ct. Cl. 1954) wherein it is stated with respect to an exchange of property between unrelated parties that "the value of the two properties exchanged in an arms-length transaction are either equal in fact, or presumed to be equal."

95. 1977-2 C.B. 92.

for the fact that a more clearly defined element of personal services may attach to the former. Perhaps this is the reason that Priv. Ltr. Rul. 8208164 restricts the proprietorship from rendering goldsmithing and jewelry design services to the redeeming corporation under a long term contract or commitment. No such restriction is placed on a leasing arrangement; the lease in Rev. Rul. 77-467 had an original term of ten years with five years remaining at the time of the redemption.⁹⁶ This apparently represents a concern that a continuing relationship presents an opportunity for the redeemed shareholder to exercise control over the redeeming corporation. This is precisely the issue presented by services rendered as an employee or independent contractor and yet in the context of a vendor relationship the Service permits continuity as long as it is not mandated by contract, whereas in an independent contractor relationship a per se prohibition is imposed apparently without respect to the duration of the arrangement.⁹⁷

Since *Lynch* affirms what appears to be the long standing position of the Service that independent contractor relationships are prohibited per se,⁹⁸ there is no reason to believe that any change in position will be manifested toward vendor/vendee or joint venture relationships as a matter of ruling policy. The same inconsistency exists now as previously in that the nature of the service relationship as it bears on the issue of control is ignored contrary to what appears to be the intent of the parenthetical exclusion of section 302(c)(2)(A)(i). However, by treating services performed pursuant to a vendor/vendee relationship differently than services performed pursuant to an independent contractor relationship, certainly does not help to provide certainty in determining the tax results of redemption transactions, the avowed purpose of the statutory exclusion as stated in *Lynch*.⁹⁹ This inconsistency apparently requires an inquiry into the nature and degree of the services performed pursuant to a vendor/vendee and joint venture relationships to determine if there is continuity and actual control but imposes a per se pro-

96. *Id.*

97. Admittedly the independent contractor relationship in *Lynch v. Commissioner*, 801 F.2d 1176, 1177 (9th Cir. 1986) existed pursuant to a five year contract, but that fact does not appear to be critical to the decision.

98. Rev. Rul. 70-104, 1970-1 C.B. 66.

99. *Lynch*, 801 F. 2d at 1179.

hibition with respect to an independent contractor relationship. It would appear that the characteristic which distinguishes these relationships is that the former involves ad hoc services to the redeeming corporation as well as the general public; in other words, holding out to do business generally and not merely with the redeeming corporation. But the same can be said of certain independent contractor relationships, and, as such, all independent contractor relationships should be subject to the same factual inquiry rather than prohibited per se in *Lynch*. Perhaps that inquiry should not, as in *Lennard*¹⁰⁰ and *Lynch*,¹⁰¹ stress the common law distinction between an employee and an independent contractor, but the nature of the service relationship itself in light of the underlying statutory purpose to inhibit continuing control by the redeemed shareholder.

In the absence of a long term contract or commitment which raises the issue of continuing control, the Service appears to permit an exchange of goods and services because the redeemed shareholder does not have an economic stake in the corporation, since he has neither a claim on corporate profits nor assets,¹⁰² but merely the right to payment for the item sold or exchanged. Although not specifically stated, an exchange is apparently considered to create a prohibited interest within the meaning of section 302(c)(2)(A) only if it generates an economic benefit to the redeemed shareholder while also causing an economic detriment to the redeeming corporation. This criteria is applicable to a vendor/vendee relationship as well as the lease approved in Rev. Rul. 77-467;¹⁰³ both are exchanges in which each party derives a business motivated benefit but not at the expense of the other. The necessity of a detriment to the redeeming corporation as a necessary element to the retention of a prohibited interest is exemplified by the Service's approval of continued group insurance coverage for the redeemed shareholder.¹⁰⁴ The redeemed shareholder clearly derives a benefit

100. Estate of Lennard, 61 T.C. 554 (1974).

101. *Lynch*, 801 F. 2d 1176 (9th Cir. 1986).

102. See *supra* note 64 and, more generally, B.BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 15.08 (1979) in which only sales between related corporations at other than fair market value are discussed as presenting dividend issues; thus, inferentially, sales at market value do not present a claim against the assets of the selling corporation.

103. 1977-2 C.B. 92.

104. See Priv. Ltr. Ruls. 8236037 (June 8, 1982) (group medical insurance); 7937081

from this transaction since the cost of group coverage is ordinarily less than equivalent individual coverage. But apparently that is not considered determinative in the absence of an economic detriment to the corporation.¹⁰⁵ It is not a prohibited interest because the corporation has not used the continuing relationship to distribute assets or earnings to the redeemed shareholder¹⁰⁶ in a manner similar to a distribution in respect of any investor's "interest" in the distributing corporation.

This conclusion is not so clearly appropriate when applied to a joint venture relationship as distinguished from that of a vendor/vendee. Nevertheless, upon analysis it appears correct. In a joint venture each party must devote capital and/or services to the activities of the venture on a continuing basis in order to derive a shared profit.¹⁰⁷ As a consequence, a redeemed shareholder who participates in the venture could be viewed as retaining a prohibited interest in the redeeming corporation in the form of the personal profit derived from his continued use of those assets of the redeeming corporation devoted to joint venture activities. But this overlooks the value received by the corporation from the joint venture. It has risked the use of its assets in exchange for the profit potential inherent in the venture as has the redeeming shareholder. Neither derives an advantage

(June 18, 1979) (group accident and health insurance) and 8021099 (Feb. 28 1980) (life insurance). In order that the redeeming corporation not suffer an out of pocket detriment the redeemed shareholder is required to reimburse the corporation for the premiums and administrative costs associated with this coverage.

105. A similar result reached in I.R.C. § 132(a)(1) which provides for the exclusion from income of any service provided to an employee if the employer ordinarily offers such service to customers in the ordinary course of its business and "the employer incurs no substantial additional cost (including foregone revenues) in providing such service to the employee"

106. A similar conclusion was reached in Priv. Ltr. Rul. 8237078 (June 17, 1982) in which a sublease of property by the redeeming corporation to the redeemed shareholder at a less than fair market value rental, but one equal to the corporation's prime lease rental obligation, was not considered the retention of a prohibited interest under section 302(c)(2)(A)(i). However, the corporation does in fact suffer a detriment in that transaction, since the intangible value of the lease (the difference between The corporation's rental cost and the fair rental value of the property) could have been realized in an arms length sublease. Apparently, the Service either overlooked this benefit or erroneously viewed a detriment to exist only if tangible asset values were made available to the redeeming shareholder rather than an economic expectancy.

107. A joint venture for tax purposes is viewed as a partnership established for a single business venture. See *Podell v. Commissioner*, 55 T.C. 429, 431 (1970). For the characteristics necessary to a partnership relationship generally, see *W. MCKEE, W. NELSON AND R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, § 3.02 (1978).

from the capital or services of the other except to the extent that the interaction of both may produce profits not available to either acting alone. Thus, there is an exchange in which each participant risks its capital or services in the joint venture in pursuit of greater profits, rather than deploying those resources in an alternative enterprise. Neither has obtained an advantage to the detriment of the other. Consequently, the coupling of a redeeming shareholder benefit with a detriment to the redeeming corporation necessary to the retention of a prohibited interest is absent.¹⁰⁸

IV. CONCLUSION

The Ninth Circuit Court of Appeals decision in *Lynch* goes too far in holding all employment relationships to be prohibited within the meaning of section 302(c)(2)(A). By creating a so called "bright line" rule in order to provide certainty in forecasting the consequences of redemption transactions, it will, in fact, foster uncertainty as to the consequences of other legitimate, post redemption relationships which involve the rendition of ser-

108. A somewhat imperfect analogy may exist if the corporation were to guarantee a debt of the redeeming shareholder to a third party lender. This provides an immediate benefit to the redeeming shareholder and at least a potential detriment to the corporation if it must make good on the guarantee. However, if the shareholder were to pay the corporation fair value for such guarantee the potential detriment is removed. In the joint venture situation, the corporation is compensated for its potential detriment, by the redeeming shareholders corresponding risk of his capital and/or services. A similar use of corporate assets has been condoned by the Service in a debtor/creditor context. In Priv. Ltr. Rul. 8315049 (Jan 13, 1983) a redeemed shareholder was permitted to maintain his indebtedness to the corporation pursuant to a five year note payable monthly at five percent interest without the continuing debtor relationship being considered a prohibited interest. Provided the interest in question is reasonable at the time the note is executed, the corporation is in receipt of adequate consideration for the use of its funds in the same manner fair rent compensates for the use of property as approved in Priv. Ltr. Rul. 8328088 (April 14, 1983) (service approved redeemed shareholder lease of office space from redeeming corporation at a fair rental). However, the Service apparently was in error when it approved a \$500,000 borrowing of corporate funds by the redeemed shareholder pursuant to a non interest bearing demand note as not constituting a prohibited interest. Priv. Ltr. Rul. 8311011 (Dec. 8, 1982). The ruling predates the enactment of I.R.C. § 7872 by The Tax Reform Act of 1984, Pub. L. 98-369, § 172, 98 stat. 699 (1984), which is intended to overrule existing precedent by subjecting the economic benefit derived from below market rate loans to tax. Since it is now clear that a taxable benefit is derived from the interest free use of borrowed funds, such benefit, coupled with the detriment incurred by the corporation resulting from its failure to realize interest income or an investment benefit from the alternative deployment of the borrowed funds, should now constitute the retention of a prohibited interest pursuant to I.R.C. § 302(c)(2)(A)(i) or (ii).

vices to the redeeming corporation.

Literally applied, the rule in *Lynch* prohibits all relationships in which the sale of goods and services are involved, unless the statutory language is interpreted as permitting some degree of service which does not rise to the dignity of a prohibited interest. But if such an interpretation were possible, similar criteria should be applied to distinguish between those independent contractor relationships having characteristics which mirror the employment relationships prohibited by the literal language of the statute and those service relationships unlikely to provide current, relevant information which enables the redeemed shareholder to influence the formulation of policy on an informed basis. Ad hoc independent contractor, vendor/vendee, and joint venture relationships do not provide even this appearance of control and should be prohibited only upon a showing that the redeemed shareholder actually exercises control of, or maintains a financial stake in, the affairs of the redeeming corporation.

It could be argued that those consultative arrangements that foster the same relationship to the corporation in terms of continuity of information as an officer, director or employee relationship should be prohibited not because actual control is exercised by the redeemed shareholder, but solely on the basis of that similarity. The difficulty with this argument, as presented and approved in *Lynch*,¹⁰⁹ is that it is based on a presumption of control which is not specifically provided by the statute. Once created it is difficult to formulate a basis upon which such presumption can be selectively applied to exclude relationships which do not project the potential evil embodied by consultative relationships involving services rendered only for the the redeemed corporation and those consultative relationships involving ad hoc services performed in other contexts.

109. *Lynch*, 801 F.2d at 1179-81.