Corporate Income Tax

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CALI® eLangdell® Press 2018

About the Author

Professor William Kratzke is a Cecil C. Humphreys Professor of Law at the University of Memphis. He received his B.A. in Political Science and the Far Eastern & Russian Institute from the University of Washington in 1971. This naturally caused him to be interested in attending law school. He received his J.D. from Valparaiso University in 1974 and was a member of the Valparaiso University Law Review's editorial board. He received his LL.M. from Georgetown University in 1977.

Professor William Kratzke teaches tax law courses at the University of Memphis. He has been a faculty member there since 1979. He has taught courses across the curriculum. In addition to tax courses, he has taught trademarks, torts, civil procedure, world trade law, economic analysis, and other courses. He visited Santa Clara University and the University of Mississippi. He received Fulbright Teaching Awards in 1997 (Moldova) and 2001-2002 (Russia).

Professor Kratzke has written in the areas of tax law, trademark law, tort law, and antitrust law.

Notices

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Instructions to the Student

Students should have an abridged edition of the Code and Regulations.

References to the Code are either IRC § x or simply as § x. References to a regulation are Reg. § _.xxx-x.

This material assumes the student has taken a course in Basic Income Tax.

-WPK

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This material also includes links to interactive lessons posted at CALI's website. Access to the lessons requires membership, either through your law school or an individual membership. Students can confirm that their law school is a member here. Additional information about membership is available here.

Preface

This book is a basic corporate tax text. I intend the text to be suitable for a three-hour course. I hope that the text is accessible to law students with widely different backgrounds. I assume that students who take the course already have taken a course in basic income tax.

I have relied heavily on CALI exercises by Professor James Edward Maule (Villanova University). These exercises review and teach a little substance. Each exercise zeroes in on a specific topic and should take a student about twenty minutes to complete. A student who works through the exercises should be able to determine whether she adequately understands the material.

My use of pronouns referring to non-specific persons alternates between the feminine and masculine chapter by chapter.

I benefitted greatly from the comments of anonymous reviewers, and I thank them for their efforts.

WPK
Memphis, Tennessee, August 2018

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Chapter 1: Preliminary Considerations

A corporation is a "person," subject to the income tax rules that govern taxation of any person. Most – but not all – of those rules are the subject of a course on Basic Income Tax. Of course, the corporation is an inanimate entity – and for that reason the Code uses the word "individual" in rules applicable only to living people. There are, as well, rules in the Code that apply only to corporations. This course considers mostly the tax consequences of what corporations do with respect to their owners, i.e., their shareholders. Shareholders form the corporation. Corporations may pay their shareholders from their after-tax profits. Corporations may purchase, i.e., redeem, shares from their shareholders. A corporation may distribute shares of stock to its shareholders. The tax consequences of these corporate-shareholder transactions fall mainly on the shareholders. Some transactions do have tax consequences that fall directly on the corporation, e.g., liquidation, sale of assets, merging with another corporation. Even in those cases, those tax consequences will matter to shareholders.

We study in this course the basics of treating a corporation as a separate taxpayer, i.e., separate and apart from the shareholders who own it. As separate taxpayers, a corporation and its shareholders may transact with each other as if transacting with third persons. A shareholder may be an employee of the corporation, may lend money to or borrow money from the corporation, may sell assets to or buy assets from the corporation, etc. If such transactions are not arm's length transactions, some adjustments may be in order. Such transactions generate their own tax consequences.

Corporate Investment of retained earnings: An investor – whether an individual or a corporation – invests after-tax money. If a corporation pays less in income tax than an individual on the same income, the corporation can invest a greater portion of its income than an individual. The greater investment hopefully produces greater income, further enhancing the value of the shareholder's shares.

As a separate taxpayer and apart from its shareholders, the corporation accounts for its own income and losses. Thus, for income tax purposes, the shareholder of a corporation that suffers a loss derives no income tax benefit from those losses other than a probable reduction in the value of the shares that she owns. On the other hand, once the corporation has paid income tax on its profits, it may retain those profits; shareholders owe no tax until the corporation distributes its profits to them, and the corporation determines the timing of any distribution. The value of the shareholder's shares should increase. If the corporate tax rate is (much) lower than the individual tax rate, the shareholder may accumulate more wealth than if she had simply earned the same profits in a sole proprietorship. In such cases, the shareholder gains/loses only by selling her shares and relinquishing to that extent her interest in the corporation. Whatever long-term gain an individual shareholder eventually realizes from the sale or redemption of her shares will be subject to income tax at capital gains rates lower than those applicable to ordinary income.

Let's assume that our corporations are all (fabulously) profitable and that their shareholders want

to enjoy those profits. (This will make this course much more interesting than studying corporations with no income, and therefore no choices of what to do with it.) Naturally, shareholders want to share as little of these profits with the government as possible. To do this, those who control the corporation must pay close attention to the rates at which corporate income is taxed relative to individual income. Furthermore, many of the corporations whose affairs we examine are closely-held, and the interests of the corporation's managers and its shareholders are very closely aligned.

Corporate payments of dividends are *not* deductible to the corporation. This means that income that passes through the corporation to shareholders is subject to two levels of income tax: first to the corporation itself and then, upon payment of the dividend, to the shareholder. This double tax on corporate income has been subject to criticism from the beginning. Nevertheless, the United States Supreme Court has held that it is constitutional. *Flint v. Stone Tracy Co.*, 220 U.S. 107, 151-52 (1911) (Constitution does not require "excise upon the particular privilege of doing business in a corporate capacity" to be apportioned according to population). The double tax on corporate profits that shareholders receive drives many decisions concerning the structure of payments from corporations to shareholders.

Prior to enactment of the Tax Cuts and Jobs Act in December 2017, corporate tax rates were progressive. Surtaxes on higher amounts of income eliminated the progressivity. At more than $18,333,333 of taxable income, both the marginal and effective tax rates on corporation income were 35%.[1] The Tax Cuts and Jobs Act makes the corporate tax rate a flat 21% on all taxable corporate income. IRC § 11(b).[2] The highest marginal tax rate on an individual's taxable income is now 37%, down slightly from 39.6%. The highest marginal income tax rates for individuals and corporations are now 16 percentage points apart, up from 4.6 percentage points. The increase in this spread may drive some taxpayers to try to generate corporate income and for the corporation to retain its after-tax profits. The time value of money will effectively reduce the burden of any subsequent income tax that a shareholder might eventually have to pay.

When the difference between individual income tax rates and corporate tax rates increases, the urge to have corporations earn income and retain it increases. This point undoubtedly motivated many of the taxpayers that appear in the cases ahead to do what they did. A corporation's ability to retain (i.e., hoard) its profits is not without limit. Congress addressed these matters in the Personal Holding Company Tax (I.R.C. §§ 541-47) and the Accumulated Earnings Tax (I.R.C. §§ 531-37). The Tax Cuts and Jobs Act likely increased the relevance of these taxes.

Personal Holding Company Tax, I.R.C. §§ 541 to 547: A closely-held (as specifically defined,

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[1] The Tax Cuts and Jobs Act also eliminated the alternative minimum tax on corporations.

[2] The individual tax rate on taxable income is now subject to federal income tax at seven different rates (eight if we count zero). The highest rate is 37% (previously 39.6%). There is a rate preference for taxable income that is net capital gain, with a maximum rate of 20% (plus a surtax of 3.8% for very high-income taxpayers). The tax brackets are indexed for inflation.

§ 542(a)(2)) corporation that derives at least 60% of its "personal holding company income" (as specifically defined, § 543) is subject to a 20% tax on its undistributed personal holding company income (§ 541). The tax rate not coincidentally is the highest marginal tax rate on an individual's qualified dividend income. The United States Supreme Court has stated that –

> [t]he object of the personal holding company tax is to force corporations which are "personal holding companies" to pay in each tax year dividends at least equal to the corporation's undistributed personal holding company income – i.e., its adjusted taxable income less dividends paid to shareholders of the corporation, *see* § 545 – thus ensuring that taxpayers cannot escape personal taxes by accumulating income at the corporate level. This object is effectuated by imposing on a personal holding company both the ordinary income tax applicable to its operation as a corporation and a penalty tax of [20%] on its undistributed personal holding company income. *See* §§ 541, 545, 561. Since the penalty-tax rate equals or exceeds the highest rate applicable to individual taxpayers, *see* 26 U.S.C. § 1 (1970 ed. and Supp. V), it will generally be in the interest of those controlling the personal holding company to distribute all personal holding company income, thereby avoiding the [20%] tax at the corporate level by reducing to zero the tax base against which it is applied.

Fulman v. United States, 434 U.S. 528, 531 (1978). Until recently, there was little advantage outside of the international arena to resorting to personal holding companies to shelter income. The Tax Cuts and Jobs Act changed that.

Accumulated Earnings Tax, I.R.C. §§ 531 to 537: Congress has imposed a 20% tax (§ 531) on a corporation's "accumulated taxable income" (§ 535), i.e., accumulations "beyond the reasonable needs of the business" (§ 533(a)).

> The accumulated earnings tax is one congressional attempt to deter use of a corporate entity to avoid personal income taxes. The purpose of the tax "is to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for taxes on the dividends received.

United States v. Donruss Co., 393 U.S. 297, 303 (1969) (citation omitted). An accumulation of earnings and profits "is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business" Reg. § 1.537-1(a). During the recent period of multi-billion dollar losses that some corporations have absorbed and marginal tax rates on corporate and individual incomes that were not significantly different, the Accumulated Earnings Tax was not often on the minds of business persons who simply wanted to stay afloat. The Tax Cuts and Jobs Act might change that thinking.

I. Choosing Whether and When to Incorporate

When one or more persons wish to engage in business, they initially determine the entity in which they will conduct their business. In this course, we deal with those occasions when persons have chosen to do business as a corporation. They might have chosen to do business as a sole proprietorship, a partnership, a limited liability company, a subchapter S corporation,[3] or a C corporation.[4] This is a rough outline of the entities from which the owner(s) of a business may choose. One policy of the Code is that the tax consequences of the choice itself should be as minimal as possible so that tax considerations do not drive the choice. However, the reality is Code taxes the profits of the entities differently. Specifically, it taxes the profits of C corporations at a flat 21% rate and then taxes dividends upon their distribution.[5] It taxes the profits of other entities at progressive rates applicable to individual taxpayers. The double tax on corporate profits has influenced business owners in their decision whether and when to incorporate. For many businesses, it is a no-brainer: do not incorporate and instead do business in another form for which the business owner is accorded limited liability.

Election to do business in one form rather than another does not forever preclude electing another form later. Once the business-owners have made a choice, it is easy to "go up the ladder" (i.e., to convert from a sole proprietorship to a partnership, then to a limited liability company, then to an S corporation, and then to a C corporation). However for a C corporation, except for converting from a C corporation to an S corporation, it can be quite costly to come down. This is because there are tax consequences to liquidating a C corporation itself, but not to liquidating any of the other entities. (This is not to say that there would not be tax consequences to the *owner* of another liquidating entity.)

Equally important as the simple observation that corporate profits are subject to a double tax upon distribution to shareholders are such matters as the anticipated relative tax burdens applicable to the choice that a taxpayer makes – and that in turn requires consideration of whether net gains or losses are likely. The Tax Cuts and Jobs Act has made this a more nuanced determination. Some considerations relevant to the decision whether to incorporate – not all related to the Tax Cuts and Jobs Act – include the following:

- The tax rate applicable to C corporations is now a flat 21%. The tax rates applicable to individual taxpayers (including the owners of so-called pass-through entities) is progressive and tops out at 37%. Obviously, taxpayers who are considering incorporation as a C corporation would want to determine the likely relative tax burdens or incorporating or not incorporating.

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[3] A "small business corporation." § 1361(a)(1).

[4] A corporation that is not a "small business corporation." § 1361(a)(2).

[5] We will assume that the dividends are "qualified" under § 1(h)(11)(B) and so subject to income tax at the capital gain rates when individuals are the taxpayers.

•These tax rates apply to losses and deductions as well as to income. As a separate taxpayer, a corporation's losses do not provide a tax benefit to its shareholders. And a taxpayer saves more when losses or deductions would otherwise be subject to a higher rate of tax.

•The double tax only applies upon the distribution of a dividend. Shareholder(s) of a closely-held corporation can time the distribution of a dividend to suit themselves and exploit the time value of money to reduce the burden of an income tax on the distribution.

•The assets that an individual taxpayer transfers to a corporation are probably more secure from the claims of the individual's creditors than when held by another entity.

•Corporations can pay dividends to passive investors. This can effectively permit income-splitting among family members.

•A C corporation has a perpetual existence. The death, incapacity, retirement, divorce, etc. of a business's owners do not affect the continued existence of a corporation the way such matters might affect a sole proprietorship or a partnership.

•Ownership of a C corporation is manifested by shares. This can be convenient when transferring an ownership interest, whether by sale or inheritance. Ownership of shares may facilitate the implementation of a step-up in basis under § 1014.

•C corporations usually have easier access to capital markets. Raising capital, either through debt or equity, will be easier for a C corporation.

•For some taxpayers, a C corporation may better accommodate their concern with anonymity.

•A C corporation can have an unlimited number of shareholders who reside anywhere. This might not be true of other entity forms.

•The Tax Cuts and Jobs Act curtailed an individual taxpayer's employee and non-business profit-seeking deductions. IRC § 67(g) (no miscellaneous deductions allowed until 2026). This limitation does not apply to C corporations.

•The Tax Cuts and Jobs Act created a deduction for pass-through entities of 20% of their taxable income. IRC § 199A. A C corporation may not avail itself of this deduction. A taxpayer should consider the likely impact and size of a § 199A deduction. For the moment, we can note that this will depend on how much taxpayer pays in W-2 wages and/or the unadjusted basis of its depreciable property. *See* chapter 7 (subchapter S corporations).

•The Tax Cuts and Jobs Act makes the dividends paid to domestic corporations by foreign subsidiaries fully deductible. IRC § 245A. If a taxpayer is likely to seek profits in international markets, she should consider doing business as a corporation, whether as an S corporation or as a C corporation. Otherwise, she is subject to U.S. income taxation on her worldwide income.

Obviously, this is not an exhaustive list of matters that a business owner should consider when deciding whether to form a C corporation. Rather the list should serve as a reminder that the decision whether to form a C corporation is not always obvious. And as noted, before the business entity becomes a C corporation, the decision is not immutable. It may be that only over time, factors that lead to a decision to incorporate as a C corporation may emerge.

The Code defines a "corporation" that is subject to the federal income tax to include an association, joint-stock company, and insurance company. § 7701(a)(3). At one time, the "double tax" on corporate income led many to resist IRS classification of their business entities as one of the entities included within the ambit of the term "corporation." The regulations now alleviate much of the litigation over classification by giving an "eligible entity" a choice of the tax treatment it wishes. Reg. § 301.7701-3(a). There are certain entities that the regulations classify as per se corporations; hence, they may not elect to be taxed as an entity other than a corporation. Reg. § 301.7701-3(a). Such entities include –

- •entities organized under laws describing them as corporations, joint-stock companies, or joint-stock associations;
- •insurance companies;
- •entities engaged in banking activities;
- •entities wholly owned by a State or political subdivision or by a foreign government; and
- •various foreign entities organized under the laws of other jurisdictions.

Reg. § 301.7701-2(b).

Congress has encouraged investment in small businesses that have issued stock. Section 1045 permits a non-corporate investor to elect to roll over built-in gain from one "small business investment company" to another. IRC § 1045(a). An individual may exclude 50% of the gain on "qualified small business stock" held for more than five years, § 1202(a)(1), and Congress permanently increased the exclusion to 100% in response to the economic crisis of 2008, § 1202(a)(4). Section 1244 permits an individual or partnership to treat losses as ordinary rather than capital when incurred on the sale of certain small business stock. § 1244(a). Naturally, there are limits and details that a taxpayer must consider in the application of these provisions.

From a tax perspective, the decisions whether and when to incorporate will often depend initially on whether the owners of a business can take advantage of business deductions. Because a corporation is a separate taxpayer, business losses may be "locked inside the corporation" – and reduce no one's taxable income until the entity is profitable.

Commissioner v. Bollinger, 485 U.S. 340 (1988)

Justice SCALIA delivered the opinion of the Court.

Petitioner, the Commissioner of Internal Revenue, challenges a decision by the United States Court of Appeals for the Sixth Circuit holding that a corporation which held record title to real property as agent for the corporation's shareholders was not the owner of the property for purposes of federal income taxation. We granted certiorari to resolve a conflict in the Courts of Appeals over the tax treatment of corporations purporting to be agents for their shareholders. [citations omitted].

I

Respondent Jesse C. Bollinger, Jr., developed, either individually or in partnership with some or all of the other respondents, eight apartment complexes in Lexington, Kentucky. (For convenience we will refer to all the ventures as "partnerships.") Bollinger initiated development of the first apartment complex, Creekside North Apartments, in 1968. The Massachusetts Mutual Life Insurance Company agreed to provide permanent financing by lending $1,075,000 to "the corporate nominee of Jesse C. Bollinger, Jr." at an annual interest rate of eight percent, secured by a mortgage on the property and a personal guarantee from Bollinger. The loan commitment was structured in this fashion because Kentucky's usury law at the time limited the annual interest rate for noncorporate borrowers to seven percent. Ky.Rev.Stat. §§ 360.010, 360.025 (1972). Lenders willing to provide money only at higher rates required the nominal debtor and record titleholder of mortgaged property to be a corporate nominee of the true owner and borrower. On October 14, 1968, Bollinger incorporated Creekside, Inc., under the laws of Kentucky; he was the only stockholder. The next day, Bollinger and Creekside, Inc., entered into a written agreement which provided that the corporation would hold title to the apartment complex as Bollinger's agent for the sole purpose of securing financing, and would convey, assign, or encumber the property and disburse the proceeds thereof only as directed by Bollinger; that Creekside, Inc., had no obligation to maintain the property or assume any liability by reason of the execution of promissory notes or otherwise; and that Bollinger would indemnify and hold the corporation harmless from any liability it might sustain as his agent and nominee.

Having secured the commitment for permanent financing, Bollinger, acting through Creekside, Inc., borrowed the construction funds for the apartment complex from Citizens Fidelity Bank and Trust Company. Creekside, Inc., executed all necessary loan documents including the promissory note and mortgage, and transferred all loan proceeds to Bollinger's individual construction account. Bollinger acted as general contractor for the construction, hired the necessary employees, and paid the expenses out of the construction account. When construction was completed, Bollinger obtained, again through Creekside, Inc., permanent financing from Massachusetts Mutual Life in accordance with the earlier loan commitment. These loan proceeds were used to pay off the Citizens Fidelity construction loan. Bollinger hired a resident manager to rent the apartments, execute leases with tenants, collect and deposit the rents, and maintain operating records. The manager deposited all rental receipts into, and paid all operating expenses from, an operating account, which was first opened in the name of Creekside, Inc., but was later changed to "Creekside Apartments, a partnership." The operation of Creekside North Apartments generated losses for the taxable years 1969, 1971, 1972, 1973, and 1974, and ordinary income for the years 1970, 1975, 1976, and 1977. Throughout, the income and losses were reported by Bollinger on his individual income tax returns.

Following a substantially identical pattern, seven other apartment complexes were developed by respondents through seven separate partnerships. ... The corporation had no assets, liabilities, employees, or bank accounts. In every case, the lenders regarded the partnership as the owner of the apartments and were aware that the corporation was acting as agent of the partnership in holding record title. The partnerships reported the income and losses generated by the apartment complexes on their partnership tax returns, and respondents reported their distributive share of

the partnership income and losses on their individual tax returns.

The Commissioner of Internal Revenue disallowed the losses reported by respondents, on the ground that the standards set out in *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949), were not met. The Commissioner contended that National Carbide required a corporation to have an arm's-length relationship with its shareholders before it could be recognized as their agent. Although not all respondents were shareholders of the corporation, the Commissioner took the position that the funds the partnerships disbursed to pay expenses should be deemed contributions to the corporation's capital, thereby making all respondents constructive stockholders. Since, in the Commissioner's view, the corporation rather than its shareholders owned the real estate, any losses sustained by the ventures were attributable to the corporation and not respondents. Respondents sought a redetermination in the United States Tax Court. The Tax Court held that the corporation was the agent of the partnerships and should be disregarded for tax purposes. On appeal, the United States Court of Appeals for the Sixth Circuit affirmed. We granted the Commissioner's petition for certiorari.

II

For federal income tax purposes, gain or loss from the sale or use of property is attributable to the owner of the property. *See Helvering v. Horst*, 311 U.S. 112, 116-117 (1940); *Blair v. Commissioner*, 300 U.S. 5, 12 (1937); *see also Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948). The problem we face here is that two different taxpayers can plausibly be regarded as the owner. Neither the Internal Revenue Code nor the regulations promulgated by the Secretary of the Treasury provide significant guidance as to which should be selected. It is common ground between the parties, however, that if a corporation holds title to property as agent for a partnership, then for tax purposes the partnership and not the corporation is the owner. Given agreement on that premise, one would suppose that there would be agreement upon the conclusion as well. For each of respondents' apartment complexes, an agency agreement expressly provided that the corporation would "hold such property as nominee and agent for" the partnership, and that the partnership would have sole control of and responsibility for the apartment complex. The partnership in each instance was identified as the principal and owner of the property during financing, construction, and operation. The lenders, contractors, managers, employees, and tenants – all who had contact with the development – knew that the corporation was merely the agent of the partnership, if they knew of the existence of the corporation at all. In each instance the relationship between the corporation and the partnership was, in both form and substance, an agency with the partnership as principal.

The Commissioner contends, however, that the normal indicia of agency cannot suffice for tax purposes when, as here, the alleged principals are the controlling shareholders of the alleged agent corporation. That, it asserts, would undermine the principle of *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), which held that a corporation is a separate taxable entity even if it has only one shareholder who exercises total control over its affairs. Obviously, *Moline*'s separate-entity principle would be significantly compromised if shareholders of closely held corporations could, by clothing the corporation with some attributes of agency with respect to particular assets, leave themselves free at the end of the tax year to make a claim – perhaps

even a good-faith claim – of either agent or owner status, depending upon which choice turns out to minimize their tax liability. The Commissioner does not have the resources to audit and litigate the many cases in which agency status could be thought debatable. Hence, the Commissioner argues, in this shareholder context he can reasonably demand that the taxpayer meet a prophylactically clear test of agency.

We agree with that principle, but the question remains whether the test the Commissioner proposes is appropriate. The parties have debated at length the significance of our opinion in *National Carbide Corp. v. Commissioner*, *supra*. In that case, three corporations that were wholly owned subsidiaries of another corporation agreed to operate their production plants as "agents" for the parent, transferring to it all profits except for a nominal sum. The subsidiaries reported as gross income only this sum, but the Commissioner concluded that they should be taxed on the entirety of the profits because they were not really agents. We agreed, reasoning first, that the mere fact of the parent's control over the subsidiaries did not establish the existence of an agency, since such control is typical of all shareholder-corporation relationships; and second, that the agreements to pay the parent all profits above a nominal amount were not determinative since income must be taxed to those who actually earn it without regard to anticipatory assignment. We acknowledged, however, that there was such a thing as "a true corporate agent ... of [an] owner-principal," and proceeded to set forth four indicia and two requirements of such status, the sum of which has become known in the lore of federal income tax law as the "six *National Carbide* factors":

> "[1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent."

We readily discerned that these factors led to a conclusion of nonagency in *National Carbide* itself. There each subsidiary had represented to its customers that it (not the parent) was the company manufacturing and selling its products; each had sought to shield the parent from service of legal process; and the operations had used thousands of the subsidiaries' employees and nearly $20 million worth of property and equipment listed as assets on the subsidiaries' books.

The Commissioner contends that the last two *National Carbide* factors are not satisfied in the present case. To take the last first: The Commissioner argues that here the corporation's business purpose with respect to the property at issue was not "the carrying on of the normal duties of an agent," since it was acting not as the agent but rather as the owner of the property for purposes of Kentucky's usury law. We do not agree. It assuredly was not acting as the owner in fact, since respondents represented themselves as the principals to all parties concerned with the loans. Indeed, it was the lenders themselves who required the use of a corporate nominee. Nor does it

make any sense to adopt a contrary-to-fact legal presumption that the corporation was the principal, imposing a federal tax sanction for the apparent evasion of Kentucky's usury law. To begin with, the Commissioner has not established that these transactions were an evasion. Respondents assert without contradiction that use of agency arrangements in order to permit higher interest was common practice, and it is by no means clear that the practice violated the spirit of the Kentucky law, much less its letter. It might well be thought that the borrower does not generally require usury protection in a transaction sophisticated enough to employ a corporate agent – assuredly not the normal modus operandi of the loan shark. That the statute positively envisioned corporate nominees is suggested by a provision which forbids charging the higher corporate interest rates "to a corporation, the principal asset of which shall be the ownership of a one (1) or two (2) family dwelling," Ky.Rev.Stat. § 360.025(2) (1987) – which would seem to prevent use of the nominee device for ordinary home-mortgage loans. In any event, even if the transaction did run afoul of the usury law, Kentucky, like most States, regards only the lender as the usurer, and the borrower as the victim. *See* Ky.Rev.Stat. § 360.020 (1987) (lender liable to borrower for civil penalty), § 360.990 (lender guilty of misdemeanor). Since the Kentucky statute imposed no penalties upon the borrower for allowing himself to be victimized, nor treated him as *in pari delicto*, but to the contrary enabled him to pay back the principal without any interest, and to sue for double the amount of interest already paid (plus attorney's fees), *see* Ky.Rev.Stat. § 360.020 (1972), the United States would hardly be vindicating Kentucky law by depriving the usury victim of tax advantages he would otherwise enjoy. In sum, we see no basis in either fact or policy for holding that the corporation was the principal because of the nature of its participation in the loans.

Of more general importance is the Commissioner's contention that the arrangements here violate the fifth *National Carbide* factor – that the corporate agent's "relations with its principal must not be dependent upon the fact that it is owned by the principal." The Commissioner asserts that this cannot be satisfied unless the corporate agent and its shareholder principal have an "arm's-length relationship" that includes the payment of a fee for agency services. The meaning of *National Carbide*'s fifth factor is, at the risk of understatement, not entirely clear. Ultimately, the relations between a corporate agent and its owner-principal are always dependent upon the fact of ownership, in that the owner can cause the relations to be altered or terminated at any time. Plainly that is not what was meant, since on that interpretation all subsidiary-parent agencies would be invalid for tax purposes, a position which the *National Carbide* opinion specifically disavowed. We think the fifth *National Carbide* factor – so much more abstract than the others – was no more and no less than a generalized statement of the concern, expressed earlier in our own discussion, that the separate-entity doctrine of *Moline* not be subverted.

In any case, we decline to parse the text of *National Carbide* as though that were itself the governing statute. As noted earlier, it is uncontested that the law attributes tax consequences of property held by a genuine agent to the principal; and we agree that it is reasonable for the Commissioner to demand unequivocal evidence of genuineness in the corporation-shareholder context, in order to prevent evasion of *Moline*. We see no basis, however, for holding that unequivocal evidence can only consist of the rigid requirements (arm's-length dealing plus agency fee) that the Commissioner suggests. Neither of those is demanded by the law of agency,

which permits agents to be unpaid family members, friends, or associates. *See* RESTATEMENT (SECOND) OF AGENCY §§ 16, 21, 22 (1958). It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent and not principal with respect to the asset for all purposes, and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset. Since these requirements were met here, the judgment of the Court of Appeals is
Affirmed.
Justice KENNEDY took no part in the consideration or decision of this case.

Questions and comments:

1. What were the tax advantages of operating the apartment complexes as partnerships rather than as corporations?

- Do you think that Bollinger and his partners anticipated income during construction of the apartment complexes?
- What about after construction?

2. Is the real problem here that state legislatures too often enact usury laws without regard to market conditions, i.e., that the market rate of interest may exceed the rates that such laws permit? What if the inflation rate is higher than the rate of interest that a state usury law will permit?

3. The corporate income tax does not enjoy universal support as a means of raising revenue. There have been calls to integrate the individual and corporate income taxes into one tax. *See, e.g.*, *Treasury Department Report*, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS, January 8, 1992. In the Tax Cuts and Jobs Act, Congress responded to the steady drumbeat of calls to reduce it quite substantially.

II. The Corporation's Capital Structure: Getting Money Out of the Corporation Through Payments of Loan Principal and Interest

A corporation must of course have capital to operate. It may raise capital by selling ownership (equity) interests in it. In the case of a typical corporation, this takes the form of stock. Owners of stock have, to one degree or another, the rights to control the corporation through the exercise of voting rights, to share in the corporation's profits, to enjoy benefits derived from the corporation's growth, and to share in the proceeds of a liquidation. The value of these rights, i.e., the value of a shareholder's stock, depend on the profitability of the corporation. There are no guarantees that a corporation will

Shareholder contributions to capital: Taxpayer may acquire shares directly from the corporation in exchange for money other property. Such "contributions to capital" generate no immediate tax consequences to the corporation. IRC §§ 118(a), 1032(a).

be profitable. If the corporation is not profitable, the value of the stock that shareholders own may be nominal.

A corporation may choose to sell equity interests that give the investor less than all the rights of stock ownership just noted. For example, some equity investors may purchase stock that gives them the right to receive dividends, but not the right to vote (control) on corporate matters. Conversely, some investors may purchase an equity interest that gives them the right to vote (control) the corporation but only a subordinate right to receive dividends. The Code contemplates that corporations may issue common stock and preferred stock. Owners of common stock usually have the greatest right to control the corporation through voting. However, their rights to share in the profits of the corporation are generally subordinate to the rights of others. In the case of a highly profitable corporation, this is not a problem. Things are different if the corporation is not profitable. "The term 'preferred stock' generally refers to stock which, in relation to other classes of stock outstanding enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent." Reg. § 1.305-5(a) (3rd sentence). Owners of preferred stock are *preferred* with respect to the payment of dividends that are usually *limited* in amount. Corporations share profits with shareholders by payment of dividends – whose source is the *after-tax* profit of the corporation. Receipt of a dividend does not diminish the shareholder's interest in the corporation.

Alternatively, a corporation may borrow capital. A creditor does not own an interest in a corporation but is entitled to be paid before shareholders are paid. The interest that a corporation pays to a creditor *reduces the corporation's profits subject to tax*. § 163. The interest income that the creditor receives is included in her gross income. § 61(a)(4). Receipt of the loan principal is not income to the borrower. Extension of a loan is not deductible by the creditor. Once the creditor has been paid, the creditor no longer has any rights with respect to the corporation.

There are critical differences in the way the Code treats equity financing (stock) and debt financing (borrowing). The profits with which a corporation pays dividends to a shareholder are subject to income tax at two levels: first the corporation pays income tax on its profits, and second, the shareholder pays income tax on the dividend that she receives. The profits with which a corporation pays interest to a creditor are subject to income tax only at the creditor level. The profits with which a corporation repays loan principal to a creditor are subject to income tax only at the corporate level.

In a closely-held corporation, the same persons may be both shareholders and lenders. If all the shareholders agree to loan money to the corporation in the same relative amounts as the number of shares that they own, the corporation's capital structure would not differ no matter what the amount they all agreed to lend. Suppose that five persons form a corporation, and each purchases $100 worth of common stock. Each also agrees to loan the corporation $100,000. The corporation has $500,500 of capital with which to operate. It would matter little if each shareholder purchased $100,000 worth of stock and loaned the corporation $100. The corporation would still have $500,500 of capital with which to operate.

But the Code would treat the taxpayers in these scenarios quite differently – assuming we honor the form of the transactions. We assume that the corporation will be (very) profitable. If all the financing of the corporation were through the sale of equity interests, all the profits that the corporation shares with the shareholders would be subject to two levels of income tax. If the corporation borrows the money, the corporate profits used to pay the creditors would be subject to only one level of income tax. Creditors would pay income tax on interest income. The corporation of course does not pay income tax on the income with which it pays interest. The profits that the corporation uses to repay the principal will be subject to income tax at the corporate level, but not at the shareholder level.

If ownership of a closely-held corporation is not likely to change, there would be no reason not to finance the operation of the corporation with as much debt as possible. The IRS would see things differently – viewing the interests of creditors in such situations as the same as those of owners of equity interests. Not surprisingly, the characterization of an investor's interest – whether equity or debt – has been the subject of much litigation.

Whether the holder of an equity interest will be paid depends on the success of the business. Whether the holder of a debt interest will be paid does not depend (in theory) on the success of the business. If the risk of non-payment is sufficiently great, the holder of the instrument more closely resembles the holder of an equity interest.

The following case presents interesting facts. Obviously, Mr. Jemison received (or had received on other occasions) tax advice. Notice the care he exercised to make his role appear to be a creditor rather than something else. For which of the "loans" was repayment more contingent on the success of the business?

Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972)

SIMPSON, Circuit Judge

This is an appeal from a determination by the Tax Court of tax deficiencies against the corporate taxpayer, Plantation Patterns, Incorporated (New Plantation hereinafter, to distinguish it from an earlier corporation with the same name) for the fiscal years ending September 30, 1963-65, for the respective amounts of $2,947.12, $51,719.69, and $23,732.28, and against the individual taxpayers, John S. Jemison, Jr. (Mr. Jemison) and his wife, Marie S. Jemison (Mrs. Jemison) of $28,403.91 for their taxable year 1963. [footnote omitted]. The cases were consolidated for trial in the Tax Court as they are for purposes of this appeal.

I. THE FACTS

... New Plantation, ... filed income tax returns, on the accrual basis ...

New Plantation's corporate predecessor, which was also called Plantation Patterns, Inc. (Old Plantation) was engaged in the business of manufacturing wrought iron furniture ...

Prior to September 28, 1962, the stockholders of Old Plantation and the outstanding shares therein were owned as follows:

	Number of Shares
Thomas E. Jernigan	162,483
William C. Jernigan	80,718
John M. Goodwin	8,812
H. Ferrell Jernigan	353
James C. Stone	17,624
Total	270,000

Before that date Mr. Thomas E. Jernigan was president and Mr. William C. Jernigan was vice president and secretary of Old Plantation.

[In 1962,] ... Messrs. Thomas E. and William C. Jernigan ... decided that it would be in their best interests to sell the wrought iron furniture business of Old Plantation and to develop ... [Old Plantation's] United Chair Division's metal office chair business.

During the summer of 1962, the shareholders of Old Plantation decided that they would attempt to sell their interests in both the wrought iron furniture and metal office chair businesses by sale of their Old Plantation stock. In July of 1962, Mr. Jack Parish, a member of ... [Old Plantation's] accounting firm ... contacted Mr. John S. Jemison, Jr., the president and controlling shareholder of Jemison Investment Co., Inc., and inquired if he would be interested in purchasing or finding a purchaser for the stock of Old Plantation.

At that time Mr. Jemison was an experienced investment banker, having been in that business for at least twenty years. ...

Jemison Investment Co., Inc. had acted as agent or broker for purchasers and sellers of businesses since its organization by Mr. Jemison in 1949. During 1962, Jemison Investment Co., Inc. had assets of eleven million dollars, including a number of wholly owned subsidiaries ...

... Parish arranged for negotiations in July and August, 1962, between Messrs. Jemison and Thomas E. Jernigan concerning the sale of Old Plantation. These negotiations led to a general understanding between Messrs. Jemison and Thomas E. Jernigan that a corporation would be formed to purchase all the stock of Old Plantation and that Old Plantation would sell its United Chair Division's metal office chair business to Messrs. Thomas E. and William C. Jernigan.

A letter addressed to Mr. Thomas E. Jernigan dated August 24, 1962, on the letterhead of Jemison Investment Co., Inc. and signed by Mr. Jemison, set forth a conditional offer to purchase

the "assets of the Plantation Patterns Division." This letter stated:

> "We would organize a new corporation to be known as Plantation Patterns Corporation (it is understood that you would agree to change the name of the existing corporation) and we would pay in a total of $155,000 in cash – $150,000 in 6½% subordinated notes – which notes would be subordinated to your notes – and $5,000 in common stock."

On September 25, 1962, Mr. Jemison caused New Plantation to be organized ... Upon its incorporation, New Plantation issued ten shares of common stock with a par value of $100 per share to its incorporators. On the same date that it was incorporated, the incorporators transferred those ten shares of stock to Mrs. Marie S. Jemison.

On September 26, 1962, New Plantation issued an additional 40 shares of common stock to Mrs. Jemison for a price of $4,000 cash. Mrs. Jemison paid for this additional 40 shares and her initial ten shares of stock by her check for $5,000 dated September 26, 1962. The record does not indicate whether or not the funds for the purchase of the stock came from the separate estate of Mrs. Jemison. The total capital stock of New Plantation, consisting of the 50 shares of common stock held by Mrs. Jemison, remained at $5,000 through September 30, 1966.

Mrs. Jemison took no active part in the preliminary negotiations leading up to the incorporation of New Plantation on September 25, 1962, in any of the events that took place thereafter, or in the management of New Plantation from the time it was incorporated to September 30, 1966, inclusive. Mrs. Jemison, her husband and Mr. Thomas Bradford were the directors of New Plantation. A meeting of the directors and a joint meeting of the directors and stockholders of New Plantation took place on September 28, 1962. Although Mrs. Jemison was the sole shareholder of record and a director, she attended neither meeting. Mr. Jemison was active in the management of New Plantation. Mr. Jemison testified that he had contacts with large department stores that sold wrought iron furniture.

On September 27, 1962, New Plantation obtained $150,000 from Bradford and Company, Inc., an unrelated finance and investment company, for which it issued 6½% serial debentures aggregating $150,000 maturing in $50,000 units on September 1, 1974, 1975, and 1976. The debentures were subordinated to all other indebtedness of New Plantation and were not guaranteed as to payment of either principal or interest. Mr. Thomas Bradford controlled Bradford and Company. The loan by Bradford and Company was made as an inducement to Mr. Jemison to place Mr. Bradford's son with New Plantation. Although this advance was made with little security and no priority as to repayment, the Tax Court found that it was a bona fide loan.

The ... terms of sale were embodied in an agreement dated September 28, 1962 between New Plantation and the stockholders of Old Plantation. Pursuant to that agreement, the stockholders agreed to sell and New Plantation agreed to buy the stock of Old Plantation for a stated consideration equal to the net worth of Old Plantation plus $644,909.53. The total purchase price was to be paid as follows:

(1) A cash payment of $100,000 at the time of closing;
(2) An amount equal to the book value of the United Chair Division ($183,435.84), without interest, in installments on January 10, 1963, March 15, 1963 and June 15, 1963;[6] and
(3) The balance ($609,878.33) in equal installments of $50,000 beginning October 1, 1963, and each year thereafter, with a final installment of $109,878.33 due on October 1, 1973. The notes representing such installments were to be guaranteed by the Jemison Investment Company and by Mr. Jemison, personally.

....

Further pursuant to the agreement of September 28, 1962, the stockholders of Old Plantation transferred their stock to New Plantation for a stated consideration of $893,314.17, of which $100,000 was paid in cash at the time of the sale, and the balance of $793,314.17 was payable in installments – three totaling $183,435.84 in 1963, with no interest; and $609,878.83 at 5½% interest, payable in ten annual installments of $50,000 each on October 1 of 1963 through 1972, and a final installment on October 1, 1973, of $109,878.33.

New Plantation issued 15 non-interest-bearing notes aggregating $183,435.84 to evidence the payments due January 10, 1963, March 15, 1963 and June 15, 1963. These notes were not guaranteed and the indebtedness was subordinated to all other indebtedness of New Plantation except the $150,000 owed to Bradford and Company.[7] The parties who negotiated the agreement intended that payment of these notes would be effected through the sale by Old Plantation of its United Chair Division's metal office chair business to Messrs. Thomas E. and William C. Jernigan.

New Plantation also issued fifty-five 5½% serial notes aggregating $609,878.33 to evidence the remaining payments due on account of the purchase of the stock. These notes were guaranteed absolutely as to principal and interest by Mr. Jemison individually and by the Jemison Investment Co., Inc. Jemison Investment Co., Inc. received a guarantee fee of $15,000 per year for its guarantee. Mr. Jemison did not receive any fee for his guarantee. The guarantees were required due to the small down payment made on the purchase and the requirement that the debt be unsecured to enable New Plantation to obtain financing for its operations.

The notes for $50,000 due October 1, 1963 and $50,000 due October 1, 1964 were not subordinated so that Mr. Jemison could arrange for the sellers to discount these notes with a bank. This enabled Messrs. Thomas E. and William C. Jernigan to obtain additional capital for development of the office chair business. The remaining notes were subordinated to all other

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[6] In turn, Messrs. Thomas E. Jernigan and William C. Jernigan agreed to purchase the assets of the United Chair Division for the same amount payable on the same terms.

[7] The Commissioner conceded that the principal payments on these non-interest-bearing notes did not result in dividend income to the Jemisons.

indebtedness except the 6½% serial debentures issued to Bradford and Company.

Pursuant to another agreement dated September 28, 1962, Old Plantation agreed to sell the assets of its United Chair Division to Messrs. Thomas E. and William C. Jernigan, effective as of the close of business on August 31, 1962. In consideration for that sale, Messrs. Thomas E. and William C. Jernigan agreed to pay to Old Plantation the sum of $183,435.84. In its final return Old Plantation reported that its basis in the assets of the United Chair Division equaled the proceeds received on that sale.

As of September 28, 1962, Old Plantation was liquidated. Its assets were transferred to and its liabilities were assumed by New Plantation. [footnote omitted]. Following the liquidation of Old Plantation, the business and assets of the United Chair Division were immediately transferred to Messrs. Thomas E. and William C. Jernigan, who issued to New Plantation a non-interest-bearing promissory note dated September 28, 1962 in the principal amount of $183,435.84 payable as follows:

Due Date	Amount
October 8, 1962	$83.435.84
March 15, 1963	$50,000.00
June 15, 1963	$50,000.00

Total	$183,435.84

The Messrs. Jernigan duly made the payments on this note on or before the due date, while New Plantation similarly paid the non-interest-bearing notes aggregating $183,435.84 due January 10, 1963, March 14, 1963 and June 14, 1963. As a result, the United Chair Division was acquired by Messrs. Thomas E. and William C. Jernigan through an exchange or offset of notes.

During the period from October 1, 1962 to September 30, 1966, New Plantation duly paid principal and interest as due on the 6½% debentures issued to Bradford and Company and on the 5½% notes issued to the stockholders of Old Plantation. The payments were made by New Plantation without recourse to any additional financing.

During its four taxable years ended September 30, 1963 through September 30, 1966, New Plantation accrued $117,652.65 interest expense on the 5½% serial notes issued to the shareholders of Old Plantation, and $39,000 on the 6½% debentures issued to Bradford and Company, which amounts it deducted on its tax returns filed for those years as the Tax Court noted in its findings of fact.

In the notice of deficiency sent to New Plantation for its taxable years ended September 30, 1963 through September 30, 1966, inclusive, the Commissioner disallowed as an expense the deductions claimed by New Plantation for such interest.[8]

[8] The Commissioner conceded in the Tax Court that New Plantation was entitled to an expense deduction

In its return for the period September 25 to September 30, 1962, New Plantation reported assets received (according to a computation of the adjusted basis of its stock on September 28, 1962, and the allocation of that adjusted basis to the assets received in liquidation from Old Plantation, as shown in the Tax Court's findings) and liabilities assumed on the liquidation of Old Plantation.

The sum of $184,936.04 shown as the fair market value of the inventory in the schedules included by New Plantation in its return represented the book value of the inventory of Old Plantation computed as the lower of average cost or market. The Tax Court determined that the fair market value of the inventory received by New Plantation on the liquidation was $228,376.12 ... and that New Plantation otherwise properly valued the tangible assets on the liquidation.[9]

In the notice of deficiency addressed to Mr. and Mrs. Jemison for the calendar year 1963, the Commissioner determined that the individual taxpayers realized dividends in the amount of $184,274.23 on account of the following payments by Old Plantation:

Payment of non-interest-bearing note due 3/14/63	$50,000.00
Payment of non-interest-bearing note due 6/15/63	$50,000.00
Payment of 5½% note due 10/1/63	$50,000.00
Payment of interest on 5½% note due 10/1/63	$33,543.31
Payment on account of 5½ % note of minority stockholder on 10/24/63	$730.92

Total	$184,274.23

The Tax Court held that all steps taken by Mr. Jemison and the shareholders of Old Plantation were parts of a single transaction for the purchase by New Plantation of the wrought iron furniture business of Old Plantation, and, applying the relevant factors with respect to debt-equity situations to the facts here, one of which was found to be thin capitalization, that the guaranteed debt must be treated as an indirect contribution to New Plantation's capital by Mr. Jemison. Therefore, it held that New Plantation was not entitled to deductions claimed under § 163 for interest on the 5½% serial notes in its taxable years ended September 30, 1963 to September 30, 1966 and that the Jemisons were taxable in 1963 under §§ 301 and 316 with the principal and interest payments on these guaranteed notes in that year.[10] Their deficiency was fixed at $28,403.91.

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for the $39,000 interest paid on the 6½% debentures issued to Bradford and Company.

[9] [The Commissioner did not appear this valuation. The Tax Court stated that on September 30, 1962, the value of New Plantation's assets was $1,261,327.81. It had liabilities of $761,327.81.]

[10] The Tax Court allowed the Jemisons a deduction for interest paid the sellers by New Plantation.

II. THE ISSUES ON APPEAL

The issues presented for our consideration are these:

1. Whether $100,000 of guaranteed 5½% serial debentures issued by New Plantation to the sellers of Old Plantation are to be treated as debt for income tax purposes where the notes were not subordinated and were paid when due by New Plantation without recourse to other financing?

2. Whether $509,878.33 of guaranteed 5½% notes issued by New Plantation to the sellers of Old Plantation are to be treated as debt for income tax purposes where the notes were subordinated to general creditors but were senior to $150,000 of other debentures which the Tax Court did treat as debt for income tax purposes?

3. Whether Jemison Investment Company, a co-guarantor, rather than John S. Jemison, Jr., a co-guarantor, should be deemed to have made the contribution to the equity capital of New Plantation in the event that any of the $609,878.33 principal amount of 5½% notes is deemed to represent a contribution to the equity capital of New Plantation?

III. THE RELEVANT LAW

The criteria for adjudicating debt-equity cases were set forth most clearly by Judge Jones for this Court in 1963 in *Montclair, Inc. v. C.I.R.*, 5 Cir., 1963, 318 F.2d 38[, 40]. ... [T]he factors which bear most strongly on the determination of the label to be applied to the transaction are enunciated:

> "(1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) 'thin' or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of 'dividend' money; (11) the ability of the corporation to obtain loans from outside lending institutions."[11]

... The tests are not "talismans of magical power," and the most that can be said is that they are a source of helpful guidance. [citation omitted]. Thus we decide debt-equity issues by a case by case analysis, applying the *Montclair* rubrics as best we can to the facts at hand.

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[11] This delineation was not intended to prevent the consideration of other factors which may be relevant in a particular case. *See* Dillin v. United States, 5 Cir. 1970, 433 F.2d 1097 at footnote 3, page 1100.

IV. TREATMENT OF THE $100,000 UNSUBORDINATED 5½% DEBENTURES AND THE $509,878.33 PARTIALLY SUBORDINATED 5½% NOTES

With regard to the $100,000 unsubordinated debentures, the taxpayers urge us to reverse the Tax Court for the following reasons: (1) There was a reasonable prospect of payment when due, (2) the notes were not subordinated to any other indebtedness of New Plantation, (3) the holders, along with general creditors, had first claim on more than $1,000,000 in assets of New Plantation, (4) the notes matured within two years, (5) the notes could have been paid by New Plantation's cash flow, and (6) the notes were paid when due without recourse to additional financing.

Of these factors, taxpayers point first and foremost to the fact that the debentures were totally unsubordinated, and thus conferred on the holders the right to participate with general creditors. ...

Taxpayers also vigorously assert that the assets of the corporation were more than adequate to support the $100,000 unsubordinated notes because on September 30, 1962, New Plantation's assets had a fair market value of $1,261,327.81. Central to this appeal is the taxpayers' contention that the Tax Court erroneously concluded that New Plantation was thinly capitalized.

Additionally, with regard to the $100,000 of unsubordinated 5½% debentures, taxpayers emphasize that they were to mature within two years, a factor militating strongly against a conclusion that the money was put "at the risk" of the business. Bolstering this point, taxpayers state that the cash flow from depreciation in 1963 and 1964, the years of payment of the $100,000 notes, exceeded the principal payments of $50,000 due on the notes. They say that in view of the fact that the interest on the notes is deducted in determining net income, it was not necessary for New Plantation to have net income to pay these notes, and thus their repayment was not contingent on the profitability of the business.

Finally, the taxpayers criticize the Tax Court for not giving greater weight in assessing the economic realities of the situation to the fact that the notes were paid on time. Taxpayers claim that giving this development its proper weight will lead us to the conclusion that the Tax Court was clearly erroneous in its holding that when the notes were issued there was no reasonable expectation that New Plantation could pay the notes. In this regard taxpayers also insist that the Tax Court gave undue emphasis to the overall debt-equity ratio, which they assert bears slight relevance to the determination of the treatment given unsubordinated notes. Taxpayers argue that whether a corporation can pay all of its debts is irrelevant to the question whether it can pay its priority debts.

Turning to the remaining $509,878.33 of partially subordinated 5½% serial debentures, the taxpayers argue five points in support of their proposition that the Tax Court erred: (1) There was reasonable prospect of payment when due, (2) the notes, though partially subordinated, were senior to $150,000 of 6½% debentures and $5,000 of common stock, (3) the assets of New Plantation were sufficient to support the debt, (4) the cash flow was sufficient to pay the debt,

and (5) the notes were paid when due without recourse to additional financing.

Many of the arguments made by the taxpayers in favor of debt treatment for the $100,000 unsubordinated debentures are equally applicable for the remaining $509,878.33 of partially subordinated notes, and the taxpayers have urged us to accord them equal vitality here. New arguments also are raised at this juncture, however. Taxpayers contend that it is anomalous and inconsistent for the Tax Court to characterize the $509,878.33 partially subordinated debentures as equity while at the same time characterizing inferior fully subordinated debentures held by Bradford and Company as debt, arguing that if the fully subordinated 6½% notes held by Bradford and Company are equity, surely the $509,878.33 debentures are entitled to the same treatment.

Here the taxpayers protest vigorously against the Tax Court's determination of the proper debt-equity ratio to apply in assessing the nature of the transaction. The principal dispute with the Tax Court revolves about that Court's valuation of the intangible assets of New Plantation, with particular emphasis on the personal business skills of Mr. Jemison. The Tax Court did recognize that intangible assets not carried on the balance sheet might have a bearing on the ability of the corporation to pay its debts. *Murphy Logging Company v. United States*, 9 Cir. 1967, 378 F.2d 222. But the Tax Court held that the relationship of Mr. Jemison's business skills to the well-being of New Plantation was not demonstrated with the specificity requisite to alter the picture of the overall debt-paying potential of New Plantation. ... [T]he taxpayers contend that the record amply demonstrates that Mr. Jemison was a veritable financial genius, commanding Jemison Investment Company, a company with control of assets valued at more than $11,000,000 and with annual gross receipts of over $10,000,000. They point to the record as reflecting that Mr. Jemison was successfully engaged in a broad variety of business ventures. He was a director of several successful corporations, a bank, and two insurance companies. More important, however, taxpayers assert, is Mr. Jemison's demonstrated close contact with several large department store chains which provided ideal outlets for New Plantation's products. Taxpayer on this account urges that a proper debt-equity ratio should take into account the financial skills of Mr. Jemison.

Without receding from their strong stand that the 5½% debentures constitute debt, the taxpayers alternatively argue that if the court should hold that such notes do not constitute debt, the same equity treatment should be given to the 6½% subordinated debentures held by Bradford and Company. Stated otherwise, they argue that if the 5½% partially subordinated debentures are to be regarded as equity, then the 6½% totally subordinated debentures should logically be deemed to constitute preferred stock in New Plantation. Taxpayers point out that long-term debt held by non-stockholders has been held to be an equity interest in the nature of preferred stock. *Foresun, Inc. v. Commissioner of Internal Revenue*, 6 Cir. 1965, 348 F.2d 1006, *affirming* 41 T.C. 706 (1964). Taxpayers claim that they were denied the right to further trial on this point in the Tax Court, and they contend that at the very least this Court should remand the case to the Tax Court to permit development of further evidence as to the treatment to be given the $150,000 in Bradford and Company notes. If these notes are regarded as equity, taxpayers argue that the debt-equity ratio of New Plantation would be approximately 4 to 1 ($609,878.33 to $155,000), and not the plus 125 to 1 ratio which the government asserts is the proper debt-equity ratio

($759,878.33 to $5,000). This would effectively demolish the Tax Court finding of thin capitalization.

The Commissioner answers these contentions with the familiar tax law precept: substance and not form determines proper tax treatment for a transaction, urging that the substance of this transaction is that a corporation was sold for a price more than $600,000 in excess of its net worth, with payment promised by a new corporation without significant capital or other assets, whose only solidarity was the guarantee of the individual taxpayer, Mr. Jemison. The Commissioner continues that the guarantee was in reality a contribution of capital and that in substance the payments on the notes were dividends on the Jemison capital investment taxable to them as income.

More specifically the Commissioner places primary emphasis on the Tax Court's findings that the assets of the new corporation vis a vis its debts were insufficient to give New Plantation viable independence as a corporation. The Tax Court found that the corporate assets of New Plantation were "wholly inadequate to sustain a debt of $609,878.33." ... The Commissioner discounts the fact that New Plantation was in actuality able to pay its obligations without resort to its guarantors, pointing out that we must view the transaction on the basis of the economic realities as they existed at New Plantation's inception, and not in the light of later developments. As matters stood September 28, 1962, asserts the Commissioner, the deal had not set up a bona fide corporation reasonably to be expected to manage to go it alone, and later developments do not alter the nature of the transaction for tax purposes.

Making further use of the debt vs. equity criteria established by *Montclair* and later cases, the Commissioner notes particularly that the sellers took the unusual step of agreeing to subordinate all but $100,000 of the purchase money notes. The Commissioner asserts that this action was taken because the sellers looked first and foremost to the guarantee of Mr. Jemison, an obligation which was primary in nature.

The Commissioner also claims that no third party arm's-length creditors, because of New Plantation's paper thin capitalization, would have loaned the amount of money by which the corporation became indebted. Establishment of any indebtedness, argues the respondent, would have required Mr. Jemison's guarantee, and therefore for tax purposes the indebtedness should be regarded as that of the Jemisons.

Resolving these two conflicting views of this amorphous transaction is no easy task, but we are not persuaded that the taxpayers have successfully demonstrated the incorrectness of the position taken by the Tax Court. Certainly we recognize that this transaction was initially cast to have all of the outward appearances of a debt transaction, complete with instruments styled "debentures" which had fixed maturity dates. But these surface considerations do not end our examination. Closer scrutiny establishes that the other factors which would give the transaction the aura of debt are noticeable by their absence.

Of critical importance in determining whether financial input is debt or equity is whether or not

the money is expended for capital assets. In the instant case the substantial portion of the $609,878.33 was directed to the purchase of capital assets and to finance initial operations. In contrast, only $5,000.00 was set up as equity to finance launching of the corporate venture.

Other equity factors exist. While the sellers were ostensibly to look to the corporation for payment of the debt, it is apparent from the meager capital position of the company that Mr. Jemison's guarantee was regarded as the real undergirding for the deal. Our conclusion is reinforced by noting that the sellers apparently considered financially acceptable the agreement to subordinate the great majority of the 5½% debentures to almost all other corporate indebtedness so long as the debentures were guaranteed by Mr. Jemison. Mr. Jemison's guarantee was, of course, an obligation primary in nature.

Further, while Mrs. Jemison was the stockholder of record, and Mr. Jemison on the surface was only a guarantor, surrounding circumstances clearly demonstrate that Mr. Jemison completely controlled the shares held by Mrs. Jemison. Mrs. Jemison seldom attended the meetings of the corporation, and took little active interest in it. In contrast, Mr. Jemison was intimately and continuously involved in the operations of New Plantation. Regarding Mr. Jemison as the "constructive" owner of the stock, we have an identity of interest between the stockholder and the guarantor – a factor which points strongly toward equity treatment.

The record cannot support a determination by us that the Tax Court's finding that New Plantation was thinly capitalized is "clearly erroneous." [citation omitted]. The balance sheet of the corporation showed that its quick assets (cash and accounts receivables) of $317,000 could not cover its current liabilities of approximately $490,000. This ratio is one of the acid test indicators used by businessmen to determine the health of a business. After the dissolution of Old Plantation the new corporation had tangible assets, at fair market value, of approximately $1,064,000 securing debts of approximately $1,078,000. We regard this as thin capitalization, as did the Tax Court.

The guarantee enabled Mr. Jemison to put a minimum amount of cash into New Plantation immediately, and to avoid any further cash investment in the corporation unless and until it should fall on hard times. At the same time he exercised total control over its management. Adding together the personal guarantee of Mr. Jemison to the guarantee of Jemison Investment Company, which was wholly owned by him and Mr. Jemison's control of New Plantation, we think that the result is that Mr. Jemison's guarantee simply amounted to a covert way of putting his money "at the risk of the business." Stated differently, the guarantee enabled Mr. Jemison to create borrowing power for the corporation which normally would have existed only through the presence of more adequate capitalization of New Plantation.

We do not regard as significant the fact that ultimately things progressed smoothly for New Plantation and that its debts were paid without additional financing. The question is not whether, looking back in time, the transaction was ultimately successful or not, but rather whether at its inception there was a reasonable expectation that the business would succeed on its own. The transaction must be judged on the conditions that existed when the deal was consummated, and

not on conditions as they developed with the passage of time. [citations omitted]. When New Plantation was incorporated its prospects of business success were questionable indeed without the Jemison guarantees.

We hold also that the Tax Court was correct in refusing to give value to the intangible financial skills of Mr. Jemison for purposes of computing the corporation's debt-equity ratio. ... In our view courts should be wary in giving weight to such intangible assets as those attributed to Mr. Jemison. Certainly business acumen or financial wizardry of stockholders or corporate management could not properly be valued and placed on the corporate balance sheet under generally accepted principles of accounting, although they might afford window dressing in a footnote. ... [W]e conclude that intangible assets such as those claimed for Mr. Jemison have no place in assessing debt-equity ratio unless it can be shown by convincing evidence that the intangible asset has a direct and primary relationship to the well-being of the corporation. Additionally it seems clear to us that the assets sought to be valued must be something more than management skills and normal business contacts. These are expected of management in the direction of any corporation.

We decide only this case. We do not assert that intangible assets are never a proper consideration in assessing debt-equity ratio. Nevertheless we agree with the Tax Court that courts should proceed cautiously in giving value to such intangible assets in the absence of special circumstances demonstrating a primary relationship to the corporation. That standard is not met by evidence that Mr. Jemison was a talented business man with useful contacts among department stores.

Our holding does not require that we find the notes held by Bradford and Company to be equity interests. While the Bradford and Company notes were subordinated, subordination is far from the sole criterion for determining whether an interest is debt or equity. It is not controlling. Aside from this single factor this record is productive of nothing to indicate that this was not a bona fide loan made by Bradford with the primary motive of inducing New Plantation to employ young Bradford. We agree with the Tax Court that this was a legitimate loan.

V. SHOULD THE EQUITY CONTRIBUTION BE DEEMED TO HAVE BEEN MADE BY JEMISON INVESTMENT COMPANY RATHER THAN BY MR. JEMISON?

The Tax Court found that the equity contribution was to be attributed to Mr. Jemison and not to Jemison Investment Company. Although acknowledging that Jemison Investment Company received a fee of $15,000.00 for its guarantee on the notes, the Tax Court reasoned that inasmuch as Mr. Jemison controlled both Jemison Investment and New Plantation, the fee for the guarantee was either a matter of internal accounting or for cosmetic effect, and not an indication that the sellers of Old Plantation realistically looked to Jemison Investment Company for any security. It is uncontested that practically all of Mr. Jemison's assets consisted of stock in Jemison Investment Company. It owned the house he lived in and the automobile he drove, but he owned it in its entirety. Furthermore, the Tax Court found that the sellers of Old Plantation only investigated the credit of Mr. Jemison, and that the Messrs. Jernigans as sellers looked at all

times to Mr. Jemison's guarantee as the real insurance for the notes.

Although the appellants cast some doubt on the Tax Court's finding that the sellers did not investigate the financial statements of the Jemison Investment Company, in no other respect have they demonstrated error in the Tax Court's conclusion that through all of the haze of corporate red tape, the real financial keystone supporting the entire deal, the person to whom the sellers ultimately looked for their protection in the event of the failure of New Plantation was Mr. John S. Jemison, Jr.

VI. CONCLUSION

Error is not demonstrated on this record. None of the Tax Court's Findings and Conclusions based upon stipulated facts are shown to be "clearly erroneous." The decision of the Tax Court as to all matters raised by this appeal is

Affirmed.

Questions and comments:

1. What would have been Mr. Jemison's reason for having Mrs. Jemison own stock of New Plantations rather than himself? A dividend is a distribution by a corporation made "with respect to its stock." § 301(a). How can a corporation make a distribution "with respect to its stock" to someone who is not a shareholder? The distribution would be a payment with respect to what? Remember, Mr. Jemison was an experienced and successful investment banker.

2. What is a "debenture?" What does it mean for a debt to be subordinate to another?

3. Rather than sell stock and buy back certain assets, why couldn't the owners of Old Plantation simply have sold the other assets to New Plantation? What do you think the tax consequences of a sale of assets would be relative to a sale of stock?

4. What opportunities arise in the context of buying/selling a corporation to manipulate debt/equity rules?

5. Do you think that Bradford and Company would have been willing to recharacterize its advance of $150,000 as equity rather than debt?

6. Evidently Old Plantation was very good at manufacturing wrought iron furniture – at least it was good enough for the parties to make plans on the assumption that the wrought iron furniture business would generate sufficient revenue to service all the loans involved.

- Assuming New Plantation paid off the $800,000 of debt obligations, how would the income that went towards repayment have been taxed?
- How, i.e., to whom, will the New Plantation's income be taxed after the Fifth Circuit's decision?

7. The "common law" of debt-equity cases always seems to involve a consideration of "factors." The Fifth Circuit offered eleven factors. The court in *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) offered 16 factors, *viz*.:

> (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

Is this list better than the one announced in *Montclair, Inc.*? Such factors are evidentiary in nature, and as the court in *Plantation Patterns* said, there is no universally applicable test to resolve such issues. Why do you think this is so?

8. Why do you think that Congress (or the Secretary of the Treasury) can't simply announce a black letter debt to equity ratio and apply it to all cases?

9. Preview: why would it matter that the guarantee was extended personally by Mr. Jemison and not by the Jemison Investment Company? Quickly scan § 243.

Note on § 385

A congressional effort to deal with the debt-equity problem is § 385, which was enacted in 1969. Read it.

First, note that Congress seems willing to pass the buck to the Secretary of the Treasury to handle the matter through rulemaking. § 385(a). The parenthetical indicates that Congress is willing to have the Treasury treat corporate financing as partly equity and partly debt, i.e., not all-or-nothing. Second, Congress required the Secretary to name factors to consider in resolving debt-equity questions; Congress offered a non-exclusive list of five factors to get the ball rolling. § 385(b). Third, the issuer of an interest in a corporation and all holders of the interest are bound by their choice of characterization, whether debt or equity – but the IRS is not so bound. § 385(c)(1). The holder of an interest may – subject to regulations – announce on its tax return that it is taking a position contrary to the choice that the issuer has made. § 385(c)(2).

> •[How would this affect Mr. Jemison's alternative contention that the Bradford money was for an equity investment rather than a loan?]

In 1980, Treasury proposed regulations. The regulations contained some objective standards, but also contained some subjective standards with safe harbors. Commentators criticized the proposed regulations for, among other things, not taking the approach of prescribing guidelines – as the statute seems to require. Debt-equity issues also arise in the international arena, and the proposed regulations did not address such transactions.[12] In 1983, the IRS withdrew the proposed regulations. *See generally* Marie Sapirie, *Regulation Redux: The Debt-Equity Regs in 1980 and Today*, TAX NOTES 449 (July 25, 2016).

Why do you think that it is so difficult to draft regulations that will "work?" Can you identify elements that are *always* (or *never*) present when someone loans money to another? If so, it should be a simple matter to codify, at a minimum, these elements as conclusively indicative of debt rather than equity.

In April 2016, Treasury proposed new § 385 regulations. 81 Fed. Reg. 20912 (2016). In October 2016, Treasury promulgated final regulations. The new rules have much to say about debt between members of an "expanded group," a chain of corporations linked by at least 80% ownership of stock. In the context of the issues raised in cases involving closely-held corporations, Reg. § 1.385-1(b) provides:

> (b) General rule. Except as otherwise provided in the Internal Revenue Code and the regulations thereunder, including the § 385 regulations, whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness (or as in part stock and in part indebtedness) is determined based on common law, including the factors prescribed under such common law.

Is it possible that by requiring Treasury to set forth factors to consider, § 385(b), Congress created an undue constraint?

III. Getting Money Out of the Corporation Through Deductible Payments

In a closely held corporation, we expect to find that the same people wear different hats. For example, a major shareholder may also be (one of) the corporation's most important employees. A shareholder may be the lessor or seller of property to a corporation. The tax consequences of money moving into or out of the corporation through these various transactions is likely to be quite different – and less burdensome – than those that follow from the corporation sharing its

[12] Before December 2017, the United States had one of the highest corporate income tax rates in the world, and the corporate income tax applied to the worldwide income of U.S. corporations. A U.S. corporation may form a wholly-owned foreign subsidiary (or be the wholly-owned subsidiary of a foreign firm). The U.S. corporation may borrow from the foreign corporation to finance its operations in many places. The interest that the U.S. firm pays reduces that income of the affiliated group that would otherwise be subject to the highest corporate income tax. This arrangement is one form of "income-stripping."

after-tax profits with shareholders through dividends. In all cases, the *bona fides* of the underlying transaction is the issue on which the case will turn.

A. Employment

Whether a "salary" is in fact a dividend is a question that arises often in the context of the corporation claiming a deduction for payment of a "reasonable" salary under § 162(a)(1).

Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983)

HUG, Circuit Judge

Elliotts, Inc. ("Taxpayer"), challenges the Tax Court's determination of deficiencies in its 1975 and 1976 tax returns. It argues that the Tax Court erred in finding that part of the compensation paid Taxpayer's chief executive and sole shareholder during those years constituted a dividend distribution and thus was not deductible under § 162(a)(1) of the Internal Revenue Code. We reverse.

I. BACKGROUND

Taxpayer is an Idaho corporation that sells equipment manufactured by John Deere Co. and services equipment made by Deere and several other manufacturers. Its principal place of business is Burley, Idaho. During the period relevant here, Taxpayer had business locations in both Burley and Idaho Falls, Idaho. [footnote omitted]. The Idaho Falls location dealt only in industrial equipment; the Burley office sold and serviced a wide range of agricultural and industrial equipment. Out of approximately 168 John Deere agricultural dealers in the zone comprising seven western states, Taxpayer remained, at the time of trial, one of only three dealers handling both agricultural and industrial equipment.

Taxpayer was incorporated in 1952. During its first year, it grossed $500,000 in agricultural equipment sales in the Burley area. It employed about eight people at that time. By 1975, Taxpayer was employing 40 people, selling both agricultural and industrial equipment throughout southeast Idaho, and achieving gross annual sales in excess of $5 million.

Edward G. Elliott has been Taxpayer's chief executive officer since its incorporation and he has also been its sole shareholder since 1954. He has always had total managerial responsibility for Taxpayer's business. In addition to being Taxpayer's ultimate decision and policy maker, he has performed the functions usually delegated to sales and credit managers. It is undisputed that he works about 80 hours each week.

For several years, Taxpayer has paid Elliott a fixed salary of $2000 per month plus a bonus at year's end. Since Taxpayer's incorporation, Elliott's bonus has been fixed at 50% of net profits

(before subtraction of taxes and management bonuses).

On its return for the fiscal year ending February 28, 1975, Taxpayer claimed a $181,074 deduction for total compensation paid Elliott. It claimed a similar $191,663 deduction on its return for the fiscal year ending February 28, 1976. The Commissioner of Internal Revenue ("Commissioner") found these deductions to be in excess of the amounts Taxpayer properly could deduct as reasonable salary under § 162(a)(1). On June 16, 1978, the Commissioner issued Taxpayer a notice of deficiency which limited deductions for Elliott's salary to $65,000 for each fiscal year.

Taxpayer petitioned the Tax Court for a redetermination of liability. The court, after reviewing the testimony and statistical evidence, concluded that the payments to Elliott, in addition to providing compensation for personal services, were intended in part to distribute profits. Although the Tax Court acknowledged that it could not determine what amounts paid Elliott actually were dividends, it found that the total amounts paid him were in excess of reasonable compensation. It determined that $120,000 was reasonable compensation for the year 1975 and that $125,000 was reasonable for 1976. The deficiencies assessed to Taxpayer by the Commissioner were reduced accordingly. Taxpayer appeals the Tax Court's determination of reasonable compensation.

II. THE SHAREHOLDER-EMPLOYEE PROBLEM

The issue presented by this case concerns the deductibility by a corporation of payments ostensibly made as compensation for services to an employee who is also a shareholder. If the payments are reasonable compensation for services rendered, the corporation may deduct them. 26 U.S.C. § 162(a)(1). If, however, they are actually dividends, they are not deductible. Thus, it will normally be in a corporation's interest to characterize such payments as compensation rather than dividends.[13]

The general problem is that of distinguishing between dividends and compensation for services received by a shareholder-employee of a closely held corporation. What makes this situation troublesome is that the shareholder-employee and the corporation are not dealing with each other at arm's length. It is likely to be in the interests of both the corporation and the shareholder-employee to characterize any payments to the shareholder-employee as compensation rather than dividends. For this reason, a taxpayer's characterization of such payments may warrant close scrutiny to ensure that a portion of the purported compensation payments is not a disguised

[13] The recipient is taxed at ordinary income rates on both dividends and wages. If the recipient is a significant shareholder, his interest in the corporation may cause him to prefer to characterize such payments as compensation. Moreover, for payments made between 1971 and 1981, as is the case here, a high-income recipient has a strong incentive to characterize such payments as compensation rather than dividends: pre-1982 dividends are taxable at a maximum rate of 70% while the maximum tax rate for wages received between 1971 and 1981 is 50%. 26 U.S.C. § 1 (amended 1983) and § 1348 (repealed 1981). (Since 1982, the maximum tax rate for both wages and dividends has been 50%. 26 U.S.C. § 1 (1982).)

dividend. *See Nor-Cal Adjusters v. Commissioner*, 503 F.2d 359, 361 (9th Cir. 1974).

The problem of determining whether compensation payments contain an element of disguised dividend is exacerbated in a case such as this one where the shareholder-employee is the corporation's sole shareholder. Not only is a sole shareholder likely to have complete control over the corporation's operations, he will also be the only recipient of its dividends. If a corporation has multiple shareholders, the existence of a plan which compensates shareholder-employees in proportion to their ownership interests may be evidence that compensation payments contain disguised dividends. In the case of a sole shareholder, such evidence is meaningless.

Section 162(a)(1) of the Internal Revenue Code permits a corporation to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." There is a two-prong test for deductibility under § 162(a)(1): (1) the amount of the compensation must be reasonable and (2) the payments must in fact be purely for services. Reg. § 1.162-7(a) (1960); *Nor-Cal*, 503 F.2d at 362.

Proof of the second prong, which requires a "compensatory purpose," can be difficult to establish because of its subjective nature. *See* Note, *Reasonable Compensation and the Close Corporation:* McCandless, *the Automatic Dividend Rule, and the Dual Level Test*, 26 STAN. L. REV. 441, 447 (1974) (hereafter "Note, *Reasonable Compensation*"). The existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable under the first prong. For these reasons, courts generally concentrate on the first prong – whether the amount of the purported compensation is reasonable. *See, e.g.*, *Pacific Grains, Inc. v. Commissioner*, 399 F.2d 603 (9th Cir. 1968); Note, *Reasonable Compensation*, 26 STAN. L. REV. at 447; Coggin, *The Status of the* McCandless *Doctrine,* 55 TAXES 720, 720 (Nov. 1977) (hereafter "Coggin"). Courts have generally not delved into whether a compensatory purpose exists under the second prong except in those rare cases where the Commissioner has come forward with evidence that purported compensation payments, although reasonable in amount, were in fact disguised dividends. *See, e.g.*, *Klamath Medical Serv. Bureau v. Commissioner*, 29 T.C. 339, 348-49 (1957), *aff'd*, 261 F.2d 842 (9th Cir. 1958), *cert. denied*, 359 U.S. 966 (1959). *See generally* Note, *Reasonable Compensation*, 26 STAN. L. REV. at 447 & n.35. By and large, the inquiry under § 162(a)(1) has turned on whether the amounts of the purported compensation payments were reasonable.

One court has departed from this practice of restricting the inquiry in most cases to the reasonableness of the payments. In *Charles McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970), the Court of Claims held that ostensible compensation payments paid to two shareholder-employees, even though reasonable in amount, "necessarily" contained disguised dividends because the closely held corporation had been profitable and had not paid out any dividends since its formation. *Id.* 1339-40. [footnote omitted]. This has become known as the "automatic dividend rule," and has been subjected to much criticism. *E.g.*, Coggin, 55 TAXES 720; Walthall, McCandless – *Implications for Compensation Planning and Dividend Policy*, 6 CUM. L. REV. 1 (1975) (hereafter "Walthall"); Note, *Reasonable Compensation*, 26 STAN. L.

REV. 441.

We reject the automatic dividend rule of *McCandless* for several reasons. First, there is no statute requiring profitable corporations to pay dividends. Congress has chosen to handle abuses in this area through the accumulated earnings tax. 26 U.S.C. §§ 531-537; *see* Walthall, 6 CUM. L. REV. at 16-19; Note, *Reasonable Compensation*, 26 STAN. L. REV. at 449-50. Beyond the penalties contained in the accumulated earnings tax, Congress has not indicated that it wants the Commissioner or the courts to require the payment of dividends as a matter of federal tax policy. *See Casey v. Commissioner*, 267 F.2d 26, 30 (2d Cir. 1959); *Laure v. Commissioner*, 70 T.C. 1087, 1098 (1978).

Second, the automatic dividend rule is based on the faulty premise that shareholders of a profitable corporation will demand dividends. *See McCandless*, 422 F.2d at 1339-40. Shareholders are generally concerned with the return on their investment. While some shareholders may prefer to see their return in the form of dividends, others will prefer to have the corporation reinvest its profits so that their return will be in the form of appreciation and the potential of greater future return. *See*, Note, *Reasonable Compensation*, 26 STAN. L. REV. at 450-53. If the shareholders prefer to have their return in the form of appreciation rather than dividends, there is nothing in the law precluding the corporation from reinvesting its profits.

Third, it may well be in the best interests of the corporation to retain and reinvest its earnings. As the Supreme Court has noted, "Directors of a closely held, small corporation must bear in mind the relatively limited access of such an enterprise to capital markets. This may require a more conservative policy with respect to dividends than would be expected of an established corporation with securities listed on national exchanges." *United States v. Byrum*, 408 U.S. 125, 140 (1972). Not only may retained earnings be the most rational source of financing for a small corporation, "[s]uppliers or outside lenders may insist upon the retention of earnings as a cushion for the credit which they extend or to insure that the firm has sufficient operating funds to continue functioning as a going concern." Walthall, 6 CUM. L. REV. at 15.

For these reasons, we will not presume an element of disguised dividend from the bare fact that a profitable corporation does not pay dividends.

In determining the deductibility of compensation payments paid to shareholder-employees, we will continue to concentrate on the reasonableness of those payments. In the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness. But where, as here, the evidence focuses only on reasonableness and the failure to pay dividends, and there is no other evidence of an intent to hide dividends in compensation payments, our inquiry will be confined to the reasonableness issue. The inquiry into reasonableness is a broad one and will, in effect, subsume the inquiry into compensatory intent in most cases.

In evaluating the reasonableness of compensation paid to a shareholder-employee, particularly a sole shareholder, it is helpful to consider the matter from the perspective of a hypothetical

independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The nature and quality of the services should be considered, as well as the effect of those services on the return the investor is seeing on his investment. The corporation's rate of return on equity would be relevant to the independent investor in assessing the reasonableness of compensation in a small corporation where excessive compensation would noticeably decrease the rate of return.

Bearing in mind the preceding discussion, we now turn to the reasonableness of the compensation paid by Taxpayer to Elliott.

III. REASONABLENESS DETERMINATION

Section 162(a)(1) provides that a taxpayer may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," including "a reasonable allowance for salaries or other compensation for personal services actually rendered." 26 U.S.C. § 162(a)(1). That Elliott actually rendered services as an employee of Taxpayer is not disputed. At issue is whether the payments made to Elliott are attributable to that employment relationship or to his role as Taxpayer's sole shareholder. Our inquiry focuses on whether the Tax Court, in finding that a part of the payments made to Elliott could not be attributed to his employment status, correctly defined and applied the factors that determine what is "reasonable compensation" under § 162(a)(1).

Although we accord deference to the Tax Court's special expertise, definition of the appropriate factors is reviewable by this court as a question of law. [citations omitted]. The Tax Court's findings of fact, derived from application of the appropriate factors, must be affirmed unless clearly erroneous. [citations omitted].

Our cases have defined a number of factors that are relevant to this attribution determination, "with no single factor being decisive of the question." *Pacific Grains*, 399 F.2d at 606. For analytical purposes, these factors may be divided into five broad categories.

A. Role in Company

The first category of factors concerns the employee's role in the taxpaying company. Relevant considerations include the position held by the employee, hours worked, and duties performed, *American Foundry v. Commissioner*, 536 F.2d 289, 291-92 (9th Cir. 1976), as well as the general importance of the employee to the success of the company, *American Foundry*, 536 F.2d at 291-92. If the employee has received a large salary increase, comparing past duties and salary with current responsibilities and compensation also may provide significant insights into the reasonableness of the compensation scheme. *Pacific Grains*, 399 F.2d at 605, 607.

The Tax Court found that Elliott worked 80 hours per week, performed the functions of general manager, sales manager, and credit manager, and made all policy decisions concerning the parts and service department. These are all appropriate considerations. The Tax Court also considered

Elliott's qualifications and found that although he was a "capable executive" he had no "special expertise." The Tax Court did not seem, however, to consider Elliott's extreme personal dedication and devotion to his work. To the extent that this benefited the corporation, it is surely something for which an independent shareholder would have been willing to compensate Elliott. Because we reverse and remand on other grounds, we point this out so that the Tax Court may consider it on remand.

B. External Comparison

The second set of relevant factors is a comparison of the employee's salary with those paid by similar companies for similar services. *See Hoffman Radio Corp. v. Commissioner*, 177 F.2d 264, 266 (9th Cir. 1949); *E. Wagner & Son v. Commissioner*, 93 F.2d 816, 819 (9th Cir. 1937).

The Tax Court did compare Elliott's compensation to that of managers at other John Deere dealers. In making these comparisons, it appears that the Tax Court considered that Elliott was performing the functions that two or three people performed at other dealers. This was correct. Such comparisons should be made on the basis of services performed. *See* E. *Wagner*, 93 F.2d at 818; Reg. § 1.162-7(b)(3). If Elliott was performing the work of three people, the relevant comparison would be the combined salaries of those three people at another dealer.

C. Character and Condition of Company

The third general category of factors concerns the character and condition of the company. The focus under this category may be on the company's size as indicated by its sales, net income, or capital value. *See E. Wagner*, 93 F.2d at 819; *General Water Heater Corp. v. Commissioner*, 42 F.2d 419, 420 (9th Cir. 1930). Also relevant are the complexities of the business and general economic conditions. To the extent that they are relevant to this case, the Tax Court did adequately consider these factors.

D. Conflict of Interest

The fourth category focuses on those factors that may indicate a conflict of interest. The primary issue within this category is whether some relationship exists between the taxpaying company and its employee which might permit the company to disguise nondeductible corporate distributions of income as salary expenditures deductible under § 162(a)(1).[14] Such a potentially exploitable relationship may exist where, as in this case, the employee is the taxpaying company's sole or controlling shareholder, see *Nor-Cal*, 503 F.2d at 361; *Pacific Grains*, 399 F.2d at 607; *E. Wagner*, 93 F.2d at 817, 819, or where the existence of a family relationship indicates that the terms of the compensation plan may not have been the result of a free bargain, *Harolds Club v. Commissioner*, 340 F.2d 861, 865 (9th Cir. 1965). Other factors also may point toward an attempt to distribute income through "compensation," including the existence of a

[14] This may also be probative of a presence or absence of compensatory intent.

bonus system that distributes all or nearly all of the company's pre-tax earnings, *Nor-Cal*, 503 F.2d at 362; *Klamath Medical*, 261 F.2d at 846; *Sunset Scavenger Co. v. Commissioner*, 84 F.2d 453, 455 (9th Cir. 1936), that amounts to a disproportionately large percentage of gross income when combined with salary, *Pacific Grains*, 399 F.2d at 607; *General Water Heater*, 42 F.2d at 420, or that provides large bonuses to owner-executives, but none to non-owner management, *Nor-Cal*, 503 F.2d at 361.

In this case, where Elliott was the sole shareholder, the sort of relationship existed that warrants scrutiny. The mere existence of such a relationship, however, when coupled with an absence of dividend payments, does not necessarily lead to the conclusion that the amount of compensation is unreasonably high. Further exploration of the situation is necessary.

In such a situation, as discussed earlier, it is appropriate to evaluate the compensation payments from the perspective of a hypothetical independent shareholder. If the bulk of the corporation's earnings are being paid out in the form of compensation, so that the corporate profits, after payment of the compensation, do not represent a reasonable return on the shareholder's equity in the corporation, then an independent shareholder would probably not approve of the compensation arrangement. If, however, that is not the case and the company's earnings on equity remain at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary.[15]

During the fiscal year ending February 28, 1975, Taxpayer reported equity of $415,133 and net profits (profits less taxes and compensation paid Elliott) of $88,969 – a return of 21%. For fiscal year 1976, Taxpayer reported equity of $513,429 and net profits of $98,297 – a return of 19%. Thus, the average rate of return on equity during these years was 20%. The Tax Court failed to consider the significance of this data. It seems clear, however, that this rate of return on equity would satisfy an independent investor and would indicate that Taxpayer and Elliott were not exploiting their relationship.[16]

The Tax Court erred by limiting its analysis in this area to the facts that Elliott was Taxpayer's sole shareholder and Taxpayer paid no dividends. These are relevant factors, but they cannot be viewed in isolation. Taxpayer's no-dividend policy does not by itself demonstrate that the relationship between Taxpayer and Elliott was being exploited.

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[15] It should be noted that there are situations in which the compensation paid to employees is reasonable and yet the corporation may suffer a loss or an inadequate return on equity.

[16] Over the period from 1968 to 1978, during which the bonus formula was in effect, the average rate of return on equity was 15%, based on corporate profit in relation to net book value. There was also evidence, which was not disputed, that the market value of the corporation had increased from the initial shareholder investment of $19,000 to a current market value at the time of trial of $5,000,000. Utilizing these market value figures, Professor Albrecht, an expert witness, testified that this resulted in an annual compounded return of 56%.

This is also probative of Elliott's management contributions to Taxpayer.

E. Internal Consistency

Finally, evidence of an internal inconsistency in a company's treatment of payments to employees may indicate that the payments go beyond reasonable compensation.[17] Bonuses that have not been awarded under a structured, formal, consistently applied program generally are suspect, *see Nor-Cal*, 503 F.2d at 362, as are bonuses consistently designated in amounts tracking either the percentage of the recipient's stock holdings, *id*.; *General Water Heater*, 42 F.2d at 420, or some type of tax benefit, *Pacific Grains*, 399 F.2d at 607 (bonus adjusted according to available surtax exemption). Similarly, salaries paid to controlling shareholders are open to question if, when compared to salaries paid non-owner management, they indicate that the level of compensation is a function of ownership, not corporate management responsibility. *Sunset Scavenger Co.*, 84 F.2d at 456. On the other hand, evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question was reasonable.

There was evidence in this case of a longstanding, consistently applied compensation plan. Since Taxpayer's incorporation, it had paid to Elliott an annual bonus equal to 50% of its net profits. Taxpayer contended before the Tax Court that because the yearly bonuses paid Elliott were derived from a predetermined formula that had been in use for over 20 years, it could be inferred that the bonuses constituted compensation for services rather than a dividend distribution. It noted that under the bonus formula Elliott's salary in some prior years had been too low to compensate him for the services he had rendered to Taxpayer, so that the higher salaries in the years in issue "resulted in average reasonable compensation during the 10-year period ... 1968 through 1978."

In considering the significance of this longstanding bonus formula, the Tax Court erred in several respects.

The Tax Court failed to consider the reasonableness of the contingent formula itself; it concentrated instead on the amounts paid under the formula in two particular years. Such a formula may overcompensate in good years and undercompensate in bad years. This feature, however, does not necessarily make the formula unreasonable. It is permissible to pay and deduct compensation for services performed in prior years. *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930).

Whether payments under such a formula are reasonable will depend on whether the formula is reasonable. The reasonableness of a longstanding formula should not be determined on the basis of just one or two years. Taxpayer persuasively argues that, accepting the Tax Court's determination of reasonable compensation for 1974 and 1975, Elliott was severely

[17] This may also be probative of a presence or absence of compensatory intent.

undercompensated in terms of constant dollars in six of the seven preceding years.[18]

Also relevant to the reasonableness of the formula used in this case is the return on equity an independent investor would have achieved. A formula which would not allow a reasonable return on equity is likely to be unreasonable. In this case, however, as discussed earlier, the return on equity in the years at issue was about 20%.

Over the long run, such a formula should reasonably compensate for the work done, the performance achieved, the responsibility assumed, and the experience and dedication of the employee. At the same time, it should not stand in the way of a satisfactory return on equity.

The Tax Court also discounted the significance of the bonus formula on the ground that "[n]o special incentive is necessary to insure [Elliott's] best efforts since he would 'receive the fruits of success through his status as the majority shareholder.'" To the extent that this implied that incentive payment plans for shareholder-employees are unreasonable, it was error.

Incentive payment plans are designed to encourage and compensate that extra effort and dedication which can be so valuable to a corporation. There is no reason a shareholder-employee should not also be entitled to such compensation if his dedication and efforts are instrumental to the corporation's success. In this case, there is no doubt that Elliott's extreme dedication and hard work were valuable to Taxpayer. If an outside investor would approve of such a compensation plan, that plan is probably reasonable. The fact that the recipient is a shareholder-employee does not make the plan unreasonable.

IV. CONCLUSION

We reverse and remand to the Tax Court for reconsideration in light of this opinion. On remand, the Tax Court should begin its analysis by looking at the reasonableness of the compensation payments and should consider the bonus payments in the context of the reasonableness of the formula used. It should not be assumed solely from Elliott's role as sole shareholder and the absence of dividends that the compensation payments necessarily contained disguised dividends. These are just two of many factors to be considered.

REVERSED and REMANDED.

Questions and comments:

1. The court lays out what is at stake: characterizing a distribution as payment for service rather than a dividend results in only one layer of income tax. And as the lower court pointed out in a footnote, the stakes were higher when dividends were taxed as ordinary income.

[18] A formula which is reasonable at its inception may later become unreasonable because of changed circumstances. Where a formula has proved reasonable over a long period of time, however, it should normally not be deemed unreasonable solely because it has overcompensated in one or two years.

2. Many courts apply a list of factors to such cases that do not necessarily point to one conclusion. Focusing on an independent investor at the least provides a "lens" through which to view the factors. Alternatively, the test may do more by providing a presumption of reasonableness or unreasonableness, thus casting the burden of proof on the one who would upset the presumption. *See Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 839 (7th Cir. 1999).

3. If a corporation has not paid dividends in the (recent) past, the court in *McCandless Tile Serv. v. United States*, 422 F.2d 1336 (Ct. Cl. 1970) assumed that a payment of compensation was necessarily partly a dividend. As the court noted, such an assumption ("automatic dividend") was subject to criticism and was not widely adopted.

4. Do you think that a shareholder who performs multiple duties should be entitled to multiple salaries? Is there any other information you might want to know if this were your case to decide?

5. The "independent investor" approach itself raises some questions:

- Should the court derive a firm's rate of return by dividing its net income by its equity for a specific year? Or should it determine its rate of return by determining its growth rate, compounded, for the years in which it did not pay a dividend?

- How does a court determine the appropriate benchmark rate of return?

- How does a court measure a firm's equity?

See generally Anne E. Moran, *The Independent Investor Test for Reasonable Compensation: Lens, Laser, or Labyrinth?*, TAX PRACTICE MEMORANDUM (BNA) (Dec. 28, 2016).

B. Sale of Property

Burr Oaks Corporation v. Commissioner, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967)

KNOCH, Circuit Judge

The petitioners, Burr Oaks Corporation, A. Aaron Elkind and Rosella Elkind, Harold A. Watkins and Fannie G. Watkins, Maurice Ritz and Esther Leah Ritz, instituted these proceedings in the Tax Court to contest deficiencies in income taxes determined against them. ... The cases were consolidated. ... The Tax Court held that the transfer of certain land by the petitioners A. Aaron Elkind, Harold A. Watkins and Maurice Ritz (hereinafter called 'the individual appellants') to the corporate appellant represented a contribution to capital and not a sale. Accordingly, the Tax Court determined a deficiency against the corporate appellant for fiscal years ended September 30, 1958, 1959 and 1960. The Tax Court found deficiencies for one of the individual appellants,

but also found an overpayment by all three of the individual appellants for 1959. The individual appellants have taken this appeal because of their concern as to adverse effect on future taxable years.

The three individual appellants acquired a tract of undeveloped land in 1957 for $100,000, which the appellants state to be less than the then market value.
After discarding plans to develop a regional shopping center or an industrial park, the individual appellants decided to subdivide the land, improve it and sell lots. The Burr Oaks Corporation was formed. The individual appellants transferred the land to it, and, in return, each received a two-year 6% promissory note in the principal amount of $110,000. The sum of $30,000 still due on the original purchase was entered on the corporation's books as 'Mortgage Payable.' Another account 'Land Contract Payable' in the amount of $330,000 represented the three notes.

At the trial in the Tax Court, the appellants' expert witness testified that the property transferred to the corporation was worth at least $360,000. The Tax Court, however, found more convincing the testimony of the Commissioner's expert witness who stated that the land had a fair market value of only $125,000. On the basis of all the evidence adduced, the Tax Court found a fair market value of not more than $165,000 at the time of the transfer.

The wives and brothers of the three appellants transferred a total of $4,500 in cash to the corporation and received common stock ... They are the only stockholders of record. ...

However, all control of the corporation was relinquished to the three individual appellants, who dominated its affairs, despite engagement of a manager and an accounting firm.

....

The Tax Court decided that the three promissory notes did not represent a true indebtedness. In 1959, these three notes, in the amount of $110,000 each, were surrendered by payment of $23,000 in cash on each note, and a new one-year promissory note dated November 1, 1959, in the amount of $87,000 at 6% was given in exchange for each of these three notes. Later the same year, the corporation paid $8000 to each of three noteholders and issued new promissory notes in the amount of $79,000. On December 29, 1959, the corporation purported to pay these notes, although at the close of business that day it had a bank balance of only $5,398.88. Immediately after such purported payment, the three individual appellant-noteholders each lent the corporation $79,000 in return for three new one-year promissory notes dated December 31, 1959, in the amount of $79,000 each. The Tax Court construes this transaction as a mere extension of the maturity date. *Cf. Arthur L. Kniffen*, 1962, 39 TC 553, 565-566. Additional payments were made to each of the three individual appellants as follows:

8/31/60	$ 8,000
1/31/61	$15,000
12/31/61	$10,000

leaving a balance of $46,000 due each at the time of the trial. None of the earnings of the corporation were distributed to any of the shareholders of record.

Although the appellants all treated the transfer of the land in November, 1957, as a sale, the three individual appellants reported no gain until 1959 when the corporation 'paid' the promissory notes issued at the transfer. In their returns for 1959, the three reported long term capital gains of $85,729.06. The Commissioner determined that this was ordinary income. The Commissioner increased the corporation's taxable income for 1958 through 1960 on the ground that the corporation claimed too high a basis or cost for the land it sold during that period.

The Tax Court considered the 'notes' to be preferred stock because the three holders occupied a preferred position compared to the common stockholders, the 6% interest constituting a prior charge on the earnings of the corporation.

The three individual appellants contend that they transferred the Burr Oaks property, a capital asset held in excess of six months, to the corporation in return for promissory notes, valid indebtednesses incurred by the corporation, resulting in gain properly reportable in 1959 when the notes were paid in full. The Tax Court noted that the three individual appellants were all cash basis taxpayers who should have reported as income the fair market value of the notes received in exchange for the property sold. *Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue*, 1933, 287 U.S. 462, 468.

The corporation asserts that it bought the Burr Oaks property at a cost of $360,000 and that that should be its correct basis.

The Tax Court disregarded the form of the transaction and determined the substance of it to be not a sale but an equity contribution. Substance, rather than form, is the controlling factor in determining proper tax treatment. *Sherwood Memorial Gardens, Inc*., 42 T.C. 211, 1964, *on appeal Sherwood Memorial Gardens, Inc. v. Commissioner of Internal Revenue*, 7 Cir., 1965, 350 F.2d 225.

The Tax Court found the transfer lacking the essential characteristics of a sale, but, on the contrary, possessed of the elements normally found in equity contribution. *See Emanuel N. Kolkey*, 1956, 27 T.C. 37, *affirmed*, *Kolkey v. Commissioner of Internal Revenue*, 7 Cir., 1958, 254 F.2d 51. In that case, certain criteria were established:

> Was the capital and credit structure of the new corporation realistic? What was the business purpose, if any, of organizing the new corporation? Were the noteholders the actual promoters and entrepreneurs of the new adventure? Did the noteholders bear the principal risks of loss attendant upon the adventure? Were payments of 'principal and interest' on the notes subordinated to dividends and to the claims of creditors? Did the noteholders have substantial control over the business operations; and, if so, was such control reserved to them, as an integral part of the plan under which the notes were issued? Was the 'price' of the properties, for which the notes were issued

disproportionate to the fair market value of such properties? Did the noteholders, when default of the notes occurred, attempt to enforce the obligations?

In this case, the corporation was organized with a paid-in capital of only $4500, but shortly thereafter reflected liability of $360,000 on its books. Although it was anticipated that the City of Madison, Wisconsin, would pay the major costs of improvement of the tract to be subdivided, the corporation would have to incur development costs estimated at $100,000 or more. Within two months, the corporation borrowed $15,000 from individual appellant Aaron Elkind and on February 28, 1958, borrowed another $10,000 from him. Although the taxpayers assert that a number of lots were ready for sale and that heavy capitalization was therefore unnecessary, the sales were not so quickly made as to eliminate the need to borrow. The land was the corporation's only asset.

When the payment to the transferors is dependent on the success of an untried undercapitalized business with uncertain prospects, a strong inference arises that the transfer is an equity contribution.

The three individual appellants, though not shareholders, controlled the corporation's affairs. Harold Watkins was president. Aaron Elkind, his wife, Maurice Ritz, his brother Philip, Harold Watkins and his wife were directors. The manager had been employed by Aaron Elkind in varying capacities for about 15 years. His activity was supervised by Maurice Ritz's accounting firm.

After hearing the testimony of the shareholders, Maurice Ritz's brothers, Mrs. Elkind and Mrs. Watkins, the Tax Court was convinced that they knew and understood little of the corporation's business and were subject to the control of the three individual appellants. Two of the latter agreed that the corporation was formed to allow them to receive a part of the development profits. The large 'sales price' extended the time during which the three individual appellants participated as 'creditors' and the amounts they could withdraw as principal if the corporation were successful.

....

The Tax Court found the payments to the three individual appellants ... should be treated as dividends.

After close scrutiny of the entire record, we conclude that the decisions of the Tax Court are correct and must be affirmed.
Affirmed.

Questions and comments:

1. Why do you think that the parties' valuations of the property were different by a multiple of almost 3, *i.e.*, $125,000 and $360,000. What were the taxpayers trying to do?

2. The corporation did pay the three notes down from $110,000 to $46,000. Where did that money come from? Where is it now? How many times was it taxed and to whom?

3. A contribution to capital, as we shall see in chapter 2, is not a taxable event under § 351 if persons who transfer property to a corporation are in control of the corporation immediately after its formation. They have a basis in their stock equal to the basis that they had in the property that they transferred. The corporation has a basis in the property it receives equal to the basis that the property had when the shareholders transferred it.

•How would the application of these rules have wreaked havoc with the taxpayers' plans?

4. It is unlikely that a shareholder's sale of property to a closely-held corporation shortly after its purchase should reflect a trebling of the property's value. The proximity in time between the shareholder's purchase and sale of the property should be a relevant consideration in addition to the ones mentioned by the court.

5. A shareholder may lease property to a closely-held corporation. The same valuation problems will arise. The parties may treat the rental value of the property as more than it really is.

C. Loans to Shareholders

Characterizing advances from corporations to shareholders as loans (rather than dividends) is one way to get money out of a corporation and into the hands of a shareholder without either corporation or shareholder paying any income tax on the transfer. Whether a transfer of money from one party to another is a loan is a question raised in many contexts, e.g., security deposits, embezzled money. The intent of the parties at the time the arrangement is established is what matters. The debtor must intend to repay, and that intent must exist at the time the funds are borrowed. The creditor must intend to enforce the obligation.

Section 7872 will impute a market rate of interest – either as interest or as reflective of the discounted value of a repayment obligation – into below-market corporation/shareholder loans of $10,000 or more. Before § 7872 becomes relevant, there must be a loan.

Bergersen v. Commissioner, 109 F.3d 56 (1st Cir. 1997)

BOUDIN, Circuit Judge

This appeal involves a tax dispute posing two questions: whether certain payments to the taxpayers by a controlled company were constructive dividends (rather than loans) and whether the taxpayers were residents of Illinois (rather than Puerto Rico) in 1986 and 1987. The Tax Court answered yes to both questions, resulting in adverse consequences for the taxpayers, who

now appeal. We affirm the Tax Court.

... The taxpayers are Earl and Evelyn Bergersen, a long-married couple who resided for many years in Illinois. Earl Bergersen practiced as an orthodontist in Winnetka, Illinois, starting in 1959. In addition to practice and part-time teaching, Earl Bergersen invented and patented new orthodontic products, which enjoyed a good deal of success.

In the early 1970s, the Bergersens incorporated Ortho-Tain, Inc., under Delaware law, to manufacture and sell products based upon Earl Bergersen's inventions. At all times pertinent, the couple were the only members of the Ortho-Tain board of directors. During the tax years at issue in this case (1985-1987), the Bergersens also held all of the class A voting shares in the company (56 each), with five class B voting shares held by each of their three children. Each of the children also held between 100 and 300 shares of class C nonvoting stock. Santos Ortiz, manager of the company's Puerto Rico plant, held 200 shares of class D nonvoting stock, and Thomas Sedwick, the tool and die maker at the plant, held 190 shares of class E nonvoting stock.

Initially based in Winnetka, the plant was moved to Puerto Rico in 1976. The Bergersens hoped to move to Puerto Rico eventually; residents of Puerto Rico are exempt from U.S. income tax on income derived from Puerto Rico sources. 26 U.S.C. § 933. After the plant moved, Ortho-Tain elected to be treated as a possessions corporation, exempting it from U.S. income tax on Puerto Rico source income. *Id*. § 936. The company also received a 15-year industrial tax exemption from Puerto Rico, which also permitted Puerto Rico residents to receive company dividends free of income tax. [citation omitted].

During the late 1970s, Ortiz and Sedwick ran the Puerto Rico plant while the Bergersens handled the company's finances from Illinois. Ortho-Tain's sales grew from $600,000 in 1977 to $1.2 million in 1987. During these years, the taxpayers received no salary from the company, and no dividends were declared on their stock until 1987. During most of the period, modest dividends (ranging from $5,000 to around $22,000) were paid annually to Ortiz and to Sedwick.

In this same period, Ortho-Tain's accumulated undistributed earnings grew from just under $350,000 in 1977 to just over $5 million in 1986. The company's possession status freed it from the U.S. accumulated earnings tax. 26 U.S.C. § 936(g). Meanwhile, starting in 1982, Earl Bergersen borrowed substantial amounts from the company, totaling almost $3,700,000 by 1987. The loans were evidenced by unsecured demand notes and carried interest rates of 8.5 to 10 percent; the taxpayers regularly paid this interest to the company and deducted the interest payments on their U.S. income tax returns for the years 1982 through 1986.

Apart from one loan repayment of about $400,000 in 1984, the loans were carried on Ortho-Tain's books until March 1987, when Ortho-Tain issued dividends of about $2,800,000 to the taxpayers, which they treated as exempt from U.S. income tax under § 933 and immediately paid back to the company to reduce their outstanding loans. The remaining loan balance was repaid after further dividends of just over $2,000,000 to taxpayers in 1988. As one might guess, it is the position of the Internal Revenue Service that the loans were constructive dividends subject to

U.S. income tax when made.

The other issue in dispute concerns the timing of the Bergersens' move to Puerto Rico. Looking toward this move, they purchased land in Puerto Rico in 1981 and, over the next several years, planned an elaborate house. Construction began in 1984 but, because of delays, the house was not finished as expected by late 1985. In the meantime, starting in 1984, Earl Bergersen turned over much of his orthodontics practice to another dentist and spent only a few days a month with established patients.

In July 1985, the Bergersens sold their Winnetka house and in September 1985 agreed to buy a town house in Glenview, Illinois. In April 1986, they joined a Glenview social club. They also sublet an apartment in Puerto Rico from their employee Sedwick from November 1985 through October 1986. When the sale closed on the Winnetka house in November 1985, the Bergersens dispersed their belongings to various places in Illinois and Puerto Rico.

By summer 1986, the Bergersens' new Puerto Rico house had one bedroom finished, which they used on occasion, and they installed a housekeeper couple in the house. More of their furnishings were shipped there in August 1986. At about the same time, the Bergersens shipped a car to Puerto Rico, registered it, and activated a country club membership there. They obtained an occupancy permit for the new house in January 1987, but construction continued until August 1987.

During 1986 and 1987, the Bergersens traveled a good deal for both business and pleasure, dividing their time between Puerto Rico and the United States mainland. They spent 108 days in Puerto Rico in 1986 and 93 there in 1987. They spent 107 days in the Glenview town house in 1986 and 138 days there in 1987. Thus, in 1986, they spent 150 days in places other than Illinois and Puerto Rico; in 1987, the figure was 134 days. Earl Bergersen spent no more than a few weeks each year seeing patients in Winnetka.

In February 1987, the Bergersens replaced Illinois drivers' licenses that they had lost. In August 1987, the new Puerto Rico house was completed, and the government admits that the taxpayers used it as their principal residence thereafter. Earl Bergersen wound up his Winnetka practice in late 1987. In 1988, the Bergersens acquired Puerto Rico voting cards and, in 1989, Puerto Rico drivers' licenses.

The present case began after the Internal Revenue Service reviewed the taxpayers' income tax returns for 1985 through 1987. In due course, the IRS ruled that the loans made to the Bergersens in these years were not bona fide loans but constructive dividends; the result was to include the amounts received as part of the taxpayers' reportable income and to disallow deductions taken by them for interest payments on the loans.

The IRS also concluded that the Bergersens in 1986 and 1987 were not bona fide residents of Puerto Rico for the entire year, as they claimed, but were residents of Illinois for all of 1986 and part of 1987. It is common ground that § 933 excludes Puerto Rico source income from U.S.

income tax only where the taxpayer is a resident of Puerto Rico for the entire year in question. *Vazquez v. Commissioner*, 66 T.C.M. (CCH) 406, 407, 1993 WL 315404 (1993); Reg. § 1.933-1(a). Accordingly, the IRS determination meant that the moneys the Bergersens received from Ortho-Tain in those years were not excludable from U.S. income tax under § 933.

The Bergersens petitioned the Tax Court to redetermine ... 26 U.S.C. § 6213. The case was tried before the Tax Court in April 1994. In August 1995, the Tax Court ... held that the loans were constructive dividends and that the Bergersens were not residents of Puerto Rico for the entire year either in 1986 or 1987. This appeal followed.

The Loan or Dividend Issue. The loan or dividend issue, which is not uncommon in tax cases involving controlled companies, usually poses the question whether the owner is trying to smuggle earnings out of the company without paying personal income tax. A dividend or salary paid to an owner is taxable as income; a loan, being only a temporary transfer, is not. But if a "loan" by the company to an owner is not intended to be repaid, then allowing that label to control would effectively deprive the government of its tax bite on dividends and salaries.

The conventional test is to ask whether, at the time of the withdrawal in question, the parties actually intended repayment. *Crowley v. Commissioner*, 962 F.2d 1077, 1079 (1st Cir. 1992). Explaining that "intent" is difficult to discern, courts regularly resort to objective criteria, asking whether the transaction bears the traditional hallmarks of a loan or of a dividend. *Id.* In any event, purporting to be looking at intent, appeals courts generally describe such intent as a fact, *id.* at 1080, and subject the fact-finder's determination to clear error review, *see id.*; *see also Commissioner v. Duberstein*, 363 U.S. 278, 290-91 (1960).

Here, the government invokes this deferential standard of review. It argues that the finding of constructive dividends cannot be clearly erroneous in light of the various indicia mentioned by the Tax Court as suggesting dividend status; that the loans had no collateral and no fixed repayment schedule; that no limits were set on the amounts to be borrowed; that the proceeds were used by the Bergersens for personal purposes; and that Ortho-Tain accumulated huge earnings but paid the Bergersens no dividends during the years of the loans until 1987.

The Bergersens, on the other hand, say that the Tax Court made an error of law by stressing that the Bergersens were trying to "avoid taxes" by delaying dividends until they moved to Puerto Rico; Congress, the Bergersens point out, chose in § 936(g) to allow possessions companies to accumulate earnings in Puerto Rico and to distribute the amounts free of U.S. income tax to those who have moved there. And the Bergersens dispute the government's portrayal and weighing of the objective factors.

Like white asparagus or a blood orange, this first issue is not ordinary fare but an odd variation, caused by the interplay of ordinary factors with Puerto Rico tax status. The Bergersens may well have intended to repay the loans after they moved to Puerto Rico. After all, at that point they could do so by declaring a dividend to themselves free of U.S. (and Puerto Rico) income tax; and after using the dividends to repay the loans, they remained free to use the repaid funds for a new

dividend, again without U.S. (or local) tax consequences.

The situation is thus very different from the ordinary loan-or-dividend case, where repayment of the loan to the company would effectively preclude a tax-free distribution. Here, the Bergersens could reasonably have intended to repay the money and reap the benefits of a tax-free distribution. Nor would there have been anything wrong if the Bergersens, knowing that they were moving eventually to Puerto Rico, had accumulated earnings in the company but refrained from withdrawing them until after the move.

The question here, then, is whether the Bergersens could pay out moneys to themselves before moving to Puerto Rico and avoid U.S. income taxes by designating the payments as loans. We think that this ought to depend upon whether, in overall character and context, the payments were more like loans or more like dividends. After all, "intent to repay" is merely a functional test that is usually suitable; but the purpose of the tax law is to tax transactions, not rubrics or labels. [citation omitted].

Here, the payments had some of the traditional indicia of loans (notes existed, interest was paid). In other respects, formalities were absent (no fixed repayment date, no collateral, no credit limit). But regardless of formalities, the nominal loans, paid by a controlled company that was accumulating large earnings but paying its main owners no dividends, effectively gave the Bergersens permanent tax-free control over the moneys.

If after their move, the Bergersens had decided not to repay but to cancel the loans as a form of dividend, there would have been no tax due on this dividend. If instead – as actually happened – they declared cash dividends and repaid the loans, the effect was to redeposit the money in their own corporate vehicle, available for redistribution to them at any time, again with no tax consequences. As the Tax Court observed, the repayment was effectively a "meaningless exchange of checks." Indeed, even the earlier interest payments could be recovered by the Bergersens without tax effects.

Thus, at the very outset of the loans, the Bergersens knew that there was no effective corporate constraint to induce repayment, nor (given the intended move to Puerto Rico) any meaningful tax consequences from a permanent failure to repay. An effective permanent transfer of corporate funds to an owner is the hallmark of a dividend or a salary, and not a loan. There is nothing wrong with an owner making such a transfer. But when made to a U.S. mainland resident, the transfer is subject to U.S. income tax.[19]

---

[19] Nor does it matter that the Bergersens might have achieved their ends through a different device, say, by borrowing the money from a bank – a real loan requiring repayment – and repaying it with a tax-free dividend declared after the move to Puerto Rico. The taxpayers are stuck with the transaction they chose to employ. *See Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-49 (1974).

Looking through form to substance, *see Commissioner v. Court Holding Co.*, 324 U.S. 331, 333-34 (1945), we reach the same result as the Tax Court and therefore need not concern ourselves on this issue with the proper standard of review (since even de novo review would lead to affirmance). The claim that the Tax Court made a mistake of law in construing § 933 without giving sufficient consideration to § 936(g) is a red herring. Congress' policy permitted the company to accumulate earnings in Puerto Rico free of tax; it did not authorize tax-free dividends to Illinois residents.

The Residence Issue. We turn now to a more conventional issue, namely, whether the Bergersens were residents of Illinois during 1986 and at least part of 1987, as the Tax Court ruled, or whether they were residents of Puerto Rico for either or both years in their entirety. ...

....

... Clearly the Bergersens did intend eventually to base themselves and remain permanently in Puerto Rico; that is why they embarked on construction of a very expensive house in 1984, before the tax years in dispute. The question for us, as we see it, is when the Bergersens had effectively moved their base to Puerto Rico and established their residence there.

As the Tax Court candidly said, the Bergersens' conduct amounts to a move to Puerto Rico carried out over a period of time. ...

....

We agree with the Tax Court that for 1986 and at least part of 1987, the Bergersens were residents of Illinois and not yet of Puerto Rico. ...

....

... [T]he Bergersens were perfectly free to consider tax advantages in moving their residence to Puerto Rico, and here we think that tax motives provide little help in determining when this move occurred. (A tax motive does, however, help explain why the payments were structured as loans.)

....

Because the Bergersens were not bona fide residents of Puerto Rico either in 1986 or for the full year in 1987, they were not entitled to avoid U.S. income tax on Puerto Rico source income in those years. 26 U.S.C. § 933. As the "loans" were constructive dividends, they were taxable income to the Bergersens when made, and the Bergersens were not entitled to deduct the interest payments to the company. [citation omitted].

Affirmed.

Questions and comments:

1. Most cases involving loans that are really dividends involve shareholders who treat their wholly-owned corporations as their *alter egos*. This one involved an effort to minimize income tax by matching tax exempt income with tax-free money (loan). The taxpayers (or their tax counsel) were clever – just not clever enough.

2. As in other contexts, *intent to repay at the time the loan is made* is necessary to make the transaction a loan. In distinguishing loans from dividends, the corporation must intend to enforce the repayment obligation.

3. Section 7872 does not apply to de minimis (less than $10,000) loans from corporation to shareholder so long as tax avoidance is not one of the principal purposes of the interest arrangement. If Ortho-Tain's loans to the Bergersens had not provided for the payment of interest, do you think that the Bergersens could have "passed" this test of § 7872?

4. Not surprisingly, courts will consider various factors when determining whether an advance is a loan or a dividend. In *Miller v. Comm'r*, 41 T.C.M. (CCH) ¶ 139, T.C. Memo. 1980-445 (1980), the court articulated the balancing of factors that led it to conclude that the corporation had extended a loan to the shareholder/debtor. Paraphrasing the court's discussion of the indicia of dividends or loan, the following considerations are relevant.

Militating in favor of treating the advances as loans –

(1) the shareholder/debtor executes a demand note;
(2) the shareholder/debtor actually repays part or all of the loan;
(3) the corporation treats the loans as receivables, both on its books and when dealing with third parties for whom this matters;
(4) the shareholder/debtor owns sufficient assets to repay the loans.

Militating in favor of treating the advance as dividends –

(1) the demand note does not provide for the payment of interest;
(2) the shareholders/debtors does not make interest payments on the loan;
(3) the shareholder/debtor does not give security for the loan;
(4) the shareholder exercises control over the corporation – perhaps because the debtor is the sole shareholder;
(5) there is no documented limitation on the amount of transfers to shareholder/debtors;
(6) the corporation paid dividends or wages to the shareholder/debtor.

We can add to this list with any evidence that indicates loan or dividend:

- A history of not paying dividends tends to show that advances are dividends.
- A set maturity date tends to show that advances are loans.

Chapter 2: Forming the Corporation

Read IRC §§ 351, 357, 358, 362, 368(c), 1032, 1223.

Formation of a corporation involves forming an entity separate and apart from the shareholders who form and own it. Congress felt that mere changes in the form in which taxpayers do business should not be an occasion for imposing an income tax. Subject to certain conditions, the Code does not inhibit the formation of corporations by taxing the exchanges that must occur.

The corporation issues shares. Shareholders may exchange property and/or services with the corporation for shares. (Shareholders may receive shares *and* property if the corporation has already acquired property). In most contexts, exchanges are recognition events. However, § 351 provides that no recognition occurs if certain conditions prevail, namely that the transferor or group of transferors –

1. transfer *property* (including money) to the corporation,
2. solely in exchange for *stock*, and
3. immediately after the exchange, the transferor or group of transferors *control* the corporation. "Control" is ownership of 80% of the total voting power of all classes of stock entitled to vote and of each and every other class of stock. § 368(c).

§ 351(a). Section 1032(a) provides that a corporation recognizes no gain or loss when it exchanges its own stock for money or property, irrespective of whether the exchange qualifies for nonrecognition treatment of the shareholder(s).

•Example 1: Quincy and Rebecca formed the Plover Corporation. Quincy transferred Blackacre, ab = $100, fmv = $250, to the corporation in exchange for 25 shares of Plover Corporation voting common stock. Rebecca transferred Whiteacre, ab = $175, fmv = $250, to the corporation in exchange for 25 shares of Plover Corporation voting common stock. This is all the Plover Corporation stock outstanding. The fmv of each share of voting common stock is $10. While Quincy *realized* $150 of gain on the exchange, and Rebecca *realized* $75 of gain on the exchange, neither *recognizes* gain. The Plover Corporation, which now owns Blackacre and Whiteacre, recognizes no gain or loss on the exchange.

Investors in property who transfer that property to a corporation that they control retain an investment substantially the same as the investment that they surrendered. The continuity of their investment is manifested by their "control." Section 351(a) defers to § 368(c) to define "control." "Control" is ownership of "at least" 80% of the total voting power of all classes of stock entitled to vote *and* "at least" 80% of the total number of shares of all the corporation's other class(es) of stock. The IRS has construed this requirement to be 80% of the total voting power of all classes of stock entitled to vote, no matter how voting power is distributed among classes of stock, and 80% of each and every class of a corporation's non-voting stock. Rev. Rul. 59-259, 1959-2 C.B. 115. "Ownership of large numbers of non-voting shares in a multi-class stock structure would not necessarily assure, in itself, the continuation of substantial proprietary interest in modified corporate forms as contemplated by the statute." *Id.*

•Example 2: In addition to the exchanges in Example 1, Samuel transferred $500 cash to the Plover Corporation in exchange for 50 shares of Plover Corporation's Class B nonvoting common stock. Neither Quincy, Rebecca, nor Samuel recognize gain (or loss) on the exchanges. All are transferors of property, and together, transferors of property own 80% or more of shareholders' total voting power and 80% or more of each and every class of Plover Corporation's nonvoting stock.

The reach of § 351 extends to more than formation of the corporation. *Any* time these conditions prevail, the exchange is a non-recognition event because such conditions indicate a sufficient continuity of interest in the corporation.

•Example 3: Same as Example 1. Three years after formation of Plover Corporation, the total value of Plover Corporation's outstanding stock has increased to $800. Quincy and Rebecca both transfer $160 to the Plover Corporation, and Seth transfers Greenacre, ab = $210, fmv = $320, to the Plover Corporation. Quincy and Rebecca both receive 5 more shares of voting common stock, and Seth receive 10 shares. The total value of Plover's voting common stock is now $1140, and the corporation has 70 shares outstanding. Even though the second transfer did not involve 80% of the total voting power of the corporation, the exchange qualifies for § 351 treatment. Both Quincy and Rebecca may count the shares they already owned at the time of the second transfer in making this determination. Hence, on the second exchanges, transferors of property own 100% of the voting shares of Plover Corporation. 100% > 80%.

•Example 3A: Same as Example 3, except that only Quincy and Seth make the property transfers described. Now there are 65 shares outstanding. Transferors of property own 40 of them. 40 < (80% of 65). The second exchange does not qualify for non-recognition treatment, and Seth must pay income tax on $110 of gain.

The Code does not forever leave untaxed gain realized on a § 351 exchange, but merely defers imposition of the tax. Deferral occurs through the mechanism of basis transfer. The transferor of property to the corporation takes a basis in his stock equal to the basis he had in the property transferred. § 358(a) (with adjustments for any gain or loss that falls outside nonrecognition provisions of § 351(a)). Moreover, the shareholder's holding period in his stock carries over from the holding period he had in the property that he transferred. § 1223(1). This preserves the character of the gain, whether capital or ordinary. The transferee corporation takes the transferor's basis in the property it receives from the shareholder. § 362(a)(1). The corporation also takes the transferring shareholder's holding period, i.e., tacks the shareholder's holding period to its own. § 1223(2). The shareholder and the corporation will recognize gain on the subsequent disposition of what they received in the § 351 exchange. If a transferring shareholder transfers Blackacre whose fmv is greater than its basis to a corporation in a § 351(a) transaction and receives stock, the corporation will recognize taxable gain when it sells Blackacre. The transferring shareholder will recognize gain when he sells the stock, assuming its fmv is the same as the fmv of Blackacre. Notice that these basis transfer rules can cause two taxpayers – the transferring shareholder and the transferee corporation – both to recognize gain whose origin is the property that the shareholder transferred to the corporation. That is the consequence of

creating a taxpayer, i.e., the corporation, or transferring the property to it in an exchange in which no gain or loss is recognized. If a portion of the transaction is subject to federal income tax because the shareholder received something to "boot" in addition to stock, that portion of the transaction occurs outside of the § 351(a) transaction and is subject to only one level of federal income tax. (*See* § IV *infra*).

•Example 4: Same facts as Example 1. Assume also that Quincy purchased Blackacre 27 months ago. Rebecca purchased Whiteacre 7 months ago. Quincy will have an adjusted basis in his stock of $100. If he were to sell it for $250, i.e., its fmv had not changed, he would recognize $150 of taxable LTCG – precisely the amount of gain he did not have to recognize on the initial exchange. If Rebecca sold her stock one month after the initial exchange for $250, she would recognize $75 of taxable STCG, precisely the amount of gain she did not have to recognize on the initial exchange. If she had waited 5 months and 1 day after the initial exchange to sell her stock, her recognized gain would have been LTCG. If Plover Corporation sells Blackacre for $250, it must recognize $150 of taxable capital gain – assuming Blackacre is a capital asset.

Transfers to an Investment Company: Section 351(e)(1) provides that nonrecognition treatment does not extend to transfers to an "investment company." Investors who held highly appreciated assets could at one time transfer them to a newly-formed corporation to which other similarly situated investors would also transfer their highly-appreciated securities. The stock which such investors received would be backed by a more diversified portfolio than what any one of them individually had owned. Reg. § 1.351-1(c) provides that a transfer is to an "investment company" if the direct or indirect result is a diversification of the shareholders' interests and the transferee is either a regulated investment company, a real estate investment trust, or a corporation more than 80% of whose assets (excluding cash and nonconvertible debt) are assets held for investment.

This scheme should logically allow for the duplication of losses at the shareholder and corporate levels. For many years, it did. Congress amended § 362 in the American Jobs Creation Act of 2004. Pub. L. No. 108-357, § 836, 118 Stat. 1594, 1595. Section 362(e)(2)(A) provides that if the properties that a shareholder transfers to the corporation have aggregate bases greater than the properties' aggregate fmv, then the corporation must reduce its bases in the properties so that their aggregate bases are not greater than the aggregate fmv of the properties. The reduction(s) is (are) made property-by-property in proportion to the transferring shareholder's *built-in losses* in the property(ies) that he exchanges. § 362(e)(2)(B). The shareholder and corporation may together agree to reverse this pattern, i.e., the shareholder would reduce the basis of his stock and the corporation would take carryover bases in the property(ies) that it receives. § 362(e)(2)(C). *See* chapter 2:VA *infra*.

•Example 5: Uriah and Victor form the Plover Corporation. Uriah transfers Blackacre, ab = $100, fmv = $250, to Plover Corporation in exchange for voting common stock. Victor transfers the following properties to the Plover Corporation: Whiteacre, ab = $50, fmv = $60; Greenacre, ab = $75, fmv = $45; Redacre, ab = $100, fmv = $60; and Brownacre, ab = $25, fmv = $15. We will determine Plover Corporation's basis in each of the properties that it received.

•Uriah transferred one property, and it has built-in gain. Plover Corporation's basis in Blackacre is $100.

•Victor transferred several properties. Determine the aggregate bases and aggregate fmv of the properties. Aggregate bases = $50 + $75 + $100 + $25 = $250. Aggregate fmv of the properties = $60 + $45 + $60 + $15 = $180. Aggregate bases exceed aggregate fmv, so Plover Corporation must reduce the bases of the individual properties that it received from Victor by a total of $70 in proportion to the built-in losses in the properties.

•Identify only the properties with built-in losses, i.e., Greenacre ($30 of built-in loss), Redacre ($40 of built-in loss), and Brownacre ($10 of built-in loss). Their total built-in loss is $80.

•3/8 of the total built-in loss is attributable to Greenacre. 4/8 of the total built-in loss is attributable to Redacre. 1/8 of the total built-in loss is attributable to Brownacre. So:

•Reduce Plover Corporation's basis in Greenacre by 3/8 of $70, i.e., $26.25, to $48.75. Reduce Plover Corporation's basis in Redacre by 4/8 of $70, i.e., $35, to $65. Reduce Plover Corporation's basis in Brownacre by 1/8 of $70 ($8.75) to $16.25.

•Plover Corporation's basis in Whiteacre is $50.

Problem:

A, B, and C form the Flom Corporation. A transfers Blackacre to Flom Corporation in exchange for 100 shares of Flom voting common stock. A purchased Blackacre four years ago for $15,000. At the time of transfer, Blackacre's fmv was $20,000. B transfers $20,000 in cash in exchange for 100 shares of Flom voting common stock. C transfers inventory that he purchased six years ago for $17,000 in exchange for 100 shares of Flom common stock. At the time of transfer, the fmv of the inventory was $20,000. A, B, and C are the only shareholders of Flom Corporation, and the 300 shares of voting common stock are the only shares of Flom stock outstanding. Answer the following questions and cite the relevant statute.

•How much gain or loss did A, B, and C *realize* on their respective exchanges with Flom Corporation?

•How much gain or loss must A, B, and C *recognize* on their respective exchanges with Flom Corporation?

•A, B, and C no longer own Blackacre, cash, or inventory. Rather they each own 100 shares of voting common stock of Flom Corporation. What is each shareholder's basis in his shares of Flom Corporation?

•Upon the transfers of cash or property, what is the holding period of A, B, and C for their Flom Corporation stock?

•How much gain or loss must Flom Corporation recognize on its exchanges with the three shareholders? What is it holding period of Flom Corporation for Blackacre, the cash, and the inventory?

I. Transfer of Property to the Corporation

To come within § 351, transferors must transfer "property." Services are not property and so are outside of § 351's non-recognition provisions. Often, a taxpayer "labors" (renders services) to produce something and then transfers that "something" to the corporation. While courts may be generous in characterizing different "somethings" as property, taxpayers should be careful about whether they are creating something for the corporation or for themselves.

James v. Commissioner, 53 T.C. 63 (1969)

SIMPSON, Judge

The respondent determined deficiencies in income tax and additions to tax for the year 1963 ...

The issue for decision is whether the transaction by which Mr. James and Mr. Talbot acquired stock in a corporation was taxable or whether such transaction was tax free under § 351 of the ... Code of 1954. [footnote omitted]. The answer to the question thus posed with respect to each person depends on the transfer of property or as compensation for services.

FINDINGS OF FACT

....

The petitioners William A. James and Beryl N. James are husband and wife, and the petitioners C.N. Talbot and Lula E. Talbot are husband and wife. All the petitioners resided in Myrtle Beach, S.C. ...

For many years, Mr. James was a building, real estate promoter, and developer with offices in Myrtle Beach, S.C. ... During 1963, the James Construction Co. was licensed by the State of South Carolina to engage in the business of general contracting.

On January 12, 1963, Mr. and Mrs. Talbot entered into an agreement with Mr. James for the promotion and construction of a rental apartment project, consisting of not less than 50 apartments, the project to conform to Federal Housing Administration (FHA) standards. The agreement provided that on completion of the project the parties would form a corporation to take title to the project. The voting stock in such corporation was to be distributed one-half to the Talbots and one-half to Mr. James, and nonvoting stock was to be issued to the parties "as the equity of each party in the corporation shall be," with the proviso that Mr. James should have the right to purchase up to 50 percent of such stock over a period of years. The Talbots agreed to transfer to the corporation the land on which the apartment project was to be built, such land to be the only asset contributed by the Talbots to the venture. Mr. James agreed "to promote the project * * * and * * * (to) be responsible for the planning, architectural work, construction,

landscaping, legal fees, and loan processing of the entire project." The agreement gave him until January 1, 1964, to promote the project and to obtain the necessary FHA commitment and financing, with an option to terminate the agreement if the project became unfeasible or impossible.

After the execution of the January 12 agreement, Mr. James began negotiations to fulfill his part of the contract. He made arrangements with an attorney and an architectural firm to perform the work necessary to meet FHA requirements – development of legal documents, preparation of architectural plans, and the like; and he obtained from United Mortgagee Service Corp. (United Mortgagee), a lender, its agreement to finance the project and a commitment by FHA to insure the financing. Mr. James personally met with the FHA only twice – once in connection with the amount of the commitment and again at the final closing of the loan, after construction of the project was completed in the late summer of 1964. Most of the arrangements necessary to the securing of the loan and the FHA commitment were handled by the attorney, the architectural firm, and United Mortgagee. The attorney's and architect's fees were not paid by Mr. James but were paid out of the proceeds of the construction loan by the corporation subsequently established.

On August 8, 1963, the FHA issued to United Mortgagee a commitment for the insurance of advances in the amount of $850,700 to Chicora Apartments, Inc., for the apartment project sponsored by Mr. James and the Talbots. On August 27, 1963, United Mortgagee sent Mr. James a draft of a proposed agreement to make a first mortgage loan of $850,700 on the Chicora Apartment project in accordance with Mr. James' application for such loan. [footnote omitted] The proposed agreement also provided that United Mortgagee would advance to Mr. James personally the amount for FHA-required working capital and other specified sums, such advances to be secured by specified portions of the construction loan or mortgage proceeds. Although the record does not reveal whether this proposed agreement was ever executed, the subsequent activities of the parties indicate that some such agreement was consummated. On August 29, 1963, Mr. James executed a promissory note payable to United Mortgagee in the amount of $1,149.03, the amount of the "FHA Commitment Fee." Mr. James signed this note, which was secured by the mortgage proceeds, individually, and as president of Chicora Apartments, Inc., although the corporation had not been created at that time.

On November 5, 1963, Chicora Apartments, Inc. (Chicora), was granted, upon application of Messrs. Talbot and James, a corporate charter, stating its authorized capital stock to consist of 20 no-par common shares. On the same date, the land on which the apartment project was to be constructed was conveyed to Chicora by Mrs. Talbot in consideration for 10 shares of stock. Nine of these shares were issued to Mrs. Talbot, and one share was issued to Mr. Talbot. Chicora's board of directors determined that on the date of this conveyance the value of the real property so transferred was $44,000. Also on November 5, 1963, 10 shares of stock were issued to Mr. James. The minutes of a meeting of Chicora's board of directors held on that date state that those 10 shares were issued to Mr. James in consideration of his "transfer" to the corporation of the "following described property":

1. FHA Commitment ... whereby the FHA agrees to insure a mortgage loan in the amount

> of $850,700.00, [on the Talbots' land] ..., provided 66 apartment units are constructed thereon in accordance with plans and specifications as prepared by Lyles, Bissett, Carlisle & Wolff, Architects-Engineers, of Columbia, South Carolina.
>
> 2. Commitment from United Mortgagee Servicing Corp., agreeing to make a mortgage loan on said property in the amount of $850,700.00 and also commitment from said mortgagee to make an interim construction loan in an identical amount.
>
> ....

Thus, as a result of these transactions, Chicora had outstanding all 20 of its authorized shares of stock.

On November 6, 1963, the FHA issued to Chicora its commitment ... in the amount of $850,700. Under FHA regulations, this commitment could not be issued to an individual, but was required to be issued to a corporation. ...

The apartment project was built by W.A. James Construction Co. Construction was begun in late 1963 or early 1964, and the buildings were completed and occupancy begun on or about July 28, 1964.

The usual procedures were followed with regard to the FHA commitment fee and the FHA working capital. Mr. James acquired the funds for the commitment fee by the note executed by him on August 29, 1963. On November 19, 1963, Mr. James executed two notes in favor of United Mortgagee; the first was for $17,015, the amount of the required working capital, and the second was for $2,126.75. Mr. James received these amounts from United Mortgagee in accordance with FHA requirements. Both notes were to be paid out of the 'contractor's cash fee' and were secured by the mortgage proceeds, and each bore the notation of consent of Chicora and W.A. James Construction Co. to the assignment of the contractor's fee. The funds so advanced to Chicora in the credit of Mr. James, including the commitment fee, were to be, and were, repaid out of the initial advances under the FHA guarantees to Chicora. The commitment fee and the working-capital requirement, accordingly, were paid out of the construction loan advance to the corporation.

Both Mr. and Mrs. James and Mr. and Mrs. Talbot deemed their receipt of Chicora common stock to be in return for a transfer of property to a controlled corporation under § 351. Accordingly, neither family reported any income from such receipt on their respective income tax returns for 1963. In his statutory notice of deficiency, the respondent determined that Mr. James received such stock, with a value of $22,000, for services rendered and not in exchange for property, and thus received taxable income in that amount. He further determined that the Talbot's transfer of property to Chicora did not meet the requirements of § 351, with the result that they should have recognized a long-term capital gain of $14,675 – the difference between $7,325, the basis of the land transferred, and $22,000, the value of the stock received.

OPINION

The first, and critical, issue for our determination is whether Mr. James received his Chicora stock in exchange for the transfer of property or as compensation for services. The petitioners argue that he received such stock in consideration of his transfer to Chicora of the FHA and United Mortgagee commitments and that such commitments constituted "property" within the meaning of § 351. [footnote omitted]. ... Mr. James was not expected to render future services to the corporation in exchange for the issuance of stock to him. ... Thus, the sole question on this issue is whether Mr. James' personal services ... resulted in the development of a property right which was transferred to Chicora, within the meaning of § 351.

....

According to the petitioners' argument, Mr. James, as a result of the services performed by him, acquired certain contract rights which constituted property and which he transferred to Chicora. The fact that such rights resulted from the performance of personal services does not, in their view, disqualify them from being treated as property for purposes of § 351. ...

It is altogether clear that for purposes of § 351, not every right is to be treated as property. ... [W]hatever may be considered as property for purposes of local law, the performance of services, or the agreement to perform services, is not to be treated as a transfer of property for purposes of § 351. Thus, if in this case we have merely an agreement to perform services in exchange for stock of the corporation to be created, the performance of such services does not constitute the transfer of property within the meaning of § 351.

Although patents and secret processes – the product of services – are treated as property for purposes of § 351, we have carefully analyzed the arrangement in this case and have concluded that Mr. James did not transfer any property essentially like a patent or secret process; he merely performed services for Chicora. In January of 1963, he entered into an agreement to perform services for the corporation to be created. He was to secure the necessary legal and architectural work and to arrange for the financing of the project, and these were the services performed by him. Although he secured the services of the lawyer and the architect, they were paid for by the corporation. He put in motion the wheels that led to the FHA commitment, but it was not a commitment to him – it was a commitment to United Mortgagee to insure a loan to Chicora, a project sponsored by Mr. James. It was stipulated that under the FHA regulations, a commitment would not be issued to an individual, but only to a corporation. Throughout these arrangements, it was contemplated that a corporation would be created and that the commitment would run to the corporation. The petitioners rely heavily on the claim that Mr. James had a right to the commitment, that such right constituted property, and that such right was transferred to the corporation in return for his stock. However, the commitment was not his to transfer; he never acquired ownership of the commitment – he could not and did not undertake to acquire such ownership. The evidence as to the commitment by United Mortgagee to make a loan for the construction of the project is somewhat incomplete, but since all the parties knew that a corporation was to be formed and that the FHA commitment would be made to that corporation,

it seems clear that there was no commitment to loan to Mr. James the funds necessary for the construction of the project. Thus, throughout these arrangements, Mr. James never undertook to acquire anything for himself; he was, in accordance with his agreement with the Talbots, making the preliminary arrangements for the construction of the apartment project. The enterprise would be operated, once the initial steps were completed, by a corporation, Chicora, and everything that was done by him was done on behalf of the contemplated corporation. In these circumstances, it seems clear that Mr. James received his share of the stock in the corporation in return for the services performed by him and that he did not transfer any property, within the meaning of § 351, to the corporation. [citations omitted].

The facts of this case are substantially similar to those in *U.S. v. Frazell*, 335 F.2d 487 (C.A. 5, 1964), *rehearing denied*, 339 F.2d 885 (C.A. 5, 1964), *certiorari denied* 380 U.S. 961 (1964). In that case, the taxpayer, a geologist, investigated certain oil and gas properties to be acquired by a joint venture, and he was to receive an interest in the joint venture. However, before any transfer was made to him, a corporation was formed to take over the assets of the joint venture, and part of the stock was transferred to the taxpayer. It was not clear whether the taxpayer acquired an interest in the joint venture which was then exchanged for his share of the stock or whether he acquired the stock directly in exchange for the services performed by him. The court found that, in either event, the taxpayer received compensation for his services. If he received the stock in return for the services performed by him, such stock was taxable as compensation; and he did not transfer any property to the corporation within the meaning of § 351. *See also Mailloux v. Commissioner*, 320 F.2d 60 (C.A. 5, 1963), *affirming on this issue a Memorandum Opinion of this Court*.

The next question is whether the Talbots are taxable on the gain realized from the exchange of their land for Chicora stock. Section 351(a) applies only if immediately after the transfer those who transferred property in exchange for stock owned at least 80 percent of Chicora's stock. § 368(c). Since ... James is not to be treated as a transferor of property, he cannot be included among those in control for purposes of this test. *Fahs v. Florida Machine & Foundry Co.*, 168 F.2d 957 (C.A. 5, 1948); *Mojonnier & Sons, Inc.*, 12 T.C. 837 (1949); BITTKER & EUSTICE, [FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 70 (2d ed. 1966).] The transferors of property, the Talbots, did not have the required 80-percent control of Chicora immediately after the transfer, and therefore, their gain must be recognized. ...

....

Decisions will be entered for the respondent.

Questions and comments:

1. What should James have done differently to bring his case within § 351?
    - *Compare United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984) (letter from life insurance company to taxpayer committing to taxpayer personally for 60 days to loan money at a favorable interest rate and to lease property on favorable terms; letter is

property for purpose of § 721).

2. Suppose Mr. James had contributed $100 cash and services valued at $21,900. In Rev. Proc. 77-37, the IRS announced the following:

> § 3.07. When a person transfers property to a corporation in exchange for stock ... of such corporation and the primary purpose of the transfer is to qualify under § 351 ... the exchanges of property by other persons transferring property, the property transferred will not be considered to be of relatively small value, within the meaning of [Reg. §] 1.351-1(a)(1)(ii), if the fair market value of the property transferred is equal to, or in excess of, 10 percent of the fair market value of the stock ... already owned (or to be received for services) by such person.

If the value of the stock Mr. James received was $22,000, how much cash should he contribute for the Talbots not to be taxed on the built-in gain in the property they contributed?

3. As taxpayers contended, patents or secret processes that taxpayers created with their labor constitute property. In fact, courts have held that "whatever may be transferred" constitutes property. *See, e.g.*, *In the Matter of Chrome Plate, Inc.*, 614 F.2d 990, 995 (5th Cir. 1980). Hence, such matters would seem to turn on whether taxpayer has undertaken an obligation to perform services *for* the corporation or owns something without regard to the corporation's rights.

In Rev. Rul. 64-56, 1964-1 C.B. 133, the IRS announced:

> Once it is established that "property" has been transferred, the transfer will be tax-free under § 351 even though services were used to produce the property. Such is generally the case where the transferor developed the property primarily for use in its own manufacturing business. However, where the information transferred has been developed specially for the transferee, the stock received in exchange for it may be treated as payment for services rendered.

4. The corporation who benefits from the services provided to it in exchange for stock should be able to deduct (or capitalize) the fair market value of the stock it issued for those services. § 83(h).

5. Section 351(d)(2) provides that "stock issued for ... indebtedness of the transferee corporation which is not evidenced by a security ... shall not be considered as issued for property." This allows the creditor to claim a bad debt deduction if the amount of the debt exceeds the value of the stock received. Of course, by excluding such transactions from the reach of §351(a), if the value of the stock exceeds taxpayer's basis in the debt, taxpayer must recognize taxable gain on the exchange to the extent of the excess.

II. Control "Immediately After the Exchange"

"Control" is ownership of 80% of the total voting power of all classes of stock entitled to vote and of each and every other class of stock. Reg. § 1.351-1(a)(1) provides in part:

> The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025 (1976)

WILES, Judge

Respondent determined deficiencies in petitioners' income taxes ...

... The only issue for decision is whether a certain corporate formation was nontaxable under § 351(a). [footnote omitted] This depends solely upon whether the primary incorporator had "control" of the requisite percentage of stock immediately after the exchange within the meaning of § 368(c).

FINDINGS OF FACT

Petitioners are the Intermountain Co., previously known as Intermountain Lumber Co., and its affiliates (hereinafter collectively referred to as Intermountain or petitioner). ...

....

From 1948 until March of 1964, Mr. Dee Shook (hereinafter Shook) individually owned a sawmill at Conner, Mont. During that time Mr. Milo Wilson (hereinafter Wilson) had logs processed there into rough lumber for a fee. Shook owned the remaining logs processed at the sawmill, which constituted about half of all the logs processed there.

From 1954 until March of 1964, rough lumber from the sawmill was processed into finished lumber at a separate finishing plant which Shook and Wilson owned as equal shareholders.

In March of 1964, fire damaged the sawmill. Shook and Wilson wanted to replace it with a larger one so that the finishing plant could operate at full capacity. Shook was financially unable, however, to do so. He accordingly induced Wilson to personally coguarantee a $200,000 loan to provide financing. In return, Wilson insisted upon an equal voice in rebuilding the sawmill and upon an opportunity to become an equal shareholder with Shook in the new sawmill.

On May 28, 1964, Shook, Wilson, and two other individuals, all acting as incorporators, executed articles of incorporation for S & W Sawmill, Inc. (hereinafter S & W). The corporate name, S & W, was derived from the names Shook and Wilson.

Minutes of the first stockholders meeting on July 7, 1964, stated in part that "Mr. Shook informed the meeting that a separate agreement was being prepared between he [sic] and Mr. Wilson providing for the sale of one-half of his stock to Mr. Wilson." Also on that date, 1 share was issued to each of the other two incorporators.

Shook executed a bill of sale for his sawmill equipment and deeded his sawmill site to S & W on July 15 and 16, 1964, respectively. In exchange, Shook received 364 S & W shares on July 15, 1964. Shook and Wilson also received 1 share each as incorporators. The 364 shares and the 4 incorporation shares constituted all outstanding capital stock of S & W on July 15, 1964.

Also on that date, minutes of a special meeting stated in part that "The President, Dee Shook, announced that he and Milo E. Wilson had entered into an agreement whereby Mr. Wilson was to purchase 182 shares of Mr. Shook's stock." That agreement, dated July 15, 1964, and entitled "Agreement for Sale and Purchase of Stock" (hereinafter agreement for sale) provided in part as follows:

> it is the intention of all the incorporators that Shook and Wilson are to be the owners of the majority of the stock of said corporation;
>
> AND WHEREAS, it is the desire and plan of both parties hereto that a sufficient number of shares of stock be sold by Shook to Wilson so that eventually the stock ownership would be equal;
>
> AND WHEREAS, the purchase of said shares of stock by Wilson from Shook is to be financed by a series of payments;
>
> IT IS THEREFORE AGREED, That for and in consideration of the covenants to be performed and the payments to be made as hereinafter set forth, the sale and purchase of said stock is to be as follows:
>
> 1. Dee Shook is to sell to Milo E. Wilson 182 shares of stock in S & W SAWMILL, INC. for the agreed price of $500.00 per share.
>
> 2. Wilson is to pay Shook for said stock as follows:
>
> > Interest on unpaid balance due is to be paid annually ...
> >
> > ....
> >
> > In addition to interest $6,000.00 on the principal is due November 1, 1969.

> In addition to interest, $15,000.00 on the principal is due annually, beginning Nov. 1, 1970, and continuing until the entire purchase price is paid. The payments may be made in advance at any time and in any amount.
>
> 3. As each principal payment is made the proportionate number of shares of stock are to be transferred on the corporate records and delivered to Wilson.
>
> 4. ....
>
> 5. For the period of one year from the date hereof Wilson is to have the full power to vote all of the stock herein agreed to be sold to him by Shook. Thereafter the voting rights of the stock is (sic) to be determined by the stock ownership records of the corporation.

On July 15, 1964, Shook also executed an irrevocable proxy granting to Wilson voting rights in 182 shares until September 10, 1965. Two other documents also executed on that date related to share ownership between Shook and Wilson. One, entitled "S & W Sawmill, Inc. Stockholders" Restrictive Agreement,' provided in part as follows:

> ....
>
> IT IS THE INTENTION AND PURPOSE of the incorporators that the majority of the ownership of the corporation is to be held by Dee Shook and Milo E. Wilson on an equal share basis when Milo E. Wilson completes the purchase of the stock certificates which are the subject of said purchase agreement.

The other, entitled "Option To Buy Stock Forming Part Of Stockholders' Restrictive Agreement," provided in part that "the ownership of shares in S & W Sawmill, Inc., as the same now stands, to-wit: Dee Shook 365 shares, Milo E. Wilson 1 shares (sic) * * * shall continue."

In connection with the agreement for sale, Shook deposited stock certificates representing 182 shares with an escrow agent on July 17, 1964.

On August 19, 1964, S & W borrowed $200,000, in part upon the personal guarantees of Shook, Wilson, and their wives. The loan agreement referred to Shook and Wilson as "the principal officers and stockholders" of S & W. S & W agreed therein to insure the lives of Shook and Wilson for $100,000 each.

....

Wilson made all payments in 1965 and 1966 specified in the agreement for sale and accordingly claimed interest deductions on his Federal income tax returns for those years.

On July 1, 1967, before principal payments were required by the agreement for sale, petitioner [Intermountain] purchased all outstanding S & W stock. In anticipation of this purchase, a letter

to petitioner dated May 3, 1967, and signed by Shook and Wilson stated as follows:

> To have it in the record, Milo E. Wilson owes Dee Shook $91,000 for 182 shares of S & W Sawmill Inc. stock in escrow at Citizens State Bank Hamilton Montana. On the purchase contract, Intermountain Lumber Co. would pay Dee Shook $91,000.00 more over the 14 yrs. than Milo E. Wilson.

OPINION

Section 351 provides, in part, that no gain shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation. [footnote omitted] "Control" is defined for this purpose in § 368(c) as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. [footnote omitted]

In this case, respondent is in the unusual posture of arguing that a transfer to a corporation in return for stock was nontaxable under § 351, and Intermountain is in the equally unusual posture of arguing that the transfer was taxable because § 351 was inapplicable. The explanation is simply that Intermountain purchased all stock of the corporation, S & W, from its incorporators, and that Intermountain and S & W have filed consolidated income tax returns for years in issue. Accordingly, if § 351 was applicable to the incorporators when S & W was formed, S & W and Intermountain must depreciate the assets of S & W on their consolidated returns on the incorporators' basis. § 362(a). [footnote omitted] If § 351 was inapplicable, and the transfer of assets to S & W was accordingly to be treated as a sale, S & W and Intermountain could base depreciation on those returns on the fair market value of those assets at the time of incorporation, which was higher than the incorporators' cost and which would accordingly provide larger depreciation deductions. §§ 167(g), 1011, and 1012. [footnote omitted]

Petitioner thus maintains that the transfer to S & W of all of S & W's property at the time of incorporation by the primary incorporator, one Dee Shook, was a taxable sale. It asserts that § 351 was inapplicable because an agreement for sale required Shook, as part of the incorporation transaction, to sell almost half of the S & W shares outstanding to one Milo Wilson over a period of time, thereby depriving Shook of the requisite percentage of stock necessary for "control" of S & W immediately after the exchange.

Respondent, on the other hand, maintains that the agreement between Shook and Wilson did not deprive Shook of ownership of the shares immediately after the exchange, as the stock purchase agreement merely gave Wilson an option to purchase the shares. Shook accordingly was in "control" of the corporation and the exchange was thus nontaxable under § 351.

Respondent has abandoned on brief his contention that Wilson was a transferor of property and therefore a person to also be counted for purposes of control under § 351. Respondent is correct in doing so, since Wilson did not transfer any property to S & W upon its initial formation in

July of 1964. Wilson's agreement to transfer cash for corporate stock in March of 1965 cannot be considered part of the same transaction.

Since Wilson was not a transferor of property and therefore cannot be counted for control under § 351, [citation omitted], we must determine if Shook alone owned the requisite percentage of shares for control. This determination depends upon whether, under all facts and circumstances surrounding the agreement for sale of 182 shares between Shook and Wilson, ownership of those shares was in Shook or Wilson.

A determination of "ownership," as that term is used in § 368(c) and for purposes of control under § 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation. Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of § 351. By contrast, if there are no restrictions upon freedom of action at the time he acquired the shares, it is immaterial how soon thereafter the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation. *Stephens, Inc. v. U.S.*, 464 F.2d 53, 66-67 (8th Cir. 1972), *cert. denied*, 409 U.S. 1118 (1973); *Barker v. U.S.*, 200 F.2d 223, 229 (9th Cir. 1952); *S. Klein on the Square, Inc.*, 14 T.C. 786, 789-790 (1950), *aff'd*, 188 F.2d 127, 129 (2d Cir. 1951), *cert. denied*, 342 U.S. 824 (1951); *American Bantam Car Co.*, 11 T.C. 397, 404-08 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); *Wilgard Realty Co.*, 43 B.T.A. 557, 561 (1941), *aff'd*, 127 F.2d 514, 516 (2d Cir. 1942), *cert. denied*, 317 U.S. 655 (1942); *Schumacher Wall Board Corp*., 33 B.T.A. 1211, 1214 (1936), *aff'd*, 93 F.2d 79, 81 (9th Cir. 1937); *Wilbur F. Burns*, 30 B.T.A. 163, 171-72 (1934), *aff'd sub nom*. *Bassick v. Comm'r*, 85 F.2d 8, 10 (2d Cir. 1936), *cert. denied*, 299 U.S. 592 (1936); *Federal Grain Corp*., 18 B.T.A. 242, 248-49 (1929).

After considering the entire record, we have concluded that Shook and Wilson intended to consummate a sale of the S & W stock, that they never doubted that the sale would be completed, that the sale was an integral part of the incorporation transaction, and that they considered themselves to be coowners of S & W upon execution of the stock purchase agreement in 1964. These conclusions are supported by minutes of the first stockholders meeting on July 7, 1964, at which Shook characterized the agreement for sale as a "sale"; minutes of a special meeting on July 15, 1964, at which Shook stated Wilson was to 'purchase' half of Shook's stock; the "Agreement for Sale and Purchase of Stock" itself, dated July 15, 1964, which is drawn as an installment sale and which provides for payment of interest on unpaid principal; Wilson's deduction of interest expenses in connection with the agreement for sale, which would be inconsistent with an option; the S & W loan agreement, in which Shook and Wilson held themselves out as the "principal stockholders" of S & W and in which S & W covenanted to equally insure Shook and Wilson for $100,000; the March 1965 stock purchase agreement with S & W, which indicated that Shook and Wilson "are to remain equal" shareholders in S & W; the letter of May 1967 from Shook and Wilson to Intermountain, which indicated that Wilson owed

Shook the principal balance due on the shares as an unpaid obligation; and all surrounding facts and circumstances leading to corporate formation and execution of the above documents. Inconsistent and self-serving testimony of Shook and Wilson regarding their intent and understanding of the documents in evidence is unpersuasive in view of the record as a whole to alter interpretation of the transaction as a sale of stock by Shook to Wilson.

We accordingly cannot accept respondent's contention that the substance varied from the form of this transaction, which was, of course, labeled a "sale." ...

....

We thus believe that Shook, as part of the same transaction by which the shares were acquired (indeed, the agreement for sale was executed before the sawmill was deeded to S & W), had relinquished when he acquired those shares the legal right to determine whether to keep them. Shook was under an obligation, upon receipt of the shares, to transfer the stock as he received Wilson's principal payments. *Cf. S. Klein on the Square, Inc*., 14 T.C. 786, 790 (1950), *aff'd*, 188 F.2d 127 (2d Cir. 1951), *cert. denied*, 342 U.S. 824 (1951). We note also that the agreement for sale gave Wilson the right to prepay principal and receive all 182 shares at any time in advance. Shook therefore did not own, within the meaning of § 368(c), the requisite percentage of stock immediately after the exchange to control the corporation as required for nontaxable treatment under § 351.

We note also that the basic premise of § 351 is to avoid recognition of gain or loss resulting from transfer of property to a corporation which works a change of form only. *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 3.01, p. 3-4 (3d ed. 1971). Accordingly, if the transferor sells his stock as part of the same transaction, the transaction is taxable because there has been more than a mere change in form. *See, e. g*., *Wilbur F. Burns*, 30 B.T.A. 163 (1934), *aff'd. sub nom*. *Bassick v. Comm'r*, 85 F.2d 8 (2d Cir. 1936), *cert. denied*, 299 U.S. 592 (1936). In this case, the transferor agreed to sell and did sell 50 percent of the stock to be received, placed the certificates in the possession of an escrow agent, and granted a binding proxy to the purchaser to vote the stock being sold. Far more than a mere change in form was effected.

We accordingly hold for petitioner. Because of concessions of other issues,
Decisions will be entered under Rule 155.

Questions and comments:

1. The parties were obviously advised by tax counsel. Nevertheless, at a time when Wilson owed Shook $91,000 and presumably owned 91 shares, they provided in a contract with an outside buyer that the buyer was to pay Shook $91,000 more than it paid Wilson. What is wrong with that? Who benefitted at the expense of the other?

2. The parties took positions opposite from what taxpayers and the Commissioner usually argue.

Why? While § 351(a) provides for nonrecognition in certain circumstances, you should surmise from this case that there is nothing optional or elective about the application of § 351(a).

3. Why should the Commissioner so easily have conceded that Wilson was not part of the transferor group?

4. Corporation X transferred property to a newly organized corporation, Newco, in exchange for all of Newco's stock (a single class of voting common stock). Pursuant to a prearranged binding agreement between X and corporation Y, X sold 40 percent of its Newco stock for its fair market value to Y, and Y purchased securities (other than stock) for cash from Newco. Newco would not have been formed if Y had not agreed to purchase securities for cash from Newco and part of the Newco stock from X.

•Does nonrecognition treatment apply under § 351(a)? *See* Rev. Rul 79-70.

5. Corporation Z and a group of investors, pursuant to a binding agreement between them, transferred property to a newly organized corporation, Newco, in exchange for all of Newco's stock (a single class of voting common stock). Z and the investors received 80 percent and 20 percent, respectively, of Newco's stock. Pursuant to the agreement Z sold an amount of its Newco stock for its fair market value to the investors to bring its ownership down to 49 percent. Newco would not have been formed if the investors had not agreed to transfer property to it and their agreement to do so was conditioned on the sale by Z to them of part of Z's Newco stock.

•Does nonrecognition treatment apply under § 351(a)? *See* Rev. Rul. 79-194 (Situation 1).

6. X, a domestic corporation, operates a branch in a foreign country. The foreign country enacted a nationalization law that required that the business that X's branch was engaged in be incorporated in the foreign country and that its citizens be the majority owners of such corporation. A governmental agency in the foreign country directed X to transfer all of the assets of its branch to a newly formed foreign country corporation that is, or will be, at least 51% owned by its citizens. Accordingly, X and a group of investors, who were citizens of the foreign country, pursuant to a binding agreement between them, transferred property to Newco, a corporation newly organized in the foreign country, in exchange for all of Newco's stock (a single class of voting common stock). X and the investors received 99% and one percent, respectively, of Newco's stock. Pursuant to the agreement, X sold an amount of its Newco stock for its fair market value to the investors to bring its ownership down to 49%; the investors would pay X in a series of yearly installments. Newco would not have been formed if the investors had not agreed to transfer property to it and their agreement to do so was conditioned on the sale by X to them of part of X's Newco stock. Further, the investors transferred property to Newco in order to become co-transferors with X, and they purchased X's Newco stock in lieu of the assets of X's branch because of the foreign governmental agency's directive. ... The fair market value of each asset transferred is in excess of its basis.

•Does nonrecognition treatment apply under § 351(a)? *See* Rev. Rul. 79-194 (Situation 2); *cf.* Reg. § 1.351-1(a)(1)(ii) (discussed in *Estate of Kamborian v. Commissioner*, *infra*).

7. Reg. § 1.351-1(a)(1) concerning "immediately after the exchange" is to the effect that such immediacy turns on the prior definition of rights rather than simultaneity of the exchanges. This seems to invite application of the "step transaction doctrine." Under the "step transaction doctrine," a court (or the IRS) may integrate more than one transaction into one single transaction. In *Intermountain Lumber*, the parties were careful to spell out their rights and obligations over the course of several years, and the court treated all of the transactions undertaken in fulfillment of the parties' promises as a single transaction. There are three tests that courts may apply in determining whether the "step transaction" is applicable:

•End result: When the parties intend the end result of more than one transaction from the beginning, courts may apply the "step transaction doctrine."

•Mutual interdependence: when steps are so interdependent that none would have been undertaken without the others, courts may apply the "step transaction doctrine." Indeed, each step would be pointless without the others.

•Binding commitment: when parties enter a binding commitment to take certain steps after other steps, courts may apply the "step transaction doctrine."

III. The Transferor Group

Section 351(a) is applicable even when transferors do not *acquire* control of the corporation through an exchange. This is consistent with the rationale that nonrecognition treatment is accorded to transactions where the transferors do not substantially alter their interests in the business. It is also consistent to count a transferor-shareholder's pre-existing share ownership in the 80% determinations. Some taxpayers may try to take advantage of this to qualify transactions that otherwise violate the spirit of § 351. Read Reg. § 1.351-1(a)(1).

Kamborian v. Commissioner, 56 T.C. 847 (1971), *aff'd*, 469 F.2d 219 (1st Cir. 1972)

The Commissioner determined deficiencies in petitioners' income tax ...

....

The cases relate to petitioners' transfer of certain securities to International Shoe Machine Corp. in exchange for its common stock. 'Specifically in question is whether gain realized by petitioners as a result of that transaction qualifies for nonrecognition under § 351, I.R.C. 1954 ...

FINDINGS OF FACT

....

1. International Shoe Machine Corp. (International) was incorporated in Massachusetts in 1938 and at the time of the trial herein was engaged in the business of manufacturing and leasing shoe machinery and the sale of related supplies. On April 1, 1964, International's articles of organization were amended to provide for a 20 for 1 split of its common stock into two classes of common stock: Class A, $1 par, voting stock, and class B, $1 par, nonvoting stock. ...

On September 1, 1965, prior to the transaction here in question, International's capital stock was held as follows:

	Shares of International	
Name	Class A common	Class B common
Jacob Kamborian Revocable Trust	20,324	182,916
Jacob Kamborian, Jr.	4,220	37,980
Lisbeth (Kamborian) Godley	3,620	32,580
Michael Becka	60	540
Elizabeth Kamborian Trust	5,000	45,000
Others	3,916	35,244
Total:	37,140	334,260

Jacob S. Kamborian (Jacob) founded International and served as its president at all times relevant herein. Jacob S. Kamborian, Jr., and Lisbeth Kamborian Godley are the children of Jacob and his wife, Elizabeth. Michael Becka (Becka) is not related to the members of the Kamborian family. At the time of the trial herein he had been employed by International or an affiliate since at least 1943 and had served as International's executive vice president and general manager since approximately 1960. As such he was responsible for the operations of all of International's departments and reported directly to Jacob, the president of the corporation.

Jacob established the Jacob S. Kamborian Revocable Trust on April 13, 1965. Article I of the Declaration of Trust (which identified Jacob as SETTLOR) set forth the trust's purposes:

> ARTICLE I. The SETTLOR has executed this Trust to arrange for the continued management of his equity interests in INTERNATIONAL SHOE MACHINE CORPORATION and its affiliated companies and to create a family protective fund which will provide for the maintenance and comfort of the SETTLOR during his life, and after his death for the benefit of his children and their issue, all in the manner hereafter provided.
>
> ....

The Elizabeth Kamborian Trust (Elizabeth's trust) was established by Jacob in 1949. At about that time Jacob and Elizabeth experienced domestic difficulties; they separated for a time; and the trust was established on their reconciliation in order to provide financial security for Mrs. Kamborian. The initial trust corpus consisted of 2,500 shares of International stock. ...

....

... At all times relevant herein, Becka served as the managing trustee; Mrs. Godley did not live in Boston during this period; and periodically Becka informed her of the trust's activities. As of September 1, 1965, the only assets of the trust were 5,000 shares of International's class A common stock and 45,000 shares of its class B common stock.

As of September 1, 1965, International's board of directors consisted of Jacob, Jacob, Jr., Albert Kamborian (Jacob's brother), Becka, Paul Hirsch II, Harold V. Daniels, and Roy S. Flewelling.
Campex Research & Trading Corp. (Campex), a Swiss corporation with its principal place of business in Zug, Switzerland, was a patent holding and licensing company. It held primarily foreign shoe machine patents (i.e., patents not issued by the United States) and granted and administered licenses under them in a number of European countries and in Mexico. On September 1, 1965, and prior to the transaction here in question, the outstanding stock of Campex was held as follows:

Name	Shares of Campex
Jacob Kamborian Revocable Trust	39
Jacob Kamborian, Jr.	4
Lisbeth (Kamborian) Godley	4
Michael Becka	3

On September 1, 1965, the board of directors of International authorized Jacob to enter into an agreement under which (a) the owners of all of the issued and outstanding shares of Campex would exchange their stock for common stock of International and (b) certain stockholders of International would purchase for cash additional shares of International's common stock. ...

As part of the transaction it was contemplated that the Elizabeth Kamborian Trust would purchase additional shares of theretofore unissued International stock for about $5,000, so that the former owners of the Campex stock and the Elizabeth Kamborian Trust, when considered collectively and treated as transferors under § 351(a), I.R.C. 1954, would own at least 80 percent of International's stock immediately after the transaction in an attempt to comply with the requirements of § 368(c), I.R.C. 1954. If the Elizabeth Kamborian Trust were not taken into account, the International stock held by the former owners of Campex immediately after the transaction amounted to 77.3 percent of each class of outstanding stock of International— an amount that was insufficient to satisfy the requirements of § 368(c).

....

International acquired Campex stock as part of its program of preparing for a public issue of its stock. On the advice of underwriters and other specialists, it was thought that ownership of foreign patents would enable International to display worldwide activities which would be of value in establishing the price of the public issue. If the contemplated public offering had been made, it would also have been necessary to remove existing restrictions on the sale of International's stock. ...

As vice president and general manager of International, Becka participated from the beginning in the planning of the acquisition of the Campex stock. Moreover, during 1964 and 1965, Jacob was seriously ill for an extended period of time, underwent a number of operations, and was hospitalized for a number of months. For approximately 9 months he was on his back and for a year thereafter he was very limited in what he could do. During this period Becka was in charge of International's affairs, and it was at about this time that International acquired the Campex stock. During the course of planning for the transaction, International received legal advice with regard to qualifying the acquisition as a tax-free exchange, and the variations of tax free exchange of stocks were discussed at some length.

As trustee of Elizabeth's trust, Becka borrowed approximately $5,000 at an interest rate of 6 percent in order to finance the trust's purchase of the total of 418 shares of International stock on September 1, 1965. The corpus of the trust consisted exclusively of International stock, and Becka anticipated that the loan would be repaid out of dividends paid on the stock. In deciding to acquire additional International stock, Becka also anticipated that International would make a public offering which might enhance the value of the stock.

... In his discussions with Elizabeth, Becka explained that because the $5,000 loan would have to be repaid out of dividends paid on the International stock held by the trust, her income from the trust would be diminished until the loan was repaid. Elizabeth told Becka to go ahead with the transaction.

....

On their respective Federal income tax returns for 1965, petitioners reported no gain or loss stemming from the exchange of their Campex stock for International stock. In his deficiency notices to petitioners, the Commissioner determined that they realized long-term capital gains ...

....

OPINION

RAUM, Judge

1. Exchange of Campex stock for International stock. – Petitioners contend that the gain they realized on their transfer of Campex stock to International in return for International's common stock qualifies for nonrecognition under § 351(a), I.R.C. 1954. [footnote omitted]. That section

provides for nonrecognition of gain or loss on the transfer of property to a corporation in exchange for the corporation's stock or securities— if immediately after the exchange the transferor or transferors are in control of the corporation. Section 351(a) makes reference to § 368(c), I.R.C. 1954, for the definition of control;

> § 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.
> (c) CONTROL. – For purposes of part I (other than § 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Immediately after the exchange here in issue the stock of International was held as follows:

	Shares of— Class A (voting common)	Class B (non-voting common)	Percent of total of each class
Jacob S. Kamborian Revocable Trust	22,108	198,971	56.01
Jacob S. Kamborian, Jr.	4,403	39,627	11.16
Lisbeth (Kamborian) Godley	3,803	34,227	9.64
Michael Becka	197	1,775	0.50
Elizabeth Kamborian Trust	5,042	45,376	12.77
Others	3,916	35,244	9.92
Total	39,469	355,220	

Petitioners contend that the transferors of property for purposes of § 351(a) were the five named stockholders listed above and that their percentage stockholdings after the transfer satisfy the 80-percent control requirement imposed by §§ 351(a) and 368(c).

The Commissioner's position is that only the first four stockholders listed above – i.e., the former owners of Campex – may be considered as transferors of property here, that the fifth (the Elizabeth Kamborian Trust) may not be taken into account in this connection, and that since there would thus be a failure to satisfy the control requirement, all gain realized on the exchange must be recognized. In particular, he urges that International stock issued to the Elizabeth Kamborian Trust in return for $5,016 does not qualify as stock issued for property within the meaning of § 351(a) and that consequently the persons making qualified transfers of property to International in return for its stock held only 77.3 percent of its stock after the exchange. The Commissioner relies on regulations § 1.351-1(a)(1)(ii) [provides in part]:

> § 1.351-1 Transfer to corporation controlled by transferor.
>
> ...

(ii) Stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property.

....

The Commissioner contends that since the Elizabeth Kamborian Trust purchased only 42 shares of class A common and 376 shares of class B common, the securities issued were of relatively small value in relation to the 5,000 shares of class A common and 45,000 shares of class B common which it already held and that the primary purpose of the transfer was to qualify the exchange of Campex stock by the other stockholders for nonrecognition treatment under § 351(a).

Petitioners attack the Commissioner's position on a variety of grounds. They urge (a) that regulations § 1.351-1(a)(1)(ii) is invalid; (b) that even if valued [*sic* valid] it is inapplicable to the transaction in issue; and (c) that even if the regulation is valid and applicable, the Commissioner's determination of the fair market value of the International stock received by petitioners is erroneous.

(a) Validity of the regulation — Initially we note the well-settled principle that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statues and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501; *see also Bingler v. Johnson*, 394 U.S. 741, 749-750; *Colgate Co. v. United States*, 320 U.S. 422, 426; *Fawcus Machine Co. v. United States*, 282 U.S. 375, 378; *Brewster v. Gage*, 280 U.S. 327, 336; *Textile Mills Corp. v. Commissioner*, 314 U.S. 326, 336-339; *Boske v. Comingore*, 177 U.S. 459, 470; *Regal, Inc.*, 53 T.C. 261, 263-264, *aff'd per curiam* 435 F.2d 922 (C.A. 2); *William F. Sanford*, 50 T.C. 823, 832, *aff'd* 412 F.2d 201 (C.A. 2), *cert. denied*, 396 U.S. 841; *cf. United States v. Correll*, 389 U.S. 299, 307.

In arguing that regulations § 1.351-1(a)(1)(ii) is invalid, petitioners point first to the "proportionate interest" test which was included in § 112(b)(5), the predecessor of § 351, under the 1939 Code:

§ 112. RECOGNITION OF GAIN OR LOSS.
(b) EXCHANGES SOLELY IN KIND —
....

(5) TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR. – No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation,

> and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as other property or money) shall be considered as stock or securities received by such transferor.

The "proportionate interest" test was eliminated when § 351 was enacted in 1954. The committee reports reflect congressional dissatisfaction with the uncertainty which had developed in applying the test (H. REPT. NO. 1337, 83d Cong., 2d Sess., pp. A116-A117 (1954)):

> The basic change from present law made by your committee in § 351 is the elimination of the so-called "proportionate interest" test. This requirement, which appears in § 112(b)(5) of the 1939 Code, permits nonrecognition of gain and loss only if the stock and securities received by each transferor are substantially in proportion to the interest of such transferor in the property prior to the exchange. This requirement, which, if unsatisfied, serves to vitiate the tax-free nature of the entire transaction, caused considerable uncertainty in its application. In eliminating the proportionate interest test your committee intends that no gain or loss will be recognized to a transferor transferring property to a corporation under § 351 irrespective of any disproportion of the amount of stock or securities received by him as a result of the transfer. Thus, if M and N each owning property having a value of $100 transfers such property to a newly formed corporation X, and M receives all of the stock, such transaction would not be subject to tax under § 351. To the extent, however, that the existing disproportion between the value of the property transferred and the amount of stock or securities received by each of the transferors results in an event taxable under other provisions of this code, your committee intends that such distribution will be taxed in accordance with its true nature. For example, if individuals A and B, father and son, organize a corporation with 100 shares of common stock and A transfers property worth $80 in exchange for 20 shares of stock, while B transfers property worth $20 to the corporation in exchange for 80 shares of stock, no gain or loss will be recognized under § 351. If, however, it is determined that in fact A has made a gift to B, it is your committee's intention that such gift would be subject to tax under the provisions of § 2501 and following. Similarly, if in the preceding example, B had rendered services to A and the disproportion in the amount of stock received constituted, in effect, the payment of compensation by A to B, it is your committee's intention that such compensation will be appropriately taxed. B will be taxable upon the fair market value of the 60 shares of stock received in excess of that received in exchange for his property as an amount received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis of the 60 shares of stock in his hands and its fair market value.

See also id. at 39; S. REPT. NO. 1622, 83d Cong., 2d Sess., pp. 50, 264 (1954). Petitioners assert that § 1.351-1(a)(1)(ii) incorporates a proportionate-interest test and that it therefore exceeds the scope of § 351. We disagree. Despite superficial similarities to the "proportionate interest" test, § 1.351-1(a)(1)(ii) is a very different provision.
The "proportionate interest" test was apparently designed to limit the applicability of § 112(b)(5) of the 1939 Code to transactions which did not result in substantial shifts in equity or property interests among the transferor-stockholders. On the other hand, the current regulation appears to be calculated to exclude from the scope of § 351 transactions which would ordinarily fail to meet the 80-percent requirement but which attempt to satisfy it by appending a token exchange of property for stock by one or more persons with stockholdings sufficient to place all of the transferors "in control" of the corporation. We think that the objective of the regulation is considerably narrower than that of the "proportionate interest" test.

The effect of the regulation is also more limited than that of the "proportionate interest" test. Transactions not satisfying the "proportionate interest" test were completely disqualified from nonrecognition treatment under § 112(b)(5) of the 1939 Code. The regulation, on the other hand, disqualifies only particular exchanges by particular stockholders from the scope of § 351 of the 1954 Code; if the remaining transferors can satisfy the 80-percent requirement and otherwise qualify under the statute, the regulation does not prevent them from obtaining nonrecognition treatment.

The uncertainty created by the "proportionate interest" test resulted largely from judicial development of two different tests of proportionality under the statue, and from confusion with regard to application of the tests. *Compare Bodell v. Commissioner*, 154 F.2d 407 (CA 1) ("relative value" test), *affirming* a Memorandum Opinion of this Court, and *United Carbon Co. v. Commissioner*, 90 F.2d 43 (CA 4) ("relative value" test), *rev'g* 32 B.T.A. 1000, *with Mather & Co. v. Commissioner*, 171 F.2d 864 (CA3) ("control test"), *cert. denied*, 337 U.S. 907. *See also Turner Construction Co. v. United States*, 364 F.2d 525, 537-538 (CA2); *Uinta Livestock Corp. v. United States*, 355 F.2d 761, 768-769 (CA10); *George M. Holstein III*, 23 T.C. 923. *Cf.* Hoffman, *The Substantial Proportionment Requirement of Section 112(b)(5)*, 5 TAX L. REV. 235. Section 1.351-1(a)(1)(ii), however, provides a clear statement of the comparison to be made; a similar state of uncertainty therefore need not arise. We conclude that congressional elimination of the "proportionate interest" test in 1954 provides no basis for holding the regulation invalid.[20]

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[20] It is not without significance that regs. § 1.351-1(b)(1) expressly takes into account elimination of the "proportionate interest" test:

> Sec. 1.351-1 Transfer to corporation controlled by transferor.
>
> (b)(1) Where property is transferred to a corporation by two or more persons in exchange for stock or securities, as described in paragraph (a) of this section it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some

Petitioners also contend that the regulation's reference to "property which is relatively small value in comparison to the value of stock or securities already owned" and its reliance upon the taxpayer's motive find support nowhere in the language of § 351 and that the regulation is for that reason invalid as beyond the scope of the statute. Again, we must disagree. By disqualifying certain token exchanges, the regulation is reasonably designed to exclude from the scope of § 351 transactions which comply with its requirements in form but not in substance. Far from being unreasonable or inconsistent with the statute, the regulation promotes its purpose by helping to ensure substantial compliance with the control requirement before the nonrecognition provisions become operative. In this light the absence of direct support for the regulation in the language of the statute is of minimal significance. [footnote omitted]. *Cf. Fabian Tebon, Jr.*, 55 T.C. 410, 412-416. We conclude that the regulation is valid.

(b) Applicability of the regulation. – Petitioners contend that even if it is valid, the regulation is inapplicable to the transaction here in issue. They argue first that even if Elizabeth's trust had not purchased shares of International stock, the control requirement would have been satisfied, that therefore the purchase was not necessary to meet the control requirement, and that consequently the regulation is by its own terms inapplicable. Petitioners reach this conclusion by asserting that the shares held by Becka and Lisbeth Godley as trustees of Elizabeth's trust should be attributed to them as individuals [footnote omitted] and added to the shares they held personally in nonfiduciary capacities. On the basis of this premise, petitioners conclude that the 80-percent-control requirement would have been satisfied even if Elizabeth's trust had not participated in the September 1, 1965, transaction. [footnote omitted]. Petitioners' argument is ingenious but unacceptable, for it falters on petitioners' premise that the trust's shares may be attributed to the individual trustees. While legal title to the shares may have been in the names of the trustees, they had no beneficial interest in such shares. The distinction is not one of form but of plain economic reality. [footnote omitted] In these circumstances we think the trustees' interests in the trust's shares were far too remote to justify attributing the shares to them for purposes of § 351. [footnote omitted].

Petitioners also contend that the primary purpose for the trust's acquisition of International's stock was not to qualify the other stockholders' exchanges under § 351 and that for this reason the regulation is inapplicable. We note at the outset that the regulation does not make it entirely clear whose purpose is to be taken into account. However, both parties have assumed that the purpose of the transferor of property is critical. The language of the regulation (which appears to distinguish between a "transfer" of property and the issuance of stock) supports their assumption, and we shall therefore proceed on this basis. Although Elizabeth's trust was technically the transferor herein, the parties have also assumed that Becka's purpose is critical in this respect –

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of such stock and securities had been used to make gifts (§ 2501 and following), to pay compensation (§ 61(a) (1)), or to satisfy obligations of the transferor of any kind.

The regulation scrupulously adheres to the language of the 1954 committee reports. See pp. 862-863 supra. As a companion provision to regs. § 1.351-1(a)(1)(ii), it provides additional support for our conclusion.

apparently on the ground that as the managing trustee he was primarily responsible for the decision to make the purchase of International stock. We shall proceed on the basis of this assumption as well.

The question of Becka's primary purpose is one of fact, *cf. Malat v. Riddell*, 383 U.S. 569, and after a review of all the evidence we conclude that his primary purpose was to qualify the other stockholders' exchanges under § 351. We note in particular that at about the time of the transaction, Jacob was ill and Becka was in charge of International's affairs, that in planning the acquisition Becka participated in lengthy discussions with regard to planning the transaction as a tax-free exchange, and that both the vote of International's board of directors and the agreement of September 1, 1965, treated the purchase by Elizabeth's trust and the exchange of Campex stock by the other stockholders as component parts of an integrated transaction avowedly designed to meet the 80-percent-control requirement and thereby qualify for nonrecognition treatment under § 351.

At the trial herein, Becka testified that if the trust had not participated in the transaction, the issue of International stock to the other major stockholders would have diluted the trust's percentage interest in International and that he authorized the purchase of International stock in order to minimize such dilution. In particular he testified that the total percentage stock interest held by the trust and the two Kamborian children exceeded 33⅓ percent and that preservation of that interest protected Mrs. Kamborian against the making of certain corporate decisions (requiring a two-thirds majority) without her consent. [footnote omitted]. We do not give his testimony very much weight, however. The record does not establish whether or why the children were regarded as allies of Mrs. Kamborian rather than as allies of her husband. Moreover, the trust's participation in the transaction left them with an aggregate stock interest of 33.57 percent— only 0.08 of 1 percent more than they would have held if the trust had not purchased any additional shares.

Becka also testified that he authorized the purchase of the stock because it was a "good investment." While he may well have taken this into account in making his decision, the record leaves us convinced that the purchase was made primarily to qualify the exchanges by the other stockholders (one of whom was Becka himself)11 under § 351. We conclude that § 1.351-1(a)(1)(ii) is applicable.

....

Decisions will be entered under Rule 50.

Questions and comments:

1. What is (was) the "disproportionate interest" test? What was wrong with it?

2. The court provides a rationale for Reg. § 1.351-1(a)(1)(a)(ii). What is it?

3. In Rev. Proc. 77-37, the IRS stated:

> § 3.07. When a person transfers property to a corporation in exchange for stock ... of such corporation and the primary purpose of the transfer is to qualify under § 351 ... the exchanges of property by other persons transferring property, the property transferred will not be considered to be of relatively small value, within the meaning of [Reg. §] 1.351-1(a)(1)(ii), if the fair market value of the property transferred is equal to, or in excess of, 10 percent of the fair market value of the stock ... already owned (or to be received for services) by such person.

If the revenue procedure had already been promulgated, and the parties in *Kamborian* had tried to fall within its terms, how much stock would the trust have had to purchase? Remember, the trust already owned 13% of the outstanding shares of International Shoe Machine Corp.

4. One who renders only services in exchange for stock cannot be a part of the transferor group for purposes of § 351(a).

Do the CALI exercise: Corporate Taxation: Formation: Formation of C Corporations: Advanced Issues.

IV. Boot and Derivative Issues

If a transferor/shareholder/taxpayer receives something aside from or in addition to stock – i.e., something to "boot" – then the transferor has not exchanged property "solely" for stock. It is of course possible for transferors of property to have "control" of the corporation after the transfer(s) of property and for one or more of the transferors to receive boot. The amount of boot in a § 351 transaction is either the amount of money or the fair market value of other property received. Section 351(b)(1) provides that the shareholder must pay tax on the gain from the exchange or the boot received, whichever is less. Taxpayer may not recognize loss. § 351(b)(2).

A. Transfer of Multiple Properties

Rev. Rul. 68-55, 1968-1 C.B. 140

Advice has been requested as to the correct method of determining the amount and character of the gain to be recognized by Corporation X under § 351(b) ... under the circumstances described below.

Corporation Y was organized by X and A, an individual who owned no stock in X. A transferred 20x dollars to Y in exchange for stock of Y having a fair market value of 20x dollars and X transferred to Y three separate assets and received in exchange stock of Y having a fair market value of 100x dollars plus cash of 10x dollars.In accordance with the facts set forth in the table below if X had sold at fair market value each of the three assets it transferred to Y, the result would have been as follows:

	Asset 1	Asset 2	Asset 3
Character of Asset	Capital asset held more than [1 year]	Capital asset held not more than [1 year]	§ 1245 property
fair market value	$22x	$33x	$55x
adjusted basis	$40x	$20x	$25x
Gain (loss)	($18x)	$13x	$30x
Character of gain or loss	LTCL	STCG	Ordinary income

The facts in the instant case disclose that with respect to the § 1245 property the depreciation subject to recapture exceeds the amount of gain that would be recognized on a sale at fair market value. Therefore, all of such gain would be treated as ordinary income under § 1245(a)(1) of the Code.

Under § 351(a) ..., no gain or loss is recognized if property is transferred to a corporation solely in exchange for its stock and immediately after the exchange the transferor is in control of the corporation. If § 351(a) ... would apply to an exchange but for the fact that there is received, in addition to the property permitted to be received without recognition of gain, other property or money, then under § 351(b) ... gain (if any) to the recipient will be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property received, and no loss to the recipient will be recognized.

The first question presented is how to determine the amount of gain to be recognized under § 351(b) ... The general rule is that each asset transferred must be considered to have been separately exchanged. See the authorities cited in Revenue Ruling 67-192, C.B. 1967-2, 140, and in Revenue Ruling 68-23, which hold that there is no netting of gains and losses for purposes of applying §§ 367 and 356(c) ... Thus, for purposes of making computations under § 351(b) ..., it is not proper to total the bases of the various assets transferred and to subtract this total from the fair market value of the total consideration received in the exchange. Moreover, any treatment other than an asset-by-asset approach would have the effect of allowing losses that are specifically disallowed by § 351(b)(2) ...

The second question presented is how, for purposes of making computations under § 351(b) ..., to allocate the cash and stock received to the amount realized as to each asset transferred in the

exchange. The asset-by-asset approach for computing the amount of gain realized in the exchange requires that for this purpose the fair market value of each category of consideration received must be separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets. See Reg. § 1.1245-4(c)(1) ... which, for the same reasons, requires that for purposes of computing the amount of gain to which § 1245 ... applies each category of consideration received must be allocated to the properties transferred in proportion to their relative fair market values.

Accordingly, the amount and character of the gain recognized in the exchange should be computed as follows:

	Total	Asset 1	Asset 2	Asset 3
fair market value of asset transferred	$110x	$22x	$33x	$55x
percent of total fair market value		20%	30%	50%
fair market value of Y stock received in exchange	$100x	$20x	$30x	$50x
cash received in exchange	10x	2x	3x	5x
amount realized	$110x	$22x	$33x	$55x
adjusted basis		$40x	$20x	$25x
gain (loss) realized		($18x)	$13x	$30x

Under § 351(b)(2) ... the loss of 18x dollars realized on the exchange of Asset Number I is not recognized. Such loss may not be used to offset the gains realized on the exchanges of the other assets. Under § 351(b)(1) ..., the gain of 13x dollars realized on the exchange of Asset Number II will be recognized as short-term capital gain in the amount of 3x dollars, the amount of cash received. Under §§ 351(b)(1) and 1245(b)(3) ..., the gain of 30x dollars realized on the exchange of Asset Number III will be recognized as ordinary income in the amount of 5x dollars, the amount of cash received.

Questions and comments:

1. How does the approach of Rev. Rul. 68-55 prevent the changing of character of gain or loss on the § 351 exchange? How does it prevent the immediate recognition of losses?

2. For the shareholder, the basis rules on the receipt of boot are stated in §§ 358(a) and (d). The basic mechanics are first, taxpayer-transferor reduces the basis of the stock that he received by the fmv of the boot received, and then increases it by the amount of gain recognized and subject to income tax. § 358(a). The basis of any boot other than money received is its fmv. § 358(a)(2).

- Assumption of a taxpayer's liability by another party to the exchange counts as money received by the taxpayer on the exchange. § 358(d)(1).

3. For the corporation, the basis rules when the shareholder/transferor receives boot are stated in § 362(a). The basis of the property that the corporation acquires is the same as it was in the hands of the transferor, increased by the amount of gain that transferor recognized.

4. Notice: to the extent it is taxed to the transferor, the boot transaction occurs outside of the § 351 exchange, i.e., as if two taxpayers exchanged properties with each other in a taxable exchange. Thus, with respect to boot there will be no duplication of taxable gain for the shareholder and the corporation.

5. Section 358(b)(1) provides that when a shareholder transfers multiple properties to the corporations, the basis of the shares that the shareholder receives is to be determined under rules that the Secretary of the Treasury prescribes. In a revenue ruling, the IRS has held that a transferor of properties of different character and holding periods who receives more than one class of stock may not designate which property was exchanged for which shares of stock. Rev. Rul. 85-164, 1985-2 C.B. 117. Instead, every share of every class that the transferor receives has both a split character and a split holding period, proportional to the fmv of the different classes of stock that the transferor receives.

With some modification, the facts of that revenue ruling were the following: a sole proprietor transferred –

- accounts receivable, ab = $0, fmv = $60,
- depreciable machinery held more than one year (and so § 1231 property), ab = $5, fmv = $10, and
- land & building held more than one year (and so § 1231 property), ab = $25, fmv = $30.

The property was exchanged with the corporation for all the corporation's class A voting common stock (fmv = $60) and all of the corporation's class B nonvoting common stock (fmv = $40).

- Taxpayer may *not* designate which property is exchanged for which stock, e.g., accounts receivable for class A voting common stock and § 1231 property for class B nonvoting common stock.
- "[T]he aggregate basis of property transferred [by the shareholder] is allocated among the stock ... received in proportion to the *fair market values of each class* [of stock that shareholder received]."

•The total adjusted basis of the assets that taxpayer transferred was $30.
•The total fmv of the class A voting common stock was 60% of the total value of all stock issued in the exchange for taxpayer's property.
    •60% of the basis of what taxpayer transferred was $18. Taxpayer's basis in its class A voting common shares is $18.
•The total fmv of the class B nonvoting common stock was 40% of the total value of all stock issued in the exchange for taxpayer's property.
    •40% of the basis of what taxpayer transferred was $12. Taxpayer's basis in its nonvoting common stock is $12.
•The holding period of the stock received is determined by the *fmv of the assets exchanged* for the stock. 40% of the value of what the shareholder transferred was for § 1231 (LTCG) property. 60% of the value of what shareholder transferred was for property with a zero holding period.
•The "amount realized" on any disposition of class A voting common stock or class B nonvoting stock must be allocated in the same manner as the allocation of holding period. After allocating basis in the same manner, we can conclude that –
    •60% of any gain to be recognized on sale of voting common stock will be short term gain.
    •60% of any gain to be recognized on sale of nonvoting common stock will be short term gain.
    •40% of any gain to be recognized on sale of voting common stock will be long term gain.
    •40% of any gain to be recognized on sale of voting common stock will be long term gain.
•Suppose that shareholder sells ⅓ of her class A voting shares for $20 before she has held them for more than one year. What is the amount and character of the gain she must recognize?
    •Shareholder's total basis in all her class A voting shares is $18. ⅓ of that amount is $6. Upon sale for $20, shareholder must recognize $14 of income.
        •60% of that amount is $8.40, and it is short-term gain.
        •40% of that amount is $5.60, and it is long-term gain.

6. How do the rule(s) of Rev. Rul. 85-164 prevent a shareholder from changing the character of gain or loss?

Problem:
Stephen and Peter formed Alpha Corporation. Stephen transferred to Alpha Corporation $10,000 cash in exchange for 100 shares of common voting stock of Alpha Corporation. Peter transferred to Alpha Corporation Blackacre, ab = $7000, fmv = $12,000 in exchange for 100 shares of voting common stock of Alpha Corporation plus $2000 cash. Assume that § 351 applies.
A. Irrespective of whether subject to federal income tax, what was Peter's realized gain/loss on the exchange?

B. On how much income must Peter pay income tax? What is Peter's basis in his Alpha

Corporation voting common stock? What is Alpha Corporation's basis in Blackacre?

C. What B if Peter's basis in Blackacre had been $11,000?

D. Now suppose that Stephen exchanged $8000 plus a 2011 Toyota Corolla (ab = $750, fmv = $2000) for 100 shares of voting common stock. Peter transferred Blackacre, ab = $7000, fmv = $12,000 for 100 shares of voting common stock of Alpha Corporation plus the 2011 Toyota Corolla.

> 1. Irrespective of whether subject to federal income tax, how much was Stephen's gain/loss on the exchange? How much is subject to federal income tax? What is Alpha Corporation's basis in the 2011 Toyota Corolla?
>
> 2. On how much income must Peter pay income tax? What is Peter's basis in his stock and in the 2011 Toyota Corolla? How much income of Alpha is subject to federal income tax? *See* IRC § 311(b). What is Alpha's Corporation basis in Blackacre?

B. Assumption of Liabilities

The assumption of one's liabilities by another in an exchange transaction is generally treated as the receipt of money and therefore included in one's "amount realized" on the exchange. In the context of § 351, treating assumption of what may be substantial liabilities as the receipt of cash (i.e., taxable boot) could severely dampen enthusiasm for incorporating. After all, most real estate is subject to liabilities. In *United States v. Hendler*, 303 U.S. 564, 565 (1938), the Supreme Court nevertheless affirmed the notion that another's assumption of one's liabilities is equivalent to receiving cash – even if the effect of such a holding was to dampen enthusiasm for nonrecognition transfers:

> The transaction, however, under which the Borden Company assumed and paid the debt and obligation of the Hendler Company is to be regarded in substance as though the $534,297.40 had been paid directly to the Hendler Company. The Hendler Company was the beneficiary of the discharge of its indebtedness. Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors.

Congress responded by enacting what is now § 357. How does § 357 treat the corporation's assumption of the shareholder's liabilities? Taken together, what is the rule of § 357(c), § 358(a)(1), and § 358(d)? How might a taxpayer take advantage or even abuse these rules?

Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967)

O'SULLIVAN, Circuit Judge

This matter is before us on the petition of taxpayers, F.W. Drybrough and the executor of the estate of his deceased wife, Citizens Fidelity Bank & Trust Company, to review a decision of the Tax Court of the United States ... The issues before us are (1) the tax effect of the assumption of liabilities in connection with transfers by Drybrough to controlled corporations, and (2) the deductibility of interest paid on certain mortgage indebtedness. ...

Commencing in the twenties and continuing to the time of the events here involved, Drybrough had been a successful investor in downtown Louisville real estate and, with his wife, also operated a successful mercantile collection agency. To implement acquisition of various holdings, he borrowed heavily from banks and insurance companies. Thus in 1940, 1945 and 1946, years of relevance here, Drybrough borrowed, on the security of his real estate holdings, the sums of $200,000.00, $200,000.00 and $500,000.00, respectively, from the National Life and Accident Insurance Company (National Life). These borrowings were generally used to pay off or consolidate balances of existing mortgages or to acquire additional parcels of real estate.

On April 3, 1953, Drybrough borrowed $700,000.00 from National Life, secured by a mortgage on several parcels of real estate. Of such monies, $357,185.16 was used to pay off his 1946 loan from National Life and some other debts and expenses. The balance, $342,814.84, was deposited in Drybrough's commercial Account with the Liberty National Bank & Trust Co. of Louisville. In May, following, Drybrough withdrew from this account $203,602.00 and transferred such sum to an account styled "Public Garage, M.S. Drybrough, owner," allegedly as partial payment of principal and the accrued interest due upon a note of $260,000.00 which he had, on January 1, 1952, given to his wife to evidence an indebtedness to her. Although the Public Garage account into which this sum was deposited was in Marion's name, Drybrough had power to draw checks on it. It may be assumed that it was he who subsequently proceeded to buy, in Marion's name, $200,000 of tax exempt securities, paying for them out of the Public Garage account funds.

In 1957 Drybrough still owed $600,000 on the 1953 loan from National Life. At that time he desired to incorporate certain of his real estate holdings and have the resulting companies take over the payment of the 1953 mortgage balance. ...

... Accordingly, ... he transferred to four newly organized corporations, ... four parcels of real estate subject to the 1953 mortgage; each of the corporations agreed to pay an assigned share of that mortgage. Drybrough received all of the issued shares of stock of the respective corporations, and shortly thereafter made a gift of 40% of such shares to his son, F.W. Drybrough, Jr.

On March 15, 1957, Drybrough borrowed the sum of $150,000 from the Liberty Bank of Louisville, mortgaging a property known as 620 South Fifth Street. This property was once a part of the security for the 1953 loan, but had been released therefrom in 1956. Relevant to this property, Drybrough had, in 1956, included in a letter to National Life the observation that, "620 South Fifth and the Mexican Village property are both clear and I am eager to mortgage them to the limit before combining these two properties in a corporation." The proceeds of this $150,000 loan were deposited in Drybrough's commercial account at the Liberty Bank. Drybrough

testified that he had an original intention to use this money to acquire some additional property, but the specific proceeds were not so employed; they were disbursed by Drybrough primarily to purchase tax exempt securities. He did, however, use other of his funds to purchase two parcels of property costing over $150,000. After putting the $150,000 mortgage on the 620 South Fifth Street property, he conveyed, by gift, an undivided 40% interest in the fee thereof to his son. Thereafter on June 28, 1957, the father and son transferred this property to a new corporation, 620 South Fifth Street, Inc., in exchange for 60% and 40%, respectively, of that company's issued shares. The corporation took title to the property subject to the $150,000 mortgage and assumed and agreed to pay its then balance of $149,000.

A total of five corporations were thus created in 1957, four of them assuming the balance unpaid on the 1953 mortgage, and the fifth assuming the 1957 mortgage. ...

On their joint tax return for 1957, Drybrough and Marion reported $223,806.12 as long term capital gain arising from the transfers of the properties to, and the assumption of liability by, the newly created controlled corporations. That sum represented the total amount by which the mortgage debt assumed by the transferee corporations exceeded Drybrough's basis in the respective assets transferred; such amount would be taxable under § 357(c)(1), and the taxpayer's return assumed that the gain on the transfers was not otherwise taxable by virtue of the provisions of 357(a) ... The Commissioner, however, assessed a deficiency, claiming that § 357(b) [footnote omitted] controlled, on his assertion that Drybrough had failed to prove that his principal purpose in arranging these transactions was not that of tax avoidance and was not for a bona fide business purpose and, therefore, the assumption of the liabilities should be treated as money received on the exchange. A deficiency of $170,306.89 was assessed for the year 1957.

The Commissioner also disallowed Drybrough's deduction of the interest paid on $200,000.00 of the $700,000.00 borrowed in 1953, on the claim that this sum was used to purchase tax exempt securities. Section 265(2) [now § 265(a)(2)] forbids such deduction. [footnote omitted]. A deficiency arising from the disallowance of these interest deductions was accordingly assessed.

The Tax Court sustained the Commissioner's determinations in the above respects. We reverse the Tax Court's holding that the assumption of a total of $600,000.00 of the 1953 borrowing by the four corporations organized on June 1, 1957, was taxable in full. We affirm its holding as to the assumption of the $149,000 mortgage by 620 South Fifth Street, Inc. (the 1957 borrowing); and we affirm the disallowance of the interest paid on $200,000 of the 1957 mortgage of $700,000.

1) 1957 corporate assumptions of 1953 mortgage debt.

Until the Supreme Court's 1938 decision in *U.S. v. Hendler*, 303 U.S. 564 (1938), taxpayers and the Treasury Department had assumed that no taxable event occurred when a taxpayer transferred encumbered assets to a controlled corporation which assumed the obligations of the encumbrance. Such an assumption was not considered as "other property or money" as those terms were used in [§ 351] ... The simplest form of such a tax free exchange was the changing of

a business enterprise from a proprietorship to the corporate form. Even though the assets transferred had acquired a market value in excess of their cost, or base, and consequently the stock shares received by the transferor were worth the enhanced value of the transferred assets, still no taxable gain was then realized. Such gain, however, did not escape taxation because upon subsequent sale or other transfer, the stock shares carried the same basis as the original assets that had been transferred. The *Hendler* decision, however, held that the amount of such an assumed obligation was equivalent to "other property or money" and required that the gain be immediately recognized by the transferor. Continued application of this rule forebode serious consequences to the federal treasury as well as to taxpayers, and Congress was quick to provide amelioration by enactment of the predecessor to 357. [citation omitted]. Section [357] was adopted as the needed remedy, providing that in an otherwise tax-free exchange if "as part of the consideration another party (the transferee) to the exchange assumes a liability of the taxpayer (the transferor) or acquires from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as 'other property or money' received by the taxpayer * * *."

To guard against abuse of the privilege granted, Congress attached an exception which now as part of 357 provides in subsection (b) ... that if in making the exchange, the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid federal income tax "on the exchange," or if not such purpose, was not a bona fide business purpose, then the assumption or acquisition should in the total amount thereof be considered "as money received by the taxpayer on the exchange." This section also provides that in determining the principal purpose of the taxpayer there should be taken "into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made." Notwithstanding this broad contextual area to be considered, we emphasize that the purpose to avoid income tax is precisely narrowed to a purpose "with respect to the assumption" and to a purpose to avoid income tax "on the exchange."

We read this language as excluding from identification as a purpose to avoid tax on the exchange, the original and unrelated motivation for borrowing the money which created the assumed obligation. In this case, Drybrough in 1953 borrowed $700,000; substantially one-half of this sum was used to pay off existing mortgage indebtedness and expenses connected with the borrowing, and the other half was deposited in Drybrough's bank account. Of this latter amount, Drybrough used $203,602 to pay accrued interest and principal on a note allegedly owing to his wife; he also paid some $90,493.00 to his collection agency and $5,000 to his wife to reimburse advances which had admittedly been made to him to purchase further real estate. We may accept the Tax Court's unclear assertion that the note to Drybrough's wife was a sham, and that of the money allegedly paid thereon, $200,000 had been in truth borrowed and used to purchase tax exempt securities. We cannot find or infer, however, that the purposes thus served revealed as a matter of fact or law a purpose to avoid income tax "on the exchange" made four years later when in 1957 Drybrough's business as an investor in real estate was converted from a proprietorship to corporate enterprises. Assuming an intent by Drybrough to save or avoid income tax by the 1953 purchase of tax exempt securities, such purpose cannot be said to be a part of "the principal purpose of the taxpayer (Drybrough) with respect to the assumption" of the balance of the 1953 loan by the corporations which came into existence in 1957.

It is clear that the Tax Court was of the view that under the facts of this case a purpose to avoid income tax "on the exchange" could be found by inquiry into the reasons for, and the use of the proceeds of, the 1953 borrowing. Its opinion extensively details facts relevant to this subject and ... observes: "We believe that it is relevant to the 1957 assumption of Drybrough's liabilities by the newly formed corporations to consider the nature of the liability assumed." [citation omitted]. Under the statute's language, it was proper to consider "the nature of the liability assumed" but under the facts of this case we do not consider that the use that Drybrough made of the 1953 borrowing was of controlling importance here. With some intervening language, the above quoted excerpt was followed by emphasis on the fact that by having the corporations assume the debt owed by him, he reduced his exposure to personal liability. "Thus, although Drybrough stood as security for the corporate indebtedness, he would not, as a practical matter, have been called upon to satisfy the liabilities, except in the most unusual circumstances." [citation omitted].

Such is true, but is no more than the result in all tax free exchanges where a wholly owned corporation is successor to the assets and liabilities of a proprietorship.

With reference to the inquiry into the use made by Drybrough of the proceeds of the 1953 borrowing, the language of the Ninth Circuit in *Easson v. C.I.R.*, 294 F.2d 653, 659 (CA 9 1961) is pertinent:

> The test suggested by the Commissioner looks to the origin of the encumbrance and to the use of the proceeds derived from it. Section [357], however, says nothing about the origin of the encumbrance. It says only that if a corporation "acquires from the taxpayer property subject to a liability such * * * acquisition shall not be considered as" boot, unless the taxpayer's principal purpose regarding the acquisition is tax avoidance or not a bona fide business purpose. Nor is there anything in the section which deals with the reasons for the encumbrance, or the manner in which the mortgage proceeds are used.

There was evidence also that part of the motivation for incorporating was to allow the long term retirement of Drybrough's debt out of the corporate earnings; such earnings, when applied to the 1953 loan, would likely be taxed at a lower rate than they would be in Drybrough's own tax bracket. Drybrough's expectation, however, that income tax would be saved by the lower rate that would apply to the corporate earnings as contrasted with his own income tax exposure was not, in our view, a purpose to avoid "Federal income tax on the exchange." We read such to be the holding of the Tax Court's own decision in *W.H.B. Simpson v. Comm'r*, 43 T.C. 900 (1965) announced some months after the decision before us. In *Simpson*, the Tax Court said,

> We do not believe it (357(b)) was intended to require recognition of gain on bona fide transactions designed to rearrange one's business affairs in such a manner as to minimize taxes in the future, consistent with existing provisions of the law. 43 T.C. at 916.
>
> ... [I]n using the term "liability" in §§ 351 and 357, Congress was concerned with the

> assumption by the transferee of an existing liability of the transferor, not with the manner in which it might subsequently be discharged. It is clear that as the corporation paid off the liabilities the value of petitioner's stock in Collins-Crain would be increased and petitioner's gain would be recognized upon disposition of that stock. But under the law the gain on that stock will be deferred until it is disposed of, and under § 351 recognition of the gain resulting from the appreciation in value of the securities transferred will also be postponed until the Collins-Crain stock is disposed of. We find no permanent escape from taxation of any of this gain. We do not believe the fact alone that the income which will be used to pay off the liabilities to which the securities were subjected will be taxed at a lower rate falls within the tax-avoidance purpose contemplated in § 357(b). 43 T.C. at 917.

In *Simpson*, *supra*, the Tax Court held the exchange there made to be tax free and in seeking to distinguish *Simpson* from its earlier decision of the *Drybrough* case which we now review, said: "Unlike in the *Drybrough* case, and in *W.H. Weaver*, 32 T.C. 411 (1959) *aff'd sub nom*. *Bryan v. Comm'r*, 281 F.2d 238 (CA4 1960), petitioner did not incur the liabilities to which the transferred securities were subject immediately prior to the transfer and solely in anticipation thereof." 43 T.C. at 917.

But in the case before us the 1953 mortgage liability of Drybrough had not been incurred "immediately prior to the transfer" and was not incurred "solely in anticipation" of the forming of the corporations in 1957.

While the Tax Court did not with desirable clarity give separate treatment to the tax avoidance purpose as distinguished from the need of Drybrough to prove also that his 1957 incorporations had "a bona fide business purpose," we read its decision as a finding that Drybrough did not have "a bona fide business purpose" for the 1957 incorporations. This was error. Drybrough testified that included in his motivation for not paying off the $600,000 mortgage before incorporating was his desire to keep as liquid as possible to be able to make further investments; to put the involved real estate investments in a more manageable condition for estate planning; and generally to obtain the advantages that attend operating in the corporate form. The Tax Court's suggestion that Drybrough by liquidating other assets could have obtained sufficient cash to pay off the $600,000 so that the corporate assets would be debt free is not impressive. Such conduct, would be unwise and certainly not good practice. For many years Drybrough was engaged in the business of buying and holding downtown Louisville real estate, and operating those holdings in various enterprises such as parking lots. The conversion of these businesses into corporate form was clearly to serve a bona fide business purpose. What was done here was substantially the "garden variety" of tax free exchange – the shift of a proprietorship to a wholly owned corporation which assumed the debts of the proprietorship.

... We are of the view ... that the Tax Court's use of impermissible tests in assessing Drybrough's purposes amounted to an error of law subject to our review, and we reverse its determination that the assumption in question is controlled by 357(b) of the 1954 Internal Revenue Code.

2) Corporate assumption of the 1957 $150,000.00 mortgage.

We sustain the Tax Court's holding that the assumption by 620 South Fifth Street, Inc., on June 28, 1957, of the $150,000 mortgage which had been placed on the assets transferred to that corporation on March 15, 1957, had not been proven by Drybrough to be otherwise than for a principal purpose "to avoid income tax on the exchange." In late 1956 Drybrough had, with reference to the 620 South Fifth Street property, written to National Life "620 South Fifth and Mexican Village property are both clear and I am eager to mortgage them to the limit before combining these two properties in a corporation." This was a clear expression that the creation of the debt was directly in anticipation of, and connected in purpose with, having the corporation assume the debt, thus releasing to Drybrough $150,000 of the value of this asset without a present realization of taxable gain on the exchange. The borrowed money was used to purchase tax-exempt securities; it was not used to carry on the purposes of the business enterprise of 620 South Fifth Street, Inc., nor in furtherance of Drybrough's general real estate investments, justifying also a finding that the assumption could not be accommodated under the "bona fide business purpose" requirement of 357(b)(1)(B). We think it was a fair inference too that Drybrough's conduct was equivalent to a pro tanto liquidation of the involved asset, and that his purpose "with respect to the assumption" disclosed a plan to avoid realization of gain on this liquidation by selling the mortgaged asset to his controlled corporation. It was permissible for the Tax Court to find in this transaction "a purpose to avoid Federal income tax on the exchange," 357(b)(1)(A).

We find no fault with the legal standard employed to reach the above conclusions; and cannot hold as clearly erroneous the factual findings involved.

3) Disallowance of interest deduction on $200,000.00.

Out of the proceeds of the 1953 borrowing of $700,000 Drybrough put $203,602.00 into the Public Garage account, allegedly as payment on indebtedness to his wife, and then used $200,000 of that payment to purchase tax exempt bonds in the name of his wife Marion. Applying [§ 265(a)(2)], the Commissioner disallowed the deduction taken for interest paid on the $700,000 mortgage to the extent of $200,000.00. The Tax Court found support for the Commissioner on two grounds: first, that Drybrough's claim that he owed his wife the $203,602.00 put into her account was a sham; and second, that even if the $200,000 used to purchase the tax exempt securities was Marion Drybrough's money, the 1953 borrowing of $700,000 was, to the extent of $200,000, "indebtedness incurred or continued to purchase or carry obligations * * * the interest on which is wholly exempt from the taxes imposed by this title," and therefore under [265(a)(2)], the interest thereon was not deductible.

[The court upheld these determinations.]

Accordingly, we reverse the Tax Court's decision to the extent that it finds that the assumption of the balance of the 1953 loan by the four corporations organized on June 1, 1957, should 'be considered as money received by the taxpayer (Drybrough) on the exchange,' 357(b) IRC 1954;

in all other respects, relevant to this petition for review, the Tax Court's decision is affirmed.

Questions and comments:

1. Why would taxpayer be "eager to mortgage [his personally owned properties] to the limit before combining these two properties in a corporation?"

2. Notice: In 1957, taxpayers paid income tax on $223,806.12 of capital gain. The liabilities that the corporations assumed exceeded their bases in the properties. Taxpayers' gained access to loan proceeds by paying only the capital gains rate of tax rather than the ordinary income rate of tax.

3. How important is the timing of encumbering property with a loan liability and later transferring it to the corporation? The court quoted from *W.H.B. Simpson v. Comm'r*, 43 T.C. 900 (1965). What did the court say about the timing of these events in *Simpson*?

4. The penalty for running afoul of § 357(b) is severe. If prior to incorporating, Drybrough had borrowed $1M, gave a mortgage on property that he owned, transferred the property subject to the mortgage to a newly formed corporation, and used $1000 to pay off a personal credit card bill, *all* of the liability that the corporation assumed would be boot – not merely $1000.

Do the CALI exercise: Corporate Taxation: Formation: Formation of C Corporations: The Effect of Liabilities.

C. Non-Qualified Preferred Stock

Until 1989, a § 351(a) nonrecognition transfer required that the transferor receive from the corporation "stock or securities." This permitted tax-free incorporation even though transferors who received securities that were not stock might essentially be creditors of the corporation rather than owners of equity interests. From the view of the corporation, the issuance of debt securities made the transaction appear to be more like the purchase of the transferor's assets than the issuance of stock in exchange for the transferor's property. In the Omnibus Budget Reconciliation Act of 1989,[21] Congress deleted the phrase "or securities" from § 351(a) so that exchanges qualified for § 351 treatment only if the transferor of property received *stock* in return.

Exchanges could still qualify for § 351 non-recognition treatment when shareholders received "preferred stock," i.e., stock whose rights the corporation must satisfy before it satisfies the rights accorded its common stock. On the other hand, the rights of preferred shareholders to

[21] Pub. L. No. 101-239, § 7203(a), 103 Stat. 2333, 2334.

dividends may be limited to a specified amount, no matter how profitable the corporation is.[22] Holders of preferred stock may also have no voting rights. In some respects, the interest of a holder of preferred stock resembles that of a creditor. Payments to holders of preferred stock *are* dividends in that the corporation must have earnings and profits from which to pay dividends. (*See* chapter 3, *infra*.) Thus, the rights of holders of preferred stock are inferior to those of creditors – whose right to payment does not depend on the corporation being profitable at all. The fact that payment of dividends to preferred shareholders must occur before payment of dividends to common shareholders places the holder of preferred stock between creditors and shareholders who hold common stock – whether voting or nonvoting.

The characteristics of preferred stock are partly like those of debt instruments and partly like those of equity instruments. In the Taxpayer Relief Act of 1997,[23] Congress created "non-qualified preferred stock," which is preferred stock that has one of four characteristics of debt:

> 1. the holder of the stock may require the issuer or a related person to redeem or purchase the stock within 20 years of its issuance if no contingency makes the likelihood of such redemption or repurchase remote; OR
>
> 2. the issuer of the stock or a related person is required to redeem or purchase the stock within 20 years of its issuance if no contingency makes the likelihood of such redemption or repurchase remote; OR
>
> 3. the issuer of the stock or a related person has the right to redeem or purchase the stock if on the issue date, it is more likely than not that the right will be exercised and no contingency makes the likelihood of such redemption or repurchase within 20 years remote; OR
>
> 4. the dividend rate varies at least in part directly or indirectly with reference to some index.

§ 351(g)(2)(A and B).[24]

If as part of a § 351 exchange, a transferor receives non-qualified preferred stock, the transferor is to treat it as boot. § 351(g)(1). However, the non-qualified preferred stock *is* a class of stock of

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[22] For purposes of § 351, preferred stock is not only "limited and preferred," but also "does not participate in corporate growth to any significant extent." § 351(g)(3)(A). To avoid the label of "preferred stock," the likelihood of participating in earnings and corporate growth to a significant extent must be "real and meaningful." *Id.*

[23] Pub. L. No. 105-34, § 1014, 111 Stat. 919.

[24] There are exceptions if a right may be exercised "only upon" the death, disability, or mental incompetency of the holder of the stock. § 351(g)(2)(C)(i)(I). This exception does not apply if any class of stock of the corporation is readily traded on an established securities market. § 351(g)(2)(C)(ii)(I). In the case of a transfer in exchange for services, there is an exception if the right may be exercised "only upon" the holder's separation from service. § 351(g)(2)(C)(i)(II).

which transferors of property must own 80% for the exchange to qualify for § 351 nonrecognition treatment. S. REP. NO. 105-174 at 178 ("the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under section 351(a), unless and until regulations may provide otherwise").

Do the CALI exercise: Corporate Taxation: Formation: Formation of C Corporations: Basic Issues.

D. Boot and the Installment Method

Review IRC § 453.

A shareholder/transferor may receive an installment obligation of the corporation as part of a § 351 exchange. A regulation proposed in 1984[25] allows taxpayer to report income from the receipt of boot on the installment method. Prop. Reg. § 1.453-1(f)(3)(ii) (first sentence). The proposed regulation assigns basis both to the stock (not taxable) that the shareholder/transferor received in the exchange and to the installment obligation (taxable).

The basis of the *stock* is tentatively the lesser of

- the basis that the shareholder/transferor had in the property transferred plus cash transferred to the corporation

  or

- the stock's fmv plus transferred liabilities to the extent not subject to tax under § 357(c)(1).

If the first of these is less, shareholder transferor's basis in his stock is the basis of the property plus any cash transferred less liabilities assumed by the corporation. If the second of these is less, shareholder/transferor's

Limitations on Reporting Boot Income on the Installment Method:

- The taxpayer/shareholder may elect not to have the installment method apply. § 453(d)(1).
- The taxpayer/shareholder may not use the installment method in a sale of depreciable property to a "related person" unless taxpayer can establish to the satisfaction of the Secretary that tax avoidance was not one of the "principal purposes" of the transfer, § 453(g)(1 and 2). A "related person" in this context includes a corporation of which the shareholder/transferor owns directly or indirectly more than 50% of the value of the corporation's outstanding stock. §§ 1239(b)(1); 1239(c)(1)(A). The constructive ownership rules of § 267(c)(1, 2, 4, and 5) apply.
- Taxpayer/shareholder may not use the installment method to the extent that any of the gain would be depreciation recapture. § 453(i)(1).
- Taxpayer/shareholder may not use the installment method in a dealer disposition or the transfer of inventory of personal property. § 453(b)(2).

[25] *Installment Obligations Received in Certain Nonrecognition Exchanges*, 49 Fed. Reg. 18866 (proposed May 3, 1984).

basis in his stock is the fmv of the stock received less liabilities assumed by the corporation.

The basis of the installment obligation is the "excess basis" – i.e., amount by which the second of these is greater than the first. The "selling price" and "contract price" are determined without regard to the liabilities that the corporation assumes (other than those subject to tax under § 357(c)(1)). Prop. Reg. § 1.453-1(f)(3)(ii) (fourth sentence). Any other boot that the shareholder/transferor receives is added to the contract and selling price for purposes of § 453 calculations and treated as a payment in the year of the exchange. Prop. Reg. § 1.453-1(f)(3)(ii) (second sentence).

The shareholder/transferor's determination of his basis in the stock he receives is made as if the installment method did not apply. Prop. Reg. § 1.453-1(f)(3)(ii) (sixth sentence). The corporation applies the rule of § 362(a) by taking a transferred basis in the property that shareholder transferred, increasing it by any amount the shareholder recognizes on the exchange, and increasing it as and when shareholder pays tax on installment note payments that he received as boot. Prop. Reg. § 1.453-1(f)(3)(ii) (eighth sentence).

•Example 6: Nestor and Ophelia form the Plover Corporation. Nestor contributes $10,000 to Plover Corporation in exchange for 1000 shares of voting common stock, fmv = $10/share. Ophelia contributes Blackacre, ab = $14,000, fmv = $18,000 in exchange for 1000 shares of voting common stock of Plover Corporation and an 8-year note for $8000, to be paid in 8 annual installments of $1000 plus adequate interest on the declining balance. Nestor takes a $10,000 basis in his shares. The note that Ophelia received is boot. In assigning basis to her stock and the installment note, the effect of Prop. Reg. § 1.453-1(f)(3)(ii) is to transfer her basis in Blackacre plus cash that she transfers to the corporation to her stock to the extent of the stock's fmv. That is $10,000. The "excess basis" is $4000, and that is Ophelia's basis in the note. The contract price and the selling price is $8000. 50% of each payment will be taxable income. The corporation will take a $14,000 basis in Blackacre and increase it by the amount of income as and when Ophelia recognizes it. Eventually, Plover Corporation's basis in Blackacre will be $18,000.

•Notice: Ophelia paid tax on boot or gain, whichever is less. The boot was $8000. Her gain on the exchange was $4000. She pays tax (eventually) on $4000. Her basis in the note after all payments have been made is $8000, the fmv of the note. *See* § 351(a)(2).

•Example 6A: Same facts except that Ophelia's basis in Blackacre is $8000. She will transfer all her basis in Blackacre (plus the cash she transferred to the corporation, i.e., $0) to the stock since it is less than the stock's fmv. Her basis in the note will be $0, so all of every installment payment will be taxable income. Plover Corporation's basis in Blackacre will be $8000, and Plover Corporation may increase the basis as and when Ophelia recognizes income from the installment note. Eventually, Plover Corporation's basis in Blackacre will be $16,000.

•Notice: Ophelia paid tax on boot or gain, whichever is less. The boot was $8000. Her gain on the exchange was $10,000. She pays tax (eventually) on $8000. Her

basis in the note after all payments have been made is $8000, the fmv of the note. *See* § 351(a)(2). Her basis in the stock of $8000 leaves her with $2000 of built-in gain.

•Example 6B: Same facts except that Ophelia's basis in Blackacre is $6000 and Blackacre is encumbered by a $5000 mortgage. Plover Corporation exchanges 1000 shares of voting common stock, assumes the $5000 mortgage, and gives Ophelia a note for $3000, payable in 8 annual installments of $375 plus adequate interest. The fmv of the stock that Ophelia received plus the liability that Plover Corporation assumed ($6000 + $5000) is more than her basis in Blackacre ($6000) plus cash transferred ($0), so all the basis is assigned to her stock. Section 358(a)(1)(A) and § 358(d)(1) require that she reduce her basis in her stock by the liability assumed, i.e., by $5000. Ophelia's basis in her stock is $1000. Her basis in the note is $0 so all the payments she receives will be taxed. Plover Corporation has a $6000 basis in Blackacre that will increase as and when Ophelia recognizes payments on the note. Eventually, Plover Corporation's basis in Blackacre will be $9000.

•Notice: Ophelia paid tax on boot or gain, whichever is less. The boot was $3000. Her gain on the exchange was $12,000. She pays tax (eventually) on $3000. Her basis in the note after all payments have been made is $3000, the fmv of the note. *See* § 351(a)(2). Her basis in the stock of $1000 leaves her with $9000 of built-in gain.

V. Basis to Shareholders and to Corporation

A. Duplicating Built-in Gains and Losses by Corporations and Shareholders[26]

When a shareholder transfers appreciated or depreciated property to a corporation in a § 351 transaction, the basis rules apparently require (permit) two different taxpayers to recognize the transferor's built-in gains or losses in the property he transfers that exist on the date of the transfer. When the corporation sells the property, it will recognize gain or loss; when the shareholder sells shares, he will recognize gain or loss. A transferor might take advantage of the loss rules by "stuffing" the corporation with multiple loss properties. Section 362(e)(2) addresses this problem.[27]

Section 362(e)(2) provides that when one transferor transfers multiple properties whose aggregate adjusted bases is less than their aggregate fair market values in a § 351 exchange or as

[26] This section reviews the substance of the chapter's introduction.

[27] § 336(d)(1 and 2) address the same problem in the context of a liquidation of a non-subsidiary corporation.

a contribution to capital, the transferee's aggregate adjusted bases may not exceed the aggregate fair market values of the properties. § 362(e)(2)(A). If the aggregate adjusted bases of properties transferred exceed their aggregate adjusted bases, the transferee must reduce the adjusted bases of properties in proportion to their total built-in losses. § 362(e)(2)(B). Such an adjustment will eliminate aggregate loss. This was illustrated in Example 5, *supra*. The transferor and transferee may both elect for the transferor to reduce the basis of his stock so that its basis does not exceed its fmv. § 362(e)(2)(C). The transferee would then take the transferor's adjusted bases in the properties. § 362(e)(2)(C)(i)(I).

Problem:
A, B, and C form Corporation X in a § 351 transaction. Each received 1000 shares of voting common stock. A contributed $1000 cash. B contributed equipment, adjusted basis = $1500, fmv = $1000. C contributed four pieces of property: Blackacre, adjusted basis = 140, fmv = $100; Brownacre, adjusted basis = $700, fmv = $500; Greenacre, adjusted basis = $100, fmv = $250; and Whiteacre, adjusted basis = $230, fmv = $150.

A. What is Corporation X's adjusted basis in the equipment, Blackacre, Brownacre, Greenacre, and Whiteacre?
B. What is A's basis in his stock?
C. What is B's basis in his stock?
D. What is C's basis in his stock?
E. What would your answers to A, B, C, and D be if an election is made under § 362(e)(2)(C)? Who must make the election?

B. Including Shareholder's Promissory Note as Adding to Stock Basis

Suppose that a transferor of property – perhaps the only shareholder of a corporation – contemplates transferring property that in the aggregate is subject to more liabilities than his adjusted bases in the properties in exchange for stock. The exchange will qualify for § 351 nonrecognition treatment. However, shareholder knows that he will owe income tax on the excess of liabilities that the corporation assumes over his aggregate bases under § 357(c)(1)? Can the transferor escape this "trap" by writing his own promissory note to the corporation? If the corporation is very closely held – again, suppose that the transferor is the only shareholder – is there something disingenuous about escaping tax on income simply by making a promise that no one will enforce?

Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998)

KOZINSKI, Circuit Judge

We must unscramble a Rubik's Cube of corporate tax law to determine the basis of a note contributed by a taxpayer to his wholly-owned corporation.

The Transaction

The taxpayer, Donald Peracchi [footnote omitted], needed to contribute additional capital to his closely-held corporation (NAC) to comply with Nevada's minimum premium-to-asset ratio for insurance companies. Peracchi contributed two parcels of real estate. The parcels were encumbered with liabilities which together exceeded Peracchi's total basis in the properties by more than half a million dollars. As we discuss in detail below, under § 357(c), contributing property with liabilities in excess of basis can trigger immediate recognition of gain in the amount of the excess. In an effort to avoid this, Peracchi also executed a promissory note, promising to pay NAC $1,060,000 over a term of ten years at 11% interest. Peracchi maintains that the note has a basis equal to its face amount, thereby making his total basis in the property contributed greater than the total liabilities. If this is so, he will have extracted himself from the quicksand of § 357(c) and owe no immediate tax on the transfer of property to NAC. The IRS, though, maintains that (1) the note is not genuine indebtedness and should be treated as an unenforceable gift; and (2) even if the note is genuine, it does not increase Peracchi's basis in the property contributed.

The parties are not splitting hairs: Peracchi claims the basis of the note is $1,060,000, its face value, while the IRS argues that the note has a basis of zero. If Peracchi is right, he pays no immediate tax on the half a million dollars by which the debts on the land he contributed exceed his basis in the land; if the IRS is right, the note becomes irrelevant for tax purposes and Peracchi must recognize an immediate gain on the half million. The fact that the IRS and Peracchi are so far apart suggests they are looking at the transaction through different colored lenses. To figure out whether Peracchi's lens is rose-tinted or clear, it is useful to take a guided tour of §§ 351 and 357 and the tax law principles undergirding them.

Into the Lobster Pot: Section 351[28]

The Code tries to make organizing a corporation pain-free from a tax point of view. A capital contribution is, in tax lingo, a "nonrecognition" event: A shareholder can generally contribute capital without recognizing gain on the exchange.[29] It's merely a change in the form of

[28] "Decisions to embrace the corporate form of organization should be carefully considered, since a corporation is like a lobster pot: easy to enter, difficult to live in, and painful to get out of." BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.01[3] (6th ed. 1997) (footnotes omitted) (hereinafter BITTKER & EUSTICE).

[29] The income tax often operates as a tax on transactions. Regardless of when a taxpayer realizes accretions to his economic wealth, income is usually recognized when a measuring event occurs, such as receipt of a paycheck or the "sale or exchange" of property. But the Code exempts certain sales and exchanges from recognition, such as when a sale is involuntary, or merely a change in the form of ownership, or otherwise warrants nonrecognition. See generally BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 44.1.1 (2d ed. 1990) ("The Code contains numerous nonrecognition provisions covering a wide range of transactions that have little in common except that they have elicited a legislative judgment that the taxpayer's realized gain or loss should not be taxed or deducted when the exchange or other event occurs."). Congress has not deemed the

ownership, like moving a billfold from one pocket to another. *See* I.R.C. § 351. [footnote omitted]. So long as the shareholders contributing the property remain in control [footnote omitted] of the corporation after the exchange, § 351 applies: It doesn't matter if the capital contribution occurs at the creation of the corporation or if – as here – the company is already up and running. The baseline is that Peracchi may contribute property to NAC without recognizing gain on the exchange.

Gain Deferral: Section 358(a)

Peracchi contributed capital to NAC in the form of real property and a promissory note. Corporations may be funded with any kind of asset, such as equipment, real estate, intellectual property, contracts, leaseholds, securities or letters of credit. The tax consequences can get a little complicated because a shareholder's basis in the property contributed often differs from its fair market value. The general rule is that an asset's basis is equal to its "cost." *See* I.R.C. § 1012. But when a shareholder like Peracchi contributes property to a corporation in a nonrecognition transaction, a cost basis does not preserve the unrecognized gain. Rather than take a basis equal to the fair market value of the property exchanged, the shareholder must substitute the basis of that property for what would otherwise be the cost basis of the stock. [footnote omitted]. This preserves the gain for recognition at a later day: The gain is built into the shareholder's new basis in the stock, and he will recognize income when he disposes of the stock.

The fact that gain is deferred rather than extinguished doesn't diminish the importance of questions relating to basis and the timing of recognition. In tax, as in comedy, timing matters. Most taxpayers would much prefer to pay tax on contributed property years later – when they sell their stock – rather than when they contribute the property.[30] Thus what Peracchi is seeking here is gain deferral: He wants the gain to be recognized only when he disposes of some or all of his stock.

Continuity of Investment: Boot and Section 351(b)

Continuity of investment is the cornerstone of nonrecognition under § 351. Nonrecognition assumes that a capital contribution amounts to nothing more than a nominal change in the form of ownership; in substance the shareholder's investment in the property continues. But a capital contribution can sometimes allow a shareholder to partially terminate his investment in an asset or group of assets. For example, when a shareholder receives cash or other property in addition to stock, receipt of that property reflects a partial termination of investment in the business. The shareholder may invest that money in a wholly unrelated business, or spend it just like any other form of personal income. To the extent a § 351 transaction resembles an ordinary sale, the nonrecognition rationale falls apart.

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organization of a corporation an appropriate event for recognition of income.

[30] Of course, should the taxpayers be lucky enough to die before disposing of the stock, their heirs would take a stepped-up basis in the stock equal to its fair market value as of the date of death. *See* I.R.C. § 1014.

Thus the central exception to nonrecognition for § 351 transactions comes into play when the taxpayer receives "boot" – money or property other than stock in the corporation – in exchange for the property contributed. *See* I.R.C. § 351(b). Boot is recognized as taxable income because it represents a partial cashing out. It's as if the taxpayer contributed part of the property to the corporation in exchange for stock, and sold part of the property for cash. Only the part exchanged for stock represents a continuation of investment; the part sold for cash is properly recognized as yielding income, just as if the taxpayer had sold the property to a third party.

Peracchi did not receive boot in return for the property he contributed. But that doesn't end the inquiry: We must consider whether Peracchi has cashed out in some other way which would warrant treating part of the transaction as taxable boot.

Assumption of Liabilities: Section 357(a)

The property Peracchi contributed to NAC was encumbered by liabilities. Contribution of leveraged property makes things trickier from a tax perspective. When a shareholder contributes property encumbered by debt, the corporation usually assumes the debt. And the Code normally treats discharging a liability the same as receiving money: The taxpayer improves his economic position by the same amount either way. *See* I.R.C. § 61(a)(12). NAC's assumption of the liabilities attached to Peracchi's property therefore could theoretically be viewed as the receipt of money, which would be taxable boot. *See U.S. v. Hendler*, 303 U.S. 564 (1938).

The Code takes a different tack. Requiring shareholders like Peracchi to recognize gain any time a corporation assumes a liability in connection with a capital contribution would greatly diminish the nonrecognition benefit § 351 is meant to confer. Section 357(a) thus takes a lenient view of the assumption of liability: A shareholder engaging in a § 351 transaction does not have to treat the assumption of liability as boot, even if the corporation assumes his obligation to pay. *See* I.R.C. § 357(a).

This nonrecognition does not mean that the potential gain disappears. Once again, the basis provisions kick in to reflect the transfer of gain from the shareholder to the corporation: The shareholder's substitute basis in the stock received is decreased by the amount of the liability assumed by the corporation. *See* I.R.C. § 358(d), (a). The adjustment preserves the gain for recognition when the shareholder sells his stock in the company, since his taxable gain will be the difference between the (new lower) basis and the sale price of the stock.

Sasquatch and The Negative Basis Problem: Section 357(c)

Highly leveraged property presents a peculiar problem in the § 351 context. Suppose a shareholder organizes a corporation and contributes as its only asset a building with a basis of $50, a fair market value of $100, and mortgage debt of $90. Section 351 says that the shareholder does not recognize any gain on the transaction. Under § 358, the shareholder takes a substitute basis of $50 in the stock, then adjusts it downward under § 357 by $90 to reflect the assumption

of liability. This leaves him with a basis of minus $40. A negative basis properly preserves the gain built into the property: If the shareholder turns around and sells the stock the next day for $10 (the difference between the fair market value and the debt), he would face $50 in gain, the same amount as if he sold the property without first encasing it in a corporate shell.[31]

But skeptics say that negative basis, like Bigfoot, doesn't exist. *Compare Easson v. Commissioner*, 33 T.C. 963, 970 (1960) (there's no such thing as a negative basis) *with Easson v. Commissioner*, 294 F.2d 653, 657-58 (9th Cir. 1961) (yes, Virginia, there is a negative basis). Basis normally operates as a cost recovery system: Depreciation deductions reduce basis, and when basis hits zero, the property cannot be depreciated farther. At a more basic level, it seems incongruous to attribute a negative value to a figure that normally represents one's investment in an asset. Some commentators nevertheless argue that when basis operates merely to measure potential gain (as it does here), allowing negative basis may be perfectly appropriate and consistent with the tax policy underlying nonrecognition transactions. *See, e.g.*, J. Clifton Fleming, Jr., *The Highly Avoidable Section 357(c): A Case Study in Traps for the Unwary and Some Positive Thoughts About Negative Basis*, 16 J. CORP. L. 1, 27-30 (1990). Whatever the merits of this debate, it seems that § 357(c) was enacted to eliminate the possibility of negative basis. *See* George Cooper, *Negative Basis*, 75 HARV. L. REV. 1352, 1360 (1962).

Section 357(c) prevents negative basis by forcing a shareholder to recognize gain to the extent liabilities exceed basis. [footnote omitted]. Thus, if a shareholder contributes a building with a basis of $50 and liabilities of $90, he does not receive stock with a basis of minus $40. Instead, he takes a basis of zero and must recognize a $40 gain.

Peracchi sought to contribute two parcels of real property to NAC in a § 351 transaction. Standing alone the contribution would have run afoul of § 357(c): The property he wanted to contribute had liabilities in excess of basis, and Peracchi would have had to recognize gain to the extent of the excess, or $566,807.[32]

The Grift: Boosting Basis with a Promissory Note

Peracchi tried to dig himself out of this tax hole by contributing a personal note with a face amount of $1,060,000 along with the real property. Peracchi maintains that the note has a basis in his hands equal to its face value. If he's right, we must add the basis of the note to the basis of the real property. Taken together, the aggregate basis in the property contributed would exceed

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[31] If the taxpayer sells the property outright, his amount realized includes the full amount of the mortgage debt, *see* Crane v. Commissioner, 331 U.S. 1 (1947), and the result is as follows: Amount realized ($10 cash + $90 debt) − $50 Basis = $50 gain.

[32] Peracchi remained personally liable on the debts encumbering the property transferred to NAC. NAC took the property subject to the debts, however, which is enough to trigger gain under the plain language of § 357(c). *See* Owen v. Commissioner, 881 F.2d 832, 835-36 (9th Cir. 1989).

....

the aggregate liabilities ...

Under Peracchi's theory, then, the aggregate liabilities no longer exceed the aggregate basis, and § 357(c) no longer triggers any gain. The government argues, however, that the note has a zero basis. If so, the note would not affect the tax consequences of the transaction, and Peracchi's $566,807 in gain would be taxable immediately. [footnote omitted].

Are Promises Truly Free?

Which brings us (phew!) to the issue before us: Does Peracchi's note have a basis in Peracchi's hands for purposes of § 357(c)?[33] The language of the Code gives us little to work with. The logical place to start is with the definition of basis. Section 1012 provides that "[t]he basis of property shall be the cost of such property...." But "cost" is nowhere defined. What does it cost Peracchi to write the note and contribute it to his corporation? The IRS argues tersely that the "taxpayers in the instant case incurred no cost in issuing their own note to NAC, so their basis in the note was zero." *See Alderman v. Commissioner*, 55 T.C. 662, 665 (1971); Rev. Rul. 68-629, 1968-2 C.B. 154, 155.[34] Building on this premise, the IRS makes Peracchi out to be a grifter: He holds an unenforceable promise to pay himself money, since the corporation will not collect on it unless he says so.

It's true that all Peracchi did was make out a promise to pay on a piece of paper, mark it in the corporate minutes and enter it on the corporate books. It is also true that nothing will cause the corporation to enforce the note against Peracchi so long as Peracchi remains in control. But the IRS ignores the possibility that NAC may go bankrupt, an event that would suddenly make the note highly significant. Peracchi and NAC are separated by the corporate form, and this gossamer curtain makes a difference in the shell game of C Corp organization and reorganization. Contributing the note puts a million dollar nut within the corporate shell, exposing Peracchi to the cruel nutcracker of corporate creditors in the event NAC goes bankrupt. And it does so to the tune of $1,060,000, the full face amount of the note. Without the note, no matter how deeply the corporation went into debt, creditors could not reach Peracchi's personal assets. With the note on the books, however, creditors can reach into Peracchi's pocket by enforcing the note as an unliquidated asset of the corporation.

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[33] Peracchi owned all the voting stock of NAC both before and after the exchange, so the control requirement of § 351 is satisfied. Peracchi received no boot (such as cash or securities) which would qualify as "money or other property" and trigger recognition under 351(b) alone. Peracchi did not receive any stock in return for the property contributed, so it could be argued that the exchange was not "solely in exchange for stock" as required by § 351. Courts have consistently recognized, however, that issuing stock in this situation would be a meaningless gesture: Because Peracchi is the sole shareholder of NAC, issuing additional stock would not affect his economic position relative to other shareholders. *See, e.g.*, Jackson v. Commissioner, 708 F.2d 1402, 1405 (9th Cir. 1983).

[34] We would face a different case had the Treasury promulgated a regulation interpreting § 357(c). A revenue ruling is entitled to some deference as the stated litigating position of the agency which enforces the tax code, but not nearly as much as a regulation. Ruling 68-629 offers no rationale, let alone a reasonable one, for its holding that it costs a taxpayer nothing to write a promissory note, and thus deserves little weight.

The key to solving this puzzle, then, is to ask whether bankruptcy is significant enough a contingency to confer substantial economic effect on this transaction. If the risk of bankruptcy is important enough to be recognized, Peracchi should get basis in the note: He will have increased his exposure to the risks of the business – and thus his economic investment in NAC – by $1,060,000. If bankruptcy is so remote that there is no realistic possibility it will ever occur, we can ignore the potential economic effect of the note as speculative and treat it as merely an unenforceable promise to contribute capital in the future.

When the question is posed this way, the answer is clear. Peracchi's obligation on the note was not conditioned on NAC's remaining solvent. It represents a new and substantial increase in Peracchi's investment in the corporation.[35] The Code seems to recognize that economic exposure of the shareholder is the ultimate measuring rod of a shareholder's investment. *Cf.* § 465 (at-risk rules for partnership investments). Peracchi therefore is entitled to a step-up in basis to the extent he will be subjected to economic loss if the underlying investment turns unprofitable. [citations omitted].

The economics of the transaction also support Peracchi's view of the matter. The transaction here does not differ substantively from others that would certainly give Peracchi a boost in basis. For example, Peracchi could have borrowed $1 million from a bank and contributed the cash to NAC along with the properties. Because cash has a basis equal to face value, Peracchi would not have faced any § 357(c) gain. NAC could then have purchased the note from the bank for $1 million which, assuming the bank's original assessment of Peracchi's creditworthiness was accurate, would be the fair market value of the note. In the end the corporation would hold a million dollar note from Peracchi – just like it does now – and Peracchi would face no § 357(c) gain.[36] The only economic difference between the transaction just described and the transaction

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[35] We confine our holding to a case such as this where the note is contributed to an operating business which is subject to a non-trivial risk of bankruptcy or receivership. NAC is not, for example, a shell corporation or a passive investment company; Peracchi got into this mess in the first place because NAC was in financial trouble and needed more assets to meet Nevada's minimum premium-to-asset ratio for insurance companies.

[36] In a similar vein, Peracchi could have first swapped promissory notes with a third party. Assuming the bona fides of each note, Peracchi would take a cost basis in the third party note equal to the face value of the note he gave up. Peracchi could then contribute the third party note to NAC, and (thanks to the added basis) avoid any § 357(c) gain. NAC could then close the circle by giving the third party note back to the third party in exchange for Peracchi's note, leaving Peracchi and NAC in exactly the same position they occupy now.

The IRS might attack these maneuvers as step transactions, but that would beg the question: Does the contribution of a shareholder's note to his wholly-owned corporation have any real economic effect, or is it just so much window dressing? If the debt has real economic effect, it shouldn't matter how the shareholder structures the transaction.

The only substantive difference between the avoidance techniques just discussed – swapping notes or borrowing from a third party – and the case here is the valuation role implicitly performed by the third party. A bank would not give Peracchi the face value of the note unless his credit warranted it, while we have no assurance that NAC wouldn't do so. We readily acknowledge that our assumptions fall apart if the shareholder isn't creditworthy. Here, the government has stipulated that Peracchi's net worth far exceeds the value of the note, so creditworthiness is not at issue. But we limit our holding to cases where the note is in fact worth approximately its face value.

Peracchi actually engaged in is the additional costs that would accompany getting a loan from the bank. Peracchi incurs a "cost" of $1 million when he promises to pay the note to the bank; the cost is not diminished here by the fact that the transferor controls the initial transferee. The experts seem to agree: "Section 357(c) can be avoided by a transfer of enough cash to eliminate any excess of liabilities over basis; and since a note given by a solvent obligor in purchasing property is routinely treated as the equivalent of cash in determining the basis of the property, it seems reasonable to give it the same treatment in determining the basis of the property transferred in a § 351 exchange." BITTKER & EUSTICE ¶ 3.06[4][b].

We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. *See Commissioner v. Tufts*, 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here Peracchi will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily creates problems in the partnership context, where the entity's loss deductions (resulting from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. [citation omitted]. We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.[37]

We find further support for Peracchi's view by looking at the alternative: What would happen if the note had a zero basis? The IRS points out that the basis of the note in the hands of the corporation is the same as it was in the hands of the taxpayer. Accordingly, if the note has a zero basis for Peracchi, so too for NAC. *See* § 362(a).[38] But what happens if NAC – perhaps facing the threat of an involuntary petition for bankruptcy – turns around and sells Peracchi's note to a third party for its fair market value? According to the IRS's theory, NAC would take a carryover basis of zero in the note and would have to recognize $1,060,000 in phantom gain on the

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[37] Our holding therefore does not extend to the partnership or S Corp context.

[38] *But see* Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989). In *Lessinger*, the Second Circuit analyzed a similar transaction. It agreed with the IRS's (faulty) premise that the note had a zero basis in the taxpayer's hands. But then, brushing aside the language of § 362(a), the court concluded that the note had a basis in the corporation's hands equal to its face value. The court held that this was enough to dispel any § 357(c) gain to the taxpayer, proving that two wrongs sometimes do add up to a right.

We agree with the IRS that *Lessinger's* approach is untenable. Section 357(c) contemplates measuring basis of the property contributed in the hands of the taxpayer, not the corporation. Section 357 appears in the midst of the Code sections dealing with the effect of capital contributions on the shareholder; §§ 361 et seq., on the other hand, deal with the effect on a corporation, and § 362 defines the basis of property contributed in the hands of the corporation. Because we hold that the note has a face value basis to the shareholder for purposes of § 357(c), however, we reach the same result as *Lessinger*.

subsequent exchange, even though the note did not appreciate in value one bit. That can't be the right result.

Accordingly, we hold that Peracchi has a basis of $1,060,000 in the note he wrote to NAC. The aggregate basis exceeds the liabilities of the properties transferred to NAC under § 351, and Peracchi need not recognize any § 357(c) gain.

Genuine Indebtedness or Sham?

The Tax Court never reached the issue of Peracchi's basis in the note. Instead, it ruled for the Commissioner on the ground that the note is not genuine indebtedness. The court emphasized two facts which it believed supported the view that the note is a sham: (1) NAC's decision whether to collect on the note is wholly controlled by Peracchi and (2) Peracchi missed the first two years of payments, yet NAC did not accelerate the debt. These facts certainly do suggest that Peracchi paid imperfect attention to his obligations under the note, as frequently happens when debtor and creditor are under common control. But we believe the proper way to approach the genuine indebtedness question is to look at the face of the note and consider whether Peracchi's legal obligation is illusory. And it is not. First, the note's bona fides are adequate: The IRS has stipulated that Peracchi is creditworthy and likely to have the funds to pay the note; the note bears a market rate of interest commensurate with his creditworthiness; the note has a fixed term. Second, the IRS does not argue that the value of the note is anything other than its face value; nothing in the record suggests NAC couldn't borrow against the note to raise cash. Lastly, the note is fully transferable and enforceable by third parties, such as hostile creditors. On the basis of these facts we hold that the note is an ordinary, negotiable, recourse obligation which must be treated as genuine debt for tax purposes. [citation omitted].

The IRS argues that the note is nevertheless a sham because it was executed simply to avoid tax. Tax avoidance is a valid concern in this context; § 357(a) does provide the opportunity for a bailout transaction of sorts. For example, a taxpayer with an unencumbered building he wants to sell could take out a nonrecourse mortgage, pocket the proceeds, and contribute the property to a newly organized corporation. Although the gain would be preserved for later recognition, the taxpayer would have partially cashed out his economic investment in the property: By taking out a nonrecourse mortgage, the economic risk of loss would be transferred to the lender. [footnote omitted]. Section 357(b) addresses this sort of bailout by requiring the recognition of gain if the transaction lacks a business purpose. [footnote omitted]

Peracchi's capital contribution is not a bailout. Peracchi contributed the buildings to NAC because the company needed additional capital, and the contribution of the note was part of that transaction. The IRS, in fact, stipulated that the contribution had a business purpose. Bailout potential exists regardless of whether the taxpayer contributes a note along with the property; § 357(b), not 357(c), is the sword the Service must use to attack bailout transactions.

Is the note a gift?

The IRS also offers a more refined version of the sham transaction argument: The note was really a gift to NAC because Peracchi did not receive any consideration from the exchange. The IRS admits that the tax deferral resulting from avoiding § 357(c) gain is a benefit to Peracchi. It argues, nonetheless, that this is not enough to make the bargain enforceable because it works no detriment to NAC. This argument would classify all contributions of capital as gifts. A corporation never gives up anything explicitly when it accepts a capital contribution. Instead, the corporation implicitly promises to put the money to good use, and its directors and officers undertake the fiduciary duty to generate the highest possible return on the investment. The contribution of the note was no more a gift than the contribution of $1 million in cash to the corporation would have been; it does not reflect the "detached and disinterested generosity" which characterizes a gift for purposes of federal income taxation. *See Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960).

The Aftermath

We take a final look at the result to make sure we have not placed our stamp of approval on some sort of exotic tax shelter. We hold that Peracchi is entitled to a step up in basis for the face value of the note, just as if he contributed cash to the corporation. *See* § 358. If Peracchi does in fact keep his promise and pay off the note with after tax dollars, the tax result is perfectly appropriate: NAC receives cash, and the increase in basis Peracchi took for the original contribution is justified. Peracchi has less potential gain, but he paid for it in real dollars.

But what if, as the IRS fears, NAC never does enforce the note? If NAC goes bankrupt, the note will be an asset of the estate enforceable for the benefit of creditors, and Peracchi will eventually be forced to pay in after tax dollars. Peracchi will undoubtedly have worked the deferral mechanism of § 351 to his advantage, but this is not inappropriate where the taxpayer is on the hook in both form and substance for enough cash to offset the excess of liabilities over basis. By increasing his personal exposure to the creditors of NAC, Peracchi has increased his economic investment in the corporation, and a corresponding increase in basis is wholly justified.[39]

Conclusion

We hold that Peracchi has a basis of $1,060,000 in the note, its face value. As such, the aggregate liabilities of the property contributed to NAC do not exceed its basis, and Peracchi does not recognize any § 357(c) gain. The decision of the Tax Court is REVERSED. The case is remanded for entry of judgment in favor of Peracchi.

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[39] What happens if NAC does not go bankrupt, but merely writes off the note instead? Peracchi would then face discharge of indebtedness income to the tune of $1,060,000. This would put Peracchi in a worse position than when he started, since discharge of indebtedness is normally treated as ordinary income. Peracchi, having increased his basis in the stock of the corporation by $1,060,000 would receive a capital loss (or less capital gain) to that extent. But the shift in character of the income will normally work to the disadvantage of a taxpayer in Peracchi's situation.

FERNANDEZ, Circuit Judge, Dissenting:
Is there something that a taxpayer, who has borrowed hundreds of thousands of dollars more than his basis in his property, can do to avoid taxation when he transfers the property? Yes, says Peracchi, because by using a very clever argument he can avoid the strictures of § 357(c). He need only make a promise to pay by giving a "good," though unsecured, promissory note to his corporation when he transfers the property to it. That is true even though the property remains subject to the encumbrances. How can that be? Well, by preparing a promissory note the taxpayer simply creates basis without cost to himself. *But see* 26 U.S.C. § 1012; Rev. Rul. 68-629, 1968-2 C.B. 154; *Alderman v. Commissioner*, 55 T.C. 662, 665 (1971). Thus he can extract a large part of the value of the property, pocket the funds, use them, divest himself of the property, and pay the tax another day, if ever at all.

But as with all magical solutions, the taxpayer must know the proper incantations and make the correct movements. He cannot just transfer the property to the corporation and promise, or be obligated, to pay off the encumbrances. That would not change the fact that the property was still subject to those encumbrances. According to Peracchi, the thaumaturgy that will save him from taxes proceeds in two simple steps. He must first prepare a ritualistic writing – an unsecured promissory note in an amount equal to or more than the excess of the encumbrances over the basis. He must then give that writing to his corporation. That is all.[40] But is not that just a "promise to pay," which "does not represent the paying out or reduction of assets?" *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 583 (1977). Never mind, he says. He has nonetheless increased the total basis of the property transferred and avoided the tax. I understand the temptation to embrace that argument, but I see no real support for it in the law.

Peracchi says a lot about economic realities. I see nothing real about that maneuver. I see, rather, a bit of sortilege that would have made Merlin envious. The taxpayer has created something – basis – out of nothing.

Thus, I respectfully dissent.

Questions and comments:

1. Judge Kozinski's opinion nicely summarizes all of the tax law that this chapter considers. Take note.

2. Be aware that the issue may not be resolved. As the court in *Peracchi* noted, *Alderman v. Commissioner*, 55 T.C. 662, 665 (1971) held on indistinguishable facts directly contrary to what the CA9 held. In relevant part, the Tax Court said: "The Aldermans incurred no cost in making the note, so its basis to them was zero. The basis to the corporation was the same as in the hands of the transferor, i.e., zero."

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[40] What is even better, he need not even make payments on the note until after the IRS catches up with him. I, by the way, am dubious about the proposition that the Tax Court clearly erred when it held that the note was not even a genuine indebtedness.

3. The court in *Peracchi* noted the increase in the taxpayer's personal liability exposure. But a shareholder guarantee of the liabilities that the corporation assumes does not prevent the application of § 357(c). *See Seggerman Farms, Inc. v. Commissioner*, 308 F.3d 803, 807 (CA7 2002) ("'personal guaranties of corporate debt are not the same as incurring indebtedness to the corporation because a guaranty is merely a promise to pay in the future if certain events should occur. [Their] guaranties do not constitute economic outlays'" (*quoting* Tax Court)); *Owen v. Commissioner*, 881 F.2d 832, 835-36 (CA9), *cert. denied*, 493 U.S. 1070 (1990) (shareholders remained liable on liabilities they guaranteed that the corporation assumed; § 357(c) applicable).

4. What is a bailout? How did the court use the term? Did taxpayer Drybrough successfully execute one or more bailouts?

5. Thaumaturgy: capability of a magician or a saint to work magic or miracles.

VI. Section 351 and Assignment of Income

Recall the essence of *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930): Income is taxed to the one who earned it. This has implications when the right to income is reflected in accounts receivable. Suppose that the account receivable is earned by a cash method taxpayer who transfers it to a corporation which is then taxed to the corporation upon collection. If we treat an account receivable as "property," we seem to facilitate avoidance of the "assignment of income" principle. [This problem does not arise when the taxpayer who transfers an account receivable to a corporation is an accrual method taxpayer. Why not?]

Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974)

ALDISERT, Circuit Judge

In this appeal by a corporate taxpayer from a grant of summary judgment in favor of the government in a claim for refund, we are called upon to decide the proper treatment of accounts receivable and of inventory transferred from a cash basis partnership to a corporation organized to continue the business under 26 U.S.C. § 351(a). [footnote omitted]. This appeal illustrates the conflict between the statutory purpose of § 351, postponement of recognition of gain or loss, and the assignment of income and tax benefit doctrines.

....

From 1942 until February 28, 1957, a partnership comprised of Loy T. Hempt, J.F. Hempt, Max C. Hempt, and the George L. Hempt Estate was engaged in the business of quarrying and selling stone, sand, gravel, and slag; manufacturing and selling ready-mix concrete and bituminous

material; constructing roads, highways, and streets, primarily for the Pennsylvania Department of Highways and various political subdivisions of Pennsylvania, and constructing driveways, parking lots, street and water lines, and related accessories.

The partnership maintained its books and records, and filed its partnership income tax returns, on the basis of a calendar year and on the cash method of accounting, so that no income was reported until actually received in cash. Accordingly, in computing its income for federal income tax purposes, the partnership did not take uncollected receivables into income, ... although ... accounts receivable reflecting sales already made ... existed to a substantial extent at the end of each of the partnership's taxable years. ...

On March 1, 1957, the partnership business and most of its assets were transferred to the taxpayer solely in exchange for taxpayer's capital stock, the 12,000 shares of which were issued to the four members of the partnership. These shares constituted 100% of the issued and outstanding shares of the taxpayer. This transfer was made pursuant to § 351(a) ... Thereafter, the taxpayer conducted the business formerly conducted by the partnership.

Among the assets transferred by the partnership to the taxpayer for taxpayer's shares of stock were accounts receivable in the amount of $662,824.40 arising from performance of construction projects, sales of stone, sand, gravel, etc., and rental of equipment prior to March 1, 1957. ...

Commencing with its initial fiscal year (which) ended February 28, 1958, taxpayer maintained its books and filed its corporation income tax returns on the cash method of accounting and, accordingly, did not take uncollected receivables into income ... In its taxable years ending in 1958, 1959, and 1960, taxpayer collected the respective amounts of $533,247.87, $125,326.71 and $4,249.72 of the accounts receivable in the aggregate amount of $662,824.40 that transferred to it, and included those amounts in income in computing its income for its federal income tax returns for those years, respectively.

As a result of an examination extending over a period of years, ... income was adjusted ... to accrue unreported sales (accounts receivable) made during the taxable years in question ... The result was an increase in taxpayer's taxable income for the fiscal year ended February 28, 1958, in the amount of $258,201.35.

The Commissioner of Internal Revenue assessed deficiencies in taxpayer's federal income taxes for its fiscal years ending February 28, 1958, and 1959. The taxpayer paid the amounts in 1964, and in 1965 filed claims for refund of $621,218.09 plus assessed interest. [footnote omitted]. The claims were disallowed in full on September 24, 1968, and the district court action was timely instituted on December 5, 1968.

The district court held: ... taxpayer was properly taxable upon collections made with respect to accounts receivable which were transferred to it in conjunction with the § 351 incorporation ...

I.

Taxpayer argues here, as it did in the district court, that because the term 'property' as used in § 351 does not embrace accounts receivable, the Commissioner lacked statutory authority to apply principles associated with § 351. The district court properly rejected the legal interpretation urged by the taxpayer.

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We fail to perceive any special reason why a restrictive meaning should be applied to accounts receivables so as to exclude them from the general meaning of 'property.' Receivables possess the usual capabilities and attributes associated with jurisprudential concepts of property law. They may be identified, valued, and transferred. Moreover, their role in an ongoing business must be viewed in the context of § 351 application. The presence of accounts receivable is a normal, rather than an exceptional accoutrement of the type of business included by Congress in the transfer to a corporate form. They are 'commonly thought of in the commercial world as a positive business asset.' *E.I. Du Pont de Nemours and Co. v. United States*, 471 F.2d 1211, 1218 (Ct. Cl. 1973). As aptly put by the district court: 'There is a compelling reason to construe 'property' to include ... (accounts receivable): a new corporation needs working capital, and accounts receivable can be an important source of liquidity.' [footnote omitted]. ...

The taxpayer next makes a strenuous argument that 'the government is seeking to tax the wrong person.' [footnote omitted]. It contends that the assignment of income doctrine as developed by the Supreme Court applies to a § 351 transfer of accounts receivable so that the transferor, not the transferee-corporation, bears the corresponding tax liability. It argues that the assignment of income doctrine dictates that where the right to receive income is transferred to another person in a transaction not giving rise to tax at the time of transfer, the transferor is taxed on the income when it is collected by the transferee; that the only requirement for its application is a transfer of a right to receive ordinary income; and that since the transferred accounts receivable are a present right to future income, the sole requirement for the application of the doctrine is squarely met. In essence, this is a contention that the nonrecognition provision of § 351 is in conflict with the assignment of income doctrine and that § 351 should be subordinated thereto. Taxpayer relies on the seminal case of *Lucas v. Earl*, 280 U.S. 538 (1929), and its progeny [footnote omitted] for support of its proposition that the application of the doctrine is mandated whenever one transfers a right to receive ordinary income.

On its part, the government concedes that a taxpayer may sell for value a claim to income otherwise his own and he will be taxable upon the proceeds of the sale. Such was the case in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958), in which the taxpayer-corporation assigned its oil payment right to its president in consideration for his cancellation of a $600,000 loan. Viewing the oil payment right as a right to receive future income, the Court applied the reasoning of the assignment of income doctrine, normally applicable to a gratuitous assignment, and held that the consideration received by the taxpayer-corporation was taxable as ordinary income since it essentially was a substitute for that which would otherwise be received at a future time as ordinary income.

Turning to the facts of this case, we note that here there was the transfer of accounts receivable from the partnership to the corporation pursuant to § 351. We view these accounts receivable as a present right to receive future income. In consideration of the transfer of this right, the members of the partnership received stock – a valid consideration. The consideration, therefore, was essentially a substitute for that which would otherwise be received at a future time as ordinary income to the cash basis partnership. Consequently, the holding in *Lake* would normally apply, and income would ordinarily be realized, and thereby taxable, by the cash basis partnership-transferor at the time of receipt of the stock.

But the terms and purpose of § 351 have to be reckoned with. By its explicit terms § 351 expresses the Congressional intent that transfers of property for stock or securities will not result in recognition. It therefore becomes apparent that this case vividly illustrates how § 351 sometimes comes into conflict with another provision of the Internal Revenue Code or a judicial doctrine, [footnote omitted] and requires a determination of which of two conflicting doctrines will control.

As we must, when we try to reconcile conflicting doctrines in the revenue law, we endeavor to ascertain a controlling Congressional mandate. Section 351 has been described as a deliberate attempt by Congress to facilitate the incorporation of ongoing businesses and to eliminate any technical constructions which are economically unsound.[41]

Appellant-taxpayer seems to recognize this and argues that application of the *Lake* rationale when accounts receivable are transferred would not create any undue hardship to an incorporating taxpayer. 'All a taxpayer (transferor) need do is withhold the earned income items and collect them, transferring the net proceeds to the Corporation. Indeed ... the transferor should retain both accounts receivable and accounts payable to avoid income recognition at the time of transfer and to have sufficient funds with which to pay accounts payable. Where the taxpayer (transferor) is on the cash method of accounting (as here), the deduction of the accounts payable would be applied against the income generated by the accounts receivable.'

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[41] 'One of the purposes of this section (§ 202(c)(3) of the Revenue Act of 1921) was to permit changes in form (of business) involving no change in substance to be made without undue restriction from the tax laws.' Note, *Section 351 of the Internal Revenue Code and 'Mid-Stream' Incorporations*, 38 U. CIN. L. REV. 96 (1969). *See* S. REP. NO. 275, 67th Cong. 1st Sess. 11 (1921). This intention is also reflected in the report of the House of Representatives accompanying 351 of the Internal Revenue Code of 1954. H.R. REP. NO. 1337, 83rd Cong. 2d Sess. 34 (1954).

The House Ways and Means Committee recommended that nonrecognition treatment be granted for incorporation, reorganization and certain other types of exchanges to 'permit business to go forward with the readjustments required by existing conditions' and to prevent 'taxpayers from taking colorable losses in wash sales and other fictitious exchanges.' *See* H.R. REP. 350, 67th Cong., 1st Sess. 10 (1921). The Senate Finance Committee added that such treatment would eliminate 'many technical constructions which are economically unsound.' *See* S. REP. 275, 67th Cong., 1st Sess. 12 (1921). Weiss, *Problems in the Tax-Free Incorporation of a Business*, 41 IND. L.J. 666 n.4 (1966).

While we cannot fault the general principle 'that income be taxed to him who earns it,' to adopt taxpayer's argument would be to hamper the incorporation of ongoing businesses; additionally it would impose technical constructions which are economically and practically unsound. None of the cases cited by taxpayer, including *Lake* itself, persuades us otherwise. In *Lake* the Court was required to decide whether the proceeds from the assignment of the oil payment right were taxable as ordinary income or as long term capital gains. Observing that the provision for long term capital gains treatment 'has always been narrowly construed so as to protect the revenue against artful devices,' 356 U.S. at 265, the Court predicated its holding upon an emphatic distinction between a conversion of a capital investment – 'income-producing property' – and an assignment of income per se. 'The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future.' *Ibid*., at 266. A § 351 issue was not presented in *Lake*. Therefore the case does not control in weighing the conflict between the general rule of assignment of income and the Congressional purpose of nonrecognition upon the incorporation of an ongoing business. [footnote omitted].

We are persuaded that, on balance, the teachings of *Lake* must give way in this case to the broad Congressional interest in facilitating the incorporation of ongoing businesses. As desirable as it is to afford symmetry in revenue law, we do not intend to promulgate a hard and fast rule. [footnote omitted]. We believe that the problems posed by the clash of conflicting internal revenue doctrines are more properly determined by the circumstances of each case. Here we are influenced by the fact that the subject of the assignment was accounts receivable for partnership's goods and services sold in the regular course of business, that the change of business form from partnership to corporation had a basic business purpose and was not designed for the purpose of deliberate tax avoidance, and by the conviction that the totality of circumstances here presented fit the mold of the Congressional intent to give nonrecognition to a transfer of a total business from a non-corporate to a corporate form.

But this too must be said. Even though § 351(a) immunizes the transferor from immediate tax consequences, § 358 [footnote omitted] retains for the transferors a potential income tax liability to be realized and recognized upon a subsequent sale or exchange of the stock certificates received. As to the transferee-corporation, the tax basis of the receivables will be governed by § 362. [footnote omitted]

....

... [T]he judgment of the district court will be affirmed.

Questions and comments:

1. Why was the corporate taxpayer in the relatively unusual position of arguing that what shareholders had transferred to the corporation was *not* property within § 351?

2. The case is authority for the position that accounts receivable are "property" for purposes of

§ 351(a). This creates problems for individuals and partnerships who keep their accounts on the cash method if they incorporate and become accrual method taxpayers. As in *Hempt*, a big tax bill may come due at once.

3. The case involves accounts receivable transferred to an accrual method corporation. What problems arise if the transfer is to a cash method corporation?

Rev. Rul. 80-198, 1980-2 C.B. 113

ISSUE
Under the circumstances described below, do the nonrecognition of gain or loss provisions of § 351 of the Internal Revenue Code apply to a transfer of the operating assets of an ongoing sole proprietorship (including unrealized accounts receivable) to a corporation in exchange solely for the common stock of a corporation and the assumption by the corporation of the proprietorship liabilities?

FACTS
Individual A conducted a medical practice as a sole proprietorship, the income of which was reported on the cash receipts and disbursements method of accounting. A transferred to a newly organized corporation all of the operating assets of the sole proprietorship in exchange for all of the stock of the corporation, plus the assumption by the corporation of all of the liabilities of the sole proprietorship. The purpose of the incorporation was to provide a form of business organization that would be more conducive to the planned expansion of the medical services to be made available by the business enterprise.

The assets transferred were tangible assets having a fair market value of $40,000 and an adjusted basis of $30,000 and unrealized trade accounts receivable having a face amount of $20,000 and an adjusted basis of zero. The liabilities assumed by the corporation consisted of trade accounts payable in the face amount of $10,000. The liabilities assumed by the corporation also included a mortgage liability, related to the tangible property transferred, of $10,000. A had neither accumulated the accounts receivable nor prepaid any of the liabilities of the sole proprietorship in a manner inconsistent with normal business practices in anticipation of the incorporation. If A had paid the trade accounts payable liabilities, the amounts paid would have been deductible by A as ordinary and necessary business expenses under § 162 of the Code. The new corporation continued to utilize the cash receipts and disbursements method of accounting.

LAW AND ANALYSIS
The applicable section of the Code is § 351(a), which provides that no gain or loss shall be recognized when property is transferred to a corporation in exchange solely for stock and securities and the transferor is in control (as defined by § 368(c)) of the transferee corporation immediately after the transfer.

In *Hempt Bros., Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974), *cert. denied*, 419 U.S. 826

(1974), the United States Court of Appeals for the Third Circuit held, as the Internal Revenue Service contended, that a cash basis transferee corporation was taxable on the monies it collected on accounts receivable that had been transferred to it by a cash basis partnership in a transaction described in § 351(a) of the Code. The corporate taxpayer contended that it was not obligated to include the accounts receivable in income; rather the transferor partnership should have been taxed on the stock the partnership received under the assignment of income doctrine which is predicated on the well established general principle that income be taxed to the party that earned it.

The court in *Hempt Bros*. solved the conflict between the assignment of income doctrine and the statutory nonrecognition provisions of § 351 of the Code by reasoning that if the cash basis transferor were taxed on the transfer of the accounts receivable, the specific congressional intent reflected in § 351(a) that the incorporation of an ongoing business should be facilitated by making the incorporation tax free would be frustrated.

The facts of the instant case are similar to those in *Hempt Bros*. in that there was a valid business purpose for the transfer of the accounts receivable along with all of the assets and liabilities of A's proprietorship to a corporate transferee that would continue the business of the transferor. Further, A had neither accumulated the accounts receivable nor prepaid any of the account payable liabilities of the sole proprietorship in anticipation of the incorporation, which is an indication that, under the facts and circumstances of the case, the transaction was not designed for tax avoidance.

HOLDING

The transfer by A of the operating assets of the sole proprietorship (including unrealized accounts receivable) to the corporation in exchange solely for the common stock of the corporation and the assumption by the corporation of the proprietorship liabilities (including accounts payable) is an exchange within the meaning of § 351(a) of the Code. Therefore, no gain or loss is recognized to A with respect to the property transferred, including the accounts receivable. ... [T]he assumption of the trade accounts payable that would give rise to a deduction if A had paid them is not, pursuant to § 357(c)(3), considered as an assumption of a liability for purposes of §§ 357(c)(1) and 358(d). [citation omitted]. The corporation, under the cash receipts and disbursements method of accounting, will report in its income the account receivables as collected, and will be allowed deductions under § 162 for the payments it makes to satisfy the assumed trade accounts payable when such payments are made.

A's basis in the stock received in the exchange of property for stock under § 358(a)(1) of the Code is $20,000 which is calculated by decreasing A's $30,000 basis in the assets transferred by the $10,000 mortgage liability under §§ 358(a)(1)(A)(ii) and 358(d)(1). No adjustment to such basis is made under § 358(a)(1)(A)(ii) because of the assumption by the corporation of the $10,000 in accounts payable inasmuch as the general rule of § 358(d)(1), which requires the basis in the stock received to be decreased by the liabilities assumed, does not apply by reason of § 358(d)(2), which provides that § 358(d)(1) does not apply to the amount of any liabilities defined in § 357(c)(3) such as accounts payable that would have been deductible by A as

ordinary and necessary business expenses under § 162 in the taxable year paid if A had paid these liabilities prior to the exchange. [citation omitted].

LIMITATIONS

Section 351 of the Code does not apply to a transfer of accounts receivable which constitute an assignment of an income right in a case such as *Brown v. Commissioner*, 40 B.T.A. 565 (1939), *aff'd* 115 F.2d 337 (2d Cir. 1940). In *Brown*, an attorney transferred to a corporation, in which he was the sole owner, a one-half interest in a claim for legal services performed by the attorney and his law partner. In exchange, the attorney received additional stock of the corporation. The claim represented the corporation's only asset. Subsequent to the receipt by the corporation of the proceeds of the claim, the attorney gave all of the stock of the corporation to his wife. The United States Court of Appeals for the Second Circuit found that the transfer of the claim for the fee to the corporation had no purpose other than to avoid taxes and held that in such a case the intervention of the corporation would not prevent the attorney from being liable for the tax on the income which resulted from services under the assignment of income rule of *Lucas v. Earl*, 281 U.S. 111 (1930). Accordingly, in a case of a transfer to a controlled corporation of an account receivable in respect of services rendered where there is a tax avoidance purpose for the transaction (which might be evidenced by the corporation not conducting an ongoing business), the Internal Revenue Service will continue to apply assignment of income principles and require that the transferor of such a receivable include it in income when received by the transferee corporation.

Likewise, it may be appropriate in certain situations to allocate income, deductions, credits, or allowances to the transferor or transferee under § 482 of the Code when the timing of the incorporation improperly separates income from related expenses. *See Rooney v. United States*, 305 F.2d 681 (9th Cir. 1962), where a farming operation was incorporated in a transaction described in § 351(a) after the expenses of the crop had been incurred but before the crop had been sold and income realized. The transferor's tax return contained all of the expenses but none of the farming income to which the expenses related. The United States Court of Appeals for the Ninth Circuit held that the expenses could be allocated under § 482 to the corporation, to be matched with the income to which the expenses related. Similar adjustments may be appropriate where some assets, liabilities, or both, are retained by the transferor and such retention results in the income of the transferor, transferee, or both, not being clearly reflected.

Questions and comments:

1. In the Revenue Act of 1978, P.L. 95-600, § 365(a), (c), Congress added § 357(c)(3) to the Code. Prior to that time, the courts had adopted contradictory positions that were gravitating towards the rule of § 357(c)(3). *Compare Raich v. Comm'r*, 46 T.C. 604, 608-11 (1966) (accounts receivable have zero basis; tax on excess of liabilities over basis even though accounts receivable exceed accounts payable) *with Focht v. Comm'r,* 68 T.C. 223, 229 (1977), *acq.* 1980-2 C.B. 1 ("An obligation should not be treated as a liability, under sections 357 and 358, to the extent that its payment would have been deductible if made by the transferor;" "the term 'liability' [§§ 357(a) and 357(c)] should be limited to those obligations that, if transferred, cause

gain recognition”).

2. Articulate the rules of *Brown* and *Rooney*.

3. Read § 482.

VII. Contributions to Capital

How should the Code treat a contribution to capital that does not occur in the context of a § 351 exchange?

Commissioner v. Fink, 483 U.S. 89 (1987)

Justice POWELL delivered the opinion of the Court.

The question in this case is whether a dominant shareholder who voluntarily surrenders a portion of his shares to the corporation, but retains control, may immediately deduct from taxable income his basis in the surrendered shares.

I

Respondents Peter and Karla Fink were the principal shareholders of Travco Corporation, a Michigan manufacturer of motor homes. Travco had one class of common stock outstanding and no preferred stock. Mr. Fink owned 52.2 percent, and Mrs. Fink 20.3 percent, of the outstanding shares.[42] Travco urgently needed new capital as a result of financial difficulties it encountered in the mid-1970's. The Finks voluntarily surrendered some of their shares to Travco in an effort to “increase the attractiveness of the corporation to outside investors.” Mr. Fink surrendered 116,146 shares in December 1976; Mrs. Fink surrendered 80,000 shares in January 1977. As a result, the Finks’ combined percentage ownership of Travco was reduced from 72.5 percent to 68.5 percent. The Finks received no consideration for the surrendered shares, and no other shareholder surrendered any stock. The effort to attract new investors was unsuccessful, and the corporation eventually was liquidated.

On their 1976 and 1977 joint federal income tax returns, the Finks claimed ordinary loss deductions totaling $389,040, the full amount of their adjusted basis in the surrendered shares. [footnote omitted]. The Commissioner of Internal Revenue disallowed the deductions. He concluded that the stock surrendered was a contribution to the corporation’s capital. Accordingly, the Commissioner determined that the surrender resulted in no immediate tax

[42] In addition, Mr. Fink’s sister owned 10 percent of the stock, his brother-in-law owned 4.1 percent, and his mother owned 2.2 percent.

consequences, and that the Finks' basis in the surrendered shares should be added to the basis of their remaining shares of Travco stock.

In an unpublished opinion, the Tax Court sustained the Commissioner's determination for the reasons stated in *Frantz v. Commissioner*, 83 T.C. 162, 174-182 (1984), *aff'd*, 784 F.2d 119 (CA2 1986), *cert.* [*denied*, 483 U.S.1019 (1987)]. In *Frantz* the Tax Court held that a stockholder's non pro rata surrender of shares to the corporation does not produce an immediate loss. The court reasoned that "[t]his conclusion ... necessarily follows from a recognition of the purpose of the transfer, that is, to bolster the financial position of [the corporation] and, hence, to protect and make more valuable [the stockholder's] retained shares." Because the purpose of the shareholder's surrender is "to decrease or avoid a loss on his overall investment," the Tax Court in *Frantz* was "unable to conclude that [he] sustained a loss at the time of the transaction." "Whether [the shareholder] would sustain a loss, and if so, the amount thereof, could only be determined when he subsequently disposed of the stock that the surrender was intended to protect and make more valuable." The Tax Court recognized that it had sustained the taxpayer's position in a series of prior cases. [footnote omitted]. But it concluded that these decisions were incorrect, in part because they "encourage[d] a conversion of eventual capital losses into immediate ordinary losses."[43]

In this case, a divided panel of the Court of Appeals for the Sixth Circuit reversed the Tax Court. 789 F.2d 427 (1986). The court concluded that the proper tax treatment of this type of stock surrender turns on the choice between "unitary" and "fragmented" views of stock ownership. Under the "fragmented view," "each share of stock is considered a separate investment," and gain or loss is computed separately on the sale or other disposition of each share. According to the "unitary view," "the 'stockholder's entire investment is viewed as a single indivisible property unit,'" and a sale or disposition of some of the stockholder's shares only produces "an ascertainable gain or loss when the stockholder has disposed of his remaining shares." The court observed that both it and the Tax Court generally had adhered to the fragmented view, and concluded that "the facts of the instant case [do not] present sufficient justification for abandoning" it. It therefore held that the Finks were entitled to deduct their basis in the surrendered shares immediately as an ordinary loss, except to the extent that the surrender had increased the value of their remaining shares. The Court of Appeals remanded the case to the Tax Court for a determination of the increase, if any, in the value of the Finks' remaining shares that was attributable to the surrender.

Judge Joiner dissented. Because the taxpayers' "sole motivation in disposing of certain shares is to benefit the other shares they hold [,] ... [v]iewing the surrender of each share as the termination of an individual investment ignores the very reason for the surrender." He concluded: "Particularly in cases such as this, where the diminution in the shareholder's corporate control and equity interest is so minute as to be illusory, the stock surrender should be

[43] The Court of Appeals for the Second Circuit affirmed the Tax Court's holding and agreed with its reasoning. Frantz v. Commissioner, 784 F.2d 119, 123-126 (1986), *cert. pending*.

regarded as a contribution to capital."

We granted certiorari to resolve a conflict among the Circuits, [footnote omitted] and now reverse.

II

A

It is settled that a shareholder's voluntary contribution to the capital of the corporation has no immediate tax consequences. 26 U.S.C. § 263; 26 CFR § 1.263(a)-2(f) (1986). Instead, the shareholder is entitled to increase the basis of his shares by the amount of his basis in the property transferred to the corporation. *See* 26 U.S.C. § 1016(a)(1). When the shareholder later disposes of his shares, his contribution is reflected as a smaller taxable gain or a larger deductible loss. This rule applies not only to transfers of cash or tangible property, but also to a shareholder's forgiveness of a debt owed to him by the corporation. 26 CFR § 1.61-12(a) (1986). Such transfers are treated as contributions to capital even if the other shareholders make proportionately smaller contributions, or no contribution at all. *See, e.g.*, *Sackstein v. Commissioner*, 14 T.C. 566, 569 (1950). The rules governing contributions to capital reflect the general principle that a shareholder may not claim an immediate loss for outlays made to benefit the corporation. *Deputy v. Du Pont*, 308 U.S. 488 (1940); *Eskimo Pie Corp. v. Commissioner*, 4 T.C. 669, 676 (1945), *aff'd*, 153 F.2d 301 (CA3 1946). We must decide whether this principle also applies to a controlling shareholder's non pro rata surrender of a portion of his shares.[44]

B

The Finks contend that they sustained an immediate loss upon surrendering some of their shares to the corporation. By parting with the shares, they gave up an ownership interest entitling them to future dividends, future capital appreciation, assets in the event of liquidation, and voting rights.[45] Therefore, the Finks contend, they are entitled to an immediate deduction. *See* 26 U.S.C. §§ 165(a) and (c)(2). In addition, the Finks argue that any non pro rata stock transaction "give[s] rise to immediate tax results." For example, a non pro rata stock dividend produces income because it increases the recipient's proportionate ownership of the corporation. *Koshland v. Helvering*, 298 U.S. 441 (1936).[46] By analogy, the Finks argue that a non pro rata surrender of shares should be recognized as an immediate loss because it reduces the surrendering

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[44] The Finks concede that a pro rata stock surrender, which by definition does not change the percentage ownership of any shareholder, is not a taxable event. *Cf.* Eisner v. Macomber, 252 U.S. 189 (1920) (pro rata stock dividend does not produce taxable income).

[45] As a practical matter, however, the Finks did not give up a great deal. Their percentage interest in the corporation declined by only 4 percent. Because the Finks retained a majority interest, this reduction in their voting power was inconsequential. Moreover, Travco, like many corporations in financial difficulties, was not paying dividends.

[46] In most cases, however, stock dividends are not recognized as income until the shares are sold. *See* 26 U.S.C. § 305.

shareholder's proportionate ownership.

Finally, the Finks contend that their stock surrenders were not contributions to the corporation's capital. They note that a typical contribution to capital, unlike a non pro rata stock surrender, has no effect on the contributing shareholder's proportionate interest in the corporation. Moreover, the Finks argue, a contribution of cash or other property increases the net worth of the corporation. For example, a shareholder's forgiveness of a debt owed to him by the corporation decreases the corporation's liabilities. In contrast, when a shareholder surrenders shares of the corporation's own stock, the corporation's net worth is unchanged. This is because the corporation cannot itself exercise the right to vote, receive dividends, or receive a share of assets in the event of liquidation. G. JOHNSON & J. GENTRY, FINNEY AND MILLER'S PRINCIPLES OF ACCOUNTING 538 (7th ed. 1974). [footnote omitted].

III

A shareholder who surrenders a portion of his shares to the corporation has parted with an asset, but that alone does not entitle him to an immediate deduction. Indeed, if the shareholder owns less than 100 percent of the corporation's shares, any non pro rata contribution to the corporation's capital will reduce the net worth of the contributing shareholder.[47] A shareholder who surrenders stock thus is similar to one who forgives or surrenders a debt owed to him by the corporation; the latter gives up interest, principal, and also potential voting power in the event of insolvency or bankruptcy. But, as stated above, such forgiveness of corporate debt is treated as a contribution to capital rather than a current deduction. The Finks' voluntary surrender of shares, like a shareholder's voluntary forgiveness of debt owed by the corporation, closely resembles an investment or contribution to capital. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 3.14, p. 3-59 (4th ed. 1979) ("If the contribution is voluntary, it does not produce gain or loss to the shareholder"). We find the similarity convincing in this case.

The fact that a stock surrender is not recorded as a contribution to capital on the corporation's balance sheet does not compel a different result. Shareholders who forgive a debt owed by the corporation or pay a corporate expense also are denied an immediate deduction, even though neither of these transactions is a contribution to capital in the accounting sense. [footnote omitted]. Nor are we persuaded by the fact that a stock surrender, unlike a typical contribution to capital, reduces the shareholder's proportionate interest in the corporation. This Court has never held that every change in a shareholder's percentage ownership has immediate tax consequences. Of course, a shareholder's receipt of property from the corporation generally is a taxable event.

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[47] For example, assume that a shareholder holding an 80 percent interest in a corporation with a total liquidation value of $100,000 makes a non pro rata contribution to the corporation's capital of $20,000 in cash. Assume further that the shareholder has no other assets. Prior to the contribution, the shareholder's net worth was $100,000 ($20,000 plus 80 percent of $100,000). If the corporation were immediately liquidated following the contribution, the shareholder would receive only $96,000 (80 percent of $120,000). Of course such a non pro rata contribution is rare in practice. Typically a shareholder will simply purchase additional shares.

See 26 U.S.C. §§ 301, 316. In contrast, a shareholder's transfer of property to the corporation usually has no immediate tax consequences. § 263.

The Finks concede that the purpose of their stock surrender was to protect or increase the value of their investment in the corporation.[48] They hoped to encourage new investors to provide needed capital and in the long run recover the value of the surrendered shares through increased dividends or appreciation in the value of their remaining shares. If the surrender had achieved its purpose, the Finks would not have suffered an economic loss. *See* Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 VA. TAX. REV. 81, 104-108 (1983). In this case, as in many cases involving closely held corporations whose shares are not traded on an open market, there is no reliable method of determining whether the surrender will result in a loss until the shareholder disposes of his remaining shares. Thus, the Finks' stock surrender does not meet the requirement that an immediately deductible loss must be "actually sustained during the taxable year." 26 CFR § 1.165-1(b) (1986).

Finally, treating stock surrenders as ordinary losses might encourage shareholders in failing corporations to convert potential capital losses to ordinary losses by voluntarily surrendering their shares before the corporation fails. In this way shareholders might avoid the consequences of 26 U.S.C. § 165(g)(1), which provides for capital-loss treatment of stock that becomes worthless. [footnote omitted]. Similarly, shareholders may be encouraged to transfer corporate stock rather than other property to the corporation in order to realize a current loss.[49]

We therefore hold that a dominant shareholder who voluntarily surrenders a portion of his shares to the corporation, but retains control, does not sustain an immediate loss deductible from taxable income. Rather, the surrendering shareholder must reallocate his basis in the surrendered shares

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[48] Indeed, if the Finks did not make this concession their surrender probably would be treated as a nondeductible gift. *See* 26 CFR § 25.2511-1(h)(1) (1986).

[49] Our holding today also draws support from two other sections of the Code. First, § 83 provides that, if a shareholder makes a "bargain sale" of stock to a corporate officer or employee as compensation, the "bargain" element of the sale must be treated as a contribution to the corporation's capital. S. REP. NO. 91-552, pp. 123-124 (1969), 1969 U.S. CODE CONG. & ADMIN. NEWS 1978, pp. 2027, 2155; 26 CFR § 1.83-6(d) (1986). Section 83 reversed the result in *Downer v. Commissioner*, 48 T.C. 86 (1967), a decision predicated on the fragmented view of stock ownership adopted by the Court of Appeals in this case. To be sure, Congress was concerned in § 83 with transfers of restricted stock to employees as compensation rather than surrenders of stock to improve the corporation's financial condition. In both cases, however, the shareholder's underlying purpose is to increase the value of his investment.

Second, if a shareholder's stock is redeemed – that is, surrendered to the corporation in return for cash or other property – the shareholder is not entitled to an immediate deduction unless the redemption results in a substantial reduction in the shareholder's ownership percentage. §§ 302(a), (b), (d); 26 CFR § 1.302-2(c) (1986). Because the Finks' surrenders resulted in only a slight reduction in their ownership percentage, they would not have been entitled to an immediate loss if they had received consideration for the surrendered shares. 26 U.S.C. § 302(b). Although the Finks did not receive a direct payment of cash or other property, they hoped to be compensated by an increase in the value of their remaining shares.

to the shares he retains.[50] The shareholder's loss, if any, will be recognized when he disposes of his remaining shares. A reallocation of basis is consistent with the general principle that "[p]ayments made by a stockholder of a corporation for the purpose of protecting his interest therein must be regarded as [an] additional cost of his stock," and so cannot be deducted immediately. *Eskimo Pie Corp. v. Commissioner*, 4 T.C., at 676. Our holding today is not inconsistent with the settled rule that the gain or loss on the sale or disposition of shares of stock equals the difference between the amount realized in the sale or disposition and the shareholder's basis in the particular shares sold or exchanged. *See* 26 U.S.C. § 1001(a); 26 CFR § 1.1012-1(c)(1) (1986). We conclude only that a controlling shareholder's voluntary surrender of shares, like contributions of other forms of property to the corporation, is not an appropriate occasion for the recognition of gain or loss.

IV

For the reasons we have stated, the judgment of the Court of Appeals for the Sixth Circuit is reversed.
It is so ordered.

Justice BLACKMUN concurs in the result.
Justice WHITE, concurring [omitted].
Justice SCALIA, concurring [omitted].
Justice STEVENS, dissenting [omitted].

Questions and comments:

1. What was it that the Finks were trying to accomplish by surrendering some shares of common stock to the corporation?

•There's more to the story than is revealed in our edited version of the case. A lender told the corporation to raise $900,000 of new capital – $700,000 in equity and $200,000 in subordinated debt. The corporation decided to raise the new equity by issuing 700,000 shares of $1 par preferred stock convertible into 1,400,000 shares of common stock. Obviously the conversion ratio was 2:1.

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[50] The Finks remained the controlling shareholders after their surrender. We therefore have no occasion to decide in this case whether a surrender that causes the shareholder to lose control of the corporation is immediately deductible. In related contexts, the Code distinguishes between minimal reductions in a shareholder's ownership percentage and loss of corporate control. *See* § 302(b)(2) (providing "exchange" rather than dividend treatment for a "substantially disproportionate redemption of stock" that brings the shareholder's ownership percentage below 50 percent); § 302(b)(3) (providing similar treatment when the redemption terminates the shareholder's interest in the corporation).

In this case we use the term "control" to mean ownership of more than half of a corporation's voting shares. We recognize, of course, that in larger corporations – especially those whose shares are listed on a national exchange – a person or entity may exercise control in fact while owning less than a majority of the voting shares. *See* Securities Exchange Act of 1934, § 13(d), 48 Stat. 894, 15 U.S.C. § 78m(d) (requiring persons to report acquisition of more than 5 percent of a registered equity security).

•The shareholders felt that it would be easier to find an angel if the corporation could promise control of the corporation to an investor. Hence, it would be necessary to have outstanding fewer than 1,400,000 shares of common stock. Taxpayers hit on the idea of transferring back to the corporation the shares involved in this case.

•Query: why not simply increase the conversion ratio?

•When no outside investor was forthcoming, the surrendering shareholders purchased the newly issued convertible preferred stock.

2. What if the surrender of stock in *Fink* had caused taxpayers to lose control of the corporation? Would that justify a conclusion that an immediate loss had occurred? In the last footnote of our edited version of the case, the Court made clear that it was not answering this question – nor did it "suggest" an answer.

3. The Court adopted the unitary view of stock ownership in the context of a dominant shareholder.

4. For the shareholder, a voluntary contribution to the capital of the corporation has no immediate tax consequences. Instead, the basis of what the shareholder contributes is added to shareholder's basis in his stock in the corporation.

5. Why is the forgiveness of a corporate debt not really like the surrender of stock to the corporation – as the Court asserts? Can a shareholder's surrender of shares to the corporation improve the financial position of the corporation? Can forgiveness of debt improve the financial position of the corporation?

6. Section 118(a) provides that a corporation's gross income does not include "any" contribution to its capital. The basis of property that the corporation receives from a shareholder as a contribution to capital carries over from the one who contributed it. § 362(a)(2). However, § 118(b) excepts from this provision contributions in aid of construction or a contribution as a customer or potential customer. Such "contributions" may appear to be too much like consideration for an exchange with the corporation. It also excepts "any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such."

7. Contributions to the capital of a corporation by non-shareholders are not included in the income of the corporation under § 118(a)(1). But under § 362(c)(1), the corporation's basis in noncash property contributed by a non-shareholder is $0. Moreover, the adjusted basis of any property acquired by the corporation within 12 months after a non-shareholder's contribution of money must be reduced by the amount of that money, and any excess must be used to reduce the basis of other property held by the corporation on the last day of the 12-month period in accord with regulations prescribed by the Secretary of the Treasury. § 362(c). Why should non-shareholder contributions be given such unfavorable treatment to the corporation as compared with shareholder contributions?

•contributions by shareholders are essentially treated as payments for additional stock.

•in the case of non-shareholders, their contributions are accessions to the corporation's wealth. But recognition of the gain is delayed by reducing the basis of assets acquired or already owned by the corporation.

Chapter 3: Dividends

Read IRC §§ 301, 316, 317.

Introductory Note: Ownership of stock entitles a shareholder to receive dividends from the corporation, to share in control of the corporation (i.e., to vote), and to share in the proceeds of the corporation's liquidation (which implicitly is the right to share in the corporation's growth). In this chapter, we identify the tax consequences of a corporation's payment of *dividends* and the shareholder's receipt of dividends. The legal issues arising in this context mainly involve identification of those distributions that constitute the payment of dividends.[51] We have assumed that our corporations are profitable and that shareholders want to share in those profits. A dividend is the corporation's distribution of some or all its after-tax profits with shareholders. To be a dividend, the corporation must distribute "property" to a shareholder. IRC § 316(a). The term "property" means "money, securities, and any other property [,] except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." § 317(a). It *does* however include an obligation of the distributing corporation. IRC § 317(a).

A dividend distribution to a shareholder is made "with respect to" the shareholder's stock. IRC § 301(a). A distribution with respect to the shareholder's stock does not affect the shareholder's ongoing interest in the corporation. It does not alter the shareholder's basis. The shareholder gives no consideration for the distribution. Ownership of stock is the reason for the distribution – as opposed to a distribution because the recipient transacts with the corporation in the capacity of employee, lender, seller, lessor, or the like. Moreover, "[e]xcept as otherwise provided ..., every [corporate] distribution is made out of e&p to the extent thereof" and therefore constitutes a dividend. § 316(a) (carryout ¶).

Recall that a corporation may not deduct a dividend distribution to its shareholder(s) from its taxable income. Thus, the corporate income that upon distribution becomes a dividend is subject to two levels of tax. At one time, an individual who received dividend income was subject to the same rate of tax on that income as the tax on wage income, i.e., ordinary rates. Now individual taxpayers pay the same tax as they pay on long term capital gains on their "qualified dividends."[52] As we have noted,[53] this second level of income tax drove many taxpayers to

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[51] Section 301(a) makes the distribution of "dividends" a residual distribution – i.e., "[e]xcept as otherwise provided in this chapter, a distribution of property ... shall be treated in the manner provided in [§ 301(c)]." There are, as we shall see, several places in this chapter that "otherwise provide," e.g., redemptions, distributions in liquidation of the corporation.

[52] Beginning in 2003, the income tax for individuals (and those who determine their income tax liability under § 1 of the Code) on their "qualified" dividend income was reduced to the rate applicable to their long term capital gain income. § 1(h)(11) ("net capital gain" includes "qualified dividend income"). P.L. 108-27, § 302(a). "Qualified dividend income" includes dividends paid by domestic corporations. § 1(h)(11)(B)(i)(I). It also includes dividends paid by "qualified foreign corporations," § 1(h)(11)(B)(i)(II), i.e., a corporation incorporated in a U.S. possession, a corporation entitled to the benefits of an income tax treaty, or a corporation whose stock is readily tradable on an established U.S. securities market. § 1(h)(11)(C). The maximum income tax rate on "net capital gain"

characterize distributions as something besides the payment of a dividend.

Income taxation as dividend income is dependent on a distribution from the corporation to the shareholder. If the corporation makes no distribution of its earnings with respect to its stock, shareholders realize no gross income. This naturally flows from the fact that a corporation is an entity separate and apart from its shareholders.

> As is well known, a corporation, except in a few instances, is an entity, distinct from the stockholders. When it has earnings, the stockholders do not, by reason of that fact, have income. When it segregates those earnings, even though such earnings have accumulated in a surplus, and declares a dividend payable in money, then the stockholder receives income; or if the corporation takes from its surplus, assets and distributes them in kind to the stockholders, the latter derives income. If the corporation keeps its earnings or profits and allows them to accumulate thus building up a surplus, the surplus belongs to the corporation, not the stockholders, and while the value of the stock may increase, the stockholders do not realize on the profits until the surplus, or part thereof is distributed to them, or until they dispose of their stock.

Sprouse v Commissioner, 122 F.2d 973, 976 (CA9 1941), *aff'd*, 318 US 604 (1943) (footnotes omitted) (non-taxable stock dividend).

In this chapter, we first examine the capacity of a corporation to pay dividends – which the Code considers to be the corporation's "earnings and profits" (e&p). We then examine some instances of a corporation's payment of dividends by providing a benefit to a shareholder.[54] Specifically, corporations may permit shareholders the use of corporate property, pay shareholder obligations, or engage in bargain transactions with shareholders. We consider the tax consequences to both the shareholder and the corporation of distributions of property to the shareholder. This includes consideration of how distributions of money and property affect a corporation's e&p. Finally, we examine the Code's treatment of a corporation's receipt of dividends from a corporation in which it owns stock.

I. Distributions from Earnings and Profits

Read Reg. § 1.316-2(a, b, c), § 312.

The Code's implicit conception of a corporation is that shareholders purchase stock, and the

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is now 20%. § 1(h)(1)(D). However, § 1(h)(11) does not change the character of dividend income – it is still "ordinary income." Thus, capital losses do not offset dividend income.

[53] Chapter 1, *supra*.

[54] In chapter 1, we examined this topic in the context of payment of salaries to shareholders who are also employees.

corporation uses the proceeds of such sales to purchase capital goods that enable it to make income. The money (or property) shareholders exchange for shares become the corporation's "capital account." The corporation must separately account for in what might variously be called the corporation's "surplus" account, "profits" account, or something similar. Corporations pay dividends to their shareholders out of their profits – not out of the capital goods that it had purchased with money (or other property) contributed by shareholders. This dichotomy between capital and profits is embedded in the Code. Section 61(a)(7) provides that dividends constitute gross income. A dividend is a distribution that a corporation makes to its shareholders from the corporation's retained earnings and profits (e&p). "[T]o render the stockholder taxable, there must be both earnings made and a dividend paid. Neither earnings without dividend nor a dividend without earnings subject the stockholder to taxation ..." *Eisner v. Macomber*, 252 U.S. 189, 231-32 (1919) (Brandeis, J., dissenting).

Section 316(a) provides that a dividend is a corporation's distribution of property to its shareholder from its current earnings and profits (e&p) and from its accumulated e&p. Neither the Code nor the regulations define "earnings and profits." Hence, we must fill in some blanks from certain information that we know. Section 312 names *adjustments* to a corporation's e&p – once we have a figure to which we make such adjustments. Those adjustments manifest a corporation's capacity to make distributions to shareholders. A corporation's e&p do not necessarily reflect the corporation's after-tax income – although the computation of e&p may begin with that figure.

> Although earnings and profits can be derived by adjustments to surplus, it is more common to start with taxable income, and, to the extent that the Code and regulations define "earnings and profits," both ordinarily take taxable income as the point of departure.

BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.03[2] at 8-22 (Student ed. 2000). Earnings and profits of the current year are reduced by federal income and excess profits taxes for such year – for such money is not available for distribution to shareholders. Some transactions may have tax

In *Eisner v. Macomber*, 252 U.S. 189 (1919) shareholder Macomber owned shares of Standard Oil stock. Standard had accumulated substantial profits. Rather than distribute those profits to its shareholders, Standard declared a one-for-two stock dividend. Its purpose was to convert the surplus (i.e., profits) to capital – presumably reducing its profits account. The distribution of dividends pro rata to all shareholders would not change the value of any shareholder's holding, and Standard Oil would not have segregated any assets for any shareholder's separate use. Under such circumstances, the United States Supreme Court held that Macomber had not realized any gross income by receipt of such stock

•The Code implicitly regards a corporation's assets as either capital – *i.e.*, assets that the corporation uses to make profits – or as profits. A corporation may issue stock to convert its profits to capital, but the Code does not recognize that the corporation's capacity to pay dividends has been diminished by such a transaction. *Cf.* § 312 (no provision providing for adjustment to corporation's e&p account by such a distribution).

consequences without affecting the corporation's capacity to make a distribution to its shareholders – and vice versa: some transactions might not have tax consequences and yet affect the corporation's capacity to make a distribution to its shareholders. Section 312 reflects these points.

Corporations could, if they chose, not pay dividends to shareholders but could instead invest their profits in more capital goods. A corporation that does not distribute its after-tax earnings may invest them in capital assets. Such an investment does not affect the amount of the corporation's earnings – but of course it makes a distribution to shareholders less likely. "[E]arnings and profits is an economic concept that the tax law utilizes 'to approximate a corporation's power to make distributions which are more than just a return of investment.'" *Estate of Uris v. Commissioner*, 605 F.2d 1258, 1265 (CA2 1979) (citation omitted). A corporation's e&p are not (necessarily) kept in a separate and identifiable account. Rather they reflect the corporation's current and historical profitability and its distribution of dividends.

Section 316(a) contemplates that a U.S. corporation has two e&p accounts: (1) an "accumulated" e&p account, and (2) a "current" e&p account, i.e., the corporation's e&p for the entire current tax year. The corporation is deemed to make distributions first from current e&p to the extent thereof, and second from accumulated e&p to the extent thereof. Reg. § 1.316-2(a).[55] The tax consequence of a distribution from earnings and profits is governed by § 301(c). What rule(s) does § 301(c) state?

A distribution from a corporation's e&p quite naturally reduces the corporation's e&p. § 312(a)(1). The definition of "current" and "accumulated" e&p creates questions of when the reduction occurs and by how much. The following revenue ruling illustrates some fundamental principles concerning the effect(s) of dividend distributions on a corporation's e&p.

Rev. Rul. 74-164, 1974-1 C.B. 74

X corporation and Y corporation each using the calendar year for Federal income tax purposes made distributions of $15,000 to their respective shareholders on July 1, 1971, and made no other distributions to their shareholders during the taxable year. The distributions were taxable as provided by § 301(c) of the Internal Revenue Code of 1954.

Situation 1.

At the beginning of its taxable year 1971, X corporation had earnings and profits accumulated after February 28, 1913, of $40,000. It had an operating loss for the period January 1, 1971 through June 30, 1971, of $50,000 but had earnings and profits for the entire year 1971 of $5,000.

[55] ... and third to e&p accumulated before March 1, 1913, and fourth to other sources.

Situation 2.

At the beginning of its taxable year 1971, Y corporation had a deficit in earnings and profits accumulated after February 28, 1913, of $60,000. Its net profits for the period January 1, 1971 through June 30, 1971, were $75,000 but its earnings and profits for the entire taxable year 1971 were only $5,000.

Situation 3.

Assume the same facts as in Situation 1 except that X had a deficit in earnings and profits of $5,000 for the entire taxable year 1971.

Situation 4.

Assume the same facts as in Situation 1 except that X had a deficit in earnings and profits of $55,000 for the entire taxable year 1971.

Section 301(a) and 301(c) of the Code provides, in part, that: (1) the portion of a distribution of property made by a corporation to a shareholder with respect to its stock which is a dividend (as defined in § 316), shall be included in the shareholder's gross income; (2) the portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock; and (3) the portion which is not a dividend to the extent that it exceeds the adjusted basis of the stock and is not out of increase in value accrued before March 1, 1913, shall be treated as gain from the sale or exchange of property.

Section 316(a) of the Code provides that the term 'dividend' means any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year computed as of the close of the taxable year without diminution by reason of any distribution made during the year, and without regard to the amount of earnings and profits at the time the distribution was made.

Section 1.316-2(a) of the Income Tax Regulations provides, in part, that in determining the source of a distribution, consideration should be given first, to the earnings and profits of the taxable year; and second, to the earnings and profits accumulated since February 28, 1913, only in the case where, and to the extent that, the distributions made during the taxable year are not regarded as out of the earnings and profits of that year.

Applying the foregoing principles, in Situation 1, the earnings and profits of X corporation for the taxable year 1971 of $5,000 and the earnings and profits accumulated since February 28, 1913, and prior to the taxable year 1971, of $40,000 were applicable to the distribution paid by it on July 1, 1971. Thus, $5,000 of the distribution of $15,000 was paid from the earnings and profits of the taxable year 1971 and the balance of $10,000 was paid from the earnings and profits accumulated since February 28, 1913. Therefore, the entire distribution of $15,000 was a dividend within the meaning of § 316 of the Code.

In Situation 2 the earnings and profits of Y corporation for the taxable year 1971 of $5,000 were applicable to the distribution paid by Y corporation on July 1, 1971. Y corporation had no earnings and profits accumulated after February 28, 1913, available at the time of the distribution. Thus, only $5,000 of the distribution by Y corporation of $15,000 was a dividend within the meaning of § 316 of the Code. The balance of such distribution, $10,000 which was not a dividend, applied against and reduced the adjusted basis of the stock in the hands of the shareholders, and to the extent that it exceeded the adjusted basis of the stock was gain from the sale or exchange of property.

In the case of a deficit in earnings and profits for the taxable year in which distributions are made, the taxable status of distributions is dependent upon the amount of earnings and profits accumulated since February 28, 1913, and available at the dates of distribution. In determining the amount of such earnings and profits, § 1.316-2(b) of the regulations provides, in effect, that the deficit in earnings and profits of the taxable year will be prorated to the dates of distribution.

Applying the foregoing to Situations 3 and 4 the distribution paid by X corporation on July 1, 1971, in each situation was a dividend within the meaning of § 316 of the Code to the extent indicated as follows:

Situation #3

Accumulated Earnings and Profits: (E&P) 1/1	$40,000
E&P deficit for entire taxable year ($5,000) Prorate to date of distribution 7/1 (½ of $5,000)	(2,500)
E&P available 7/1	$37,500
Distribution 7/1 ($15,000)	(15,000) taxable as a dividend
E&P deficit from 7/1-12/31	(2,500)
Accumulated E&P balance 12/31	$20,000

Situation #4

Accumulated E&P 1/1	$40,000
E&P deficit for entire taxable year ($55,000) Prorate to date of distribution 7/1 (½ of $55,000)	(27,500)
E&P available 7/1	$12,500

Distribution 7/1 ($15,000)	(12,500) taxable as a dividend
E&P deficit from 7/1 to 12/31	(27,500)
Accumulated E&P balance 12/31	($27,500)

Questions and comments:

1. The IRS said: "In determining the amount of such earnings and profits, § 1.316-2(b) of the regulations provides, in effect, that the deficit in earnings and profits of the taxable year will be prorated to the dates of distribution." Read the last sentence of Reg. § 1.316-2(b). Does it support the conclusion that the IRS stated?

2. At the close of the current tax year, the corporation's e&p (which is no longer "current") is added to or subtracted from its accumulated e&p.

Problem

1. Pelican Corporation is a calendar year taxpayer. At the beginning of year 1, it had an accumulated e&p of minus $15,000. On September 15, its current e&p was $35,000. On December 31, its current e&p was $30,000. On September 15, it distributed $35,000 to Quigley, its only shareholder. Quigley's basis in her stock is $20,000.

- How much is Quigley's dividend income? What is the basis of Quigley's stock at the beginning of year 2? What is Pelican Corporation's accumulated e&p at the beginning of year 2?

2. Same as #1, except that Pelican Corporation waited until January 15 of year 2, after it had closed its books on year 1, and distributed $30,000 to Quigley. For all of year 2, Pelican Corporation's current e&p was $0. Does this change your answers to question 1, i.e., for year 1?

3. Maximart Corporation has four equal shareholders. It began the year with $10,000 of accumulated e&p. For the current year, its current e&p is $0. On December 31 of the current year, it distributed $3000 to each of its four shareholders. How much of the distribution should be taxed as a dividend to each shareholder as a dividend? What is Maximart's accumulated e&p at the start of the following year?

- Think: from what you know about e&p at this point, should it be possible for a corporation to have a negative e&p – either accumulated or current?

- If so, should a corporation's distribution be an occasion that can take the corporation's e&p – accumulated or current – negative?

- *See* Reg. § 1.316-1(a)(2) ("Where a corporation distributes property to its shareholders

> ..., the amount of the distribution which is a dividend to them may not exceed the earnings and profits of the distributing corporation.”).

4. Pelican Corporation is a calendar-year taxpayer. It has one class of common stock outstanding. At the beginning of this year, Pelican Corporation had $60,000 of accumulated e&p. Pelican Corporation’s current e&p for this year is $40,000. On February 1, it distributed $30,000 to shareholder Quigley. On June 1, it distributed $30,000 to shareholder Robin. On September 1, it distributed $30,000 to shareholder Saxon. On December 1, it distributed $30,000 to shareholder Tilbury. How much dividend income did each shareholder receive. Read Reg. § 1.316-2(a, b, c), especially Reg. § 1.316-2(c) (Example).

- Suppose that shareholder Tilbury had sold her shares to Ursula on September 30. Pelican Corporation pays Ursula $30,000 on December 1. How much dividend income did Ursula receive?

5. Same as #4, except that Pelican also had one class of preferred stock outstanding. The corporate charter provides that holders of preferred stock are to be paid a dividend of $6/share before the corporation pays a dividend to holders of any other class of stock. On December 31, Pelican Corporation paid Victoria – the only holder of Pelican preferred stock – $6/share. Victoria owned 1000 shares of Pelican preferred. Distributions were made as in #4.

- How would this affect your answer to question 4. *See* Rev. Rul. 69-440.

Why should there be two e&p accounts when a corporation (obviously) must maintain profitability to pay dividends? In the Revenue Act of 1936, Congress responded to the President Roosevelt’s request to tax the undistributed earnings and profits of corporations, deeming it unfair that shareholders who received a dividend owed a surtax on it whereas those who did not receive dividends from profitable corporations in which they owned shares did not owe a surtax. The solution to this unfairness was to make corporations subject to a surtax on “undistributed net income.” “Undistributed net income” did not include dividends that the corporation paid to its shareholders. Corporations were given a “dividend credit” for dividends that they paid. Under the “undistributed net income” surtax, it was possible for a corporation that had a deficit in its accumulated earnings and profits account to be profitable in the current year and owe a surtax. So:

> In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends-paid credit for the purposes of the undistributed-profits surtax, § 115(a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable come to the shareholder and a dividends-paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary.

S. REP. NO. 2156 (74th Cong., 2d Sess., 1936), *reprinted at* 1939-1 (part 2) C.B. 667, 689. The “undistributed net income” tax lasted only from 1936 to 1939. The substance of old § 115(a) lives on in § 316(a).

Do the CALI exercise: Corporate Taxation: Distributions: Distributions of Cash by C Corporations.

II. Distributions "With Respect to [Shareholder's] Stock"

To be a dividend, a corporation's distribution must be "with respect to" the shareholder's stock. IRC § 301(a). As the problems above showed, the distribution cannot be with respect to another relationship with the corporation, e.g., employer/employee, buyer/seller, lender/borrower. The statutory language does not often raise any close questions. The following case almost did.

Boulware v. United States, 552 U.S. 421 (2008)

Justice SOUTER delivered the opinion of the Court.

Sections 301 and 316(a) of the Internal Revenue Code set the conditions for treating certain corporate distributions as returns of capital, nontaxable to the recipient. 26 U.S.C. §§ 301, 316(a) ... The question here is whether a distributee accused of criminal tax evasion may claim return-of-capital treatment without producing evidence that either he or the corporation intended a capital return when the distribution occurred. We hold that no such showing is required.

I

"[T]he capstone of [the] system of sanctions … calculated to induce … fulfillment of every duty under the income tax law," *Spies v. United States*, 317 U.S. 492, 497 (1943), is 26 U.S.C. §7201, making it a felony willfully to "attemp[t] in any manner to evade or defeat any tax imposed by" the Code. [footnote omitted]. One element of tax evasion under §7201 is "the existence of a tax deficiency," *Sansone v. United States*, 380 U.S. 343, 351 (1965); *see also Lawn v. United States*, 355 U.S. 339, 361 (1958),[56] which the Government must prove beyond a reasonable doubt, see *ibid*. ("[O]f course, a conviction upon a charge of attempting to evade assessment of income taxes by the filing of a fraudulent return cannot stand in the absence of proof of a deficiency").

Any deficiency determination in this case will turn on §§ 301 and 316(a) of the Code. According to § 301(a), unless another provision of the Code requires otherwise, a "distribution of property" that is "made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in [§ 301(c)]." Under § 301(c), the portion of the distribution that is a "dividend," as defined by § 316(a), must be included in the recipient's gross income; and the portion that is not a dividend is, depending on the shareholder's basis for his stock, either a nontaxable return of capital or a gain on the sale or exchange of stock, ordinarily taxable to the shareholder as a capital gain. Finally, § 316(a) defines "dividend" as

> any distribution of property made by a corporation to its shareholders –
> (1) out of its earnings and profits accumulated after February 28, 1913, or

[56] "[T]he elements of §7201 are willfulness[,] the existence of a tax deficiency, ... and an affirmative act constituting an evasion or attempted evasion of the tax." *Sansone v. United States*, 380 U.S. 343, 351 (1965). ...

> (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Sections 301 and 316(a) together thus make the existence of "earnings and profits"[57] the decisive fact in determining the tax consequences of distributions from a corporation to a shareholder with respect to his stock. This requirement of "relating the tax status of corporate distributions to earnings and profits is responsive to a felt need for protecting returns of capital from tax." 4 Bittker & Lokken ¶ 92.1.1, p. 92–3.

II

In this criminal tax proceeding, petitioner Michael Boulware was charged with several counts of tax evasion and filing a false income tax return, stemming from his diversion of funds from Hawaiian Isles Enterprises (HIE), a closely held corporation of which he was the president, founder, and controlling (though not sole) shareholder. At trial, [footnote omitted] the United States sought to establish that Boulware had received taxable income by "systematically divert[ing] funds from HIE in order to support a lavish lifestyle." 384 F.3d 794, 799 (CA9 2004). The Government's evidence showed that

> [Boulware] gave millions of dollars of HIE money to his girlfriend … and millions of dollars to his wife … without reporting any of this money on his personal income tax returns. ... [H]e siphoned off this money primarily by writing checks to employees and friends and having them return the cash to him, by diverting payments by HIE customers, by submitting fraudulent invoices to HIE, and by laundering HIE money through companies in the Kingdom of Tonga and Hong Kong. *Ibid.*

In defense, Boulware sought to introduce evidence that HIE had no retained or current earnings and profits in the relevant taxable years, with the consequence (he argued) that he in effect received distributions of property that must have been returns of capital, up to his basis in his stock. *See* § 301(c)(2). Because the return of capital was nontaxable, the argument went, the Government could not establish the tax deficiency required to convict him.

The Government moved in limine to bar evidence in support of Boulware's return-of-capital theory, on the grounds of "irrelevan[ce] in [this] criminal tax case," The Government relied on the Ninth Circuit's decision in *United States v. Miller*, 545 F.2d 1204 (1976), in which that court held that in a criminal tax evasion case, a diversion of funds may be deemed a return of capital only after "some demonstration on the part of the taxpayer and/or the corporation that such [a

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[57] Although the Code does not "comprehensively define 'earnings and profits,'" 4 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 92.1.3, p.92–6 (3d ed. 2003) (hereinafter BITTKER & LOKKEN), the "[p]rovisions of the Code and regulations relating to earnings and profits ordinarily take taxable income as the point of departure," *id.*, at 92–9.

distribution was] intended to be such a return," *id.*, at 1215. Boulware, the Government argued, had offered to make no such demonstration.

The District Court granted the Government's motion, and when Boulware sought "to present evidence of [HIE's] alleged over-reporting of income, and an offer of proof relating to the issue of … dividends," *id*., at 135, the District Court denied his request. The court said that "[n]ot only would much of [his proffered] evidence be excludable as expert legal opinion, it is plainly insufficient under the *Miller* case," *id.*, at 138, and accordingly declined to instruct the jury on Boulware's return-of-capital theory. The jury rejected his alternative defenses (that the diverted funds were nontaxable corporate advances or loans, or that he used the moneys for corporate purposes), and found him guilty on nine counts, four of tax evasion and five of filing a false return.

The Ninth Circuit affirmed. 470 F.3d 931 (2006). It acknowledged that "imposing an intent requirement creates a disconnect between civil and criminal liability," but thought that under *Miller*, "the characterization of diverted corporate funds for civil tax purposes does not dictate their characterization for purposes of a criminal tax evasion charge." 470 F.3d, at 934. The court held the test in a criminal case to be "whether the defendant has willfully attempted to evade the payment or assessment of a tax." *Ibid*. Because Boulware "'presented no concrete proof that the amounts were considered, intended, or recorded on the corporate records as a return of capital at the time they were made,'" *id.*, at 935 (quoting *Miller*, *supra*), the Ninth Circuit held that Boulware's proffer was "properly rejected … as inadequate," 470 F.3d, at 935.

Judge Thomas concurred because the panel was bound by *Miller*, but noted that "*Miller* – and now the majority opinion – hold that a defendant may be criminally sanctioned for tax evasion without owing a penny in taxes to the government." 470 F.3d, at 938. That, he said, not only "indicate[s] a logical fallacy, but is in flat contradiction with the tax evasion statute's requirement … of a tax deficiency." *Ibid*. (internal quotation marks omitted).[58]

We granted certiorari to resolve a split among the Courts of Appeals over the application of §§ 301 and 316(a) to informally transferred or diverted corporate funds in criminal tax proceedings.[59] We now vacate and remand.

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[58] Judge Thomas went on to say that the Government would prevail even without Miller's rule because, in his view, Boulware's diversions were "unlawful," and the return-of-capital rules would not apply to diversions made for unlawful purposes.

[59] As noted, the Ninth Circuit holds that §§ 301 and 316(a) are not to be consulted in a criminal tax evasion case until the defendant produces evidence of an intent to treat diverted funds as a return of capital at the time it was made. See 470 F.3d 931 (2006) (case below). By contrast, the Second Circuit allows a criminal defendant to invoke §§ 301 and 316(a) without evidence of a contemporaneous intent to treat such moneys as returns of capital. *See United States v. Bok*, 156 F.3d 157, 162 (1998) ("[I]n return of capital cases, a taxpayer's intent is not determinative in defining the taxpayer's conduct"). Meanwhile, the Third, Sixth, and Eleventh Circuits arguably have taken the position that §§ 301 and 316(a) are altogether inapplicable in criminal tax cases involving informal distributions. *See United States v. Williams*, 875 F.2d 846, 850-852 (CA11 1989); *United States v. Goldberg*, 330 F.2d 30, 38 (CA3 1964); *Davis v. United States*, 226 F.2d 331, 334–335 (CA6 1955); *but see* Brief for Petitioner 16 ("[T]hese cases

III

A

The colorful behavior described in the allegations requires a reminder that tax classifications like "dividend" and "return of capital" turn on "the objective economic realities of a transaction rather than … the particular form the parties employed," *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978); a "given result at the end of a straight path is not made a different result … by following a devious path," *Minnesota Tea Co. v. Helvering*, 302 U. S. 609, 613 (1938). [footnote omitted]. As for distributions with respect to stock, in economic reality a shareholder's informal receipt of corporate property "may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend," *Palmer v. Commissioner*, 302 U.S. 63, 69 (1937), or as effective a means of returning a shareholder's capital, *see ibid*. Accordingly, "[a] distribution to a shareholder in his capacity as such ... is subject to § 301 even though it is not declared in formal fashion." B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶8.05[1], pp. 8-36 to 8-37 (6th ed. 1999) (hereinafter BITTKER & EUSTICE); *see also* Gardner, *The Tax Consequences of Shareholder Diversions in Close Corporations*, 21 TAX L. REV. 223, 239 (1966) (hereinafter Gardner) ("Sections 316 and 301 do not require any formal path to be taken by a corporation in order for those provisions to apply").

There is no reason to doubt that economic substance remains the right touchstone for characterizing funds received when a shareholder diverts them before they can be recorded on the corporation's books. While they "never even pass through the corporation's hands," BITTKER & EUSTICE ¶8.05[9], p. 8-51, even diverted funds may be seen as dividends or capital distributions for purposes of §§ 301 and 316(a), *see Truesdell v. Commissioner*, 89 T.C. 1280 (1987) (treating diverted funds as "constructive" distributions in civil tax proceedings). The point, again, is that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930); *see also Griffiths v. Commissioner*, 308 U.S. 355, 358 (1939).[60]

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can be read to address the allocation of the burden of proof on the return of capital issue, rather than the applicable substantive principles").

[60] Thus in the period between this Court's decisions in *Commissioner v. Wilcox*, 327 U.S. 404 (1946) (holding embezzled funds to be nontaxable to the embezzler) and *James v. United States*, 366 U.S. 213 (1961) (overruling *Wilcox*, holding embezzled funds to be taxable income), the Government routinely argued that diverted funds were "constructive distributions," taxable to the recipient as dividends. *See generally* Gardner 237 ("While *Wilcox* was good law, the safest way to insure that both the corporation and the shareholder would be taxed on their respective gain from the diverted funds was to label them dividends"); 4 BITTKER & LOKKEN ¶ 92.2(7), p. 92-23, n. 37.

B

Miller's view that a criminal defendant may not treat a distribution as a return of capital without evidence of a corresponding contemporaneous intent sits uncomfortably not only with the tax law's economic realism, but with the particular wording of §§ 301 and 316(a), as well. As those sections are written, the tax consequences of a "distribution by a corporation with respect to its stock" depend, not on anyone's purpose to return capital or to get it back, but on facts wholly independent of intent: whether the corporation had earnings and profits, and the amount of the taxpayer's basis for his stock. *Cf. Truesdell v. Commissioner*, Action on Decision 1988-25, 1988 WL 570761 (Sept. 12, 1988) (recommendation regarding acquiescence); IRS Non Docketed Service Advice Review, 1989 WL 1172952 (Mar. 15, 1989) (reply to request for reconsideration) ("[I]ntent is irrelevant. ... [E]very distribution made with respect to a shareholder's stock is taxable as ordinary income, capital gain, or not at all pursuant to section 301(c) dependent upon the corporation's earnings and profits and the shareholder's stock basis. The determination is computational and not dependent upon intent").

When the *Miller* court went the other way, needless to say, it could claim no textual hook for the contemporaneous intent requirement, but argued for it as the way to avoid two supposed anomalies. First, the court thought that applying §§ 301 and 316(a) in criminal cases unnecessarily emphasizes the exact amount of deficiency while "completely ignor[ing] one essential element of the crime charged: the willful intent to evade taxes . ..." 545 F.2d, at 1214. But there is an analytical mistake here. Willfulness is an element of the crimes charged because the substantive provisions defining tax evasion and filing a false return expressly require it, *see* §7201 ("Any person who willfully attempts ..."); §7206(1) ("Willfully makes and subscribes ..."). The element of willfulness is addressed at trial by requiring the Government to prove it. Nothing in §§ 301 and 316(a) as written (that is, without an intent requirement) relieves the Government of this burden of proving willfulness or impedes it from doing so if evidence of willfulness is there. Those two sections as written simply address a different element of criminal evasion, the existence of a tax deficiency, and both deficiency and willfulness can be addressed straightforwardly (in jury instructions or bench findings) without tacking an intent requirement onto the rule distinguishing dividends from capital returns.

Second, the *Miller* court worried that if a defendant could claim capital treatment without showing a corresponding and contemporaneous intent,

> "[a] taxpayer who diverted funds from his close corporation when it was in the midst of a financial difficulty and had no earnings and profits would be immune from punishment (to the extent of his basis in the stock) for failure to report such sums as income; while that very same taxpayer would be convicted if the corporation had experienced a successful year and had earnings and profits." 545 F.2d, at 1214.

"Such a result," said the court, "would constitute an extreme example of form over substance." *Ibid.* The Circuit thus assumed that a taxpayer like Boulware could be convicted of evasion with no showing of deficiency from an unreported dividend or capital gain.

But the acquittal that the author of *Miller* called form trumping substance would in fact result from the Government's failure to prove an element of the crime. There is no criminal tax evasion without a tax deficiency, [footnote omitted], and there is no deficiency owing to a distribution (received with respect to a corporation's stock) if a corporation has no earnings and profits and the value distributed does not exceed the taxpayer-shareholder's basis for his stock. Thus the fact that a shareholder distributee of a successful corporation may have different tax liability from a shareholder of a corporation without earnings and profits merely follows from the way §§ 301 and 316(a) are written (to distinguish dividend from capital return), and from the requirement of tax deficiency for a § 7201 crime. Without the deficiency there is nothing but some act expressing the will to evade, and, under §7201, acting on "bad intentions, alone, [is] not punishable," *United States v. D'Agostino*, 145 F.3d 69, 73 (CA2 1998).

It is neither here nor there whether the *Miller* court was justified in thinking it would improve things to convict more of the evasively inclined by dropping the deficiency requirement and finding some other device to exempt returns of capital. [footnote omitted]. Even if there were compelling reasons to extend § 7201 to cases in which no taxes are owed, it bears repeating that "[t]he spirit of the doctrine which denies to the federal judiciary power to create crimes forthrightly admonishes that we should not enlarge the reach of enacted crimes by constituting them from anything less than the incriminating components contemplated by the words used in the statute," *Morissette v. United States*, 342 U.S. 246, 263 (1952) (opinion for the Court by Jackson, J.). If § 301, § 316(a), or § 7201 could stand amending, Congress will have to do the rewriting.

C

Not only is *Miller* devoid of the support claimed for it, but it suffers the demerit of some anomalies of its own. First and most obviously, §§ 301 and 316 are odd stalks for grafting a contemporaneous intent requirement, given the fact that the correct application of their rules will often become known only at the end of the corporation's tax year, regardless of the shareholder's or corporation's understanding months earlier when a particular distribution may have been made. Section 316(a)(2) conditions treating a distribution as a constructive dividend by reference to earnings and profits, and earnings and profits are to be "computed as of the close of the taxable year … without regard to the amount of the earnings and profits at the time the distribution was made." A corporation may make a deliberate distribution to a shareholder, with everyone expecting a profitable year and considering the distribution to be a dividend, only to have the shareholder end up liable for no tax if the company closes out its tax year in the red (so long as the shareholder's basis covers the distribution); when such facts are clear at the time the reporting forms and returns are filed,[61] the shareholder does not violate § 7201 by paying no tax

[61] Sometimes these facts are not clear, and in certain circumstances a corporation may be required to assume it is profitable. For example, the instructions to IRS Form 1099–DIV provide that when a corporation is unsure whether it has sufficient earnings and profits at the end of the taxable year to cover a distribution to shareholders, "the entire payment must be reported as a dividend." *See* http://www.irs.gov/pub/irs-pdf/i1099div.pdf (as visited Feb. 15, 2008, and available in Clerk of Court's case file).

on the moneys received, intent being beside the point. And since intent to make a distribution a taxable one cannot control, it would be odd to condition nontaxable return-of-capital treatment on contemporaneous intent, when the statute says nothing about intent at all.

The intent interpretation is strange for another reason, too (a reason in some tension with the Ninth Circuit's assumption that an unreported distribution without contemporaneous intent to return capital will support a conviction for evasion). The text of § 301(a) ostensibly provides for all variations of tax treatment of distributions received with respect to a corporation's stock unless a separate provision of the Code requires otherwise. Yet *Miller* effectively converts the section into one of merely partial coverage, with the result of leaving one class of distributions in a tax status limbo in criminal cases. That is, while § 301(a) expressly provides that distributions made by a corporation to a shareholder with respect to its stock "shall be treated in the manner provided in [§ 301(c)]," under *Miller*, a distribution from a corporation without earnings and profits would fail to be a return of capital for lack of contemporaneous intent to treat it that way; but to the extent that distribution did not exceed the taxpayer's basis for the stock (and thus become a capital gain), § 301(a) would leave the distribution unaccounted for.

It is no answer to say that § 61(a) of the Code would step in where § 301(a) has been pushed out. Although § 61(a) defines gross income, "[e]xcept as otherwise provided," as "all income from whatever source derived," the plain text of § 301(a) does provide otherwise for distributions made with respect to stock. So using § 61(a) as a stopgap would only sanction yet another eccentricity: § 301(a) would be held not to cover what its text says it "shall" (the class of distributions made with respect to stock for which no other more specific provision is made), while § 61(a) would need to be applied to what by its terms it should not be (a receipt of funds for which tax treatment is "otherwise provided" in § 301(a)).

The implausibility of a statutory reading that either creates a tax limbo or forces resort to an atextual stopgap is all the clearer from the Ninth Circuit's discussion in this case of its own understanding of the consequences of *Miller*'s rule: the court openly acknowledged that "imposing an intent requirement creates a disconnect between civil and criminal liability," 470 F.3d, at 934. In construing distribution rules that draw no distinction in terms of criminal or civil consequences, the disparity of treatment assumed by the Court of Appeals counts heavily against its contemporaneous intent construction (quite apart from the Circuit's understanding that its interpretation entails criminal liability for evasion without any showing of a tax deficiency).

Miller erred in requiring a contemporaneous intent to treat the receipt of corporate funds as a return of capital, and the judgment of the Court of Appeals here, relying on Miller, is likewise erroneous.

IV

The Government has raised nothing that calls for affirmance in the face of the Court of Appeals's reliance on *Miller*. The United States does not defend differential treatment of criminal and civil cases, and it thus stops short of fully defending the Ninth Circuit's treatment. The Government's

argument, instead, is that we should affirm under the rule that before any distribution may be treated as a return of capital (or, by a parity of reasoning, a dividend), it must first be distributed to the shareholder "with respect to . . . stock." *Id*., at 19 (internal quotations omitted). The taxpayer's intent, the Government says, may be relevant to this limiting condition, and Boulware never expressly claimed any such intent. *See ibid.* ("[I]ntent is … relevant to whether a payment is a 'distribution … with respect to [a corporation's] stock'"); *but see* Tr. of Oral Arg. 44 ("[J]ust to be clear, the Government is arguing for an objective test here").

The Government is of course correct that "with respect to … stock" is a limiting condition in § 301(a). See supra, at 2–3.[62] As the Government variously says, it requires that "the distribution of property by the corporation be made to a shareholder because of his ownership of its stock," and that " 'an amount paid by a corporation to a shareholder [be] paid to the shareholder in his capacity as such,' " (quoting 26 CFR § 1.301–1(c) (2007) (emphasis deleted)).

This, however, is not the time or place to home in on the "with respect to … stock" condition. Facts with a bearing on it may range from the distribution of stock ownership[63] to conditions of corporate employment (whether, for example, a shareholder's efforts on behalf of a corporation amount to a good reason to treat a payment of property as salary). The facts in this case have yet to be raked over with the stock ownership condition in mind, since *Miller* seems to have pretermitted a full consideration of the defensive proffer, and if consideration is to be given to that condition now, the canvas of evidence and Boulware's proffer should be made by a court familiar with the whole evidentiary record.[64]

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[62] Another limiting condition is that the diversion of funds must be a "distribution" in the first place (regardless of the "with respect to stock" limitation), though the Government is content to assume that § 301(a)'s "distribution" language is capacious enough to cover the diversions involved here, and that if Boulware bears the burden of production in going forward with the defense that the funds he received constituted a "distribution" within the meaning of § 301(a), *see* n. 14, *infra*, that burden has been met. Nor does the Government dispute that Boulware offered sufficient evidence of his basis and HIE's lack of earnings and profits.

[63] See, e.g., Truesdell v. Commissioner, IRS Non Docketed Service Advice Review, 1989 WL 1172952 (Mar. 15, 1989) ("We believe a corporation and its shareholders have a common objective – to earn a profit for the corporation to pass onto its shareholders. Especially where the corporation is wholly owned by one shareholder, the corporation becomes the alter ego of the shareholder in his profit making capacity. ... [B]y passing corporate funds to himself as shareholder, a sole shareholder is acting in pursuit of these common objectives"). We note, however, that although Boulware was not a sole shareholder, the Tax Court has taken it as "well settled that a distribution of corporate earnings to shareholders may constitute a dividend," and so a return of capital as well, "notwithstanding that it is not in proportion to stockholdings." *Dellinger v. Commissioner*, 32 T. C. 1178, 1183 (1959); *see ibid*. (noting that because other stockholders did not complain when a taxpayer received unequal property, "under the circumstances they must be deemed to have ratified the distribution"); *see also Crowley v. Commissioner*, 962 F. 2d 1077 (CA1 1992); *Lengsfield v. Commissioner*, 241 F. 2d 508 (CA5 1957); Baird v. Commissioner, 25 T. C. 387 (1955); *Thielking v. Commissioner*, 53 TCM 746 (1987), ¶87, 227, P-H Memo TC.

[64] Boulware does not dispute that he bears the burden of producing some evidence to support his return-of-capital theory, including evidence that the corporation lacked earnings and profits and that he had sufficient basis in his stock to cover the distribution. He instead argues that, as to the "with respect to … stock" requirement, it suffices to show "[t]hat he is a stockholder, and that he did not receive this money in any nonstockholder capacity." *Id*., at 57. The Government, for its part, on the authority of *Holland v. United States*, 348 U. S. 121 (1954) and *Bok*, 156 F. 3d, at 163–164, argues that Boulware must offer more evidence than that. We express no view on that issue here,

As a more specific version of its "with respect to ... stock" position, the Government says that the diversions of corporate funds to Boulware were in fact unlawful, see Brief for United States 34–37; see also n. 5, supra, and it argues that §§301 and 316(a) are inapplicable to illegal transfers, see Brief for United States 34–37; see also D'Agostino, 145 F.3d, at 73 ("[T]he 'no earnings and profits, no income' rule would not necessarily apply in a case of unlawful diversion, such as embezzlement, theft, a violation of corporate law, or an attempt to defraud third party creditors" (emphasis in original)); see also n. 8, supra. The Government goes so far as to claim that "[t]he only rational basis for the jury's judgment was a conclusion that [Boulware] unlawfully diverted the funds." Brief for United States 37.

But we decline to take up the question whether an unlawful diversion may ever be deemed a "distribution ... with respect to [a corporation's] stock," a question which was not considered by the Ninth Circuit. We do, however, reject the Government's current characterization of the jury verdict in Boulware's case. True, the jurors were not moved by Boulware's suggestion that the diversions were corporate advances or loans, or that he was using the funds for corporate purposes. But the jury was not asked, and cannot be said to have answered, whether Boulware breached any fiduciary duty as a controlling shareholder, unlawfully diverted corporate funds to defraud his wife, or embezzled HIE's funds outright.

V

Sections §§ 301 and 316(a) govern the tax consequences of constructive distributions made by a corporation to a shareholder with respect to its stock. A defendant in a criminal tax case does not need to show a contemporaneous intent to treat diversions as returns of capital before relying on those sections to demonstrate no taxes are owed. The judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

Notes and Questions:

1. On remand, the United States Court of Appeals for the Ninth Circuit held that defendant Boulware was not entitled to a return-of-capital jury instruction. *United States v. Boulware*, 558 F.3d 971 (CA9), *cert. denied*, 558 U.S. 1048 (2009). Defendant sought instructions upon which a jury might find that the transactions were loans or that he held the funds in trust to purchase his then-wife's stock as well as on a return-of-capital theory. The Ninth Circuit stated

> The Supreme Court declined the opportunity to define the contours of the phrase "with respect to stock," leaving that for another day. So do we. [footnote omitted]. It suffices,

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just as we decline to consider the more general question whether the Second Circuit's rule in *Bok*, which places on the criminal defendant the burden to produce evidence in support of a return-of-capital theory, is authorized by *Holland* and consistent with *Sandstrom v. Montana*, 442 U.S. 510 (1979), and related cases.

> however, to say that at the very least a taxpayer must tender some evidence of nexus between the corporate distribution and stock ownership, or show that there were no other alternate explanations, [footnote omitted] in order to proceed with a return of capital theory at trial. Boulware did neither, and the district court was justified in declining to allow him to present another alternative theory to the jury.

Id. at 977.

2. It is not necessary that a corporation "intend" to pay a dividend for a distribution to be a taxable dividend. In the absence of intent, how the Government or the Commissioner show a "nexus" between a corporate distribution and stock ownership? In a footnote omitted from the above excerpt, the court observed:

> 7. Put another way, "when you have eliminated the impossible, whatever remains, however improbable, must be the truth." Sir Arthur Conan Doyle, *Tales of Sherlock Holmes: The Sign of the Four*, p. 228 (Grosset & Dunlap 1892). Of course, a defendant may pursue alternative theories. However, when one attempts to characterize a transaction solely by negative inference, rather than affirmative proof, one usually must eliminate other possible theories, not prove their viability.

Id., n.7. So is it clear how to prove that a distribution is with respect to stock (or that it isn't)?

3. Should Boulware wish that HIE have *any* e&p?

4. Should Boulware want to have more – or less – basis in his stock than the amount that HIE "distributed" to him? *United States v. Boulware*, 558 F.3d 971, 977-78 (9th Cir.), *cert. denied*, 558 U.S. 1048 (2009) (insufficient evidence to establish defendant's basis).

Problems:

1. Minimax Corporation (a calendar year taxpayer) has been profitable since its founding yet has never paid its shareholders a dividend. As a result its accumulated e&p at the beginning of this year was $40,000. Its current e&p for this year is $25,000. On December 31 of this year it pays Jaymar, one of its four shareholders who works full-time for the corporation, a year-end bonus of $10,000. How much of the payment should be taxed as a dividend to Jaymar? *See* Reg. § 1.301-1(c).

> •What effect would your answer have on the corporation's e&p, either current or accumulated?

III. Disguised Dividends

A. Use of corporate property

Tanner v. Commissioner, 45 T.C.M. 1419 (1983), T.C. Memo 1983-230

WILES, Judge

Respondent determined deficiencies in petitioners' 1977 and 1978 Federal income taxes in the amounts of $522 and $517, respectively. After concessions, the issues for decision are whether petitioners received constructive dividends from their personal use of automobiles owned by their closely held corporation and, if so, the amount of such dividends.

Findings of Fact

...

Petitioners Ray R. Tanner, Jr. (Ray) and Patricia M. Tanner (Patricia), husband and wife, resided in Phoenix, Arizona ...

At all relevant times, petitioners were minority shareholders in Ray Tanner Motors, Inc. (hereinafter Tanner Motors or the corporation), an Arizona corporation with a principal office in Phoenix, Arizona. The officers of Tanner Motors include: Ray Tanner, Sr. [footnote omitted], President; petitioner, Ray Tanner, Jr., Vice President; and George Wylie, Vice President. During the years in issue, it was the policy of Tanner Motors to provide each officer with the use of new Volvo automobiles under a personal car purchase plan for which documents of title and license registrations were held in the name of the corporation. Between 1977 and 1978, petitioners obtained three automobiles exclusively for personal use under this plan. Petitioners used each automobile for approximately one year before obtaining a new model each spring. [footnote omitted]. Petitioners did not own any other vehicles during the years in issue and they did not reimburse Tanner Motors for the personal use of these automobiles.

The cost to the corporation of providing these vehicles to petitioners was approximately $500 per year which included maintenance expenses, licensing and registration fees, and insurance premiums on each vehicle. Petitioners paid all gasoline costs. Each of the cars was covered by the manufacturer's warranty during the periods that petitioners used them, and repair costs charged to the corporation were paid by the manufacturer. After each car was driven approximately 6,000 miles, it was sold at a profit through the corporation's used car sales department. All such profit was included in the income of Tanner Motors.

In the notice of deficiency, respondent determined that the fair market value of petitioners' personal use of Volvo automobiles owned by Tanner Motors constituted constructive dividends in the amounts of $1,440 in each of 1977 and 1978. Accordingly, their taxable income was

increased by $1,440 in both 1977 and 1978, resulting in deficiencies in their Federal income taxes of $522 and $517, respectively.

Opinion

The issue for decision is whether petitioners received constructive dividends from their personal use of corporate automobiles and, if so, the amount of such dividends.

It is well settled that corporate expenditures, or the making available of corporate-owned property to stockholders for their personal benefit, may constitute constructive dividends taxable to those stockholders. *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225, 1238 (1971); *Challenge Manufacturing Co. v. Commissioner*, 37 T.C. 650 (1962); *American Properties, Inc. v. Commissioner*, 28 T.C. 1100 (1957), *aff'd*, 262 F.2d 150 (9th Cir. 1958). Under §§ 301 and 316, a dividend is any corporate distribution to its shareholders out of earnings and profits. That the formalities of a dividend are lacking or that the distribution is not recorded on the corporation books is of no consequence. *Silverstein v. Commissioner*, 36 T.C. 438 (1961); *Sachs v. Commissioner*, 32 T.C. 815, 820 (1959), *aff'd*, 277 F.2d 879, 882 (8th Cir.), *cert. denied*, 364 U.S. 833 (1960). The amount of a constructive dividend generally is equal to the fair market value of the benefits conferred. *Challenge Manufacturing Co. v. Commissioner*, *supra* at 663; § 301(b)(1)(A).

The record in the instant case establishes that petitioners enjoyed, for their personal benefit, the free use of Volvo automobiles owned by Tanner Motors. Petitioners have failed to prove that Tanner Motors did not have earnings and profits for the years in issue in amounts at least equal to the fair market value of the use of the Volvo automobiles. *See* §§ 301(c) and 316(a). Moreover, petitioners have failed to present any evidence that the fair market value of their personal use of the Volvo automobiles was less than that determined by respondent. Consequently, we uphold respondent's determination that petitioners' use of the Volvo automobiles owned by Tanner Motors constituted constructive dividends for 1977 and 1978 in the amount of $1,440 per year. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

To reflect the foregoing,

Decision will be entered for the respondent.

Questions and comments:

1. What issues would have been raised if taxpayers had argued that their use of the automobiles was salary rather than dividend. The corporation could have deducted payment of salary. *See Gardner v. Comm'r*, T.C. Memo. 1976-349, *aff'd*, 613 F.2d 160 (6th Cir. 1980) (taxpayer has burden of proving intent to provide automobile intended as salary).

2. There are many other devices by which corporations may try to get money to their

shareholders in a transaction on which either the shareholder or the corporation would pay no income tax. Corporations may pay more than a reasonable salary, more than the fair market value of property it purchases, more than the fair rental value of property that it rents, etc. We considered these topics in chapter 1, *supra*.

B. Corporate payment of personal obligations

Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966)

STEPHENSON, District Judge

This is an appeal by the taxpayer [footnote omitted] from the District Court's judgment denying recovery for that portion of his 1956 income taxes alleged to have been assessed and collected wrongfully. The taxpayer made a timely claim for a refund. Jurisdiction exists under the provisions of 28 U.S.C. § 1346 (a)(1).

... [T]he taxpayer Sullivan purchased the assets of an automobile dealership in Blytheville, Arkansas in 1941. He then formed a corporation to operate the dealership. The individual who became resident manager of the dealership, Loy Eich, eventually acquired 120 shares of the 300 shares of stock outstanding – the rest being owned by taxpayer Sullivan. When Eich terminated his management of the dealership in February 1948, Sullivan purchased his 120 shares of stock. Thereafter, in September, 1948, Frank Nelson became the resident manager of the dealership under an arrangement which included an agreement permitting Nelson to acquire up to forty (40) per cent of the stock and further providing for taxpayer's repurchase of said stock upon Nelson's termination of his employment. After acquiring approximately 38% of the corporation's outstanding stock, Nelson announced his intention to depart from his position in 1956 and offered to sell his stock to taxpayer Sullivan. The corporation's Board of Directors then authorized the redemption of Nelson's stock by the corporation.

The ultimate question before the District Court involved a determination of whether the payment by the corporation in redemption of Nelson's stock constituted a taxable distribution to taxpayer Sullivan, the sole remaining stockholder of the corporation. The District Court found that taxpayer Sullivan was unconditionally and primarily obligated to purchase Nelson's stock in 1956 and that said stock was purchased by the Corporation out of profits distributable as a dividend and therefore held that the taxpayer constructively received income equivalent to a dividend in the amount paid by the Corporation for said stock, ($198,334.58). ...

... The District Court was justified in concluding that Sullivan was unconditionally obligated to purchase Nelson's stock. [footnote omitted].

At this juncture, the payment by the corporation to Nelson presents two basic questions: (1) Was that payment in actuality a dividend and therefore includable in Sullivan's gross income under §§ 61(a)(7), 316(a) and 301(c)(1) of the Internal Revenue Code? (2) If the payment is considered

as a corporate redemption of stock, was the payment includable in Sullivan's gross income as being essentially equivalent to a dividend within the meaning of § 302(b)(1)? This court has recognized that both questions are to be resolved as fact issues. *Idol v. Commissioner of Internal Revenue*, 319 F.2d 647 (8th Cir. 1963). If a finding is supported by substantial evidence on the record as a whole and is not against or induced by an erroneous view of the law, it will not be disturbed on appeal.

When an individual shareholder receives an economic benefit through a diversion of corporate earnings and profits, such a receipt may be taxed as a constructive dividend. [footnote omitted]. This court set forth a criteria [*sic* criterion] for determining whether a payment constitutes a constructive dividend in *Sachs v. Commissioner of Internal Revenue*, 277 F.2d 879, 882-883 (8th Cir. 1960):

> "The motive, or expressed intent of the corporation is not determinative, and constructive dividends have been found contrary to the expressed intent of the corporation. The courts, as arbiters of the true nature of corporate payments, have consistently used as a standard the measure of receipt of economic benefit as the proper occasion for taxation." (footnote omitted).

...

The general net effect and the purpose of and circumstances surrounding the transaction involved herein must be carefully scrutinized to ascertain whether Sullivan received a taxable dividend. Prior to the transaction, Sullivan held approximately 62% of the shares outstanding while Nelson owned the remaining shares. As previously discussed, Sullivan was unconditionally obligated to purchase Nelson's stock if it was offered to him for sale. After the transaction was completed, the relevant facts were essentially as follows: (1) Sullivan's personal obligation had been discharged (2) Sullivan owned all of the outstanding shares of stock of the corporation (3) the corporation's assets were decreased by the amount paid to Nelson for his stock (4) Nelson's stock was held by the corporation as treasury stock. It is true that in terms of the financial worth of Sullivan's interest in the corporation, it was the same after the transaction as it was before.[65] The transaction still resulted in an economic benefit to Sullivan, however, because he was relieved of his personal obligation to purchase Nelson's stock. [footnote omitted]. After careful consideration this court concludes that there was no corporate business purpose or other factor which justifies the taxpayer's position that as to him the payment must be considered a stock redemption and not the equivalent of a dividend. [footnote omitted]. On the facts of this case, Sullivan received a taxable dividend as the result of the corporation's purchase of Nelson's stock.

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[65] Prior to the transfer of Nelson's stock Sullivan owned 186 shares of the 300 shares outstanding. His stock at this time was worth approximately $323,597.00. After the transfer, his 186 shares were the only outstanding stock of the corporation. Due to the corporate purchase of Nelson's stock, however, the value of the taxpayer's shares remained at approximately $323,597.00.

This court is aware that it is often difficult to distinguish true substance from mere form. Tax law places some weight and significance on form and the choice of one alternative rather than another for achieving a desired end is often critical and may be determinative of the tax effect of a transaction. [footnote omitted]. The taxpayer has failed to establish grounds for reversal. The judgment of the District Court is affirmed.

Questions and comments:

1. When persons form a closely-held corporation, it should not be too difficult for them to anticipate that one or more of them might wish to sell her shares. Or a majority might want to buy out the shares of one shareholder. Or a shareholder might die. Etc. In short, there will be situations where it is necessary for the other shareholders or the corporation to buy out the interest of that shareholder.

Life insurance can play a role. Remember: payment of life insurance premiums is not deductible, but receipt of life insurance proceeds paid by reason of death is not included in gross income. If life insurance is to play a role, who should own the policy? Who should pay the premiums? Would it ever be possible for the life insurance policy to outlast its usefulness, and if so, what should happen to the policy?

2. Consider the options that the following important revenue ruling present for corporate planning.

Rev. Rul. 69-608, 1969-2 C.B. 42

... Where the stock of a corporation is held by a small group of people, it is often considered necessary to the continuity of the corporation to have the individuals enter into agreements among themselves to provide for the disposition of the stock of the corporation in the event of the resignation, death, or incapacity of one of them. Such agreements are generally reciprocal among the shareholders and usually provide that on the resignation, death, or incapacity of one of the principal shareholders, the remaining shareholders will purchase his stock. Frequently such agreements are assigned to the corporation by the remaining shareholder and the corporation actually redeems its stock from the retiring shareholder.

Where a corporation redeems stock from a retiring shareholder, the fact that the corporation in purchasing the shares satisfies the continuing shareholder's executory contractual obligation to purchase the redeemed shares does not result in a distribution to the continuing shareholder provided that the continuing shareholder is not subject to an existing primary and unconditional obligation to perform the contract and that the corporation pays no more than fair market value for the stock redeemed.

On the other hand, if the continuing shareholder, at the time of the assignment to the corporation of his contract to purchase the retiring shareholder's stock, is subject to an unconditional

obligation to purchase the retiring shareholder's stock, the satisfaction by the corporation of his obligation results in a constructive distribution to him. The constructive distribution is taxable as a distribution under § 301 of the Internal Revenue Code of 1954.

If the continuing shareholder assigns his stock purchase contract to the redeeming corporation prior to the time when he incurs a primary and unconditional obligation to pay for the shares of stock, no distribution to him will result. If, on the other hand, the assignment takes place after the time when the continuing shareholder is so obligated, a distribution to him will result. While a pre-existing obligation to perform in the future is a necessary element in establishing a distribution in this type of case, it is not until the obligor's duty to perform becomes unconditional that it can be said a primary and unconditional obligation arises.

The application of the above principles may be illustrated by the situations described below.

Situation 1
A and B are unrelated individuals who own all of the outstanding stock of corporation X. A and B enter into an agreement that provides in the event B leaves the employ of X, he will sell his X stock to A at a price fixed by the agreement. The agreement provides that within a specified number of days of B's offer to sell, A will purchase at the price fixed by the agreement all of the X stock owned by B. B terminates his employment and tenders the X stock to A. Instead of purchasing the stock himself in accordance with the terms of the agreement, A causes X to assume the contract and to redeem its stock held by B. In this case, A had a primary and unconditional obligation to perform his contract with B at the time the contract was assigned to X. Therefore, the redemption by X of its stock held by B will result in a constructive distribution to A. *See William J. and Georgia K. Sullivan v. United States of America*, 244 F. Supp. 605 (1965), *aff'd*, 363 F.2d 724 (1966), *certiorari denied*, 387 U.S. 905 (1967).

Situation 2
A and B are unrelated individuals who own all of the outstanding stock of corporation X. An agreement between them provides unconditionally that within ninety days of the death of either A or B, the survivor will purchase the decedent's stock of X from his estate. Following the death of B, A causes X to assume the contract and redeem the stock from B's estate.

The assignment of the contract to X followed by the redemption by X of the stock owned by B's estate will result in a constructive distribution to A because immediately on the death of B, A had a primary and unconditional obligation to perform the contract.

Situation 3
...

Situation 4
A and B owned all of the outstanding stock of X corporation. A and B entered into a contract under which, if B desired to sell his X stock, A agreed to purchase the stock or to cause such stock to be purchased. If B chose to sell his X stock to any person other than A, he could do so at

any time. In accordance with the terms of the contract, A caused X to redeem all of B's stock in X.

At the time of the redemption, B was free to sell his stock to A or to any other person, and A had no unconditional obligation to purchase the stock and no fixed liability to pay for the stock. Accordingly, the redemption by X did not result in a constructive distribution to A. *See S.K. Ames, Inc., v. Commissioner*, 46 B.T.A. 1020 (1942), *acq.*, C.B. 1942-1, 1.

Situation 5
A and B owned all of the outstanding stock of X corporation. An agreement between A and B provided that upon the death of either, X will redeem all of the X stock owned by the decedent at the time of his death. In the event that X does not redeem the shares from the estate, the agreement provided that the surviving shareholder would purchase the unredeemed shares from the decedent's estate. B died and, in accordance with the agreement, X redeemed all of the shares owned by his estate.

In this case A was only secondarily liable under the agreement between A and B. Since A was not primarily obligated to purchase the X stock from the estate of B, he received no constructive distribution when X redeemed the stock.

Situation 6
B owned all of the outstanding stock of X corporation. A and B entered into an agreement under which A was to purchase all of the X stock from B. A did not contemplate purchasing the X stock in his own name. Therefore, the contract between A and B specifically provided that it could be assigned by A to a corporation and that, if the corporation agreed to be bound by the terms, A would be released from the contract.

A organized Y corporation and assigned the stock purchase contract to it. Y borrowed funds and purchased all of the X stock from B pursuant to the agreement. Subsequently Y was merged into X and X assumed the liabilities that Y incurred in connection with the purchase of the X stock and subsequently satisfied these liabilities.

The purchase by Y of the stock of X did not result in a constructive distribution to A. Since A did not contemplate purchasing the X stock in his own name, he provided in the contract that it could be assigned to a corporation prior to the closing date. A chose this latter alternative and assigned the contract to Y. A was not personally subject to an unconditional obligation to purchase the X stock from B. *See Arthur J. Kobacker and Sara Jo Kobacker, et al. v. Commissioner*, 37 T.C. 882 (1962), *acq.*, C.B. 1964-2, 6. *Compare Ray Edenfield v. Commissioner*, 19 T.C. 13 (1952), *acq.*, C.B. 1953-1, 4.

Situation 7
A and B owned all of the outstanding stock of X corporation. An agreement between the shareholders provided that upon the death of either, the survivor would purchase the decedent's shares from his estate at a price provided in the agreement. Subsequently, the agreement was

rescinded and a new agreement entered into which provided that upon the death of either A or B, X would redeem all of the decedent's shares of X stock from his estate.

The cancellation of the original contract between the parties in favor of the new contract did not result in a constructive distribution to either A or B. At the time X agreed to purchase the stock pursuant to the terms of the new agreement, neither A nor B had an unconditional obligation to purchase shares of X stock. The subsequent redemption of the stock from the estate of either pursuant to the terms of the new agreement will not constitute a constructive distribution to the surviving shareholder.

Questions and comments:

1. How might taxpayer Sullivan have planned better?

C. Bargain sales to shareholders

Reg. § 1.301-1(j) provides in part: "If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which § 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value."

- Examine § 311(a). How does the rule of § 311(a) apply to the distribution of property to which § 301 applies?

Honigman v. Commissioner, 466 F.2d 69 (6th Cir. 1972)

PHILLIPS, Chief Judge

This is an appeal and cross-appeal from a decision of the United States Tax Court ... We affirm as to the issues on appeal and reverse as to the issue on cross-appeal.

The principal controversy involves the tax consequences of the sale of corporate property below market value to a minority shareholder. A secondary unrelated question will be treated in Part III of this opinion, *infra*.

I.

... The National Building Corporation was incorporated under the laws of Michigan in 1946 to engage in the ownership and operation of commercial real estate. Its principal stockholders were the Honigman family (35%), the Silberstein family (35%) and the Galperin family (20%). A member of each family held a position as a director and officer of National.

In early 1963 steps were undertaken to effect a complete liquidation of National. A preliminary agreement to sell its principal asset, the First National Building in Detroit, was entered into in February 1963. At that time, National's only unsuccessful investment was the Pantlind Hotel in downtown Grand Rapids, Michigan, which it had acquired in 1951. Taxpayers were aware that the Pantlind should be sold prior to adoption of the liquidation plan in order to permit the corporation to recognize the loss on this sale while shielding it from recognition of the substantial gains to be realized from the sale of the remaining assets. During this time, unsuccessful efforts were made to sell the hotel at offering prices ranging from $200,000 to $250,000 over its $590,000 mortgage. At an informal meeting of the directors in April, Jason Honigman proposed that the property be sold for a "nominal" price of $50,000 over mortgage. The hotel had not been offered previously at this price, nor was such an offer ever made to outsiders. Ben Silberstein initially indicated an interest in the transaction, but subsequently declined the purchase. Honigman later decided to buy the property at the "nominal" price.

The Pantlind Hotel Corporation was organized under Michigan law to purchase the hotel for some $661,000, representing assumption of the mortgage and a $21,000 tax liability, and $50,000 cash. Mrs. Edith Honigman, wife of Jason Honigman, was the sole stockholder. Title was transferred on May 27, 1963. Two days later a further adjustment of about $38,000 was paid to National. At the time of the sale, National's adjusted basis in the Pantlind was approximately $1,486,000.

In August 1963 National adopted a qualified liquidation plan. All assets were sold within one year and the proceeds distributed pro rata to the shareholders.

The Honigmans reported no income from the May transaction on their 1963 joint income tax return. National deducted the difference between the sale price and the basis of the Pantlind as a business loss on its corporate tax return. The Commissioner determined a deficiency against the Honigmans individually, asserting that they had received a taxable dividend from the Pantlind sale equal to the excess of the fair market value over the purchase price. ... A further deficiency was asserted against the Honigmans as transferees of National, the Commissioner disallowing National's claimed loss deduction on the ground that the constructive dividend to the Honigmans was not recognizable as a loss by the corporation. Similar transferee liability was asserted against the Silbersteins and Galperins.

These deficiencies were contested in a consolidated Tax Court proceeding. The Tax Court found that the fair market value of the Pantlind at the time of sale was $830,000. The court held the transaction to have been a dividend to the Honigmans to the extent of the difference between the market value and sale price and a sale to the extent of the difference between adjusted basis and market value. The former was held to be includible as income to the Honigmans and not deductible by National. The latter was held to be deductible by National.

... On the record before us, we decline to set aside the Tax Court's finding of fair market value in the amount of $830,000.

The principal legal argument on behalf of the taxpayers is that the excess of fair market value over purchase price of an asset purchased from a corporation by a stockholder is a necessary but not sufficient condition for the declaration of a constructive dividend to the extent of the excess. It is urged that there also must be an intent to distribute a dividend and that such intent is negated by a showing that the sale was made in good faith for a valid business purpose to a noncontrolling stockholder.

We do not accept this argument. ...

As stated by the Supreme Court:

> "[I]t is clear that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a 'distribution of property' as that term is used in § 316. Such a sale thus results in a dividend to shareholders unless some specific exception or qualification applies." *Commissioner v. Gordon*, 391 U.S. 83, 89-90 (1968) (footnote omitted).
>
> "If a distribution meets the requirements of the statutory definition of a dividend, then it is regarded as such notwithstanding the fact that it was intended to be a payment of some other kind. *Christopher v. Burnet*, 55 F.2d 527, 528 (CADC 1931); *Hadley v. Commissioner*, 36 F.2d 543, 544 (CADC 1929). It is not necessary that the dividend be formally declared, or that the payment be termed a dividend, or that the payment be made to all the shareholders. *Lengsfield v. Commissioner*, 241 F.2d 508, 511 (5th Cir. 1957); *Regensburg v. Commissioner*, 144 F.2d 41, 44 (2d Cir.), *cert. denied*, 323 U.S. 783 (1944). For example, distributions have been regarded as dividends where a corporation makes a loan to a shareholder and later cancels the indebtedness, or sells property to a shareholder for a purchase price far below its fair market value, or pays compensation to an office-shareholder in an amount in excess of the value of his services. In cases such as these and others involving the same problem, courts have had little difficulty in holding the distribution or that part of it in excess of the quid pro quo, to be a dividend, notwithstanding the fact that neither the shareholder nor the corporation 'intended' that a dividend be paid. It is not the intent of the parties that governs the characterization of the distribution, but rather the economic and consequent legal effect of their actions." *Dynamics Corporation of America v. United States*, 392 F.2d 241, 246-247 (Ct. Cl. 1968). *Accord United States v. Smith*, 418 F.2d 589, 593-594 (5th Cir. 1969).

Taxpayers' reliance on *Palmer v. Commissioner of Internal Revenue*, 302 U.S. 63 (1937), is misplaced. As noted in *Palmer*, a constructive dividend results where a "transaction is in purpose *or effect* used as an implement for the distribution of corporate earnings to the stockholders." *Id*. at 70 (emphasis supplied).

The Tax Court found that the sale of the Pantlind below market diminished the net worth of National. There was no question that National had sufficient earnings and profits to support a dividend in the amount stated in the deficiency notice. ...

Taxpayers further assert that the decision of the Tax Court was erroneous on the ground that the Pantlind was sold to a corporation not a shareholder of National. ... [T]he evidence shows to our satisfaction that, looking through form to substance, the sale was made to the Honigmans. [citations omitted].

... Accordingly, the decision of the Tax Court with respect to the individual liability of the Honigmans is affirmed.

II.

We turn next to the cross appeal of the Commissioner. The Tax Court held that the sale of the Pantlind Hotel by National to the Honigmans was partly a constructive dividend and partly a sale. To reiterate the details of this transaction, the hotel had an adjusted basis to National of $1,468,168.51. The Honigmans purchased the hotel for $661,280.21. The Tax Court found that its fair market value was $830,000. It held that the transfer of the hotel to the Honigmans was to be treated for tax purposes as in part a dividend to the Honigmans in an amount equal to the difference between the purchase price and the hotel's fair market value (i.e., a constructive dividend of $168,719.79); and in part a sale to the extent of the excess of basis over fair market value. The Tax Court thus fragmented the transaction into part dividend, part sale. It further held that only the sale portion constituted a taxable event with respect to National. National was allowed a recognizable loss on this transaction to the extent of the difference between the fair market value of the hotel and its adjusted basis. Under the holding, National was allowed to allocate 100 per cent of the hotel's basis to the sale portion of the transaction.

The Commissioner asserts that this part of the decision of the Tax Court is in direct contravention of the Congressional purpose and nonrecognition mandate contained in § 311(a), which provides that no gain or loss shall be recognized to a corporation on distributions to a shareholder with respect to its stock. The Commissioner contends that the purpose of § 311 is to segregate and remove from gain or loss recognition those distributions which are made to shareholders on account of their status as shareholders. We agree with the Commissioner.

The portion of the hotel transaction which the Tax Court held to be a constructive dividend distribution to the Honigmans represented a distribution to shareholders with respect to National's stock under § 301. The non-recognition of loss provision contained in § 311 would prohibit any recognition of loss on this part of the transaction. Yet, by allowing National a loss on the transaction measured by the difference between the hotel's adjusted basis and its fair market value, the Tax Court has permitted National to receive the benefit of a loss on that portion of the transaction held to be a distribution with respect to National's stock. We agree with the Commissioner that in order to give effect to the requirement of § 311, the basis of the hotel must be fragmented proportionately between the sales aspect and the distribution aspect of the transaction. The sale portion should be given recognition only to the extent that the basis allowable to the sale exceeds the consideration paid. Since the Honigmans paid $661,280 for the hotel property which had a fair market value of $830,000, they have purchased in their capacity

as buyers a fractional interest represented by $661,280/$830,000. The loss resulting to National from the sale portion of the transaction thus should be computed by allocating a like per cent of the adjusted basis ($1,174,534) to the sale portion, which would result in a recognized loss to National of the difference between the consideration paid and the proportionate share of the basis allocated to the consideration paid.

In the present case, using approximate figures for the purchase price ($660,000), market value ($830,000) and adjusted basis ($1,470,000), approximately 66/83 of the property was sold and 17/83 was distributed as a dividend.

Therefore, we reverse as to that part of the decision of the Tax Court covered by the cross-appeal of the Commissioner. We remand for recomputation of the loss properly recognizable by National and the resulting amount of transferee liability for each of the taxpayers.

III.

...

Affirmed in part, reversed in part, and remanded for further proceedings consistent with this opinion.

Questions and comments:

1. Articulate the difference in the way the Tax Court treated the distribution from National to the Honigmans and the way the Sixth Circuit treated the distribution – for both National and the Honigmans.

2. A corporation may not claim a loss on the distribution of property to a shareholder. § 311(a). A corporation *may* claim a loss when it sells property for less than its adjusted basis. What trap awaits a closely-held corporation that sells loss property to a shareholder? *See* §§ 267(a), 267(b)(2), 267(c).

3. The court quoted from *Gordon*. The excerpt reminds us that corporation/shareholder loans that are never repaid, sale of corporate property to shareholders at a bargain price, and corporate payment of excess compensation to a shareholder/employee are methods of paying shareholders disguised dividends.

4. In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), the Supreme Court held that the distribution of appreciated property was not a taxable event to the corporation. Section 311(a) codified this result. Section 311(b) reversed the result with respect to the distribution of gain property. *Honigman* of course involved the distribution of loss property, so the corporation was most anxious to sell it rather than distribute it. Its loss on a distribution would not be allowed, but it was allowed when the distribution was part of a liquidation. § 336(a).

D. Below-market loans, § 7872, and Other Ploys

Read IRC § 7872.

The unfavorable tax treatment of dividends may impel corporations and shareholders to enter into other transactions whereby the corporation can get money into the hands of shareholders or otherwise provide an accession to wealth. As always, tax consequences turn on the reality of the transaction. Corporations may loan money to shareholders for little or no interest. of repayment. The shareholder's use of the corporation's money without payment of interest is certainly an accession to wealth. Nevertheless, courts held that a shareholder of a corporation did not realize gross income because he received an interest-free loan from the corporation. *See Beaton v. Comm'r*, 664 F.2d 315 (CA1 1981) (president and sole shareholder; adhering to rule of *Dean v. Comm'r*, 35 T.C. 1083 (1961)); *Suttle v. Comm'r*, 625 F.2d 1127 (CA4 1980) (adhering to rule of *Dean*). In 1984, Congress added § 7872 to the Code. Deficit Reduction Act of 1984 (DEFRA), Pub. L. 98-369, § 172(a), 98 Stat. 699. Section 7872 applies to below-market loans in several contexts, but our concern is with corporation/shareholder loans.

Sections 7872(a), (b), (c)(1)(C), (e), (f)(1), and (f)(2) address below-market loans between corporations and shareholders.

- A corporation/shareholder loan may be a demand loan or a term loan. A "demand loan" is a loan which is payable in full at any time on the demand of the lender. … [S]uch term also includes any loan with an indefinite maturity." § 7872(f)(5). A "term loan" is "any loan which is not a demand loan." § 7872(f)(6).

- If a below-market loan is a demand loan, § 7872(a) provides that foregone interest is treated first as paid by the lender to the borrower, and then paid by the borrower to the lender. So, if a corporation lends money to a shareholder at below market rates, the difference between market interest rate and the interest rate charged is treated as paid by the corporation to the shareholder. Such a payment would be given dividend treatment under the rules of § 301(c). The shareholder's payment would be treated as a contribution to the corporation's capital.

- If such a loan is not a demand loan, § 7872(b) provides that the amount borrowed minus the present value of repayments is to be treated as transferred from lender to borrower. A corporation would be treated as having paid a dividend in that amount.

Section 7872 applies to corporation/shareholder loans only if the aggregate amount of loans is more than $10,000, § 7872(c)(3)(A), unless tax avoidance is one of the principal purposes of the arrangement. § 7872(c)(3)(B).

In *KTA-Tator, Inc. v. Comm'r*, 108 T.C. 100, 106-07 (1997), the tax court offered the following

example:

> In the case of a below-market demand loan from a corporation to a shareholder, the corporation is treated as transferring to the shareholder, and the shareholder is treated as paying to the corporation, an amount equal to the foregone interest. The deemed transfer from the corporation to the shareholder is treated as a distribution, which generally is taxed as a dividend to the shareholder. §§ 61(a)(7), 301(c)(1); H. CONF. REPT. 98-861 [at 1013 (1984), 1984-3 C.B. [1,] at 267. The shareholder generally may deduct the deemed interest payment to the corporation. H. CONF. REPT. 98-861, *supra* at 1013, 1984-3 C.B. at 266. The shareholder's income from the deemed dividend and the shareholder's deduction for the deemed payment of interest may offset each other within the meaning of the temporary regulation. The corporation, on the other hand, is subject to tax on the foregone interest but is not entitled to a deduction for the deemed distribution it made to the shareholder. Therefore, it has no deduction to offset the interest income from the loan. Similarly, petitioner has interest income but is not entitled to a deduction for the deemed distribution it made ….

Problem:
Assume that the Applicable Federal Rate is 10%. Corporation loans $100,000 to one of its shareholders who uses the proceeds to pay for her daughter's university tuition.
A. If the loan is a demand loan, what would be the tax consequences to Corporation and to shareholder at the end of year 1?
B. If the loan is a term loan, how would you determine the tax consequences to Corporation and to shareholder at the end of year 1?

IV. Corporate Distributions: Tax Consequences to Shareholder

Read §§ 61(a)(7), 301, 311.

A corporate distribution to a shareholder does not affect the shareholder's ownership interest in the corporation. However, the tax consequences to the shareholder depend upon whether the distribution is less or more than the corporation's e&p. Section 61(a)(7) provides that gross income includes dividends. Section 301 informs whether a corporate distribution is in fact a "dividend."

How much is the distribution? The amount of the distribution is the fair market value of the property (§ 301(b)(1)) on the date of distribution (§ 301(b)(3)) less any corporate liability that the shareholder assumes (§ 301(b)(2)(A)) or any liability to which the distributed property is subject (§ 301(b)(2)(B)). The fmv of the property presumptively is not less than a liability to which the property is subject. § 311(b)(2), cross-referencing § 336(b).

What is the tax treatment to the shareholder of a distribution of property? Section 301 governs

the shareholder's treatment of the distribution. If the distribution is less than the corporation's e&p available for distribution, all the distribution is dividend income. § 301(c)(1). If the corporation's e&p is less than the distribution, the excess first reduces the shareholder's basis in her stock, § 301(c)(2), and then is treated as a gain from the sale or exchange of property, § 301(c)(3).

What is the shareholder's basis in the property that the corporation distributed to her? The shareholder takes a fair market value basis in the property she receives as a dividend. § 301(d). This is true even if the shareholder takes the property subject to a liability.

- A taxpayer's basis in property represents her after-tax investment in that property. Basis is a taxpayer's money that will not (again) be subject to income tax.

- If a taxpayer receives property subject to a liability, its fair market value net of liabilities is of course less than its fair market value. However, because shareholder will have to pay those liabilities with after-tax income and a taxpayer may use debt to obtain basis, taxpayer should be entitled to a fair market value basis in the property she receives in a distribution.

What is the shareholder's basis in her stock with respect to which the corporation makes a distribution? A corporation's distribution of a dividend does not affect her basis in her stock with respect to which the corporation makes a distribution,[66] except when the distribution exceeds the corporation's e&p.

Problems:

1. Myron owns common stock in Hannibal Corporation, a calendar year taxpayer. Myron's basis in his stock is $10,000. Hannibal Corporation had $4000 of accumulated e&p at the beginning of this year. In the current year, Hannibal has $3000 of current e&p. Hannibal distributed to Myron Blackacre (ab to Hannibal Corporation = $10,000; fmv = $10,000). This was the only distribution that Hannibal Corporation made this year.

- What are the tax consequences of the distribution to Myron?

- What is the tax consequence of the distribution to Hannibal Corporation?

- What is Hannibal Corporation's accumulated e&p on January 1 of the next year?

2. Same as #1, but the fmv of Blackacre is $16,000 at the time of distribution.

3. Same as #1, but the fmv of Blackacre is $8000 at the time of distribution.

4. Same as #1, except that Blackacre is subject to a $4000 liability that Myron assumes.

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[66] This is unlike the treatment of a distribution of profits by a partnership or an S corporation where the partner or shareholder reduces her basis by the amount of the distribution. §§ 705(a)(2), 1367(a), 1368(d).

5. Same as #1, except that Blackacre is subject to a $12,000 liability that Myron assumes.

V. Income Tax Consequences to Corporation of Distributions to Shareholders and Their Effect on Earnings and Profits, § 312

Read §§ 311, 312.

A corporation's e&p is a measure of a corporation's ongoing profitability reduced by the distributions the corporation has made to its shareholders. A corporation's e&p is not kept in a special bank account. In fact, a corporation's e&p may unavailable for distribution because the corporation has invested its after-tax income in the corporation's business. Such investments do not reduce the corporation's e&p because such a use of corporate funds hardly reduces the profitability of the corporation. From this point, we can conclude that a corporation's e&p reflect its *capacity to pay a dividend*, even if it does not pay a dividend or make a distribution.

> *Corporate distributions of loss property*: A corporation must recognize the built-in gain on any property it distributes to a shareholder. It may *not* recognize loss. § 311(a). If the Code permitted a corporation to recognize loss a distribution, the corporation could too easily manipulate its tax liability through distributions of loss property to shareholders. To recognize a loss, the corporation must engage in a transaction with someone other than a shareholder. Recall that in *Honigman v. Comm'r*, the corporation sold loss property to a shareholder. Were it not for the fact that the sale occurred in the context of a corporate liquidation, the corporation could not recognize a loss.

Recall that computation of a corporation's e&p begins with its after-tax income. Section 312 prescribes adjustments – additions and subtractions – to the corporation's e&p account. A corporation's treatment of various items for *income tax purposes* and for *e&p purposes* vary – generally in recognition that earnings and profits reflect a corporation's capacity to make distributions to its shareholders without impairing its capital – and that this may not coincide with what the Code deems to be the corporation's income on which it should pay income tax. In addition to the specific rules that § 312 sets forth, courts and the IRS resolve questions of the effect of distributions on a corporation's e&p consistent with these principles.

Naturally a corporation's distribution of cash to shareholders reduces a corporation's e&p dollar-for-dollar. § 312(a)(1). More difficult questions arise when the corporation distributes property other than money. A corporation and its shareholders are separate taxpayers and each separately accounts for distributions.

Income tax consequences of corporate distributions of appreciated or depreciated property: Section 311(b) requires the corporation to recognize gain upon its distribution of appreciated property to a shareholder. When a corporation distributes property other than cash to a shareholder, we treat the transaction the same as we would treat the corporation's sale of the

asset for its fair market value followed by a distribution of the amount realized to the shareholder. The "use of appreciated property to pay for something is a recognition event." Here, that "something" is a distribution. The corporation is paying for a distribution that may or may not be a dividend. The corporation must recognize taxable gain on the distribution of appreciated property to a shareholder. § 311(b)(1). The corporation may *not* recognize loss on the distribution of property to a shareholder. § 311(a).

Effect of corporate distributions of appreciated or depreciated property on corporation's e&p: A corporation's distribution of appreciated property is simultaneously a tax recognition event to the corporation *and* a distribution to shareholder(s) with implications for the corporation's e&p. Section 312(b) requires that the corporation first increase its e&p by the amount of the property's built-in gain, and second reduce its e&p by the fmv of the property distributed. The net result is the corporation reduces its e&p by the basis of the property it distributed to a shareholder.

Example: Corporation Q has accumulated e&p of $25,000 and current e&p of $0, except for whatever e&p the following transaction produces. For now, disregard the effect of income tax liability on Corporation Q's e&p. Corporation Q distributes some stock of Corporation R that it purchased several years ago to shareholder S. Corporation Q's basis in its Corporation R's stock is $25,000. Its fmv at the time of distribution is $31,000.

•On how much income must Corporation Q pay income tax? How much is shareholder S's dividend? What is Corporation Q's e&p after the distribution?

•Corporation Q must recognize $6000 on the distribution. This tax treatment is the same as the tax treatment as a sale for $31,000 followed a distribution of the sales proceeds to shareholder S. This taxable gain will produce $6000 of current e&p for Corporation Q.

•Shareholder S's dividend is $31,000, the fmv of the stock that she received. Corporation Q has $31,000 of e&p ($25,000 accumulated e&p and $6000 current e&p).

•Corporation Q's e&p after the distribution is $0.
$25,000 (acc. e&p) + $6000 (excess of fmv over adjusted basis) − $31,000 (fmv of distribution)

Distributions of Loss Property and the Corporation's e&p: A corporation may not recognize loss on the distribution of loss property to a shareholder. In such a case, the corporation reduces its e&p by the adjusted basis of the loss property. In effect, the corporation *does* recognize loss for purposes of e&p. Do you see how this occurs?

When a corporation distributes loss property – which is something it should not want to do – § 312(b) has no application. Section 312(a)(3) requires the corporation to reduce its e&p by the basis of the property distributed.

The corporation's capacity to pay dividends: In computing its tax liability, a corporation may benefit from Code provisions that exclude certain income from its taxable income, accelerate deductions, or that defer recognition of taxable income. Such provisions do not affect a corporation's profitability, and therefore do not affect it capacity to pay dividends. We see this in the adjustments to a corporation's e&p that § 312 requires. A corporation may not reduce its e&p

to the extent that a depreciation allowance is greater than that allowable under the straight-line method. § 312(k).[67] A corporation must compute its e&p without regard to the installment method. § 312(n)(5). A taxpayer that uses inventory accounting must compute its e&p with the FIFO (first in first out) method, even if it computes it tax liability using the LIFO (last in first out) method. § 312(n)(4).

Reg. § 1.312-6(b) brings within the scope of e&p income exempted by statute, income not taxable under the Constitution, and all items of gross income includible in gross income under § 61.

Problem:

1. Consider this example: Corporation A distributes to its sole shareholder Benes property with a fair market value of $10,000 and a basis of $15,000. It has $20,000 of earnings and profits.

    •How much loss may Corporation A recognize on this distribution for income tax purposes?

    •If Corporation A makes no other distributions during the year, what should be its e&p after the distribution?

    •What is Benes's basis in the property?

See Reg. § 1.312-1(c) (Example 2).

2. Same facts, except that Corporation A's basis in the property is $7500.

    •How much gain must Corporation A recognize on this distribution for income tax purposes?

    •If Corporation A makes no other distributions during the year, what should be its e&p after the distribution?

    •What is Benes's basis in the property?

3. Same facts as #2, except that the property is subject to a $1500 liability that Benes assume?

    •How much gain must Corporation A recognize on this distribution for income tax purposes?

    •If Corporation A makes no other distributions during the year, what should be its e&p after the distribution?

    •What is Benes's basis in the property?

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[67] Expensing under §§ 179, 179B, 179C, 179D, and 179E reduces a corporation's e&p ratably over five years. § 312(k)(3)(B).

See § 312(c).

4. What should be the effect on a corporation's e&p of its receipt of tax exempt interest income? Reg. § 1.312-6(b).

5. Payment of life insurance premiums is not deductible because the receipt of life insurance proceeds paid by reason of death is excluded from gross income. § 101(a)(1). How should a corporation treat the payment of life insurance premiums for e&p purposes? If a corporation receives life insurance proceeds paid by reason of death, should the corporation include such amounts in its e&p? *See* Rev. Rul. 54-230, 1954-1 C.B. 114.

6. Under certain circumstances, a taxpayer who makes a charitable contribution of appreciated property may deduct the fmv of the property without ever paying income tax on the built-in long term gain on the property. § 170(e)(1). If a corporation donates property with built-in long term gain to a charity under the circumstances that § 170(e) prescribes and deducts the fmv of the property without paying income tax on the built-in gain – what should be the effect of the contribution on the corporation's e&p? *See* Rev. Rul. 78-123, 1978-1 C.B. 87.

7. How should a corporation adjust its e&p when it makes a bargain sale to a shareholder? *See Dellinger v. Comm'r*, 32 T.C. 1178 (1959).

8. What should be the effect on a corporation's e&p of the portion of a dividend it receives from another corporation that it deducts?

9. Section 108(a) excludes from the gross income of certain taxpayers discharge of debt income. Taxpayer must reduce the tax attributes named in § 108(b). Taxpayer may elect to reduce its adjusted basis in depreciable property pursuant to the rules of § 1017. § 108(b)(5).

- What is the rule concerning adjustments to e&p provided by § 312(*l*)? Why should that rule be different than it is for discharge of debt that either is not excluded from the corporation's gross income or that the corporation applies to reduce other tax attributes, e.g., net operating loss carryovers?

Do the CALI exercise: Corporate Taxation: Distributions: Calculation of C Corporation Earnings and Profits.

Do the CALI exercise: Corporate Taxation: Distributions: Distributions of Property by C Corporations.

VI. Corporate Shareholders

Read § 243.

Corporations who receive dividends from corporations in which they own stock may deduct a substantial portion of the dividend that they receive. This is because such corporations are themselves owned by shareholders. When those shareholders receive their share of corporate profits as dividends, such profits already have been subject to two (or more) levels of income tax. Section 61(a)(7) provides that dividends are gross income, but § 243 allows corporations to deduct a portion of the dividends they receive from a domestic corporation, the portion depending on the proportion of the dividend-paying corporation that the dividend-receiving corporation owns. Specifically, a corporation that owns less than 20% by vote and value of another corporation may deduct 50% of the dividends it receives from that other corporation. § 243(a)(1). A corporation that owns at least 20% but less than 80% by vote and value of another corporation may deduct 65% of the dividends it receives from that other corporation. §§ 243(a)(1), 243(c)(1). A corporation that owns at least 80% of the stock by vote and value of another corporation may deduct 100% of the dividends it receives from that other corporation. §§ 243(a)(3), 243(b).

> The Tax Cuts and Jobs Act reduced the dividends-received deduction. The deduction had been 70% for corporations owning less than 20% by vote and value of the stock of another corporation, 80% for a corporation owning at least 20% but less than 80% of the dividend-paying corporation, and 100% for a dividend received from a member of an affiliated group. The justification for such reductions was that the maximum corporate rate on taxable income was reduced from 35% to 21%, a 40% decrease.

We have seen that much of corporate tax caselaw is driven by individual shareholder's desire to avoid characterizing corporate distributions as dividends. Corporations do not enjoy a preferential tax rate on their capital gains. Not surprisingly, corporations will view receipt of dividend income quite differently than individuals would look at dividend income. Corporations often seek tax treatment contrary to what individuals want.

Litton Indus., Inc. v. Commissioner, 89 T.C. 1086 (1987)

CLAPP, Judge

Respondent determined a deficiency in petitioner's Federal corporate income tax for the year ended July 29, 1973 in the amount of $11,583,054. After concessions, the issue for decision is whether Litton Industries received a $30,000,000 dividend from Stouffer Corporation, its wholly owned subsidiary, or whether that sum represented proceeds from the sale of Stouffer stock to Nestle Corporation.

FINDINGS OF FACT

...

Litton Industries, Inc. (petitioner) and its subsidiaries manufactured and sold, inter alia, business systems and equipment, defense and marine systems, industrial systems and equipment, and microwave cooking equipment. ...

On October 4, 1967, petitioner acquired all the outstanding stock of Stouffer Corporation (Stouffer), a corporation whose common stock was listed and traded on the New York stock exchange. Stouffer manufactured and sold frozen prepared food and operated hotels and food management services and restaurants. ...

....

... In early 1972, Charles B. Thornton (Thornton), the chairman of Litton's board of directors, Joseph Imirie, president of Stouffer, and James Biggar, an executive of Stouffer, discussed project 'T.I.B.,' i.e., the sale of Stouffer. In July 1972, Litton's board of directors discussed the mechanics and problems of selling Stouffer. As of August 1, 1972 Stouffer's accumulated earnings and profits exceeded $30,000,000. On August 23, 1972, Stouffer declared a $30,000,000 dividend which it paid to Litton in the form of a $30,000,000 negotiable promissory note, and at that time, Thornton believed that Litton would have no difficulty in receiving an adequate offer for Stouffer. Two weeks later, on September 7, 1972, petitioner announced publicly its interest in disposing of Stouffer. Subsequent to said announcement, Litton received inquiries from a number of interested sources, including TWA, Green Giant, investment banking houses, and business brokers about the possible purchase of all or part of the Stouffer business.

Beginning in mid-September 1972, Litton and several underwriters discussed the feasibility of a public offering of Stouffer Stock. In early September 1972, Litton negotiated with Lehman Brothers for a public offering of Stouffer stock, but Lehman Brothers decided not to participate in the offering. During October 1972, Litton, Stouffer and Merrill Lynch, a brokerage firm that thought Stouffer had an excellent outlook, prepared a public offering of Stouffer stock. During November 1972, petitioner, Stouffer, and Hornblower and Weeks prepared a partial public offering of Stouffer stock. Merrill Lynch had a policy of not effecting partial distributions of corporate subsidiaries and thus did not participate in the negotiations with Hornblower and Weeks. In mid-December 1972, Litton decided that a complete public offering was preferable and abandoned the idea of a partial public offering. The S-1 Registration Statement, which Stouffer filed with the Securities and Exchange Commission, stated that $30,000,000 of the proceeds would be used to pay the promissory note which Litton received as a dividend.

On March 1, 1973, Nestle Alimentana S.A. Corporation (Nestle), a Swiss corporation, offered to buy all of Stouffer's stock for $105,000,000. On March 5, 1973, Nestle paid Litton $74,962,518 in cash for all the outstanding stock of Stouffer and $30,000,000 in cash for the promissory note.

Because Litton sold Stouffer to Nestle, the underwriters stopped work on the scheduled public offering.

OPINION

The issue for decision is whether the $30,000,000 dividend declared by Stouffer on August 23, 1972, and paid to its parent, Litton by means of a negotiable promissory note was truly a dividend for tax purposes or whether it should be considered part of the proceeds received by Litton from the sale of all of Stouffer's stock on March 1, 1973. If, as petitioner contends, the $30,000,000 constitutes a dividend, petitioner may deduct 85 percent of that amount as a dividend received credit pursuant to § 243(a), [footnote omitted] as that section read during the year at issue. However, if the $30,000,000 represents part of the selling price of the Stouffer stock, as contended by respondent, the entire amount will be added to the proceeds of the sale and taxed to Litton as additional capital gain. Respondent's approach, of course produces the larger amount of tax dollars.

The instant case is substantially governed by *Waterman Steamship Corp. v. Commissioner*, 50 T.C. 650 (1968), *rev'd*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971). Respondent urges us to follow the opinion of the Fifth Circuit, which in substance adopted the position of Judge Tannenwald's dissent (concurred in by three other judges) from our Court-reviewed opinion. If we hold for respondent, we must overrule our majority opinion in *Waterman Steamship*. Petitioner contends that the reasoning of the Fifth Circuit in *Waterman Steamship* should not apply since the facts here are more favorable to petitioner. Additionally, petitioner points out that several business purposes were served by the distribution here which provide additional support for recognition of the distribution as a dividend. For the reasons set forth below, we conclude that the $30,000,000 distribution constituted a dividend which should be recognized as such for tax purposes. We believe that the facts in the instant case lead even more strongly than did the facts in *Waterman Steamship* to the conclusion that the $30,000,000 was a dividend. Accordingly, we hold that the Stouffer distribution to Litton was a dividend within the meaning of § 243(a).

In many respects, the facts of this case and those of *Waterman Steamship* are parallel. The principal difference, and the one which we find to be most significant, is the timing of the dividend action. In *Waterman Steamship*, the taxpayer corporation received an offer to purchase the stock of two of its wholly-owned subsidiary corporations, Pan-Atlantic and Gulf Florida, for $3,500,000 cash. The board of directors of Waterman Steamship rejected that offer but countered with an offer to sell the two subsidiaries for $700,000 after the subsidiaries declared and arranged for payments of dividends to Waterman Steamship amounting in the aggregate to $2,800,000. Negotiations between the parties ensued, and the agreements which resulted therefrom included, in specific detail, provisions for the declaration of a dividend by Pan-Atlantic to Waterman Steamship prior to the signing of the sales agreement and the closing of that transaction. Furthermore, the agreements called for the purchaser to loan or otherwise advance funds to Pan-Atlantic promptly in order to pay off the promissory note by which the dividend had been paid. Once the agreement was reached, the entire transaction was carried out

by a series of meetings commencing at 12 noon on January 21, 1955, and ending at 1:30 p.m. the same day. At the first meeting the board of directors of Pan-Atlantic met and declared a dividend in the form of a promissory note in the amount of $2,799,820. The dividend was paid by execution and delivery of the promissory note. At 12:30 p.m., the board of directors of the purchaser's nominee corporation ('Securities') met and authorized the purchase and financing of Pan-Atlantic and Gulf Florida. At 1 p.m., the directors of Waterman authorized the sale of all outstanding stock of Pan-Atlantic and Gulf Florida to Securities. Immediately following that meeting, the sales agreement was executed by the parties. The agreement provided that the purchaser guaranteed prompt payment of the liabilities of Pan-Atlantic and Gulf Florida including payment of any notes given by either corporation as a dividend.

Finally at 1:30 p.m., the new board of directors of Pan-Atlantic authorized the borrowing of sufficient funds from the purchaser personally and from his nominee corporation to pay off the promissory note to Waterman Steamship, which was done forthwith. As the Fifth Circuit pointed out, '[b]y the end of the day and within a ninety minute period, the financial cycle had been completed. Waterman had $3,500,000, hopefully tax-free, all of which came from Securities and McLean, the buyers of the stock.' This Court concluded that the distribution from Pan-Atlantic to Waterman was a dividend. The Fifth Circuit reversed, concluding that the dividend and sale were one transaction.

The timing in the instant case was markedly different. The dividend was declared by Stouffer on August 23, 1972, at which time the promissory note in payment of the divided was issued to Litton. There had been some general preliminary discussions about the sale of Stouffer, and it was expected that Stouffer would be a very marketable company which would sell quickly. However, at the time the dividend was declared, no formal action had been taken to initiate the sale of Stouffer. It was not until 2 weeks later that Litton publicly announced that Stouffer was for sale. There ensued over the next 6 months many discussions with various corporations, investment banking houses, business brokers, and underwriters regarding Litton's disposition of Stouffer through sale of all or part of the business to a particular buyer, or through full or partial public offerings of the Stouffer stock. All of this culminated on March 1, 1973, over 6 months after the dividend was declared, with the purchase by Nestle of all of Stouffer's stock. Nestle also purchased the outstanding promissory note for $30,00,000 in cash.

In the instant case, the declaration of the dividend and the sale of the stock were substantially separated in time in contrast to *Waterman Steamship* where the different transactions occurred essentially simultaneously. In *Waterman Steamship*, it seems quite clear that no dividend would have been declared if all of the remaining steps in the transaction had not been lined up in order on the closing table and did not in fact take place. Here, however, Stouffer declared the dividend, issued the promissory note and definitely committed itself to the dividend before even making a public announcement that Stouffer was for sale. Respondent argues that the only way petitioner could ever receive the dividend was by raising revenue through a sale of Stouffer. Therefore, respondent asserts the two events (the declaration of the dividend and then the sale of the company) were inextricably tied together and should be treated as one transaction for tax purposes. In our view, respondent ignores the fact that Stouffer could have raised sufficient

revenue for the dividend from other avenues, such as a partial public offering or borrowing. Admittedly, there had been discussions at Litton about the sale of Stouffer which was considered to be a very saleable company. However, there are many slips between the cup and the lip, and it does not take much of a stretch of the imagination to picture a variety of circumstances under which Stouffer might have been taken off the market and no sale consummated. Under these circumstances it is unlikely that respondent would have considered the dividend to be a nullity. On the contrary, it would seem quite clear that petitioner would be charged with a dividend on which it would have to pay a substantial tax. Petitioner committed itself to the dividend and, thereby, accepted the consequences regardless of the outcome of the proposed sale of Stouffer stock. [citation omitted].

Since the facts here are distinguishable in important respects and are so much stronger in petitioner's favor, we do not consider it necessary to consider further the opinion of the Fifth Circuit in *Waterman Steamship*.

The term 'dividend' is defined in § 316(a) as a distribution by a corporation to its shareholders out of earnings and profits. The parties have stipulated that Stouffer had earnings and profits exceeding $30,000,000 at the time the dividend was declared. This Court has recognized that a dividend may be paid by a note. *T.R. Miller Mill Co. v. Commissioner*, 37 B.T.A. 43, 49 (1938), *aff'd*, 102 F.2d 599 (5th Cir. 1939). Based on these criteria, the $30,000,000 distribution by Stouffer would clearly constitute a dividend if the sale of Stouffer had not occurred. We are not persuaded that the subsequent sale of Stouffer to Nestle changes that result merely because it was more advantageous to Litton from a tax perspective.

… A variety of factors present here preclude a finding of sham or subterfuge. Although the record in this case clearly shows that Litton intended at the time the dividend was declared to sell Stouffer, no formal action had been taken and no announcement had been made. There was no definite purchaser waiting in the wings with the terms and conditions of sale already agreed upon. At that time, Litton had not even decided upon the form of sale of Stouffer. Nothing in the record here suggests that there was any prearranged sale agreement, formal or informal, at the time the dividend was declared.

Petitioner further supports its argument that the transaction was not a sham by pointing out Litton's legitimate business purposes in declaring the dividend. Although the code and case law do not require a dividend to have a business purpose, it is a factor to be considered in determining whether the overall transaction was a sham. [citation omitted]. Petitioner argues that the distribution allowed Litton to maximize the gross after-tax amount it could receive from its investment in Stouffer. From the viewpoint of a private purchaser of Stouffer, it is difficult to see how the declaration of a dividend would improve the value of the stock since creating a liability in the form of a promissory note for $30,000,000 would reduce the value of Stouffer by approximately that amount. However, since Litton was considering disposing of all or part of Stouffer through a public or private offering, the payment of a dividend by a promissory note prior to any sale had two advantages. First, Litton hoped to avoid materially diminishing the market value of the Stouffer stock. At that time, one of the factors considered in valuing a stock,

and in determining the market value of a stock was the 'multiple of earnings' criterion. Payment of the dividend by issuance of a promissory note would not substantially alter Stouffer's earnings. Since many investors were relatively unsophisticated, Litton may have been quite right that it could increase its investment in Stouffer by at least some portion of the $30,000,000 dividend. Second, by declaring a dividend and paying it by a promissory note prior to an anticipated public offering, Litton could avoid sharing the earnings with future additional shareholders while not diminishing to the full extent of the pro rata dividend, the amount received for the stock. Whether Litton could have come out ahead after Stouffer paid the promissory note is at this point merely speculation about a public offering which never occurred. The point, however, is that Litton hoped to achieve some business purpose and not just tax benefits in structuring the transaction as it did.

Under these facts, where the dividend was declared 6 months prior to the sale of Stouffer, where the sale was not prearranged, and since Stouffer had earnings and profits exceeding $30,000,000 at the time the dividend was declared, we cannot conclude that the distribution was merely a device designed to give the appearance of a dividend to a part of the sales proceeds. In this case the form and substance of the transaction coincide; it was not a transaction entered into solely for tax reasons, and it should be recognized as structured by petitioner.

On this record, we hold that for Federal tax purposes Stouffer declared a dividend to petitioner on August 23, 1972, and, subsequently, petitioner sold all of its stock in Stouffer to Nestle for $75,000,000.

Decision will be entered under Rule 155.

Questions and comments:

1. What facts seem particularly important in distinguishing this case from *Waterman Steamship*?

2. When the dust settled, what was Stouffer's accumulated e&p going forward?
    •Maybe that's why this is called "dividend stripping."

3. When a corporation owns shares in another corporation, it usually prefers dividend treatment of a distribution to redemption treatment, i.e., sale of a capital asset. Section 301(e) provides that when a corporation owns directly or indirectly 20% or more of
    •the voting power of another corporation OR

    •the total value of all outstanding stock of another corporation (except for nonvoting stock that is limited and preferred as to dividends)

and the corporation would be entitled to a dividends received deduction, § 312 is to be applied without regard to § 312(k) or § 312(n)(1 to 6). The effect of this will be to decrease the distributing corporation's e&p and so decrease the amount of the distribution that is a dividend to corporations that own at least 20% of the stock of another corporation but less than 80%. Such

corporations pay a tax on 20% of such dividends.

4. Let's assume and imagine: Assume that all the stock of Corporation S is worth $105M and that S has $30M cash. Its accumulated e&p are also $30M. Corporation L owns all the stock of Corporation S and would like to sell it. It may choose to skim off the cash for itself and sell the stock for $75M. Alternatively, it may choose to sell the stock for $105M. Why might Corporation N find paying $105M for all the stock of a corporation that holds $30M cash particularly attractive? Isn't part of the transaction simply paying $30M for $30M cash?

Now imagine: Corporation N pays $105M to Corporation L for all the stock of Corporation S. It skims off the $30M cash. Since Corporation S has $30M of accumulated e&p, all the distribution from Corporation S to Corporation N is dividend. Since Corporation N owns 80% or more (i.e., 100%) of the stock of Corporation S, it may deduct $30M as a dividends-received deduction under § 243. All the stock of Corporation S is now worth presumably $75M. Imagine further that Corporation N sells the stock of Corporation S to Corporation TWA for $75M. Corporation N now has a capital loss of $30M ($105M − $75M). Corporation N can use this loss to offset Corporation N's capital gains. § 1211(a). [Remember: Corporations may reduce capital gain income only by offsetting capital losses against it, and corporations do not enjoy a capital gain preferential tax rate. Hence, the $30M loss reduces Corporation N's income tax according to its marginal tax bracket, now 21%.] When the dust settles, Corporation N pockets $30M of tax-free cash and can offset $30M of capital gain income.

- [We might imagine that Corporation L would insist on capturing some of that $30M and negotiate accordingly with N over the price of the Corporation S stock.]

5. Note 4 (more): Section 1059 addresses this relatively risk-free manufacture of capital losses. Section 1059(a) provides that a corporation that receives an "extraordinary dividend" with respect to stock that the corporation has not held for more than two years before the dividend announcement date must decrease its basis in the stock of the other corporation by the untaxed portion of the dividend it receives. § 1059(a)(1). If the untaxed portion of an extraordinary dividend is more than the corporation's basis in the stock, the excess is treated as gain from the sale or exchange of the stock. § 1059(a)(2).

- In the case of Corporation N, the untaxed portion of the dividend it received was 100%. Hence, if the dividend was an "extraordinary dividend" with respect to stock that Corporation N had not held for two years prior to the dividend announcement date, its basis in Corporation S stock would be reduced from $105M to $75M. Upon sale for $75M to Corporation TWA, it would recognize no capital gain or loss.

An "extraordinary dividend" is a dividend that exceeds 5% of the corporation's basis in the stock of the other corporation in the case of preferred stock dividends or that exceeds 10% of the corporation's basis in the stock of the other corporation in the case of any other stock. § 1059(b)(1 and 2).[68]

[68] There are more details to the workings of § 1059, but this suffices to give you an idea of how it works.

6. Section 246(c) denies the dividends-received deduction entirely to corporations who have not held stock in the dividend-paying corporation for at least 45 days in the 91-day period before and after the ex-dividend date. § 246(c)(1). This minimum holding period is extended to 90 days of a 181-day period in the case of preferred dividends attributable to periods aggregating more than 366 days. § 246(c)(2).[69]

7. Section 246A limits the dividends-received deduction when a corporation owns less than 50% of the stock of another (by vote and value) corporation, § 246A(c), and has financed the purchase of such stock with debt, § 246A(d)(3). Section 246A also applies if the corporation is one of five or fewer shareholders and holds less than 20% of the stock (by vote and value) of the other corporation. § 246A(c)(2)(B). Section 246A(d)(1) establishes an "average indebtedness percentage," i.e., the amount borrowed divided by the basis of the stock purchased. A corporate taxpayer must reduce its dividend-received deduction by this percentage. § 246A(a).

[69] There are a few more details to the workings of § 246(c), but this suffices to give you an idea of how it works.

Chapter 4: Redemptions of Stock

Introduction

Read IRC §§ 302, 317. Skim §§ 303, 304.

We assume that the corporation we established in chapter 2 has been profitable, and the value of the shareholders' shares has increased. There are various ways that shareholders – as shareholders[70] – can reap the increase in the value of their shares.

A corporation may share some of its profits with its shareholders by distributing a dividend. The corporation pays tax on its profits, and shareholders pay tax on the dividend they receive.[71] Although the shareholder pays income tax on a dividend, the shareholder continues to own the stock with respect to which the dividend was paid and retains the rights that he had with respect to voting control, dividends, and proceeds upon liquidation. A dividend is a return *on* the shareholder's stock. The corporation's retained earnings (i.e., e&p) are diminished by the amount it has paid out in dividends. Dividends are "ordinary income" – not capital gains – although they may be subject to income tax at rates lower than those generally applicable to ordinary income. *See* §§ 1(h)(11) ("qualified dividends" received by individual taxpayers).

Alternatively, a shareholder may sell his shares to another person. The price at which the shareholder can sell his shares will reflect the profitability of the corporation, i.e., the shareholder may sell at a gain because the corporation has retained or invested profits that it previously earned. Of course, if the shareholder sells his shares, he no longer owns them and cannot share in control of the corporation, will not share in any future dividends, and does not share in any proceeds upon liquidation. This much is obvious, but note that the shareholder has reaped the increase in the value of his shares attributable to the profitability of the corporation – *and* that the corporation retains the earnings that contributed to

Don't forget that: Ownership of shares gives a shareholder certain interests in a corporation. The United States Court of Appeals for the Second Circuit said in *Himmel v. Comm'r*, 338 F.2d 815, 817 (2d Cir. 1964):

> Ownership of stock can involve three important rights: (1) to vote, and thereby exercise control, (2) to participate in current earnings and accumulated surplus, and (3) to share in net assets on liquidation. Ownership of common stock generally involves all of these. Ownership of preferred stock generally involves the last two, but only to limited extents, unless otherwise provided.

Upon any adjustments, notice what interests a shareholder surrenders and what interests he retains.

[70] ... and not as lenders, sellers, lessors, employees, etc.

[71] We are disregarding corporate shareholders.

the increase in the shares' value. The sale of shares for a gain gives rise to capital gains. They offset capital losses and at least for individual taxpayers, are subject to income tax at rates lower than those imposed on ordinary income.

There is a middle ground. The corporation may itself buy shareholders' shares from some of its shareholders. A corporate redemption of a shareholder's stock results in a return *of* the shareholder's investment. The shareholder no longer owns the shares that the corporation redeems and to that extent surrenders whatever control, dividend, and liquidation rights those shares represented. In this regard, the redemption *might* resemble a sale. The corporation does *not* retain the earnings with which it makes such a purchase. In this regard and from the standpoint of the corporation, the redemption resembles the payment of a dividend. "It is possible for such a transaction to resemble, exactly or substantially, either a dividend or a sale. For tax purposes the payment is considered ordinary income if, by its 'net effect,' it is 'essentially equivalent to a dividend.'" *Himmel v. Comm'r*, 338 F.2d 815, 817 (2d Cir. 1964). If the redemption is not "essentially equivalent to a dividend," then the shareholder will be treated for tax purposes as if he sold the shares, i.e., a capital transaction.

Taxing dividends paid to individuals as net capital gain: When stock has a low basis – perhaps $0 – the income tax on a dividend or a redemption treated as a sale or exchange would be nearly equal. This reduces the importance of characterizing a corporate distribution as a dividend. However, upon death § 1014 increases the basis of stock to its fmv, effectively sheltering a distribution treated as a sale or exchange from *any* income tax. Cf. *Rickey v. United States*, 592 F.2d 1251, 1253 (5th Cir. 1979). Moreover, the rules governing reduction of a corporation's e&p differ for payments of dividends and distributions in redemption treated as a sale or exchange. Characterization of a distribution as a dividend or as a redemption still matters.

At a very early time, corporations and shareholders figured out ways to make the payment of dividends appear to be redemptions. To take a simple example, a corporation might issue a "stock on stock" dividend – say a one share stock dividend for every share each shareholder owns. The issuance of the stock dividend would not be a taxable event to shareholders. *Eisner v. Macomber*, 252 U.S. 189, 199 (1919). The corporation could later buy back those dividend shares for cash. If *all* the shareholders sold their dividend shares back to the corporation, the result would be the same as it would have been if the corporation had simply paid a dividend. The corporation's earnings would be diminished by what it paid out. Shareholders would retain their rights to control, to future dividends, and to proceeds upon liquidation. Such a redemption would be "essentially equivalent to a dividend." *See Smith v. United States*, 121 F.2d 692, 694 (3d Cir. 1941) (redemption of all shares of preferred stock issued to sole shareholder in order to capitalize accumulated earnings; "distribution and cancellation or redemption equivalent to the distribution of taxable dividends" within the meaning of the statute); *Commissioner v. Ahlborn*, 77 F.2d 700, 700-01 (3d Cir. 1935) (purchase of ⅓ of shares of all three shareholders of corporation does not come within redemption provision of Code); *Hill v. Comm'r*, 66 F.2d 45, 47 (4th Cir. 1933) (no unified plan to distribute surplus but issuance of preferred stock dividend followed five years later by corporate redemption of all preferred stock resulted in payment of

dividend).

Whether a distribution to redeem shares is treated as a sale or exchange of a capital asset depends upon "the effect [of the distribution] on the shareholder's basic rights vis-a-vis the corporation and other shareholders," and evaluation of those effects "depends upon many facts." *Himmel v. Comm'r*, 338 F.2d 815, 817 (2d Cir. 1964). A redemption that will be treated as an exchange surely requires that there be a disproportionate reduction in at least one of the interests that a shareholder owns in a corporation vis-à-vis other shareholders. However, what reductions(s) must occur is not entirely clear. Section 302 governs these questions.

In measuring a reduction of a shareholder's interest in a corporation, we should regard the shares that another person or entity owns as shares of the taxpaying shareholder himself if the shareholder can control the exercise of the rights that ownership of those shares represents or the shareholders share a common interest. Application of attribution rules may lead to the conclusion that there is not in fact a (significant) reduction in the interest that a shareholder owns vis-à-vis other shareholders. Section 318 establishes rules of attribution. Another provision of the subchapter C (§§ 301 to 386) may invoke – and § 302(c)(1) invokes them.

Tax Cuts and Jobs Act: Large U.S. corporations that engage in international business could defer the U.S. income tax on profits from foreign operations by conducting those operations through foreign subsidiaries that the U.S. firm controlled. The income of foreign subsidiaries was taxable only upon repatriation as dividends. U.S. income tax on the dividend income of subsidiaries was deferrable simply by having the foreign subsidiary not repatriate dividend income. Some U.S. corporations accumulated vast amounts of cash, that they held overseas. The Tax Cuts and Jobs Act added § 245A, which provides a deduction of dividends paid to a U.S. corporate "shareholder," one who owns 10% or more of the foreign corporation by vote and value. This will make cash available to domestic corporations that they may choose to distribute to shareholders. As such funds "come home," the importance of the topics in this chapter will increase.

Section 317(b) defines a "redemption" to be the corporation's acquisition of its own stock from a shareholder in exchange for "property." Section 302(a) provides that a corporate redemption of its stock insofar as it is described in §§ 302(b)(1, 2, 3, 4, or 5) "shall be treated as a distribution in part or full payment in exchange for the stock." On the other hand, if a corporation redeems its stock in a transaction not described in §§ 302(b)(1, 2, 3, 4, or 5) – and no other section in subchapter C applies[72] – then the distribution is treated as one to which § 301 applies, § 302(d), i.e., it is taxed as a dividend.

Our initial concern will be with §§ 302(b)(1, 2, and 3). These provisions treat distributions in redemption of stock as exchanges when there is a sufficient reduction of a shareholder's interest in the corporation. We also examine § 302(b)(4), which treats as redemptions corporate redemptions that manifest a genuine contraction of the corporation's business activities. We

[72] Reminder: § 301(a), the section describing the treatment of dividends, begins with the words "[e]xcept as otherwise provided in this chapter …" This makes § 301 into a residual provision.

will briefly examine § 302(b)(5). We will consider § 304, a provision applicable when a shareholder who controls two corporations sells shares of one corporation to the other and must treat the consideration given as the distribution of a dividend. Finally, we will examine § 303; that provision gives exchange treatment to certain distributions whose proceeds are used to pay death taxes of a decedent whose estate included the shares redeemed.

I. Attribution Rules, § 318

Read § 318(a)(1, 2, and 3).

Section 318 presents a scheme of attributing ownership of shares of stock to another person. Presumably that person can exercise sufficient control over the owner that we should regard that person as the owner of that stock. Section 318 states rules of attribution but says nothing about the occasions for such attribution. Other sections of the Code may invoke the attribution rules of § 318. Sections 302 and 304 both invoke § 318 to determine whether the corporate distributions to which those sections apply should be treated as an exchange for stock.

As you read through § 318, notice in each provision: *from* whom (or what) are shares attributed, and *to* whom (or what).

- § 318(a)(1) states rules of attribution within the family. Call this a "1" attribution. Read it and answer these questions:
  - Is a child considered to own shares of stock that his grandparent owns?
  - Is a grandparent considered to own shares of stock that his grandchild owns?
  - Is a brother considered to own shares of stock that his sister owns?
- § 318(a)(2) states rules of attribution *from* partnerships, trusts, or corporations *to* partners, beneficiaries, or shareholders. Call this a "2" attribution. Read it and answer these questions:
  - LMN partnership owns 50 shares of Bosco Corporation common stock. LaJuan is a 1/5 partner in LMN. How many shares of Bosco Corporation common stock is LaJuan considered to own because he is a partner in the LMN partnership?
  - The Bluenose trust owns 250 shares of Bosco Corporation common stock. Max has a 1/50 actuarial interest in the Bluenose trust. How many shares of Bosco common stock is Max considered to own because he is a beneficiary of the Bluenose trust?
  - The Cribble Corporation owns 500 of the 10,000 outstanding shares of Bosco Corporation common stock. Natalie owns 40 of the 100 outstanding shares of Cribble Corporation common stock. Cribble Corporation has no other stock

outstanding. How many shares of Bosco common stock is Natalie considered to own because she owns shares of Cribble Corporation?

•Same, except that Natalie owns 60 of the 100 outstanding shares of Cribble Corporation. How many shares of Bosco common stock is Natalie considered to own because she owns shares of Cribble Corporation?

•§ 318(a)(3) states rules of attribution *from* partners, beneficiaries, or shareholders *to* partnerships, trusts, or corporations. Call this a "3" attribution.

•LaJuan is a 1/5 partner in the LMN Partnership. He owns 200 of the 1000 outstanding shares of Bosco Corporation common stock. How many shares of Bosco Corporation common stock is LMN considered to own because LaJuan is a 1/5 partner?

•The Bluenose trust owns 250 shares of Bosco Corporation common stock. Max has a 1/50 actuarial interest in the Bluenose trust. He owns 250 of the 1000 outstanding shares of Bosco Corporation common stock. How many shares of Bosco Corporation common stock is the Bluenose Trust considered to own because Max is a beneficiary of the Bluenose trust?

•Same facts, except that Max has a 1/10 actuarial interest in the Bluenose trust?

•Natalie owns 40 of the 100 outstanding shares of Cribble Corporation. She also owns 500 of the 10,000 outstanding shares of Bosco Corporation common stock. How many shares of Bosco Corporation is Cribble Corporation considered to own because Natalie is a shareholder of Cribble Corporation?

•Same, except that Natalie owns 60 of the 100 outstanding shares of Cribble Corporation?

Read § 318(a)(5).

•§ 318(a)(5)(A): Stock owned by attribution is to be reattributed to others, but –

•§ 318(a)(5)(B): A "1" attribution cannot follow another "1" attribution, and –

•§ 318(a)(5)(C): A "2" cannot follow a "3" attribution.

•Why do you think a "1" cannot follow a "1," and a "2" cannot follow a "3?"

Do the CALI exercise: Corporate Taxation: Redemptions: Constructive Ownership of Stock. Have a paper napkin and a pen handy as it will help to diagram the facts of these questions.

II. Interest-Reducing Reductions: § 302(b)(1, 2, and 3)

Section 302(a) states the rule that if redeems its stock in a transaction described by § 302(b)(1, 2, 3, 4, or 5), the redemption "shall be treated as a distribution in part of full payment in exchange for the stock." Assuming the stock is a capital asset, gain or loss on the exchange computed as (amount realized) minus adjusted basis will be capital in character. A distribution not described in § 302(b)(1, 2, 3, 4, or 5) is not treated as an exchange and is therefore treated as a dividend. A dividend distribution dividend is included in a taxpayer's gross income in full – without reduction for adjusted basis. Sections 302(b)(1, 2, and 3) apply when a corporate redemption sufficiently reduces the shareholder's interest in the corporation.

A. § 302(b)(1): Distributions Not Essentially Equivalent to a Dividend

Read §§ 302(a) and 302(b)(1). What does "not essentially equivalent to a dividend" mean?

United States v. Davis, 397 U.S. 301 (1970)

Justice MARSHALL delivered the opinion of the Court.

In 1945, taxpayer [footnote omitted] and E.B. Bradley organized a corporation. In exchange for property transferred to the new company, Bradley received 500 shares of common stock, and taxpayer and his wife similarly each received 250 such shares. Shortly thereafter, taxpayer made an additional contribution to the corporation, purchasing 1,000 shares of preferred stock at a par value of $25 per share.

The purpose of this latter transaction was to increase the company's working capital, and thereby to qualify for a loan previously negotiated through the Reconstruction Finance Corporation. It was understood that the corporation would redeem the preferred stock when the RFC loan had been repaid. Although, in the interim, taxpayer bought Bradley's 500 shares and divided them between his son and daughter, the total capitalization of the company remained the same until 1963. That year, after the loan was fully repaid and in accordance with the original understanding, the company redeemed taxpayer's preferred stock.

In his 1963 personal income tax return, taxpayer did not report the $25,000 received by him upon the redemption of his preferred stock as income. Rather, taxpayer considered the redemption as a sale of his preferred stock to the company – a capital gains transaction under § 302 of the Internal Revenue Code of 1954 resulting in no tax, since taxpayer's basis in the stock equaled the amount he received for it. The Commissioner of Internal Revenue, however, did not approve this tax treatment. According to the Commissioner, the redemption of taxpayer's stock was essentially equivalent to a dividend, and was thus taxable as ordinary income under §§ 301 and

316 of the Code. Taxpayer paid the resulting deficiency, and brought this suit for a refund. The District Court ruled in his favor, and, on appeal, the Court of Appeals affirmed.

The Court of Appeals held that the $25,000 received by taxpayer was "not essentially equivalent to a dividend" within the meaning of that phrase in § 302(b)(1) of the Code because the redemption was the final step in a course of action that had a legitimate business (as opposed to a tax avoidance) purpose. That holding represents only one of a variety of treatments accorded similar transactions under § 302(b)(1) in the circuit courts of appeals. [footnote omitted]. We granted certiorari in order to resolve this recurring tax question involving stock redemptions by closely held corporations. We reverse.

I

The Internal Revenue Code of 1954 provides generally in §§ 301 and 316 for the tax treatment of distributions by a corporation to its shareholders; under those provisions, a distribution is includable in a taxpayer's gross income as a dividend out of earnings and profits to the extent such earnings exist. [footnote omitted]. There are exceptions to the application of these general provisions, however, and among them are those found in § 302, involving certain distributions for redeemed stock. The basic question in this case is whether the $25,000 distribution by the corporation to taxpayer falls under that section – more specifically, whether its legitimate business motivation qualifies the distribution under § 302(b)(1) of the Code. Preliminarily, however, we must consider the relationship between 302(b)(1) and the rules regarding the attribution of stock ownership found in § 318(a) of the Code.

Under subsection (a) of § 302, a distribution is treated as "payment in exchange for the stock," thus qualifying for capital gains, rather than ordinary income treatment, if the conditions contained in any one of the four paragraphs of subsection (b) are met. [Sections 302(b)(2, 3, and 4) do not apply.] [T]axpayer agrees that, for the purposes of §§ 302(b)(2) and (3), the attribution rules of § 318(a) apply, and he is considered to own the 750 outstanding shares of common stock held by his wife and children in addition to the 250 shares in his own name. [footnote omitted].

Taxpayer, however, argues that the attribution rules do not apply in considering whether a distribution is essentially equivalent to a dividend under § 302(b)(1). According to taxpayer, he should thus be considered to own only 25 percent of the corporation's common stock, and the distribution would then qualify under § 302(b)(1) since it was not pro rata or proportionate to his stock interest, the fundamental test of dividend equivalency. *See* Treas. Reg. § 1.302-2(b). However, the plain language of the statute compels rejection of the argument. In subsection (c) of § 302, the attribution rules are made specifically applicable "in determining the ownership of stock for purposes of this section." Applying this language, both courts below held that § 318(a) applies to all of § 302, including § 302(b)(1) – a view in accord with the decisions of the other courts of appeals,[73] a longstanding treasury regulation,[74] and the opinion of the leading

[73] *See* Levin v. Commissioner, 385 F.2d 521, 526-527 (CA2 1967); Commissioner v. Berenbaum, 369 F.2d 337, 342 (CA10 1966); Ballenger v. United States, 301 F.2d 192, 199 (CA4 1962; Bradbury v. Commissioner, 29

commentators.[75]

Against this weight of authority, taxpayer argues that the result under paragraph (1) should be different because there is no explicit reference to stock ownership, as there is in paragraphs (2) and (3). Neither that fact, however, nor the purpose and history of § 302(b)(1) supports taxpayer's argument. The attribution rule designed to provide a clear answer to what would otherwise be a difficult tax question – formed part of the tax bill that was subsequently enacted as the 1954 Code. ...

... [I]t was necessary that the attribution rules apply to § 302(b)(1) unless they were to be effectively eliminated from consideration with regard to §§ 302(b)(2) and (3) also. For if a transaction failed to qualify under one of those sections solely because of the attribution rules, it would, according to taxpayer's argument, nonetheless qualify under § 302(b)(1). We cannot agree that Congress intended so to nullify its explicit directive. We conclude, therefore, that the attribution rules of § 318(a) do apply; and, for the purposes of deciding whether a distribution is "not essentially equivalent to a dividend" under § 302(b)(1), taxpayer must be deemed the owner of all 1,000 shares of the company's common stock.

II

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 equivalent to a dividend" within the meaning of that phrase in § 302(b)(1),[76] and therefore do not reach the Government's alternative argument that, in any event, the distribution should not, on the facts of this case, qualify for capital gains treatment. [footnote omitted].

The predecessor of § 302(b)(1) came into the tax law as § 201(d) of the Revenue Act of 1921, 42 Stat. 228:

> A stock dividend shall not be subject to tax but if after the distribution of any such 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, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend. ...

F.2d 111, 116-117 (CA1 1962).

[74] *See* Treas. Reg. § 1.302-2(b).

[75] *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 292 n.32 (2d ed.1966).

[76] Of course, this just means that a distribution in redemption to a sole shareholder will be treated under the general provisions of § 301, and it will only be taxed as a dividend under § 316 to the extent that there are earnings and profits.

Enacted in response to this Court's decision that pro rata stock dividends do not constitute taxable income, *Eisner v. Macomber*, 252 U.S. 189 (1920), the provision had the obvious purpose of preventing a corporation from avoiding dividend tax treatment by distributing earnings to its shareholders in two transactions – a pro rata stock dividend followed by a pro rata redemption – that would have the same economic consequences as a simple dividend. Congress, however, soon recognized that, even without a prior stock dividend, essentially the same result could be effected whereby any corporation,

> especially one which has only a few stockholders, might be able to make a distribution to its stockholders which would have the same effect as a taxable dividend.

H.R. REP. NO. 1, 69th Cong., 1st Sess., 5. In order to cover this situation, the law was amended to apply "(whether or not such stock was issued as a stock dividend)" whenever a distribution in redemption of stock was made "at such time and in such manner" that it was essentially equivalent to a taxable dividend. Revenue Act of 1926, § 201(g), 44 Stat. 11.

This provision of the 1926 Act was carried forward in each subsequent revenue act, and finally became § 115(g)(1) of the Internal Revenue Code of 1939. Unfortunately, however, the policies encompassed within the general language of § 115(g)(1) and its predecessors were not clear, and there resulted much confusion in the tax law. At first, courts assumed that the provision was aimed at tax avoidance schemes, and sought only to determine whether such a scheme existed. [citation omitted]. Although later the emphasis changed and the focus was more on the effect of the distribution, many courts continued to find that distributions otherwise like a dividend were not "essentially equivalent" if, for example, they were motivated by a sufficiently strong nontax business purpose. ... There was general disagreement, however, about what would qualify as such a purpose, and the result was a case-by-case determination with each case decided "on the basis of the particular facts of the transaction in question." [citation omitted].

By the time of the general revision resulting in the Internal Revenue Code of 1954, the draftsmen were faced with what has aptly been described as "the morass created by the decisions." *Ballenger v. United States*, 301 F.2d 192, 196 (CA4 1962). In an effort to eliminate "the considerable confusion which exists in this area," and thereby to facilitate tax planning, H.R. REP. NO. 1337, 83d Cong., 2d Sess., 35, the authors of the new Code sought to provide objective tests to govern the tax consequences of stock redemptions. Thus, the tax bill passed by the House of Representatives contained no "essentially equivalent" language. Rather, it provided for "safe harbors" where capital gains treatment would be accorded to corporate redemptions that met the conditions now found in §§ 302(b)(2) and (3) of the Code.

It was in the Senate Finance Committee's consideration of the tax bill that § 302(b)(1) was added, and Congress thereby provided that capital gains treatment should be available "if the redemption is not essentially equivalent to a dividend." Taxpayer argues that the purpose was to continue "existing law," and there is support in the legislative history that § 302(b)(1) reverted "in part" or "in general" to the "essentially equivalent" provision of § 115(g)(1) of the 1939

Code. According to the Government, even under the old law, it would have been improper for the Court of Appeals to rely on "a business purpose for the redemption" and "an absence of the proscribed tax avoidance purpose to bail out dividends at favorable tax rates." [citations omitted]. However, we need not decide that question, for we find from the history of the 1954 revisions and the purpose of § 302(b)(1) that Congress intended more than merely to reenact the prior law.

In explaining the reason for adding the "essentially equivalent" test, the Senate Committee stated that the House provisions

> appeared 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.

S. REP. NO. 1622, 83d Cong., 2d Sess., 44. This explanation gives no indication that the purpose behind the redemption should affect the result. [footnote omitted]. Rather, in its more detailed technical evaluation of § 302(b)(1), the Senate Committee reported as follows:

> ... Your committee ... intends that, in applying this test for the future ..., the inquiry will 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. For this purpose, the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits, causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absence of earnings and profits.

S. REP. NO. 1622, *supra*, at 234.

The intended scope of § 302(b)(1), as revealed by this legislative history, is certainly not free from doubt. However, we agree with the Government that, by making the sole inquiry relevant for the future the narrow one whether the redemption could be characterized as a sale, Congress was apparently rejecting past court decisions that had also considered factors indicating the presence or absence of a tax avoidance motive. [footnote omitted]. At least that is the implication of the example given. Congress clearly mandated that pro rata distributions be treated under the general rules laid down in §§ 301 and 316, rather than under § 302, and nothing suggests that there should be a different result if there were a "business purpose" for the redemption. Indeed, just the opposite inference must be drawn, since there would not likely be a tax avoidance purpose in a situation where there were no earnings or profits. We conclude that the Court of Appeals was therefore wrong in looking for a business purpose and considering it in deciding whether the redemption was equivalent to a dividend. Rather, we agree with the Court of Appeals for the Second Circuit that "the business purpose of a transaction is irrelevant in determining dividend equivalence" under § 302(b)(1). *Hasbrook v. United States*, 343 F.2d 811, 814 (1965).

Taxpayer strongly argues that to treat the redemption involved here as essentially equivalent to a dividend is to elevate form over substance. Thus, taxpayer argues, had he not bought Bradley's shares or had he made a subordinated loan to the company instead of buying preferred stock, he could have gotten back his $25,000 with favorable tax treatment. However, the difference between form and substance in the tax law is largely problematical, and taxpayer's complaints have little to do with whether a business purpose is relevant under § 302(b)(1). 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.

We conclude that that is what Congress did when enacting § 302(b)(1). 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 § 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. Clearly, taxpayer here, who (after application of the attribution rules) was the sole shareholder of the corporation both before and after the redemption, did not qualify under this test. The decision of the Court of Appeals must therefore be reversed, and the case remanded to the District Court for dismissal of the complaint.

It is so ordered.

Justice DOUGLAS, with whom THE CHIEF JUSTICE and Justice BRENNAN concur, dissenting. [omitted]

Questions and comments:

1. The Court accounts for the "not essentially equivalent to a dividend" language of § 302(b)(1).

2. Can you identify any black-letter rules that the Court provides?

3. In the last paragraph of its opinion, the Court said: "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." How much of a reduction in a shareholder's proportionate interest is sufficient to be "meaningful?"

4. Consider the following and determine what bright-line rules exist concerning "meaningful reduction" about which you would feel comfortable advising a client prospectively. Note particularly the requisite reduction in voting control, rights to future dividends, and rights to proceeds upon liquidation.

- Redemption by corporation of shares of its voting common stock (only class of stock outstanding) that reduces shareholder's interest from 90 percent to 60 percent is not meaningful reduction of shareholder's interest, does not qualify as distribution not

essentially equivalent to dividend within meaning of § 302(b)(1) and, therefore, is not distribution in exchange for stock under 26 U.S.C. § 302(a). Rev Rul 78-401, 1978-2 CB 127.

•Reduction in shareholder's percentages of total voting stock from 50.54-percent preredemption in 1965 to 43.28-percent postredemption in 1969 was "meaningful." *Roebling v. Comm'r*, 77 T.C. 30, 57 (1981).

•A redemption by a corporation of any amount of its nonvoting, nonconvertible, nonparticipating preferred stock, which is not "section 306 stock," but which is preferred as to dividends and in liquidation, and all of which is owned by an individual who owns none of the corporation's common stock either directly or by attribution, qualifies as not essentially equivalent to a dividend under § 302(b)(1). Rev. Rul. 77-426, 1977-2 CB 87.

•A trust held only nonvoting preferred stock and nonvoting common stock, but held some voting common by attribution from a beneficiary – who in turn owned no nonvoting preferred or nonvoting common. The beneficiary and two other shareholders together owned sufficient shares to elect a majority of the corporation's board of directors. A redemption of some of the trust's nonvoting preferred was essentially equivalent to a dividend. "[I]t is significant that (as a result of [attribution]) the redemption did not reduce the trust's percentage of the vote in X. It is true that T reduced its percentage interest in current earnings, accumulated surplus, and net assets upon liquidation, and reduced the fair market value of its ownership in X. However, when the redeemed shareholder has a voting interest (either directly or by attribution), a reduction in voting power is a key factor in determining the applicability of § 302(b)(1)." Rev. Rul. 85-106, 1985-2 CB 116.

•A corporation had only one class of stock outstanding. A redemption of an estate's 250 shares of common stock by the corporation, whose remaining 1,500 shares of such stock are equally divided between the estate's sole beneficiary and an unrelated individual, constitutes a meaningful reduction of the estate's interest and is not essentially equivalent to a dividend under § 302(b)(1) of the Code. The redemption reduced the estate's total voting rights from 57% to 50%. Rev. Rul. 75-502, 1975-2 CB 111.

•Redemption of all stock in corporation held directly by inter vivos trust created by controlling shareholder was not essentially equivalent to dividend since there was meaningful reduction in trust's interest in corporation from 30% (direct and indirect) ownership to 24.3% (indirect). "As a result of the redemption, the trust 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." Rev Rul 75-512, 1975-2 CB 112.

•When a shareholder who holds precisely 0.2% of a publicly traded corporation's outstanding stock has a portion of the stock redeemed pursuant to a tender offer that also

reduces the number of shares held by other shareholders so that the shareholder still holds precisely 0.2% of the corporation's outstanding stock, the redemption does not qualify as an exchange within the meaning of §§ 302(a) and 302(b)(1). The pro rata stock interest of the shareholder was not reduced. Rev. Rul. 81-289, 1981-2 C.B. 82.

•A corporation's redemption of a portion of its stock was not essentially equivalent to a dividend under § 302(b)(1) with respect to the small number of shares (several hundred out of a total of 28 million) acquired from a family corporation's wholly owned subsidiary. The subsidiary's stock interest was 96.7% of what it was prior to the redemption. Its percentage ownership was reduced from .0001118% to .0001081%. Rev. Rul. 76-385, 1976-2 CB 92.

5. Section 302(b)(6): In addition to § 302(b)(1), § 302(b)(2, 3, and 4) provide for exchange treatment provided certain conditions are met when a corporation distributes property in redemption of a shareholder's shares. The requirements of § 302(b)(2, 3, and 4) are more rigorous than they are for § 302(b)(1). Section 302(b)(6) provides that a "failed" § 302(b)(2, 3, or 4) redemption must still be tested under § 302(b)(1) for exchange treatment.

6. A distribution in redemption of stock that is treated as "a payment in exchange for the stock" presents few problems insofar as the shareholder's basis in his stock is concerned. But what of a distribution in redemption of stock that is not treated as "a payment in exchange for stock?" If the corporation has earnings and profits, the distribution is treated to that extent as a dividend. What happens to the basis that shareholder had in stock that he no longer owns?

•Basis is money that is not subject to income tax in the hands of the owner – usually because it has already been subject to income tax. The shareholder should not lose the credit he deserves for having paid that tax.

•What should happen to shareholder's basis if the distribution was not in redemption of all the shareholder's stock?

•What if after a distribution that is a dividend, the shareholder owns no stock directly but owns some stock by attribution?

Reg. § 1.302-2(c) says that in such cases, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." The regulations leave us to glean from examples just what "proper adjustment of the basis of the remaining stock" is.

•Read the three examples. What rules can you articulate?

Basis Shifting: We assume that individual taxpayers prefer distributions to be exchanges rather than dividends. What if taxpayer does not care? Perhaps taxpayer does not pay U.S. income taxes. Such a non-taxpayer might receive a distribution in complete redemption of all his stock. Let's say that the distribution is a dividend because stock is attributed to him. To the taxpayer the distribution carries no income tax, *and* taxpayer shifts the basis of stock attributed to him back to the source of the attribution. Is this fair?

7. (Note 6 continued): In Notice 2001-45, 2001-33 I.R.B. 129, 2001-2 C.B. 129, the IRS

announced that it would challenge certain basis-shifting transactions that generate tax losses or reduce tax gains.

> In the transaction, there is a redemption of stock that is owned by a person (other than the Taxpayer) that is not subject to U.S. tax or is otherwise indifferent to the Federal income tax consequences of the redemption. Purportedly as a result of the application of the attribution rules of § 318, the redemption of stock is claimed to be a dividend under § 301 rather than a payment in exchange for stock under § 302(a).

Shifting basis to the party from whom there was attribution enables that party to generate losses or decrease gain upon sale of his shares. Such basis-shifting is based on the premise that "an adjustment is appropriate where the redeemed [taxpayer] is required to include the full redemption proceeds as a dividend in gross income that is subject to U.S. tax and such [taxpayer] retains no stock to which the basis of the redeemed stock could attach." Absent U.S. tax on the dividend, presumably the IRS may challenge the loss or reduced gain resulting from the additional basis in a subsequent sale.

Is it fair that the IRS may apply its attribution rules on "facts and circumstances," but taxpayers may not? Or does such a question mis-characterize the problem?

Do the CALI exercise: Corporate Taxation: Redemptions: Consequences of Redemptions Under Section 302

Do the CALI exercise: Corporate Taxation: Redemptions: Redemptions Not Equivalent to Dividends: Section 302(b)(1).

•As always, do not be afraid of learning something.

B. § 302(b)(2): Substantially Disproportionate Redemption of Stock

Section 302(b)(2) treats a corporate distribution in redemption of a corporation's stock as "a payment in exchange for stock" if certain tests are met. Without doubt, § 302(b)(1) is more generous in giving exchange treatment to corporate distributions in redemption of their stock – but § 302(b)(2) can be applied prospectively with considerably more certainty because its tests are mechanically applied. For a distribution in redemption of stock to be treated as an exchange, § 302(b)(2) requires that –

> •the percentage of all of corporation's *voting stock* that the shareholder owns after the redemption is *less than* 80% of the percentage of all of the corporation's voting stock that the shareholder held immediately prior to the redemption, §§ 302(b)(2)(A and C); AND
>
> •the percentage of all the corporation's *common stock* that the shareholder owns after the

redemption is *less than* 80% of the percentage of all the corporation's common stock that the shareholder held prior to the redemption, §§ 302(b)(2)(A and C); AND

•after the redemption the shareholder whose shares the corporation redeems owns *less than* 50% of the total combined voting power of all classes of stock entitled to vote.

The attribution rules of § 318 apply in determining the number of shares that a shareholder is deemed to own both before and after the distribution in redemption of the shareholder's stock. § 302(c)(1).

Rev. Rul. 87-88, 1987-2 C.B. 81

ISSUE

If shares of both voting and nonvoting common stock are redeemed from a shareholder in one transaction, are the two classes aggregated for purposes of applying the substantially disproportionate requirement in § 302(b)(2)(C)? ...

FACTS

X corporation had outstanding 10 shares of voting common stock and 30 shares of nonvoting common stock. The fair market values of a share of voting common stock and a share of nonvoting common stock are approximately equal. A owned 6 shares of X voting common stock and all the nonvoting common stock. The remaining 4 shares of the X voting common stock were held by persons unrelated to A within the meaning of § 318(a) ...

X redeemed 3 shares of voting common stock and 27 shares of nonvoting common stock from A in a single transaction. Thereafter, A owned 3 shares of X voting common stock and 3 shares of nonvoting common stock. The ownership of the remaining 4 shares of X voting common stock was unchanged.

LAW AND ANALYSIS

If a distribution in redemption of stock qualifies under § 302(b)(2) ... as substantially disproportionate, the distribution is treated under § 302(a) as a payment in exchange for the stock redeemed.

Under § 302(b)(2)(B) and (C) ..., a distribution is substantially disproportionate if (i) the shareholder owns less than 50% of the total combined voting power of the corporation immediately after the redemption, (ii) immediately after the redemption the ratio of voting stock owned by the shareholder to all the voting stock of the corporation is less than 80% of the same ratio immediately before the redemption, and (iii) immediately after the redemption the ratio of common stock owned by the shareholder to all of the common stock of the corporation (whether

voting or nonvoting) is less than 80% of the same ratio immediately before the redemption.

Under § 302(b)(2)(C) ..., if more than one class of common stock is outstanding, the determination in (iii) above is made by reference to fair market value. Section 302(b)(2) applies to a redemption of both voting stock and other stock (although not to the redemption solely of nonvoting stock). Reg. § 1.302-3(a).

With regard to requirements (i) and (ii) described above, after the redemption, A owned less than 50% of the voting power of X (43%), and A's voting power was reduced to less than 80% of the percentage of voting power in X that A owned before the redemption (from 60% to 43% for a reduction to 72% of the preredemption level).

With regard to requirement (iii) above, § 302(b)(2)(C) ... provides that, if there is more than one class of common stock outstanding, the fair market value of all of the common stock (voting and nonvoting) will govern the determination of whether there has been the requisite reduction in common stock ownership. The fact that this test is based on fair market value and is applied by reference to all of the common stock of the corporation suggests that the requirement concerning reduction in common stock ownership is to be applied on an aggregate basis rather than on a class-by-class basis. Thus, the fact that A has no reduction in interest with regard to the nonvoting common stock and continues to own 100% of this stock does not prevent the redemption of this class of stock from qualifying under § 302(b)(2) when the whole transaction meets § 302(b)(2) requirements. To conclude otherwise would require that, notwithstanding a redemption of one class of common stock in an amount sufficient to reduce the shareholder's aggregate common stock ownership by more than 20% in value, every other class of common stock owned by the shareholder must be subject to a redemption.

Prior to the redemption, A owned 90% of the total fair market value of all the outstanding X common stock (36 out of the 40 shares of voting and nonvoting common stock). After the redemption, A owned 60% of the total fair market value of all the X common stock (6 out of 10 shares). The reduction in ownership (from 90% to 60%) was a reduction to less than 80% of the fraction that A previously owned of the total fair market value of all the X common stock.

HOLDING

If more than one class of common stock is outstanding, the provisions of § 302(b)(2)(C) ... are applied in an aggregate and not a class-by-class manner. Accordingly, the redemption by X of 3 shares of voting common stock and 27 shares of nonvoting common stock qualifies as substantially disproportionate within the meaning of § 302(b)(2), even though A continues to own 100% of the outstanding nonvoting common stock.

Questions and comments:

1. Some stock is counted only for fulfilling the first 80% requirement, and some is counted both for fulfilling the first and second 80% requirement.

2. Reg. § 1.302-3(a)(3) provides in part: "Section 302(b)(2) does not apply to the redemption solely of nonvoting stock (common or preferred)." Is it sufficient for § 302(b)(2) to be applicable that a corporation redeems the shares of a shareholder who owns *only* nonvoting preferred stock if the shareholder holds shares of voting common stock by attribution?

•A corporation's redemption of its nonvoting preferred stock that is all owned by one shareholder, and 20 of the 50 shares of the corporation's voting common owned by his son who is unrelated to the corporation's other shareholder who owns the remaining 30 shares of voting common, is a substantially disproportionate distribution as to both the father and son within the meaning of § 302(b)(2) that qualifies as an exchange under § 302(a). Rev. Rul. 77-237, 1977-2 CB 88.

3. Reg. § 1.302-3(a)(3) also provides in part: "[I]f a redemption is treated as an exchange to a particular shareholder under the terms of § 302(b)(2), such section will apply to the simultaneous redemption of nonvoting preferred stock (which is not § 306 stock) owned by such shareholder and such redemption will also be treated as an exchange."

•A revenue ruling fills in the picture.

•Redemption of *voting* preferred stock without reduction in shareholder's ownership of common stock may qualify as substantially disproportionate redemption under 26 U.S.C. § 302(b)(2) even though shareholder owns no common stock either directly or constructively. Rev. Rul. 81-41, 1981-1 C.B. 121.

4. Read § 302(b)(2)(D). Why do you think that this provision is in the Code? *See* problem 1 immediately below.

•The determination of whether a plan exists depends on "all the facts and circumstances." Reg. § 1.302-3(a)(3) (last sentence).

•For purposes of determining whether a redemption qualifies as substantially disproportionate, two redemptions must be considered in aggregate, pursuant to 26 U.S.C. § 302(b)(2)(D), when the first shareholder's redemption is undertaken with knowledge of the impending redemption of the second shareholder, despite the absence of any agreement between the two shareholders. Rev. Rul. 85-14 (1985) 1985-1 CB 92.

5. On the other hand, suppose that A and B form a corporation, each owning one half of the corporation's shares. The corporation has issued 100 shares. Several years later, they wish to bring in C. How should the following series of events be treated.

•A and B each sell 15 shares to C. The corporation then redeems five shares each from A and B.

•Would the result be the same if the corporation redeemed five shares each from A and B, *and then* A and B each sold 15 shares to C?

•A and B cause the corporation to issue 25 new shares to C. The corporation then redeems 25 shares each from A and B.

•Would the result be the same if the corporation redeemed 25 shares each from A and B, *and then* the corporation issued 25 shares to C?

•*See* Rev. Rul. 75-447, 1975-2 C.B. 113.

Problem:

1. Consider: "Corporation M has outstanding 400 shares of common stock of which A, B, C, and D each own 100 shares, [i.e.,] 25%. No stock is considered constructively owned by A, B, C, or D under § 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C."

•For which shareholders are these redemptions disproportionate under § 302(b)(2)? *See* Reg. § 1.302-3(b) Example.

2. Cribble Corporation has one class of voting common, with 1000 shares outstanding. Alpha and Omega each own 300 shares. They are unrelated to each other. The remaining 400 shares are owned by others who are unrelated to Alpha or Omega. Both Alpha and Omega have basis in their stock equal to its fmv, and Cribble has ample e&p.

a. On January 1 of the current year, Cribble distributes cash to Alpha and Omega to redeem 100 shares from both Alpha and Omega. Will this qualify "as a distribution in part or full payments in exchange for the stock" of Alpha and Omega?

b. Same facts except that Cribble distributes cash to Alpha on January 1 of the current year and distributes cash to Omega on July 1, 2½ years from now?

3. Dibble Corporation has two classes of stock outstanding – 1000 shares of Class A voting common and 1000 shares of Class B non-voting common. Beta, Gamma, Delta, and Phi each own 250 shares of Class A stock. Rho, Lambda, Sigma, and Chi each own 250 shares of Class B stock. None of the shareholders of either class is related to each other, and no other person owns any stock of Dibble Corporation. Rho and Beta both have basis in their stock equal to its fmv. Dibble has ample e&p.

a. On January 1 of the current year, Dibble redeemed 100 shares of Rho's Class B stock with a cash distribution. Will this qualify "as a distribution in part of full payments in exchange for the stock" of Rho?

b. Same facts, except that the Class B stock is non-voting preferred stock. Will Dibble's distribution qualify "as a distribution in part or full payments in exchange for the stock" of Rho?

c. Same facts as (a) except that Rho is Beta's father. In addition to redeeming 100 shares of Rho's non-voting common stock Dibble Corporation also redeems 100 shares of Beta's voting common stock. Will either of Dibble's distributions to Beta or Rho qualify "as a distribution in part or full payments in exchange for [their] stock"?

4. Eiffel Corporation has two classes of stock outstanding – 1000 shares of Class A voting common and 500 shares of Class B nonvoting common. Kappa and Nu each owns 500 Class A shares. Omicron owns all 500 shares of Class B nonvoting common. Omicron is Kappa's father. Kappa and Omicron both have basis in their stock equal to its fmv. Eiffel has ample e&p. Eiffel distributes cash to both Kappa and Omicron to redeem 250 shares of the stock that they own. Will either Eiffel's distribution to Kappa or Omicron qualify "as a distribution in part or full payment in exchange for [their] stock"?

5. Mosky Corporation has 1000 shares of voting common outstanding. It has no other stock outstanding. It has accumulated ample e&p.

- Belfry Corporation owns 400 shares of Mosky. FATHER owns 60% of Belfry's outstanding shares.

- The BBS Partnership owns 210 shares of Mosky. FATHER'S children – BROTHER1, BROTHER2, and SISTER1 are the three equal partners of BBS.

- SISTER1 owns 190 shares of Mosky.

- The estate of Uncle (the late brother of FATHER) owns 200 shares of Mosky. FATHER'S children – BROTHER1, BROTHER2, and SISTER2 – are the only beneficiaries of Uncle's estate.

a. How many shares of Mosky does FATHER own directly and by attribution?

b. Would Mosky Corporation's redemption of 100 of SISTER1's shares qualify as "a distribution in part or full payment in exchange for the stock" as to SISTER1? – as to FATHER?

c. Assume that Belfry Corporation redeemed enough of father's shares so to reduce his interest in Belfry is reduced to 40%. Many years later, Mosky Corporation redeemed 100 of Belfry's shares. How many shares may Mosky Corporation redeem from Belfry Corporation for the distribution to qualify as "a distribution in part or full payment in exchange for" stock as to FATHER?

6. F Corporation has 100 shares of voting common stock outstanding. This is all of F Corporation's outstanding stock. The Estate of P owns 80 of F Corporation's shares. Emily holds a 30% interest in the estate. Emily's son, Frank, holds a 40% interest in the estate. Greta – who is not related to Emily or to Frank – holds 25% interest in the estate.

a. How many shares does Emily own, directly and by attribution?

b. How many shares does Frank own, directly and by attribution?

c. How many shares does Greta own, directly and by attribution?

7. Can you derive a formula to determine the minimum number of shares that a corporation must redeem from one shareholder in order to qualify the distribution as an exchange under § 302(b)(2)? Let's say that:

N = the number of shares the shareholder holds directly and by attribution
T = the total number of shares outstanding
X = the number of shares that must be redeemed.

Prove that: to get below 80%, the corporation must redeem X shares where

$$X > 0.2NT/(T - 0.8N)$$

Prove that: to get below 50%, the corporation must redeem X shares where

$$X > 2N - T$$

Apply these two formulas to a redemption problem and X will probably be two different numbers. Redeem the greater number.

Do the CALI exercise: Corporate Taxation: Redemptions: Substantially Disproportionate Redemptions: Section 302(b)(2).

•Have Reg. § 1.302-3 at your fingertips.

C. § 302(b)(3): Complete Termination of Interest

Read §§ 302(b)(3) and 302(c). By its terms, § 302(b)(3) can apply in an unlimited number of factual scenarios. However, there are recurring fact patterns that raise issues of its application. We consider: transfers of a family-held business from one generation to the next, transfers of a family-held business when there is intra-family hostility, transfers in furtherance of a distribution plan where the putative distributee has no interest in participating in the business of the corporation, transfers in the context of a divorce settlement, and transfers of a corporation from one owner to another.

1. Intergenerational Transfers of Business

Imagine: Parents began a business many years ago, and they incorporated it. They have children to whom they wish to pass the business on. One or more members of the second generation begin "helping out" and eventually learn the business. The second generation buys a nominal number of shares. The corporation then redeems all the shares of the first generation by giving a sizable promissory note. The first generation now owns directly none of the outstanding shares of the corporation, but they own by attribution from the second generation all of corporation's outstanding shares.

If only we could make family attribution go away: all the payments on the promissory note would be taxed as long-term capital gain.

Section 302(c)(2) provides a procedure to waive family attribution (a "1" attribution) when the corporation redeems *all* the stock of a shareholder, thus assuring its treatment as a distribution in exchange for the corporation's stock.

But there are conditions and procedures to follow –

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

HALL, Circuit Judge

The Commissioner of the Internal Revenue Service (Commissioner) petitions for review of a Tax Court decision holding that a corporate redemption of a taxpayer's stock was a sale or exchange subject to capital gains treatment. The Commissioner argues that the taxpayer held a prohibited interest in the corporation after the redemption and therefore the transaction should be characterized as a dividend distribution taxable as ordinary income. We agree with the Commissioner and reverse the Tax Court.

I

Taxpayers, William and Mima Lynch, formed the W.M. Lynch Co. on April 1, 1960. The corporation issued all of its outstanding stock to William Lynch (taxpayer). The taxpayer specialized in leasing cast-in-place concrete pipe machines.[77] He owned the machines individually but leased them to the corporation which in turn subleased the equipment to independent contractors.

On December 17, 1975 the taxpayer sold 50 shares of the corporation's stock to his son, Gilbert Lynch (Gilbert), for $17,170. Gilbert paid for the stock with a $16,000 check given to him by the taxpayer and $1,170 from his own savings. The taxpayer and his wife also resigned as directors and officers of the corporation on the same day.

On December 31, 1975 the corporation redeemed all 2300 shares of the taxpayer's stock. In exchange for his stock, the taxpayer received $17,900 of property and a promissory note for $771,920. Gilbert, as the sole remaining shareholder, pledged his 50 shares as a guarantee for the note. In the event that the corporation defaulted on any of the note payments, the taxpayer would have the right to vote or sell Gilbert's 50 shares.

[77] The cast-in-place process avoids the need to transport precast pipe to the job site. Instead, a trench is dug wide enough to accommodate the desired pipe diameter. A cast-in-place machine moves along the trench while fresh cement is poured from transport trucks. The machine casts the bottom third of the pipe first, and then forms are added to complete the remaining two-thirds.

In the years immediately preceding the redemption, Gilbert had assumed greater managerial responsibility in the corporation. He wished, however, to retain the taxpayer's technical expertise with cast-in-place concrete pipe machines. On the date of the redemption, the taxpayer also entered into a consulting agreement with the corporation. The consulting agreement provided the taxpayer with payments of $500 per month for five years, plus reimbursement for business related travel, entertainment, and automobile expenses.[78] In February 1977, the corporation and the taxpayer mutually agreed to reduce the monthly payments to $250. The corporation never withheld payroll taxes from payments made to the taxpayer.

After the redemption, the taxpayer shared his former office with Gilbert. The taxpayer came to the office daily for approximately one year; thereafter his appearances dwindled to about once or twice per week. When the corporation moved to a new building in 1979, the taxpayer received a private office.

In addition to the consulting agreement, the taxpayer had other ties to the corporation. He remained covered by the corporation's group medical insurance policy until 1980. When his coverage ended, the taxpayer had received the benefit of $4,487.54 in premiums paid by the corporation. 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. Payments to the taxpayer under the plan totaled $96.05.

II

We must decide whether the redemption of the taxpayer's stock in this case is taxable as a dividend distribution under 26 U.S.C. § 301 or as long-term capital gain under 26 U.S.C. § 302(a). [footnote omitted]. Section 302(a) provides that a corporate distribution of property in redemption of a shareholder's stock is treated as a sale or exchange of such stock if the redemption falls within one of four categories described in § 302(b). If the redemption falls outside of these categories, then it is treated as a dividend distribution under § 301 to the extent of the corporation's earnings and profits.[79]

Section 302(b)(3) provides that a shareholder is entitled to sale or exchange treatment if the corporation redeems all of the shareholder's stock. In order to determine whether there is a complete redemption for purposes of § 302(b)(3), the family attribution rules of § 318(a) must be applied unless the requirements of § 302(c)(2) are satisfied. Here, if the family attribution rules apply, the taxpayer will be deemed to own constructively the 50 shares held by Gilbert (100% of the corporation's stock) and the transaction would not qualify as a complete redemption within

[78] The corporation leased or purchased a pickup truck for the taxpayer's use in 1977. If someone at the corporation needed the truck, the taxpayer would make it available to him.

[79] On the date of the redemption, W.M. Lynch Co. had accumulated earnings and profits of $315,863, and had never paid a dividend.

the meaning of § 302(b)(3).

Section 302(c)(2)(A) states in relevant part:

> In the case of a distribution described in subsection (b)(3), [the family attribution rules in] § 318(a)(1) shall not apply if –
>
> > (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor. ...

The Commissioner argues that in every case the performance of post-redemption services is a prohibited interest under § 302(c)(2)(A)(i), regardless of whether the taxpayer is an officer, director, employee, or independent contractor.

The Tax Court rejected the Commissioner's argument, finding that the services rendered by the taxpayer did not amount to a prohibited interest in the corporation. In reaching this conclusion, the Tax Court relied on a test derived from *Lewis v. Commissioner*, 47 T.C. 129, 136 (1966) (Simpson, J., concurring):

> Immediately after the enactment of the 1954 Code, it was recognized that § 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. Thus, in determining whether a prohibited interest has been retained under § 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 the corporation and benefit by its operations. 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 retained under § 302(c)(2)(A)(i).

Lynch v. Commissioner, 83 T.C. 597, 605 (1984) (citations omitted).

After citing the "control or financial stake" standard, the Tax Court engaged in a two-step analysis. First, the court concluded that the taxpayer was an independent contractor rather than an employee because the corporation had no right under the consulting agreement to control his actions.[80] Second, the court undertook a "facts and circumstances" analysis to determine whether the taxpayer had a financial stake in the corporation or managerial control after the redemption. Because the consulting agreement was not linked to the future profitability of the

[80] Finding that the taxpayer was not an employee obviated the need to decide whether the parenthetical language in § 302(c)(2)(A)(i) prohibited employment relationships per se. *See* Seda v. Commissioner, 82 T.C. 484, 488 (1984) (court stated that "section 302(c)(2)(A)(i) may not prohibit the retention of all employment relationships").

corporation, the court found that the taxpayer had no financial stake. The court also found no evidence that the taxpayer exerted control over the corporation. Thus, the Tax Court determined that the taxpayer held no interest prohibited by § 302(c)(2)(A)(i).

III

... The Tax Court's interpretation of what constitutes a prohibited interest under § 302(c)(2)(A)(i) is a question of law reviewed de novo. [citations omitted].

We reject the Tax Court's interpretation of § 302(c)(2)(A)(i). An individualized determination of whether a taxpayer has retained a financial stake or continued to control the corporation after the redemption is inconsistent with Congress' desire to bring a measure of certainty to the tax consequences of a corporate redemption. We hold that a taxpayer who provides post-redemption services, either as an employee or an independent contractor, holds a prohibited interest in the corporation because he is not a creditor.

The legislative history of § 302 states that Congress intended to provide "definite standards in order to provide certainty in specific instances." S. REP. NO. 1622, 83d Cong. 2d Sess. 233, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4870. "In lieu of a factual inquiry in every case, [§ 302] is intended to prescribe specific conditions from which the taxpayer may ascertain whether a given redemption" will qualify as a sale or be treated as a dividend distribution. H.R. REP. NO. 1337, 83d Cong. 2d Sess. 35, *reprinted* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4210. The facts and circumstances approach created by the Tax Court undermines the ability of taxpayers to execute a redemption and know the tax consequences with certainty.

The taxpayer's claim that the Senate rejected the mechanical operation of the House's version of § 302 is misleading. The Senate did reject the House bill because the "definitive conditions" were "unnecessarily restrictive." S. REP. NO. 1622, 83d Cong., 2d Sess. 44, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4675. However, the Senate's response was to add paragraph (b)(1) to § 302, which reestablished the flexible, but notoriously vague, "not essentially equivalent to a dividend" test. This test provided that all payments from a corporation that were not essentially equivalent to a dividend should be taxed as capital gains. The confusion that stemmed from a case-by-case inquiry into "dividend equivalence" prompted the Congress to enact definite standards for the safe harbors in § 302(b)(2) and (b)(3). The Tax Court's refusal to recognize that § 302(c)(2)(A)(i) prohibits all noncreditor interests in the corporation creates the same uncertainty as the "dividend equivalence" test.

The problem with the Tax Court's approach is apparent when this case is compared with *Seda v. Commissioner*, 82 T.C. 484 (1984). In *Seda*, a former shareholder, at his son's insistence, continued working for the corporation for two years after the redemption. He received a salary of $1,000 per month. The Tax Court refused to hold that § 302(c)(2)(A)(i) prohibits the retention of

employment relations per se, despite the unequivocal language in the statute.[81] Instead, the court applied the facts and circumstances approach to determine whether the former shareholder retained a financial stake or continued to control the corporation. The Tax Court found that the monthly payments of $1,000 constituted a financial stake in the corporation. This result is at odds with the holding in *Lynch* that payments of $500 per month do not constitute a financial stake in the corporation. [citations omitted]. The court also found in *Seda* no evidence that the former shareholder had ceased to manage the corporation. Again, this finding is contrary to the holding in *Lynch* that the taxpayer exercised no control over the corporation after the redemption, even though he worked daily for a year and shared his old office with his son. [citations omitted] Seda and *Lynch* thus vividly demonstrate the perils of making an ad hoc determination of "control" or "financial stake."

A recent Tax Court opinion further illustrates the imprecision of the facts and circumstances approach. In *Cerone v. Commissioner*, 87 T.C. 1 (1986), a father and son owned all the shares of a corporation formed to operate their restaurant. The corporation agreed to redeem all of the father's shares in order to resolve certain disagreements between the father and son concerning the management of the business. However, the father remained an employee of the corporation for at least five years after the redemption, drawing a salary of $14,400 for the first three years and less thereafter. The father claimed that he was entitled to capital gains treatment on the redemption because he had terminated his interest in the corporation within the meaning of § 302(b)(3).

Even on the facts of *Cerone*, the Tax Court refused to find that the father held a prohibited employment interest per se. Instead, the Tax Court engaged in a lengthy analysis, citing both *Seda* and *Lynch*. The court proclaimed that *Lynch* reaffirmed the rationale of *Seda*, even though *Lynch* involved an independent contractor rather than an employee. After comparing the facts of *Seda* and *Cerone*, the Tax Court eventually concluded that the father in *Cerone* held a financial stake in the corporation because he had drawn a salary that was $2,400 per year more than the taxpayer in *Seda* and had been employed by the corporation for a longer period after the redemption. However, the Tax Court was still concerned that prohibited interest in *Seda* might have been based on the finding in that case that the taxpayer had both a financial stake and continued control of the corporation. The Tax Court, citing *Lynch*, held that the "test is whether he retained a financial stake or continued to control the corporation." Thus, the Tax Court found that the father in *Cerone* held a prohibited interest because he had a financial stake as defined by *Seda*.

Although the Tax Court reached the correct result in *Cerone*, its approach undermines the definite contours of the safe harbor Congress intended to create with §§ 302(b)(3) and 302(c)(2)(A)(i). Whether a taxpayer has a financial stake according to the Tax Court seems to depend on two factors, length of employment and the amount of salary. Length of employment

[81] Eight of the seventeen Tax Court judges who reviewed *Seda* concurred in the result but would have classified all officer, director, or employee relationships as prohibited interests under § 302(c)(2)(A)(i).

after the redemption is irrelevant because Congress wanted taxpayers to know whether they were entitled to capital gains treatment on the date their shares were redeemed. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 235-36, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4872-73. *See also* Treas. Reg. § 1.302-4(a)(1) (taxpayer must attach a statement disclaiming any interest in the corporation with the first tax return filed after the distribution). As for the amount of annual salary, the Tax Court's present benchmark appears to be the $12,000 figure in *Seda*. Salary at or above this level will be deemed to be a financial stake in the enterprise, though the $6,000 annual payments in this case were held not to be a financial stake. There is no support in the legislative history of § 302 for the idea that Congress meant only to prohibit service contracts of a certain worth, and taxpayers should not be left to speculate as to what income level will give rise to a financial stake.

In this case, the taxpayer points to the fact that the taxpayers in *Seda* and *Cerone* were employees, while he was an independent contractor. On appeal, the Commissioner concedes the taxpayer's independent contractor status. We fail to see, however, any meaningful way to distinguish *Seda* and *Cerone* from *Lynch* by differentiating between employees and independent contractors. All of the taxpayers performed services for their corporations following the redemption. To hold that only the employee taxpayers held a prohibited interest would elevate form over substance. The parenthetical language in § 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. Furthermore, the Tax Court has in effect come to ignore the parenthetical language. If employment relationships are not prohibited interests per se, then the taxpayer's status as an employee or independent contractor is irrelevant. What really matters under the Tax Court's approach is how the taxpayer fares under a facts and circumstances review of whether he has a financial stake in the corporation or managerial control.[82] Tax planners are left to guess where along the continuum of monthly payments from $500 to $1000 capital gains treatment ends and ordinary income tax begins.

Our holding today that taxpayers who provide post-redemption services have a prohibited interest under § 302(c)(2)(A)(i) is inconsistent with the Tax Court's decision in *Estate of Lennard v. Commissioner*, 61 T.C. 554 (1974). That case held that a former shareholder who, as an independent contractor, provided post-redemption accounting services for a corporation did not have a prohibited interest. The Tax Court found that "Congress did not intend to include independent contractors possessing no financial stake in the corporation among those who are

[82] The Tax Court's focus on managerial control or a financial stake originated with Judge Simpson's concurrence in *Lewis*, 47 T.C. at 136-38. His interpretation of § 302(c)(2)(A) is supported by Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 33 n.72 (1956). Professor Bittker argues that Congress' goal was to ensure that taxpayers who transferred only ostensible control or maintained a financial stake in the corporation did not receive the benefit of capital gains treatment. He is no doubt correct. However, the means selected by Congress to achieve this goal do not allow for an individualized determination of control and financial stakes. Instead, § 302(c)(2)(A)(i) operates mechanically: the taxpayer must sever all but a creditor's interest to avoid the family attribution rules and thereby receive capital gains treatment. Nowhere in the legislative history of § 302(c) does Congress intimate that courts may use a flexible facts and circumstances test to determine the existence of managerial control or a financial stake.

considered as retaining an interest in the corporation for purposes of the attribution waiver rules." We disagree. In the context of *Lennard*, the Tax Court appears to be using financial stake in the sense of having an equity interest or some other claim linked to the future profit of the corporation. Yet, in cases such as *Seda* and *Cerone*, the Tax Court has found that fixed salaries of $12,000 and $14,400, respectively, constitute a financial stake. Fees for accounting services could easily exceed these amounts, and it would be irrational to argue that the definition of financial stake varies depending on whether the taxpayer is an employee or an independent contractor. In order to avoid these inconsistencies, we conclude that those who provide post-redemption services, whether as independent contractors or employees, hold an interest prohibited by § 302(c)(2)(A)(i) because they are more than merely creditors.

In addition, both the Tax Court and the Commissioner have agreed that taxpayers who enter into management consulting contracts after the redemption possess prohibited interests. *Chertkof v. Commissioner*, 72 T.C. 1113, 1124-25 (1979), *aff'd*, 649 F.2d 264 (4th Cir. 1981); Rev. Ruling 70-104, 1970-1 C.B. 66 (1970). Taxpayers who provide such services are, of course, independent contractors. However, unlike the Commissioner's opinion in Rev. Ruling 70-104 that all management consulting agreements are prohibited interests, the Tax Court applies the financial stake or managerial control test. In *Chertkof*, the court found that because the services provided under the contract "went to the essence" of the corporation's existence, the taxpayer had not effectively ceded control. Here, the Tax Court distinguished *Chertkof* on the ground that the taxpayer did not retain control of the corporation, but instead provided only limited consulting services. We believe that any attempt to define prohibited interests based on the level of control leads to the same difficulties inherent in making a case-by-case determination of what constitutes a financial stake.[83]

IV

Our decision today comports with the plain language of § 302 and its legislative history. [citations omitted]. Taxpayers who wish to receive capital gains treatment upon the redemption of their shares must completely sever all noncreditor interests in the corporation.[84] We hold that

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[83] Determining the existence of control is particularly difficult in the context of a family-held corporation. The exercise of control often will not be obvious because a parent may influence a child, and hence corporate decisionmaking, in myriad ways. Our rule that the provision of services is a prohibited interest eliminates the need to make a speculative inquiry into whether the parent still controls the corporation after the redemption. Of course, no rule could or should prohibit post-redemption parent-child communication concerning the management of the corporation.

[84] Our definition of a prohibited interest still leaves an open question as to the permissible scope of a creditor's interest under § 302(c)(2)(A)(i). *See, e.g.,* Treas. Reg. § 1.302-4(d) (a creditor's claim must not be subordinate to the claims of general creditors or in any other sense proprietary, i.e., principal payments or interest rates must not be contingent on the earnings of the corporation).

The taxpayer argues that some creditor relationships might result in an "opportunity to influence" as great or greater than any officer, director, or employee relationship. He cites Rev. Ruling 77-467, 1977-2 C.B. 92 which concluded that a taxpayer who leased real property to a corporation, after the corporation redeemed his shares, held a creditor's interest under § 302(c)(2)(A)(i). While the taxpayer here may be correct in his assessment of a creditor's

the taxpayer, as an independent contractor, held such a noncreditor interest, and so cannot find shelter in the safe harbor of § 302(c)(2)(A)(i). Accordingly, the family attribution rules of § 318 apply and the taxpayer fails to qualify for a complete redemption under § 302(b)(3). The payments from the corporation in redemption of the taxpayer's shares must be characterized as a dividend distribution taxable as ordinary income under § 301.

REVERSED.

Questions and comments:

1. Section 302(c)(2) permits a distributee to waive family attribution – and only family attribution – in cases of a complete termination of interest if certain conditions are met. Not surprisingly, the procedure for waiver and the conditions of waiver should assure that the one whose shares the corporation redeems truly has no interest in the corporation.

•The redeemed shareholder may not retain an interest in the corporation, including an interest as officer, director, or employee. The redeemed shareholder may retain an interest as a creditor. § 302(c)(2)(A)(i).

•The distributee may not acquire any such interest within 10 years of the date of distribution other than by bequest or inheritance. § 302(c)(2)(A)(ii). AND

• The distributee must file a notice with his first return for the taxable year in which the distribution occurs. The distributee must represent that he has not acquired a prohibited interest and that he will notify the IRS of the acquisition of any such interest other than by bequest or inheritance. § 302(c)(2)(A)(iii), Reg. § 1.302-4(a).

The reacquisition of even one share can make an entire distribution subject to dividend treatment under § 301.

•However, attribution rules will not apply to determine whether the redeemed shareholder has acquired a prohibited interest in the corporation. Rev. Rul. 71-562, 1971-2 C.B. 173. In that ruling, father and son-1 each owned 50% of the outstanding shares of the corporation. The corporation redeemed all of father's shares, and waivers were filed. Within ten years, son-2 purchased some shares from son-1. Son-2's shares were not attributed to father.

2. Note 2 (continued): The waiver rules do not apply to redemptions of stock that the shareholder acquired directly or indirectly within 10 years prior to the date of distribution from a person whose ownership of stock would at the time of distribution be attributed to the distributee. This is the so-called "look-back" rule. § 302(c)(2)(B)(i).

•What fact pattern is this provision intended to address? Notice that the attribution rules

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"opportunity to influence" a corporation, he overlooks the fact that Congress specifically allowed the right to retain such an interest.

under this provision are not restricted to family attribution.

Moreover, the waiver rules do not apply to redemptions of stock if another person acquired shares directly or indirectly from the distributee within 10 years prior to the distribution where such person's stock is attributed to the distributee. § 302(c)(2)(B)(ii).

•What fact pattern is this provision intended to address? Notice again that the attribution rules under this provision are not restricted to family attribution.

These two provisions do not apply if the acquisition or disposition by the respective distributees did not have "as one of its principal purposes the avoidance of Federal income tax." § 302(c)(2)(B) (carryout ¶).

3. Returning to the scenario that we imagined at the outset of this section: How realistic is it to expect that the first generation will not own what the United States Court of Appeals for the Third Circuit regards as a prohibited interest?

•Notice that the Tax Court in several cases was willing to consider facts and circumstances to determine whether the redeemed shareholder had retained a prohibited interest. Does this provide any insight into the types of considerations that should be relevant in § 302(b)(3) cases?

4. Within the context of redemptions under § 302, we have seen that § 302(b)(1) provides a standard that can be uncertain of application. Sections 302(b)(2 and 3) provide "safe harbors." The purpose of "safe harbors" is to avoid uncertainty of application. The court is no doubt correct in its observations that a "facts and circumstances" approach to § 302(c)(2) will not avoid uncertain application.

5. Theoretically then, cases such as *Lynch* could be decided under § 302(b)(1). How should cases such as *Lynch* fare under that standard?

6. The redeemed shareholder *may* in fact retain a rather significant interest.

•Landlord relationship: A taxpayer whose stock in a family corporation is redeemed and who retires as a corporate officer but continues to receive payments, not dependent on the corporation's future earnings or subordinate to the corporation's general creditors, representing an arm's length charge for the corporation's use of a building owned by the taxpayer, does not have a prohibited interest in the corporation within the meaning of § 302(c)(2)(A)(i). Rev. Rul. 77-467, 1977-2 C.B. 92.

•Unfunded pension: A entered into a pension agreement with X Corporation prior to X's redemption of all of A's shares. A's pension agreement represents the sole relationship between A and X after the redemption of A's X stock. Although the pension agreement is unfunded, payments under the agreement are not dependent upon the future earnings of X and A's claim to such payments are not subordinate to the claims of X's general creditors. The only rights in X retained by A are those contract rights available to enforce X's duties under the pension agreement. Such relationship does not provide A with an

interest in X that is prohibited by § 302(c)(2)(A)(i). Rev. Rul. 84-135, 1984-2 C.B. 80.

7. Might a creditor have rights sufficiently significant to be considered an owner or manager of the corporation? Read Reg. § 1.302-4(d) (if payments of principal or the interest rate depend on earnings of corporation, "lender" has "proprietary" interest in corporation).

•Should retention of a security interest in the redeemed stock constitute a prohibited interest?

Hurst v. Commissioner, 124 T.C. 16 (2005)

HOLMES, J.
Richard Hurst founded and owned Hurst Mechanical, Inc. (HMI), a thriving small business in Michigan that repairs and maintains heating, ventilating, and air conditioning (HVAC) systems. He bought, with his wife Mary Ann, a much smaller HVAC company called RHI; and together they also own the building where HMI has its headquarters.

When the Hursts decided to retire in 1997, they sold RHI to HMI, sold HMI to a trio of new owners who included their son, and remained HMI's landlord. Mary Ann Hurst stayed on as an HMI employee at a modest salary and with such fringe benefits as health insurance and a company car.

The Hursts believe that they arranged these transactions to enable them to pay tax on their profit from the sale of HMI and RHI at capital gains rates over a period of fifteen years. The Commissioner disagrees.

FINDINGS OF FACT

....

In April 1979, the Hursts opened their own HVAC business, working out of their basement and garage. Mr. Hurst handled the technical and sales operations while Mrs. Hurst did the bookkeeping and accounting. The business began as a proprietorship, but in November of that year they incorporated it under Michigan law, with Mr. Hurst as sole shareholder of the new corporation, named Hurst Mechanical, Inc. (HMI). In 1989, HMI elected to be taxed under subchapter S of the Code, and that election has never changed. [footnote omitted]. The firm grew quickly, and after five years it had about 15 employees; by 1997, it had 45 employees and over $4 million in annual revenue.

... The Hursts bought [a] building [on Safety Drive in Belmont, Michigan] in their own names and leased it to HMI. In early 1994, the Hursts bought another HVAC business, Refrigerator Man, Inc., which they renamed R.H., Inc. (RHI). Each of the Hursts owned half of RHI's stock.

In 1996, with HMI doing well and settled into a stable location, the Hursts began thinking about

retirement. Three employees had become central to the business and were to become important to their retirement plans. One was Todd Hurst, who had grown up learning the HVAC trade from his parents. The second was Thomas Tuori. Tuori was hired in the mid-1980s to help Mary Ann Hurst manage HMI's accounting, and by 1997 he was the chief financial officer of the corporation. The last of the three was Scott Dixon, brought on in 1996, after Richard Hurst came to believe that HMI was big enough to need a sales manager. Dixon anticipated the potential problems posed by the Hursts' eventual retirement so, before joining the firm, he negotiated an employment contract that included a stock option. His attorney also negotiated stock option agreements for Tuori and Todd Hurst at about the same time. These options aimed to protect Dixon and the others if HMI were sold.

In late 1996, Richard Hurst was contacted by Group Maintenance American Corporation (GMAC). GMAC was an HVAC consolidator – a company whose business plan was to buy small HVAC businesses and try to achieve economies of scale – and it offered to buy HMI for $2.5 million. Mr. Hurst told Tuori, Dixon, and Todd about GMAC's offer, and they themselves confirmed it – only to learn that GMAC had no interest in keeping them on after a takeover. Convinced they were ready to run the business, they approached Mr. Hurst in May 1997 with their own bid to buy his HMI stock, matching the $2.5 million offered by GMAC. Mr. Hurst accepted the offer, confident that the young management team he had put together would provide a secure future for the corporation he had built up over nearly twenty years.

Everyone involved sought professional advice from lawyers and accountants who held themselves out as having expertise in the purchase and sale of family businesses. The general outline of the deal was soon clear to all. The Hursts would relinquish control of HMI and RHI to Tuori, Dixon, and Todd Hurst, and receive $2.5 million payable over fifteen years. HMI, Inc. would continue to lease the Safety Drive property from the Hursts. The proceeds from the sale of the corporations and the rent from the lease would support the Hursts during their retirement. Mrs. Hurst would continue to work at HMI as an employee, joining the firm's health plan to get coverage for herself and her husband. Tuori, Dixon, and Todd Hurst would own the company, getting the job security they would have lacked had HMI been sold.

Everything came together on July 1, 1997: HMI bought 90 percent of its 1000 outstanding shares from Mr. Hurst for a $2 million note. Richard Hurst sold the remaining 100 shares in HMI to Todd Hurst (51 shares), Dixon (35 shares), and Tuori (14 shares). The new owners each paid $2500 a share, also secured by promissory notes. HMI bought RHI from the Hursts for a $250,000 note. [footnote omitted]. (All these notes, from both HMI and the new owner, had an interest rate of eight percent and were payable in 60 quarterly installments.) HMI also signed a new 15-year lease for the Safety Drive property, with a rent of $8,500 a month, adjusted for inflation. The lease gave HMI an option to buy the building from the Hursts, and this became a point of some contention – described below – after the sale. And, finally, HMI also signed a ten-year employment contract with Mrs. Hurst, giving her a small salary and fringe benefits that included employee health insurance.

If done right, the deal would have beneficial tax and nontax effects for the Hursts. From a tax

perspective, a stock sale would give rise to long-term capital gain, taxed at lower rates than dividends.[85] And by taking a 15-year note, rather than a lump sum, they could qualify for installment treatment under § 453, probably letting them enjoy a lower effective tax rate.

There were also nontax reasons for structuring the deal this way. HMI's regular bank had no interest in financing the deal, and the parties thought that a commercial lender would have wanted a security interest in the corporations' assets. By taking a security interest only in the stock, the Hursts were allowing the buyers more flexibility should they need to encumber corporate assets to finance the business.

But this meant that they themselves were financing the sale. And spreading the payments over time meant that they were faced with a lack of diversification in their assets and a larger risk of default. To reduce these risks, the parties agreed to a complicated series of cross-default and cross-collateralization provisions, the net result of which was that a default on any one of the promissory notes or the Safety Drive lease or Mrs. Hurst's employment contract would constitute a default on them all. Since the promissory notes were secured by the HMI and RHI stock which the Hursts had sold, a default on any of the obligations would have allowed Mr. Hurst to step in and seize the HMI stock to satisfy any unpaid debt.

As it turned out, these protective measures were never used, and the prospect of their use seemed increasingly remote. Under the management of Todd Hurst, Dixon, and Tuori, HMI boomed. The company's revenue increased from approximately $4 million annually at the time of the sale to over $12 million by 2003. Not once after the sale did any of the new owners miss a payment on their notes or the lease.

The Hursts reported the dispositions of both the HMI and RHI stock on their 1997 tax return as installment sales of long-term capital assets. The Commissioner disagreed, and recharacterized these dispositions as producing over $400,000 in dividends and over $1.8 million in immediately recognized capital gains. In the resulting notice of deficiency for the Hursts' 1997 tax year, he determined that this (and a few much smaller adjustments) led to a total deficiency of $538,114, and imposed an accuracy-related penalty under § 6662 of $107,622.80. ...

OPINION

Figuring out whether the Hursts or the Commissioner is right requires some background vocabulary. In tax law, a corporation's purchase of its own stock is called a "redemption." § 317(b). The Code treats some redemptions as sales under § 302, but others as a payment of dividends to the extent the corporation has retained earnings and profits, with any excess as a return of the shareholder's basis, and any excess over basis as a capital gain. Distributions

[85] This was an important consideration to the Hursts – although HMI was an S corporation at the time of these transactions, and thus subject only to a single tier of tax, §§ 1363, 1366, it had been a C corporation until 1989 and still had $383,000 in accumulated earnings from those years that had not been distributed to Mr. Hurst. Without careful planning, these earnings might end up taxed as dividends under § 1368(c).

characterized as dividends, return of basis, or capital gains are commonly called "§ 301 distributions" ...

The rules for redemptions and distributions from S corporations, which are found in § 1368 and its regulations, add a layer of complexity, especially when the corporation has accumulated earnings and profits (as both HMI and RHI did). These rules require computation of an "accumulated adjustments account," an account which tracks the accumulation of previously taxed, but undistributed, earnings of an S corporation. Distributions up to the amount of the accumulated adjustments account are generally tax free to the extent they do not exceed a shareholder's basis in his stock. (Some of the Hursts' proceeds from their sales of their stock benefited from these rules, but that was not a point of contention in the case.)

For much of the Code's history (including 1997), noncorporate sellers usually preferred a redemption to be treated as a sale because that offered the advantage of taxation at capital gains rates and the possible recognition of that gain over many years under § 453's provisions for installment sales. This preference led to increasingly elaborate rules for determining which redemptions qualify as sales and which are treated as dividends or other § 301 distributions. The Code has three safe harbors: redemptions that are substantially disproportionate with respect to the shareholder, § 302(b)(2); redemptions that terminate a shareholder's interest, § 302(b)(3); and redemptions of a noncorporate shareholder's stock in a corporation that is partially liquidating, § 302(b)(4). Each of these safe harbors comes with its own regulations and case law.

The Code also allows redemption treatment if a taxpayer can meet the vaguer standard of proving that a particular redemption is "not essentially equivalent to a dividend." § 302(b)(1). The relevant regulation notes that success under this standard turns "upon the facts and circumstances of each case." Reg. § 1.302–2(b).

Given the stakes involved, the Hursts and their advisers tried to steer this deal toward the comparatively well-lit safe harbor of § 302(b)(3) – the "termination redemption." Reaching their destination depended on redeeming the HMI stock in a way that met the rules defining complete termination of ownership. And one might think that a termination redemption would be easy to spot, because whether a taxpayer did or didn't sell all his stock looks like a simple question to answer. Congress, however, was concerned that taxpayers would manipulate the rules to get the tax benefits of a sale without actually cutting their connection to the management of the redeeming corporation. The problem seemed especially acute in the case of family-owned businesses, because such businesses often don't have strict lines between the roles of owner, employee, consultant, and director.

The Code addresses this problem by incorporating rules attributing stock ownership of one person to another (set out in § 318) in the analysis of transactions governed by § 302. Section 318(a)(1)(A)(ii), which treats stock owned by a child as owned by his parents, became a particular obstacle to the Hursts' navigation of these rules because their son Todd was to be one of HMI's new owners. This meant that the note that Mr. Hurst received from HMI in exchange for 90 percent of his HMI stock might be treated as a § 301 distribution, because he would be

treated as if he still owned Todd's HMI stock – making his "termination redemption" less than "complete".

But this would be too harsh a result when there really is a complete termination both of ownership and control. Thus, Congress provided that if the selling family member elects to keep no interest in the corporation other than as a creditor for at least ten years, the Commissioner will ignore the § 318 attribution rules. § 302(c)(2); Reg. § 1.302-4. [footnote omitted].

[The primary tax issue] ... in this case turns on whether Richard Hurst proved that the sale of his HMI stock was a termination redemption, specifically whether he kept an interest "other than an interest as a creditor" in HMI. ...

....

A. Complete Termination of Interest in HMI

The Hursts' argument is simple – they say that Richard (who had owned all the HMI stock) walked completely away from the company, and has no interest in it other than making sure that the new owners keep current on their notes and rent. The Commissioner's argument is more complicated. While acknowledging that each relationship between the Hursts and their old company – creditor under the notes, landlord under the lease, employment of a non-owning family member – passes muster, he argues that the total number of related obligations resulting from the transaction gave the Hursts a prohibited interest in the corporation by giving Richard Hurst a financial stake in the company's continued success.

In analyzing whether this holistic view is to prevail, we look at the different types of ongoing economic benefits that the Hursts were to receive from HMI: (a) The debt obligations in the form of promissory notes issued to the Hursts by HMI and the new owners, (b) their lease of the Safety Drive building to HMI; and (c) the employment contract between HMI and Mrs. Hurst.

1. Promissory Notes

There were several notes trading hands at the deal's closing. One was the $250,000 note issued by HMI to the Hursts for their RHI stock. The second was the $2 million, 15-year note, payable in quarterly installments, issued to Mr. Hurst by HMI in redemption of 90 percent (900 of 1000) of his HMI shares. Mr. Hurst also received three 15-year notes payable in quarterly installments for the remaining 100 HMI shares that he sold to Todd Hurst, Dixon, and Tuori. All these notes called for periodic payments of principal and interest on a fixed schedule. Neither the amount nor the timing of payments was tied to the financial performance of HMI. Although the notes were subordinate to HMI's obligation to its bank, they were not subordinate to general creditors, nor was the amount or certainty of the payments under them dependent on HMI's earnings. [citations omitted]. All of these contractual arrangements had cross-default clauses and were secured by the buyers' stock. This meant that should any of the notes go into default, Mr. Hurst would have the right to seize the stock and sell it. The parties agree that the probable outcome of such a sale

would be that Mr. Hurst would once again be in control of HMI.

Respondent questions the cross-default clauses of the various contractual obligations, and interprets them as an effective retention of control by Mr. Hurst. But in *Lynch v. Commissioner*, 83 T.C. 597 (1984), *rev'd. on other grounds*, 801 F.2d 1176 (9th Cir. 1986), we held that a security interest in redeemed stock does not constitute a prohibited interest under § 302. We noted that "[t]he holding of such a security interest is common in sales agreements, and * * * not inconsistent with the interest of a creditor." [citation omitted]. Furthermore, at trial, the Hursts offered credible evidence from their professional advisers that these transactions, including the grant of a security interest to Mr. Hurst, were consistent with common practice for seller-financed deals.

2. The Lease

HMI also leased its headquarters on Safety Drive from the Hursts. As with the notes, the lease called for a fixed rent in no way conditioned upon the financial performance of HMI. Attorney Ron David, who was intimately familiar with the transaction, testified convincingly that there was no relationship between the obligations of the parties and the financial performance of HMI. The transactional documents admitted into evidence do not indicate otherwise. There is simply no evidence that the payment terms in the lease between the Hursts and HMI vary from those that would be reasonable if negotiated between unrelated parties. And the Hursts point out that the IRS itself has ruled that an arm's-length lease allowing a redeeming corporation to use property owned by a former owner does not preclude characterization as a redemption. Rev. Rul. 77–467, 1977–2 C.B. 92.

The Commissioner nevertheless points to the lease to bolster his claim that Mr. Hurst kept too much control, noting that in 2003 he was able to persuade the buyers to surrender HMI's option to buy the property. Exercising this option would have let HMI end its rent expense at a time of low mortgage interest rates, perhaps improving its cashflow – and so might well have been in the new owners' interest. But the Hursts paid a price when the new owners gave it up. Not only did the deal cancel the option, but it also cut the interest rate on the various promissory notes owed to the Hursts from eight to six percent. So we think the Commissioner is wrong in implicitly asserting that the buyers should have engaged in every behavior possible that would be adverse to the elder Hursts' interest, and focus on whether the elder Hursts kept "a financial stake in the corporation or continued to control the corporation and benefit by its operations." *Lynch*, 83 T.C. at 604. Ample and entirely credible testimony showed that the discussions about HMI's potential purchase of the Safety Drive location were adversarial: The Hursts as landlords wanted to keep the rent flowing, and the new owners wanted to reduce HMI's cash outlays. Though the Hursts kept their rents, the new owners did not give up the option gratuitously – making this a negotiation rather than a collusion.

3. Employment of Mrs. Hurst

At the same time that HMI redeemed Mr. Hurst's stock and signed the lease, it also agreed to a

ten-year employment contract with Mrs. Hurst. Under its terms, she was to receive a salary that rapidly declined to $1000/month and some fringe benefits – including health insurance, use of an HMI-owned pickup truck, and free tax preparation.

In deciding whether this was a prohibited interest, the first thing to note is that Mrs. Hurst did not own any HMI stock. Thus, she is not a "distributee" unable to have an "interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor." § 302(c)(2)(A)(i). The Commissioner is thus forced to argue that her employment was a "prohibited interest" for Mr. Hurst. And he does, contending that through her employment Mr. Hurst kept an ongoing influence in HMI's corporate affairs. He also argues that an employee unrelated to the former owner of the business would not continue to be paid were she to work Mrs. Hurst's admittedly minimal schedule. And he asserts that her employment was a mere ruse to provide Mr. Hurst with his company car and health benefits, bolstering this argument with proof that the truck used by Mrs. Hurst was the same one that her husband had been using when he ran HMI.

None of this, though, changes the fact that her compensation and fringe benefits were fixed, and again – like the notes and lease – not subordinated to HMI's general creditors, and not subject to any fluctuation related to HMI's financial performance. Her duties, moreover, were various administrative and clerical tasks – some of the same chores she had been doing at HMI on a regular basis for many years. And there was no evidence whatsoever that Mr. Hurst used his wife in any way as a surrogate for continuing to manage (or even advise) HMI's new owners. *Cf. Lynch*, 801 F.2d at 1179 (former shareholder himself providing post-redemption services).

It is, however, undisputed that her employment contract had much the same cross-default provisions that were part of the lease and stock transfer agreements. The Commissioner questions whether, in the ordinary course of business, there was reason to intertwine substantial corporate obligations with the employment contract of only one of 45 employees. He points to this special provision as proof that the parties to this redemption contemplated a continuing involvement greater than that of a mere creditor.

In relying so heavily on the cross-default provisions of the Hursts' various agreements, though, the Commissioner ignores the proof at trial that there was a legitimate creditor's interest in the Hursts' demanding them. They were, after all, parting with a substantial asset (the corporations), in return for what was in essence an IOU from some business associates. Their ability to enjoy retirement in financial security was fully contingent upon their receiving payment on the notes, lease, and employment contract. As William Gedris, one of the Hursts' advisers, credibly testified, it would not have been logical for Mr. Hurst to relinquish shares in a corporation while receiving neither payment nor security.

The value of that security, however, depended upon the financial health of the company. Repossessing worthless shares as security on defaulted notes would have done little to ensure the Hursts' retirement. The cross-default provisions were their canary in the coal mine. If at any point the company failed to meet any financial obligation to the Hursts, Mr. Hurst would have

the option to retrieve his shares immediately, thus protecting the value of his security interest instead of worrying about whether this was the beginning of a downward spiral. This is perfectly consistent with a creditor's interest, and there was credible trial testimony that multiple default triggers are common in commercial lending.

We find that the cross-default provisions protected the Hursts' financial interest as creditors of HMI, for a debt on which they had received practically no downpayment, and the collection of which (though not "dependent upon the earnings of the corporation" as that phrase is used in Reg. § 1.302-4(d)) was realistically contingent upon HMI's continued financial health. The buyers likewise had a motivation to structure the transaction as they did – their inability to obtain traditional financing without unduly burdening HMI's potential for normal business operations. Even one of the IRS witnesses showed this understanding of Mr. Hurst's relationship to the new owners after the redemption – the revenue agent who conducted the audit accurately testified that Mr. Hurst was "going to be the banker and wanted his interests protected."

The number of legal connections between Mr. Hurst and the buyers that continued after the deal was signed did not change their character as permissible security interests. Even looked at all together, they were in no way contingent upon the financial performance of the company except in the obvious sense that all creditors have in their debtors' solvency.

Moreover, despite the Commissioner's qualms, we find as a matter of fact that Mr. Hurst has not participated in any manner in any corporate activity since the redemptions occurred – not even a Christmas party or summer picnic. His only dealing with HMI after the sale was when, as noted above, he dickered with the buyers over their purchase option on the Safety Drive property. These facts do not show a continuing proprietary stake or control of corporate management.

....

To reflect the foregoing and incorporate other stipulated issues,
Decision will be entered under Rule 155.

Questions and comments:

1. The court provides a nice overview of the interplay between §§ 302(b)(3), 302(c)(2), and 318.

2. The Commissioner attacked the arrangements under § 304, but did so in an untimely manner. In an omitted part of the opinion, the court held that it could not consider § 304 because it constituted "new matter." However, you should not treat this case as not involving § 304 issues. After all, Robert Hurst (through attribution and otherwise) controlled two corporations, HMI and RHI. He sold stock in RHI to HMI.

- The court also determined that while Mrs. Hurst was an employee of an S Corporation, she was also a 2%-owner. Thus, the cost of her health insurance should be treated as gross income to her, although partially deductible under § 162(*l*)(1)(B) [now § 162(*l*)(5)].

•Not surprisingly, the court also overturned the assessment of a penalty.

3. Suppose that the corporation fails to make a payment on a promissory note that owes a first generation shareholder. What rights may a creditor reserve to seize property of the corporation? *See* Reg. § 1.302-4(e).

•Distinguish *Hurst* from Reg. § 1.302-4(e).

4. In *Lynch*, the Tax Court had considered whether taxpayer had retained a sufficient interest to constitute a financial or managerial interest in the success of the company. The Third Circuit held that these matters were irrelevant if Mr. Lynch worked in some capacity, whether as employee or as independent contractor, for the company. In *Hurst*, does it not seem that the same considerations find a place in determining whether an interest as a creditor may constitute a prohibited interest? And the question is appropriate for Mrs. Hurst's continuing status as an employee.

•In Rev. Rul. 79-334, 1979-2 C.B. 127, the IRS ruled that where taxpayer whose shares were redeemed accepted within 10 years' appointment by will to be a trustee of a trust that held voting stock in a corporation in which trustees could vote, the requirements of § 302(c)(2) were not violated. Taxpayer's interest was less than the interests that § 302(c)(2)(A)(ii) permitted, i.e., stock acquired by bequest or inheritance.

•But: the IRS ruled that when taxpayer-child sold all his interest in a corporation and taxpayer's parents later gifted stock of the same corporation to taxpayer's child and appointed taxpayer to be custodian of the stock under the Uniform Gift to Minors Act and entitled to vote the stock, § 302(c)(2)(A)(ii) was violated. Rev. Rul. 81-233, 1981-2 CB 83.

5. Articulate the Commissioner's position in this case. Does it not seem to be the flip side of the same "facts and circumstances" coin that the CA3 rejected in *Lynch*?

6. How would the Hursts have treated their sale of RHI stock to HMI if they had sold such stock at a loss? What effect does waiver under § 302(c)(2) have on the applicability of § 267(a)(1)?

7. *Avoidance of Federal Income Tax*: Consider the following:

•Taxpayer received 80 shares from his grandparent and 20 shares from his father. Father owned the remaining 500 shares of the corporation. Taxpayer had no interest in managing the corporation. Two years later, father bought 20 shares from taxpayer for fmv. Corporation redeemed taxpayer's other 80 shares. Corporation had no plans to redeem the 20 shares father purchased from taxpayer, and taxpayer was not an officer, director, or employee of corporation. Taxpayer did not attempt to retain control or an economic interest in the corporation. HELD: Father's "reacquisition from [taxpayer] of the 20 shares of previously gifted stock, immediately prior to the redemption of [taxpayer's] remaining ... shares, is not deemed to have had as one of its principal purposes the avoidance of federal income tax notwithstanding that the gift of such shares and the subsequent reacquisition of such shares occurred within the 10-year period

preceding the redemption of B's remaining X shares." Rev. Rul. 85-19, 1985-1 CB 94.

•Father owned all the stock of X Corporation. He gifted half of it to son, "who is active and knowledgeable in the affairs of the business of X and who intends to control and manage the corporation in the future." X Corporation then redeemed all of father's remaining shares. "The gift of stock was intended solely for the purpose of enabling [father] to retire while leaving the business to [son]. Therefore, the avoidance of Federal income tax will not be deemed to have been one of the principal purposes of the gift of stock from [father] to [son], notwithstanding the reduction of the capital gains tax payable by father as a result of the gift of appreciated stock prior to the redemption. Rev. Rul. 77-293, 1977-2 CB 91.

Do the CALI exercise: Corporate Taxation: Redemptions: Redemptions Terminating Shareholder's Interests: Section 302(b)(3).

2. Transfers of a Business When There is Intra-Family Hostility

In many of the cases in which taxpayer relies on § 302(b)(3) to obtain redemption treatment, waiver of family attribution is critical. In the absence of family attribution, former shareholders would not have much difficulty in showing that they do not directly hold any interest in the corporation. Congress presumably adopted the attribution rules because it perceived either a unity of interest among the parties or control by one party over another. Taxpayers not unreasonably may believe that if the presumptions underlying the attribution rules, especially the family attribution rules, simply are not true, then the rules should not be applicable. The language of § 318 however does not contemplate a policy-oriented approach to application of the family attribution rules; its language establishing attribution is mandatory ("shall").

Section 301(b)(6) provides that in determining whether a redemption meets the requirements of § 302(b)(1) ("not essentially equivalent to a dividend"), the fact that a redemption fails the tests of §§ 302(b)(2, 3, or 4) is not to be taken into account. Section 302(b)(1) contemplates a "facts and circumstances" approach to whether a distribution is "not essentially equivalent to a dividend." Reg. § 1.302-2(b)(1). Might courts consider the presence of intra-family hostility as a "fact and circumstance" in resolving § 302(b)(1) questions?

In *Haft Trust v. Commissioner*, 510 F.2d 43 (CA1 1975), the court said yes:

> The effect of the transaction rather than its motivation is determinative. *Section 302(b)(1)* requires a "*meaningful reduction* of the shareholder's proportionate interest in the corporation," *id.* (emphasis supplied). This language certainly seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules.

Id. at 47. That case involved a father's ownership of shares that were attributed to four trusts,

each benefitting one of his children. Father and mother divorced, and mother was given custody of the children. The corporation redeemed all the shares owned by the four trusts. Mother, a new husband, and children, moved to another city. Father had very little contact with the children after that. Father was indifferent to the children, rarely saw them, and stopped making court-ordered child support payments. The court remanded the case for consideration of the fact of such indifference in determining whether the distribution in redemption of the trust's shares were "not essentially equivalent to the payment of a dividend."

Are there any highly foreseeable and undesirable consequences of such a holding?

Haft Trust has not been endorsed by any other court post *Davis*. The IRS announced that it would not follow *Haft* because a "facts and circumstances" is inconsistent with the mechanical approach that § 318 requires. Rev. Rul. 80-26, 1980-1 CB 66. The Tax Court and the Fifth Circuit have given *Davis* a closer look than did the court in *Haft Trust* and concluded that family hostility in no way affects applicability of the attribution rules. In *Metzger Trust v. Comm'r*, 693 F.2d 459, 466 (CA5 1982), *cert. denied*, 463 U.S. 1207 (1983), the court said:

> The *Davis* Court was referring to a meaningful reduction in the shareholder's interest *after* application of the attribution rules. It would be strange indeed if what the Court really meant was that the attribution rules are to be applied before determining dividend equivalency, but then in the course of determining dividend equivalency their applicability could be reconsidered. If that were so, the attribution rules would hardly "provide a clear answer to what would otherwise be a difficult tax question ..." *Davis*, 397 U.S. at 306.

Id. at 466 (emphasis in original; footnotes omitted). And in *Cerone v. Comm'r*, 87 T.C. 1, 16 (1986), the court said: "[F]amily hostility does not prevent application of the attribution rules. At most, as we suggested in *Metzger Trust*, family hostility comes into play only in determining, *after the attribution rules have been applied*, whether any reduction in stock ownership is meaningful." In *Cerone*, all of the outstanding remaining shares after the redemption were attributed to taxpayer from his son. Since taxpayer owned 100% of the shares prior to the redemption – half directly and half by attribution – and owned 100% of the shares after the redemption – all by attribution – there could not be a "meaningful" reduction in taxpayer's interest.

In light of this approach, do you think that intra-family hostility *can* have much of a role to play in analyzing cases under § 302(b)(1)?

3. Waiver of Family Attribution by an Entity

Read § 302(c)(2)(C). Congress added this provision to the Code in the Tax Equity and Fiscal

Responsibility Act of 1982.[86]

Consider the facts of *Crawford v. Comm'r*, 59 T.C. 830 (1973), *nonacq.* 1974-2 C.B. 5.[87] H and W (residents of California, a community property state) had two sons, S-1 and S-2. H/W, S-1, and S-2 each owned ⅓ of the stock in each of two corporations. The parties agreed that in the event of H's death, W would offer her shares to the corporation for redemption. H died. W was the sole beneficiary of H's estate. The estate offered its ½ interest in H and W's shares to the respective corporations, which redeemed them. Both corporations distributed cash to W. She filed § 302(c)(2) agreements with her tax return. The estate filed § 302(c)(2) agreements with its tax return. Under the family attribution rules, shares of S-1 and S-2 would be attributed to W. The Commissioner argued that the estate was not entitled to waive family attribution; only family members described in § 318(a)(1)(A) could waive attribution. The Commissioner argued that half of the distributions to W should be taxed as a dividend. Tax court disagreed and noted that the language of § 318(c)(2) did not restrict the power to waive family attribution to family members and that it should not matter whether the estate first distributed the stock to the beneficiary instead of offering it to the corporation.

The facts of *Crawford* and the position of the Commissioner raised two issues: (1) can an entity waive family attribution; (2) should it matter whether an estate distributes stock rather than the cash proceeds of a redemption from it because if the estate does not distribute stock, *it* technically is the distributee and it would own all the shares (a "1" followed by a "3").

Section 302(c)(3) provides answers: An entity may waive family attribution. It does not matter whether the estate (or other entity) distributes shares or proceeds to the beneficiary (or partner, beneficiary, or shareholder).

What role do you think W played in the management or operations of the corporation after H died? As a policy matter, should it not be rather straight-forward to redeem her shares without other shares being attributed to her?

Notice just how narrow § 302(c)(2)(C) is. Exactly what attribution can be waived and by whom (or what)?

- A "1" followed by a "3?" And no other?

- Suppose S-2 had also been a beneficiary of the estate? Would the result in *Crawford* have been the same after enactment of § 302(c)(2)(C)? *See Estate of Webber v United States*, 263 F. Supp. 703, 707 (E.D. Ky. 1967), *aff'd*, 404 F.2d 411, (CA6 1968); Rev. Rul. 71-261, 1971-1 CB 108.

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[86] P.L. 97-248, § 228(a)

[87] A case with issues similar to the issues in *Crawford* and with the same result was *Johnson Trust v. Commissioner*, 71 T.C. 941 (1979).

Notice also the requirements that § 302(c)(2)(C)(i)(II) imposes for entity waiver.

Now consider the facts of *Rickey v. United States*, 592 F.2d 1251 (CA5 1979) – a case decided prior to enactment of § 302(c)(2)(C). Father owned 57% of the outstanding shares of corporation. His three children owned 35% of the outstanding shares of corporation. His three children and Wife were the sole legatees under his will. Father died, and the corporation redeemed all the estate's shares – the ones Father had owned prior to his death. Because of the redemption, the three children owned 82% of the outstanding shares of the corporation. The estate distributed the cash among the four legatees. The Commissioner treated the distribution as essentially equivalent to a dividend. The court refused to adopt a "crabbed" reading of § 302(c)(2) and permitted the estate to waive attribution under § 318(a)(3). *Id.* at 1258.

•Shortly thereafter, Congress endorsed the holding in *Rickey* by enacting § 302(c)(2)(C). Did it really endorse the holding in § 302(c)(2)(C)?

Avoidance of Federal Income Tax: In Rev. Rul. 85-19, 1985-1 C.B. 94, the IRS stated:

> Tax avoidance ... within the meaning of § 302(c)(2)(B) ... requires both the presence of a certain state of mind on the part of the taxpayer in connection with the acquisition or the disposition of stock, coupled with the accomplishment of the tax avoidance design via a redemption of stock. Tax avoidance, therefore, cannot be present, for example, merely because there has been a transfer of stock by one § 318(a)(1) relative to another, when such transfer was not in contemplation of redemption of the balance of the transferor's stock nor of the stock transferred to the transferee. *See* Rev. Rul. 56-556, 1956-2 C.B. 177; Rev. Rul. 56-584, 1956-2 C.B. 179; Rev. Rul. 57-387, 1957-2 C.B. 225. Similarly, tax avoidance cannot be present merely because a shareholder has transferred stock to a related person within the meaning of § 318(a)(1) even though such transfer may have been in contemplation of redemption of the balance of the transferor's stock or of the stock transferred to the transferee, if in fact no redemption of either the transferor's stock or the stock transferred to the transferee actually occurs.

4. Transfers in the Context of a Divorce Settlement

Imagine: Spouses are married and together own a substantial portion – perhaps all –the stock of a corporation. The corporation grows – often due to the efforts of the spouses. The spouses divorce. They do not want a court to draft the terms of their dissolution, so they must work out the terms of alimony and a property settlement. The tax consequences of a property settlement are essentially nothing for the parties except for the tax consequences of gains/losses built in to the property that they receive from the settlement (§ 1041). It probably will not be prudent (or even possible) for both to continue their involvement in the corporation; hence one of the spouses must dispose of his stock. As part of the property settlement, they agree that one of the spouses will buy the stock of the other or cause the corporation to redeem all the stock of the other spouse – a distribution that should qualify for § 302(b)(3) sale or exchange treatment. Often a promissory note is involved. This would mean that the spouse whose shares are

redeemed must pay income tax at capital gain rates on the amount realized in excess of his basis. The incidence and amount of tax liability would of course be a part of the settlement discussions.

After finalization of the divorce, the distributee spouse reneges and does not pay income tax on a distribution in exchange for stock. The distributee spouse argues that the payment fulfills the distributee-former spouse's primary and unconditional obligation under the property settlement. As in *Sullivan*, the corporation's fulfillment of that obligation is a taxable dividend to the one whose obligation the corporation fulfills. *See, e.g.*, *Read v. Comm'r*, 114 T.C. 14, 38 (2000), *aff'd sub. nom. without opinion*, *Mulberry Motor Parts, Inc. v. Comm'r*, 273 F.3d 1120 (CA 11 2001) (§ 1041(a) applies to distributee spouse's transfer of stock; no gain or loss recognized); *Arnes v. United States*, 981 F.2d 456, 460 (CA9 1992) (§ 1041(a) applies to distributee spouse's transfer of stock; no gain or loss recognized). These arrangements were the subject of much litigation.

Note that after careful negotiation, there is a double-cross. In 2003,[88] Treasury promulgated a regulation that provides more certainty. (It might not be in your edited version of the Code and Regulations, so it is reprinted here):

> § 1.1041-2(a) **Redemptions of stock**. – (a) *In general. – (1) Redemption of stock not resulting in constructive distributions*. – Notwithstanding Q&A-9 of Reg. § 1.1041-1T(c), if a corporation redeems stock owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (non-transferor spouse), then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.
>
> (2) *Redemption of stock resulting in constructive distribution*. – Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.
>
> (b) *Tax consequences* – (1) *Transfers described in paragraph (a)(1) of this section*. – Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this

[88] Department of the Treasury, *Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse*, 63 Fed. Reg. 1534 (Jan.13, 2003).

section. See § 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under § 302(d) will be subject to § 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(2) *Transfers described in paragraph (a)(2) of this section*. – The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually made such transfers. Accordingly, § 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of § 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. See § 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under § 302(d) will be subject to § 301 if received from a Subchapter C corporation or § 1368 if received from a Subchapter S corporation.

(c) *Special rules in case of agreements between spouses or former spouses – (1) Transferor spouse taxable*. – Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that –

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) *Nontransferor spouse taxable*. – Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that –

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

The parties are free to choose who will bear the tax burden resulting from a corporate redemption of one of the party's stock. The "default" rules of Reg. § 1.1041-2(a)(1 and 2) refer to "applicable tax law." Presumably this means determining whether the non-transferor spouse has a "primary and unconditional" obligation to purchase the stock of the transferring spouse. The regulation contains two provisions that the parties must be careful to include to obtain this predictable treatment.

5. Redemptions in the Context of an Acquisition

Can you imagine a situation where § 302(b)(3) might enable one to acquire control of a corporation?

Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954)

GOURLEY, District Judge

The appeal relates to the interpretation of § [302(b)(1)] ... and poses the question –

Is a distribution of substantially all of the accumulated earnings and surplus of a corporation, which are not necessary to the conduct of the business of the corporation, in redemption of all outstanding shares of stock of said corporation owned by one person essentially equivalent to the distribution of a taxable dividend under the Internal Revenue Code?

The District Court answered in the affirmative and sustained a deficiency assessment by the Commissioner of Internal Revenue.

... [W]e believe the judgment should be reversed.

....

The question stems from the following circumstances:

Appellant is the widow of the person who was the motivating spirit behind the closed corporation which engaged in the business of excavating and laying of sewers. Through death of her husband she became the owner of all shares of stock issued by the corporation. She operated the business until remarriage, when her second husband assumed the management. As a result of a marital rift, separation, and final divorce, taxpayer sought to dispose of her company to a

competitor who was anxious to eliminate competition.

Prospective buyer did not want to assume the tax liabilities which it was believed were inherent in the accumulated earnings and profits of the corporation. To avoid said profits and earnings as a source of future taxable dividends, buyer purchased part of taxpayer's stock for cash. Three weeks later, after corporate reorganization and corporate action, the corporation redeemed the balance of taxpayer's stock, purchasing the same as treasury stock which absorbed substantially all of the accumulated earnings and surplus of the corporation.

Taxpayer, in her tax return, invoked [§ 302(b)(3)] ... as constituting a cancellation or redemption by a corporation of all the stock of a particular shareholder, and therefore was not subject to being treated as a distribution of a taxable dividend.

The District Court sustained the deficiency assessment of the Commissioner that the amount received from accumulated earnings and profits was ordinary income since the stock redeemed by the corporation was "at such time and in such manner as to make the redemption thereof essentially equivalent to the distribution of a taxable dividend" under [§ 302(b)(1)] ...

The District Court's findings were premised upon the view that taxpayer employed a circuitous approach in an attempt to avoid the tax consequences which would have attended the outright distribution of the surplus to the taxpayer by the declaration of a taxable dividend.

The rationale of the District Court is dedicated to piercing the external manifestations of the taxpayer's transactions in order to establish a subterfuge or sham.

Nevertheless, the general principle is well settled that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes or altogether avoid them, *by means which the law permits*. *Gregory v. Helvering*, 293 U.S. 465, 469; [citation omitted]. The taxpayer's motive to avoid taxation will not establish liability if the transaction does not do so without it. [citations omitted].

The question accordingly presented is not whether the overall transaction, admittedly carried out for the purpose of avoiding taxes, actually avoided taxes which would have been incurred if the transaction had taken a different form, but whether the sale constituted a taxable dividend or the sale of a capital asset. [citation omitted].

It is a salutary fact that [§ 302(b)(3)] ... is an exception to [§ 301] ... that all distributions of earning and profits are taxable as a dividend.

The basic precept underlying the capital gains theory of taxation as distinguished from ordinary income tax is the concept that a person who has developed an enterprise in which earnings have been accumulated over a period of years should not be required to expend the ordinary income tax rate in the one year when he withdraws from his enterprise and realizes his gain.

Common logic dictates that a fair basis of measuring income is not determined upon the profits on hand in the year of liquidation but is properly attributable to each year in which the profits were gained.

We cannot concur with the legal proposition enunciated by the District Court that a corporate distribution can be essentially equivalent to a taxable dividend even though that distribution extinguishes the shareholder's interest in the corporation. To the contrary, we are satisfied that where the taxpayer effects a redemption which completely extinguishes the taxpayer's interest in the corporation, and does not retain any beneficial interest whatever, that such transaction is not the equivalent of the distribution of a taxable dividend as to him. *Tiffany v. Commissioner of Internal Revenue*, 16 T.C. 1443.

The statutory concept of dividend is a distribution out of earnings and profits, and normally it is proportionate to shares and leaves the shareholder holding his shares as his capital investment. *Flinn v. Commissioner of Internal Revenue*, 37 B.T.A. 1085.

Complete and partial liquidations are treated for the purpose of the statute, as sales with a consequent measure of gain or loss, even though the proceeds may to some extent be derived from earnings. *Hellmich v. Hellman*, 276 U.S. 233.

The use of corporate earnings or profits to purchase and make payment for all the shares of a taxpayer's holdings in a corporation is not controlling, and the question as to whether the distribution in connection with the cancellation or the redemption of said stock is essentially equivalent to the distribution of a taxable dividend under the Internal Revenue Code and Treasury Regulation must depend upon the circumstances of each case.

Since the intent of the taxpayer was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation, the conclusion is inevitable that the distribution of the earnings and profits by the corporation in payment for said stock was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend.

In view of the fact that the application of [§ 301] ... contemplates that the shareholder receiving the distribution will remain in the corporation, the circumstances of this proceeding militate against treating taxpayer's sale as a distribution of a taxable dividend.

....

We conclude that under the facts and circumstances of the present case the District Court was in error, and the taxpayer is not liable as a distributee of a taxable dividend under [§ 301] ...

The decision and judgment of the District Court is reversed and the case remanded with instructions to enter judgment in accordance with this opinion.

Questions and comments:

1. Suppose that the corporation had redeemed most of taxpayer's shares. *Then* taxpayer sold her few remaining shares to the third-party competitor. Her plan all along was that she would have no interest in the corporation and that the competitor would own all the shares. Should the result have been different? *Cf.* Rev. Rul. 75-447, 1975-2 C.B. 113 (applying § 302(b)(2)).

6. Redemptions from Corporate Shareholders

Suppose: X corporation has outstanding 200,000x shares of voting common stock, which is widely held and publicly traded. On June 1 of the current year, X offered to purchase shares of its common stock at the rate of $250 per share. On June 2 of the current year, Y corporation, which owned no X common stock either directly or constructively under § 318 prior to X's offer, purchased 4000 shares of X stock on the market for a total price of $1,000,000, and immediately tendered 800 shares to X for redemption. (Why did Y corporation tender *exactly* 800 shares?) On June 21 of the current year, Y sold the remaining 3200 shares of X stock on the market for $800,000. Y claimed a $200,000 dividends received deduction. Because Y no longer owned the 800 shares that it tendered to X and because Y claimed dividend treatment, Y increased its basis in its remaining shares. On June 22 of the current year, Y sold the remaining shares for $800,000 and claimed a short-term capital loss of $200,000 that it will apply against short-term capital gains from other sources.

- If the corporate distribution and ensuing sale of shares on the open market are considered together in aggregate, how should they be treated?

- *See* Rev. Rul. 77-226, 1977-2 C.B. 90.

- If the redemption of a shareholder's shares qualifies for sale or exchange treatment under § 302(b), should a shareholder be allowed to elect dividend treatment instead?

Imagine we are corporate tax counsel for the parties in the following case and with the benefit of hindsight can apply the learning of *Zenz* and Rev. Rul. 75-447.

Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958)

MARIS, Circuit Judge

This is a petition to review a decision of the Tax Court. ... [This] case involves [petitioner's] income tax liability for the year 1951. ... The facts as found by the Tax Court, some of which were stipulated, may be summarized as follows:

J.R. Holsey Sales Company, a New Jersey corporation, was organized on April 28, 1936, as an Oldsmobile dealership. Taxpayer has been president and a director of the company since its

organization. Only 20 shares were issued out of the 2,500 shares of no par value stock authorized; these 20 shares were issued to Greenville Auto Sales Company, a Chevrolet dealership, in exchange for all of the latter's right, title, and interest to the Oldsmobile franchise and other assets with respect to the franchise which had been owned and operated by the Greenville Company. The 20 shares issued were assigned a value of $11,000. Taxpayer's father, Charles V. Holsey, in 1936, owned more than two-thirds of the outstanding stock of the Greenville Company, and taxpayer was vice-president and a director of that corporation.

On April 30, 1936, taxpayer acquired from the Greenville Company an option to purchase 50% of the outstanding shares of the Holsey Company for $11,000, and a further option to purchase, within ten years after the exercise of the first option, all the remaining shares for a sum to be agreed upon. The Greenville Company owned all of the outstanding stock of the Holsey Company from its organization in 1936 until November, 1939, when taxpayer exercised his first option and purchased 50% of the outstanding stock of the Holsey Company for $11,000.

On June 28, 1946, the further option in favor of taxpayer was revised. Under the terms of the revised option, taxpayer was granted the right to purchase the remaining outstanding shares of the Holsey Company at any time up to and including June 28, 1951, for $80,000. The revised option was in favor of taxpayer individually and was not assignable by him to anyone other than a corporation in which he owned not less than 50% of the voting stock. On the date of the revision of this option, taxpayer's father owned 76% of the stock of the Greenville Company and taxpayer was a vice-president and director of that corporation. ...

On January 19, 1951, taxpayer assigned his revised option to the Holsey Company; on the same date the Holsey Company exercised the option and paid the Greenville Company $80,000 for the stock held by it. This transaction resulted in taxpayer becoming the owner of 100% of the outstanding stock of the Holsey Company. In his income tax return for the year 1951, taxpayer gave no effect to this transaction.

... On January 19, 1951, when the revised option was exercised, the earned surplus of the Holsey Company was in excess of $300,000.

The Oldsmobile franchise, under which the Holsey Company operated, was a yearly contract entered into by the Corporation and the manufacturer in reliance upon the personal qualifications and representations of taxpayer as an individual. It was the manufacturer's policy to have its dealers own all of the stock in dealership organizations.

The Commissioner determined that the effect of the transaction of January 19, 1951, wherein the Holsey Company paid $80,000 to the Greenville Company for 50% of the outstanding stock of the Holsey Company, constituted a dividend to taxpayer, the remaining stockholder. The Commissioner therefore asserted a deficiency against taxpayer in the sum of $41,385.34. The Tax Court sustained the Commissioner.

The question presented for decision in this case is whether the Tax Court erred in holding that

the payment by the Holsey Company of $80,000 to the Greenville Company for the purchase from that company of its stock in the Holsey Company was essentially equivalent to the distribution of a taxable dividend to the taxpayer, the remaining stockholder of the Holsey Company. To determine that question we must begin with the applicable statute, [§§ 301, 302(b)(3)] ...

It will be observed that [§ 301] defines a dividend as a distribution made by a corporation "to its shareholders". Accordingly unless a distribution which is sought to be taxed to a stockholder as a dividend is made to him or for his benefit it may not be regarded as either a dividend or the legal equivalent of a dividend. Here the distribution was made to the Greenville Company, not to the taxpayer. This the Government, of course, concedes but urges that it was made for the benefit of the taxpayer. It is true that it has been held that a distribution by a corporation in redemption of stock which the taxpayer stockholder has a contractual obligation to purchase is essentially the equivalent of a dividend to him since it operates to discharge his obligation. *Wall v. United States*, 164 F.2d 462 (CA4 1947); *Ferro v. Commissioner of Internal Revenue*, 242 F.2d 838 (CA3 1957); *Zipp v. Commissioner of Internal Revenue*, 259 F.2d 119 (CA6 1958). But where, as here, the taxpayer was never under any legal obligation to purchase the stock held by the other stockholder, the Greenville Company, having merely an option to purchase which he did not exercise but instead assigned to the Holsey Company, the distribution did not discharge any obligation of his and did not benefit him in any direct sense.

It is, of course, true that the taxpayer was benefited indirectly by the distribution. The value of his own stock was increased, since the redemption was for less than book value, and he became sole stockholder. But these benefits operated only to increase the value of the taxpayer's stock holdings; they could not give rise to taxable income within the meaning of the Sixteenth Amendment until the corporation makes a distribution to the taxpayer or his stock is sold. *Eisner v. Macomber*, 252 U.S. 189 (1920); *Schmitt v. Commissioner of Internal Revenue*, 208 F.2d 819 (CA3 1954). In the latter case in a somewhat similar connection this court said ...:

> "During these years when Wolverine was buying its own shares it, of course, was subject to income tax as a corporation. Mrs. Green was subject to tax on whatever profit she made by the sale of these shares to the corporation. But what happened to warrant imposing a tax upon Schmitt and Lehren?[[89]] If one owns a piece of real estate and, because of its favorable location in a city, the land becomes increasingly valuable over a period of years, the owner is not subject to income taxation upon the annual increase in value. In the same way, if a man owns shares in a corporation which gradually become more valuable through the years he is not taxed because of the increase in value even though he is richer at the end of each year than he was at the end of the year before. If he disposes of that which has increased, of course he must pay tax upon his profit. All of this is hornbook law of taxation; nobody denies it."

[89] [Schmitt and Lehren were the only two shareholders of Wolverine other than Mrs. Green, a widow who inherited her shares from her late husband. Schmitt and Lehren did not have the means to buy Mrs. Green's shares. After several years, the corporation finally agreed to buy her shares.]

We think that the principle thus stated is equally applicable here. Indeed the Tax Court itself has so held in essentially similar cases. *S.K. Ames, Inc., v. Commissioner*, 46 B.T.A. 1020 (1942); *Fred F. Fischer v. Commissioner*, 6 T.C.M. 520 (1947).

The question whether payments made by a corporation in the acquisition and redemption of its stock are essentially equivalent to the distribution of a taxable dividend has been often before the courts and certain criteria have been enunciated. The most significant of these is said to be whether the distribution leaves the proportionate interests of the stockholders unchanged as occurs when a true dividend is paid. *Ferro v. Commissioner of Internal Revenue*, 242 F.2d 838, 841 (CA3 1957). The application of that criterion to the facts of this case compels the conclusion that in the absence of a direct pecuniary benefit to the taxpayer the Tax Court erred in holding the distribution in question taxable to him. For in his case prior to the distribution the taxpayer and the Greenville Company each had a 50% interest in the Holsey Company whereas after it was over the taxpayer had 100% of the outstanding stock and the Greenville Company none.

The Government urges the lack of a corporate purpose for the distribution and the taxpayer seeks to establish one. But we do not consider this point for, as we have recently held, "[i]t is the effect of the redemption, rather than the purpose which actuated it, which controls the determination of dividend equivalence." *Kessner v. Commissioner of Internal Revenue*, 248 F.2d 943, 944 (CA3 1957). Nor need we discuss the present position of the Government that the transaction must be treated as a sham and the purchase of the stock as having been made by the taxpayer through his alter ego, the Holsey Company. For the Tax Court made no such finding, doubtless in view of the fact that at the time the taxpayer owned only 50% of the stock and was in a minority on the board of directors. On the contrary that court based its decision on the benefit which the distribution by the corporation to the Greenville Company conferred upon the taxpayer, which it thought gave rise to taxable income in his hands.

For the reasons stated we think that the Tax Court erred in its decision. The decision will accordingly be reversed and the cause remanded for further proceedings not inconsistent with this opinion.

McLAUGHLIN, Circuit Judge (dissenting).

I think that the net effect of the facile operation disclosed in this case amounts to the distribution of a taxable dividend to the taxpayer. I do not think that the *Schmitt* decision controls here. Quite the contrary to the *Schmitt* facts, this taxpayer himself acquired a valuable option to buy the shares and solely on the theory of a gift of the option rights would make the corporation the true purchaser. I agree with the Tax Court that "[t]he assignment of the option contract to J.R. Holsey Sales Co. was clearly for the purpose of having that company pay the $80,000 in exercise of the option that was executed for petitioner's personal benefit. The payment was intended to secure and did secure for petitioner exactly what it was always intended he should get if he made the payment personally, namely, all of the stock in J.R. Holsey Sales Co."

I would affirm the Tax Court decision.

Questions and comments:

1. Diagram the facts.

2. After the purchase (redemption?) of Greenville's shares by the J.R. Holsey Company, Greenville owned no more shares of J.R. Holsey Company. How do you think Greenville treated the payment it received from J.R. Holsey Sales Company?

> •Moreover, how should we expect J.R. Holsey Company to treat its receipt of its own stock at what was evidently a bargain price?

3. What would have been the result if the Commissioner had brought its case against Charles V. Holsey, arguing that he had received a taxable dividend?

III. Partial Liquidations: § 302(b)(4)

The partial liquidation of a corporation through redemption of shares implies a contraction of the corporation and so, a reduction of its capital. A distribution of the corporation's capital should be treated as a return of capital by shareholders. A partial liquidation of a corporation implies a corporation's distribution of some of its capital in exchange for a pro rata portion of all shareholders' shares. To the shareholder, such a pro rata distribution would "feel" exactly like what the Supreme Court in *Davis* said is "always" essentially equivalent to a dividend. Because pro rata distributions characterized as partial liquidations can receive capital gain treatment, it should not be surprising that corporations and their shareholders may find characterizing their pro rata distributions as "partial liquidations" to be attractive.

Perhaps for that reason, whether a distribution in exchange for shares is a partial liquidation is determined by viewing things from the perspective of the distributing corporation. Read §§ 302(b)(4) and 302(e). Prior to 1982, § 346 governed the tax consequences of partial liquidations. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[90] Congress moved "partial liquidations" to § 302. However, the regulations governing partial liquidations have never been renumbered. *See, e.g.*, Reg. § 1.346-1. One court outlined the conflicting considerations thus:

> The only requirement of § 346(a)(2) which is in issue is whether the distributions by the corporations were "not essentially equivalent to a dividend." According to the legislative history of the section, qualification under this subsection depends primarily on the existence of a bona fide corporate contraction. Such a corporate contraction qualifies to

[90] P.L. 97-248, § 222(c)(1).

> the same extent as under previous law. 3 1954 U.S. CODE CONG. & AD. NEWS 4680, 4899.
>
> From the stockholder's point of view a pro rata distribution in partial liquidation of a corporation is similar to an ordinary dividend. Distributions in partial liquidation are "characterized by what happens solely at the corporate level ...." 3 1954 U.S. CODE CONG. & AD. NEWS 4680, although §§ 331 and 346 are concerned with the tax treatment of the shareholder.
>
> Because a distribution qualifying under § 346(a)(2) possesses many of the characteristics of a dividend taxed at ordinary income rates, the sale or distribution of assets claimed to constitute a corporate contraction must be a significant event in the history of the corporation if sale or distribution of assets is not to become a convenient pretext for bail-out of earnings and profits at capital gain rates. 5 BITTKER & EUSTICE, FED. INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS, ¶ 9.52, 3d Ed.

Mains v. United States, 508 F.2d 1251, 1255 (CA6 1975) (footnote omitted).

Consider how well these conflicting considerations have been resolved.

Imler v. Commissioner, 11 T.C. 836 (1948), acq.

The Commissioner determined a deficiency of $2,410.27 in the petitioner's income and victory tax for the year 1943. The sole question is, was the retirement of certain shares of its stock by the Imler Supply Co. in 1942 accomplished at such time and in such manner as to make the distribution and cancellation and redemption essentially equivalent to a taxable dividend? The question arises on the following facts:

FINDINGS OF FACT.

....

During the periods here involved, the petitioner was a stockholder of Imler Supply Co., hereinafter called the company, a Pennsylvania corporation organized in 1923, 654 shares of which company, having a par value of $50 per share, were issued for cash at par. The corporation has never paid a stock dividend.

....

Previous to December 1, 1941, the company was engaged in the business of retinning and soldering metals and in the rental of excess space in buildings owned by the company. The company owned 5 buildings, consisting of a 7-story brick building and 4 smaller buildings. The main building was equipped with a large freight elevator capable of carrying automobiles. The

company rented space in its buildings to the Allegheny County Milk Exchange at a fixed rental of $650 per month, the exchange being entitled to whatever space it required for its operations. Prior to December 1, 1941, the exchange used all of the sixth floor of the main building and one-half of the seventh floor. The rental allocable to this space was from $100 to $125 per floor. The portion of the seventh floor that was not used in the actual operation by the exchange was rented for storing various items of freight, including automobiles.

On December 1, 1941, a fire destroyed the two upper floors of the main building. This building was covered by insurance and in April 1942, the company recovered $28,603 as insurance proceeds on account of the fire.

After the insurance proceeds were received, the company obtained an estimate as to the cost of rebuilding the 2 top floors of the main building, which had been destroyed by the fire. It was estimated that the cost would run from $40,000 to $50,000. The company did not have sufficient cash to rebuild at this cost at that time. Because of war conditions and consequent scarcity of materials, building was difficult. The company decided to remove the 2 top floors of the main building which had been burned out and to place a roof over the fifth floor. It was estimated that the cost of this operation would be $15,340. The company thereupon removed the remains of the 2 top floors and placed a roof over the building at the fifth floor, making a 5-story out of what had been a 7-story building.

... [A]t a meeting of the directors of the company held April 6, 1942, a resolution was adopted in which the following appeared:

> Mr. Imler stated to the Meeting that the loss occasioned by the fire on December 1, 1941 had been settled with the insurance companies for the sum of $28,603.00; that it had been deemed advisable to tear down the walls of the sixth and seventh floors of the seven-story building damaged by fire and not rebuild that portion of the building, so that we now have instead of a seven-story building a five-story building. He further stated that after the payment of repairs and damages caused by the fire that we would have about $15,000.00 more cash than was needed to operate the Company. He stated that in his opinion he thought it advisable that the stockholders of the Company sell to the Company and the Company buy from the stockholders 300 shares of the Capital Stock of the Company at $50.00 a share totaling $15,000.00.

....

On motion duly seconded it was unanimously

> RESOLVED: That the Company offer to purchase from ... Stockholders [about half of their shares] ... pay therefor the sum of $50.00 per share ... and that said shares be cancelled.

....

The resolution of the board of directors of the company was duly carried out ...

Petitioner [was one of the shareholders who turned in some of the stock that he owned in exchange for $50/share.] ...

....

The cash working capital of the company for some years prior to December 1, 1941, ranged from $7,500 to $9,000. The cash balance of the company, exclusive of the estimated fire proceeds left after reconstruction of the building, was $9,628.76. At that time approximately $4,500 had been expended on the damaged building and it was estimated that the total cost of repairing and reroofing the building would amount to $15,340. This estimated cost proved to be excessive in the amount of $175.81.

Except for the remaining proceeds of fire insurance, the company could not have paid a dividend in the amount of $15,000 on April 6, 1942, without borrowing money.

After the building was repaired and reduced in size, Imler Supply Co. discontinued its retinning and soldering activities and has never resumed the same. This cessation of activity was primarily due to the fact that the corporation lacked space for storage of articles required in its retinning and soldering operations, together with the fact that war conditions and scarcity of materials made such operations unprofitable.

The purchase by the company from petitioner ... of ... shares of the corporation's capital stock ... constituted a partial liquidation of the corporation under ... the Internal Revenue Code.

The acquisition and cancellation of the stock of the company ... were not made at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend ...

OPINION.

VAN FOSSAN, Judge: The issue here raised presents a question of fact depending on the circumstances of the particular case. [citation omitted]. No sole or universally applicable test can be laid down. [citation omitted ... Though decided cases are not controlling, they are helpful as indicating what elements have been considered important, *viz*., the presence or absence of a real business purpose, the motives of the corporation at the time of the distribution, the size of the corporate surplus, the past dividend policy, and the presence of any special circumstance relating to the distribution.

In our findings of fact we have indicated our conclusions of fact that the acquisition and cancellation by Imler Supply Co. of certain shares of its capital stock in 1942 were not made at such time and in such manner as to be essentially equivalent to a distribution of a taxable dividend ...; or, as stated otherwise, that the transaction constituted a partial liquidation ...

The principal building owned by the company had been damaged by fire in 1941. When the company undertook to repair the building it was found that, because of war conditions, the shortage of building materials, and high costs, it was advisable to abandon 2 damaged floors and reduce the 7-story building to one of 5 stories. The consequence was that the company found its facilities inadequate to carry on the retinning and soldering operations formerly engaged in. Moreover, these operations had proven unprofitable in recent experience because of war conditions and shortage of necessary materials. For these reasons the company discontinued the retinning and soldering operations. This reduction in operations likewise reduced the amount of capital necessary for carrying on the business activities of the company. This was a bona fide contraction of business operations and consequent reduction in capital used. The company thus had a real and legitimate purpose for reducing its outstanding capital stock.

The motives of the corporation were all related to the above business purpose and were, therefore, legitimate and properly conceived. If the excess of insurance proceeds be set to one side, the surplus of the company had remained almost constant for 10 years. The company had followed a conservative dividend policy throughout its history and had not paid a dividend since 1934. The original issuance of the stock had occurred many years before and there was no connection between the issuance and the redemption of the same. There was no special circumstance or condition relating to the distribution excepting the fact that the company had in its hands the excess insurance proceeds which formed the basis of the distribution. We are convinced that, except for the fire and the excess insurance proceeds, there would have been no distribution.

Under the facts here present, the redemption of the company's stock was not accomplished at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend.

Reviewed by the Court.

Questions and comments

1. In *Imler*, there was a readily identifiable event (fire) as well as a visible manifestation (removal of two floors from a building) that caused the corporation to contract its business. The corporation also discontinued two distinct business activities, i.e., soldering and retinning. The corporation also had funds derived from the event (insurance proceeds) that did not represent earnings and profits. It would not be difficult to conclude that payment of the proceeds to shareholders represented a partial liquidation of the corporation. It was a smaller corporation than before the fire, and the payment fairly accurately measured how much smaller.

- Suppose that the corporation had distributed only half of the insurance proceeds to shareholders. Should that qualify as a partial liquidation? How would you determine the number of shares the corporation had redeemed? *See Gordon v. Comm'r*, 424 F.2d 378, 386-87 (2d Cir. 1970).

2. Suppose that there are funds (assets) derived from the event that caused the contraction, but the corporation distributes some of its other assets of equal value. A corporation engaged in poultry processing accumulates securities. The corporation enters the chicken farming business. The business was profitable for a time, but then it began losing money. The corporation decided to sell the chicken farming business and accepted from the buyer a note secured by a mortgage. Rather than distribute the note to shareholders in a redemption of some of their shares, it distributed the appreciated securities.

•Partial liquidation? *See* Rev. Rul. 79-275, 1979-2 CB 137.

3. Consider: corporation does not pay dividends for many years and builds up a substantial reserve of earnings and profits. It accumulated earnings rather than distribute them as dividends because it planned to expand its facilities. When it abandoned those plans, it redeemed some of each shareholder's shares pro rata. This substantially reduced the corporation's e&p.

•Partial liquidation?

•Rather than a contraction of the corporation, isn't this simply the payment of a dividend? *See* Reg. § 1.346-1(a) (second to last sentence).

•*See McGuire v Comm'r*, 84 F.2d 431, 432 (7th Cir. 1936), *cert. denied*, 299 U.S. 591 (1936); *McCarthy v. Conley*, 229 F. Supp. 517, 526-27 (D. Conn. 1964) *aff'd*, 341 F.2d 948 (2d Cir. 1965), *cert. denied*, 382 U.S. 838 (1965).

4. On the other hand, what if the source of the redemption funds is not the corporation's accumulated e&p? Suppose that its business required it to keep a bank account sufficient to meet a bank's requirements for the corporation to extend letters of credit for the benefit of customers who purchased steel from a particular foreign manufacturer. When the foreign manufacturer terminated its arrangement with the corporation, the corporation lost 95% of its gross income. There was no need to keep the bank account, and corporation used the funds in that account to redeem pro rata a portion of shareholder's shares.

•Partial liquidation? *See* Rev. Rul. 75-3, 1975-1 CB 108.

Suppose: a corporation that provides mass transit services enters into an arrangement with a regional transit authority (Authority) whereby the Authority will subsidize the operations of the corporation and purchase new busses when needed. The corporation could therefore redeem some of each shareholder's shares with funds it had accumulated for the purpose of replacing busses. Otherwise, there was no significant change in the corporation's business activities.

•Partial liquidation? *See* Rev. Rul. 78-55, 1978-1 CB 88.

5. How can we distinguish between a genuine contraction and a payment that is essentially equivalent to a dividend? What factors are relevant in making this determination?

•accumulating earnings & profits without paying a dividend?
•pro rata distributions?
•continued business operation?
•rapidly declining sales and the response thereto?

•a full-line department store facing competition from new shopping centers changes to a discount apparel store and sells a different type of merchandise. It eliminates 33 of its 40 departments. Its sales declined from $4M to $600K. It reduces leased floor space by 85% and reduces the number of employees from 270 to 20. It sold all assets associated with the eliminated departments including inventory and distributed the proceeds pro rata to shareholders in exchange for a portion of their outstanding stock.

•Partial liquidation? *See* Rev. Rul. 74-296, 1974-1 CB 80.

•a corporation purchases raw skins and processes them into leather that it markets to a certain segment of the leather market. Its profits decline rapidly. In an effort to revitalize the business, it buys a different type of raw skins, processes them into leather, and markets them to a different segment of the leather trade. Things did not improve. The corporation decided to liquidate inventory – a long process in view of poor market conditions. The corporation "proposes to redeem a portion of its stock with cash from the sale of United States Series G bonds and from the proceeds of the inventories being liquidated in the ordinary course of business."

•Partial liquidation? *See* Rev. Rul. 60-322, 1960-2 C.B. 118.

6. What facts (evidence) in *Imler* would support the conclusion that the payment was a partial liquidation? What facts (evidence) would support the conclusion that the payment was essentially equivalent to a dividend?

7. What are the conditions of the safe harbor of § 302(e)? When is a business separate from another?

•Should it matter that what the business taxpayer retains generates a very small portion of what was the corporation's total income prior to the partial liquidation? *See Blaschka v. United States*, 393 F.2d 983, 990-91 (Ct. Cl. 1968).

8. How does the safe harbor resemble or differ from a "corporate contraction?"

9. Note: § 302(b)(4) does not apply to corporate shareholders. This means that any distribution to a corporation would be treated as a dividend. However, § 1059(e)(1) provides that such dividends are extraordinary dividends irrespective of how long the corporate shareholder has held the stock. This means that the amount of the dividend reduces the basis that the corporate shareholder has in its stock. § 1059(a).

Do the CALI exercise: Corporate Taxation: Redemptions: Redemptions in Partial Liquidations: Section 302(b)(4).

IV. Section 302(b)(5)

Section 302(b)(1, 2, 3, and 4) did not provide any test to determine how to apply "the 'not essentially equivalent to a dividend' test in the case of an open-end RIC [regulated investment company] whose shareholders 'sell' their shares by having them redeemed by the issuing RIC and where multiple redemptions by different shareholders may occur daily."[91] Section 302(b)(5), by cross-referencing § 67(c)(2)(B), now provides that –

> the redemption of stock of a publicly offered RIC is treated as an exchange if the redemption is upon the demand of the shareholder and the company issues only stock which is redeemable upon the demand of the shareholder. A publicly offered RIC is a RIC the shares of which are (1) continuously offered pursuant to a public offering, (2) regularly traded on an established securities market, or (3) held by no fewer than 500 persons at all times during the taxable year.[92]

V. Redemptions to Pay Death Taxes: § 303

Read IRC § 303.

Section 303 treats a distribution to a shareholder of a corporation whose shares are included in determining the gross estate of a decedent as a payment in exchange for the stock. § 303(a). The amount distributed cannot exceed the amount of estate, inheritance, legacy, and succession taxes collected because of decedent's death – including interest – plus funeral and administrative expenses deductible under § 2053 (or § 2106 in the case of a nonresident noncitizen). § 303(a). The basis step-up (or step-down) of 1014 makes such a redemption advantageous. The distribution is apt to generate very little, if any, income tax.

Section 303 does not apply to distributions to the extent they exceed the amount of those expenses. The purpose of § 303 is to facilitate the financing of such taxes when an estate consists largely of shares of a closely-held family corporation; the shares might otherwise be illiquid. The benefits of § 303 do not depend upon illiquidity or even that the proceeds of a redemption be used to pay for the taxes and expenses named. *See United States v. Lake*, 406 F.2d 941, 948 (CA5 1969) (not required "that amounts received in redemption be used to pay the taxes and expenses;" "stockholders may be able to redeem stock that is included in the estate of the decedent even though they have no obligation to pay any of the death taxes or expenses"). If the

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[91] Joint Committee Summary of P.L. 111-325, Regulated Investment Company Modernization Act of 2010.

[92] Joint Committee Summary of P.L. 111-325 (Regulated Investment Company Modernization Act of 2010), Explanation of Provision.

corporation distributes more than the amount of the taxes and expenses named, the excess is tested under § 302 for exchange treatment and relevant attribution rules under § 318 apply. *See* Rev. Rul. 71-261, 1971-1 C.B. 108 (excess of redemption over amount needed to pay death taxes and administration and funeral expenses tested under § 302 and found to be essentially equivalent to dividend and taxable as such to estate).

Congress limited the benefits of § 303 to those occasions when the stock owned by the estate is greater than 35% of the value of the decedent's gross estate minus the sum of amounts deductible under §§ 2053 and 2054. Notice that it is not necessary that the stock be in a corporation that is closely held and might in fact be publicly traded stock of which decedent owned a substantial amount. The estate may count shares in any corporation in which decedent owned 20% or more of the corporation's outstanding stock to reach the 35% threshold. § 303(b)(2)(B). The estate may also count shares that the surviving spouse holds as community property, joint tenants, tenants by the entirety, or tenants in common. § 303(b)(2)(B). However, in reaching the 35% threshold, the estate does not get the benefit of § 318 attribution. *See Estate of Byrd v. Comm'r*, 388 F.2d 223, 232 (CA5 1967) (§ 318 inapplicable to § 303).

Section 303 also requires that the interest of a shareholder in the estate be directly reduced by the obligation to pay any of the taxes or expenses named. § 303(c). Thus, if decedent provided in his will that such taxes and expenses should could come out of the residue of the estate and that the stock should pass to a specific legatee with no liability for such payments, the opportunity to redeem shares from the estate is lost.

Problems:

Decedent died and left a gross estate valued at $1M. Various estate, inheritance, and legacy taxes came to $250,000 – which the executor paid from the residue of the estate. Administrative expenses came to $50,000. Decedent made the following specific bequests to his son:

> All the stock of Family Corporation XYZ that decedent owned. Decedent owned 20% of the outstanding stock of Family Corporation XYZ. Its fmv is $40,000. Decedent's wife (i.e., decedent's son's mother) owns 45% of the outstanding stock, and her father owns the other 35%.
>
> All the stock of Family Corporation ABC that decedent owned. Decedent owned 20% of the outstanding stock of Family Corporation ABC. Its fmv is $200,000. Decedent's wife (i.e., decedent's son's mother) owns 45% of the outstanding stock, and her father owns the other 35%.
>
> $400,000 worth of Mega Corporation stock that it has offered to redeem. Decedent owned 0.05% of the shares of Mega Corporation's outstanding stock.

How would a redemption of the stock of any of these corporations of Decedent's son's shares be treated under § 303?

Would it make any difference if Decedent's son received these shares as the residuary legatee of Decedent's estate and the taxes and expenses were to come out of the residue of the estate?

VI. Redemptions Through Related Corporations, § 304

Read IRC § 304.

The shareholders of closely-held corporations often own shares in more than one such corporation, and there is overlap in the identity of the shareholders of the corporations. To get cash out of a corporation without dividend treatment, they might sell stock that they personally own in one of the corporations to another corporation that they control. If they remain in control of both corporations, the sale has not appreciably reduced their interest in the corporation whose stock they sold, yet they appear to be entitled to exchange treatment on the transaction.

- Recall that in *Hurst*, the senior Hursts owned the stock of HMI and of RHI. They also owned the property that the two corporations leased from them. It seems that all their businesses had prospered. The Hursts sold their RHI stock to HMI. In form, this would appear to be the sale of stock to a third person and so not subject to scrutiny under § 302.

- Not so fast. The effect of a purchase by one corporation of the stock of another corporation's stock closely related to it too strongly resembles the effect of a redemption.

- § 304 establishes an intricate scheme by which to determine whether such related-party sales should be treated as redemptions.

When two corporations are subject to *common control*, § 304 subjects a shareholder's sale of one corporation's stock to the other corporation to the tests of §§ 302 and 303 for exchange treatment. "Control" means ownership of stock possessing at least 50% by either vote *or* value of all the corporations' stock. § 304(c)(1). Moreover, if a person(s) is in control (as just defined) of a corporation which in turns owns at least 50% of another corporation by vote *or* by value, such person(s) is deemed to control that other corporation. § 304(c)(1). For purposes of determining ownership of stock, the attribution rules of § 318 apply, § 304(c)(3)(A), with certain modifications that broaden the applicability of § 304.

- Proportional attribution from a corporation to a shareholder (§ 318(a)(2)(C)) is made if the corporation owns at least 5% of the shares of the acquiring or issuing corporation. § 304(c)(3)(B)(i).

- Additionally, there is proportional attribution from a shareholder to a corporation when the shareholder owns at least 5% but less than 50% of the stock of the corporation. § 304(c)(3)(B)(ii).

- If the shareholder owns 50% of the stock of the corporation, there is attribution of *all* the

stock that the shareholder owns to such corporation. § 318(a)(3)(C).

•Read § 304(c)(2)(B). Two of more unrelated transferors between whom there would otherwise be no attribution may nevertheless constitute a control group. "In any case in which two or more persons, in the aggregate, control two corporations, § 304(a)(1) will apply to sales by such persons of stock in either corporation to the other ... provided the sales by each of such persons are related to each other." Reg. § 1.304-2(b). Thus § 304 can apply to unrelated shareholders who both sell stock of one corporation to another when their combined holdings constitute "control" of both corporations, and not merely to instances where "control" exists only because of attribution. *Coates Trust v. Commissioner*, 480 F.2d 468, 473 (CA9 1973), *cert. denied*, 414 U.S. 1045 (1973).

Section 304 addresses two types of control relationships: brother-sister corporations and parent-subsidiary corporations.

Brother-sister Sales/redemptions: Section 304(a)(1) provides that a corporation that purchases stock (the acquiring corporation) of another corporation (the issuing corporation) from a person(s) who controls both corporations will be treated as making a distribution in redemption of the its own (the acquiring corporation's) stock. This triggers an analysis under §§ 302 or 303. If the analysis leads to the conclusion that the distribution is not payment in exchange for stock, then § 301 applies.

[Note that after a putative sale, the very shares that the shareholder sold will be proportionally attributed back to him because of his control of the acquiring corporation, thus making the applicability of § 304 more likely.]

The acquiring corporation has acquired shares of the issuing corporation. If § 301 applies, the acquiring corporation is treated as having issued its own shares and exchanged them for the shares that it ostensibly purchased in a § 351 transaction. The acquiring corporation is treated as then redeeming the stock that it issued. § 304(a)(1) (carryout ¶); Reg. § 1.304-2(a) (shareholder's receipt of property "shall be treated as received in redemption of stock of the acquiring corporation").

•The stock of the "acquiring corporation" that the person(s) who controls the issuing corporation is deemed to receive is included in determining whether such person(s) controls the "acquiring corporation." § 304(c)(2)(A). Moreover, the "control" group includes those shareholders of the "issuing corporation" who transferred shares of such stock to the acquiring corporation who, after such transfer, are in control of the "acquiring corporation." § 304(c)(2)(B).

A § 302(b) analysis is made with reference to the "issuing corporation," i.e., the corporation whose shares were purchased. § 304(b)(1); Reg. § 1.304-2(a). If such analysis leads to the conclusion that the distribution is a dividend and not an exchange, the distribution comes first from the e&p of the acquiring corporation and then from the e&p of the issuing corporation. § 304(b)(2).

If § 301 applies, then the stock that the acquiring corporation "purchased" will be treated as a contribution to capital, and the corporation takes the shareholder's basis in it. Reg. § 1.304-2(a). The shareholder increases his basis in his remaining shares of the issuing corporation that he "contributed" by his basis in those shares. Reg. § 1.304-2(a).

A controlling shareholder who receives property from a corporation in a transaction to which both § 304 and § 351(a) apply must apply § 304. §304(b)(3)(A). Moreover, §§ 357 and 358 do not apply – meaning that the shareholder must treat corporate assumption of a shareholder liability as the receipt of cash. § 304(b)(3)(A).[93]

Parent-subsidiary Sales/redemptions: The same rules apply when a subsidiary corporation purchases shares of the parent corporation from a shareholder. § 304(a)(2). The "issuing corporation" must "control" the "acquiring" corporation. § 304(a)(2). The "property" that the subsidiary provides is treated as a distribution in redemption of the stock of the "issuing corporation," i.e., the parent. § 304(a)(2) (carryout ¶).

- Notice that in the case of a sale of a shareholder's parent stock to the parent's subsidiary, the property distributed is treated as that of the *parent* (i.e., the *issuing* corporation), not the subsidiary (i.e., the acquiring corporation).

Example: Corporation S, a wholly-owned subsidiary of corporation P, purchased a portion of P's stock from A, the sole shareholder of P, for cash. P is not in receipt of a constructive distribution from S when S purchases P's stock from a third party. P's adjusted basis in S's stock will remain the same as it was prior to the transaction, and S, under § 1012 of the Code, will have a basis in P's stock acquired in the transaction equal to the amount paid therefor. The distribution to A is treated as a distribution of property (pursuant to § 302(d) of the Code) under § 301 of the Code because A is the sole shareholder of P. This distribution is treated as a dividend to A to the extent of the earnings and profits of P. *See* Rev. Rul. 69-261, 1969-1 C.B. 94, *as modified by* Rev. Rul. 80-189, 1980-1 C.B. 106.

Sales/redemptions that can be characterized as both brother-sister and parent-subsidiary transactions: Application of attribution rules can make brother-sister relationships into parent-subsidiary relationships – and vice versa. A four-word parenthetical in § 304(a)(1) establishes a sequence for analyzing § 304 problems: First, apply the rules governing parent-subsidiary redemptions, the then apply the rules governing brother-sister redemptions.

[93] There is an exception to this rule for a liability incurred by the transferor to acquire the stock or to acquire stock subject to such a liability. § 302(b)(3)(B)(i). The exception only prevails if the transferor acquired the stock from a person from whom no stock is attributed to the transferor under § 318 – except that owning an option is not considered to be ownership of the stock – or whose interest is completely terminated and who waives attribution under § 302(c)(2). § 304(b)(3)(B)(iii).

Problems:

1. All the outstanding stock of X corporation (1000 shares of voting common stock) is owned by individuals A (60 percent), B (20 percent), and C (20 percent). All the outstanding stock of Y corporation (1000 shares of voting common stock) is owned by individuals D (70 percent), E (20 percent), and F (10 percent). A and D are father and son. A sold 200 shares of his X Corporation stock to Y Corporation. A's basis in the 200 shares is $500. A's basis in the 600 shares that he owns if $1500. Y Corporation paid A $1100 for 200 shares of X Corporation stock. Y Corporation's e&p is $800; X Corporation's e&p is $600.

- •Has A received a dividend? How much?
- •After Y Corporation's purchase, what is Y Corporation's e&p? After Y Corporation's purchase, what is X Corporation's e&p?
- •What is Y Corporation's basis in the X Corporation stock that it purchased from A?
- •What is A's basis in the X Corporation stock that he still owns?

1A. What if D owned 35% of the shares of Y Corporation when Y Corporation purchased 200 of A's shares of X Corporation?

2. "Decedent, who was an officer and director of X corporation and Y corporation, died in [2009]. After decedent's death, his estate owned 18% of the outstanding stock of X and 50% of the outstanding stock of Y. The remainder of the X and Y stock was owned equally by A and B, the decedent's two sons, who were the sole beneficiaries of decedent's estate. The stock of X accounted for approximately 20% of the value of the decedent's gross estate ... while the stock of Y accounted for approximately 40% of the value of the decedent's gross estate ... Estate and inheritance taxes and funeral and administration expenses, as described in § 303 of the Code, were 250x dollars. In order to meet expenses, the executors of decedent's estate decided to sell all of the X stock to Y. Y purchased all the shares of X stock from the estate for 100x dollars."

- •Describe the tax consequences of this purchase. *See* Rev. Rul. 71-527, 1971-2 CB 174.

3. "Corporation X owns 70% of the stock of corporation Y and 100% of the stock of corporation Z. [Y owns 100% of the stock of corporation S.] Y sold all of the stock of its wholly owned subsidiary, S, to Z for cash. The purchase price of the S stock was its fair market value [, which was more than the e&p of corporations Z and Y]. All of the corporations are domestic corporations."

- •Describe the tax consequences of this sale. *See* Rev. Rul. 70-496, 1970-2 CB 74, *obsoleted* Rev. Rul. 2003-99, 2003-34 I.R.B. 388.

4. Parent Corporation owns 100% of the shares of Subsidiary Corporation. H owns 60% of the shares of Parent. Subsidiary Corporation purchases 15% of the shares of Parent Corporation from H.

- •Describe the tax consequences of his sale.

Do the CALI exercise: Corporate Taxation: Redemptions: Redemption Through the Use of Related Corporations: Section 304.

VII. Consequences of Redemptions to Corporation

A payment by a corporation to redeem its own shares from a shareholder comes initially from its earnings and profits, but there are limits. Read § 312(n)(7). A payment to a shareholder in redemption of the shareholder's stock may reduce the corporation's e&p *pro tanto* or *pro rata*.

- A *pro tanto* reduction is a dollar-for-dollar reduction of the corporation's e&p. For every dollar the corporation pays to a shareholder in redemption of the shareholder's stock, the corporation's e&p is reduced by one dollar.

- A *pro rata* reduction is a proportionate reduction. The corporation reduces its e&p by the same proportion as the redemption reduces the outstanding shares.

- A corporate distribution in redemption of its stock reduces its e&p *pro tanto* up to the amount of a *pro rata* distribution.

- The allocation of e&p among different classes of stock is made according to the weighted dividend rights of each class of stock. H.R. REP. NO. 98-861, 840 (1984). Thus, if a corporation has two classes of stock outstanding, class A and class B, and class A has a 2:1 preference in dividend rights to class B, two-thirds of the corporation's e&p will be allocated to class A and one-third of the corporation's e&p will be allocated to class B.

"When both ordinary distributions under § 301 of the Code and redemption distributions under § 302 are made during the same taxable year and the combined distributions exceed earnings and profits for the year, the ordinary distributions take priority in determining current earnings available for dividends. Only current earnings in excess of the ordinary distributions are treated as available for redemption distributions." Rev. Rul. 75-339, 1974-2 C.B. 103.

- A redemption for an amount that exceeds an allowable reduction in a corporation's e&p reduces the corporation's capital account.

Problems:

1. Corporation X has 1000 shares of one class of stock outstanding. A, B, C, and D – all unrelated to each other – each own 250 shares with a basis of $2000 (i.e., $8/share). Corporation X's accumulated e&p is $20,000.

A. Corporation X redeems 100 shares of its stock from shareholder A for $1750. What are the tax consequences to A? What is Corporation X's remaining e&p?

B. Same facts except that Corporation X distributes $2250. What are the tax consequences to A? What is Corporation X's remaining e&p?

Chapter 5: Distributions of Stock

I. Concerns about Converting Ordinary Income into Capital Gain and Changing a Shareholder's Relative Interest in a Corporation: From *Macomber* to §§ 305, 306 and 307

On occasion and for various reasons, corporations may distribute stock to their shareholders. In *Eisner v. Macomber*, 252 U.S. 189 (1920), the United States Supreme Court held that a shareholder of the Standard Oil Company had *not* realized income when Standard Oil had distributed one share of Standard Oil common stock to *all* its shareholders for every share of common stock that they owned. [We call such a distribution "common on common."] Standard Oil's purpose the distribution was to convert its retained profits to capital. Perhaps Standard Oil wanted to spend its retained profits on more oil wells to make more money. If Standard Oil had distributed profits to its individual shareholders, the dividends would have been taxable as ordinary income to them. By distributing stock instead of cash, Standard Oil made it possible for shareholders to sell the shares Standard Oil distributed to them and realize capital gain/loss – while retaining the shares that represented their original contribution to the corporation's capital. Standard Oil permitted conversion of its shareholders' ordinary income to capital gain. This contravenes a strong policy that a taxpayer should not be permitted to change the character of income from ordinary income to capital gain.

In *Eisner v. Macomber*, the Court observed that the distribution of stock in such a manner "does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of shares, with consequent dilution of the value of each share." *Id.* at 211. What the shareholder received was not "income" within the meaning of the Sixteenth Amendment. *Id.*[94]

> *An analogy*: We can view all of a corporation's outstanding shares of stock as a pie. Shareholders own a slice of the pie; the size of their slice depends on the number of shares that they own. A one-for-one stock-on-stock distribution does not alter the overall size of the pie, nor any shareholder's relative portion of it. The slice that they owned has been divided into two slices that together, equal in size their original slice. In this sense, the shareholder gains nothing. There is no gain to subject to an income tax.

The holding in *Eisner v. Macomber* perforce reflects that the market will value a corporation – and so also values its shares of stock – by taking account of both its capital and retained profits. So long as there is no effort to tax

[94] The Supreme Court extended the rule of *Eisner v. Macomber* by holding that extending the opportunity to all existing shareholders to purchase additional shares of stock on a pro rata basis for less than fair market value was not the distribution of a dividend that constitutes "income" within the Sixteenth Amendment. *Miles v. Safe Deposit & Trust Co.*, 259 U.S. 247, 252 (1922).

shareholders' shares of corporate profits *at the time they are earned*, it does not matter whether the corporation traces its assets to the capital contributions of investors or to its reinvestment of profits. The pie neither expands nor shrinks contingent on the label given to its constituent parts. And if the pie neither expands nor shrinks, the number of slices into which it is cut does not matter. A "common on common" when there is only one class of common outstanding, then, is not a taxable stock dividend. Nevertheless, "the camel's head is in the tent" insofar as the conversion of the character of income from dividend income into capital gain is concerned. A shareholder who sells dividend stock realizes capital gain, even though the stock (may have) represented corporate earnings.

Review: Recall that the basic rights of shareholders are to receive dividends, to vote (i.e., control), and share proceeds upon liquidation (i.e., to share in corporate growth). It is possible to sever one of these rights from the others and then to subdivide the severed interests, *ad infinitum*. The owners of these severed interests may own "stock," but not all of the corporation's stock is the same. For example, preferred stock is preferred and limited as to dividends, but holders of preferred stock do not share in the corporation's growth. Holders of non-voting common shares share in corporate growth and dividends, but have no right to control. And so on.

A distribution of stock on stock may simply be a way of altering the individual slices of the pie without changing the overall size of the pie – or the amount of pie each shareholder owns. For example, a distribution to shareholders of a new class of non-convertible non-voting common alters each shareholder's slice and dilutes the dividend rights attached to each share of common. However, the *same persons* still own *all* the corporation's dividend rights in the same proportion that they did before the distribution. The sum of each shareholder's interests has not changed. The mere issuance of stock that alters the slices of the pie should not be the occasion for taxing gain, for there is no gain to tax.

•If a shareholder sells shares of such dividend stock to others, any capital gain would be subject to income tax as such. The shareholder succeeds in subjecting income to income tax at only capital gain rates and retains the same level of control of the corporation as well as interest in its assets.

•And if the corporation makes a distribution in redemption of those shares, treatment of the distribution as made in exchange for the shareholder's dividend stock would have served the end of converting dividend income into capital gains through a redemption.

•The Code does not permit this, but addresses the matter with a "wait and see' approach to determine whether to tax gains as capital gains upon disposition to a third party or as a distribution of dividends. *See* § 306; § III *infra*.

Still other distributions of stock on stock do change the *relative* interests of shareholders with respect to their claims upon corporate profits or assets. The distribution of dividend-paying stock to some shareholders but not to others gives the holders of the dividend stock a claim to a greater share of corporate profits. The distribution of common stock to some holders of common stock but not to others gives the holders of the dividend stock a greater power of voting control, greater participation in corporate growth, and/or a greater claim upon corporate assets in the event of a liquidation. Such a stock dividend should be subject to income tax because the wealth of those

shareholders has increased at the expense of those who did not receive such dividends.

Congress has enacted rules that specifically govern the distribution of stock and stock rights – rather than leave the field to courts to determine whether such distributions are included in "gross income." Sections 305 and 306 reflect congressional concern with stock dividends that serve the objectives of either converting the character of income or changing the relative interests of shareholders vis-a-vis each other.[95] Section 307 provides for allocating the basis of the stock on which the corporation makes a distribution between that stock and the dividend stock.

> *Use your tax intuition to answer these questions*: When a corporation distributes a nontaxable stock dividend, e.g., "common on common," how should shareholders determine their bases in the "old" and the "new" shares? *See* § 307(a); *Beckers v. United States*, 42 F.2d 300, 303 (Ct. Cl.), *cert. denied*, 282 US 882 (1930); *Chapman v. United States*, 63 Ct. Cl. 106, 111, *cert. denied*, 275 U.S. 524 (1927). What should be the effect of the distribution of a non-taxable stock dividend on the corporation's earnings and profits? *See* 312(d)(1)(B).

Suppose that a distribution of stock *does* "alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of her holding or of the aggregate holdings of the other stockholders as they stood before?" Suppose that the *value* of the interest of a shareholder who receives stock does not change, but the nature of the shareholder's interest does change? Suppose that a corporation issues "common on preferred?"

Koshland v. Helvering, 298 U.S. 441 (1936)

Justice ROBERTS delivered the opinion of the Court.

The writ of certiorari was granted in this case to resolve a conflict between the decision below

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[95] Earlier versions of the Code manifested clumsy congressional efforts not to contradict the holding of *Eisner v. Macomber* while addressing concerns about enriching some shareholders at the expense of others or of "bailing out" corporate earnings. To this point, the position that Congress may not tax a "common on common" stock dividend remains on solid constitutional footing. In *Helvering v. Griffiths*, 318 U.S. 371 (1936), the Commissioner asked the Supreme Court to overrule *Eisner v. Macomber*. The Standard Oil Company of New Jersey had declared a common on common stock dividend. Justice Jackson observed:

> The tax is asserted under the general provision ... of the ... Code that income includes "dividends," together with the specific provision of § 115(f)(1) that:
>
> > A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution. [footnote omitted].
>
> Was Congress thereby saying that such a dividend as we have here is not being taxed, in view of the *Eisner v. Macomber* decision, or was it saying that, regardless of that decision, it is being taxed?

Id. at 372-73. The Court held that the statute did not subject a "common on common" stock dividend to income tax; it did not reach the contention that it should reconsider *Eisner v. Macomber*. *Id.* at 404. Justice Douglas dissented, concluding that *Eisner v. Macomber* should be overruled. *Id.* at 409 (Douglas, dissenting). Justices Black and Murphy joined in this dissent.

[footnote omitted] and one by the Circuit Court of Appeals for the Sixth Circuit. [footnote omitted].

The question is whether ... a taxpayer who purchases cumulative nonvoting preferred shares of a corporation upon which a dividend is subsequently paid in common voting shares must, upon a sale or other disposition of the preferred shares, apportion their cost between preferred and common for the purpose of determining gain or loss.

The petitioner, in 1924 and 1926, purchased preferred stock of Columbia Steel Corporation. The company's articles of incorporation provided that holders of preferred stock should receive annual dividends of $7 a share in cash or, at the company's option, one share of common stock for each share of preferred. Dividends on the preferred were to be paid in full before any could be paid on the common; the common had voting rights, the preferred none. The preferred was redeemable at $105 per share, plus accrued dividends, and, upon dissolution or liquidation, was entitled to preferential payment of $100 per share, plus accrued dividends, and no more. The common alone was entitled in such event to the assets of the corporation remaining after payment of the preferred.

In each of the years 1925 to 1928, inclusive, the company had a surplus sufficient to pay the preferred dividends in cash, but elected to pay them in common stock. The petitioner received, in each of those years, shares of common stock as dividends on her preferred. In 1930, the corporation redeemed its preferred stock at $105 per share. In computing the profit realized by the petitioner, the Commissioner allocated to the common stock so received, in each instance, a proportionate amount of the cost of the preferred stock. He thereby decreased the resulting cost basis per share and increased the gain. The Board of Tax Appeals reversed, holding that the dividends were taxable income, were not stock dividends within the meaning of the Revenue Acts,[96] and their receipt did not reduce the cost basis of the preferred stock. The Circuit Court of Appeals reversed the Board, and approved the Commissioner's action.

The petitioner contends, first, that the dividends she received were not stock dividends exempted from taxation by the Revenue Acts; and, secondly, if exempted, they were nonetheless income, and cannot be treated as returns of capital in computing capital gain or loss. The respondent answers that the distributions were stock dividends because made in the capital stock of the corporation and come within the plain meaning of the provisions exempting stock dividends from income tax; accordingly, the Treasury regulations have consistently and continuously treated them as returns of capital, and required the original cost to be apportioned between the shares originally acquired and those distributed as dividends to obtain the cost basis for the calculation of gain or loss. We hold that the dividends were income, and may not be treated as returns of capital.

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[96] Revenue Act of 1928, § 115(f), c. 852, 45 Stat. 791, 822; Revenue Act of 1926, § 201(f), c. 27, 44 Stat. 9, 11: "A stock dividend shall not be subject to tax."

The Revenue Act of 1913 imposed an income tax on dividends. [footnote omitted]. In *Towne v. Eisner*, 245 U.S. 418, it was held that, where a corporation declared a dividend on its common stock, in the form of common stock, the dividend was not income within the intendment of the act. The Revenue Act of 1916 provided that a stock dividend should be considered income to the amount of its cash value. [footnote omitted]. In *Eisner v. Macomber*, 252 U.S. 189, it was decided that a dividend in the corporation's common stock paid to the then common stockholders was not income within the meaning of the Sixteenth Amendment, and therefore the effort to tax such dividends exceeded the power granted by the Amendment. It was said that such a dividend was not income because, by its payment, no severance of corporate assets was accomplished and the preexisting proportionate interests of the stockholders remained unaltered. After the decision, the Treasury revoked regulations to the effect that a dividend paid in the corporation's stock is income, and issued amended regulations, broadly phrased, to exempt all income in the form of stock dividends, whether the dividend shares be of the same class as those theretofore held by the stockholder or of a different class, and prescribing the method of allocating the original cost as between the old and the new stock for purposes of calculating gain or loss upon realization. Subsequently Congress adopted the Revenue Act of 1921 which provided, in § 201(d): "A stock dividend shall not be subject to tax."[97] The reason for the exemption was the decision in *Eisner v. Macomber*, *supra*. The reports of both the House and the Senate Committees dealing with the bill state that the act

> modifies the definition of dividends in existing law by exempting stock dividends from the income tax, as required by the decision of the Supreme Court in *Eisner v. Macomber*, 252 U.S. 189.[98]

Although *Eisner v. Macomber* affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, the Treasury gave the decision a broader interpretation which Congress followed in the Act of 1921. Soon after the passage of that Act, this Court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest. [footnote omitted]. Nevertheless, the successive statutes and Treasury regulations respecting taxation of stock dividends remained unaltered. [footnote omitted]. We give great weight to an administrative interpretation long and consistently followed, particularly when the Congress, presumably with that construction in mind, has reenacted the statute without change. [footnote omitted]. The question here, however, is not merely of our adopting the administrative construction, but whether it should be adopted if, in effect, it converts an income

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[97] 42 Stat. 227, 228. The same provision was repeated in all subsequent Revenue Acts; Revenue Acts of 1924 and 1926, § 201(f); Revenue Acts of 1928 and 1932, § 115(f), 26 U.S.C. § 115(f) and note; Revenue Act 1934, § 115(f).

[98] H.R. 350, 67th Cong., 1st Sess., p. 8. Senate Report No. 275, 67th Cong., 1st Sess., p. 9.

tax into a capital levy.

We are dealing solely with an income tax act. Under our decisions, the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stockholding represented, he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt is immaterial for present purposes.

The relevant capital gains provisions of the Revenue Act of 1928 are § 111(a):

> The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 113, [footnote omitted].

and Section 113:

> The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property [with exceptions having no relevancy here]. [footnote omitted].

The property disposed of was the petitioner's preferred stock. In plain terms, the statute directs the subtraction of its cost from the proceeds of its redemption, if the latter sum be the greater. But we are told that Treasury regulations [footnote omitted] long in force require an allocation of the original cost between the preferred stock purchased and the common stock received as dividend. And it is said that, while no provision of the statute authorizes a specific regulation respecting this matter, the general power conferred by the law to make appropriate regulations comprehends the subject. Where the act uses ambiguous terms or is of doubtful construction, a clarifying regulation or one indicating the method of its application to specific cases not only is permissible, but is to be given great weight by the courts. And the same principle governs where the statute merely expresses a general rule and invests the Secretary of the Treasury with authority to promulgate regulations appropriate to its enforcement. But where, as in this case, the provisions of the act are unambiguous and its directions specific, there is no power to amend it by regulation. [footnote omitted]. Congress having clearly and specifically declared that, in taxing income arising from capital gain, the cost of the asset disposed of shall be the measure of the income, the Secretary of the Treasury is without power by regulatory amendment to add a provision that income derived from the capital asset shall be used to reduce cost.

The judgment is

Reversed.

Justice STONE and Justice CARDOZO are of the opinion that the judgment should be affirmed.

....

Questions and comments:

1. Exactly what is the impact of the last full paragraph of the Supreme Court's opinion? How do we determine the basis of the dividend stock when its distribution is taxable to the shareholder?

•How did it benefit taxpayer to argue that the stock dividends *were* not exempted from income taxation? Is she volunteering to pay more income tax?

•The Supreme Court held that receipt of the stock dividend was the receipt of taxable income. How should taxpayer determine the basis of the stock received? What does this tell us about what basis is?

2. Was the Supreme Court right to reverse long-standing administrative construction of the statute? On the other hand, does it really require a careful parsing of the holding and dictum to conclude that Congress and the Treasury had read too much into the holding of *Macomber*?

•Might the fact that Congress and the Treasury "got it wrong" affect subsequent developments so that they might be less than satisfactory?

3. How does the distribution of "common on preferred" alter the relation among shareholders and between preferred shareholders and corporation? *See Comm'r v. Tillotson Mfg. Co.*, 76 F.2d 189, 190-91 (6th Cir. 1935) ("Each preferred stockholder, in consideration of relinquishing his rights to the accrued preferred dividends, secured new voting rights, and additional property rights which might well afford him a different and greater market with an increased money return.").

4. The accumulated earnings tax (§ 531 to 537) might have been regarded as a substitute for imposing an income tax on stock dividends. If a corporation could not accumulate earnings and profits, there would be no need to worry about shareholders getting such surplus out of the corporation without the Treasury benefitting from someone's payment of a tax – whether an accumulated earnings tax on the corporation or an income tax on the shareholder.

5. When a shareholder owns *all* the shares of the only class of a corporation's outstanding stock, should a distribution of "preferred on common" be subject to income tax?

•No. *Helvering v. Sprouse*, 318 U.S. 604, 607 (1943) ("the distribution brought about no change whatever in his interest in the corporation. Both before and after the event, he owned exactly the same interest in the net value of the corporation as before.").

II. Section 305

Read § 305.

We now consider cases where a corporation distributes stock or stock rights that alter the relative interests of shareholders in the corporation. Section 305 governs such cases. Notice the format of § 305. Section 305(a) provides that "[e]xcept as otherwise provided in *this* section, gross income does *not* include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock." (emphasis added). Section 305(b) lists exceptions to general rule of exclusion – i.e., distributions which *are* included in "gross income." Those distributions are treated "as a distribution to which § 301 applies ..." We generally expect a Code provision to include *everything* except what is specifically excluded. Section 305 runs counter to that intuition. It results from judicial and congressional efforts to deal with what was believed to be the rule of *Eisner v. Macomber* and with the assumption that it would be unconstitutional to alter that rule.

Notice also that § 305(a) – a rule of non-inclusion in gross income – applies only to a "distribution of the stock of a corporation made by such corporation to stockholders with respect to its stock." Section 305(b) – a rule of inclusion in gross income – applies only to a "distribution by a corporation of its stock." Other provisions of the Code govern transactions that are not a "distribution by a corporation of its stock," e.g., an exchange, a recapitalization. *Cf.* Reg. § 1.305-3(e), Example 12 (recapitalization accomplished through "single and isolated [exchange];" such exchanges not "within the purview of § 305"). Moreover, distributions that may alter the proportionate interests of some shareholders but which do not fall within any of the transactions described in § 305(b) are not governed by § 305. Such is the effect of the phrase in § 305(a) "except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock."

By now, you should have some sense of the interests that shareholders have with respect to each other and with respect to the corporation. When a distribution of stock alters either or both of such relationships, we should expect such the distribution to be subject to the rules governing income taxation of dividends. *Eisner v. Macomber* does not stand in the way. Nevertheless, we must read § 305(b) very closely.

If a corporation has cash to distribute but its shareholders would prefer not to be taxed on the receipt of a cash dividend, is there any way that the corporation can avail itself of § 305(a) to avoid such a consequence?

A. § 305(b)(1)

Read § 305(b)(1), Reg. § 1.305-2(a), and Reg. § 1.305-2(b), Example 2. Consider these questions:

> 1. Suppose a corporation gives shareholder the option of receiving cash or shares. *All* the shareholders elect to receive shares so that the relationships between shareholders and each other, and between the shareholders and the corporation do not change. Does this fall within the § 305(b)(1) exception?
>
> 2. Suppose that all shareholders receive shares and that the distribution appears to fall within § 305(a). Shareholders are entitled to have the corporation to redeem shares immediately. Does this fall within the § 305(b)(1) exception? *See* note 3, following Rev. Rul. 78-375.
>
> 3. Suppose that all shareholders receive shares and that the distribution appears to fall within § 305(a). Shareholders have the option to ask the corporation to redeem shares immediately. The corporation may exercise its discretion to deny the request, but it always accedes to the shareholder's request. Does this fall within the § 305(b)(1) exception? *See Frontier Savings Ass'n v. Comm'r*, *infra*. Should it matter that the distribution of shares is made for the very purpose of allowing one shareholder in need of cash to obtain it from the corporation by requesting a redemption while another shareholder retains her shares? *See* note 4, following *Frontier Savings*.

Rev. Rul. 78-375, 1978-2 C.B. 130

Advice has been requested as to the treatment for federal income tax purposes of a "dividend reinvestment plan" where the shareholder may not only elect to receive stock of greater fair market value than the cash dividend such shareholder might have received instead, but also the shareholder may, through the plan, purchase additional stock from the corporation at a discount price which is less than the fair market value of the stock.

X is a corporation engaged in commercial banking whose shares of common stock are widely held and are regularly traded in the over-the-counter market. In order to raise additional equity capital for corporate expansion and to provide holders of X's common stock with a simple and convenient way of investing their cash dividends and optional payments in additional shares of X common stock without payment of any brokerage commission, X established an automatic dividend reinvestment plan. An independent agent will administer the plan and will receive the stock from X in the manner described below on behalf of a participating shareholder.

The plan provides the following:

(1) Shareholders can elect to have all their cash dividends (less a quarterly service charge of 3x dollars that is paid to an independent agent of the shareholder) otherwise payable on common stock registered in the name of the shareholder automatically reinvested in shares of X common stock. The service charge is paid to the agent for administering the plan and maintaining the stock certificates for the shareholders. The shareholders who elect to participate in the plan acquire X stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date. The shareholder's option to receive a dividend in additional common stock in lieu of a cash dividend is not transferable apart from a transfer of the common shares themselves.

(2) A shareholder who participates in the dividend reinvestment aspect of the plan as described in paragraph (1) above, in addition, has the option to invest additional amounts to purchase shares of X common stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date. Optional investments by a shareholder in any quarterly dividend period must be at least 4x dollars and cannot exceed 100x dollars. The shareholder's right to invest additional amounts under the plan is not transferable apart from a transfer of the common shares themselves.

There is no requirement to participate in the plan and shareholders who do not participate receive their cash dividend payments in full. Certain shareholders have chosen not to participate; therefore, they receive their regular quarterly cash dividend. While the plan continues in effect, a participant's dividends will continue to be invested without further notice to X.

Prior to the dividend payment date no cash dividend is available to either X's participating or nonparticipating shareholders. On the dividend payment date the participant receives written notification that X is acting to effectuate the participant's option to receive stock on that date. The crediting on the plan account and notification to the participant of the exact number of shares acquired (including fractional shares) takes place shortly after the dividend payment date.

A participant may withdraw from the plan at any time, upon written request. Upon withdrawal, certificates for whole shares credited to the participant's account under the plan will be issued and a cash payment based upon the market value of the participant's fractional share interest will be paid by X, through the participant's agent, to the participant. As an alternative, the shareholder may request that all or part of the whole shares credited to its account in the plan be sold for the shareholder's account. The sale will be made by an independent agent acting on behalf of such participant and the proceeds of the sale (less any brokerage commission and transfer tax) will be forwarded to the participant. With regard to the whole shares, X will neither purchase any shares of a participant nor pay any expense attributable to the sale of such stock. Upon a request for sale of a participant's shares, a cash payment equal to the market value of the participant's fractional share interest will be paid by X, through the participant's agent, to the participant. The purpose of the payment of cash is to save X the trouble, expense, and inconvenience of issuing and transferring fractional shares and is not designed to give any particular group of shareholders an increased interest in the assets or earnings and profits of X.

Section 305(a) of the Code provides that, with certain exceptions, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock. Section 305(d)(1) provides that for purposes of the foregoing the term "stock" includes rights to acquire such stock.

Section 305(b)(1) of the Code provides that § 305(a) will not apply, and the distribution will be treated as a distribution to which § 301 applies, if the distribution is, at the election of any shareholder (whether exercised before or after the declaration), payable either in the stock of the distributing corporation or in property.

Section 305(b)(2) of the Code provides that § 305(a) will not apply, and the distribution will be one to which § 301 applies, if the distribution (or a series of distributions of which such a distribution is one) has the result of (a) the receipt of property by some shareholders, and (b) an increase in the proportionate interest of other shareholders in the assets or earnings and profits of the corporation.

Reg. § 1.305-3(b)(2) provides that in order for a distribution of stock to be considered as one of a series of distributions, it is not necessary that such distribution be pursuant to a plan to distribute cash or property to some shareholders and to increase the proportionate interests of other shareholders. It is sufficient if there is an actual or deemed distribution of stock and, as a result of such distribution, some shareholders receive cash or property and other shareholders increase their proportionate interests. This is so whether the stock distributions and the cash distributions are steps in an overall plan or are independent and unrelated. In addition, § 1.305-3(b)(3) states that there is no requirement that both elements of § 305(b)(2) of the Code (receipt of cash or property by some shareholders and an increase in proportionate interests of other shareholders) occur in the form of a distribution or series of distributions as long as the result of a distribution of stock is that some shareholders' proportionate interests increase and other shareholders in fact receive cash or property.

Section 301 of the Code states that, except as otherwise provided, a distribution of property made by a corporation to a shareholder with respect to its stock shall be included in the gross income of the shareholder to the extent the amount distributed is a dividend as defined in § 316.

Rev. Rul. 76-53, 1976-1 C.B. 87, concerns a situation where a widely held corporation that regularly distributes its earnings and profits adopted a plan permitting the shareholders to choose to have all of the cash dividends, otherwise payable on common shares owned by the shareholder, automatically invested to purchase additional shares of the corporation's stock. The shareholders who elect to participate under this plan acquire the company's stock at a price equal to 95 percent of the fair market value of such stock on the dividend payment date. That Revenue Ruling concludes that the distributions made by the corporation while the plan is in effect are properly treated as payable either in stock or in cash at the election of the shareholder within the meaning of § 305(b)(1) of the Code, and, therefore, such participating shareholders will be treated as having received a distribution to which § 301 applies by reason of § 305(b)(1).

Rev. Rul. 77-149, 1977-1 C.B. 82, concerns a situation where a corporation established a dividend reinvestment plan administered by a local bank, acting as agent for the shareholders. At a shareholder's direction the shareholder's cash dividends would be received by the participating shareholders' agent, the bank, who would then purchase the corporation's stock on the open market at 100 percent of fair market value. That Revenue Ruling held that § 301 applies directly to the cash dividends without reference to § 305(b)(1) because the distribution is payable by the corporation only in cash, and the shareholders of the corporation do not have the election of receiving their dividend distribution from the corporation in either stock or cash.

In the present case, the distributions made by X while the plan is in effect are properly treated as payable either in X's stock or in cash at the election of X's common shareholders within the meaning of § 305(b)(1) of the Code. The acquisition of stock through the dividend reinvestment aspect of the plan is identical to the situation in Rev. Rul. 76-53. Further, the present case and Rev. Rul. 76-53 are distinguishable from Rev. Rul. 77-149 because the distribution described in Rev. Rul. 77-149 was payable by the corporation only in cash, and the shareholder, through the agent, purchased the corporation's stock on the open market.

The optional investment aspect of the present case results in an increase in the proportionate interests of the shareholders making the purchase at a 5 percent discount, and this event increases their proportionate interests in the assets or earnings and profits of X within the meaning of § 305(b)(2)(B) of the Code. Furthermore, the fact that X shareholders who do not participate in the plan receive cash dividends constitutes a receipt of property by those shareholders within the meaning of § 305(b)(2)(A).

Accordingly, under the circumstances described above, it is held as follows:

(a) A shareholder of X who participates in the dividend reinvestment aspect of the plan will be treated as having received a distribution to which § 301 of the Code applies by reason of the application of section 305(b)(1). Pursuant to Reg. § 1.305-1(b), the amount of the distribution to a participating shareholder (including participating corporate shareholder) will be the fair market value of the X stock received on the date of the distribution (§ 1.301-1(b) and (d)), plus, pursuant to § 301, 3x dollars, the service charge subtracted from the amount of the shareholder's distribution.

(b) The basis of the shares credited to the account of a participating shareholder pursuant to the dividend reinvestment aspect of the plan will equal the amount of the dividend distribution, as provided in § 301(c) of the Code, measured by the fair market value of the X common stock as of the date of the distribution both as to noncorporate and corporate shareholders, pursuant to § 301(d). Reg. § 1.301-1(h)(1) and (2)(i). The quarterly service charge paid by a participant who is an individual for the production of income or for the management, conservation, or maintenance of property held for the production of income, is deductible in the year paid by such participant under § 212, provided the individual itemizes deductions. *See* Rev. Rul. 70-627, 1970-2 C.B. 158, and Rev. Rul. 75-548, 1975-2 C.B. 331. The quarterly service charge, which is paid in carrying on a trade or business by a participant who is an individual, is deductible in the

year paid by such participant under § 162. A participant who is a corporation may deduct the service charge under § 162.

(c) A shareholder of X who participates in the optional payment aspect of the plan will be treated as having received a distribution to which § 301 of the Code applies by reason of the application of § 305(b)(2). Pursuant to Reg. § 1.305-3(a), the amount of the distribution to a participating shareholder will be the difference between the fair market value on the dividend payment date of the shares purchased with the optional payment and the amount of the optional payment. § 1.305-3(b)(2).

(d) The basis to the shareholder who participates in the optional payment aspect of the plan is the excess of fair market value of the shares purchased with the optional payment over the optional payment (provided that this deemed distribution is taxable as a dividend under § 301(c)(1) of the Code) pursuant to § 301(d) and Regs. §§ 1.301-1(h)(1) and 2(i), plus the amount of the optional payment, pursuant to § 1012.

(e) A participant in the plan will not realize any taxable income upon receipt of certificates for whole shares that were credited to the participant's account pursuant to the plan. Rev. Rul. 76-53. Any cash received by an X shareholder in lieu of a fractional share interest will be treated as a redemption of that fractional share interest, subject to the provisions and limitations of § 302 of the Code. *See* Rev. Rul. 66-365, 1966-2 C.B. 116.

(f) A participant will recognize gain or loss pursuant to § 1001 of the Code when shares are sold or exchanged on behalf of the participant upon the participant's withdrawal from the plan, or when the participant sells the shares after its withdrawal from the plan. In accordance with § 1001, the amount of such gain or loss will be the difference between the amount that the participant receives for the whole shares and the participant's tax basis. Any cash received by the participants, who withdraw from the plan, in lieu of their fractional share interests will be treated as a redemption of that fractional share interest, subject to the provisions and limitations of § 302. *See* Rev. Rul. 66-365.

Rev. Rul. 77-149 is distinguished.

Questions and comments:

1. The IRS noted that in Rev. Rul. 77-149, 1977-1 C.B. 82, a local bank administered a DRIP for the shareholders of a corporation. Shareholders could direct the bank to use dividend money to buy on the open market shares of the corporation's stock at 100% of fmv. The IRS determined that § 301 applies directly to such a plan, without reference to § 305(b)(1). Is there any significance to such a holding?

2. In paragraphs (a) through (e) of the IRS's holding, account for the amounts on which a shareholder pays income tax, the character of the income, and the amount that becomes the shareholder's basis in share that they acquired.

3. Corporation issues preferred stock pro rata to its common stock shareholders. Holders of the preferred stock are entitled to have the preferred stock redeemed at any time – including immediately.

> Since the preferred stock is redeemable immediately after the distribution at the option of a shareholder, a shareholder may either hold the preferred stock or have it redeemed for money. Thus, the effect of the immediate redeemability feature of the preferred stock is to give a shareholder an election to receive either stock or property within the meaning of § 305(b)(1)(A) and (B) of the Code.
>
> Accordingly, in the instant case, the distribution is treated as a distribution of property to which § 301 of the Code applies.

Rev. Rul. 76-258, 1976-2 C.B. 95.

4. In Rev. Rul. 76-258, the corporation retained no discretion to refuse to redeem dividend shares of a shareholder. Can we measure the amount of discretion a corporation must retain for a distribution of stock not to fall within § 305(b)(1)? Consider the following case –

Frontier Savings Ass'n v. Commissioner, 87 T.C. 665, *aff'd sub nom.* Colonial Savings Ass'n v. Commissioner, 854 F.2d 1001 (CA7 1988), *cert. denied*, 489 U.S. 1090 (1989)

In statutory notices of deficiency ..., respondent determined deficiencies in petitioner's Federal income tax liabilities ...

....

... [T]he issue .... is whether stock dividends received by petitioner in 1978 and 1979 from the Federal Home Loan Bank of Chicago are taxable to petitioner under § 305(b)(1) [footnote omitted]. The resolution of this issue will affect the taxability of stock dividends received by the other 496 stockholders of the Federal Home Loan Bank of Chicago which also received stock dividends in 1978 and 1979.

FINDINGS OF FACT

....

Petitioner Frontier Savings Association (Frontier Savings) is a mutual savings and loan association ... It operates as a mutual savings association pursuant to Wisconsin law. ...

Frontier Savings has been a member and stockholder of the Federal Home Loan Bank of Chicago (the Chicago Bank) at all times since the organization of the Chicago Bank. The

Chicago Bank is one of 11 district banks (12 prior to 1946) established pursuant to the Federal Home Loan Bank Act of 1932, 47 Stat. 725, 12 U.S.C. §§ 1421 et seq. The district banks were capitalized with stock subscriptions from member institutions and the U.S. Treasury. District banks operate under the supervision of the Federal Home Loan Bank Board, an administrative agency in the Executive Branch of the Federal Government. The Federal Home Loan Bank Board also is the chartering and regulatory authority for Federal savings and loan associations and Federal mutual savings banks.

The Federal Home Loan Bank system was designed primarily as a reserve credit facility for savings and loan associations and other home mortgage credit institutions. Savings and loan associations (such as Frontier Savings) and mutual savings banks that are members or stockholders in the district banks (hereinafter referred to as members or member banks) are required by Federal law to maintain a certain capital stock ownership in the respective district banks of which they are members. The stock ownership requirements are determined at the end of each calendar year and are calculated with reference to each member bank's net home mortgage loans outstanding and total borrowings of each member from the district bank.

Each member bank generally must maintain a capital stock ownership interest in the district bank in an amount equal to at least 1 percent of the total outstanding balance of its home mortgage loans [footnote omitted] and at least equal to one-twelfth [footnote omitted] of total outstanding borrowings of the member bank from the district bank, as of December 31 of each year. Each share of stock in the district banks is valued by statute at its $100 par value. *See* 12 U.S.C. § 1426(b) and (c) (1978).

Based upon the above yearend calculations, member banks that are required to purchase additional stock of district banks must do so by January 31 of the following year at the par value of $100 per share. Member banks that own stock in district banks in excess of the required number of shares (excess shares) may request that excess shares be redeemed by the district banks.

The policy of the Chicago Bank with respect to the redemption of excess shares is reflected in the minutes of a June 18, 1979, meeting of the Chicago Bank's board of directors, as follows:

> BE IT RESOLVED, that the President of the Bank or any officer designated by him may from time to time increase or decrease the amount of stock of any member in accordance with § 6 of the Federal Home Loan Bank Act [i.e., 12 U.S.C. § 1426(c)] and the Regulations for the Federal Home Loan Bank System; provided, however, that in exercising the Bank's discretion whether or not to grant an application by a member to decrease its stock, the President or his designee shall be guided by all applicable statutory and regulatory provisions, all policies and standards adopted from time to time by this Board, including, but not limited to, the Bank's credit standards contained in the "Policies Governing Extension of Credit" as adopted by this Board and all relevant facts and circumstances.

As of December 31, 1977, Frontier Savings owned 6,721 shares of stock in the Chicago Bank, all of which it had purchased over many years from the Chicago Bank at $100 per share. On that day, the principal amount of Frontier Savings' outstanding mortgage loans and borrowings from the Chicago Bank was such that, prior to January 31, 1978, Frontier Savings was required to increase its stock interest in the Chicago Bank to 9,066 shares. Accordingly, during January of 1978, Frontier Savings purchased 2,345 additional shares of the common stock of the Chicago Bank for $234,500. ... [A]s of December 28, 1978, Frontier Savings owned 9,066 shares of the common stock of the Chicago Bank.

As stockholders in district banks, member banks are entitled to receive dividends that are declared by district banks. Prior to December 29, 1978, dividends were paid by the Chicago Bank to its member banks in the form of cash. On December 29, 1978, dividends were paid by the Chicago Bank to its member banks in the form of additional shares of common stock. On December 31, 1979, dividends were paid by the Chicago Bank to its member banks half in stock and half in cash.

DECEMBER 29, 1978, STOCK DIVIDEND

At a meeting held on November 20, 1978, the board of directors of the Chicago Bank adopted a resolution to pay a 6.58-percent dividend to its stockholders of record as of December 31, 1978. Subject to the approval of the Federal Home Loan Bank Board, the resolution stated that the dividend would be paid in the form of shares of stock in the Chicago Bank. On December 22, 1978, the Director of the Office of District Banks, Federal Home Loan Bank Board, wrote a letter to the President of the Chicago Bank approving the stock dividend.

On December 22, 1978, the Chicago Bank mailed a bulletin to its member banks, informing them that a 6.58-percent stock dividend would be paid, with fractional shares to be paid in cash. The explanation made in the bulletin for paying a stock dividend, rather than a cash dividend, was as follows:

> (1) Providing a stock rather than a cash dividend may enable your association to defer the payment of income taxes on the value of the stock dividend. You may wish to consult your tax adviser for the proper handling of a stock dividend.
>
> (2) A stock dividend can be applied toward satisfying the stock investment requirement for members that experienced a growth in assets during 1978 or that will be required to purchase additional stock due to increased borrowings from the Bank.

The bulletin also explained that most member banks would be required to increase their stock holdings in the Chicago Bank due to that year's general increase in outstanding home mortgage loans.

On December 29, 1978, [footnote omitted] the Chicago Bank distributed the 1978 stock dividend by (1) crediting the appropriate number of whole shares of stock to the stock account of each

member bank, (2) crediting an appropriate amount of cash with respect to fractional shares to the demand account of each member bank, and (3) issuing a new stock certificate to each member bank. Each new stock certificate reflected the total number of shares of stock held by each member bank before the stock dividend, the number of shares of stock distributed pursuant to the dividend, and the total number of shares of stock owned by each member bank after distribution of the dividend. ...

On December 29, 1978, a total of 234,620 shares of common stock was distributed by the Chicago Bank as a stock dividend to its 497 member banks. On December 29, 1978, Frontier Savings received 588 shares of common stock in the Chicago Bank (and cash representing fractional shares in the amount of $51.07) as its share of the 1978 stock dividend.

COMMON STOCK PURCHASES AND REDEMPTIONS RELATING TO DECEMBER 31, 1978, STOCK OWNERSHIP REQUIREMENTS

Enclosed with the December 22, 1978, bulletin mailed by the Chicago Bank to its member banks describing the 1978 stock dividend was a form entitled "Calculation of Bank Stock Requirement as of December 31, 1978." Using that form, each member bank could calculate the number of shares of stock it was required, under 12 U.S.C. § 1426(c) (1978), to own in the Chicago Bank as of December 31, 1978. If a member bank was required to purchase additional shares of stock, it could submit the form (reflecting the number of shares to be purchased) along with a check in payment therefore to the Chicago Bank. If the member bank held more shares than it legally was required to own, it could use the form to request the redemption of any excess shares. Although the Chicago Bank had no legal obligation to redeem excess shares, in prior years it routinely had done so.

On January 16, 1979, Frontier Savings completed the form calculating the number of shares of common stock in the Chicago Bank it was required to own based on its December 31, 1978, outstanding balance for home mortgage loans. That calculation indicated that Frontier Savings was required to purchase 678 additional shares of common stock in the Chicago Bank (after taking into account the shares received as part of the common stock dividend on December 29, 1978). Frontier Savings, therefore, sent a check in the amount of $67,800 to the Chicago Bank and 678 shares were credited to its stock account at the Chicago Bank. A new stock certificate was issued reflecting the ownership by Frontier Savings of a total of 10,332 shares of common stock in the Chicago Bank. During 1979, none of the shares of common stock in the Chicago Bank owned by Frontier Savings were redeemed or otherwise transferred.

Exclusive of the December 29, 1978, stock dividend received, on December 31, 1978, 195 of the 497 member banks owned sufficient shares of common stock in the Chicago Bank to meet their stock ownership requirements, and 302 member banks did not own sufficient shares to meet their stock ownership requirements. After receipt of the 1978 stock dividend, 69 member banks requested that the Chicago Bank redeem all or some of their excess shares. All such redemption requests were agreed to by the Chicago Bank and [it redeemed 94,320 shares of common stock from member banks from December 1978 through 1979.]

....

1979 CASH AND STOCK DIVIDENDS

At a meeting held on November 19, 1979, the board of directors of the Chicago Bank adopted a resolution, subject to the approval of the Federal Home Loan Bank Board, to pay a 10-percent dividend to its stockholders of record as of December 31, 1979, half of which would be paid in cash and half of which would be paid in the form of common stock of the Chicago Bank. On December 13, 1979, the Federal Home Loan Bank Board approved payment by the Chicago Bank of the proposed cash and stock dividends. On December 21, 1979, the Chicago Bank mailed a bulletin to its member banks, informing them that the 10-percent dividend would be paid to the stockholders on December 31, 1979.

On December 31, 1979, the Chicago Bank distributed the 1979 dividends by (1) adding the appropriate number of whole shares of stock to the stock account of each member, and (2) adding to the demand account of each member the amount representing the cash portion of the dividend as well as the amount of cash representing fractional shares of stock distributed as part of the dividend. A total of 209,197 shares of stock was distributed by the Chicago Bank as a stock dividend to its 497 member banks on December 31, 1979. Frontier Savings received 514 shares of Chicago Bank common stock as its portion of the 1979 stock dividend and $51,567.87 in cash as its portion of the cash dividend.

COMMON STOCK PURCHASES, SALES, AND REDEMPTIONS RELATING TO DECEMBER 31, 1979, STOCK OWNERSHIP REQUIREMENTS

The December 21, 1979, bulletin mailed to member banks concerning the 1979 dividends explained that "to help preserve the non-taxable characteristics of the stock dividend" a new procedure was being adopted for the purchase and disposition of excess shares of stock in the Chicago Bank. Instead of having member banks purchase additional shares of stock from the Chicago Bank and instead of having the Chicago Bank redeem excess shares from member banks, the new procedure called for member banks who had excess shares they wished to dispose of to sell such excess shares to other member banks who wished to buy additional shares.

Enclosed with the December 21, 1979, bulletin was a form entitled "Calculation of Bank Stock Requirement" as of December 31, 1979, and a separate form that could be used by the member banks to notify the Illinois and Wisconsin League Offices[99] of their desire to sell excess shares of stock in the Chicago Bank to other member banks. Each member bank was required to notify the Chicago Bank of any purchases of shares of stock in the Chicago Bank so the changes in ownership of the stock could be reflected on its records.

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[99] Although not explained in the record, apparently the Illinois and Wisconsin League offices were trade associations of member banks which agreed to act as intermediaries to effect the sales of stock between member banks in January of 1980.

Frontier Savings completed its form for the "Calculation of Bank Stock Requirement" on January 29, 1980. Thereon, it was indicated that, based on its December 31, 1979, loan balance figures, Frontier Savings was required to purchase 520 additional shares of common stock in the Chicago Bank. Frontier Savings, therefore, mailed a $52,000 check to the Chicago Bank, and the Chicago Bank credited Frontier Savings with 520 shares of stock, increasing the total number of shares in petitioner's stock account to 11,366.

Exclusive of the December 31, 1979, stock dividends, 282 of the Chicago Bank's 497 member banks owned sufficient shares of stock in the Chicago Bank to meet their stock ownership requirements on December 31, 1979, and 215 member banks did not own sufficient shares. After receipt of their 1979 stock dividends from the Chicago Bank, 31 member banks sold some of their stock to other member banks, and 10 bought additional stock from member banks. A total of 85,859 shares of stock in the Chicago Bank was exchanged between member banks during December of 1979 and January of 1980.

Sales of excess shares between member banks occurred only in January of 1980. Excess shares that member banks wished to dispose of after January of 1980 were redeemed by the Chicago Bank. Between February 1, 1980, and December 31, 1980, 64 member banks requested the Chicago Bank to redeem their excess shares. Sixty member banks redeemed a number of shares that was equal to or that exceeded the number of shares they received as their portion of the 1979 stock dividend. The Chicago Bank honored all redemption requests received during that period of time and [redeemed a total of 281,840 shares in 1980].

None of the shares of stock in the Chicago Bank received by Frontier Savings with respect to the 1978 and 1979 stock dividends were redeemed by the Chicago Bank or otherwise disposed of by Frontier Savings prior to 1982. In January of 1982, the Chicago Bank, at the request of Frontier Savings, redeemed 3,584 shares of its stock owned by Frontier Savings.

OPINION

The receipt of common stock dividends generally is not taxable to stockholders. § 305(a). Where, however, dividends from a corporation are payable, at the election of the stockholders, in stock or property (such as cash), the receipt of dividends will be taxable to the stockholders under the provisions of § 301. § 305(b)(1). [footnote omitted]. In that circumstance, the receipt of stock dividends will be taxable under §§ 305(b)(1) and 301 regardless of whether the stockholders exercise their election to receive the dividends in cash or other property. Reg. § 1.305-2(a). [footnote omitted].

Respondent argues that by redeeming all of the common stock it was requested to redeem from its member banks in 1979 and 1980 (and apparently doing so in years before 1979), the Chicago Bank established such a policy and practice of redeeming excess stock upon request of the member banks that the member banks should be regarded as having had an "election" to receive the 1978 and 1979 stock dividends in cash. Respondent therefore argues that the stock dividends

in question do not qualify for exemption from taxability under § 305(a) and should be taxable to the member banks under §§ 305(b)(1) and 301. For the reasons explained below, we disagree.

The Federal statute under which the Federal Home Loan Bank Board and the district banks regulate certain activities of member banks addresses the authority of district banks to redeem common stock from its member banks and explicitly describes that authority as discretionary with each district bank. Section 1426(c) of the Federal Home Loan Bank Act as amended in 1961 provides, in relevant part, as follows:

> If the bank finds that the investment of any member in stock is greater than that required under this subsection *it may, unless prohibited by said Board* [i.e., the Federal Home Loan Bank Board] *or by the provisions of paragraph (2) of this subsection, in its discretion* and upon application of such member retire the stock of such member in excess of the amount so required. * * * [12 U.S.C. § 1426(c) (1961), as amended by Act of Sept. 8, 1961, subsec. (c), Pub. L. 87-210, 75 Stat. 482. Emphasis supplied.]

A comparison of the language quoted above (reflecting the 1961 amendment to § 1426(c)) with the language of the predecessor statute to § 1426(c) (as originally enacted in 1932) is particularly significant. As originally enacted, § 1426(c) of the Federal Home Loan Bank Act of 1932, *supra*, provided as follows:

> If the board finds that the investment of any member in stock is greater than that required under this section, upon application of such member, *the bank shall pay such member for each share of stock in excess of the amount so required* an amount equal to the value of such stock * * * [Federal Home Loan Bank Act of 1932, *supra*, § 1426(c). Emphasis supplied.]

The language quoted immediately above suggests that member banks may have had the right to require district banks to redeem excess shares before the 1961 amendment to 12 U.S.C. § 1426(c). That is suggested by use in the statutory language of the mandatory "shall." Nothing, however, in the Federal Home Loan Bank Act, in its present form, suggests that since 1961 anyone other than the district banks and the Federal Home Loan Bank Board have the authority to determine whether excess shares will be redeemed.

The policy of the Chicago Bank with respect to the redemption of excess shares, as reflected in the minutes of the June 18, 1979, meeting of its board of directors, is entirely consistent with the above statutory provisions. Also, the bulletins mailed in December of 1978 and 1979 by the Chicago Bank to its members do not communicate any contrary policy to member banks. Those bulletins acknowledged that although the issuance of stock dividends was attributable, in part, to a perceived tax planning opportunity, the distributions of stock dividends also were attributable to the recognized need for a number of member banks to acquire additional shares of common stock in the Chicago Bank. With respect to the holding of excess shares, the bulletin dated December 22, 1978, simply suggested that member banks "may want to retire" such stock. The bulletin dated December 21, 1979, stated that it was "hoped that the majority of those holding

excess stock will choose to hold the stock to meet future needs and for investment purposes," but that if they chose to sell excess shares to another member bank the league offices will "make every effort to bring you in contact with a member * * * willing to purchase" the excess shares. Neither bulletin suggested that the Chicago Bank necessarily would grant any or all redemption requests.

Congress vested in the district banks and in the Federal Home Loan Bank Board discretionary authority to redeem excess shares of common stock held by member banks. Our careful examination of the record herein satisfies us that the manner in which stock dividends were paid and redeemed in 1978 and 1979 by the Chicago Bank was consistent with that grant of discretionary authority and did not vest in the member banks the unilateral right to elect or to require the Chicago Bank to redeem excess shares upon request.

Respondent concedes that the Chicago Bank did not completely abdicate its discretionary authority to redeem its stock but respondent argues that that authority was exercised so consistently in favor of redemption that member banks, as a practical matter, had the option or election to have excess shares redeemed at any time. Respondent contends that the option arose "from the circumstances of the distribution," citing Reg. § 1.305-2(a)(4). As indicated, we have carefully examined the circumstances of the stock dividends in question and conclude that the member banks, including Frontier Savings, did not have the option or election to have the Chicago Bank redeem excess shares of common stock in the Chicago Bank.

In addition to the factors explained above, we think it significant that the stock dividends of the Chicago Bank were declared and distributed in late December of 1978 and 1979. Member banks, however, normally would not be able to determine until early in the following year (after actual distribution of the stock dividends) whether they would be able even to request a redemption of some of their common stock in the Chicago Bank. In other words, on the day of distribution of the stock dividends, member banks could not know (other than through estimates and projections) whether they would be required to retain the stock dividends they received as part of their required investments in the district bank or whether the stock dividends would qualify as excess shares, in which case redemption thereof, if requested, might occur depending on the decision of the Chicago Bank. [footnote omitted].

....

We recognize that the issuance by the Chicago Bank in 1978 and 1979 of stock dividends instead of or in addition to cash dividends was motivated in part by tax considerations. We cannot conclude, however, on the facts before us that the stock dividends were a mere subterfuge for cash distributions ... or that the Chicago Bank had relinquished its discretionary authority to decline to grant stock redemption requests.

... Revenue Rulings are, of course, not binding on this Court. [citation omitted]. Respondent's litigating position herein is reflected in Rev. Rul. 83-68, 1983-1 C.B. 75. For the reasons explained above and under the facts of this case, we reject the conclusion reached therein that a

history or practice of redemptions by the Chicago Bank makes the stock dividends received by petitioner herein taxable under §§ 305(b)(1) and 301.

...

Decisions will be entered under Rule 155.

Reviewed by the Court.

Sterrett, Goffe, Chabot, Nims, Parker, Whitaker, Krner, Shields, Hamblen, Cohen, Clapp, Jacobs, and Parr agree with the majority opinion.

Simpson, J., dissents.

Gerber, Wright, and Williams, JJ., did not participate in the consideration of this case.

Hamblen, J., concurring:

I concur in the conclusion of the majority based upon the limited factual circumstances involved. If a discretionary act of the board of directors of a shareholder corporation to redeem stock dividends becomes a routine matter, it might, in my opinion, develop into an "option" that arises after the distribution or a distribution pursuant to a "plan." *See* Regs. §§ 1.305-2(a) and 1.305-3(b). In such a situation, it seems the redemptions might be periodic rather than isolated. The broad rules of § 305 could invoke different considerations under other circumstances.

Sterrett, Cohen, and Jacobs, JJ., agree with this concurring opinion.

Questions and comments:

1. The IRS acquiesced in this holding, 1990-1 C.B. 1. It reversed itself on the position that it took in Rev. Rul. 83-68, 1983-1 C.B. 75. *See* Rev. Rul. 90-98, 1990-2 C.B. 56.

2. Who is affected by a determination that a case falls within § 305(b)(1)? The shareholders whose shares are redeemed, the shareholders whose shares are not redeemed, or both?

3. Did you like the tax advice that was given by the FHLB in this case? It seems that members who did not have to purchase additional shares were able to "purchase" protection with untaxed dividend shares.

4. Consider the facts of Rev. Rul. 87-132, 1987-2 C.B. 82:

> X corporation had outstanding 300 shares of voting common stock that were owned equally by an estate and by A ... The value of the X stock held by the estate exceeded the amount specified in § 303(b)(2)(A). The estate wanted to effect a redemption pursuant to

§ 303 to pay death taxes.

In order to maintain relative voting power and to preserve continuity of management, X undertook the following two steps. First, X issued 10 shares of a new class of nonvoting common stock on each share of common stock outstanding. Thus, the estate and A each received 1,500 shares of this stock. Immediately thereafter, 1,000 shares of the nonvoting common stock were redeemed by X from the estate in exchange for cash. The overall result of these two steps was that the estate obtained the cash it needed while giving up only nonvoting stock.

HELD:

The exclusion from gross income provision of § 305(a) of the Code, and the carryover of basis provisions of § 307(a), apply to X's distribution of its new nonvoting common stock to A and the estate. Section 303(a) applies to X's distribution of cash to the estate in redemption of the 1,000 shares of its new nonvoting common stock.

Problem:

1. Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock. Individual shareholders could elect to receive either –

•two shares of Corporation X common stock for each share held on the record date.

OR

•one share of Corporation X common stock plus a Corporation Y bond that Corporation X owned. The bond had a $12 face amount. The bond's fmv on the date of distribution was $11. Corporation X's basis in the Corporation Y bond was $9.

A. In effect, each shareholder received two shares of Corporation X's common stock, but could exchange one of them for a bond of another corporation. What is the tax consequence to each shareholder and to Corporation X of receiving the share that shareholders could not exchange? If it is a distribution to which § 301 applies, what is the amount of the distribution?

B. Each shareholder received a second share of Corporation X stock and could elect to exchange it or not. What is the tax consequence to those shareholders who did not elect to exchange that share for a Corporation Y bond? If it is a distribution to which § 301 applies, what is the amount of the distribution?

C. What is the tax consequence to the shareholders of Corporation X who did elect to exchange their second share of Corporation X common stock for a Corporation Y bond? If it is a

distribution to which § 301 applies, what is the amount of the distribution? What is the shareholder's basis in the bond?

This question comes from Reg. § 1.305-2(b), Example 1. You should try to answer these questions yourself, but check your answers against Example 1.

B. § 305(b)(2)

Read § 305(b)(2).

Notice that § 305(b)(2) focuses on a *result* rather than on different treatment of different shareholders. The result must be a consequence of a distribution or a series of distributions by a corporation of its stock. The heading of § 305(b) states that § 305(a) does not apply to a distribution of stock that falls within any of five exceptions. Obviously, if a corporation distributes cash to one group of shareholders and stock to a different group of shareholders, the *result* will be "the receipt of property by some shareholders," and "an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation." But, would the result be different if a corporation distributed cash in redemption of the stock of one group of shareholders and distributed nothing to the remaining shareholders? Read Reg. § 1.305-3(b)(3).

- Should it make any difference if the distribution of cash (or other property) were not a dividend under § 301? *See id.* Is the rule of the regulation theoretically sound – or merely practically sound?

- Reg. § 1.305-3(b)(3) states in part that "a distribution of property incident to an isolated redemption of stock ... will not cause § 305(b)(2) to apply even though the redemption distribution is treated as a distribution of property to which § 301 ... applies."

Section 305(c) empowers the Secretary of the Treasury to prescribe regulations that provide that certain occasions are themselves to be treated as distributions, i.e., "deemed distributions," Reg. § 1.305-3(b)(1). Section 305(c) requires the Secretary to prescribe regulations to deem as *distributions of stock* transactions that have the effect of increasing the proportionate interest of any shareholder in the earnings and profits of the corporation *or* increasing the proportionate interest of any shareholder in the assets of the corporation. *See* Reg. § 1.305-7(a). Section 305(c) works "hand-in-glove" with § 305(b)(2) (as well as § 305(b)(3, 4, and 5)). *See* Reg. § 1.305-7(a)(2). One of the occasions of a deemed distribution is a distribution to some shareholders that is subject to § 301.

Rev. Rul. 78-60, 1978-1 C.B. 81

Advice has been requested whether under § 302(a) the stock redemptions described below qualified for exchange treatment, and whether under § 305(b)(2) and (c) the shareholders who

experienced increases in their proportionate interests in the redeeming corporation as a result of the stock redemptions will be treated as having received distributions of property to which § 301 applies.

Corporation Z has only one class of stock outstanding. The Z common stock is held by 24 shareholders, all of whom are descendants, or spouses of descendants, of the founder of Z.

In 1975, when Z had 6,000 shares of common stock outstanding, the board of directors of Z adopted a plan of annual redemption to provide a means for its shareholders to sell their stock. The plan provides that Z will annually redeem up to 40 shares of its outstanding stock at a price established annually by the Z board of directors. Each shareholder of Z is entitled to cause Z to redeem two-thirds of one percent of the shareholder's stock each year. If some shareholders choose not to participate fully in the plan during any year, the other shareholders can cause Z to redeem more than two-thirds of one percent of their stock, up to the maximum of 40 shares.

Pursuant to the plan of annual redemption, Z redeemed 40 shares of its stock in 1976. Eight shareholders participated in the redemptions. ...

Issue 1

[The distributions did not qualify for exchange treatment under § 302(b)(1, 2, or 3).]

Issue 2

Section 305(b)(2) of the Code provides that § 301 will apply to a distribution by a corporation of its stock if the distribution, or a series of distributions that includes the distribution, has the result of the receipt of property by some shareholders, and increases in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

Section 305(c) of the Code authorizes regulations under which a redemption treated as a § 301 distribution will be treated as a § 301 distribution to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by the redemption.

Reg. § 1.305-7(a) provides that a redemption treated as a § 301 distribution will generally be treated as a distribution to which §§ 305(b)(2) and 301 of the Code apply if the proportionate interest of any shareholder in the earnings and profits or assets of the corporation deemed to have made the stock distribution is increased by the redemption, and the distribution has the result described in § 305(b)(2). The distribution is to be deemed made to any shareholder whose interest in the earnings and profits or assets of the distributing corporation is increased by the redemption.

Reg. § 1.305-3(b)(3) provides that for a distribution of property to meet the requirements of § 305(b)(2) of the Code, the distribution must be made to a shareholder in the capacity as a shareholder and must be a distribution to which § 301 [or one of several other specified sections]

applies. A distribution of property incident to an isolated redemption will not cause § 305(b)(2) to apply even though the redemption distribution is treated as a § 301 distribution.

Section 305 of the Code does not make the constructive stock ownership rules of § 318(a) applicable to its provisions.

The 16 shareholders of Z who did not tender any stock for redemption in 1976 experienced increases in their proportionate interests of the earnings and profits and assets of Z (without taking into account constructive stock ownership under § 318 of the Code) as a result of the redemptions. Shareholders B and X, who surrendered small amounts of their stock for redemption in 1976, also experienced increases in their proportionate interests. The 1976 redemptions were not isolated but were undertaken pursuant to an ongoing plan of annual stock redemptions. Finally, the 1976 redemptions are to be treated as distributions of property to which § 301 of the Code applies.

Accordingly, B, X and the 16 shareholders of Z who did not participate in the 1976 redemptions are deemed to have received stock distributions to which §§ 305(b)(2) and 301 of the Code apply. *See* Reg. § 1.305-3(e), examples (8) and (9) for a method of computing the amounts of the deemed distributions.

Questions and comments:

1. Notice: 40 is ⅔ of one percent of 6000. None of the shareholders of Corporation Z actually received any stock.

2. "*Deemed distributions*:" Notice that the transactions described in § 305(c) – "a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price,[100] a redemption which is treated as a distribution to which § 301 applies" – do not necessarily involve a distribution of stock – yet such transactions may have the result described in § 305(b)(2), i.e., receipt of property by some shareholders and increase in proportionate interest in the assets or earnings and profit by other shareholders. These and other transactions that the Secretary of the Treasury may prescribe in regulations are "deemed distributions" subject to treatment under § 305(b)(2, 3, 4, or 5).

3. If we deem that a distribution has occurred when it in fact has not occurred, how do we determine the number of shares the distributee received?

•Read Reg. § 1.305-3(e), Example 8. Methodology: Determine the *increase* in percentage ownership of the corporation to the non-tendering shareholder resulting from the distribution of cash to other shareholders that is subject to § 301. Hypothesize that percentage of ownership prior to the distribution to other shareholders. Determine the number of *additional* shares the non-tendering shareholder would have to own in order to

[100] A "de minimis" difference between redemption price and issue price is treated as a difference of zero. Reg. § 1.305-3-5(b)(1) (by cross-reference to § 1273(a)(3); ¼ of 1% multiplied by the number of years).

own that percentage of the corporation. Add that number to the non-tendering shareholder's shares. Divide that total into the fair market value of the corporation's outstanding shares after the actual distribution. The quotient is the non-tendering shareholder's dividend under § 301.

4. We have already studied redemptions and know that a corporation may intend a redemption to be an exchange, but fail to execute the redemption in a manner that permits the shareholder to treat her receipt of property as an exchange for her stock. Rev. Rul. 78-60 involved periodic distributions, i.e., annual. What should happen to a non-tendering shareholder if the failed redemption is a one-time event? After all, *every* redemption of the shares of less than all shareholder(s) will necessarily increase the proportionate interests of the other shareholders.

Read Reg. § 1.305-3(e), Example 10. It seems that the non-tendering shareholders are "safe." On the other hand, Reg. § 1.305-3(b) provides definitions and rules that make § 305(b)(2) broadly applicable. Reg. § 1.305-3(b)(4) creates a 36-month presumption: distributions that are not part of a plan separated by 36 months presumptively do not result in receipt of cash or property by some shareholders and an increase in proportionate interest by other shareholders.

5. *Conversion Ratios*: A corporation with convertible stock or convertible securities must, upon distribution of dividend stock, adjust its conversion ratio. Regs. §§ 1.305-3(d)(1)(*i*); 1.305-7(b)(1).

- A change in the conversion ratio may be a deemed distribution, but "a change in the conversion ratio of convertible preferred stock made pursuant to a bona fide, reasonable, adjustment formula that has the effect of preventing dilution of the interest of the holders of such stock will not be considered to result in a deemed distribution of stock." Rev. Rul. 77-37, 1977-1 C.B. 85, *citing* Reg. § 1.305-7(b)(1).

Problems:

1. Corporation had outstanding 4000 shares of A common and 24,000 shares of B common, a ratio of 1 A share to 6 B shares. These were the only classes of stock outstanding. All the voting power was held by the A stock before distribution and remained in the A stock following the dividend. Under a dividend resolution shares of A and B stock of the Company were issued pro rata among the stockholders so that for each share of A stock held, a dividend of ½ share of A was allotted, and for each share of B, ½ share of B. Appropriate amounts were transferred from the Company's surplus account to its capital account. No change was worked in the qualifications and preferences of the two classes of stock. Do some math. Is this a taxable dividend? *See* Reg. § 1.305-3(b)(6); *Wiegand v Commissioner,* 194 F.2d 479 (3d Cir. 1952).

2. Same facts plus the following: Class A common stock and Class B common stock share equally in any liquidating distributions. The Corporation pays a cash dividend to holders of A common and one share of B common for each share of B common. Have the holders of class B common received a distribution subject to § 301?

3. Same facts: Corporation pays one share of Class B common on each share of Class A common

and one share of Class A common on each share of Class B common. Have the holders of class A common and/or class B common received a distribution subject to § 301?

4. Corporation Y is organized with two classes of stock, class A common, and class B, which is nonconvertible and limited and preferred as to dividends. A dividend is declared upon the class A stock payable in additional shares of class A stock and a dividend is declared on the class B stock payable in cash. What is the tax consequence of Corporation Y's distribution of one share class A common to each shareholder of class A common?

•Work this problem for yourself. Then check your answer at Reg. § 1.305-3(e), Example 2.

5. Corporation K is organized with two classes of stock, class A common, and class B, which is nonconvertible preferred stock. A dividend is declared upon the class A stock payable in shares of class B stock and a dividend is declared on the class B stock payable in cash. What are the tax consequences of the distribution of class B shares to the holders of class A common?

5A. Suppose instead that Corporation K declared a dividend upon the class A stock payable in a new class of preferred stock that is subordinated in all respects to the class B stock. What would be the tax consequences on the distribution to the holders of class A common, each of whom received a share of this new class of preferred stock?

•Work this problem for yourself. Then check your answer at Reg. § 1.305-3(e), Example 3.

6. Corporation W has one class of stock outstanding, class A common. The corporation also has outstanding convertible preferred stock, whose rights to dividends are limited and preferred. The preferred stock is convertible at a fixed conversion ratio that is not subject to full adjustment in the event stock dividends or rights are distributed to the class A shareholders. Corporation W distributes to the class A shareholders rights to acquire additional shares of class A stock. During the year, a cash dividend is paid on the convertible preferred stock. *See* § 305(d)(1). What are the tax consequences to the class A shareholders?

•Work this problem for yourself. Then check your answer at Reg. § 1.305-3(e), Example 4.

7. For the mathematically-inclined: Corporation O has a stock redemption program under which, instead of paying out earnings and profits to its shareholders in the form of dividends, it redeems the stock of its shareholders up to a stated amount which is determined by the earnings and profits of the corporation. If the stock tendered for redemption exceeds the stated amount, the corporation redeems the stock on a pro rata basis up to the stated amount. During the year corporation O offers to distribute $10,000 in redemption of its stock. At the time of the offering, corporation O has 1000 shares outstanding of which E and F each owns 150 shares and G and H each owns 350 shares. The corporation redeems 15 shares from E and 35 shares from G. F and H continue to hold all of their stock. Assume that the cash E and G receive is taxable under § 301. What are the tax consequences to F and H? If you find this to be a distribution to which § 301 applies, how would you determine the value of that distribution?

•Work this problem for yourself. Then check your answer at Reg. § 1.305-3(e), Example 9. You may have to look this Example up by going to Westlaw, Lexis, or another source.

C. § 305(b)(3)

A distribution or series of distributions of stock that result in receipt of preferred stock by some common shareholders and receipt of common stock by other common shareholders is subject to § 301. Such distributions obviously increase the interest of some shareholders in the earnings and profits of the corporation and increase the interest of others in the assets of the corporation. Both groups of recipients are subject to income tax, irrespective of whether the preferred stock is convertible. Reg. § 1.305-4(a).

A distribution that facially appears not to fall within § 305(b)(3) may in fact fall within § 305(b)(3) if it "can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders." Reg. § 1.305-4(b), Example 2. Suppose that a corporation has only one class of common stock outstanding and it distributes newly issued preferred on that common. The preferred stock is convertible within 6 months at a price slightly higher than the price of common on the date of distribution. Taking all factors into account, it is reasonable to anticipate that some shareholders will exercise their conversion rights, and others will not. The distribution is one to which § 301 applies. *Id.*

Problem:
Corporation X is organized with two classes of common stock, class A and class B. Dividends may be paid in stock or in cash on either class of stock without regard to the medium of payment of dividends on the other class. A dividend is declared on the class A stock payable in additional shares of class A stock and a dividend is declared on class B stock payable in newly authorized class C stock which is nonconvertible and limited and preferred as to dividends. What are the tax consequences of these distributions?

•Work this problem for yourself. Then check your answers at Reg. § 1.305-4(b), Example 1.

D. § 305(b)(4)

Any distribution of stock with respect to preferred stock is one to which § 301 applies. The only exception to this is an increase in the conversion ratio of convertible preferred stock to take account of a stock dividend or stock split of the stock into which the preferred stock is convertible.

An adjustment of the conversion ratio is apparently the only means of protecting preferred shareholders from dilution resulting from the distribution of common on common. Protecting the

holders of convertible preferred from having their interest in the assets of the corporation diluted through distribution of a common on common dividend by issuing a proportionate amount of common on preferred is subject to § 301. Rev. Rul. 83-42, 1983-1 C.B. 76.

Protecting the cumulative preferred shareholder's interest in dividends to which she is entitled may not be accomplished through the distribution of common stock to such a shareholder. "The holder of cumulative preferred stock which, by its terms, gives the holder the right to elect to receive common stock of equivalent value to the accrued dividend account if cash dividends are not paid for two successive quarters, will constructively receive a distribution of common stock with respect to preferred stock taxable under section 301 of the Code by reason of § 305(b)(4) upon the passage of two successive quarters without the payment of cash dividends." Rev. Rul. 84-141, 1984-2 CB 80.

Problem:
Corporation was in arrears in paying dividends on the only class of preferred stock that it had issued. It declared a cash dividend on each share, payable only in shares of common stock of the corporation. Shareholder owned only preferred stock. After receipt of the common stock, shareholder sold all her preferred stock. How would you compute the basis of the preferred stock for purposes of determining shareholder's gain on the sale of the preferred stock? *Commissioner v Tillotson Mfg. Co.*, 76 F.2d 189 (6th Cir. 1935).

E. § 305(b)(5)

A distribution of convertible preferred stock is subject to § 301, unless the taxpayer can establish that such a distribution will not result in the receipt of property by some shareholders and an increase in the proportionate interests in the corporation's assets or earnings and profits by other shareholders.

With any distribution of convertible preferred stock, there is some level of probability that some holders of the preferred stock will exercise their conversion rights and others will not. Such a result would fall within § 305(b)(3) (some common shareholders receive common stock and some receive preferred stock). If that probability is sufficiently high, the distribution falls within § 305(b)(5).

The regulations offer the following guidance:

> The distribution of convertible preferred stock is likely to result in a disproportionate distribution when both of the following conditions exist:
>
> (a) the conversion right expires "within a relatively short period of time" after the distribution, and
>
> (b) taking into account such factors as dividend rights, redemption provisions,

> marketability, and conversion price, it may be anticipated that some shareholders will exercise their conversion rights and others will not.

Reg. § 1.305-6(a)(2). On the other hand:

> [W]here the conversion right may be exercised over a period of many years and the dividend rate is consistent with market conditions at the time of distribution of the stock, there is no basis for predicting at what time and the extent to which the stock will be converted and it is unlikely that a disproportionate distribution will result.

Id. The regulations offer two contrasting examples. In one example, the conversion right expires after 20 years. In the other example, the conversion right expires after four months and there is a willing buyer of the preferred stock. In the first example, it was "impossible to predict the extent to which the" preferred stock will be converted into common stock. In the second example, it was anticipated that the holders of the preferred stock would either sell to the willing buyer or convert. The second case falls within § 305(b)(5), and the first does not. This is hardly precise guidance. Perhaps it does not need to be precise because §§ 305(b)(3 and 5) essentially cover the same ground. *Compare* Reg. § 1.305-4(b), Example (2) (applying § 305(b)(3); six-month deadline for conversion; facts fall within § 305(b)(3)) and Reg. § 1.305-6(b), Example 2 (applying § 305(b)(5); four-month deadline for conversion; facts fall within § 305(b)(5)).

Do the CALI exercise: Corporate Taxation: Distributions: Distributions of Interests by C Corporations.

III. Section 307: Basis in Dividend Stock

A basic principle – not universally applicable – is that all income (i.e., accessions to wealth) is subject to income tax in the hands of a taxpayer once – and only once. We assure that we do not tax income more than once by assigning "basis" to any item on which taxpayer spends her already-taxed income. "Basis" is money not to be subject to income tax (again).

When a stock dividend is not included in gross income, the dividend stock presumptively does not increase or decrease the value of the corporation. Hence, if non-taxed dividend stock has value, it must have taken that value dollar-for-dollar from the stock with respect to which the stock was distributed. The sum of the fair market value of the dividend stock and the fair market value of the stock with respect to which the dividend stock was distributed must equal the fair market value of the stock with respect to which the dividend stock was distributed immediately prior to the distribution. The distribution itself cannot create basis. Since we are not taxing the receipt of stock, we must allocate existing basis among the "old" stock and the "new" stock. We allocate existing basis among old and new stock according to the relative fair market value of each. *See Chapman v. United States*, 63 Ct. Cl. 106, 111, *cert. denied*, 275 U.S. 524 (1927) (basis of original 1800 shares was $48/share; after non-taxable stock dividend of 3600 shares,

basis was $16/share). Early on, the Commissioner applied this method of allocating basis with approval of courts. *See, e.g.*, *Appeal of S. Thomas Fuller*, 4 B.T.A. 992, 993, 1926 WL 559 (1926). Now it is the rule of § 307(a). The holding period of the "old" stock is tacked to the holding period of the "new" stock. § 1223(4).

Of course, if a stock dividend *is* subject to income tax, taxpayer pays income tax on the fair market value of the stock received – and acquires a tax basis in that stock equal to the value on which taxpayer paid income tax. Reg. § 1.301-1(h)(1 and 2(i)). There is no tacking of the holding period of the "old" stock. *Cf.* § 1223(4) (basis not determined under § 307).

Right to Acquire Stock: Section 305(d)(1) provides that the term "stock" includes rights to acquire such stock. Thus, the basis of such rights should be included in the determination of the relative fair market values of stock. This rule only applies if the stock rights are exercised or sold. Reg. § 1.307-1(a) (last sentence). The holding period of stock acquired through the exercise of rights to acquire it begins on the date taxpayer exercises that right. § 1223(5). Moreover, if the fair market value of such rights is less than 15% of the fair market value of the old stock, the fair market value of such rights does not have to be included in such a determination, § 307(b)(1), unless the taxpayer elects otherwise, § 307(b)(2).

Problems:

1. LaTonya owns 500 shares of Class A voting common of Pelham Corporation. Pelham Corporation has 100,000 shares of Class A voting common outstanding, and this is its only class of stock outstanding. LaTonya's basis in her 500 shares is $10,000. Its fair market value is $15,000. In a non-taxable distribution, Pelham distributes one share of newly issued Class A common shares for each share of Class A common shares that a shareholder owns. LaTonya received 500 shares in this distribution.

•What is the basis of each of her shares of Class A voting stock?

2. Same facts, except that Pelham Corporation distributed a non-taxable stock dividend of one share of newly issued Class B non-voting common for each share of Class A common share that a shareholder owns. LaTonya received 500 shares of Class B non-voting common in Pelham Corporation. The total value of LaTonya's 500 shares of Class B non-voting common is $6000.

•What is the basis of each of her shares of Class A stock and of each of her shares of Class B stock?

3. A taxpayer in 1947 purchased 100 shares of common stock at $100 per share and in 1954, by reason of the ownership of such stock acquired 100 rights entitling her to subscribe to 100 additional shares of such stock at $90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of $110 and the rights had a fair market value of $19 each.

•What is the basis of the rights to acquire more stock and of the common stock?

•Suppose taxpayer exercises her right to acquire 100 more shares of stock for $90/share. What is her basis in each share of stock that she purchases? What is her basis in each of her shares of "old" stock, i.e., the stock with respect to which the subscription rights were distributed?

•Work this problem. Then check your answer at Reg. § 1.307-1(b), Example.

Stripped Preferred Stock, § 305(e): Section 305(e) prescribes the tax treatment of dispositions of so-called "stripped preferred stock."

•"Stripped stock" is stock whose ownership interests of the stock itself and the right to receive dividends that have not become payable have been separated. § 305(e)(5)(A). "Stripped stock" must be limited and preferred as to dividends, may not participate in corporate growth to any significant extent, and must have a fixed redemption price. § 305(e)(5)(B).

Purchaser of Stripped Stock: A taxpayer who purchases "stripped preferred stock" must treat the "stripped preferred stock" as a bond and recognize the difference between the redemption price and the price paid for such stock as original issue discount. § 305(e)(1). The same is true of anyone who receives such stock if the basis of the stock is determined by reference to the basis of the stock in the hands of the seller, e.g., by gift. § 305(e)(1, 6).

•Treatment of the stock as a bond with original issue discount has the consequence of requiring recognition of periodic payments as they accrue. Section 305(e)(4) provides that the purchaser must treat any amount included in "gross income" as "ordinary income." Because it is "ordinary income," an individual taxpayer may not treat such income as qualified dividend income under § 1(h)(11) or as interest income. Such recognition of income will require periodic (upward) adjustments to the taxpayer's basis in the "stripped preferred stock." § 305(e)(2).

Seller of Stripped Stock: The person who "strips" the preferred stock and then sells the "stripped stock," must treat the difference between the redemption price and her adjusted basis in the stock as original issue discount. § 305(e)(3). Congress intended no inference concerning the allocation of basis by the creator of stripped stock, (See H.R. REPT. NO. 103-213, at 578 (1993) but logically the seller should allocate basis between the interests into which the stock has been divided according to their relative fair market values.

IV. Section 306 Stock

Ownership of stock gives a shareholder certain interests in the corporation, e.g., right to vote, right to share in dividends, right to share in proceeds upon liquidation. A corporation might split a shareholder's interest into its constituent parts by issuing different classes of shares. For example, a corporation might exchange one share of class B voting common stock, one share of class C non-voting common stock, and one share of class D non-voting preferred for each share of class A common stock – its only class of stock outstanding. Such a splintering of a shareholder's interest would not change the shareholder's total interest in the corporation – either by value or by control. It also would not alter the assets or earnings and profits of the corporation. If the corporation's distribution of such stock to its shareholders altered the total interests of none of them, the distributions should not be subject to income tax. Indeed, the United States Supreme Court held that a corporation's distribution of "preferred on common" to its only shareholder of its only class of stock did not constitute the distribution of a taxable dividend. *Helvering v. Sprouse*, 318 U.S. 604, 607 (1943) ("the distribution brought about no change whatever in his interest in the

corporation. Both before and after the event, he owned exactly the same interest in the net value of the corporation as before.”).

> •The splitting of common stock into common stock plus preferred stock gives shareholders something they can sell at a capital gain (i.e., preferred stock) without giving up any control rights. Shareholders of a corporation that has substantial accumulated earnings and profits can essentially “bail out” those earnings and profits at capital gain rates by selling the preferred stock. If the purchaser of the preferred stock happened to be a corporation, the issuing corporation could distribute dividends to it that would be subject to very little income tax. *Cf.* § 243(a) (dividends-received deduction).

In *Chamberlin v. Commissioner*, 207 F.2d 462 (CA6 1953), *cert. denied*, 347 U.S. 918 (1954), taxpayers owned stock in a closely-held corporation with substantial earnings and profits and executed such a “preferred stock” bail out. The corporation distributed a preferred on common stock dividend. The Commissioner argued facts-and-circumstances to claim that the proceeds of the subsequent sale of the shares of preferred stock were dividends taxable as ordinary income. This argument prevailed in Tax Court, but the United States Court of Appeals for the Sixth Circuit reversed. The issuance of the preferred stock dividend was legal, and whether it furthered a corporate purpose was irrelevant. *Id.* at 469. A purpose to avoid income tax did not change a nontaxable legal stock dividend into a taxable one. *Id.* The sale of dividend stock by the recipient does not transform the stock dividend from nontaxable to taxable. *Id.*

Congressional reaction to *Chamberlin* was swift. Its response was to enact § 306. There is now something called “section 306 stock.” A corporation distributes “section 306 stock” by distributing stock at a time when it could have paid a cash dividend instead. Indeed, if a corporation could not have paid a cash dividend at the time of distributing stock because it has no earnings and profits at the time of its distribution, the stock is not “section 306 stock.” § 306(c)(3). The tax consequences associated with the distribution of such stock are determined only upon disposition of the “section 306 stock,” not upon its distribution. The tax consequences turn on how the shareholder disposes of the “section 306 stock.”

A. Dispositions of Section 306 Stock: Tax Consequences

“Dispositions other than redemptions”: A “disposition other than a redemption” must necessarily be a disposition to a third party, e.g., disposition by sale or exchange. The consideration for the disposition therefore does not come from the corporation. Section 306(a)(1)(A) treats such dispositions as if a cash dividend had been paid upon distribution of the stock instead of a nontaxable stock dividend; the amount of the dividend is limited to the shareholder’s ratable share of the corporation’s earnings and profits on the date of distribution. Section 306(a)(1)(A) does not call the taxable income “dividend income,” but rather “ordinary income.” Section 306(a)(1)(D) provides that individuals may treat such “ordinary income” as a “dividend” for purposes of applying § 1(h)(11). A corporation may not avail itself of the

dividends-received deduction of § 243. The "amount realized" is treated as gain – but not loss (§ 306(a)(1)(C)) – to the extent that it exceeds the amount treated as a dividend plus the adjusted basis of the stock. § 306(a)(1)(B).

- The shareholder may not claim a loss on such a sale, § 306(a)(1)(C), but excess basis is added to the basis of the common stock with respect to which the stock dividend was distributed. Reg. § 1.306-1(b)(2), Example 2. This is true even if taxpayer sold only a portion of her "section 306 stock" and retained some to which the excess basis might have been assigned. Reg. § 1.306-1(b)(2), Example 3.
- The examples cited provide that excess basis is assigned to the common stock "with respect to which the preferred stock was distributed." The seller of the § 306 stock might not own the common stock at the time of sale; it seems that the generalized language of the examples leads to the conclusion that the basis is assigned to the stock, no matter who owns it.

Dispositions by redemption: A disposition of "section 306 stock" by redemption is treated as a distribution of property to which § 301 applies. § 306(a)(2). The extent to which the distribution is a dividend (or a return of capital or capital gain) depends on the earnings and profits of the corporation on the date of the redemption. Essentially, a disposition by redemption is treated as if the preferred stock had never been issued and the corporation made a distribution on the date of the redemption – except no provision is made for the application of § 302. The dividends-received deduction would be available to a corporate shareholder.

B. Definition of Section 306 Stock

In enacting § 306, Congress addressed a particular abuse, i.e., using a nontaxable distribution of preferred stock to bail out corporate earnings at capital gain rates without shareholder surrender of ownership or control rights in the corporation. If the receipt of stock facilitates such bailing out, it should be considered section 306 stock. If the receipt of stock does not facilitate such a bailing out, we expect it not to be section 306 stock – or at least subject to an exception to the applicability of § 306.

Section 306(c) does not leave matters to the participants to characterize stock as "preferred." A key concept in § 306(c) is "stock other than common stock." The following revenue rulings give an idea of the considerations that control.

Rev. Rul. 75-236, 1975-1 C.B. 106

X corporation had outstanding 1,000 shares of common stock all of which were held by five related individuals. X issued two new classes of stock, class A and class B, and distributed both classes pro rata to each individual shareholder in exchange for his X common stock in a transaction that qualified as a reorganization as defined in § 368(a)(1)(E) of the Code. No gain or

loss was recognized to the X shareholders upon the exchange of their common stock solely for class A and class B stock under § 354(a)(1). X had earnings and profits at the time of the exchange.

The class A stock has a par value of $10 per share, is nonredeemable, is voting stock, is entitled to noncumulative preferred dividends of five percent of par value prior to the payment of any dividends on the class B stock and is entitled to share equally with the class B stock upon liquidation in proportion to but not in excess of its par value. The class B stock has a par value of $10 per share, is nonredeemable, is nonvoting, has unlimited rights to dividends, subject to the prior rights of the class A stock, and on liquidation is entitled to all of the assets remaining after the required distributions to the holders of the class A stock. Neither class of stock has a fixed or determinable redemption price.

The transaction was undertaken in order to make growth stock (class B) available to key employees of the corporation and, at the same time, restrict managerial control of the corporation to the present shareholders through their ownership of class A stock. By restricting the growth of the class A stock, upon the death or retirement of any of the present shareholders, the remaining shareholders will be able to purchase the class A stock for a sum within their means and control of the company will, therefore, not fall into the hands of inexperienced persons. At the same time the heirs of the deceased shareholders will share in the growth of the company through their ownership of the class B stock.

Section 306(c) of the Code defines "section 306 stock," in part, as stock which is not common stock and which was received in a reorganization within the meaning of § 368(a) where no gain or loss was recognized upon its receipts, but only to the extent that the effect of the transaction was substantially the same as the receipt of a stock dividend. Reg. § 1.306-3(d) provides, in part, that ordinarily "section 306 stock" includes stock which is not common stock received in pursuance of a plan of reorganization if cash received in lieu of such stock would have been treated as a dividend under § 356(a)(2) or as a distribution to which § 301 applies by reason of § 356(b) or § 302(d).

Section 306(a) of the Code provides generally that if a shareholder sells or otherwise disposes of "section 306 stock" and (1) if the disposition is a redemption, the amount realized shall be treated as a distribution of property to which § 301 applies, or (2) if the disposition is not a redemption, the amount realized shall be treated as gain from the sale of property which is not a capital asset and no loss shall be recognized.

In the instant case, the class A stock distributed in the reorganization is limited and preferred as to dividends, has limited rights upon liquidation, does not participate in corporate growth to any significant extent and was distributed pro rata to the shareholders of X. Therefore, even though the class A stock is the only voting stock of X outstanding, it is stock other than common stock. *See* Reg. § 1.305-5(a). Had cash been distributed in lieu of the class A stock in the recapitalization, this distribution would have been treated as a dividend under § 356(a)(2) of the Code. Therefore, the distribution of the class A stock has substantially the same effect as the

receipt of a dividend on the class B stock.

Accordingly, the class A stock issued in the instant case is "section 306 stock" within the meaning of section 306(c) of the Code.

Questions and comments:

1. Class A shareholders had voting control of the corporation, yet their stock was "section 306 stock." What are the determinative points that made class A shares "section 306 stock?"

2. In Rev. Rul. 81-91, 1981-1 C.B. 123, the IRS considered these facts:

> A corporation had outstanding a single class of common stock held by 10 individuals, each of whom owned 20 shares. ... [T]he corporation entered into a plan of [nontaxable] recapitalization under which each outstanding share of common stock was surrendered to the corporation in exchange for one share of new class A stock plus one share of new class B stock of the corporation.
>
> Each share of the class A and class B stock had a par value of 10x dollars. The class B shares were entitled to an annual cumulative dividend of 6 percent of par value payable before any dividend was payable on the class A shares, and a prior right to repayment up to par value in the event of liquidation. After the satisfaction of the class B stock's preferences, each share of class A and class B stock shared equally as to dividends and on liquidation. Each class of shares carried equal voting rights and neither class was by its terms redeemable.

The IRS determined that the class B stock would not be section 306 stock because it

> enjoys voting rights on an equal basis with the class A stock, the only other class of stock outstanding. After satisfaction of its preference as to dividends and as to assets in the event of liquidation, the class B stock shares equally with the class A stock. These rights in the class B stock to participate in corporate growth are significant. Thus, a sale of the class B stock cannot occur without a loss of voting control and interest in the unrestricted growth of the corporation. Therefore, the bailout abuse that Congress sought to prevent by the enactment of section 306 cannot be effected through a sale of the class B stock.

The IRS offered the following as determinative considerations:

> The potential for a preferred stock bailout exists if the shareholders receive a pro rata distribution of two classes of stock in a recapitalization when the corporation has earnings and profits, and the stock of one class, because of its terms, can be disposed of without a surrender by the shareholders of significant interests in corporate growth. Thus, stock is "other than common stock" for purposes of § 306 not because of its preferred position as such, but because the preferred position is limited and the stock does not

participate in corporate growth to any significant extent.

3. Common stock that can be converted into stock other than common stock is not common stock. § 306(e)(2).

Rev. Rul. 81-186, 1981-2 C.B. 85

ISSUE

Is preferred stock received by the sole shareholder of a company in exchange for a portion of such shareholder's common stock "section 306 stock" within the meaning of § 306(c) of the ... Code, when, as part of an integrated plan, the shareholder thereafter disposes of the remaining common stock by gift?

FACTS

A domestic corporation, X, had outstanding solely 100 shares of common stock, all of which stock had been owned by A for many years. The officers of X were B, C, and D, who were, respectively, president and board chairperson, secretary, and treasurer. Operations of X were managed mainly by B and C. In addition, A, B, and C were friends of long standing, although B and C were in no way related to A. D was married to A's brother. A had no spouse or children. At the time of the transaction, A desired to be completely removed from all active business interests and to give the growth potential of X to B, C, and D. Accordingly, pursuant to an integrated plan, the following three steps were taken. First, X was authorized to issue new shares of nine percent cumulative, nonconvertible, nonvoting preferred stock. Second, A surrendered to X 97 shares of X common stock in exchange for X preferred stock of an equal fair market value. Third, immediately thereafter A gave the three remaining shares of X common stock, one share each, to B, C, and D. The transfers of these three shares were subject to the gift tax provisions of ... the Code. The transfers did not result in any increase in the amount includible in the income of B, C, or D, since the transfers were motivated solely by A's donative intent and were not in consideration of either past or future services.

The total of X's accumulated and current earnings and profits (within the meaning of § 316(a)(1) and (2) of the Code) applicable to a distribution made at the time A received the X preferred stock exceeded the fair market value of this preferred stock. None of the 100 shares of X common stock held by A was "section 306 stock" within the meaning of § 306(c) of the Code. A had no plan or intent to sell or otherwise dispose of any of the X preferred stock received. Nor was there any plan or intent for A (or for any person related to A within the meaning of § 318 of the Code) to receive any X common stock.

LAW AND ANALYSIS

Section 368(a)(1)(E) of the Code defines the term "reorganization" to include a recapitalization.

Reg. § 1.368-2(e)(3) states that a recapitalization takes place if a corporation issues preferred stock for outstanding common stock.

Under § 354 of the Code, a shareholder exchanging stock for stock in a recapitalization will not recognize gain or loss on the transaction.

Section 306(c)(1)(B) of the Code, in part, defines "section 306 stock" as stock received in a reorganization that is not common stock and with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of part III of subchapter C of chapter 1, but only to the extent that the effect of the transaction was substantially the same as the receipt of a stock dividend.

Under Reg. § 1.306-3(d), ordinarily, section 306 stock includes stock, which is not common stock, received in pursuance of a plan of reorganization (within the meaning of § 368(a) of the Code) if cash received in lieu of such stock would have been treated as a distribution to which § 301 applies by reason of § 302(d).

Under § 302(d) of the Code, if a corporation redeems its stock and if § 302(a) does not apply, such redemption shall be treated as a distribution of property to which § 301 applies. Section 302(a) provides that if a corporation redeems its stock and if § 302(b)(1), (2), (3), or (4) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock. Section 302(b)(3) provides that § 302(a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

In the present situation, A's receipt of X preferred stock in exchange for X common stock constituted a recapitalization and a reorganization within the meaning of § 368(a)(1)(E) of the Code. No gain or loss was recognized to A in accord with § 354. Thus, under Reg. § 1.306-3(d), the preferred stock received by A will be section 306 stock if cash received in lieu of such stock would have been treated as a distribution to which § 301 of the Code applied by reason of § 302(d).

For purposes of this cash-in-lieu test, it is proper to apply the rationale of *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). Under the *Zenz* rationale, there is a complete termination of shareholder interest for purposes of § 302(b)(3) of the Code when a shareholder disposes of his or her entire stock interest in a company partly through redemption and partly through a sale or gift pursuant to an integrated plan. Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 77-226, 1977-2 C.B. 90; Rev. Rul. 55-745, 1955-2 C.B. 23. *See also*, *Estate of Lukens v. Commissioner*, 246 F.2d 403 (3rd Cir. 1957); and Rev. Rul. 77-293, 1977-2 C.B. 91. Moreover, the sequence of events (whether the redemption comes before or after the sale or gift) is irrelevant for section 302(b)(3) purposes, as long as both events are part of an integrated plan. Rev. Rul. 77-226. *See* Rev. Rul. 75-447, 1975-2 C.B. 113.

In applying the cash-in-lieu test and the *Zenz* rationale, X's hypothetical redemption for cash of 97 shares of A's X stock, together with A's disposition of the remaining three shares of A's X

stock by gift, would result in a complete termination of A's stock interest in X within the meaning of § 302(b)(3) of the Code. Thus, the cash received by A would be treated in accord with § 302(a) as a distribution by X in exchange for its stock, and not as a distribution of property to which § 301 applies by reason of § 302(d). Accordingly, the receipt of the preferred stock is not substantially the same as the receipt of a stock dividend within the meaning of § 306(c)(1)(B) of the Code.

HOLDING

The X preferred stock received by A in exchange for a portion of the X common stock owned by A is not "section 306 stock" within the meaning of § 306(c) of the Code, when, as part of an integrated plan, A thereafter disposed of A's remaining common stock by gift.

Questions and comments:

1. Is a bailout of earnings and profits possible in the facts of this revenue ruling?

2. The section 306 "taint" is not lost simply by disposing of the stock other than by redemption, sale, or exchange. If the basis of any stock is determined by reference to the basis of the section 306 stock, i.e., carryover or substituted basis, it is (or remains) section 306 stock. Thus, the recipient of a gift of section 306 stock owns section 306 stock. Similarly, the common stock that the owner of section 306 stock receives in a tax-deferred exchange becomes section 306 stock. § 306(c)(1)(C). *See* Reg. § 1.306-3(e) ("common stock can be section 306 stock").

> •Notice that the basis of inherited section 306 stock is determined by the stock's fair market value at the time of death, § 1014, not by reference to its basis in anyone else's hands. Thus, death beats the section 306 taint. *See* Reg. § 1.306-3(e) (last sentence).
>
> •And of course, the purchaser of section 306 stock takes a cost basis, § 1012, and so the purchase cuts off the section 306 taint.

3. In a transaction to which § 351 applies, the section 306 taint attaches to any stock that is not common stock that would have been a dividend if cash had been received instead of such stock. § 306(c)(3). In Rev. Rul. 79-274, 1979-2 C.B. 31, the IRS considered the following set of facts: "Corporation X had outstanding 3000x shares of common stock which were owned 1500x each by individuals A and B. Corporation X is engaged in an ongoing business. For good business purposes A and B organized corporation Z and transferred all the stock of X to it. In exchange therefor A and B each received 500x shares of Z voting preferred stock and 1,000x shares of Z voting common stock." The IRS determined that the Z voting preferred stock was section 306 stock.

In the Tax Equity and Fiscal Responsibility Act of 1982,[101] Congress added § 306(c)(3) to the Code to reach the same result, *and* to apply rules "similar to" those of § 304(b)(2) in determining whether the distribution of cash would have been a dividend. That provision of course would make available the earnings and profits of both X corporation and Z corporation to determine whether the payment of cash would have been a dividend. Moreover, the more expansive attribution rules of § 304(c)(3)(B) apply. § 306(c)(4).

C. Exceptions

Section 306 by its terms contains certain exceptions. Such exceptions identify occasions where there is no risk of a bailing out of a corporation's earnings and profits as capital gains. These exceptions come in two forms: (1) § 306(b) identifies transactions where § 306(a) does not apply; however, the stock involved in such transactions may remain § 306 stock; (2) §§ 306(c)(2) and 306(e)(1) identify stock that is not section 306 stock.

No bailout risk: Section 306(a) does not apply to a disposition that terminates the shareholder's *entire* interest – including an interest by attribution under § 318(a) – in the corporation. § 306(b)(1). Section 306(a) does not apply to a redemption in complete liquidation of the corporation. § 306(b)(2). Section 306(a) does not apply to situations where gain or loss is not recognized on the disposition of the section 306 stock. § 306(b)(3). When taxpayer establishes to the satisfaction of the Secretary of the Treasury that tax avoidance was not a "principal" purpose of the distribution, disposition, or redemption of section 306 stock, whether or not simultaneously with the disposition or redemption of the common stock with respect to which the section 306 stock was distributed, § 306(a) does not apply. § 306(b)(4). A shareholder's disposition of some but not all her common stock does not necessarily establish that tax avoidance was a "principal" purpose of the issuance and disposition. *See* Rev. Rul. 75-274, 1975-1 C.B. 104.

Stock that is not section 306 stock: If a corporation has no earnings and profits and distributes stock other than common stock, it is not section 306 stock. § 306(c)(2). This provision makes clear that § 306 is aimed at bailing out earnings and profits. There can hardly be a bailout of earnings and profits if there are no earnings and profits. Reg. § 1.306-3(a). If a shareholder exchanges section 306 stock distributed with respect to common stock of a corporation for common stock in the same corporation, the common stock so received is not section 306 stock. § 306(e)(1). A shareholder acquires a greater interest in such an exchange than merely a right to receive dividends.

Problems:

1. The Sole City Corporation's business is manufacturing shoes. It has eight shareholders (A, B,

[101] P.L. 97-248, § 226(b).

C, D, E, F, G, and H), each owning 100 shares of the corporation's class A common stock. Each has a basis of $200/share in her stock (total basis of each = $20,000). This is the only outstanding Sole City stock. The corporation was very profitable, and by year 6 its value had grown to $1M. At that time its earnings and profits was $800,000. In year 6, the corporation issued one share of nonvoting, 6% nonconvertible preferred stock on each share of common. The preferred stock had a liquidation preference and a fair market value of $400/share.

A. Is the preferred stock section 306 stock? If so, is receipt of it by the eight shareholders subject to income tax?

B. What would be the fair market value of each share of common stock just prior to the distribution of the preferred stock dividend? What would be the fair market value of each share of common stock immediately after the distribution of the preferred stock? What would the basis of each share of common stock and each share of preferred stock be immediately after the distribution?

2. Same as #1. By year 10, Sole City's earnings and profits had grown to $1M. The value of the corporation had grown to $1.6M. The value of each share of common stock was $1200/share. The value of each share of preferred stock was $800/share. In year 10 –

A. Shareholder A caused Sole City Corporation to redeem all of her preferred stock for $80,000. What are the tax consequences to shareholder A and to Sole City Corporation?

B. Shareholder B sold all her Sole City Corporation preferred to I, an unrelated investor for $80,000. What are the tax consequences to shareholder B and to Sole City Corporation? Does I now own section 306 stock? What is I's basis in her Sole City Corporation preferred stock?

C. Shareholder C died and left all her stock to her son J. What are the income tax consequences to C's estate? What is J's basis in his common and preferred stock?

D. Shareholder D, together with other investors, formed the Broken Heel Corporation in a § 351 transaction. Broken Heel has no earnings and profits. Shareholder D transferred all her preferred stock to the Broken Heel Corporation in exchange for 200 shares of Broken Heel Corporation common stock. What is D's basis in the Broken Heel common stock? Is it section 306 stock? Suppose that D received nonqualified preferred stock of Broken Heel Corporation rather than common stock. What are the tax consequences to D? What is D's basis in the Broken Heel Corporation preferred stock?

E. Shareholder E gifted all of his preferred to stock to his favorite charity – the National Organization for the Preservation of High Corporate Tax Rates (assume that there's a charitable purpose there somewhere). May E claim a charitable contribution deduction? For how much? *See* Rev. Rul. 57-328, 1957-2 C.B. 229.

- The charity, assuming it's a § 501(c)(3) organization, will pay no income tax upon sale of the stock.

3. Sole City Corporation was caught importing shoes from Mexico and the nation's president slapped a 35% tariff on those shoes. Sole City's sales have slumped badly. In year 12, the value of the corporation dipped to $800,000. The value of each share of its common stock is $600/share, and the value of each share of its preferred stock is $400/share. The corporation's earnings and profits in year 12 are $200,000. In year 12 –

A. Shareholder F caused Sole City Corporation to redeem all her preferred stock for $40,000. What are the tax consequences to F and to Sole City Corporation?

B. Shareholder G caused Sole City Corporation to redeem all her common and preferred stock for $100,000. What are the tax consequences to G and to Sole City Corporation?

C. H gifted all her preferred stock to her son K in year 10. K sold the preferred stock to L in year 12. What are the tax consequences to K, L, and to Sole City Corporation?

For review:
Do the CALI exercise: Corporate Taxation: Distributions: Defining Section 306 Stock.

Do the CALI exercise: Corporate Taxation: Distributions: Section 306 Exceptions.

Chapter 6: Liquidations

I. Introduction

Read § 346(a). Skim § 336, 331, 337, 332, 334.

Section 346(a) provides that "a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of series of distributions in redemption of all of the stock of the corporation pursuant to a plan." Read § 346(a) carefully, and you realize that it does not actually provide a definition of "complete liquidation" – but rather an example of a complete liquidation, i.e., distribution in redemption of all of a corporation's stock pursuant to a plan. Nevertheless, § 346(a) is helpful in that it provides the critical elements of a liquidation, i.e., a distribution from the corporation to shareholders in redemption of all their stock.

What is important is that the corporation distributes *all* its assets in exchange for *all* its stock. The corporation pays for its stock with money or with appreciated or depreciated assets, and we may choose to recognize gain/loss or defer recognition of gain/loss. The shareholders in turn exchange appreciated or depreciated stock for money or assets, and we may choose to recognize gain/loss or defer recognition of gain/loss. The shareholders wind up with all the corporation's assets and none of its stock. The corporation winds up with all its stock and none of its assets.

Liquidation may be the natural result of a business failure and a precursor to a complete dissolution. It may also be one of a series of transactions that are undertaken to achieve a certain result. For example, an asset purchase followed by a liquidation is one means of accomplishing a business acquisition. An acquiring corporation purchases the assets of a target corporation so that shareholders of the target corporation own shares in a corporation that owns only the consideration given for the assets. The target corporation then liquidates. In this manner, the acquiring corporation has taken over the business and assets of the liquidating corporation without purchasing the stock of the liquidating corporation. The acquiring corporation has not assumed the liabilities of the target corporation, and the shareholders of the target corporation do not retain any ongoing interest of the corporation. A liquidation was a critical transaction in accomplishing an acquisition with these characteristics. Or a liquidation may facilitate an adjustment within a group of commonly owned corporations. For example, the subsidiary of a parent may transfer all its asset to its parent and then liquidate. We examine later the tax rules governing liquidation of a subsidiary corporation. Transactions such as these provide variety and complexity to the subject of liquidations – and we begin here with examination only of the basic statutory framework of the tax consequences of liquidations.

Tax treatment of liquidating distribution: The Code provides two quite different tax treatments of liquidations, both of the liquidating corporation and of the shareholders who receive the corporation's assets in exchange for their stock. The difference turns on whether the liquidating corporation is held as a subsidiary by another corporation. A subsidiary is a corporation that is at

least 80% owned, by vote and value, by another corporation. § 332(b)(1), *cross-referencing* § 1504(a)(2).

Begin with § 336(a). It is a residual or default provision, i.e., it applies when no other provision is applicable. That is the effect of the language "[e]xcept as otherwise provided in … section 337[.]"

- •Section 336(a) provides that a liquidating corporation recognizes gain or loss upon its *complete liquidation* and *distribution of its property*.
- •Section 331(a) provides that a shareholder treats amounts received in a distribution in complete liquidation of a corporation as payment for his stock.
- •Section 332(a) provides that a corporation that receives a distribution of property in *complete liquidation* of another corporation in which it has an 80% ownership interest by vote and value recognizes no gain or loss.
- •Section 337(a) provides that a subsidiary recognizes no gain or loss when § 332 applies to its liquidating distribution of property to its corporate parent.
- •Section 334(a) states basis rules applicable to non-subsidiary liquidations.
- •Section 334(b) states basis rules applicable to subsidiary liquidations.

"Distribution of property in complete liquidation": The tax treatments of §§ 331/336 and §§ 332/337 are accorded only to a "distribution of property in complete liquidation" of a corporation."

II. Nonsubsidiary Liquidation

The liquidation of a nonsubsidiary can be viewed as the final reckoning of the corporation's taxable profits and losses. The liquidating corporation ceases to be a taxable entity, and liquidation will be the last opportunity to collect income tax on its realized but unrecognized income. Both shareholders and distributing corporation must recognize gain *or loss* on the distribution. §§ 331(a)/336(a). Section 336(a) spells this out for the liquidating corporation, i.e., "as if such property were sold to the distributee at its fair market value." Section 331(b) provides that § 301 is *not* applicable to distributions in complete liquidation. The earnings and profits of the liquidating corporation simply disappear. Thus, the income that earnings and profits represent to shareholders on which there should have eventually been a tax (i.e., upon distribution(s) to shareholders) disappears. The distribution is treated as an exchange, not as a distribution of (taxable) profits. If there are losses, they will probably be capital losses – which can be offset only by capital gains. § 1211. Because gains and losses are subject to income tax at the shareholder level, the shareholder takes a fair market value basis in the assets received – not a carryover basis. § 334(a). There is of course no tacking of any holding period when the shareholder takes a fair market value basis in assets rather than a carryover basis.

If a shareholder takes property subject to a liability, the shareholder's "amount realized" is reduced by the amount of the liability. Why should the shareholder get a fair market value basis

when the shareholder's "amount realized" does not include the liability that the shareholder assumes? What should be the result if the liability is contingent, speculative, or unknown?

The corporation will measure its gain by the fair market value of property that it distributes less the adjusted basis of the property. The corporation that distributes property subject to more liability than the property's fair market value must treat the fair market value as not less than the liability. § 336(b). A liquidating corporation that is unprofitable but owns property can find that liquidation can be particularly expensive. What strategies does the following case suggest? When should a corporation consider adopting such strategies?

Norwalk v. Commissioner, T.C. Memo 1998-279

MEMORANDUM FINDINGS OF FACT AND OPINION

RUWE, Judge: These consolidated cases involve transferee liability [and] deficiencies ...

....

After concessions by the parties, the issues for decision are: (1) Whether DeMarta & Norwalk, CPA's, Inc. (the corporation), realized a gain of $588,297 on the distribution of its intangible assets to its shareholders in a liquidation; ... (3) whether Robert and Patricia DeMarta realized a capital gain of $505,935 on the receipt of property from the corporation in a liquidating distribution in 1992; (4) whether William R. Norwalk realized a capital gain of $165,940 on the receipt of property from the corporation in a liquidating distribution in 1992; ...

FINDINGS OF FACT

....

In 1985, Messrs. DeMarta and Norwalk organized DeMarta & Norwalk, CPA's, Inc., which was incorporated in California on August 14, 1985. The business of the corporation was the practice of public accounting. At all times during the corporation's existence, Messrs. DeMarta and Norwalk have been its only shareholders.

On September 3, 1985, Messrs. DeMarta and Norwalk signed separate agreements with the corporation regarding their respective ownership interests in, and rights and duties regarding, the corporation. Each agreement is entitled "Employment Agreement." The effective date set forth on these agreements was October 1, 1985, and each provides, among other things, the following:

> TERM
>
> 5. The term of employment shall be five years from the date specified in Schedule A attached to this Agreement …

….

RESTRICTIVE COVENANT

6. Employee agrees that during the term of this Agreement he will not engage in any other business duties or pursuits whatsoever, directly or indirectly, except activities approved in writing by the Board of Directors, directorships in companies not in competition with the Corporation, and passive personal investments. Furthermore, Employee will not, directly or indirectly, acquire, hold, or retain any interest in any business competing with or similar in nature to the business of the Corporation, and will not own or hold to any substantial degree any securities in any company competing with the Corporation.

* * * * * * *

DISCLOSURE OF INFORMATION

8. Employee recognizes and acknowledges that the list of the Corporation's clients, as it may exist from time to time, is a unique asset of the Corporation's business. Employee will not, during or after the term of employment, disclose the list of the Corporation's clients or any part of it to any person, firm, corporation, association, or other entity for any reason or purpose whatsoever. …

* * * * *

RECORDS

11. On the termination of this Agreement, Employee shall not be entitled to keep or preserve records or charts of the Corporation as to any client unless a client specifically requests a different disposition of those records, and in no event shall Employee be entitled to the records of clients not served by him.

Subsequent to the term of the shareholders' respective agreements with the corporation, no other agreements between the shareholders and the corporation were entered into. Accordingly, Messrs. DeMarta and Norwalk were not bound by any covenant not to compete on June 30, 1992.

As of June 30, 1992, in addition to the shareholders, the corporation had eight employees, four of whom were accountants. No other employee of the corporation signed any employment agreement with the corporation.

On June 30, 1992, the corporation's assets were distributed to its shareholders. On that date, Mr. DeMarta held 75 percent of the corporation's stock, while Mr. Norwalk held the remaining 25 percent. Only a nominal amount of assets was left in the corporation after this distribution. This distribution constituted a complete liquidation of the corporation in 1992. The corporation did not continue to provide accounting services after June 30, 1992, and the business of the

corporation did not continue. The corporation has never been dissolved.

....

On January 3, 1992, as reflected in the corporation's minutes, the board of directors (Messrs. DeMarta and Norwalk) authorized the distribution of the corporation's assets and liabilities to the shareholders. These corporate minutes provided the following reason for this distribution:

> Due to lack of profitability, it was decided to stop practice as Certified Public Accountants within the structure of DeMarta & Norwalk. It was further decided to distribute all available assets and liabilities to the shareholders. Each shareholder would then be able to pursue a professional practice on their own or as partners with other CPA(s).

On July 1, 1992, following the distribution of the corporation's assets, Messrs. DeMarta and Norwalk became partners of the accounting firm Ireland, San Filippo (the partnership), and transferred assets, distributed to them by the corporation, to the partnership. The partnership did not use the corporation's name. The tangible assets distributed to the shareholders included all the corporation's furniture and equipment, which the corporation reported on its 1992 Federal income tax return at a value of $59,455. These assets were contributed to the partnership at an agreed value of $59,455. The shareholders also transferred their share of the corporation's receivables to the partnership. These assets were contributed to the partnership (less liabilities assumed by the partnership) in exchange for the opening balances of the respective partnership capital accounts of Messrs. DeMarta and Norwalk. The partnership did not assume tax obligations of the corporation, nor did it assume the debts owed by the corporation to the shareholders. The opening capital account balances in the partnership for Messrs. DeMarta and Norwalk were $39,202 and $28,041, respectively.

Messrs. DeMarta and Norwalk each executed a partnership agreement when they joined the partnership. Under the terms of the partnership agreement, Messrs. DeMarta and Norwalk were treated as equal partners and subject to the same formula for allocation of compensation. This partnership agreement also contained certain provisions restricting the partners' ability to compete with the partnership.

The partnership assumed the corporation's lease and occupied its former offices from July 1, 1992, to April 25, 1994. On April 28, 1994, after vacating these offices, the partnership subleased the space. At the time of the sublease, the remaining term of the lease was 8 months. The partnership subsidized one-third of the rent when it subleased the space.

As of June 30, 1992, other than the shareholders, the corporation employed the following persons: Barbara Bailey; Karin Laster; Beverly Hagan, C.P.A.; Thomas Tang, C.P.A.; Don Christman, C.P.A.; Jeanette Joyce, accountant; Judy Cunningham, administrator; and Joan Long, secretary. After the liquidation of the corporation, many of its former employees were subsequently employed by the partnership. By the end of October 1992, both Beverly Hagan and

Thomas Tang left the partnership to set up their own separate accounting practices. When Mr. Tang left, Barbara Bailey, a computer consultant, and Karin Laster, a bookkeeper, also left the partnership to work for Mr. Tang.

When Ms. Hagan and Mr. Tang left to set up their individual practices, they each sent announcements to former clients of the corporation and to clients of the partnership informing them of their move. The partnership received at least 92 requests from former clients to have the information contained in their files made available to either Ms. Hagan or Mr. Tang. Pursuant to these client authorizations, the partnership permitted Ms. Hagan and Mr. Tang to copy the files of clients that left the partnership. Neither Messrs. DeMarta and Norwalk nor the partnership requested any compensation for any clients lost to either Ms. Hagan or Mr. Tang. Five years following the liquidation of the corporation, only about 10 percent of the accounts serviced by the corporation remained with the partnership.

OPINION

The principal issue underlying all these consolidated cases is the fair market value of the corporation's assets on the date of distribution.

Customer-Based Intangibles

Respondent contends that when the corporation was liquidated, it distributed to its shareholders "customer-based intangibles" in addition to tangible assets. Respondent describes the intangible assets at issue to include the corporation's client base, client records and workpapers, and goodwill (including going-concern-value). Respondent's position is that these intangibles were assets of the corporation that had a specific value and that when distributed to the shareholders in the liquidation, triggered taxable gain to the corporation. Liability in respect of a deficiency in the corporation's tax and penalty was then asserted by respondent against the shareholders of the corporation as transferees. Respondent also determined that the transfer of the customer-based intangibles received by the shareholders generated taxable gain to the shareholders.

Petitioners maintain that the corporation did not own the intangibles in question. Rather, petitioners argue that the accountants themselves owned the intangibles, and, thus, there was no transfer nor any corresponding taxable gain attributable to these intangibles.

Generally, gain or loss must be recognized by a liquidating corporation "on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value." § 336(a). Petitioners do not contend that the provisions of § 336(a) should not apply here. The corporation must recognize gain calculated as the difference between the fair market value of the distributed property and the corporation's basis in that property.

Moreover, amounts received by the shareholders in a distribution in complete liquidation of the corporation must be treated as in full payment in exchange for the corporation's stock. § 331(a).

The shareholders must recognize any gain on the receipt of the property in the liquidating distribution. The gain to the shareholder is computed by subtracting the shareholder's adjusted basis in the stock from the amount realized. § 1001(a); Reg. § 1.331-1(b). The amount realized is the sum of any money received on the distribution plus the fair market value of the property received (other than money).[102] § 1001(b). This gain is reduced by the outstanding corporate liabilities assumed by the shareholders, if any. Here, the loans payable to the shareholders totaled $96,678 as of June 30, 1992.[103]

We have recognized that goodwill is a vendible asset which can be sold with a professional practice. *LaRue v. Commissioner*, 37 T.C. 39, 44 (1961); *Watson v. Commissioner*, 35 T.C. 203, 209 (1960). Goodwill is often defined as the expectation of continued patronage. *Newark Morning Ledger Co. v. United States* 507 U.S. 546 (1993). In *Rudd v. Commissioner*, 79 T.C. 225, 238 (1982), we stated:

> The goodwill of a public accounting firm can generally be described as the intangibles that attract new clients and induce existing clients to continue using the firm. These intangibles may include an established firm name, a general or specific location of the firm, client files and workpapers (including correspondence, audit information, financial statements, tax returns, etc.), a reputation for general or specialized services, an ongoing working relationship between the firm's personnel and clients, or accounting, auditing, and tax systems used by the firm. * * *

In determining the value of goodwill, there is no specific rule, and each case must be considered and decided in light of its own particular facts. *MacDonald v. Commissioner*, 3 T.C. 720, 726 (1944). Moreover, in determining such value it is well established that the earning power of the business is an important factor. *Estate of Krafft v. Commissioner*, T.C. Memo. 1961-305. In *Staab v. Commissioner*, 20 T.C. 834, 840 (1953), we stated:

> Goodwill, then, is an intangible consisting of the excess earning power of a business. A normal earning power is expected of the business assets, and if the business has greater earnings, then the business may be said to have goodwill. This excess in earning power may be due to any one or more of several reasons, and usually this extra value exists only because the business is a going concern, being successful and profitable. Goodwill may arise from: (1) the mere assembly of the various elements of a business, workers, customers, etc., (2) good reputation, customers' buying habits, (3) list of customers and their needs, (4) brand name, (5) secret processes, and (6) other intangibles affecting earnings.

---

[102] Reg. § 1.331-1(e) provides that a shareholder's gain or loss on a liquidating distribution be calculated on a per-share basis. [The regulation now makes this point by way of example.] ...

[103] It is not clear from the record whether respondent allowed any reduction for liabilities assumed by the shareholders in making his determination.

Both parties presented testimony from expert witnesses regarding the value of the corporation's intangible assets. In appraising the value of the corporation's intangibles, petitioners' expert stated: "Intangible value within a company (or goodwill value) is based upon the existence of excess earnings." After examining financial information from the corporation's Federal income tax returns, the pay history of Messrs. DeMarta and Norwalk, and Federal Government guidelines for an accountant's pay, he found that the corporation did not have excess earnings or earnings over and above a return on tangible assets. Consequently, petitioners' expert concluded that the corporation was worth the value of its tangible assets [footnote omitted] and that there was no intangible or goodwill value at the time of the distribution to the shareholders. He then addressed the valuation of the corporation's client list. Recognizing that in a service-related business the client relationship is normally between the client and the professional who services that client, petitioners' expert concluded that "Without an effective non-competition agreement, the clients have no meaningful value." Recognizing that there was no restriction on the ability of the individual accountants to compete with the corporation, he concluded that the client-related goodwill and intangibles belonged to the professional accountants (individually) who serviced the clients and that a list of these clients had no material value.

We have held that there is no salable goodwill where, as here, the business of a corporation is dependent upon its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation. *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 207 (1998) ("personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation"); *Estate of Taracido v. Commissioner*, 72 T.C. 1014, 1023-1024 (1979); *Cullen v. Commissioner*, 14 T.C. 368, 372 (1950); *MacDonald v. Commissioner*, *supra* at 727; ...

We have no doubt that most, if not all, of the clients of the corporation would have "followed" the accountant who serviced that client if the accountant would have left the corporation. For instance, when Mr. Tang and Ms. Hagan left the partnership shortly after the corporation was liquidated, at least 92 clients engaged these former employees to provide future services. On the record here, it is reasonable to assume that the personal ability, personality, and reputation of the individual accountants are what the clients sought. These characteristics did not belong to the corporation as intangible assets, since the accountants had no contractual obligation to continue their connection with it. There is no persuasive evidence that the name and location of the corporation had any value other than for their connection with the accountants themselves.

[The court reviewed the facts and holding of *MacDonald v. Commissioner*, *supra*, a case holding that in the absence of a corporation's right to the future services of an individual, the individual's personal ability is not part of the assets that an acquiring corporation receives by acquisition of the corporation's assets.]

….

Therefore, … we hold that at the time of the corporation's liquidation it had no goodwill, either

in terms of a client list or in any other form, which could be distributed to the individual shareholders or sold to a third party.

We have carefully considered the testimony of respondent's experts who testified that in their opinion a fair value of the corporation would be $870,000, of which $266,000 would represent the value of the client list and $369,000 would represent goodwill. [footnote omitted]. However, we conclude that their opinion regarding the intangible assets of the corporation is of no probative force in light of other evidence of record and existing case law.

Respondent's experts based their opinion as to the value of the goodwill and the client list upon an approximation of earnings that they made based upon the volume of business actually done by the corporation but using cost percentages normal to the industry, which were far less than the corporation's actual operating costs. These approximations are not in line with the actual experience of the corporation, and the record does not establish that there was any reasonable expectation that such costs could have been so reduced. *See Estate of Krafft v. Commissioner*, T.C. Memo. 1961-305.

More importantly, respondent's experts valued the corporation's client list and goodwill as if a covenant not to compete was in effect on the date of distribution. Respondent's expert, Mr. Kettell, testified that such a restriction is a very important factor in valuing the intangibles of the corporation. However, we have found that there were no restrictions on the corporation's employees to compete with it on the date of distribution. Nevertheless, in determining the corporation's value, respondent's experts relied upon the restrictions expressed in the partnership agreement executed by Messrs. DeMarta and Norwalk after the distribution of the corporation's assets. The parties to the partnership agreement are Messrs. DeMarta and Norwalk and the existing partners of the partnership, not the corporation. This agreement was not enforceable by the corporation and should have no bearing on the valuation of the corporation on the date that it distributed its assets.

In view of the foregoing, we conclude that there were no transferable "customer-based intangibles" belonging to the corporation independent of the abilities, skills, and reputation of the individual accountants. "Ability, skill, experience, acquaintanceship, or other personal characteristics or qualifications do not constitute goodwill as an item of property, nor do they exist in such form that they could be the subject of transfer." *Providence Mill Supply Co. v. Commissioner*, 2 B.T.A. 791, 793 (1925). In *O'Rear v. Commissioner*, 28 B.T.A. 698, 700 (1933), *aff'd*. 80 F.2d 473 (6th Cir. 1935), we stated that "it is at least doubtful whether a professional man can sell or dispose of any goodwill which may attach to his practice except perhaps by contracting to refrain from practicing." Because there was no enforceable contract which restricted the practice of any of the accountants at the time of the distribution, their personal goodwill did not attach to the corporation. Any goodwill transferred to the partnership was that of the individual accountants, not the corporation. Under these circumstances, we conclude that the value of any "customer-based intangibles" that the corporation may have had was nominal. We hold that petitioners have met their burden of establishing that value is not allocable to the customer-based intangibles as determined by respondent.

....

Decisions will be entered under Rule 155.

Questions and comments:

1. This case should demonstrate the significance of covenants not to compete. What would the result in this case have been if the employment contract of 1985 had still been in effect and/or the other employees had been bound by the same covenants?

2. *Characterization of shareholder gains/losses*: Suppose: corporation liquidates. Both the shareholders and the corporation recognize their respective gains and losses. Four years later, the shareholders must pay a tort liability of the dissolved corporation. A corporation that pays a tort liability may deduct the expenditure as an ordinary loss. Can the shareholders of a liquidated corporation deduct such payments as ordinary loss?

- No. If the corporation had made such payments, it would have had less money to distribute to its shareholders on the liquidation. They would have realized less on the exchange of their stock. Their capital gain would have been less, or their capital loss would have been greater. They must claim a capital loss – at a time when they no longer own stock in the corporation. Matching such losses with capital gains might be a problem, to say nothing of the fact that long-term capital gain rates are lower for individuals than ordinary income rates. *See Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

3. *Liquidations/Reincorporations*: When the rule of *General Utilities* prevailed – specifically that a corporation could distribute property to shareholders without itself recognizing gain or loss while shareholders took a carryover basis of the assets – the rules of §§ 331/336 could be exploited to avoid future tax liabilities.

Shareholders could liquidate a corporation and form another corporation that looked a lot like the old one. Shareholders could make adjustments in the property that they transferred to the corporation, perhaps retaining some of it and not transferring it to the new corporation. Similarly, they might add or subtract shareholders. Such a distribution would escape the then-prevailing unfavorable treatment of dividend distributions.

- If the value of what shareholders received was less than their bases in their stock, they could recognize capital losses. If the value of what shareholders received was more than their bases in their stock, the recognized capital gain.
- They could step up the basis of the property that they received to its fmv.
- The new corporation that they formed and to which they transferred property might look a lot like the old one insofar as the nature of the business that it carried on and the assets that it owned was concerned, but the new corporation would have shed the old corporation's earnings and profits, thereby reducing the amount of future distributions that might be taxed as dividends. The new corporation would also have a stepped-up basis in its assets, the price of which was the income tax liability on their stock's

appreciation in value.

The Commissioner – through application of the step transaction doctrine – successfully argued that these schemes are simply reorganizations. Hence, all the tax attributes of the old corporation carried over, including earnings and profits history, bases in assets, and depreciation schedules. The value of such schemes depended on the tax consequences of more (or different) recognition events. The repeal of the *General Utilities* doctrine coupled with a lower tax rate on dividend income that individual shareholders receive have altered the cost/benefit calculus of such schemes.

4. *A judicial exception to § 331/336*: The purchaser of all a corporation's stock may desire the corporation's assets rather than the stock. In *Sniveley v. CIR*, 19 T.C. 850, 859 (1953), *aff'd*, 219 F.2d 266 (CA5 1955), the Tax Court held that the purchase of stock for the purpose of acquiring the corporation's assets and the liquidation of the corporation were to be treated as one transaction, i.e., the purchase of the corporation's assets. This rule will sometimes work to taxpayer's advantage and sometimes to taxpayer's disadvantage. *See also Kimbell-Diamond Milling Co. v. Comm'r*, 14 T.C. 74 (1950), *aff'd* 187 F.2d 718 (CA5), *cert. denied*, 342 U.S. 827 (1951), *infra*, chapter 9

Rev. Rul. 85-48, 1985-1 C.B. 126

ISSUE
What is the proper federal income tax treatment of amounts received by a shareholder pursuant to a series of distributions in complete liquidation of a multiple-shareholder corporation under the circumstances described below?

FACTS
Corporation X adopted a plan of complete liquidation on January 31, 1981, pursuant to which it intended to distribute all its assets (other than those required to meet claims) to its shareholders within a 12-month period beginning on the date of adoption of the plan. A, a calendar year taxpayer, had acquired 10 of the 100 outstanding shares of X stock (first block) at a cost of 10x dollars (1x dollar per share) on January 1, 1975. A had acquired an additional 20 of the 100 outstanding shares (second block) at a cost of 40x dollars (2x dollars per share) on January 1, 1980. The remaining 70 outstanding shares of X stock were owned by persons other than A.

On February 15, 1981, X sold all its assets for 600x dollars. On June 1, 1981, X distributed 150x dollars to its shareholders including 45x dollars to A pursuant to its plan of liquidation. At that time, A's adjusted basis in each block of shares was equal to A's cost. On January 1, 1982, X distributed the remaining 450x dollars to its shareholders including 135x dollars to A in its final liquidating distribution pursuant to the plan.

LAW AND ANALYSIS
Section 346(a) of the Internal Revenue Code provides that a distribution will be treated as in

complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all the stock of the corporation pursuant to a plan.

Rev. Rul. 68-348, 1968-2 C.B. 141, provides that where a sole shareholder owns more than one block of shares of a corporation and receives a series of distributions in complete liquidation of the corporation, each distribution must be allocated ratably among the several blocks of shares in the proportion that the number of shares in a particularly block bears to the total number of shares outstanding. Where a corporation has multiple shareholders, liquidation distributions must be allocated among blocks of shares held by different shareholders as well as among different blocks of shares owned by a particular shareholder. Rev. Rul. 79-10, 1979-1 C.B. 140, holds that distributions under a plan of complete liquidation made by a corporation having a single class of stock will be treated as pro-rata distributions among the outstanding shares of the corporation. Consistent with Rev. Rul. 68-348, the liquidation distributions allocated to a particular shareholder must be allocated among the several blocks of shares owned by the shareholder in the proportion that the number of shares in a particular block bears to the total number of shares owned by that shareholder.

HOLDING

Applying this principle to the situation described above, of the 45x dollars distributed to A on June 1, 1981, 15x dollars (10/30 x 45) is allocated to the first block of shares, which has an adjusted basis of 10x dollars, producing a gain of 5x dollars, and 30x dollars (20/30 x 45) is allocated to the second block of shares, which has an adjusted basis of 40x dollars, producing no recognition of gain. Hence, A's federal income tax return for the year ended December 31, 1981, should show gain of 5x dollars resulting from the distribution on June 1, 1981. After the June 1, 1981, distribution, A's adjusted basis for the shares of X stock is zero for the first block and 10x dollars for the second block.

Of the 135x dollars distributed to A on January 1, 1982, 45x dollars (10/30 x 135) is allocated to the first block of shares, producing a gain of 45x dollars, and 90x dollars (20/30 x 135) is allocated to the second block of shares, producing a gain of 80x dollars. Thus, A's return for the taxable year ended December 31, 1982, should show gains of 45x dollars and 80x dollars resulting from the January 1, 1982, distribution.

Questions and comments:

1. This revenue ruling "amplified" Rev. Rul. 68-348, 1968-2 C.B. 141. That revenue ruling also stated: "Any losses resulting from a complete liquidation will be recognized only after the corporation has made its final distribution." [citations omitted].

2. We can infer the following from these revenue rulings: a shareholder's gain or loss is computed on each share individually.[104]

[104] We take the fragmented view of stock ownership rather than the unitary view of *Fink v. Commissioner*, 483 U.S. 89 (1987); *see* chapter 2: VIII, *supra*.

•Each distribution is allocated ratably to each block of stock according to the number of shares in the block relative to the total number of shares outstanding.

3. We can also infer that a shareholder applies a "basis first" approach, i.e., shareholder recovers *all* basis before recognizing any gain.

4. It seems that if a corporate distribution to shareholders is to escape § 301, there should be some concrete indication such treatment is deserved. Perhaps that is some justification for requiring a plan. Neither § 331 nor 336 specifically requires such a plan.

Rendina v. Commissioner, T.C. Memo. 1996-392

MEMORANDUM FINDINGS OF FACT AND OPINION

BEGHE, Judge

Respondent determined a deficiency of $35,934 in petitioners' 1988 Federal income tax ... [footnote omitted]. The deficiency arose from respondent's determination that the distribution to petitioner [husband and wife; footnote omitted] of two condominium units by Wood Street Apartments, Inc. (WSAI) was a dividend.

We hold that petitioner received the condominium units as a distribution in de facto liquidation of his shares of WSAI, thereby reducing his realized gain by the amount of his basis in the shares and by the amount of certain liabilities to third parties that he assumed ...

FINDINGS OF FACT

....

Wood Street Apartments, Inc.

In 1986, petitioner[, a CPA,] and Thomas J. Ackerman (Ackerman), a construction contractor, formed WSAI as a general business corporation under Ohio law, for the purposes of constructing and selling 18 condominium units in Willoughby, Ohio. WSAI was operated as a C corporation. Petitioner and Ackerman each paid WSAI approximately $250 for an equal number of common shares of WSAI.

In 1987 and 1988, WSAI constructed the 18 condominium units, known as "South Wood Condominiums" (South Wood). South Wood consists of two-story townhouses, built in clusters of six units in each of three buildings.

WSAI financed the construction of South Wood primarily with borrowed funds. The funds used by WSAI consisted of a loan from Security Federal Savings and Loan of approximately $740,000, petitioner's deposits in WSAI's checking account of approximately $41,200, [footnote

omitted] and approximately $68,000 in loans from three of petitioner's accounting clients: William and Mary Foss (the Fosses), Vito and Adella Navar (the Navars), and Frank and Benette Posa (the Posas). The principal amounts of the loans from the Fosses, Navars, and Posas were $53,000, $10,000, and $5,000, respectively. The loan checks were made to WSAI, and deposited in WSAI's checking account at National City Bank. WSAI issued promissory notes to the lenders, providing that interest would be paid at a rate of 12 percent per year. The maturity date of each of the notes was approximately 1 year after issuance.

....

[WSAI issued new notes to the Fosses, Navars, and Posas.] With the exception of one of the Foss notes, each new note reflected a rollover of the obligation on the prior note. For the months of January, February, March, and April 1989, all interest payments due on the notes to the Fosses, Navars, and Posas were made in the name of WSAI. [footnote omitted].

In 1988, 16 of the 18 units were sold, two of which were purchased by Ackerman. ...

...

Toward the end of 1988, two of the 18 units remained unsold. Petitioner and Ackerman orally agreed that WSAI would transfer title to the two remaining condominium units to petitioner in consideration of petitioner's assumption of the Foss, Navar, and Posa notes, and petitioner's discharge of WSAI's "debt" owed to him.

In December 1988, WSAI transferred South Wood's two remaining condominium units to petitioner. Petitioner did not report any income or gain from the receipt of the two condominium units on his 1988 Federal income tax return ... WSAI filed no U.S. corporation income tax return for 1988, the tax year in which all the condominium units were sold or transferred.

With the transfer of the last two condominium units to petitioner in 1988, WSAI no longer held business assets, and ceased to be a going concern. Upon transfer of all 18 condominium units in 1988, WSAI ceased doing business, but did not formally dissolve. Its charter was revoked in 1990 for nonpayment and nonfiling of Ohio franchise tax returns.

In April 1989, petitioner sold one of the units for $67,900.

Transfer of notes from WSAI to Canterbury Construction Co.

....

The loans to the Posas and Navars, in the principal amounts of $15,000 and $10,000, respectively, have been paid. As of the date of filing of the petition, the Fosses still held a note ...

....

Corporation tax and transferee issues

On or around March 1, 1994, respondent sent petitioner, as transferee of WSAI, a 30-day letter, with a report of income tax examination and explanation of items, asserting for the taxable year 1988 that WSAI had taxable income of $272,320, resulting from gross receipts of $1,068,000 from the sale of the South Wood condominium units,[105] based on the retail sales prices as determined by the transfer taxes paid, less costs and expenses of $795,680. [footnote omitted]. The report took the position that WSAI owed 1988 U.S. corporation income tax of $89,455, and an addition of $22,364 for failure to file its corporation income tax return. WSAI's liability for 1988 U.S. corporation income tax and the failure to file addition remains unresolved; respondent had issued no statutory notice of deficiency to WSAI (or to petitioner as transferee) as of the date of issuance of this report.

OPINION

....

The substantive tax question before us is whether petitioner's receipt of two condominium units, during the taxable year 1988, was a taxable distribution from WSAI. Respondent determined that petitioner's receipt of the last two units was a dividend in the amount of $135,800 during the taxable year 1988. Petitioner contended that his receipt of the units was not taxable to him because it was offset by discharge of WSAI's debt to him, and his assumption of the Foss, Navar, and Posa notes. Petitioner also maintained that his receipt of the two units could not be a dividend because WSAI had no earnings and profits.

Petitioner, in his reply brief, raised the alternative argument that he received the condominium units in de facto liquidation of WSAI, which would entitle him to use the basis of his WSAI stock to compute his gain on the distribution, if we should determine that his payments into WSAI represented equity rather than debt. Because it appeared to us that this position might have greater merit than the primary position of either of the parties, we had them address this newly raised issue in supplemental briefs.

I. Lack of Prejudice to Respondent in Addressing Liquidation

....

II. De Facto Liquidation

Applying the three-pronged test of *Estate of Maguire v. Commissioner*, 50 T.C. 130, 140 (1968): (1) Whether there is a manifest intention to liquidate; (2) whether there is a continuing purpose to

[105] Respondent excluded the two units transferred to petitioner from the calculation of gross receipts.

terminate corporate affairs; and (3) whether the activities of the corporation and its shareholders are directed toward that objective, we are convinced that WSAI and its shareholders displayed a manifest intention to liquidate and continuing purpose to terminate corporate affairs, and that the activities of WSAI and its shareholders were directed to that end. *See Olmsted v. Commissioner*, T.C. Memo. 1984-381.

Neither the Code nor the regulations to § 331 define the term "complete liquidation." However, as we noted in *Olmsted v. Commissioner*, T.C. Memo. 1984-381, the regulations under § 332 (governing subsidiary liquidations) contain a definition of "complete liquidation" under § 332 that applies equally to § 331:

> A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts and distributing any remaining balance to its shareholders. A liquidation may be completed prior to the actual dissolution of the liquidating corporation. However, legal dissolution of the corporation is not required. Nor will the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence disqualify the transaction. [Reg. § 1.332-2(c).]

Respondent maintains that petitioner never liquidated WSAI. In support of her position, respondent relies on *Haley Bros. Constr. Corp. v. Commissioner*, 87 T.C. 498, 515–516 (1986). In *Haley Bros. Construction Corp*., the corporation at issue, Marywood Corp., was not dissolved formally in accordance with State law, and continued to maintain a checking account. We held that there was no liquidation because there was a business purpose for the continued existence of Marywood, which continued to be operated in accordance with that business purpose, holding and selling real property, maintaining a checking account, paying expenses, and filing tax returns. Moreover, the continued corporate existence of Marywood served the purpose of insulating its parent corporation from liabilities on a mortgage and in pending litigation.

In the case at hand, there was no business purpose for WSAI to continue operating. WSAI did not file a corporate tax return for 1988, and, with the sale or distribution of all of the condominium units, WSAI had no further assets of any consequence.

We are unpersuaded by respondent's assertion that, because WSAI continued some activities through the beginning of 1989, it did not liquidate. Complete liquidation can occur despite an extended liquidation process, and several earlier opinions of this court have upheld liquidations despite protracted time frames. *See, e.g.*, *Estate of Maguire v. Commissioner*, *supra*; *T.T. Word Supply Co. v. Commissioner*, 41 B.T.A. 965 (1940); *Olmsted v. Commissioner*, *supra*. In order for complete liquidation treatment to apply, it is not essential that a formal plan of liquidation be adopted or that the corporation dissolve, as long as there is a manifest intention to liquidate that is carried out. *Genecov v. United States*, 412 F.2d 556 (5th Cir. 1969); *Stamler v. Commissioner*, 145 F.2d 37 (3d Cir. 1944), *aff'g*. 45 B.T.A. 37 (1941); *Kennemer v. Commissioner*, 96 F.2d 177, 178 (5th Cir. 1938), *aff'g*. 35 B.T.A. 415 (1937); *Olmsted v. Commissioner*, *supra*; *Silverman v. Commissioner*, T.C. Memo. 1971-143; *see* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF

CORPORATIONS & SHAREHOLDERS, ¶ 10.02, at 10-9 (6th ed. 1994); 11 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 42.06, at 53 (1992 rev.).

... The intentions of petitioner and Ackerman to liquidate WSAI at the end of 1988 were apparent from the sales of WSAI's assets, its cessation of business, and the agreement of petitioner and Ackerman that WSAI would distribute the last two condominium units to petitioner, in consideration of petitioner's assumption of the corporation's liabilities to its lenders and his recovery of his investment out of the balance. With that final distribution, WSAI held title to no further assets of any substantial consequence. With the exception of interest payments made through the beginning of 1989, [footnote omitted] WSAI engaged in no further activities.

Finally, respondent argues that petitioners made no disclosure of any kind on their 1988 individual income tax return regarding the receipt of the two condominium units as a liquidating distribution, as required by Reg. § 1.331-1(d), which states:

> In every case in which a shareholder transfers stock in exchange for property to the corporation which issued such stock, the facts and circumstances shall be reported on his return unless the property is part of a distribution made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation and the corporation is completely liquidated and dissolved within one year after the distribution. *See* § 6043 for requirements relating to returns by corporations.

Reg. § 1.331-1(d) does not impair our ultimate conclusion that a de facto liquidation did occur during the taxable year 1988 in the case at hand. Although Reg. § 1.331-1(d) appears to complement § 6043 and Reg. § 1.6043-1, thereunder, providing for the filing of Form 966 (Corporate Dissolution or Liquidation) by a corporation that adopts any resolution or plan of liquidation, the filing of Form 966 is not a condition of liquidation treatment under any provision of the Internal Revenue Code. *Maguire v. Commissioner*, 222 F.2d 472, 478 (7th Cir. 1955), *rev'g*, 21 T.C. 853 (1954); *Murphy v. Commissioner*, T.C. Memo. 1996-59; *see also Fowler Hosiery Co. v. Commissioner*, 36 T.C. 201 (1961), *aff'd*, 301 F.2d 394 (7th Cir. 1962). We are satisfied that Reg. § 1.331-1(d), like the regulation under § 6043, is directory only. While compliance with these regulations serves the evidentiary function of supporting the conclusion that a distribution was received in a corporate liquidation, and helps to avoid controversies of the sort we now deal with, we regard them as playing only a facilitating role. Petitioner's compliance with Reg. § 1.331-1(d), is not a condition precedent to our treating the distribution of the condominium units to petitioner as a liquidating distribution. [footnote omitted].

We are convinced that the agreement of the WSAI shareholders, petitioner and Ackerman, for the distribution of the last two condominium units to petitioner, in consideration of his taking care of the corporate liabilities and recovering his own investment, manifested WSAI's intention to liquidate, and that that intention was carried out in the informal winding-up of WSAI's affairs that followed.

III. Computation of Gain

Having found that WSAI was liquidated in 1988, we turn to the tax treatment of petitioner's receipt of the condominium units. Section 331(a) provides that amounts received by a shareholder in complete liquidation of a corporation shall be treated as "full payment in exchange for the stock", considering a liquidating distribution, in effect, as a sale by the shareholder of his stock to the corporation. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS, at 10-4, 10-5 (6th ed. 1994); S. REPT. 398, 68th Cong., 1st Sess. 11 (1924), 1939-1 C.B. (pt. 2) 266, 274. As a result, the shareholder computes gain or loss under § 1001(a) by subtracting the adjusted basis of his stock from the amount realized (the fair market value of the distribution), and reports the difference as capital gain or loss if the stock is a capital asset in his hands.

To compute petitioner's gain, we first look at the value of the condominium units distributed to determine the amount realized. We then look at whether petitioner's deposits into the WSAI checking account were loans or equity investments; concluding that they are equity rather than debt, we add them to petitioner's basis in his WSAI stock, rather than treating them as liability offsets to the amount realized. We also look at whether petitioner assumed, or took subject to, WSAI liabilities, because the amount realized under § 1001 on the liquidation exchange is the net value of the distribution, and that amount must be reduced by the amount of liabilities assumed or taken subject to. *See Ford v. United States*, 311 F.2d 951 (1963). We then subtract the basis of petitioner's shares from the amount realized on the distribution to compute his gain.

A. Value of Condominium Units Distributed

...

... The average selling price of the other [footnote omitted] condominium units was $66,915.14. Four months after the distribution, petitioner sold one of his condominium units for $67,900.

Petitioner has not convinced us that the fair market value of his condominium units should be less than the average selling price of the other units sold, or $66,915. Thus, we find the fair market value of the condominiums transferred to petitioner to be $133,830.

B. Basis of WSAI Shares: Debt v. Equity

Respondent maintains that no loan or other value was given by petitioner to WSAI. However, the deposit records of National City Bank, where WSAI maintained a checking account, indicate that petitioner deposited $41,200 into WSAI's account. ... We are satisfied that petitioner's deposits into the WSAI account constitute value that resulted in cost to be taken into account in determining petitioner's gain on the receipt of the condominium units.

While the analysis would vary, depending on whether the investment in the corporation were debt or equity, the net tax effect to petitioner would be the same. If petitioner's investment in the

corporation were a loan, WSAI's transfer of property to petitioner in satisfaction of the loan would not be governed by § 331 to that extent. This is because the transfer would not be "in payment for" petitioner's stock. In such a case, the corporation merely would be repaying the loan, receiving equal value in exchange for the transfer, resulting in no taxable event for the transferee. *See Citizens Bank & Trust Co. v. United States*, 580 F.2d 442 (Ct. Cl. 1978); *J. Hofert Co. v. United States*, 69-1 USTC ¶ 9220 (CCH) (C.D. Cal.1969).

If petitioner's investment were equity, petitioner would be entitled to increase his basis in his WSAI shares by the amount of the investment. Under this scenario, petitioner would subtract his basis from the amount of the distribution; if the distribution should exceed petitioner's basis, the excess would be treated as capital gain from sale of the stock.

....

In the case at hand, none of the factors are [*sic* is] present that would tend to show that petitioner reasonably expected WSAI to repay the "loan" in accordance with terms in line with those generally prevailing in the business community. *See Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962), *remanding* 35 T.C. 268 (1960). Moreover, no interest payments to petitioner were made or provided for. *See Texas Farm Bureau v. United States*, 725 F.2d 307, 313-314 (5th Cir. 1984). If petitioner had been a true lender, he would have provided for interest payments. *Curry v. United States*, 396 F.2d 630, 634 (5th Cir. 1968).

We find that petitioner's $41,200 of deposits into the WSAI checking account was a contribution to the capital of WSAI. Because petitioner was a shareholder of WSAI, his $41,200 of contributions to capital is reflected in an increased basis for his WSAI stock. Reg. § 1.118-1. Thus, petitioner's basis in his WSAI stock was $41,450. [footnote omitted].

Petitioner's amount realized from the distribution of the condominium units should be reduced by the amount of the corporation's liabilities to the Posas, Fosses, and Navars that petitioner agreed to assume, and for whose discharge he made the necessary arrangements. Thus, after subtracting the assumed liabilities of $68,000 from the $92,380 gain ($133,830 amount realized minus $41,450 adjusted basis), petitioner's realized capital gain is $24,380.

....

Decision will be entered under Rule 155.

Questions and comments:

1. As this case demonstrates, failure to execute a complete liquidation can result in taxation of distributions as dividends under § 301. Furthermore, the corporation has not been liquidated for tax purposes – and remains a taxpayer.

2. There are some limitations on § 336 treatment of distributing corporations in nonsubsidiary

liquidations. Recall that in a § 351 transaction, one level of gain or loss can be transformed into two levels of gain or loss. The shareholder who transferred property to a corporation has built-in gain or loss in shares. The corporation who received property from a shareholder has built-in gain or loss in assets. A transferor of property might transfer loss property to a corporation shortly before the corporation is to liquidate, i.e., the transferor might "stuff" the corporation with loss property. Upon liquidation, the corporation recognizes a loss. The shareholder who receives the property that he transferred to the corporation recognizes loss on what had merely been built-in loss. Section 267(a)(1), which prevents loss recognition in transactions between related parties, by its terms does not apply to a distribution in complete liquidation of a corporation. Instead, § 332(d) addresses such manipulations.

3. *Section 336(d)(1)*: A corporation may not recognize loss on a distribution *to a related party* as defined in § 267 if –

•the distribution is not pro rata, § 336(d)(1)(A)(i), OR

•it acquired the loss property within 5 years of the date of distribution in a § 351 transaction or as a contribution to its capital. §§ 336(d)(1)(A)(ii) and 336(d)(1)(B). Moreover, the corporation may not recognize loss on the distribution of property whose basis is determined by reference to such property (e.g., property acquired in a like-kind exchange that the corporation exchanged for the property it acquired within 5 years of the distribution in a § 351 transaction or as a contribution to its capital). § 336(d)(1)(B).

3A. Notice that the loss property distributed does not have to be loss property when the shareholder transfers it to the corporation.

4. *Section 336(d)(2)*: When the basis of property is greater than its fair market value, a corporation in computing its *loss* on the sale, exchange, or distribution of the property, must reduce the basis of the property to its fair market value (§ 336(d)(2)(A)) immediately after acquisition *if* –

•the corporation acquired the property in a § 351 transaction or as a contribution to its capital as part of a plan whose "principal purpose" was for the corporation to recognize loss in connection with the liquidation. § 336(d)(2)(B).

•If the corporation acquires the property within 2 years prior to the adoption of a plan of complete liquidation, the property is treated as acquired for the principal purpose of recognizing loss in connection with the liquidation. § 336(d)(2)(B)(ii).

4A. Since the necessity of basis adjustment is made immediately after the acquisition, loss occurring after that time is not subject to the loss limitation rules of § 336(d)(2). This is different than the approach taken in § 336(d)(1), which only applies to distributions made to "related persons."

4B. The American Jobs Creation Act of 2004, P.L. 108-357, added § 362(e)(2) to the Code. That provision of course requires a corporation that receives one or more properties from a transferor in a § 351 transaction or as a contribution to capital must reduce its bases in loss properties so

that the aggregate bases of the properties that it receives from a transferor is not greater than the aggregate fair market value of the properties that it receives. Evidently, Congress gave no thought to the interplay of § 362(e)(2) and § 336(d).

Recall also that when § 362(e)(2) applies, the parties may agree to have the shareholder/transferor reduce his basis in his shares rather than the corporation reduce its basis in its assets. The corporation would take the properties with built-in losses. The subsequent application of §336(d) would then deny *both* the shareholder and the corporation the benefit of a built-in loss upon the occurrence of a recognition event.

Problems:

1. Maury purchased all the common stock of Zeltsin Corporation seven years ago for $1000. This was (and is) all Zeltsin's outstanding stock. Zeltsin owns assets, total basis = $500, fmv = $2000. What are the tax results of the following events?
a. Zeltsin sells its assets to third parties, distributes the cash to Maury, and liquidates?

b. Zeltsin distributes its assets to Maury, retaining enough cash to pay any resulting tax liabilities, and liquidates? What would be Maury's basis in the assets?

c. Nelson has contacted you because he is interested in acquiring the assets of Zeltsin. He may continue to operate the business of Zeltsin or he may put those assets to use in another business. He wants to know how much he should be willing to pay – and to whom – to gain control of Zeltsin's assets. What information would you want to acquire and how would you use that information in advising Nelson?

d. Same as b, *supra*, except that Zeltsin's assets are encumbered by a $250 liability. How would that change your answer to question b?

2. Oliver and Penelope are the only shareholders of Dabble Corporation. Oliver owns 750 shares, and Penelope owns 250 shares. They formed the corporation seven years ago. At that time, Oliver transferred Blackacre to the corporation, ab = $500, fmv = $750. Penelope transferred Whiteacre, ab = $400, fmv = $250. The corporation still owns these properties, but the fmv of Blackacre has decreased to $400, and the fmv of Whiteacre has increased to $400. What are the tax consequences to each of the parties if Dabble Corporation –

a. Sells Blackacre and Whiteacre to third parties, pays taxes, and distributes the proceeds to Oliver and Penelope in a ratio of 3:1 in a liquidating distribution?

b. In a liquidating distribution, Dabble distributes Blackacre and a ½ interest in Whiteacre to Oliver. It also distributes a ½ interest in Whiteacre to Penelope. Tax consequences to each of the parties?

c. Would it make any difference if the corporation was formed three years ago?

d. Would it make any difference if the corporation was formed thirteen months ago?

Do the CALI exercise: Corporate Taxation: Liquidations: Corporate Liquidations: Effects on Shareholders: Sections 331 & 334(a).

Do the CALI exercise: Corporate Taxation: Liquidations: Distributions of Property in Complete Liquidations: Section 336.

III. Liquidation of Subsidiary

Read §§ 332, 337.

When a subsidiary liquidates, the corporate shareholder (i.e., parent) receives all the liquidating subsidiary's assets without recognition of gain or loss. § 332(a). The liquidating subsidiary also does not recognize gain or loss. § 337(a). The liquidation of a subsidiary liquidation is treated for tax purposes as if nothing happened – similar to a person's transfer of assets from the right hand to the left hand. The assets have a carryover basis to the parent corporation that receives them. § 334(b)(1). The parent tacks the subsidiary's holding period to its own. § 1223(2). The parent's basis in its shares of the liquidating subsidiary disappears. The parent's gain or loss on its *stock* disappears. Its gain/loss is preserved through its taking a carryover basis in the assets it receives from the subsidiary. If the subsidiary *is not insolvent* and is indebted to the parent, a distribution to the parent is treated as made in satisfaction of the debt. § 337(b). The parent must recognize any gain on a distribution in satisfaction of a debt that the subsidiary owes to it, e.g., payment of the face amount of a bond issued by the subsidiary at a discount to the parent. Reg. § 1.332-7. A subsidiary that distributes the parent's debt to it as part of a liquidation also recognizes no gain. The parent recognizes no gain upon such a distribution. *See* Rev. Rul. 74-54, 1974-1 C.B. 76 (holding that a note is "property").

When a subsidiary liquidates, the parent succeeds to the subsidiary's tax attributes listed in § 381(c). § 381(a)(1). Some of the tax attributes to which the parent succeeds include[106] the subsidiary's –

- net operating loss, § 381(c)(1);
- earnings and profits (or deficit in earnings and profits[107]), § 381(c)(2);
- capital loss carryover, § 381(c)(3);

[106] This is not the complete list of § 381(c) – which contains twenty-three items.

[107] A deficit offsets only the acquiring corporation's earnings and profits accumulated *after* the date of transfer. § 381(c)(2)(B).

•accounting method, § 381(c)(4);
•accounting for inventories, § 381(c)(5);
•method of depreciation of remaining basis, § 381(c)(6);
•computation of installment method income, § 381(c)(8);
•computation of bond premium or bond discount amortization, § 381(c)(9);
•recovery of tax benefit items under § 111, § 381(c)(12);
•determinations of basis and recognizable income in § 1033 involuntary conversions, § 381(c)(13);
•deductions upon paying or accruing deductible liabilities of the transferring subsidiary, § 381(c)(16);
•excess charitable contribution carryovers, § 381(c)(19); and
•disallowed business interest carryovers, § 381(c)(20).

The parent may not carry *back* a liquidating subsidiary's net operating loss or a net capital loss. § 381(b)(3).

Insolvent subsidiary: If the subsidiary is insolvent, § 332 does not apply. Reg. § 1.332-2(b) provides in part that "Section 332 applies only when the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation." An insolvent subsidiary cannot make even a partial payment for the stock that the parent owns and so cannot qualify for a § 332 liquidation.

> If a shareholder receives no payment for its stock in a liquidation of the corporation, neither § 331 nor § 332 applies to the liquidation. The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that such shareholder's stock is worthless. In addition, the liquidation is an identifiable event that fixes the loss with respect to the stock.
>
> A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the fair market value of the corporation's assets is less than the corporation's liabilities. In determining the fair market value of a corporation's assets, all of the corporation's assets, including tangible and intangible assets (such as goodwill and going concern value) and assets that may not appear on the corporation's balance sheet, must be taken into account.

Rev. Rul. 2003-125, 2003-52 I.R.B. 1243. The parent may treat its stock in the subsidiary as a "worthless security" under § 165(g). Moreover, the stock is not a "capital asset," and the loss is "ordinary." § 165(g)(3); Reg. § 1.165-5(d). Since § 332 is not applicable, neither is § 381 applicable. This means that a subsidiary's net operating loss does not pass to the parent corporation. Rather, like magic, such attributes simply disappear. Section 337 only applies if § 332 applies (§ 337(a)). The inapplicability of §§ 332 or 337 also means that the subsidiary must recognize gain on any distribution. The subsidiary may not recognize loss until the property is transferred outside of the controlled group of which the parent and subsidiary are members. § 267(a)(1), § 267(f)(2)(B). These consequences might convince a parent to make the subsidiary

solvent prior to a liquidation.

Subsidiary status: For a liquidation of a subsidiary to qualify for tax deferred treatment under § 332, the parent must own at least 80% of the subsidiary's stock by vote and value from the time the parties adopt the plan of liquidation until receipt of property from the subsidiary. § 332(b)(1); Reg. § 1.332-2(a).[108] This does not include preferred stock of the subsidiary that is not entitled to vote, is limited and preferred as to dividends, does not participate in corporate growth, has redemption and liquidation rights that do not exceed the issue price of the stock, and is not convertible into another class of stock. § 1504(a)(4) (defining such stock not to be "stock" for purposes of § 1504(a)). Failure to be qualified at the time of the first distribution and to remain qualified (i.e., in "status of liquidation," Reg. § 1.332-2(c)) at all times results in non-qualification for § 332 nonrecognition treatment. Reg. § 1.332-2(a). The distribution must be in complete redemption or cancellation of the subsidiary's stock. §§ 332(b)(2), 332(b)(3). If a transfer of property by one corporation to another in exchange for stock is *not* a complete liquidation, the distributing corporation must recognize gain or loss (if allowed) on each distribution. That is the effect of the language in § 336(a) "[e]xcept as provided in this section or section 337 …"

Timing of distributions: The Code contemplates either a one-year or a three-year liquidation of a subsidiary. The starting date of the one-year period is the start of the taxable year in which the distribution(s) occur (§ 332(b)(2)), and the start of the three-year period is the first day of the first taxable year after the first distribution is made (§332(b)(3)). The focus of both rules is the time of the first distribution, not the adoption of a plan of liquidation.

> •*Distributions within the taxable year*: The liquidating corporation distributes all its property in complete cancellation or redemption of all its stock within the taxable year. A resolution authorizing a distribution of all the corporation's assets in complete cancellation or redemption of all its stock is considered to be adoption of a plan of liquidation, even though the resolution does not specify the time for completing the transfer of property. § 332(b)(2). The distributee corporation must own the specified amount of the liquidating corporation's stock and continue to own the specified amount until all the liquidating corporation's assets are transferred within the taxable year. Reg. § 1.332-3.
>
> •*Distributions within three years of close of taxable year during which first distribution is made*: The liquidating corporation must distribute all its property in complete cancellation or redemption of all its stock in accordance with a plan of liquidation that calls for transfer of all the corporation's property within three years from the end of a taxable year during which occurs the first of the distributions under the plan. § 332(b)(3).
>
> •If the taxpayer fails to be and continue to be in a qualified status or fails to

[108] Section 332 does not invoke the attribution rules of § 318. *Cf.* Reg. § 1.332-1(a) (corporation must be "the actual owner of stock (in the liquidating corporation)").

distribute all its property within the three-year period, *no* distribution is considered to be a distribution in complete liquidations. § 332(b)(3). In such a case, §§ 336/331 apply.

•The plan must state the period during which transfers of property to shareholders is to be completed. Reg. § 1.332-4(a)(1).

•The recipient corporation must file with the district director a waiver of the statute of limitations on assessment to a date at least one year after the last date of the period for assessment for the last taxable year property transfers may be completed. Reg. § 1.332-4(a)(2).

•For each of the years of the distribution period the recipient corporation may be required to file a bond assuring prompt payment of the tax computed without regard to §§ 332/334(b).

•If the transfer(s) of property is not completed within the three-year period or the recipient corporation does not continue to be qualified with respect to its stock ownership of the transferor corporation, then tax liability on every distribution must be recomputed without regard to §§ 332/334(b).

•*Liquidation status and necessity of cessation of business*: "A status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts and distributing any remaining balance to its shareholders." Reg. § 1.332-2(c).

Opting in or opting out of §§ 332/337: The basis that a subsidiary has in its assets compared to the basis that the parent has in the stock of its subsidiary may determine whether a parent wants tax-deferred treatment of a liquidation of the subsidiary. Should a corporation be permitted to adjust its holdings in another corporation with a view towards getting the tax treatment it wants when it knows that it will liquidate the subsidiary corporation?

Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956)

MAGRUDER

Granite Trust Company sued the United States in the federal court for the District of Massachusetts to recover an overpayment of income tax and declared value excess profits tax for the year 1943. From a judgment for the defendant the taxpayer has taken this appeal.

... It is agreed that if taxpayer's losses realized upon its disposition in 1943 of certain shares of common stock of the Granite Trust Building Corporation (hereinafter called the Building Corporation) are entitled to be 'recognized,' then Granite Trust Company should recover in this action an overpayment in the sum of $57,801.32, with interest ...

In 1928 the Building Corporation was organized by Granite Trust Company for the purpose of acquiring land and constructing an office building thereon to be occupied by the bank. The land

and building cost over $1,000,000 and were financed through the purchase by the taxpayer bank of all the stock of the Building Corporation. ...

Beginning at least as early as 1936, the amount at which the stock of the Building Corporation was carried upon the taxpayer's books was subjected to continuous criticism by various banking authorities. At a result, the taxpayer wrote down the value of the stock on its books, but nevertheless the examining authorities continued to press for further annual reductions.

At some time prior to October, 1943, the taxpayer's management commenced the formulation of a plan to bring this issue to a close by the expedient of having Granite Trust Company purchase the real estate from the Building Corporation for $550,000, a fair current appraisal, after which the subsidiary Building Corporation was to be liquidated. The practical problem in the execution of this plan resulted from the fact that the distribution in the liquidation of the subsidiary corporation was expected to amount to something between $65 and $66 per share upon the shares of common stock in the Building Corporation for which the taxpayer had paid $100 per share. In thus contributing to the simplification of the corporate structure of the taxpayer as a holding company, an end deemed desirable by the Congress, Granite Trust Company naturally wanted to be assured that its prospective loss to be realized upon the liquidation of its subsidiary would lawfully be 'recognized' at once so as to be available as a tax deduction.

In order that this forthcoming loss upon its investment might not be denied recognition by § 112(b)(6) of the Internal Revenue Code of 1939,[109] the taxpayer, on advice of counsel, proceeded to divest itself of some of its shares of common stock in the Building Corporation by means of several purported sales and of a gift, the facts concerning which are as follows:

As of December 1, 1943, the outstanding capital stock of the Building Corporation, all owned by the taxpayer, consisted of 2,250 shares of preferred stock and 5,000 shares of common stock, the latter being the sole voting stock. On December 6, 1943, the taxpayer sold to, or went through the form of selling to, Howard D. Johnson Company 1025 shares of common stock of the Building Corporation, that being 20.5 per cent of the outstanding voting stock. Howard D. Johnson Company paid $65.50 per share, a total of $67,137.50 ... [T]axpayer surrendered to the Building Corporation certificates covering 1,025 shares of common stock, and the Building Corporation issued to Howard D. Johnson Company a new certificate for that number of shares, which certificate was held by Howard D. Johnson Company until it was surrendered on December 17, 1943, in the course of the final liquidation of the Building Corporation.

At a meeting of the Building Corporation stockholders held on December 10, 1943, the taxpayer submitted a written offer to purchase the real estate for $550,000. The stockholders voted to accept this offer, and at the same meeting the following vote was taken:

> 'That if and when this Corporation shall receive $550,000, ... this Corporation shall be

[109] [Text of Code section omitted. The substance of § 112(b)(6) is now in § 332(a and b).]

> completely liquidated, and after payment or provision for payment of all debts of, claims against and obligations of this Corporation, all of its remaining assets shall be distributed at such time or times to stockholders of record at such date or dates, and under and subject to such circumstances as the Board of Directors may determine, to the stockholders of the Corporation pro rata in accordance with the respective priorities of the outstanding shares of the Corporation, provided, however, that such liquidation and distribution shall be made and shall be entirely completed prior to December 30, 1943.'

At the date of the foregoing corporate action by the Building Corporation, namely, December 10, 1943, Granite Trust Company was the legal and equitable holder of 3,975 shares (79.5 per cent) of the then outstanding 5,000 shares of common stock. ...

Thereafter, on December 13, 1943, the taxpayer sold, or went through the form of selling, ten shares each of the common stock in the Building Corporation to Howard D. Johnson individually and to one Ralph E. Richmond, for a price of $65.50 per share. On the same day the taxpayer donated to the Greater Boston United War Fund two shares of the common stock of the Building Corporation. Johnson and Richmond duly paid by check for the shares they bought, and the taxpayer delivered to them and to the United War Fund certificates sufficient to cover the shares sold or donated, which certificates were held by Johnson, Richmond, and the United War Fund until surrendered by them on December 17 in the course of the final liquidation of the Building Corporation.

At no time after the making of the above sales and gift did the taxpayer acquire any additional common stock in the Building Corporation.

On December 15, 1943, the real estate was conveyed to the taxpayer by the Building Corporation, and the taxpayer paid the Building Corporation the price of $550,000 ... The real estate was thereby brought on to the taxpayer's books at a cost equivalent to current fair market value, thus satisfying the banking authorities.

On December 17, 1943, the Building Corporation called for retirement at par of its outstanding preferred stock and paid the taxpayer therefor the sum of $225,000. On the same day the Building Corporation paid a final liquidating distribution in the amount of $65.77 per share with respect to each share of its outstanding common stock, and all holders surrendered their certificates for such outstanding shares. The taxpayer, as the owner of 3,953 shares of common stock, received $259,988.81. The owners of the other 1,047 shares of the Building Corporation common stock received, respectively: Howard D. Johnson Company, $67,414.25; Howard D. Johnson, $657.70; Ralph E. Richmond, $657.70; Greater Boston United War Fund, $131.54. Each payee received and retained these amounts.

On December 30, 1943, a final meeting of the Building Corporation stockholders was held, there being represented at the meeting the taxpayer, Howard D. Johnson Company, Howard D. Johnson, Ralph E. Richmond, and Greater Boston United War Found. Dissolution was voted, with authority to the corporation's directors and officers to take all steps necessary or advisable

to that end.

The taxpayer concedes that it would not have made the sales described above had it not been for § 112(b)(6) [§ 332] of the Internal Revenue Code of 1939. While the taxpayer maintains that the gift to the United War Fund was but part of the total gift to that organization for the year 1943, it seems clear, because this was the only case where shares of stock rather than cash were distributed to the charity, that at least the specific object given at this time was dictated by § 112(b)(6) [§ 332].

The precise issue before us is whether or not to give effect for tax purposes to the aforesaid sales and gift by the taxpayer. If the answer is in the affirmative, there is no doubt that the liquidation distribution of the property of the Building Corporation was not in 'complete liquidation' within the very special meaning of that phrase in § 112(b)(6) of the 1939 Code [§ 332], and, accordingly, the taxpayer may recognize the loss on its investment.

Although there is no dispute that the transactions in form at least purport to be sales and a gift, the Commissioner nevertheless maintains that we should not accord them that significance. The Commissioner's argument is in two parts: The first proposition derives from the basic finding of the district court that the taxpayer effected the liquidation 'in such manner as to achieve a tax reduction' and that this was 'without legal or moral justification.' The Commissioner attempts to bolster this argument by his traditional corporation reorganization analysis to the effect that, so long as the 'end-result' of the transactions involved complies with the 'criteria of the statute,' intermediary steps (in this case the sales and gift) should be ignored as if they were nonexistent. His reasoning is that, if the final outcome is complete liquidation of a subsidiary corporation which at the outset was wholly owned by the taxpayer, the entire procedure comes within the intendment of the statute and 'circuitous steps to avoid § § 112(b)(6) [§ 332]' occurring prior to the ultimate liquidation should be disregarded.

The Commissioner's second proposition is that there were in fact no valid sales or gift of stock made by the taxpayer. This argument rests on the taxpayer's admission that the transfers were motivated solely by tax considerations and were made in a friendly atmosphere to friendly people who knew of the decision to liquidate the corporation before the end of the year. As the Commissioner points out, the liquidation took place shortly after the transfers, and the transferees then received back the money they had paid in, plus a small profit. Therefore, the Commissioner argues, relying heavily on *Gregory v. Helvering*, 293 U.S. 465 (1935) that 'the stock transfers in question had no independent purpose or meaning – either for the transferor or the transferees – but constituted merely a transitory and circuitous routing of legal title for the purpose of avoiding taxes, within the meaning of *Gregory v. Helvering*, *supra*. It was not expected or intended by any of the parties that the transferees should become true stockholders. Legal title passed; but beneficial ownership surely never passed. The transferees who paid money for their stock knew that the subsidiary would be liquidated in a few days and that they would get their money back – as in fact they did, with additional amounts to pay them for their cooperation in serving as conduits of title.' The gift of stock to the United War Fund is dismissed as 'nothing more than a gift of the cash.'

....

Our conclusion is that the Commissioner's arguments must be rejected, and that the taxpayer should be permitted to 'recognize' the loss on its investment, which it undoubtedly realized upon the liquidation of the Building Corporation.

Initially we may note, without ruling upon it, one legal argument made by the Commissioner having to do with the efficacy of the purported sale of 1,025 shares of stock to Howard D. Johnson Company on December 6, 1943. The Commissioner contends that, to satisfy the first condition of nonrecognition prescribed in § 112(b)(6) [§ 332], it is not necessary to have a formal plan of liquidation, evidenced by a corporate resolution, but it is sufficient if there is a 'definitive determination' to achieve dissolution. It is claimed by the Commissioner that such a definitive determination existed here by November 10, 1943, and, therefore, that the sale of stock to Howard D. Johnson Company which took place on December 6, 1943 (before the formal adoption of the plan of liquidation) occurred after the 'adoption of the plan of liquidation' within the meaning of § 112(b)(6) [§ 332]. In this view the taxpayer owned 100 per cent of the subsidiary's stock on the date the plan of liquidation was adopted, from which it would follow, on the basis of the first condition of § 112(b)(6) [§ 332], that the loss should not be 'recognized.'

We need not consider the foregoing legal argument on its merits, because the subsequent actions by the taxpayer – the sales to Johnson individually and to Richmond on December 13, 1943, and the gift of stock on the same day to the United War Fund – of themselves, if valid, successfully accomplished the taxpayer's purpose of avoiding the nonrecognition provisions of § 112(b)(6) [§ 332] under the second condition contained in that subsection. This second condition[110] prescribes, in a sort of backhanded way, that gain or loss shall be recognized if, at any time on or after the date of the adoption of the plan of liquidation and prior to the date of the receipt of the property distributed in final liquidation, the receiving corporation is the owner of a greater percentage of any class of stock of the corporation being liquidated than the percentage of such stock owned by it at the time of the receipt of the property – which means that this condition precedent to the nonrecognition of a realized gain or loss is not satisfied if, in the described period, the receiving corporation has made an effective disposition of any of the shares of stock held in the subsidiary corporation, without making any countervailing acquisitions of such stock.

Turning then to the basic contentions of the Commissioner, not much need be said with reference to the proposition that the tax motive for the sales and gift rendered the transactions 'immoral' and thus vitiated them. Again and again the courts have pointed out that a 'purpose to minimize or avoid taxation is not an illicit motive.' [citations omitted].

As for the Commissioner's 'end-result' argument, the very terms of § 112(b)(6) [§ 332] make it evident that it is not an 'end-result' provision, but rather one which prescribes specific conditions

[110] [This condition is now part of § 332. *See infra*.]

for the nonrecognition of realized gains or losses, conditions which, if not strictly met, make the section inapplicable. In fact, the Commissioner's own regulations (Reg. 111, § 29.112(b)(6)) emphasize the rigid requirements of the section and make no allowance for the type of 'step transaction' theory advanced in this case.

The legislative history of § 112(b)(6) [§ 332] likewise tends to support the position of the taxpayer. That history indicates that Congress was primarily concerned with providing a means of facilitating the simplification of corporate structures pursuant to the general policy enunciated in the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. § 79 et seq. [citations omitted]. This fact, while perhaps not conclusive as to the proper interpretation of § 112(b)(6) [§ 332], nevertheless does lend a favorable background to the taxpayer's contention that the subsection, as a relief measure, was 'not designed as a strait jacket into which corporations should be forced at the penalty of forfeiture of losses on liquidation of subsidiaries.'

The more specific and more important bit of legislative history is found in the Report of the Senate Finance Committee at the time that § 112(b)(6) was reenacted, with amendments, as § 332 of the Internal Revenue Code of 1954. At this time, when Congress was engaged in a comprehensive reexamination of the Internal Revenue Code, the well-known case of *Commissioner of Internal Revenue v. Day & Zimmermann, Inc*., 151 F.2d 517 (CA3 1945), had been decided in favor of the taxpayer, and it reasonably could be supposed that Congress, had it disapproved of the decision in that case, would have overturned its conclusion by making over § 112(b)(6) [§ 332] into an 'end-result' provision. In the *Day & Zimmermann* case, the taxpayer, admittedly in order to avoid the nonrecognition provisions of § 112(b)(6) [§ 332], had sold at public auction a sufficient number of shares of a wholly owned subsidiary corporation to reduce its holdings below 80 per cent. These shares were bought, after general bidding, by the treasurer of the taxpayer, who, after receiving cash dividends in the subsequent liquidation of the companies, reported his gain and paid income tax thereon. The Third Circuit held that § 112(b)(6) [§ 332] did not apply to the liquidation, emphasizing that the treasurer had paid a fair price for the shares, had used his own money, had not been directed by anyone to bid, and that there had been no showing of any understanding existing between him and the corporation by which the latter was to retain any sort of interest in the securities or in the proceeds therefrom. [citation omitted]. *Commissioner of Internal Revenue v. Day & Zimmermann, Inc.*, is not to be distinguished, as the Commissioner suggests, on the ground that the sale of stock was at public auction, without specific negotiation between the treasurer and the taxpayer. The significant thing in the case is its ultimate rationale that the purported sales of stock to the treasurer were in fact sales, notwithstanding the tax motive which prompted the corporation to enter into the transaction; from which it would seem to be irrelevant how the transfer was arranged, or whether or not it occurred at a public auction or exchange, so long as the beneficial as well as legal title was intended to pass and did pass.

Now, what did the Congress do in 1954 in view of *Commissioner of Internal Revenue v. Day & Zimmermann, Inc.*, holding that a parent corporation contemplating the liquidation of a wholly owned subsidiary might elect, by making a transfer of an appropriate portion of the stock in the subsidiary, to avoid the conditions precedent to the nonrecognition of gain or loss prescribed in

§ 112(b)(6) [§ 332]? In reenacting that section in 1954, the Congress struck out the second condition, but left in the first condition which the taxpayer had successfully utilized in the *Day & Zimmermann* case in order to avoid a nonrecognition of a realized loss. This is what the Report of the Senate Finance Committee said at the time:

> 'Section 332. Complete Liquidations of Subsidiaries.
>
> 'Except for subsection (c) § 332 corresponds to and in general restates § 112(b)(6) of the 1939 Code and provides for the liquidation of a subsidiary corporation by its parent without the recognition of gain or loss to the parent corporation. Your committee has, however, deleted a provision which now appears in § 112(b)(6)(A) which removes a liquidation from the application of that section if the parent corporation at some time on or after the time of the adoption of the plan of liquidation and until the receipt of the property owns more stock than that owned at the time of the receipt of the property. Your committee has removed this provision with the view to limiting the elective features of the section.' (Sen. Finance Committee Report, H.R. 8300, 83d Cong., 2d Sess. 255 (1954).)

The above reference to the 'elective features' of the subsection seems inescapably to reflect a legislative understanding (admittedly not contemporaneous with enactment, however) that taxpayers can, by taking appropriate steps, render the subsection applicable or inapplicable as they choose, rather than be at the mercy of the Commissioner on an 'end-result' theory. Nowhere in the subsection is there any express reference to an 'election' or an 'option,' and the use of the word 'elective' in the committee report therefore strongly indicates, as the taxpayer argues, that the committee believed that corporations could avoid the nonrecognition provisions by transfers designed to eliminate the specific conditions contained in the subsection.

We come then to the Commissioner's second major contention, resting on *Gregory v. Helvering*, *supra*, that the sales of stock by the corporation should be ignored on the ground that they were not bona fide, and that the taxpayer therefore retained 'beneficial ownership'. The Commissioner characterizes the transfers as artificial, unessential, transitory phases of a completed tax avoidance scheme which should be disregarded.

....

In the present case the question is whether or not there actually were sales. Why the parties may wish to enter into a sale is one thing, but that is irrelevant under the *Gregory* case so long as the consummated agreement was no different from what it purported to be.

Even the Commissioner concedes that 'legal title' passed to the several transferees on December 13, 1943, but he asserts that 'beneficial ownership' never passed. We find no basis on which to vitiate the purported sales, for the record is absolutely devoid of any evidence indicating an understanding by the parties to the transfers that any interest in the stock transferred was to be retained by the taxpayer. If Johnson or Richmond had gone bankrupt, or the assets of both had

been attached by creditors, on the day after the sales to them, we do not see how the conclusion could be escaped that their Building Corporation stock would have been included in their respective assets; and if Johnson or Richmond had died, surely the holdings of stock of each would have passed to his executors of administrators, or legatees.

In addition to what we have said, there are persuasive reasons of a general nature which lend weight to the taxpayer's position. To strike down these sales on the alleged defect that they took place between friends and for tax motives would only tend to promote duplicity and result in extensive litigation as taxpayers led courts into hairsplitting investigations to decide when a sale was not a sale. It is no answer to argue that, under *Gregory v. Helvering*, there is an inescapable judicial duty to examine into the actuality of purported corporate reorganizations, for that was a special sort of transaction, whose bona fides could readily be ascertained by inquiring whether the ephemeral new corporation was in fact transacting business, or whether there was in fact a continuance of the proprietary interests under an altered corporate form. [citation omitted].

What we have said so far is related chiefly to the validity of the sales. When we turn to the gift on December 13, 1943, to the United War Fund, the taxpayer is on even firmer ground. The Commissioner says that the gift was nothing more than a gift of cash, that the charity 'was, at most, a passive transferee, without independent purpose, which held legal title to two shares for four days.' This assertion rests, when examined closely, on the simple fact that the purpose for the gift was a tax avoidance one. But this does not disqualify it as an effective gift, transferring title. A gift certainly may have a tax motive. [citations omitted]. Charitable contributions of low-cost securities are an every-day type of transfer motivated by tax purposes. The gift to the United War Fund, being valid, transferred two shares from the taxpayer after the adoption of the plan of liquidation, and alone sufficed to put the liquidation beyond the reach of the nonrecognition provisions of § 112(b)(6) [§ 332].

In short, though the facts in this case show a tax avoidance, they also show legal transactions not fictitious or so lacking in substance as to be anything different from what they purported to be, and we believe they must be given effect in the administration of § 112(b)(6) [§ 332] as well as for all other purposes. [citations omitted].

A judgment will be entered vacating the judgment of the District Court and remanding the case to that court with direction to enter judgment for the plaintiff in the sum of $57,801.32, with interest.

Questions and comments:

1. Section 267(a)(1) denies a deduction for losses incurred in the sale or exchange of property between related persons. Sections 267(a)(3) ("controlled group") and 267(f) (cross-referencing § 1563(a)) include sales between parent and subsidiary. A "subsidiary" is a corporation in which parent owns more than 50% of the stock by vote *or* value. §§ 267(f)(1), 1563(a)(1). The loss incurred upon such a sale or exchange is not forever denied, but rather deferred until the property is transferred outside of the controlled group.

2. In *Granite Trust*, taxpayer wanted to recognize losses and so had to *rid* itself of sufficient shares so that it owned less than 80% of what had been a subsidiary. What if taxpayer does not want to recognize gain upon liquidation but owns less than 80% by vote and value of the liquidating corporation's shares. It must *acquire* sufficient shares so that it owns 80% of the corporation it wants to liquidate. How would you expect the Commissioner to respond? How helpful are the following two revenue rulings in this regard?

Rev. Rul. 70-106, 1970-1 C.B. 70

The liquidation of a subsidiary fails to meet the 80 percent control requirement under § 332(b)(1) of the Code where a corporate shareholder owning 75 percent of the subsidiary's stock causes the subsidiary to redeem the minority shareholders' 25 percent interest before adopting a liquidation plan.

Minority shareholders owned twenty-five percent of the capital stock of corporation X. The remaining seventy-five percent of the capital stock of X was owned by Corporation Y. Y desired to liquidate X in a transaction to which § 332 of the Internal Revenue Code of 1954 would apply in order that Y would recognize no gain on the transaction. The minority shareholders agreed to have their stock of X redeemed. Following the distribution to the minority shareholders, Y owned all the stock of X. Y then adopted a formal plan of complete liquidation of X and all of the remaining assets of X were distributed to Y.

Held, all of the shareholders of X received a distribution in liquidation under the provisions of § 331 of the Code, and the gain is recognized to Y and gain or loss is recognized to the minority shareholders under § 331 of the Code. The liquidation fails to meet the eighty percent stock ownership requirements of § 332(b)(1) of the Code since the plan of liquidation was adopted at the time Y reached the agreement with the minority shareholders and at such time, Y owned seventy-five percent of the stock of X.

Questions and comments:

1. Apparently: Corporation Y should have purchased the stock of the minority shareholders without informing them of an intent to liquidate Corporation X. How realistic is this?

Rev. Rul. 75-521, 1975-2 C.B. 120

Liquidation following purchase of controlling interest. The 80-percent control requirement of § 332(b)(1) of the Code is met by a corporate shareholder, owning 50 percent of the stock of a corporation, that purchased all the remaining stock from individual shareholders and immediately thereafter adopted a plan of complete liquidation of the subsidiary; Rev. Rul. 70-106 distinguished.

Shareholders, who were all individuals, owned 50 percent of the capital stock of corporation X. The remaining 50 percent of the capital stock of X was owned by corporation Y for more than two years. Y desired to liquidate X in a transaction to which § 332(a) of the Internal Revenue Code of 1954 would apply in order that Y would recognize no gain on the liquidation. In accordance with § 332(b)(1), 332(a) applies if the corporation receiving the property was, on the date of the adoption of the plan of liquidation, and has continued to be until the receipt of the property, the owner of stock of the other corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock (except preferred nonvoting stock). Y purchased all the X stock owned by the individual shareholders for cash. Following the purchases from the individual shareholders, Y owned all of the stock of X. Immediately thereafter, Y adopted a plan of complete liquidation of X and all of the property of X was distributed to Y in complete cancellation of all of its stock in X within the taxable year.

Held, no gain or loss is recognized to Y upon its receipt of the property of X distributed in complete liquidation of X pursuant to § 332(a) of the Code. The liquidation meets the 80-percent stock ownership requirement of § 332(b)(1).

Rev. Rul. 70-106, 1970-1 C.B. 70, holds that the liquidation of a subsidiary fails to meet the 80-percent control requirement under § 332(b)(1) of the Code where a corporate shareholder owning 75-percent of the subsidiary's stock causes the subsidiary to redeem the minority shareholders' 25-percent interest before formally adopting a plan of liquidation. The redemption was deemed to be a distribution in liquidation instead of a distribution in redemption preceding a distribution in liquidation because the plan of complete liquidation was adopted at the time the corporate shareholder reached an agreement with the minority shareholders to have the subsidiary redeem their stock. The entire distribution came from the subsidiary pursuant to that plan. In the instant case, the purchase of X stock by Y cannot be viewed as part of the distribution in liquidation of X because a mere sale of stock between shareholders does not constitute an adoption of a plan of liquidation.

Rev. Rul. 70-106 is distinguished.

Questions and comments:

1. Does the IRS do an adequate job of distinguishing Rev. Rul. 70-106? Focus on the end result of the transactions (i.e., Corporation X's assets become assets of Corporation Y, minority shareholders of Corporation X have their shares redeemed). How can we distinguish the end result of Rev. Rul. 70-106 from that of Rev. Rul. 75-521?

2. The Tax Court may have put such questions to rest in *George L. Riggs, Inc. v. Comm'r*, 64 T.C. 474 (1975). In that case, taxpayer had various business reasons for wanting to liquidate. Taxpayer needed to acquire stock from minority shareholders and advised them of its intent. It successfully acquired such shares by May 9, 1968. The corporation formally adopted a plan of

liquidation on June 20, 1968.

> While the motives enumerated by [taxpayer] do not directly negate the notion that a liquidation may have been contemplated, discussed, or even intended prior to May 9, 1968, they do serve to sufficiently undermine the conclusions drawn by [the Commissioner] from the actions and statements to offset any presumptions that respondent's inferences are correct. Without more concrete evidence than we have before us, we cannot agree with respondent that a plan of liquidation of Riggs-Young was adopted within the meaning of § 332 prior to May 9, 1968. Lacking such a finding, we believe the date on which the resolution to liquidate was actually adopted by the shareholders should be controlling.
>
> The very most that can be gleaned from the evidence favorable to [the Commissioner's] contention is that there may have been a general intent on the part of [taxpayer's] advisers somewhere along the line prior to May 9, 1968, to liquidate Riggs-Young when and if [taxpayer] achieved 80-percent ownership of Riggs-Young stock as a result of the tender offer. However, ... the formation of a conditional general intention to liquidate in the future is not the adoption of a plan of liquidation. [citation omitted].
>
> A mere intent by a taxpayer-corporation to liquidate a subsidiary prior to meeting the 80-percent requirement of § 332 should not be tantamount to the adoption of a plan of liquidation for the subsidiary at the point in time when that intent is formulated or manifested. Such a result would thwart the congressional intent of § 332 and prior judicial interpretations of this section and its predecessor.
>
> The predecessor of § 332, was § 112(b)(6), first enacted in 1935. The purpose of § 112(b)(6) was to encourage the simplification of corporation structures and allow the tax-free liquidation of a subsidiary. [citation omitted].

64 T.C. at 487-88. By fixing on the date of adoption of a resolution to liquidate, it seems that the court allows the parent to choose the means by which it acquires 80% of the subsidiary's stock – whether by purchase or by redemption.

3. If a complete transfer within a taxable year occurs, then the shareholders' resolution authorizing the distribution of all the corporation's assets in complete cancellation or redemption of all its stock is deemed to be adoption of a plan of liquidation. § 332(b)(2); Reg. § 1.332-3.

A subsidiary may also adopt a plan of liquidation pursuant to which it makes one or a series of distributions that occur within three years from the close of the taxable year during which the first distribution occurred. § 332(b)(3). The plan must state the period during which the distribution will occur. Reg. § 1.332-4(a)(1). If the subsidiary does not complete the transfer within the three-year time frame, no distribution is considered to be a distribution in complete liquidation. § 332(b)(3). The distributing corporation must recognize gain or loss on each distribution. Reg. § 1.332-4(b).

4. The plan may be informal, but (1) must manifest an intent to liquidate; (2) the purpose to terminate corporate affairs must be continuing; and (3) the activities of the corporation and its shareholders must be directed toward that objective. *See Rendina v. Comm'r,* T.C. Memo. 1996-392, *supra* (§ 331).

5. Notice that application of § 332 by its terms ("No gain or loss *shall* be recognized ..." § 332(a)) is not optional. Taxpayer exercises the option to make it apply (or not apply) through the ownership (or non-ownership) of shares.

6. When the parent does not own 100% of the stock of the subsidiary, i.e., there are minority shareholders, the liquidation of the minority shareholders' interests is treated as a liquidation under §§ 331/336, *infra*. However, the distributing liquidating corporation may not recognize loss on any distribution to a minority shareholder. § 336(d)(3). If it were otherwise, the recognized loss would pass through to the benefit of the parent corporation. *See* §§ 381(c)(1 and 3).

7. Failure to comply with all the requirements of § 332 will mean that §§ 331 and 336, *infra*, will govern the liquidation. The parent and subsidiary may both be exchanging appreciated property. A problem may arise if a liquidation is not completed within the three-year period of § 332(b)(3). Reg. § 1.332-4(b) (last sentence) provides for recomputation of gain and loss on each distribution. While that regulation concerns the distributee parent, presumably the same rule applies to the distributor subsidiary.

Problems:

P Corporation owns all the stock of S Corporation. P's basis in the stock is $100,000. S Corporation's assets have a basis of $40,000 and a fmv of $150,000. S Corporation has accumulated earnings and profits of $60,000.

a. S Corporation is liquidated. The liquidation meets the requirements of § 332(b). What are the tax consequences to the parties?

b. What will P's aggregate basis be in the assets it acquires from S Corporation?

c. How would your answers change if S Corporation was indebted to P Corporation for $25,000?

d. Suppose that the fair market value of S Corporation's assets was $75,000. What disadvantages would there be in such a liquidation? What might the parties do to avoid such disadvantage while going through with their plans to liquidate?

Do the CALI exercise: Corporate Taxation: Liquidations: Subsidiary Liquidations: Section 332.

Chapter 7: Subchapter S

I. Introduction

In 1958, Congress enacted subchapter S, which creates a tax regime for "small business corporation[s]" whereby only the owners of the business recognize the corporation's income, gain, deductions, and losses. Income, gain, deductions, and losses "pass through" the corporate entity untaxed to the corporation's owners/shareholders. Except as specifically provided in subchapter S itself, the corporation is not a taxpaying entity. § 1363(a).[111] In contrast to the C corporation, income of the corporation that shareholders receive is subject to only one level of income tax, not two. The importance of this point grew as the difference between relatively low corporate income tax rates and relatively high individual income tax rates shrank through the 1980s and 1990s.

Why choose to be an S corporation when you can be an LLC: Prior to the late 1980s, subchapter S provided the only means by which a small business could limit its liability *and* be subject to only one level of income tax. This dual benefit is now available to limited liability companies (LLCs). There are reasons to choose to do business as an S corporation rather than as an LLC.

- In some respects, an LLC permits greater flexibility to business owners in how they allocate income, gain, deduction, and loss. But the very fact that S corporations may have less flexibility is a benefit to some business owners – those who want the clear structure and rules that subchapter S provides. The flexibility that an LLC may enjoy can come at the cost of unwanted complexity.
- An S corporation is a *corporation*, and an LLC is not a corporation. The Code provides some benefits to corporations, irrespective of whether they are S or C corporations that are not available to an LLC, e.g., a deduction of at least a portion of dividends received from another corporation under § 243 and a deduction of all dividends received from a foreign subsidiary, § 245A.
- The tax consequences of certain transactions to business owners is not always the same between an S corporation and an LLC, e.g., loans incurred by the entity, property distributions to owners. Whether one treatment or the other of such transactions is to be preferred depends on the circumstances of the taxpayer.
- Shareholders of an S corporation do not pay employment taxes on the dividends they receive. Owners of LLC interests do pay employment taxes.
- The sale of S corporation stock is quite simply the sale of a capital asset and so gain is subject to capital gain treatment. The sale of an LLC interest is riddled with special rules preserving the character of gain (and loss) as ordinary.
- An S corporation can be a party to a tax-deferred reorganization (*see* chapter 9, *infra*).

[111] The S corporation is not subject "to the taxes imposed by this chapter." That includes the alternative minimum tax, the accumulated earnings tax, and the personal holding company tax – as well as the income tax.

Hence, the shareholders of the S corporation can exchange their interest on a tax-deferred basis and enjoy pass-through treatment before the reorganization. The tax consequences of reorganizations involving a "disregarded entity" are much more problematic.

•A C corporation may elect to become an S corporation if it a "small business corporation" and elects to be an S corporation. It can do this without incurring the tax consequences of liquidating, *See* chapter 6, *supra*.

•Both S corporations and LLC are "pass-through" entities and may benefit from the deduction of 20% of "qualified business income" under § 199A.

Default definition and tax rules applicable to C and S corporations: A "C corporation" is "a corporation which is not an S corporation for such year." § 1361(a)(2). Unless subchapter S provides otherwise, subchapter C's rules apply to S corporations and their shareholders, except to the extent inconsistent with it. § 1371(a). We will find that subchapter S leaves many topics untouched – and so they are governed by the principles of subchapter C.

Definition of "small business corporation": The Code defines "small business corporation" in terms of its ownership and of its stock – not in terms of assets, profitability, or revenue. An "S corporation" is a "small business corporation for which an election under § 1362(a) is in effect for such year." § 1361(a)(1). As we shall see, the fact of an election or the failure to make an effective election has considerable significance.

We note here the conditions of being a "small business corporation." The trend has been to expand eligibility for S corporation status – but the conditions are quite rigid. Again: meeting these conditions and continuing to meet them are very important because failure to do so results in a corporation at once becoming a C corporation – whose income is subject to two levels of income tax if that income moves to the hands of shareholders. Section 1361(b)(1) provides that a "small business corporation may have –

•no more than 100[112] shareholders;

•only individuals as shareholders, as well as estates (decedent's estate or bankrupt's estate, § 1361(c)(3)), certain trusts, tax-exempt § 501(c)(3) organizations, and tax-exempt employer stock bonus, pension, or profit-sharing plans.

Disqualified entities: Section 1361(b)(2) provides that an S corporation may not be –

•a financial institution;

•an insurance company;

•a corporation that has elected to receive a credit under § 936 for income derived from sources within a U.S. possession; or

•a DISC or former DISC, i.e., domestic international sales corporation.

Thus, C corporations, partnerships, or other entities may *not* own shares of an S corporation. A "small business corporation" may *not* have –

•a nonresident alien as a shareholder; or

•more than one class of stock.

[112] This number has been increased from 10 to 15, from 15 to 25, from 25 to 35, from 35 to 75, and from 75 to 100.

An S corporation may own a C corporation, but a C corporation may not own an S corporation. § 1361(b)(1)(B). In fact, an S corporation may not own shares of another S corporation,[113] unless it owns *all* the shares of an S corporation subsidiary.

Subsidiary S corporations: While a C corporation may not own shares of an S corporation, § 1361(b)(1)(B), an S corporation may have an S corporation as a wholly-owned subsidiary ("Qualified Subchapter S Subsidiary" (QSSS) or "Qsub"). The S corporation must own 100% of the Qsub's stock and affirmatively elect to treat the subsidiary as a Qsub. § 1361(b)(3)(B). The Qsub is not treated as a separate corporation for federal tax purposes. Reg. § 1.1361-4(a)(i). Except for the 100% stock ownership requirement, the Qsub's stock is disregarded for federal tax purposes. Reg. § 1.1361-4(a)(4). "[A]ll assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation." § 1361(b)(3)(A)(ii).

> *S subsidiaries*: Formation of a subsidiary enables the parent to shield itself from liabilities arising from the subsidiary's activities. There are no tax reasons to form a subsidiary.

If the Qsub ceases to qualify for Qsub status, then the Code requires that it be treated as a new corporation that acquires all the former Qsub's assets from the S corporation and assumes all its liabilities immediately prior to such cessation in exchange for all the new corporation's stock. §1361(b)(3)(C)(i).

- If termination of Qsub status occurs because the parent corporation sold stock of the corporation and so is no longer the sole shareholder, the sale is to be treated as the sale of an undivided interest in the assets of the former Qsub (pro rated to the number of shares sold) followed by the Qsub corporation's acquisition of all the corporation's assets and liabilities in a transaction to which § 351 applies. § 1361(b)(3)(C)(ii).
- A Qsub corporation whose status as such is terminated will not be eligible to make a subchapter S election until the fifth taxable year that begins after the first taxable year for which the termination was effective. § 1361(b)(3)(D).[114] Reg. § 1361-5(c)(2) provides that a former Qsub may make an S election if immediately following termination it is otherwise eligible to make such an election and makes such an election immediately following the termination of the Qsub election.

[113] Actually, the S corporation of which an S corporation may want to own shares cannot definitionally be an S corporation. § 1361(b)(1)(B).

[114] ... unless the Secretary consents.

II. Conditions of Qualification for S Corporation Status

A. Counting Shareholders: Whom to Count

An S corporation can have no more than 100 shareholders. As a business grows and more persons wish to own an interest in it, perhaps offspring of the founders, the rules for counting shareholders gain considerable importance. Again, the penalty for running afoul of the rules is that the corporation becomes a C corporation.

Basic rule: Reg. § 1.1361-1(e)(1) provides in part that "[o]rdinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation." Thus each tenant in common and each joint tenant is a shareholder. *Id.* "The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation ..." *Id.*

Section 1361 does not contain attribution rules, but rather simply counts persons in various relationships as a single shareholder. Counting two or more persons as single shareholder for purposes of counting shareholders does *not* eliminate for *all* of such persons to meet the other qualifications of being a shareholder of an S corporation.

- A husband and wife (and their estates) are treated as a single shareholder. § 1361(c)(1)(A)(i). Both must be citizens or residents of the United States. Reg. § 1.1361-1(e)(2). A married couple that divorces becomes two shareholders instead of one.[115] Reg. § 1.1361-1(e)(2) (treatment as single shareholder ceases "upon dissolution of the marriage for any reason other than death").
- The American Jobs Creation Act of 2004 considerably enhanced the availability of S corporation status to family-owned businesses. Members of a family (and their estates) are treated as a single shareholder. § 1361(c)(1)(A)(ii). The phrase "members of a family" means a "common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any lineal descendant." § 1361(c)(1)(B)(i). A "common ancestor" must on the "applicable date" be no more than six generations removed from the youngest generation of shareholders. § 1361(c)(1)(B)(ii). The "applicable date" is the *latest* of the date of a subchapter S election, the earliest date on which a family member owns stock, or October 22, 2004. § 1361(c)(1)(B)(iii). Thus, six generations of persons who trace their lineage back to one common ancestor – no doubt long since dead – counts as one shareholder. This rule applies when counting the number of shareholders and not for other purposes. Reg. § 1.1361-1(e)(3)(i). Thus, any member of a family who owns shares must be a citizen or resident of the United States, be an individual, and must consent to election to be an S

[115] A good tax planner will anticipate this eventuality, perhaps by making divorce the triggering event of a transfer of stock to one of the spouses only.

corporation. Reg. § 1.1361-1(e)(3)(i). As a descendant from a new generation acquires stock, the determinant "common ancestor" moves down one generation.

•We do not "look through" the family when counting shareholders.

With some planning, the impact of these rules can be lessened. Nothing prevents would-be shareholders from forming a new subchapter S corporation and then forming a partnership with one or more existing subchapter S corporations. Rev. Rul. 94-43, 1994-2 C.B. 198 ("a shareholder of one S corporation [should not] be considered a shareholder of another S corporation because the S corporations are partners in a partnership").

B. Who Can Be a Shareholder

Section 1361(b)(1)(C) specifies that an S corporation may not have a nonresident alien as a shareholder. Section 1361(b)(1)(B) provides – with some exceptions noted herein – that only an "individual" may own stock in a "small business corporation." This means that the stock of an S corporation may not be owned by business entities, e.g., corporations, partnerships, LLCs, and even other S corporations. *See* Reg. § 1.1361-1(f).

Section 1361(b)(1)(C) permits an "estate" to be the shareholder of an S corporation. The estate, and not its beneficiary(ies), is the shareholder. Reg. § 1.1361-1(e)(1). An "estate" may be the "estate" of an "individual" in a bankruptcy case. § 1361(c)(3).

Section 1361(b)(1)(B) provides that certain trusts may be shareholders of a "small business corporation." Such trusts include –

Trusts: How many shareholders to count. In examining the shareholder count when a trust holds shares of the S corporation, notice when we do *not* "look through" the entity – thereby potentially enlarging the count – and when we do not "look through" the entity.

•a grantor trust (subject to §§ 671-679) "all of which is treated ... as owned by an individual who is a citizen or resident of the United States," § 1361(c)(2)(A)(i); the owner is the shareholder, § 1361(c)(2)(B)(i);

•a grantor trust whose owner dies and which continues in existence after the owner's death for no more than two years after the owner's death, § 1361(c)(2)(A)(ii); the estate of the deemed owner is the shareholder, § 1361(c)(2)(B)(ii);

•a trust with respect to stock transferred to it by will for no more than two years after such transfer, § 1361(c)(2)(A)(iii); the estate of the testator is the shareholder, § 1361(c)(B)(iii);

•a trust created "primarily to exercise the voting power of stock transferred to it," § 1361(c)(2)(A)(iv); each beneficiary is a shareholder, § 1361(c)(2)(B)(iv);

•"[a]n electing small business trust," *infra*, § 1361(c)(2)(A)(v); each potential beneficiary is a shareholder unless there is no beneficiary, in which case the trust is a shareholder, § 1361(c)(2)(B)(v); and

•an IRA trust or Roth IRA trust held by a financial institution to the extent of the stock held by such trusts when this provision was enacted,[116] § 1361(c)(2)(A)(vi); the individual for whose benefit the trust was created is a shareholder, § 1361(c)(2)(B)(v).

Qualified Subchapter S Trust (QSST): A QSST is treated as a "grantor trust." A QSST is a trust whose terms require that –

•during the life of the current income beneficiary there can be only one beneficiary of the trust, § 1361(d)(3)(A)(i);
•any distribution of trust corpus during the life of the current income beneficiary can be made only to that beneficiary, § 1361(d)(3)(A)(ii);
•the income interest of the current beneficiary must terminate on the earlier of the income beneficiary's death or the termination of the trust, § 1361(d)(3)(A)(iii);
•upon termination of the trust during the income beneficiary's life, the trust must distribute all its assets to that beneficiary, § 1361(d)(3)(A)(iv); and
•the individual to whom all the income is distributed (or required to be distributed) currently is a United States citizen or resident, § 1361(d)(3)(B).

"If the terms of the trust do not preclude the possibility that any of the[se] requirements ... will not be met, the trust will not qualify as a QSST." Reg. § 1.1361-1(j)(1)(iii). "A substantially separate and independent share of a trust within the meaning of § 663(c)[117] shall be treated as a separate trust" for these purposes. § 1361(d)(3).

The point of a QSST: A QSST is an estate planning tool. Rather than gifting stock to persons to whom the owner of the stock may not wish to transfer control, the owner of stock can shift income and appreciation in the stock's value to them.

If the beneficiary of a QSST elects,[118] the trust will be treated as a grantor trust, § 1361(d)(1)(A), and the beneficiary treated as the owner of stock in the corporation with respect to which the election is made, § 1361(d)(1)(B). The trust's disposition of the stock is treated as a disposition by the beneficiary – thus allowing the beneficiary to deduct losses suspended under §§ 465 and 469. § 1361(d)(1)(C).

Electing Small Business Trust (ESBT): An "electing small business trust" is a trust that has as beneficiaries only –

•an individual,
•an estate,
•the charitable organizations listed in §§ 170(c)(2, 3, 4, and 5),[119] and

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[116] October 22, 2004. American Jobs Creation Act of 2204, P.L. 108-357, § 233(a).

[117] These sections establish rules for the distribution by a single trust to more than one beneficiary and the treatment of the trust as separate trusts.

[118] Section 1361(d)(2) establishes rules governing the timing and effect of the election as well as its application to successive beneficiaries. The election is revocable only upon consent of the Secretary, § 1361(d)(2)(C).

[119] This includes all of the organizations to which or for the use of which a taxpayer may deduct a

•organizations that are charitable under § 170(c)(1) and which hold a contingent interest in the trust and are not current beneficiaries.[120] § 1361(e)(1)(A)(i).

No interest in an ESBT may be acquired by purchase. § 1361(e)(1)(A)(ii). The trustee must make an election for a trust to be an ESBT. §§ 1361(e)(1)(A), 1361(e)(3). The following entities may *not* be beneficiaries of an ESBT:

•a QSST;
•a trust whose income is exempt from income tax; or
•a charitable remainder trust or charitable remainder unitrust. § 1361(e)(1)(B).

An ESBT is an eligible shareholder. § 1361(c)(2)(A)(v). An ESBT may have more than one beneficiary, but unlike a QSST, each "potential current beneficiary" counts as a shareholder. Reg. § 1.1361-1(m)(4)(i). "A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust." Reg. § 1361-1(m)(4)(i); *see* § 1361(c)(2)(B)(v). If there is no potential current beneficiary, then the trust is treated as the shareholder. § 1361(c)(2)(B)(v). There are special rules for taxing the income of the ESBT. Like the QSST, the ESBT is particularly useful as an estate planning tool.

Problems:

1. Can a corporation with 101 shareholders, two of whom are first cousins, qualify as a "small business corporation, assuming it meets all of the other requirements and elects to be an S corporation?

2. The XYZ partnership engages in the practice of law; its specialty is probate law. The ABC partnership engages in the practice of law; its specialty is criminal law. The PQR partnership engages in the practice of law; its specialty is real estate law. All three partnerships have their offices in the Fourth National Bank Building. Many other tenants also rent space in the Fourth National Bank Building. The three partnerships are considering forming an S corporation for the purpose of offering various services useful to offices on an occasional basis, e.g., large copying jobs, preparation of packages for mailing. There are a total of 21 partners in the three law firms, and all are U.S. citizens. Would the entity they contemplate forming be a "small business corporation?"

C. One Class of Stock

An S corporation may not have more than one class of stock. § 1361(b)(1)(D). In enacting this limitation, Congress did not intend that S corporations could issue only one, plain vanilla, class

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contribution – except for governmental entities within the United States. §§ 170(c)(2, 3, 4, and 5).

[120] This includes governmental units within the United States. § 170(c)(1).

of common stock.

Identical rights to distributions and to share in corporate growth: A corporation does not have more than one "class of stock solely because there are differences in voting rights among the shares of common stock." § 1361(c)(4). "[A] corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock." Reg. § 1.1361-1(*l*)(1).

- Reg. § 1.1361-1(*l*)(2)(i) provides in part: "The determination of whether all outstanding shares confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distributions and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement ..."

Some common planning devices and financing devices might appear to confer different rights to distributions and to liquidation proceeds. The regulations provide specific guidance.

Buy-sell and redemption agreements: Buy-sell and redemption agreements are often important instruments of transition in closely-held corporations, which most subchapter S corporations are. "Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights ..." Reg. § 1.1361-(*l*)(2)(iii)(A).

- There is an exception if the purpose of such agreements is to circumvent the one-class-of-stock requirement. Reg. § 1.1361-1(*l*)(2)(iii)(A)(1).
- A second exception is if the agreement establishes a purchase price "significantly" greater than or less than the fair market value of the stock. Reg. § 1.1361-(*l*)(2)(iii)(A)(2). A price that is "at book value or at a price between fair market value and book value ... [is not] significantly in excess of or below the fair market value of the stock, and, thus [is] disregarded in determining whether the outstanding shares of stock confer identical rights." *Id.*
- The regulations create an exception to these pricing rules for bona fide agreements "to redeem or purchase stock at the time of death, divorce, disability, or termination of employment ..." Reg. § 1.1361-1(*l*)(2)(iii)(B) (such agreements disregarded in determining whether corporation's shares confer identical rights).
- Forfeiture provisions that cause stock to be nonvested are also disregarded. *Id.*
- Standing alone, distributions that take account of shareholders' varying interest in the current or immediately preceding taxable year do not alter the rights to liquidation and distribution proceeds. Reg. § 1.1361-1(*l*)(2)(iv).

Debt: Certain debt instruments might constitute a second class of stock; deferred compensation plans do not.[121] Reg. § 1.1361-1(*l*)(4)(i). If an instrument, obligation, or arrangement (including convertible debt, Reg. § 1.1361-1(*l*)(4)(iv)(A)) constitutes an equity interest for purposes of federal tax law *and* has a principal purpose of circumventing others' rights to distribution or liquidation proceeds or circumventing the limitation on eligible shareholders, then it constitutes a second class of stock. Reg. § 1.1361-1(*l*)(4)(ii)(A).

- There are two safe harbors to this rule.
  - Shareholder advances of $10,000 or less, i.e., "[u]nwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock ..." Reg. § 1.1361-1(*l*)(4)(ii)(B)(1).
  - Shareholders who hold the same class of obligation proportionately do not hold a second class of stock even if such obligations are considered equity under federal law unless "a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders to distribution or liquidation proceeds or to circumvent the limitation on the number of eligible shareholders. Reg. § 1.1361-1(*l*)(4)(ii)(B)(2).

Calls and convertible debt: A call option may be a second class of stock if it is "substantially certain" to be exercised and has a strike price substantially below the fair market value of the underlying stock on the date the call option is issued, is transferred to one not eligible to be a subchapter S shareholders, or is substantially modified. Reg. § 1.1361-1(*l*)(4)(iii)(A). The same is true of convertible debt that embodies these rights. Reg. § 1.1361-1(*l*)(4)(iv)(B). For these purposes, a strike price that is more than 90% of the fair market value of the underlying stock on the date the option is issued is not substantially below its fair market value. Reg. § 1.1361-1(*l*)(4)(iii)(C). A call option does not have a strike price substantially below the fair market value of the stock at the time of issue if pursuant to the terms of the instrument the price at the time of exercise cannot be substantially below the fair market at the time of exercise. Reg. § 1.1361-1(*l*)(4)(iii)(A). The regulations make exceptions to this rule for those in the business of lending and the call option is issued "in connection with a commercially reasonable loan to the corporation." Reg. § 1.1361-1(*l*)(4)(iii)(B)(1). There is also an exception for call options issued to employees or independent contractors "in connection with" the performance of services for the corporation (or a related corporation) if the call option is not transferable and does not have a readily ascertainable fair market value. Reg. § 1.1361-1(*l*)(4)(iii)(B)(2).

"Straight Debt": "Straight debt" is not a second class of stock, § 1361(c)(5)(A), even if it is treated as equity under general principles of tax law, Reg. § 1.1361-1(*l*)(iv). "Straight debt" is a "written unconditional promise to pay" a sum certain in money on a specified date. § 1361(c)(5)(B). The interest rate on "straight debt" may not be contingent on profits, the

[121] ... so long as the plan does not convey the right to vote, is an unfunded and unsecured promise to pay in the future, is issued to individual who is an employee or independent contractor who performs services for the corporation, and whose benefits are not subject to current tax. *See* Reg. § 1.1361-1(b)(4).

borrower's discretion, etc., the debt cannot be directly or indirectly convertible into stock, and the lender must be an individual, an estate, a trust eligible to be a shareholder, or "person" actively and regularly "engaged in the business of lending money." § 1361(c)(5)(B). Subordinated debt can be "straight debt." Reg. § 1.1361-1(*l*)(5)(ii).

Problems:

In the following situations, has the corporation issued a second class of stock?
1. The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 1. *See also Paige v. United States*, 580 F.2d 960 (9th Cir. 1978).

2. S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 2.

3. S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose of D's employment agreement is to circumvent the one class of stock requirement. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 3.

4. S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 4.

5. E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which § 7872 applies. Under § 7872, E is deemed to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 5.

6. S, a corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the

shareholders equal after-tax distributions. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 6.

7. F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment. *See* Reg. § 1.1361-1(*l*)(2)(vi) Example 8.

Do the CALI exercise: S Corporation Taxation: Formation and Qualification: Eligibility as Small Business Corporation.

D. Making the Election and Terminating the Election

A "small business corporation" may "elect" to be an S corporation. § 1362(a)(1). *All* shareholders must consent to the election. § 1362(a)(2). The statute and regulations prescribe rules governing this election, and the consequences of not following them can be costly. A corporation that is not an S corporation is a C corporation, and a C corporation's income that devolves to a shareholder is subject to two levels of income tax. To the planner, this is certainly not the outcome that was contemplated when the "small business corporation" was created according to the definition of that phrase. The corporation and its shareholders make their election by filing Form 2553. Reg. § 1.1362-6(a)(2). A shareholder may alternatively make an election on a separate statement. Reg. § 1.1362-6(b)(3)(i). Once an election is effective, new shareholders need not consent to the election. Reg. § 1.1362-6(a)(2)(i).

The statute prescribes when the election is effective – an important matter because until it is effective the "small business corporation" is a C corporation. An election that the shareholders make any time during a taxable year is effective for the next taxable year. § 1362(b)(1)(A). The shareholders may also make an election for the current taxable year any time before the 15th day of the third month of its taxable year, § 1362(b)(1)(B), but the corporation must have been a "small business corporation" for every single day prior to the election and every shareholder who held stock during that period must have consented to the election, § 1362(b)(2)(B). However, if the effective date of the election is in the future, the "small business corporation" must be such on the day of the election and the day of effectiveness – but not necessarily the time between. Reg. § 1.1362-2(b)(2) ("election does not terminate even if the corporation was not a small business corporation during all or part of the period beginning after the date the election was made and ending before the first day of the taxable year for which the election is effective"). An election made after the 15th day of the third month of the taxable year is treated as made for the following taxable year. § 1362(b)(3). The Secretary may determine that there was reasonable cause for not making the election and treat the election as having been timely made. § 1362(b)(5). The election, once effective, is effective for all succeeding years until terminated. § 1362(c).

The subchapter S election may be terminated in one of three ways:

- by consent of shareholders who hold more than one half of the shares. § 1362(d)(1)(B).

If such a "revocation" is made before the 15th day of the third month of the taxable year, it is effective from the first day of the taxable year. § 1362(d)(1)(C)(i). A revocation made after that day is effective on the first day of the following taxable year. § 1362(d)(1)(C)(ii). The revocation may specify a date for revocation after the date on which the revocation is made. § 1362(c)(1)(D).

- While *all* shareholders must consent to *make* an S corporation election, a simple majority is sufficient to *revoke* the election. Dissenting shareholders cannot prevent a revocation.
- A revocation may be rescinded at any time before it becomes effective. Reg. § 1.1362-2(a)(4).
- Specifying a date for revocation can ameliorate accounting difficulties.

- A subchapter S election is terminated upon the "small business corporation" ceasing to be a "small business corporation." § 1362(d)2)(A).[122] The termination is effective on and after that date. § 1362(d)(2)(B).
  - A termination caused by ceasing to be a "small business corporation" is *prospective* only. A "revocation," *supra*, may be retroactive.

- If an S corporation was previously a C corporation, has *any* (even $1) accumulated earnings and profits at the close of three consecutive tax years while an S corporation, and has "passive investment income" for those years that exceeds 25% of its gross receipts, its S election is terminated. § 1362(d)(3)(A).
  - "Passive investment income" is gross receipts derived from royalties, rents, dividends, interest, and annuities. § 1361(d)(3)(C)(i). There are exceptions to this definition, most notably for interest on obligations acquired in the ordinary course of business from the sale of inventory. § 1361(d)(3)(C)(ii). The termination is effective on the first day of the first taxable year after the third year passive investment income exceeds gross receipts. § 1362(d)(3)(A)(iii).
    - Dispositions of capital assets that are *not* stock or securities: The S corporation measures its "gross receipts" by *netting gains and losses* ("capital gain net income," § 1222(9) from the disposition of assets that are not stock or securities. § 1362(d)(3)(B)(i).
    - Sales or exchanges of capital assets that *are* stock or securities: The S corporation measures its "gross receipts" derived from the sales or exchanges of capital assets are stock or securities by taking into account *only gains* from such sales or exchanges. § 1362(d)(3)(B)(ii).
      - Should the S corporation want to include losses in determining its "gross receipts?"

[122] The corporation should prospectively take measures to prevent dissident shareholders from transferring their shares to ineligible shareholders or to a sufficient number of shareholders that the total number of shareholders will exceed 100. The corporation should make agreement to a prohibition on such transfers a condition to holding shares in the corporation.

If –

•an election with respect to an S corporation or an S subsidiary is not effective because of failure to be a "small business corporation," for failure to obtain the necessary consents, for failure to make an election in compliance with the rules governing trusts or QSSTs (§ 1362(f)(1)), and

•the Secretary determines the circumstances causing such ineffectiveness or termination of election were inadvertent, § 1362(f)(2), and

•after no more than a reasonable time steps are taken to bring the corporation into compliance, § 1362(f)(3), and

•the corporation and every person who was a shareholder at any time such steps are executed agrees to make such adjustments that the Secretary prescribes, THEN

•the corporation will be an S corporation or subchapter S subsidiary during the period that the Secretary names. § 1362(f) (carryout ¶).

A corporation (and its successors[123]) whose valid election has been terminated may not again make an S corporation election before the fifth taxable year that begins after the first taxable year for which the termination was effective – unless the Secretary consents to such an election. § 1362(g). Thus, if a revocation is effective in year 1, the corporation may elect subchapter S status effective for the first day of year 6. The Secretary automatically consents if the election was invalid from its inception – even if manifested by retroactive revocation – so that the S corporation election was never effective. Reg. § 1.1362-5(c).

Do the CALI exercise: S Corporation Taxation: Formation and Qualification: S Corporation Elections.

Do the CALI exercise: S Corporation Taxation: Termination of the S Election: The Termination of S Election by Revocation.

•This exercise gets into the specific requirements for a revocation. Have your regulations handy.

Do the CALI exercise: S Corporation Taxation: Termination of the S Election: The Termination of S Election: Causes.

The following case raises several formation/termination issues and may give some context to the rules, as well as a sense of what is at stake.

[123] A corporation is a successor if 50% or more of its shares are owned, directly or indirectly, by the same persons who owned 50% or more of the predecessor corporation on the date of termination, *and* the successor corporation must already own or acquire a substantial portion of the assets of the predecessor corporation. Reg. § 1362-5(b).

Kean v. Commissioner, 469 F.2d 1183 (9th Cir. 1972)

WM. MATTHEW BYRNE, Jr., District Judge

Appellants, petitioners in the Tax Court, were shareholders in Ocean Shores Bowl, Inc., hereinafter referred to as Bowl, a Washington corporation. They appeal from a judgment of the Tax Court invalidating Bowl's election under Subchapter S, §§ 1371-1379 of the Code, and disallowing petitioners' deductions on their personal tax returns of their pro rata shares of Bowl's 1962 and 1963 net operating losses.

Bowl was formed on March 20, 1962 and had only one class of stock issued and outstanding. On October 30, 1962 Bowl filed a timely election to be taxed as a small business corporation pursuant to § 1372 of the Code. Consents to such election were contemporaneously filed by all of the shareholders of record and their wives. As a result of the election, Bowl's net operating losses of $15,316 for the short taxable year 1962 and $56,638.28 for 1963 were deducted in pro rata shares by petitioners on their 1962 and 1963 personal income tax returns.

Some Bowl debentures and 125 shares of Bowl stock were held in the name of petitioner, William MacPherson. He and his brother, petitioner Murdock MacPherson, were engaged in the real estate business in a company called MacPhersons, Inc. Each brother owned 45% of the stock of MacPhersons, Inc. with the remaining 10% being held by their mother. William and Murdock MacPherson had many joint investments which were conducted without any written agreement. Whoever initiated the investment would normally be responsible for its management. Neither held a power of attorney for the other. The books and records of MacPhersons, Inc. were maintained by its employee, Donald Minkler.

On their 1962 joint income tax return William MacPherson and his wife deducted the net operating loss of Bowl accruing to the 125 shares in William's name. In 1963 William MacPherson and his wife deducted one half of the net operating loss for that year attributed to said shares while Murdock MacPherson and his wife deducted the other one half on their joint return. In 1964 the William MacPhersons and the Murdock MacPhersons each reported the sale of one half of the 125 shares of Bowl stock and one half of the Bowl debentures. All of these returns were prepared by Donald Minkler.

A 1965 Internal Revenue Service audit disclosed that the 125 shares of Bowl stock and Bowl debentures, issued to William MacPherson in 1962, were purchased with a MacPhersons, Inc. check. The cost of the purchase was charged on the books of MacPhersons, Inc. equally against the drawing accounts of William and Murdock. Murdock MacPherson has never been repaid by William MacPherson for the amounts taken out of his drawing account to pay for the stock and debentures.

Murdock MacPherson was not a shareholder of record of Bowl. Neither he nor his wife were mentioned in the Subchapter S election filed with the Internal Revenue Service in October, 1962; nor did they file a consent to the election. None of the other shareholders knew that Murdock

MacPherson was involved in any way with Bowl until the 1965 audit.

The Tax Court held that Bowl's Subchapter S election was invalid because Murdock MacPherson, as a beneficial owner of Bowl stock, was a shareholder within the meaning of § 1372 and had not consented to the corporation's election. Based on this finding, the court disallowed petitioners' deduction of their pro rata shares of the corporation's net operating losses.

Subchapter S of the Internal Revenue Code of 1954 allows a small business corporation, as defined by § 1371, to elect to be exempt from corporate income taxes with the consequence that its shareholders are taxed directly on the corporation's earnings or may deduct the corporation's losses. Section 1372 provides that the corporation's election is "valid only if all persons who are shareholders ... consent to such election."

Petitioners contend that since Murdock MacPherson was not a shareholder of record and was not able to exercise any rights as a shareholder under Washington law, he was not a "shareholder" under § 1372. We disagree. The question of who is a shareholder as the term is used in Subchapter S must be determined by federal rather than state law. *Putnam's Estate v. Commissioner of Internal Revenue*, 324 U.S. 393 (1945); *Morgan v. Commissioner of Internal Revenue*, 309 U.S. 78 (1940); *Old Virginia Brick Company v. Commissioner of Internal Revenue*, 367 F.2d 276 (4th Cir. 1966). Reg. § 1.1371-1(d)(1), implementing Subchapter S, states that "Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be shareholders of the corporation."

Petitioners challenge the validity of this regulation on the ground that it has no statutory basis and is in conflict with the legislative history. They rely on a portion of the report of the Senate Finance Committee discussing Subchapter S which stated:

> An election may be made to supply the tax treatment provided by this new subchapter only if all of the shareholders consent to this election. For this purpose the shareholders are those of record as of the first day of the taxable year in question, or if the election is made after that time, shareholders of record when the election is made.

S. REP. NO. 1900, 85th Cong., 2nd Sess., p. 87.

The Tax Court in *Alfred N. Hoffman*, 47 T.C. 218, 235 (1966), *aff'd sub nom. Hoffman v. Commissioner of Internal Revenue*, 391 F.2d 930 (5th Cir. 1968), in considering the contention that a shareholder of record rather than the beneficial owner of the stock must consent to the Subchapter S election, discussed the report of the Senate Finance Committee as follows:

> While this use of the words 'of record' furnishes some support for petitioner's position, it is entirely inconsistent with the basic congressional purpose to tax the undistributed corporate income only to the persons who are accountable for dividends paid by the

> corporation, and those persons are the real owners of the stock whether or not they are the shareholders 'of record.' In the circumstances, we must rely upon the all pervasive legislative purpose and not upon the foregoing fragmentary phrase in the committee report.

Subchapter S allows shareholders of a small business corporation to elect alternative tax consequences resulting from stock ownership. Without a Subchapter S election the corporation is liable for corporate taxes, the shareholders cannot deduct corporate losses, and only distributed dividends are subject to the personal income tax. If the election is made, the corporation is exempt from corporate taxes and the shareholders may deduct corporate net operating losses but must pay personal income tax on all corporate income whether distributed or not. The desirability of a Subchapter S election depends upon the individual tax considerations of each shareholder. The final determination of whether there is to be an election should be made by those who would suffer the tax consequences of it. Therefore, "shareholders" who must file a consent are not necessarily "shareholders of record" but rather beneficial owners of shares "who would have to include in gross income dividends distributed with respect to the stock of the corporation." Reg. § 1.1371-1(d)(1), *Alfred N. Hoffman*, *supra*.

A treasury regulation which supplies the definition that Congress omitted must be sustained unless unreasonable and obviously inconsistent with the statute. *Bingler v. Johnson*, 394 U.S. 741 (1969); *Commissioner of Internal Revenue v. South Texas Lumber Co.*, 333 U.S. 496 (1948). Reg. § 1.1371-1(d)(1) is consistent with the basic purpose of Subchapter S and reasonably implements the legislative mandate.

We conclude, as did the Tax Court, that William and Murdock MacPherson jointly invested in the 125 shares of Bowl stock issued to William MacPherson. Murdock MacPherson was the beneficial owner of one half of that stock in William MacPherson's name and must be considered a "shareholder" for the purpose of § 1372. Murdock MacPherson's failure to file a consent invalidates Bowl's Subchapter S election. Therefore, petitioners were not entitled to deduct their pro rata shares of Bowl's net operating loss for 1962 and 1963.

....

... [P]etitioners contend that the District Director abused the discretion reposed in him by Reg. § 1.1372-3(c)[124] and that the Tax Court erred in refusing to review the exercise of the District

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[124] Reg. § 1.1372-3(c):

> Extension of time for filing consents. An election which is timely filed for any taxable year and which would be valid, or would not have terminated, except for the failure of any shareholder to file a consent within the time prescribed in paragraph (a) or (b) of this section will not be invalid, or will not be treated as having terminated, for such reason if –
>
> > (1) It is shown to the satisfaction of the district director or director of the service center that there was reasonable cause for the failure to file such consent and that the interests of the Government will not be jeopardized by treating such election as valid, or as not having terminated,

Director's discretion.

After the judgment of the Tax Court finding that Bowl's Subchapter S election was invalid due to Murdock MacPherson's failure to consent, petitioners requested of the District Director an extension of time, pursuant to Reg. § 1.1372-3(c), in which to file consents. All the petitioners offered to file new consents for the years 1962 and 1963.

The District Director denied the request. Petitioners then filed a motion in the Tax Court for retrial, further trial or reconsideration, seeking a review of the discretion exercised by the District Director. The Tax Court denied the motion.

The District Director advised petitioners that he was rejecting the request for an extension because the Tax Court had "issued an opinion in these cases ... and because we do not feel the circumstances of this matter meet the requirements of Regs. § 1.1372-3(c)." [footnote omitted].

The fact that the Tax Court had issued an opinion invalidating Bowl's Subchapter S election was not a basis for refusing to allow petitioners an extension of time to file consents. At the time the opinion was filed, no request had been made to the District Director and nothing in the opinion precluded him from granting a subsequent request for extension.

Additionally, there is no valid basis for the District Director's determination that the requirements of Reg. § 1.1372-3(c) had not been met. Under the regulation the failure to file a consent will not invalidate the Subchapter S election and an extension of time to file new consents should be granted if it is shown to the satisfaction of the District Director that: (1) there was reasonable cause for the failure to file such consent, and (2) the government interest will not be jeopardized by treating the Subchapter S election as valid. There was reasonable cause for Murdock MacPherson's failure to file a timely consent. Murdock MacPherson was not a shareholder of record. He believed that whatever ownership interest he had in the shares did not necessitate his consent to Bowl's election. When the Internal Revenue Service disagreed with this position, the petitioners sought a judicial determination. Until the Tax Court issued its opinion, Murdock MacPherson did not know that his consent was required to consummate Bowl's election under § 1371. Furthermore, there is nothing to indicate that any government interest is jeopardized by now validating the Subchapter S election.

At the time of the Subchapter S election, petitioners, other than possibly the MacPhersons, did

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(2) Such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service, and

(3) New consents are filed within such extended period of time as may be granted by the Internal Revenue Service, by all persons who were shareholders of the corporation at any time during the taxable year with respect to which the failure to consent would (but for the provisions of this paragraph) cause the corporation's election to be invalid or to terminate, and by all persons who were shareholders of the corporation subsequent to such taxable year and prior to the date on which an extension of time is granted in accordance with this paragraph.

not know or have reason to suspect that Murdock MacPherson had any ownership interest in Bowl's stock. The District Director's failure to exercise his discretion so as to allow petitioners to file their consents deprives eight taxpayers of deductions taken in good faith ten years earlier and saddles each taxpayer with a substantial liability for back taxes. It is apparent that Reg. § 1.1372-3(c) was promulgated to prevent the harsh result reached in cases of this kind.

The District Director abused his discretion by arbitrarily refusing to allow petitioners an extension of time in which to file their consent to Bowl's Subchapter S election. *Mensik v. C.I.R.*, 328 F.2d 147 (7th Cir. 1964); *Bookwalter v. Mayer*, 345 F.2d 476 (8th Cir. 1965).

We affirm the opinion of the Tax Court, except with regard to its refusal to review the exercise of the District Director's discretion, and order the District Director to grant petitioners an extension of time to file the consents pursuant to Reg. § 1.1372-3(c).

Questions and comments:

1. What is now § 1362 was § 1372. The numbers of the relevant regulations similarly changed.

2. "Beneficial owners" of stock must consent to the election to be an S corporation. The court said of this requirement:

> Reg. § 1.1371-1(d)(1), implementing Subchapter S, states that "Ordinarily, the persons who would have to include in gross income dividends distributed with respect to the stock of the corporation are considered to be shareholders of the corporation."

The quoted portion of this excerpt is now included verbatim at Reg. § 1.1361-1(e)(1).

3. *Tax consequences of incorporation*: The tax consequences of incorporation are established in §§ 351, 358, and 362. The basic rules of subchapter K, which governs income taxation of partnerships, are that built-in gains on contributions of property are not recognized. However, when a recognition event occurs with respect to property that a partner contributed, gains/losses must be recognized by the contributing partner to the extent thereof at the time of contribution.[125] In what significant way(s) do tax-deferred transfers to an S corporation differ from tax-deferred contributions to a partnership?

4. What happens when one minority shareholder *wants* to terminate the S election, but the majority of shareholders do not want to terminate the election? All the minority shareholder needs to do to get her way is transfer a few shares to an ineligible shareholder, and the majority shareholders can do nothing to stop her, right?

[125] This may be a policy of subchapter K, but it is not perfectly executed in all cases.

A.W. Chesterton Company, Inc. v. Chesterton, 128 F.3d 1 (1st Cir. 1997)

LYNCH, Circuit Judge

This appeal involves the duties imposed by Massachusetts law on a minority shareholder in a closely held corporation. Arthur W. Chesterton ("Chesterton"), a minority shareholder in the A.W. Chesterton Company, frustrated in his efforts to dispose of his shares, proposed to transfer a portion of his stock in the Company to two shell corporations. Because such a transfer would terminate the Company's advantageous Subchapter S status ..., the district court found that the proposed transfer violated Chesterton's fiduciary duty to the Company and enjoined him from proceeding with the transfer. Chesterton appeals this finding and injunction, as well as the district court's denial of Chesterton's counterclaim for relief under M.G.L. ch. 156B. We affirm.

I.

....

The Company has been a closely held Massachusetts corporation since its inception in 1885, and is currently owned and operated by the descendants of the Company's founder, Arthur W. Chesterton. Chesterton, the defendant in this case and the grandson of the original Arthur Chesterton, is currently the Company's largest shareholder, with 27.06% of the Company's stock. The Company and its affiliates manufacture mechanical seals, packaging, pumps and related products, which are distributed throughout the world.

Two corporate events set the stage. The first occurred in 1975, when the shareholders of the Company approved the Company's Restated Articles of Organization ("the Articles"). The Articles provide the Company with a right of first refusal in the event that a shareholder seeks to transfer her shares to an individual or entity outside the immediate Chesterton family. The shareholder must give the Company 30 days notice; the Company may avoid the sale by opting to purchase the stock within the 30 days. If the Company declines the option, the shareholder may proceed with the sale as planned. Part of Chesterton's argument focuses on the fact that he had complied with these provisions of the Articles when he proposed his stock transfer.

The second occurred in 1985, when the Company's Board of Directors voted to change the Company's status ... from a Subchapter C corporation to a Subchapter S corporation. The Board perceived Subchapter S status as advantageous to the Company because it allows shareholders in a small business corporation to avoid the double taxation of income to which shareholders in a Subchapter C corporation are subject. The income of a Subchapter C corporation is taxed first at the corporate level when the company earns income, and a second time at the shareholder level when the shareholders receive the income in the form of dividends. A Subchapter S corporation, in contrast, is not taxed at the corporate level; rather, each shareholder pays income tax individually in proportion to her share of ownership in the corporation.[126] *See* 26 U.S.C.

[126] There is a drawback to Subchapter S status known as "phantom income." That phrase describes the

§§ 1361-1399.

In order to qualify for Subchapter S treatment, a corporation must be a domestic corporation which does not (1) have more than [100] shareholders, (2) have a corporation or other non-individual as a shareholder, (3) have a non-resident alien as a shareholder, and (4) have more than one class of stock. 26 U.S.C. § 1361(b). Failure to abide by any of these limitations results in automatic termination of Subchapter S status. 26 U.S.C. § 1362(d)(2).

After the Company Board voted to adopt Subchapter S status, the officers and directors sought to inform the shareholders about the benefits and limitations of the S election, and recommended that the shareholders give their consent. ... [T]he unanimous consent of the shareholders of a corporation is required in order to finalize a Subchapter S election. 26 U.S.C. § 1362(a)(2). As an officer and director of the Company at the time, Chesterton was heavily involved in this process. He led and participated in shareholder meetings regarding the Subchapter S election. At those meetings the shareholders were provided with information regarding the benefits of Subchapter S election, as well as the limitations it imposed. The shareholders unanimously consented to the Subchapter S election. Implicit in this consent was a general understanding among the shareholders that they would take no action that would adversely affect the Company's Subchapter S status.

In the early 1990's, Chesterton became discontented with the Company's performance, including its declining profits, heavy debt, and credit problems.[127] Chesterton also objects to a financial arrangement that the Company has with Chesterton International, B.V. ("BV"), a Company affiliate.[128] Under the arrangement, the affiliate BV pays the Company a large management fee,[129] which has allowed the Company to continue to pay dividends to its shareholders, despite its poor financial performance. Chesterton believes that this arrangement masks the Company's dire financial straights [*sic* straits]. He also objects to the arrangement because much of the management fee is funnelled into Company pension plans, from which Chesterton does not benefit because he is not a current Company employee.

Because of his dissatisfaction with the Company, Chesterton sought to sell his Company stock.

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liability that shareholders in an S corporation face for taxes on their share of the corporation's profits, even if those profits are not distributed to the shareholders as dividends. Chesterton makes much of the fact that the Company's shareholders are subject to the risk of phantom income, but offered no evidence that the risk had materialized.

[127] Chesterton points to testimony which showed that the Company currently has $16,000,000 in outstanding debt, that it has violated its loan agreements, and that in 1994 the Company needed to borrow money to pay dividends.

[128] The affiliate BV is owned and operated by the same shareholders and Board of Directors as the Company.

[129] Chesterton asserts that this management fee does not actually reflect the value of services provided to the BV by the Company. He argues that because the Internal Revenue Service could reclassify the excess of the fee over the value of the services as dividends to the BV shareholders, this incongruity exposes the shareholders to increased tax liability.

He found little interest because all he could offer was a minority of shares.[130] After some failed efforts to locate an investor willing to purchase his stock outright, Chesterton devised the scheme at issue in this case. Chesterton proposed to transfer a portion of his shares to two shell corporations which are wholly-owned by him. Chesterton complied with the Articles of Organization by providing the Company with the proper notice of his proposed transfer so that it could purchase his shares. The Company, however, declined because it lacks the ability to purchase the shares.

When the Company would not purchase his shares, Chesterton sought to proceed with the transfer. But that transfer would have a deleterious effect on the Company's tax status. The Company and its shareholders derive significant tax benefits from the Company's status as a Subchapter S corporation. Should a corporation become a Company shareholder, as it would under Chesterton's proposed transfer, the Subchapter S status terminates automatically. 26 U.S.C. § 1362(d)(2). If Chesterton were to consummate his proposed transfer to the shell corporations, the Company would revert to Subchapter C status. The Company's Subchapter S status enabled it to distribute an additional $5.3 million in dividends between 1985 and 1995. Reversion to Subchapter C status would represent a significant financial loss for the Company and its shareholders. Once a corporation loses its Subchapter S status, it cannot reattain that status for a minimum of five years. 26 U.S.C. § 1362(g). In fact, loss of Subchapter S status would have a more severe effect on the Company because it is currently grandfathered under an old provision which exempted Subchapter S corporations from taxes on the sale of corporate assets. *See* 26 U.S.C. § 1374(c)(1). Even if the Company eventually regained its Subchapter S status, it would permanently lose its grandfathered status.

Fearing the loss of its Subchapter S status, the Company and its shareholders instituted suit, seeking to enjoin Chesterton from effectuating his plan. The original complaint alleged breach of fiduciary duty, breach of contract, breach of implied covenant of good faith and fair dealing, and interference with an advantageous relationship. Before trial, the parties stipulated to a dismissal of all claims, with prejudice, except for the breach of fiduciary duty claim. Plaintiffs also agreed to "waive their claims for damages, but [not] their claims for equitable relief." After a bench trial, the district court ruled that the proposed transfers would violate Chesterton's fiduciary duty under Massachusetts law and that they would result in irreparable harm to the Company. The court enjoined the transfers and denied Chesterton's counterclaim for monetary relief under Mass. Gen. Laws ch. 156B.

Chesterton argues that the district court improperly determined the scope of Chesterton's fiduciary duty under Massachusetts law. He asserts that the district court improperly resurrected the waived contract claim by discussing the general agreement among the shareholders not to disrupt the Company's Subchapter S status. He argues that the district court improperly concluded that the Subchapter S election imposed an implied restriction on transferability of

[130] None of Chesterton's fellow shareholders were willing to sell their stock and join him to offer a majority package.

stock, where the Company did not follow the legal requirements for imposing stock transfer restrictions under Mass. Gen. Laws ch. 156B. ... We reject Chesterton's arguments.

II.

We review the district court's grant of a permanent injunction for abuse of discretion. *Narragansett Indian Tribe v. Narragansett Elec. Co.*, 89 F.3d 908, 912 (1st Cir. 1996) (citing *Caroline T. v. Hudson Sch. Dist*., 915 F.2d 752, 754-55 (1st Cir. 1990)). The standard for issuing a permanent injunction requires the district court to find that (1) plaintiffs prevail on the merits; (2) plaintiffs would suffer irreparable injury in the absence of injunctive relief; (3) the harm to plaintiffs would outweigh the harm the defendant would suffer from the imposition of an injunction; and (4) the public interest would not be adversely affected by an injunction. *Indian Motocycle Assoc. III Ltd. Partnership v. Massachusetts Housing Fin. Agency*, 66 F.3d 1246, 1249 (1st Cir. 1995) (internal citation omitted). The district court found, and we agree, that the public interest was not at issue in this case. We turn to the remaining three factors.

A. Success on the Merits

In *Donahue v. Rodd Electrotype Co. of New England, Inc*., 367 Mass. 578, 328 N.E.2d 505 (1975), the Massachusetts Supreme Judicial Court first announced that shareholders in a closely held corporation owe an elevated fiduciary duty to one another. [citation omitted]. After noting that close corporations bear a "striking resemblance to a partnership," the court stated that "the relationship among the stockholders must be one of trust, confidence and absolute loyalty if the enterprise is to succeed." *Id.* 328 N.E.2d at 515. The court condemned "[d]isloyalty and self-seeking conduct on the part of any stockholder" in a close corporation, and held that such shareholders owe one another a duty of "utmost good faith and loyalty." *Id.* The court stated that stockholders in a close corporation "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation." *Id.* Although the *Donahue* case itself dealt with the majority's treatment of a minority shareholder, the court expressly did not limit the application of its strict fiduciary duty standard to majority shareholders, and stated that "[i]n the close corporation, the minority may do equal damage through unscrupulous and improper 'sharp dealings' with an unsuspecting majority." *Id.* at n. 17 (citing *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957)).

The first Massachusetts case to apply the *Donahue* standard to a minority shareholder was *Smith v. Atlantic Properties, Inc*., 12 Mass.App.Ct. 201, 422 N.E.2d 798 (1981). In *Smith*, a provision in the corporate charter effectively gave minority shareholders the power to veto any distribution of dividends. Although all the other shareholders desired a distribution of dividends, the defendant steadfastly refused to agree to a distribution because nondistribution was personally beneficial to him. The appeals court held that the majority could seek protection from the actions of the minority shareholder which were detrimental to the interests of the corporation and the other shareholders. *Id.* 422 N.E.2d at 801. Although the court recognized that the veto provision was drafted in part to protect minority interests, it nevertheless determined that a minority shareholder was bound to the *Donahue* standard of fiduciary responsibility when that

shareholder's actions controlled the disposition of a particular corporate issue. *Id.* at 803 n. 9 ("'A minority shareholder whose conduct is controlling on a particular issue should be bound by no different standard [than the majority].'") (quoting Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921, 946).

....

The *Donahue* family of cases establishes that Chesterton owes the Company and its other shareholders a fiduciary duty of "utmost good faith and loyalty." The district court did not abuse its discretion in finding that Chesterton breached that duty. If Chesterton were to effectuate his proposed transfer, the Company and its shareholders would lose the substantial financial benefits they have derived from the Company's Subchapter S status. Such benefits are likely to continue if the Company maintains its Subchapter S status. Chesterton, disgruntled with overall Company performance and in pursuit of his own self-interest, has threatened to destroy these substantial benefits. No claim is before us as to whether the Company and its other shareholders have acted fairly toward Chesterton over the years; we decide only that the district court did not abuse its discretion in holding that he has not acted fairly towards them.

Chesterton's attack focuses on part of the district court's analysis:

> At the time of the S election, the shareholders were informed and understood that the Company would lose its S status if a shareholder sold shares to another corporation. By unanimously electing S status, the shareholders agreed that they would not act in any way that would cause the Company to lose the considerable benefits of S status.... In view of the agreement regarding S status, which Defendant supported and facilitated, he cannot now sell his shares in a manner that would terminate the Company's S status, even though he would have been entitled to do so under the Articles had there been no S status agreement.

A.W. Chesterton Co. v. Chesterton, 951 F. Supp. 291, 295 (D. Mass.1997). Chesterton argues that this discussion improperly resurrects a contract claim that plaintiffs voluntarily dismissed. We disagree: in context it is clear that the court was discussing the shareholders' understanding as it relates to Chesterton's fiduciary duty. Under Massachusetts law, the expectations and understanding of the shareholders are relevant to a breach of fiduciary duty determination. *See, e.g.*, *Wilkes v. Springside Nursing Home, Inc*., 370 Mass. 842, 353 N.E.2d 657, 664 (1976) (holding that the duty of utmost good faith and loyalty at a minimum requires shareholders to consider their actions in light of company policies or long-standing understandings of the shareholders). Viewed in this context, it is irrelevant whether the agreement among the shareholders that they would not act so as to destroy the Company's Subchapter S status is legally enforceable. The existence of the agreement simply sheds light on the Company's and other shareholders' expectations, and reinforces the disloyal nature of Chesterton's proposed plan. Further, the strict duty Chesterton owes is created at law and would exist regardless of any agreement.

....

Chesterton argues that the only legitimate restrictions on the transferability of Company stock are those found in the 1975 Restated Articles of Organization and that he complied with the Articles' procedural requirements by providing the Company with the proper notice of his proposed transfer. This argument misses the point. If the strict *Donahue* fiduciary obligations did not restrict otherwise legitimate actions, they would add nothing to a shareholder's legal duties. *See, e.g.*, *Smith*, 422 N.E.2d at 802 (minority shareholder breached his fiduciary duty to the corporation in exercising veto power over dividends that corporate charter gave him). Chesterton cannot defend a breach of fiduciary duty claim on the basis that he has not violated the Articles of Organization.

....

We reject all of Chesterton's inventive arguments, and affirm the district court's finding that plaintiffs succeed on the merits of their breach of fiduciary duty claim.

B. Irreparable Harm

The district court found that the Company would suffer irreparable harm from the loss of its Subchapter S status, in part because that harm is not measurable. Chesterton argues that because the harm to the Company from the loss of its Subchapter S status is entirely financial, equitable relief is inappropriate. Where the harm is not measurable, it is not an abuse of discretion to award equitable relief. *Ross-Simons of Warwick, Inc. v. Baccarat, Inc.*, 102 F.3d 12, 19 (1st Cir. 1996) ("If the plaintiff suffers a substantial injury that is not accurately measurable ... irreparable harm is a natural sequel."). The loss of advantageous tax status can form the basis for a finding of irreparable harm. *See San Francisco Real Estate Investors v. Real Estate Inv. Trust of Am.*, 701 F.2d 1000, 1007 (1st Cir. 1983) (relying on loss of advantageous tax status and other findings to support a preliminary injunction). The district court found that the actual degree of the injury was not measurable, "because the amount of the increased tax liability would be contingent on the Company's future earnings and distributions." This finding is supported by the record and common sense, and is not an abuse of discretion.

Chesterton also argues that the Company would suffer no irreparable harm in the absence of the injunction, because the Company could have achieved a return equal to the Subchapter S status tax savings by redirecting the management fee that the BV pays to the Company. He argues that if the BV made distributions of its income directly to the shareholders, rather than to the Company through the management fee, the shareholders would receive substantial sums of money. In addition, he asserts that the management fee does not accurately measure the value of services provided by the Company to the BV, and that this disparity could result in an IRS reallocation of income, in turn resulting in substantially greater taxes to the shareholders. This argument, regardless of its accuracy, is irrelevant. The fact that the Company could achieve greater distributions for its shareholders by redirecting the management fee does not alter the fact that the loss of Subchapter S status is injurious in any event.

....

C. Balance of Equities

The final consideration regarding the propriety of injunctive relief is whether, on balance, the harm plaintiffs will suffer from the proposed transfers outweighs the harm that Chesterton will suffer if his transfers are enjoined. The district court found that an injunction would not harm Chesterton because the proposed sales would do little to advance his efforts to sell the stock. The court stated that, "if [Chesterton] was unable to find a buyer for his shares in the Company, it strains logic to believe that he would be able to find a buyer for shares in [the shell corporations] when their primary assets are the very same shares he was previously unable to sell." Chesterton claims that by transferring the shares to his shell corporations, he will somehow increase the liquidity of those shares. The claim is counter-intuitive and no evidence was presented to support it. On this record, the district court's finding that the potential harm to plaintiffs outweighs the harm to defendant was proper.

....

The decision of the district court is affirmed.

Questions and comments:

1. If Chesterton had sold his shares to the shell corporations before the plaintiffs brought this suit, what would have been the result?

2. The definition of "small business corporation" essentially gives every shareholder, no matter how small her interest, a veto power over whether to continue as an S corporation. This case represents one approach to controlling exercise of that veto power.

III. Income Tax Rules Applicable to S Corporations and Their Shareholders

A. Tax Rules Applicable to S Corporations

Subchapter S establishes a "pass-through" regime, i.e., tax items "pass through" the corporation – which pays no income tax – to the shareholders. Section 1363(a) provides that "[e]xcept as otherwise provided," an S corporation shall not be subject to the taxes imposed by this chapter."[131] However, the S corporation does compute its taxable income in the same manner that an individual computes her taxable income. § 1363(b). The S corporation files an

[131] The Code does "otherwise provide" in some cases of S corporations that were previously C corporations.

information return and reports pro rata shares to its shareholders. § 6037. The S corporation must file its return by the 15th day of the third month following the end of its taxable year. Reg. § 1.6037-1(b). The S corporation computes its taxable income without regard to items that may affect different individual shareholders differently, i.e., personal exemptions, taxes paid to foreign countries, charitable contributions, net operating losses, various deductions for personal expenditures, and depletion allowances for mines, oil and gas wells, other natural deposits, and timber. § 1363(b)(2), *cross-referencing* § 703(a)(2). Elections that affect the computation of taxable income are made at the corporate level. § 1363(c)(1).[132] The S corporation treats its organizational expenditures in the same manner as a C corporation treats its organizational expenditures. § 1363(b)(3), *cross-referencing* § 248. As a pass-through entity, S corporations benefit from § 199A, *infra*.

The shareholder of an S corporation must report her pro rata share of the corporation's separately-stated items of income (including tax exempt income), loss, deduction, or credit that may affect individual shareholders' tax liability differently. 1366(a)(1)(A). The shareholder must also report her pro rata share of nonseparately stated income or loss. § 1366(a)(1)(B). If necessary to determine the gross income of a shareholder, the shareholder's gross income is her pro rata share of the corporation's gross income. § 1366(c). The character of income and loss items is "determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." § 1366(b). Section 1377(a)(1) requires pro rating both as among shares and as to the days of a taxable year. Reg. § 1.1377-1(a)(1) provides in part:

> [E]ach shareholder's pro rata share of any S corporation item described in § 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day.

If a shareholder terminates her interest in the S corporation, the corporation and all affected shareholders may agree to close the taxable year on the date of termination. § 1377(a)(2)(A). "Affected shareholders" are the shareholder who has terminated her interest and the transferee(s) of such shareholder's shares; if the corporation is a transferee, "affected shareholders" include all persons who were shareholders during the taxable year. § 1377(a)(2)(B).

There are special rules in the case of shareholders who are members of the same family, i.e., "spouse, ancestors, lineal descendants, and trusts for the primary benefit of such persons." § 1366(e), *cross-referencing* 704(e)(3). The S corporation must provide reasonable compensation to a family member for services rendered or capital provided, or the Secretary may make adjustments necessary to reflect the value of the services or capital provided to the corporation. § 1366(e).

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[132] There are exceptions for deduction and recapture of certain mining and exploration expenditures and for taxes paid to foreign countries.

Problems:

1. The stock of an S corporation is owned 50 percent by F and 50 percent by T, the minor son of F. For the taxable year, the corporation has items of taxable income equal to $70,000. Compensation of $10,000 is paid by the corporation to F for services rendered during the taxable year, and no compensation is paid to T, who rendered no services. Based on all the relevant facts and circumstances, reasonable compensation for the services rendered by F would be $30,000. What is the maximum amount of additional income that the IRS may allocate to F as compensation? What would the taxable income of the corporation be if the IRS exercised such discretion? *See* Reg. § 1.1366-3(b) Example 1.

B. Section 199A: Qualified Business Income

In the Tax Cuts and Jobs Act, Congress repealed § 199, which had provided a deduction for income derived from domestic production activities. In its place, Congress enacted § 199A. Section 199A provides a deduction to certain taxpayers who derive certain types of income from certain sources that increases as such income increases.

•**Taxpayers** who may avail themselves of this deduction may not be C corporations, § 199A(a), or employees, § 199A(c)(4),[133] § 199A(d)(1)(B). Taxpayers who may avail themselves of this deduction must therefore be the owners of "pass-through" entities or proprietorships. These are entities who pay no income tax and whose income tax items (items of income, gain, deduction, and loss) "pass through" to the individual owners of the trade or business.[134]

•**Types of Income**: Determining the amount of the § 199A deduction requires determining the amount of specific types of a taxpayer's income, determining the amount of a taxpayer's investment in certain property, calculating a percentage of those specific types of income and investment, and comparing the results of those calculations.[135] Section 199A considers several defined types of income to which the section might apply.

> •*"Taxable income"* is gross income minus allowable deductions, § 63(a), except for the deduction that § 199A itself allows. § 199A(e)(1).
>
> •*"Qualified business income"* is the net income taxpayer derives from the conduct of a trade or business to the extent the income tax items are "effectively connected with the conduct of a trade or business within the United States …" §§ 199A(c)(1), 199A(c)(3)(i). "Qualified business income" does *not* include various items of investment income.[136]

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[133] Partners who derive income from a partnership in a capacity other than as a partner or who receive guaranteed payments may not avail themselves of a deduction under § 199A.

[134] *See* § 199A(f)(1)(A)(i) (§ 199A applies at the individual or shareholder level).

[135] The section is replete with definitions whose effect is to define and delimit the scope of the deduction in pursuit of a narrow policy.

[136] Specifically, the net amount of "qualified business income" does not include capital gains/losses,

Net losses carry over to succeeding years. § 199A(c)(2).[137]

•A taxpayer's *"net capital gain"* for a taxable year is his "net long-term capital gain" minus "net short-term capital loss." § 1222(1); chapter 10, *infra*. For non-corporate taxpayers and for purposes of § 199A, § 1(h)(11) includes within *net capital gain* dividends paid by domestic corporations, dividends paid by corporations incorporated in a country with which the United States has a tax treaty, or foreign corporations whose stock is readily traded in an established securities market in the United States.

•A *"qualified cooperative dividend"* is a patronage dividend, i.e., an amount based on the quantity or value of business done with the organization, and similar payments. § 199A(e)(4). Such a dividend includes payments by farmers' cooperatives, benevolent life insurance associations, and similar mutual or cooperative companies. § 199A(e)(4)(B). Such payments must be includible in a taxpayer's gross income. § 199A(e)(4)(A).

•A *"qualified REIT dividend"* is a dividend from a real estate investment trust that is neither a capital gain dividend nor a "qualified" dividend under § 1(h)(11). § 199A(e)(3).

•*"Qualified publicly traded partnership income"* is the net amount of a partner's allocable share of income tax items from a publicly traded partnership not treated as a corporation, § 199A(e)(5)(A), or gain from the sale of an interest in a publicly traded partnership to the extent it is treated as an amount realized from the sale or exchange of property other than a capital asset. § 199A(e)(5)(B).

•**Amount of Deduction, Sources of Income:** The amount of the deduction is the sum of two different amounts. § 199A(a). A taxpayer's § 199A deduction may not exceed his taxable income reduced by his "net capital gain," as defined in § 1(h)(11). Each of these amounts is derived from calculations and comparisons.

The first amount is the sum of two amounts, i.e. –

•The *lesser* of –

•20% of the sum of "qualified business income" from all of taxpayer's "qualified trades or businesses," § 199A(b)(1)(A),

•but not more than the greater of[138]

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dividend income, interest income not properly allocable to a trade or business, gain/losses from commodities transactions or gains/losses from foreign currency transactions, gains/losses from certain "notional" contracts, amounts received from annuity contracts not connected with a trade or business, or deductions properly allocable to one of these items. § 199A(c)(3)(B).

[137] Such income does not include "qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income." § 199A(c)(1). Section 199A considers these types of income in separate calculations.

[138] Section 199A(e)(2)(A) establishes a "threshold amount" – indexed for inflation, § 199A(e)(2)(B) – of

•50% of the W-2 wages[139] that taxpayer pays, OR

•25% of the W-2 wages that taxpayer pays plus 2.5% of the unadjusted basis of "qualified property."[140] § 199A(b)(2)(B).[141]

OR

•20% of: (taxpayer's "taxable income") MINUS [(taxpayer's net capital gain as defined in § 1(h)(11)) PLUS (taxpayer's "qualified cooperative dividends)],

PLUS

•20% of "qualified REIT dividends" and "qualified publicly traded partnership income," § 199A(b)(1)(B).

The second amount is –

•The *lesser* of –

•20% of the aggregate amount of taxpayer's cooperative dividends, § 199A(a)(2)(A),

OR

•taxpayer's taxable income MINUS taxpayer's net capital gain as defined by § 1(h)(11).

$157,500 (for 2018) and twice that amount for a joint return. § 199A(e)(2)(A). If a taxpayer's "taxable income" does not exceed this threshold amount, the taxpayer's deduction is not subject to the wage (or wage and property) condition. § 199A(b)(3)(A). If taxpayer's "taxable income" exceeds the threshold amount by $50,000 or less ($100,000 or less for a joint return), and the wage (or wage and property) amount is more than taxpayer's "qualified trade or business income," taxpayer may use his "qualified trade or business income" in this calculation less an amount pro-rated according to the amount by which taxpayer's taxable income exceeds the wage (or wage and property) condition. § 199A(3)(B).

[139] More specifically, such wages are wages plus elective deferrals and must be allocable to qualified trade or business income. § 199A(b)(4).

[140] "Qualified business property" is depreciable property that the taxpayer uses in his qualified trade or business to produce qualified business income and holds at the close of the taxable year. § 199A(b)(6)(A). The depreciation period must not have ended before the close of the taxable year, § 199A(b)(6)(A)(iii), but that period is extended to the *later* of the date that is ten years after the property was placed in service or the last day of the last full year to which the applicable recovery period would apply. § 199A(b)(6) (without regard to the alternative depreciation system).

[141] A partnership or S corporation determines a partner's or shareholder's share of the W-2 wages that it pays in the same manner that it determines the partner's or shareholder's share of wage expenses. A partnership or S corporation determines a partner's or shareholder's share of unadjusted basis in the same manner that it allocates allocable shares of depreciation. An S corporation allocates items according to the pro rata share of an item. § 199A(f)(1)(A) (carryout ¶).

•**Ineligible Service Trades or Businesses:** Taxpayers engaged in the service trades or businesses of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage service, and any trade or business where the principal asset is the reputation of one or more of its employees or owners, § 1202(e)(3)(A), cross-referenced and as modified by § 199A(d)(2), may not claim a § 199A deduction. § 199A(d)(2)(A). Taxpayers who perform the services of "investing and investment management, trading, or dealing in securities …, partnership interests, or commodities …" also may not claim a § 199A deduction. § 199A(d)(2)(B).

•*Limited Exception to Ineligibility*: Taxpayers engaged in these service trades or businesses whose "taxable income" is less than the threshold amount may claim a § 199A deduction. § 199A((d)(3)(A)(i). Taxpayers engaged in these service trades or businesses whose taxable income is less than the threshold amount plus $50,000 ($100,000 for a joint return) may compute a § 199A deduction by reducing the items of "qualified business income" by the percentage of $50,000 (or $100,000 for a joint return) by which taxable income exceeds the threshold amount. §§ 199A(d)(3)(A)(ii), 199A(d)(3)(B).

•**Agricultural or Horticultural Cooperatives**: Section 199A(g) provides special rules for computing a deduction for taxable agricultural or horticultural cooperatives.[142] In no event can the § 199A deduction of such a cooperative exceed its "taxable income." § 199A(g)(2). The deduction is the *lesser* of –

•20% of the cooperative's gross income MINUS the "qualified cooperative dividends that it paid, § 199A(g)(1)(A),

OR

•the greater of –

•50% of the cooperative's W-2 wages,

OR

•25% of the cooperative's wages PLUS 2.5% of the unadjusted basis of its "qualified property," § 199A(g)(1)(B).

Section 199A replaced § 199, a measure designed to encourage all taxpayers, including corporations, to engage in manufacturing trades or businesses in the United States. Section 199A, on the other hand, provides benefits only to "pass-through" entities and sole proprietorships. By defining the limits of the deduction through reference to W-2 wages, Congress clearly aims to encourage economic activity within the United States. Notice that § 199A is not part of the

[142] The cooperative must be engaged in "the manufacturing, production, growth, or extraction … of any agricultural or horticultural product," "the marketing of agricultural or horticultural products which its patrons have … manufactured, produced, grown, or extracted," or "the provision of supplies, equipment, or services to farmers" or to cooperatives engaged in the activities named. § 199A(g)(3).

Code's methods for determining a taxpayer's net income. Rather, it provides a reward for doing something that Congress wants certain types of taxpayers to do, i.e., for (typically) small businesses to generate taxable income in the United States. *And*: the more profit such a taxpayer can derive from his domestic economic activities, the greater his deduction.

Section 199 was an effort to make U.S. manufacturers more competitive vis-a-vis foreign competition. It is also intended to encourage exports. By rewarding successful businesses, Congress is (likely to be) rewarding exporters. Congress has pursued similar objectives in other tax legislation, but the World Trade Organization (WTO) found that such legislation violated the General Agreement on Tariffs and Trade. Section 199A may also be vulnerable to a challenge before the WTO.

C. Income Tax Rules for S Corporations and Shareholders' Basis

Basis is how we keep score with the government. Section 1012 defines "basis" to be "cost," but the Code treats basis as money that will not (again) be subject to tax. Hence, if a taxpayer uses after-tax money to make an investment, that money should not again be subject to income tax. The amount of money that will not be subject to income tax is taxpayer's "basis." In the case of a subchapter S corporation, the shareholder invests after-tax money in shares and the amount of investment is the shareholder's "basis." The income, gain, deductions, or losses, that the S corporation generates pass through to the shareholders who recognize those items without the benefit of any deferral. The shareholder must pay income tax on her share of the S corporation's taxable income and gain. Those amounts are treated as shareholder investments. Since they have been subject to income tax, they should not again be subject to income tax. Hence, the shareholder increases her basis in her stock by such amounts. § 1367(a)(1). Conversely, when a shareholder reduces her taxable income by the amount of deductions or losses that pass through to her, the shareholder must reduce her basis in her shares in the S corporation. § 1367(a)(2). The shareholder also reduces basis in her stock by the amount of any expenses that are neither deductible nor chargeable to capital account. § 1367(a)(2)(D). When the S corporation makes a distribution to a shareholder, the amount of the distribution is no longer invested in the corporation, and shareholder must similarly reduce her basis in the S corporation. § 1367(a)(2)(A). The shareholder is entitled to increase her basis in her shares by the amount of any tax-exempt income that passes through the corporation to her lest such income be subject to income tax at some time in the future – in which case it would not in fact be tax exempt. The shareholder must recognize gain as if from the sale or exchange of property if a distribution exceeds her basis in her stock. § 1368(b)(2).

When a shareholder transfers property to an S corporation in a § 351 transaction, the basis rules of §§ 358 and 362 apply, i.e., shareholders carry over the basis they had in the property they transferred to the shares they now own, and the corporation takes the shareholders' bases in the property they transferred. Section 357 applies to corporate

> *You can't run a tab with the Government.* A shareholder may not take into account deductions in excess of her basis in her S corporation stock. § 1366(d)(1). Excess losses are carried to the succeeding tax year indefinitely. § 1366(d)(2).

assumption of liabilities. A special rule applies when a shareholder acquires shares in an S corporation by reason of death. While § 1014 gives the shareholders a stepped-up (or stepped-down) basis, the basis is reduced by the portion of the value attributable to income in respect of the decedent. § 1367(b)(4)(B).

Basis adjustments are made at the close of the taxable year, unless the shareholder has disposed of stock during the corporation's taxable year. Reg. § 1.1367-1(d). In that case, the adjustments are made immediately prior to the sale. Reg. § 1.1367-1(d). Reg. § 1.1367-1(f) provides the sequence in which basis adjustments are made:

1. Increases under § 1367(a)(1);
2. Decreases under § 1367(a)(2)(A), i.e., distributions to shareholders that are not included in their income;
3. Decreases under § 1367(a)(2)(D and E), i.e., nondeductible expenditures, expenditures not chargeable to capital account, and the excess of the basis of oil and gas property over depletion allowance;
4. Decreases under § 1367(a)(2)(B and C), i.e., the shareholder's pro rata share of the corporation's losses and of losses attributable to separately stated items.

A shareholder may elect to reverse #s 3 and 4. Reg. § 1.1367-1(g). The sequence is important to determinations of what losses and deductions will be allowed. In the event that the decreases exceed the shareholder's basis, the excess is carried over to the next year as a loss of the same character. Reg. § 1.1367-1(g).

Problem:

The stock of an S corporation is owned 25% by D, E, F, and G. Each has a $50,000 adjusted basis in her stock. The corporation has items of taxable income for the current year of $120,000. The corporation elected to distribute none of its earnings and to invest its earnings in expansion instead. G objected because she wanted a distribution of $30,000 cash. How much taxable income does G have for the year and what adjustments should be made to G's basis in her stock? *See Knott v. Comm'r*, T.C. Memo. 1991-352, 62 T.C.M. 287 (1991).

Do the CALI exercise: S Corporation Taxation: Taxation of the Shareholder: S Corporation Separately Stated Items.

Do the CALI exercise: S Corporation Taxation: Distributions: Distributions of Cash by an S Corporation.

The following case resolves an issue upon which several lower courts passed upon.

Gitlitz v. Commissioner, 531 U.S. 206 (2001)

Justice THOMAS delivered the opinion of the Court.

The Commissioner of Internal Revenue assessed tax deficiencies against petitioners David and Louise Gitlitz and Philip and Eleanor Winn because they used nontaxed discharge of indebtedness to increase their bases in S corporation stock and to deduct suspended losses. In this case we must answer two questions. First, we must decide whether the ... Code ... permits taxpayers to increase bases in their S corporation stock by the amount of an S corporation's discharge of indebtedness excluded from gross income. And, second, if the Code permits such an increase, we must decide whether the increase occurs before or after taxpayers are required to reduce the S corporation's tax attributes.

I

David Gitlitz and Philip Winn [footnote omitted] were shareholders of P.D.W. & A., Inc., a corporation that had elected to be taxed under subchapter S of the Code, 26 U.S.C. §§ 1361 and 1379 (1994 ed. and Supp. III). Subchapter S allows shareholders of qualified corporations to elect a "pass-through" taxation system under which income is subjected to only one level of taxation. *See Bufferd v. Commissioner*, 506 U.S. 523, 525 (1993). The corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. *See* § 1366(a)(1)(A).[143] To prevent double taxation of income upon distribution from the corporation to the shareholders, § 1367(a)(1)(A) permits shareholders to increase their corporate bases by items of income identified in § 1366(a) (1994 ed. and Supp. III). Corporate losses and deductions are passed through in a similar manner, *see* § 1366(a)(1)(A), and the shareholders' bases in the S corporation's stock and debt are decreased accordingly, *see* §§ 1367(a)(2)(B), 1367(b)(2)(A). However, a shareholder cannot take corporate losses and deductions into account on his personal tax return to the extent that such items exceed his basis in the stock and debt of the S corporation. *See* § 1366(d)(1) (Supp. III). If those items exceed the basis, the excess is "suspended" until the shareholder's basis becomes large enough to permit the deduction. *See* §§ 1366(d)(1)(2) (1994 ed. and Supp. III).

In 1991, P.D.W. & A. realized $2,021,296 of discharged indebtedness. At the time, the corporation was insolvent in the amount of $2,181,748. Because it was insolvent even after the discharge of indebtedness was added to its balance sheet, P.D.W. & A. excluded the entire discharge of indebtedness amount from gross income under 26 U.S.C. §§ 108(a) and

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[143] Section 1366(a)(1) provides:

> In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends ..., there shall be taken into account the shareholder's pro rata share of the corporation's –
>
> > (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder ....

108(d)(7)(A). On their tax returns, Gitlitz and Winn increased their bases in P.D.W. & A. stock by their pro rata share (50 percent each) of the amount of the corporation's discharge of indebtedness. Petitioners' theory was that the discharge of indebtedness was an "item of income" subject to pass-through under § 1366(a)(1)(A). They used their increased bases to deduct on their personal tax returns corporate losses and deductions, including losses and deductions from previous years that had been suspended under § 1366(d). Gitlitz and Winn each had losses (including suspended losses and operating losses) that totaled $1,010,648. With the upward basis adjustments of $1,010,648 each, Gitlitz and Winn were each able to deduct the full amount of their pro rata share of P.D.W. & A.'s losses.

The Commissioner determined that petitioners could not use P.D.W.& A.'s discharge of indebtedness to increase their bases in the stock and denied petitioners' loss deductions. Petitioners petitioned the Tax Court to review the deficiency determinations. The Tax Court, in its initial opinion, granted relief to petitioners and held that the discharge of indebtedness was an "item of income" and therefore could support a basis increase. *See Winn v. Commissioner*, T.C. Memo 286 (1997), *Memo withdrawn and reissued*, 75 T.C.M. (CCH) ¶ 1840 (1998). In light of the Tax Court's decision in *Nelson v. Commissioner*, 110 T.C. 114 (1998), *aff'd*, 182 F.3d 1152 (CA10 1999),[144] the Tax Court granted the Commissioner's motion for reconsideration and held that shareholders may not use an S corporation's untaxed discharge of indebtedness to increase their bases in corporate stock. *See Winn v. Commissioner*, 1998 T.C. Memo 71.

The Court of Appeals affirmed. It assumed that excluded discharge of indebtedness is an item of income subject to passthrough to shareholders pursuant to § 1366(a)(1)(A), but held that the discharge of indebtedness amount first had to be used to reduce certain tax attributes of the S corporation under § 108(b), and that only the leftover amount could be used to increase basis.[145] The Court of Appeals explained that, because the tax attribute to be reduced (in this case the corporation's net operating loss) was equal to the amount of discharged debt, the entire amount of discharged debt was absorbed by the reduction at the corporate level, and nothing remained of the discharge of indebtedness to be passed through to the shareholders under § 1366(a)(1)(A). Because Courts of Appeals have disagreed on how to treat discharge of indebtedness of an insolvent S corporation, *compare Gaudiano v. Commissioner*, 216 F.3d 524, 535 (CA6 2000) (holding that tax attributes are reduced before excluded discharged debt income is passed through to shareholders), *cert. pending*, No. 00-459, *Witzel v. Commissioner*, 200 F.3d 496, 498 (CA7 2000) (same), *cert. pending*, No. 99-1693, and 182 F.3d at 1150 (case below), *with United States v. Farley*, 202 F.3d 198, 206 (CA3 2000) (holding that excluded discharged debt income is passed through to shareholders before tax attributes are reduced), *cert. pending*, No. 99-1675; *see also Pugh v. Commissioner*, 213 F.3d 1324, 1330 (CA11 2000) (holding that excluded discharged debt income is subject to pass-through and can increase basis), *cert. pending*, No. 00-

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[144] In *Nelson*, the Tax Court held that excluded discharge of indebtedness does not pass through to an S corporation's shareholders because § 108 is an exception to normal S corporation pass-through rules. Specifically, the court held that, because § 108(d)(7)(A) requires that "subsections (a) [and (b) of § 108] shall be applied at the corporate level" in the case of an S corporation, it precludes any pass-through of the discharge of indebtedness to the shareholder level. *See* Nelson, 110 T.C. at 121-124.

[145] Section 108(b)(1) reads: "The amount excluded from gross income under [§ 108(a)(1)] shall be applied to reduce the tax attributes of the taxpayer ...."

242, we granted certiorari.

II

Before we can reach the issue addressed by the Court of Appeals – whether the increase in the taxpayers' corporate bases occurs before or after the taxpayers are required to reduce the S corporation's tax attributes – we must address the argument raised by the Commissioner.[146] The Commissioner argues that the discharge of indebtedness of an insolvent S corporation is not an "item of income" and thus never passes through to shareholders. Under a plain reading of the statute, we reject this argument and conclude that excluded discharged debt is indeed an "item of income," which passes through to the shareholders and increases their bases in the stock of the S corporation.

Section [61(a)(11)] states that discharge of indebtedness generally is included in gross income. Section 108(a)(1) provides an express exception to this general rule:

> Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge ... of indebtedness of the taxpayer if –
>
> .....
>
> (B) the discharge occurs when the taxpayer is insolvent.

The Commissioner contends that this exclusion from gross income alters the character of the discharge of indebtedness so that it is no longer an "item of income." However, the text and structure of the statute do not support the Commissioner's theory. Section 108(a) simply does not say that discharge of indebtedness ceases to be *an item of income* when the S corporation is insolvent. Instead it provides only that discharge of indebtedness ceases to be *included in gross income*. Not all items of income are included in gross income, *see* § 1366(a)(1) (providing that "items of income," including "tax-exempt" income, are passed through to shareholders), so mere exclusion of an amount from gross income does not imply that the amount ceases to be an item of income. Moreover, §§ 101 through 136 employ the same construction to exclude various items from gross income: "Gross income does not include ...." The consequence of reading this language in the manner suggested by the Commissioner would be to exempt all items in these sections from pass-through under § 1366. However, not even the Commissioner encourages us to reach this sweeping conclusion. Instead the Commissioner asserts that discharge of indebtedness is unique among the types of items excluded from gross income because no economic outlay is required of the taxpayer receiving discharge of indebtedness. But the Commissioner is unable to

[146] The Commissioner has altered his arguments throughout the course of this litigation. According to the Tax Court, during the first iteration of this case the Commissioner made several arguments but then settled on a "final" one – that the discharge of indebtedness of the insolvent S corporation was not an "item of income," *see* 73 T.C.M. (CCH) ¶ 3167 (1997). In the Court of Appeals, the Commissioner argued instead that, because any pass-through of excluded discharge of indebtedness to petitioners took place after any reduction of tax attributes and by then the income would have been fully absorbed by the tax attributes, no discharged debt remained to flow through to petitioners. The Commissioner relegated to a footnote his argument that discharge of indebtedness is not an "item of income."

identify language in the statute that makes this distinction relevant, and we certainly find none.

On the contrary, the statute makes clear that § 108(a)'s exclusion does not alter the character of discharge of indebtedness as an item of income. Specifically, § 108(e)(1) reads:

> Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

This provision presumes that discharge of indebtedness is always "income," and that the only question for purposes of § 108 is whether it is includible in gross income. If discharge of indebtedness of insolvent entities were not actually "income," there would be no need to provide an exception to its inclusion in gross income; quite simply, if discharge of indebtedness of an insolvent entity were not "income," it would necessarily not be included in gross income.

Notwithstanding the plain language of the statute, the Commissioner argues, generally, that excluded discharge of indebtedness is not income and, specifically, that it is not "tax-exempt income" under § 1366(a)(1)(A).[147] First, the Commissioner argues that § 108 merely codified the "judicial insolvency exception," and that, under this exception, discharge of indebtedness of an insolvent taxpayer was not considered income. The insolvency exception was a rule that the discharge of indebtedness of an insolvent taxpayer was not taxable income. *See, e.g.*, *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (CA5 1934); *Astoria Marine Construction Co. v. Commissioner*, 12 T.C. 798 (1949). But the exception has since been limited by § 108(e). Section 108(e) precludes us from relying on any understanding of the judicial insolvency exception that was not codified in § 108. And as explained above, the language and logic of § 108 clearly establish that, although discharge of indebtedness of an insolvent taxpayer is not included in gross income, it is nevertheless income.

....

Second, the Commissioner argues that excluded discharge of indebtedness is not "tax-exempt" income under § 1366(a)(1)(A), but rather "tax-deferred" income. According to the Commissioner, because the taxpayer is required to reduce tax attributes that could have provided future tax benefits, the taxpayer will pay taxes on future income that otherwise would have been

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[147] [footnote 6 by the Court] The Commissioner also contends, as does the dissent, that because § 108(d)(7)(A) mandates that the discharged debt amount be determined and applied to reduce tax attributes "at the corporate level," rather than at the shareholder level, the discharged debt, even if it is some type of income, simply cannot pass through to shareholders. In other words, the Commissioner contends that § 108(d)(7)(A) excepts excluded discharged debt from the general pass-through provisions for S corporations. However, § 108(d)(7)(A) merely directs that the exclusion from gross income and the tax attribute reduction be made at the corporate level. Section 108(d)(7)(A) does not state or imply that the debt discharge provisions shall apply only "at the corporate level." The very purpose of Subchapter S is to tax at the shareholder level, not the corporate level. Income is determined at the S corporation level, *see* § 1363(b), not in order to tax the corporation, *see* § 1363(a) (exempting an S corporation from income tax), but solely to pass through to the S corporation's shareholders the corporation's income. Thus, the controlling provision states that, in determining a shareholder's liability, "there shall be taken into account the shareholder's pro rata share of the corporation's ... items of income (including tax-exempt income) ...." § 1366(a)(1). Nothing in § 108(d)(7)(A) suspends the operation of these ordinary pass-through rules.

absorbed by the forfeited tax attributes. Implicit in the Commissioner's labeling of such income as "tax-deferred," however, is the erroneous assumption that § 1366(a)(1)(A) does not include "tax-deferred" income. Section 1366 applies to "items of income." This section expressly includes "tax-exempt" income, but this inclusion does not mean that the statute must therefore exclude "tax-deferred" income. The section is worded broadly enough to include any item of income, even tax-deferred income, that "could affect the liability for tax of any shareholder." § 1366(a)(1)(A). Thus, none of the Commissioner's contentions alters our conclusion that discharge of indebtedness of an insolvent S corporation is an item of income for purposes of § 1366(a)(1)(A).

III

Having concluded that excluded discharge of indebtedness is an "item of income" and is therefore subject to pass-through to shareholders under § 1366, we must resolve the sequencing question addressed by the Court of Appeals – whether pass-through is performed before or after the reduction of the S corporation's tax attributes under § 108(b). Section 108(b)(1) provides that "the amount excluded from gross income under [§ 108(a)] shall be applied to reduce the tax attributes of the taxpayer as provided [in this section]." Section 108(b)(2) then lists the various tax attributes to be reduced in the order of reduction. The first tax attribute to be reduced, and the one at issue in this case, is the net operating loss. *See* § 108(b)(2)(A). Section 108(d)(7)(B) specifies that, for purposes of attribute reduction, the shareholders' suspended losses for the taxable year of discharge are to be treated as the S corporation's net operating loss. If tax attribute reduction is performed *before* the discharge of indebtedness is passed through to the shareholders (as the Court of Appeals held), the shareholders' losses that exceed basis are treated as the corporation's net operating loss and are then reduced by the amount of the discharged debt. In this case, no suspended losses would remain that would permit petitioners to take deductions.[148] If, however, attribute reduction is performed *after* the discharged debt income is passed through (as petitioners argue), then the shareholders would be able to deduct their losses (up to the amount of the increase in basis caused by the discharged debt). Any suspended losses remaining then will be treated as the S corporation's net operating loss and will be reduced by the amount of the discharged debt. Therefore, the sequence of the steps of pass-through and attribute reduction determines whether petitioners here were deficient when they increased their bases by the discharged debt amount and deducted their losses.

The sequencing question is expressly addressed in the statute. Section 108(b)(4)(A) directs that the attribute reductions "shall be made *after* the determination of the *tax imposed* by this chapter for the taxable year of the discharge." (Emphases added.) *See also* § 1017(a) (applying the same

[148] Under this scenario, the shareholders' losses would be reduced by the discharge of indebtedness. However, it is unclear precisely what would happen to the discharge of indebtedness. The Court of Appeals below stated that the discharged debt would be "absorbed" by the reduction to the extent of the net operating loss and that therefore only the excess excluded discharged debt would remain to pass through to the shareholders. In contrast, another Court of Appeals suggested, albeit in dictum, that the full amount of the discharge might still pass through to the shareholder and be used to increase basis; the discharged debt amount would reduce the net operating loss but would not be absorbed by it. *Witzel v. Commissioner*, 200 F.3d 496, 498 (CA7 2000). We need not resolve this issue because we conclude that the discharge of indebtedness passes through before any attribute reduction takes place.

sequencing when § 108 attribute reduction affects basis of corporate property). In order to determine the "tax imposed," an S corporation shareholder must adjust his basis in his corporate stock and pass through all items of income and loss. *See* §§ 1366, 1367 (1994 ed. and Supp III). Consequently, the attribute reduction must be made *after* the basis adjustment and pass-through. In the case of petitioners, they must pass through the discharged debt, increase corporate bases, and then deduct their losses, all before any attribute reduction could occur. Because their basis increase is equal to their losses, petitioners have no suspended losses remaining. They, therefore, have no net operating losses to reduce.

Although the Commissioner has now abandoned the reasoning of the Court of Appeals below,[149] we address the primary arguments made in the Courts of Appeals against petitioners' reading of the sequencing provision. First, one court has expressed the concern that, if the discharge of indebtedness is passed through to the shareholder *before* the tax attributes are reduced, then there can never be any discharge of indebtedness remaining "at [the] corporate level," § 108(d)(7)(A), by which to reduce tax attributes.[150] *Gaudiano*, 216 F.3d at 533. This concern presumes that tax attributes can be reduced only if the discharge of indebtedness itself remains at the corporate level. The statute, however, does not impose this restriction. Section 108(b)(1) requires only that the tax attributes be reduced by "the *amount* excluded from gross income," (emphasis added), and that amount is not altered by the mere pass-through of the income to the shareholder.

Second, courts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, the shareholders would wrongly experience a "double windfall": They would be exempted from paying taxes on the full amount of the discharge of indebtedness, *and* they would be able to increase basis and deduct

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[149] The Commissioner has abandoned his argument related to the sequencing issue before this Court. This abandonment is particularly odd given that the sequencing issue predominated in the Commissioner's argument to the Court of Appeals. Notwithstanding the Commissioner's attempt at oral argument to distance himself from the reasoning of the Court of Appeals on this issue – the Commissioner represented to us that the Court of Appeals developed its reading of the statute *sua sponte*, – it is apparent from the Commissioner's brief in the Court of Appeals that the Commissioner supplied the very sequencing theory that the Court of Appeals adopted. *Compare, e.g.*, Brief for Appellee in Nos. 98-9009 and 98-9010 (CA10), p. 28 ("First, the discharge of indebtedness income that is excluded under Section 108(a) at the corporate level is temporarily set aside and has no tax consequences .... Second, PDW & A computes its tax attributes, i.e., taxpayers' suspended losses. Third, the excluded discharge of indebtedness income is applied against and eliminates the suspended losses. Because the excluded income is applied against – and offset by – the suspended losses, no item of income flows through to taxpayers under § 1366(a), and no upward basis adjustment is made under § 1367(a)" (citations omitted)), *with, e.g.*, 182 F.3d at 1151 ("PDW & A first must compute its discharge of indebtedness income and set this figure aside temporarily. The corporation then must calculate its net operating loss tax attribute .... Finally, the corporation must apply the excluded discharged debt to reduce its tax attributes. In this case, the net operating loss tax attribute fully absorbs the corporation's excluded discharge of indebtedness income. Thus, there are no items of income to pass through to Gitlitz and Winn").

[150] Similar to this argument is the contention that, in cases such as this one in which the shareholders' suspended losses are fully deducted before attribute reduction could take place, no net operating loss remains and no attribute reduction can occur, thus rendering § 108(b) inoperative. However, there will be other cases in which § 108(b) will be inoperative. In particular, if a taxpayer has no tax attributes at all, there will be no reduction. Certainly the statute does not condition the exclusion under § 108(a) on the ability of the taxpayer to reduce attributes under § 108(b). Likewise, in the case of shareholders similarly situated to petitioners in this case, there is also the possibility that other attributes, *see* §§ 108(b)(2)(B), (G), could be reduced.

their previously suspended losses. *See, e.g.*, 182 F.3d at 1147-1148. Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern.[151]

The judgment of the Court of Appeals, accordingly, is reversed.

It is so ordered.

Justice BREYER, dissenting.

I agree with the majority's reasoning with the exception of footnotes 6 and 10. The basic statutory provision before us is 26 U.S.C. § 108 – the provision that excludes from the "gross income" of any "insolvent" taxpayer, income that cancellation of a debt (COD) would otherwise generate. As the majority acknowledges, however, § 108 contains a subsection that sets forth a special exception. The exception, entitled "Special rules for S corporation," says:

> (A) Certain provisions to be applied at corporate level.
> In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level. 26 U.S.C. § 108(d)(7)(A).

If one reads this language literally as exclusive, both the COD exclusion (§ 108(a)) and the tax attribute reduction (§ 108(b)) would apply only "at the corporate level." Hence the COD income would not flow through to S corporation shareholders. Consequently, the insolvent S corporation's COD income would not increase the shareholder's basis and would not help the shareholder take otherwise unavailable deductions for suspended losses.

The Commissioner argues that we should read the language in this way as preventing the flow-through of the corporation's COD income. He points to the language of a House Committee, which apparently thought, when Congress passed an amendment to § 108, that the Commissioner's reading is correct. H.R. REP. NO. 103-111, pp. 624-625 (1993) ("The exclusion and basis reduction are both made at the S corporation level (§ 108(d)(7)). The shareholders' basis in their stock is not adjusted by the amount of debt discharge income that is excluded at the corporate level"). At least one commentator believes the same. *See* Loebl, *Does the Excluded COD Income of an Insolvent S Corporation Increase the Basis of the Shareholders' Stock?*, 52 U. FLA. L. REV. 957, 981-988 (2000). *But see* Lockhart & Duffy, *Tax Court Rules in* Nelson *that S Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis*, 25 WM.

[151] [footnote 10 of the Court] The benefit at issue in this case arises in part because § 108(d)(7)(A) permits the exclusion of discharge of indebtedness income from gross income for an insolvent S corporation even when the S corporation shareholder is personally solvent. We are aware of no other instance in which § 108 directly benefits a solvent entity. However, the result is required by statute. Between 1982 and 1984, § 108 provided that the exclusion from gross income and the reduction in tax attributes occurred at the shareholder level. *See* Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 3(e), 96 Stat. 1689. This provision, which paralleled the current taxation of partnerships at the partner level, *see* 26 U.S.C. § 108(d)(6), prevented solvent shareholders from benefiting as a result of their S corporation's insolvency. In 1984, however, Congress amended the Code to provide that § 108 be applied "at the corporate level." Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(b), 98 Stat. 966. It is as a direct result of this amendment that the solvent petitioners in this case are able to benefit from § 108's exclusion.

MITCHELL L. REV. 287 (1999).

The Commissioner finds support for his literal, exclusive reading of § 108(d)(7)(A)'s language in the fact that his reading would close a significant tax loophole. That loophole – preserved by the majority – would grant a solvent shareholder of an insolvent S corporation a tax benefit in the form of permission to take an otherwise unavailable deduction, thereby sheltering other, unrelated income from tax. *See Witzel v. Commissioner*, 200 F.3d 496, 497 (CA7 2000) (Posner, C.J.) ("It is hard to understand the rationale for using a tax exemption to avoid taxation not only on the income covered by the exemption but also on unrelated income that is not tax exempt"). Moreover, the benefit often would increase in value as the amount of COD income increases, a result inconsistent with congressional intent to impose a "price" (attribute reduction), *see* Lipton, *Different Courts Adopt Different Approaches to the Impact of COD Income* 92 J. TAX. 207 (2000), on excluded COD. Further, this deduction-related tax benefit would have very different tax consequences for identically situated taxpayers, depending only upon whether a single debt can be split into segments, each of which is canceled in a different year. For example, under the majority's interpretation, a $1 million debt canceled in one year would permit Taxpayer A to deduct $1 million of suspended losses in that year, thereby permitting A to shelter $1 million of unrelated income in that year. But because § 108 reduces tax attributes after the first year, five annual cancellations of $200,000 will not create a $1 million shelter. Timing is all important.

The majority acknowledges some of these policy concerns and confesses ignorance of any "other instance in which § 108 directly benefits a solvent entity," but claims that its reading is mandated by the plain text of § 108(d)(7)(A) and therefore that the Court may disregard the policy consequences. It is difficult, however, to see why we should interpret that language as treating different solvent shareholders differently, given that the words "at the corporate level" were added "in order to treat all shareholders in the same manner." H.R. REP. NO. 98-432, pt. 2, p. 1640 (1984). And it is more difficult to see why, given the fact that the "plain language" admits either interpretation, we should ignore the policy consequences. *See Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134-135 (1960) (abandoning literal meaning of 26 U.S.C. § 1221 (1958 ed.) for a reading more consistent with congressional intent). *Accord*, *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 264-267 (1958); *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 51-52 (1955); *Hort v. Commissioner*, 313 U.S. 28, 30-31 (1941).

The arguments from plain text on both sides here produce ambiguity, not certainty. And other things being equal, we should read ambiguous statutes as closing, not maintaining, tax loopholes. Such is an appropriate understanding of Congress' likely intent. Here, other things are equal, for, as far as I am aware, the Commissioner's literal interpretation of § 108(d)(7)(A) as exclusive would neither cause any tax-related harm nor create any statutory anomaly. Petitioners argue that it would create a linguistic inconsistency, for they point to a Treasury Regulation that says that the Commissioner will apply hobby loss limitations under § 183 "at the corporate level in determining" allowable deductions, while, presumably, nonetheless permitting the deduction so limited to flow through to the shareholder. Treas. Reg. § 1.183-1(f), 26 C.F.R. § 1.183-1(f) (2000). But we are concerned here with the "*application*" of an exclusion, not with "*determining*" the amount of a deduction. Regardless, the regulation's use of the words "at the corporate level," like the three other appearances of the formulation "applied" or "determined" "at the corporate level" in the Code, occur in contexts that are so very different from this one that

nothing we say here need affect their interpretation. *See* 26 U.S.C. § 49(a)(1)(E)(ii)(I) (determining whether financing is recourse financing); 26 U.S.C. § 264(f)(5)(B) (1994 ed., Supp. IV) (determining how to allocate interest expense to portions of insurance policies); 26 U.S.C. § 302(e)(1)(A) (determining whether a stock distribution shall be treated as a partial liquidation). If there are other arguments militating in favor of the majority's interpretation, I have not found them.

The majority, in footnote 6, says that the words "at the corporate level" in § 108(d)(7)(A) apply to the exclusion of COD income from corporate income and to "tax attribute reduction" but do not "suspend the operation of ... ordinary pass-through rules" because § 108(d)(7)(A) "does not state or imply that the debt discharge provisions shall apply *only* 'at the corporate level.'" It is the majority, however, that should explain why it reads the provision as nonexclusive (where, as here, its interpretation of the Code results in the "practical equivalent of [a] double deduction," *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934)). *See United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (requiring "clear declaration of intent by Congress" in such circumstances). I do not contend that § 108(d)(7)(A) must be read as having exclusive effect, only that, given the alternative, this interpretation provides the best reading of § 108 as a whole. And I can find no "clear declaration of intent by Congress" to support the majority's contrary conclusion regarding § 108(d)(7)(A)'s effect. It is that conclusion from which, for the reasons stated, I respectfully dissent.

Questions and comments:

1. Any time the Code excludes income from gross income, it is necessary to increase the taxpayer's basis by the amount excluded. Otherwise, there is in fact no exclusion but merely a deferral of tax liability.

- But is it so easy to reconcile treatment of COD income at the corporate level with basis increase at the shareholder level – simply by observing that subchapter S creates a pass-through regime?

2. How compelling was the Commissioner's argument(s)?

3. A taxpayer may not have negative basis in an asset. *Cf. Peracchi v. Comm'r*, 143 F.3d 487, 491 (CA9 1998). "You can't run a tab with the Government." Hence, an S corporation shareholder may not take into account losses or deductions greater than her basis in S corporation stock. § 1366(d)(1). Instead, the S corporation shareholder may treat such excess losses or deductions as if they were incurred by the corporation in the following taxable year. § 1366(d)(2)(A). This suspension of losses can go on indefinitely.

4. Section 1017(a) provides that discharge of indebtedness income excluded from gross income under §§ 108(b)(2)(E), 108(b)(5), or 108(c)(1) reduces taxpayer's basis in property at the beginning of the year following the taxable year of discharge.

- How does such a delay benefit the taxpayer?

5. Corporate Indebtedness and Shareholder Basis: In a partnership, each partner may include in her basis a share of the partnership's debt – whether recourse or non-recourse. An S corporation

shareholder may not include in her basis any share of the corporation's indebtedness.

Section 1367(b)(2) provides that a shareholder *does* have basis in the S corporation's indebtedness to *her*. Only after the shareholder's basis has been reduced to $0, may the shareholder use losses – but not distributions – to reduce the basis of such indebtedness. Subsequent increases to basis must be used first to restore the basis of such indebtedness before increasing a shareholder's basis in her stock.

- Basis adjustments are made at the close of the taxable year, unless the shareholder has terminated her interest in the corporation – in which case the adjustments are made immediately before the shareholder terminates her interest. Reg. § 1.1367-2(d)(1).

Lenders often look to the creditworthiness of the individual shareholders of an S corporation rather than to the corporation itself. [Indeed, in the following case, the creditworthiness of the corporation was almost meaningless.] Shareholders must exercise caution to establish the precise relationship they want.

Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir.), *cert. denied*, 493 U.S. 958 (1989)

MURNAGHAN, Circuit Judge

The appellants, Anthony D. and Marjorie F. Cuzzocrea and the Estate of Daniel Leavitt, Deceased, et al., appeal the Tax Court's decision holding them liable for tax deficiencies for the tax years 1979, 1980 and 1981. Finding the appellants' arguments unpersuasive, we affirm the Tax Court.

I.

As shareholders of VAFLA Corporation,[152] a subchapter S corporation during the years at issue, the appellants claimed deductions[153] under § 1374[154] of the Code [footnote omitted] to reflect the corporation's operating losses during the three years in question.[155] The Commissioner

[152] VAFLA is a Virginia corporation incorporated in February 1979 to acquire and operate the Six-Gun Territory Amusement Park near Tampa, Florida. At that time, both Cuzzocrea and Leavitt each paid $10,000 for their respective shares of VAFLA. Therefore, the adjusted bases of their stock amounted to $10,000 each, the cost of the stock.

[153] The Leavitts deducted a loss of $13,808 attributable to the corporation on their 1979 joint federal income tax return. The appellee disallowed $3,808 of that deduction. The Cuzzocreas deducted losses of $13,808, $29,921 and $22,746 attributable to the corporation on their 1979, 1980 and 1981 joint federal income tax returns, respectively. The appellee disallowed all of the deductions in excess of $10,000.

[154] [The principles of § 1374 are now stated in § 1366.]

[155] The first taxable year of VAFLA consisted of seven months and ended on September 30, 1979. The corporation had suffered a net operating loss of $265,566.47 and had a retained earnings deficit of $345,370.29. During its second taxable year ending September 30, 1980, the corporation suffered a net operating loss of $482,181.22 and had a retained earnings deficit of $1,093,383.56. During its third taxable year ending September 30, 1981, the corporation suffered a net operating loss of $475,175.70 and had a retained earnings deficit of $1,908,680.22.

disallowed deductions above the $10,000 bases each appellant had from their original investments.

The appellants contend, however, that the adjusted bases in their stock should be increased to reflect a $300,000 loan which VAFLA obtained from the Bank of Virginia ("Bank") on September 12, 1979, after the appellants, along with five other shareholders ("Shareholders-Guarantors"), had signed guarantee agreements whereby each agreed to be jointly and severally liable for all indebtedness of the corporation to the Bank.[156] At the time of the loan, VAFLA's liability exceeded its assets, [footnote omitted] it could not meet its cash flow requirements and it had virtually no assets to use as collateral. The appellants assert that the Bank would not have lent the $300,000 without their personal guarantees.

VAFLA's financial statements and tax returns indicated that the bank loan was a loan from the Shareholders-Guarantors. Despite the representation to that effect, VAFLA made all of the loan payments, principal and interest, to the Bank. The appellants made no such payments. In addition, neither VAFLA nor the Shareholders-Guarantors treated the corporate payments on the loan as constructive income taxable to the Shareholders-Guarantors.

The appellants present the question whether the $300,000 bank loan is really, despite its form as a borrowing from the Bank, a capital contribution from the appellants to VAFLA. They contend that if the bank loan is characterized as equity, they are entitled to add a pro rata share of the $300,000 bank loan to their adjusted bases, thereby increasing the size of their operating loss deductions.[157] Implicit in the appellants' characterization of the bank loan as equity in VAFLA is a determination that the Bank lent the $300,000 to the Shareholders-Guarantors who then contributed the funds to the corporation. The appellants' approach fails to realize that the $300,000 transaction, regardless of whether it is equity or debt, would permit them to adjust the bases in their stock if, indeed, the appellants, and not the Bank, had advanced VAFLA the money. The more precise question, which the appellants fail initially to ask, is whether the guaranteed loan from the Bank to VAFLA is an economic outlay of any kind by the Shareholders-Guarantors. To decide this question, we must determine whether the transaction involving the $300,000 was a loan from the Bank to VAFLA or was it instead a loan to the Shareholders-Guarantors who then gave it to VAFLA, as either a loan or a capital contribution.

Finding no economic outlay, we need not address the question, which is extensively addressed in the briefs, of whether the characterization of the $300,000 was debt or equity.

II.

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[156] All the guarantees to the Bank were unlimited except the guarantee of Cuzzocrea which was limited to $300,000. The Shareholders-Guarantors had an aggregate net worth of $3,407,286 and immediate liquidity of $382,542.

[157] Former § 1374 ... which was in effect during the years in issue provides that a shareholder of an electing small business corporation may deduct from gross income an amount equal to his or her portion of the corporation's net operating loss to the extent provided for in § 1374(c)(2). Such deduction is limited, however, to the sum of (a) the adjusted basis of the shareholder's stock in the corporation, and (b) the adjusted basis of any indebtedness of the corporation to the shareholder, as determined as of the close of the corporation's taxable year.

To increase the basis in the stock of a subchapter S corporation, there must be an economic outlay on the part of the shareholder. *See Brown v. Commissioner*, 706 F.2d 755, 756 (6th Cir. 1983), *aff'g*. T.C. Memo 1981-608 (1981) ("In similar cases, the courts have consistently required some economic outlay by the guarantor in order to convert a mere loan guarantee into an investment."); *Blum v. Commissioner*, 59 T.C. 436, 440 (1972) (bank expected repayment of its loan from the corporation and not the taxpayers, i.e., no economic outlay from taxpayers).[158] A guarantee, in and of itself, cannot fulfill that requirement. The guarantee is merely a promise to pay in the future if certain unfortunate events should occur. At the present time, the appellants have experienced no such call as guarantors, have engaged in no economic outlay, and have suffered no cost. [footnote omitted].

The situation would be different if VAFLA had defaulted on the loan payments and the Shareholders-Guarantors had made actual disbursements on the corporate indebtedness. Those payments would represent corporate indebtedness to the shareholders which would increase their bases for the purpose of deducting net operating losses under § 1374(c)(2)(B) [now § 1366(d)(1)(B)]. *Brown*, 706 F.2d at 757. *See also Raynor v. Commissioner*, 50 T.C. 762, 770-71 (1968) ("No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation.").

The appellants accuse the Tax Court of not recognizing the critical distinction between § 1374(c)(2)(A) [§ 1366(d)(1)(A)] (adjusted basis in stock) and § 1374(c)(2)(B) [§ 1366(d)(1)(B)] (adjusted basis in indebtedness of corporation to shareholder). They argue that the "loan" is not really a loan, but is a capital contribution (equity). Therefore, they conclude, § 1374(c)(2)(A) applies and § 1374(c)(2)(B) is irrelevant. However, the appellants once again fail to distinguish between the initial question of economic outlay and the secondary issue of debt or equity. Only if the first question had an affirmative answer, would the second arise.

The majority opinion of the Tax Court, focusing on the first issue of economic outlay, determined that a guarantee, in and of itself, is not an event for which basis can be adjusted. It distinguished the situation presented to it from one where the guarantee is triggered *and actual payments are made*. In the latter scenario, the first question of economic outlay is answered affirmatively (and the second issue is apparent on its face, i.e., the payments represent indebtedness from the corporation to the shareholder as opposed to capital contribution from the shareholder to the corporation). To the contrary is the situation presented here. The Tax Court, far from confusing the issue by discussing irrelevant matters, was comprehensively explaining why the transaction before it could not represent any kind of economic outlay by the appellants.

The Tax Court correctly determined that the appellants' guarantees, unaccompanied by further acts, in and of themselves, have not constituted contributions of cash or other property which might increase the bases of the appellants' stock in the corporation.

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[158] Even the Eleventh Circuit case on which the appellants heavily rely applies this first step. *See* Selfe v. United States, 778 F.2d 769, 772 (11th Cir. 1985) ("We agree with *Brown* inasmuch as that court reaffirms that economic outlay is required before a stockholder in a Subchapter S corporation may increase her basis.").

The appellants, while they do not disagree with the Tax Court that the guarantees, standing alone, cannot adjust their bases in the stock, nevertheless argue that the "loan" to VAFLA was in its "true sense" a loan to the Shareholders-Guarantors who then theoretically advanced the $300,000 to the corporation as a capital contribution. The Tax Court declined the invitation to treat a loan and its uncalled-on security, the guarantee, as identical and to adopt the appellants' view of the "substance" of the transaction over the "form" of the transaction they took. The Tax Court did not err in doing so.

Generally, taxpayers are liable for the tax consequences of the transaction they actually execute and may not reap the benefit of recasting the transaction into another one substantially different in economic effect that they might have made. They are bound by the "form" of their transaction and may not argue that the "substance" of their transaction triggers different tax consequences. *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579-80 (1977); *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).[159] In the situation of guaranteed corporate debt, where the form of the transaction may not be so clear, courts have permitted the taxpayer to argue that the substance of the transaction was in actuality a loan to the shareholder. *See Blum*, 59 T.C. at 440. However, the burden is on the taxpayer and it has been a difficult one to meet. That is especially so where, as here, the transaction is cast in sufficiently ambiguous terms to permit an argument either way depending on which is subsequently advantageous from a tax point of view.

In the case before us, the Tax Court found that the "form" and "substance" of the transaction was a loan from the Bank to VAFLA and not to the appellants:

> The Bank of Virginia loaned the money to the corporation and not to petitioners. The proceeds of the loan were to be used in the operation of the corporation's business. Petitioners submitted no evidence that they were free to dispose of the proceeds of the loan as they wished. Nor were the payments on the loan reported as constructive dividends on the corporation's Federal income tax returns or on the petitioners' Federal income tax returns during the years in issue. Accordingly, we find that the transaction was in fact a loan by the bank to the corporation guaranteed by the shareholders.

Whether the $300,000 was lent to the corporation or to the Shareholders/Guarantors is a factual issue which should not be disturbed unless clearly erroneous. Finding no error, we affirm.

It must be borne in mind that we do not merely encounter naive taxpayers caught in a complex trap for the unwary. They sought to claim deductions because the corporation lost money. If, however, VAFLA had been profitable, they would be arguing that the loan was in reality from the Bank to the corporation, and not to them, for that would then lessen their taxes. Under that description of the transaction, the loan repayments made by VAFLA would not be on the appellants' behalf, and, consequently, would not be taxed as constructive income to them. *See*

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[159] On the other hand, the Commissioner is not so bound and may recharacterize the nature of the transaction according to its substance while overlooking the form selected by the taxpayer. Higgins v. Smith, 308 U.S. 473, 477 (1940). ...

Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (payment by a corporation of a personal expense or debt of a shareholder is considered as the receipt of a taxable benefit). It came down in effect to an ambiguity as to which way the appellants would jump, an effort to play both ends against the middle, until it should be determined whether VAFLA was a profitable or money-losing proposition. At that point, the appellants attempted to treat the transaction as cloaked in the guise having the more beneficial tax consequences for them.

Finally, the appellants complain that the Tax Court erred by failing to apply debt-equity principles [footnote omitted] to determine the "form" of the loan. We believe that the Tax Court correctly refused to apply debt-equity principles here, a methodology which is only relevant, if at all,[160] to resolution of the second inquiry – what is the nature of the economic outlay. Of course, the second inquiry cannot be reached unless the first question concerning whether an economic outlay exists is answered affirmatively. Here it is not.

The appellants, in effect, attempt to collapse a two-step analysis into a one-step inquiry which would eliminate the initial determination of economic outlay by first concluding that the proceeds were a capital contribution (equity). Obviously, a capital contribution is an economic outlay so the basis in the stock would be adjusted accordingly. But such an approach simply ignores the factual determination by the Tax Court that the Bank lent the $300,000 to the corporation and not to the Shareholders-Guarantors.

The appellants rely on *Blum v. Commissioner*, 59 T.C. 436 (1972), and *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), to support their position. However, the appellants have misread those cases. In *Blum*, the Tax Court declined to apply debt-equity principles to determine whether the taxpayer's guarantee of a loan from a bank to a corporation was an indirect capital contribution.[161] The Tax Court held that the taxpayer had failed to carry his burden of proving

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[160] In a § 1374 [§ 1366(d)(1)] subchapter S corporation case, the inquiry whether or not the economic outlay, assuming there is one, is debt or equity appears not to matter since the economic outlay, regardless of its characterization as debt or equity, will increase the adjusted basis. There are no different tax consequences from the point of view of the taxpayer on the narrow issue of what amount of net operating losses may be deducted. Therefore, application of debt-equity principles in a case such as this one appears to be a red herring. However, we do not reach that issue because the Tax Court's factual finding that the appellants have shown no economic outlay on their part is not clearly erroneous.

[161] The *Blum* court stated:

> The respondent [Commissioner] has argued that the entire equity-contribution argument espoused by petitioner is inimical to the subch. S area. Because of our holding that the facts do not warrant the applicability of this doctrine to the present case we will not consider this rather fascinating question.

Blum, 59 T.C. at 439 n. 4. In other words, the *Blum* court never reached the second step of the analysis, if there is a second step, because it found that there was no economic outlay. The Tax Court focused on the first inquiry: "we must find that the bank in substance loaned the sums to petitioner, not the corporation, and that petitioner then proceeded to advance such funds to the corporation." *Id.* at 440. The court found that "there is no evidence to refute the fact that the bank expected repayment of its loan from the corporation and not the petitioner." *Id.*

Similarly, in *Brown*, the Sixth Circuit refused to "accept petitioners' contorted view of the transaction in furtherance of their 'substance over form' argument when, as the court below observed, 'the substance matched the form.'" Brown, 706 F.2d at 756. In other words, the loan to the corporation was, indeed, a loan to the corporation. *See also*

that the transaction was in "substance" a loan from the bank to the shareholder rather than a loan to the corporation. The *Blum* court found dispositive the fact that "the bank expected repayment of its loan from the corporation and not the petitioner." *Blum*, 59 T.C. at 440.[162]

With regard to *Selfe*, the Tax Court stated:

> the Eleventh Circuit applied a debt-equity analysis and held that a shareholder's guarantee of a loan made to a subchapter S corporation may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor. We respectfully disagree with the Eleventh Circuit and hold that a shareholder's guarantee of a loan to a subchapter S corporation may not be treated as an equity investment in the corporation absent an economic outlay by the shareholder. [footnote omitted].

The Tax Court then distinguished *Plantation Patterns*, 462 F.2d 712 (5th Cir. 1972), relied on by *Selfe*, because that case involved a C corporation, reasoning that the application of debt-equity principles to subchapter S corporations would defeat Congress' intent to limit a shareholder's pass-through deduction to the amount he or she has actually invested in the corporation.[163]

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Although *Selfe* does refer to debt-equity principles, the specific issue before it was whether any

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In re Breit, 460 F. Supp. 873 (E.D. Va. 1978).

[162] The appellants and Judge Fay, in his dissent, contend that the Tax Court has misread its earlier opinion. Indeed, Judge Fay was the author of *Blum*. However, the Tax Court, sitting en banc, has now had the opportunity to interpret more precisely the language of *Blum* in light of subsequent cases and arguments. Leavitt v. Commissioner, 90 T.C. 206 (1988) (court reviewed). We agree with the amplification the Tax Court has given *Blum*.

The confusion may be explained to some degree because the test applied in *Blum* to determine whether the bank lent the money to the corporation or to the shareholders sounds similar to one of the debt-equity factors, i.e., the source of the payments. When focusing on the proper question, however, it becomes clear that the debt-equity principles are simply irrelevant to the determination of whether the $300,000, unquestionably a loan when it left the Bank, went to VAFLA or to the appellants. In *Blum*, the fact that the bank expected repayment from the corporation indicated that it actually lent the funds to the corporation and not the shareholder. Similarly, in the case before us, the fact that VAFLA paid the principal and interest on the $300,000 loan and did not treat the payments as constructive income taxable to the Shareholders-Guarantors, indicated that the Bank actually lent the money to VAFLA and not the appellants.

[163] The Committee on Finance of the Senate stated in its report:

> The amount of the net operating loss apportioned to any shareholder pursuant to the above rule is limited under § 1374(c)(2) to the adjusted basis of the shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder.

S. REP. NO. 1983, 85th Cong., 2d Sess. at 220, (1958-3 Cum. Bull. at 1141). The word "investment" was construed to mean the actual economic outlay of the shareholder in question. Perry v. Commissioner, 54 T.C. 1293, 1296 (1970).

In other words, the economic outlay must be found to exist first.

material facts existed making summary judgment inappropriate. The Eleventh Circuit said:

> At issue here, however, is not whether the taxpayer's contribution was either a loan to or an equity investment in Jane Simon, Inc. The issue is whether the taxpayer's guarantee of the corporate loan was in itself a contribution to the corporation [as opposed to a loan from the bank] sufficient to increase the taxpayer's basis in the corporation.

The *Selfe* court found that there was evidence that the bank primarily looked to the taxpayer and not the corporation for repayment of the loan.[164] Therefore, it remanded for "a determination of whether or not the bank primarily looked to Jane Selfe [taxpayer] for repayment [the first inquiry] and for the court to apply the [thirteen] factors set out in *In re Lane*[, 742 F.2d 1311 (CA11 1984)] and § 385 to determine if the taxpayer's guarantee amounted to either an equity investment in or shareholder loan to Jane Simon, Inc. [the second inquiry]." *Id.* at 775. The implications are that there is still a two-step analysis and that the debt-equity principles apply only to the determination of the characterization of the economic outlay, once one is found.

Granted, that conclusion is clouded by the next and final statement of the *Selfe* court: "In short, we remand for the district court to apply *Plantation Patterns* and determine if the bank loan to Jane Simon, Inc. was in reality a loan to the taxpayer."[165] To the degree that the *Selfe* court agreed with *Brown* that an economic outlay is required before a shareholder may increase her basis in a subchapter S corporation, *Selfe* does not contradict current law or our resolution of the case before us. Furthermore, to the extent that the *Selfe* court remanded because material facts existed by which the taxpayer could show that the bank actually lent the money to her rather than the corporation, we are still able to agree.[166] It is because of the *Selfe* court's suggestion that

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[164] The loan officer so stated during deposition testimony. Furthermore, the bank originally extended a credit line to the taxpayer in consideration of her pledge of 4500 shares of stock in another corporation. When her business was later incorporated, the bank converted the loans made on the existing credit line to corporate loans, accompanied by taxpayer's agreement guaranteeing the corporation's indebtedness to the bank. The Eleventh Circuit noted that "a guarantor who has pledged stock to secure a loan has experienced an economic outlay to the extent that that pledged stock is not available as collateral for other investments." *Id.* at 772 n. 7. Thus, upon remand, the district court could determine that there was an economic outlay on that basis alone, before deciding whether the form of the loan was to the taxpayer or to the corporation.

This particular situation is not before us and we decline to address the question of whether a guarantee can be an economic outlay when accompanied by pledged collateral.

[165] It is unclear whether the reference to *Plantation Patterns* means that debt-equity principles should be applied or refers back to an earlier statement in the *Selfe* court's opinion which related to the initial inquiry:

> In *Plantation Patterns*, the Fifth Circuit held that a loan is deemed to be made to a stockholder who has guaranteed a corporate note when the facts indicate that the lender is looking primarily to the stockholder for repayment.

Selfe, 778 F.2d at 771.

[166] We note, however, that under the circumstances presented here, the Tax Court resolved that factual determination against the appellants because they could not overcome the uncontradicted fact that they did not treat the loan repayments made by VAFLA as constructive income to them. Such a position was inconsistent with their claim that the transaction was in actuality a loan from the Bank to them followed by their contribution of the $300,000 to the corporation.

debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder or the corporation, that we must part company with the Eleventh Circuit for the reasons stated above.

In conclusion, the Tax Court correctly focused on the initial inquiry of whether an economic outlay existed. Finding none, the issue of whether debt-equity principles ought to apply to determine the nature of the economic outlay was not before the Tax Court. The Tax Court is

AFFIRMED.

Questions and comments:

1. Section 1374 is now § 1366(d)(1).

2. *Uri v. Commissioner*, 949 F.2d 371 (10th Cir. 1991) reached a conclusion similar to the one reached by the court in *Estate of Leavitt*.

3. The court implied that the taxpayers were taking a "heads-I-win-tails-you-lose" position on the burden of repaying the loan. The court indicated that the shareholders would not pay income tax if the corporation repaid the loan. True?

- If the S corporation makes payments on the loan, presumably from its taxable income, who pays income taxes on that income?
- Would that tax burden be assessed in the same proportion as the guarantee obligations assumed by the individual shareholders?

Reg. § 1.1366-2(a)(2)(ii) states the rule of this case.

4. Suppose: Shareholder is given indebtedness basis for having guaranteed the repayment of a loan extended to the corporation (as the taxpayers in *Leavitt* wanted). Shareholder could then use that indebtedness basis to absorb corporate losses passed through to her. Shareholder would have to reduce her basis by the amount of such losses. Assume that the corporation makes payments on the loan.

- What effect should such repayment have on shareholder's indebtedness basis?

- Shouldn't shareholder have to recognize taxable income every time the corporation made a payment?

5. If shareholders want the lender to look to the corporation for repayment, is there a better way to structure the loan transaction?

- How about a back-to-back loan? The bank lends money to the shareholders individually who in turn loan the money to the corporation. The bank loans would have to be in the same proportion as the shareholders wished to assign guarantee obligations amongst themselves.

Problem:

M forms an S corporation, and she is the sole shareholder. The corporation is a calendar year taxpayer. M transfers $25,000 cash for all the corporation's stock. In addition, she contributes $25,000 in exchange for a bond. Furthermore, the corporation borrows $50,000 from the Fifth National Bank; M guarantees the loan. On October 1 of year 1, the corporation distributes $30,000 to M. The corporation also loses $27,500. What are the tax consequences to M? If M anticipated that there would be a distribution and losses in the first year, how might she have planned these transactions more to her advantage?

IV. From C to S

A C corporation can become an S corporation simply by qualifying to be one (i.e., a "small business corporation") and making the election. Such a course will reduce the income tax on corporate income that shareholders receive because such income will be subject to income tax only at the shareholder level – and not at both the corporate and shareholder levels. Of course, corporate income will pass through to shareholders and be taxed without the benefit of any deferral that otherwise results if the corporation retains the income after paying income tax on it.

This transition can be accomplished at very little tax cost, unlike a liquidation of a C corporation – taxable at both the corporate and shareholder levels – followed by transfer of the C corporation's assets to a partnership or a corporation. However, the fact that an S corporation was once a C corporation is not forgotten. The earnings and profits that a corporation accumulated while a C corporation are still subject to income tax as dividends if and when the corporation distributes them to shareholders. There are various other consequences to an S corporation resulting from the fact that it was once a C corporation. There are no carryforwards or carrybacks from a C corporation year to an S corporation year, § 1371(b)(1), or from an S corporation year to a C corporation year, § 1371(b)(2). Such attributes are suspended and become available should a corporation's status revert to what it was. Moreover, the different corporate status does not toll any tax attribute that by its terms expires. § 1371(b)(3).

The pass-through nature of an S corporation assures that there will be no *current* earnings and profits. Only distributions and redemptions from *accumulated* earnings and profits will cause an adjustment to that account. § 1371(c). The statute must provide some means of distinguishing between distributions that are from an S corporation's current income and distributions that are from its earnings and profits accumulated while it was a C corporation. Section 1368 distinguishes between S corporations that do and do not have accumulated earnings and profits. § 1368(a). The distribution of an S corporation *without* accumulated earnings and profits first reduces the shareholder's basis in her stock; distributions in excess of basis are treated as gain from the sale or exchange of property. § 1368(b)(1 and 2). S corporations that were C corporations may have accumulated earnings and profits. *Cf.* § 1368(c). Distributions from corporations with such a history require a bit more tracing.

Section 1368 identifies distributions from S corporation earnings (and not from accumulated earnings and profits) by establishing an "accumulated adjustments account" ("AAA"). This

account of the corporation (and not of its shareholders) begins with a $0 balance on the first day that the corporation is an S corporation. Reg. § 1.1368-2(a)(1). The AAA is adjusted in the same manner as shareholder basis adjustments under § 1367, except that no adjustment is made for tax exempt income, the account *can* have a negative balance, and no adjustments are made for federal taxes attributable to a year when the corporation was a C corporation. § 1368(e)(1)(A). A distribution from the S corporation to a shareholder reduces the corporation's AAA – but the distribution can neither cause nor increase a deficit in the AAA. Reg. § 1.1368-2(a)(2)(iii).

The regulations provide a sequence in which adjustments to an S corporation's AAA are to be made. Reg. § 1368-2(a)(5).

1. Increases to AAA;
2. Decreases to AAA without regard to "net negative adjustments" for the taxable year, § 1368(e)(1)(C)(1), i.e., to the extent of increases;
3. Distributions to which §§ 1368(c)(1) and 1368(b) apply, i.e., "Tier 1 *infra*.
4. Decrease for "net negative adjustments" *for the taxable year*, i.e., reductions other than for distributions MINUS increases to such account, § 1368(e)(1)(C)(ii);
5. Increase or decrease as necessary for redemptions.

This sequence is important because it identifies distributions that may or may not be dividends. Section 1368(c) establishes an ordering of the sources from which an S corporation's distribution comes. Distributions come from three tiers[167] in succession:

1. "Tier 1:" A distribution that does not exceed the corporation's AAA is treated the same as a distribution by an S corporation that has no accumulated earnings and profits, i.e., it passes through to the shareholders who pay no income tax but do reduce the bases in their stock. §§ 1368(c)(1), 1368(b)(1).

2. "Tier 2:" Distributions that exceed the corporation's AAA are treated as dividends to shareholders to the extent of the corporation's accumulated earnings and profits. § 1368(c)(2).

3. "Tier 3:" A distribution that exceeds both the corporation's AAA and its accumulated earnings and profits[168] is treated the same as a distribution by an S corporation that has no accumulated earnings and profits, i.e., it passes through to the shareholders who adjust the bases in their stock. §§ 1368(c)(3), 1368(b)(1).

The source of distributions – whether AAA or accumulated earnings and profits – is made by pro-rating all the distributions occurring during a taxable year to the balance of the corporation's AAA at the close of the taxable year. Reg. § 1.1368-2(b)(2). In the case of a redemption treated as an exchange under § 302(a) or § 303, the AAA must be adjusted by the same portion of it as the portion of all the shares redeemed. § 1368(e)(1)(B). If the S corporation's AAA is negative at

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[167] *See* BORIS I. BITTKER AND JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 6.08[3], at 6-47 to 6-40 (Student ed., 7th ed. 2000).

[168] For example, a distribution of the corporation's tax exempt income.

the time of the redemption, the S corporation's AAA is adjusted (upward) by the same portion of the corporation's deficit in its AAA as the portion of all the shares redeemed. § 1368(e)(1)(B).

The shareholders of an S corporation can avoid paying income tax on a dividend simply by not permitting the corporation to distribute more than the corporation's AAA. Of course, the corporation would continue to have accumulated earnings and profits – a point that might trigger liability for certain subchapter S taxes. *See* § 1375, *infra*. The S corporation may elect with the consent of all affected shareholders (i.e., those to whom a distribution is made, § 1368(e)(3)(B)) to distribute its accumulated earnings and profits before making distributions from AAA. § 1368(e)(3)(A). This would eliminate the need to have an AAA and eliminate the risk of triggering liability for the § 1375 tax on an S corporation's passive investment income.

Problems:

1. Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $1,500 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $1,500. For the taxable year ending December 31, 2001, S does not have a net negative adjustment as defined in § 1368(e)(1)(C). S does not make the election under § 1368(e)(3) and Reg. § 1.1368-1(f)(2) to distribute its earnings and profits before its AAA. What adjustments are made to the corporation's AAA and when, what adjustments are made to B's adjusted basis in her stock, and what is B's taxable income? *See* Reg. § 1.1368-3, Example 4.

2. Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $2,000 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $3,500. For the taxable year ending December 31, 2001, S has a net negative adjustment as defined in § 1368(e)(1)(C). S does not make the election under § 1368(e)(3) and Reg. § 1.1368-1(f)(2) to distribute its earnings and profits before its AAA. What adjustments are made to the corporation's AAA and when, what adjustments are made to B's adjusted basis in his stock, and what is B's taxable income? *See* Reg. § 1.1368-3, Example 5.

3. On January 1, 1995, Corporation S has $40 of earnings and profits and a balance in the AAA of $100. S has two shareholders, E and F, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of $50, which increases the AAA to $150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $60 to each shareholder. On September 1, 1995, S distributes $30 to each shareholder. S does not make the election under § 1368(e)(3) and § 1.1368-1(f)(2) to distribute its earnings and profits before its AAA. Describe the tax consequences of these transactions as well as the adjustments to the corporation's AAA and accumulated earnings and profits. *See* Reg. § 1.1368-3, Example 8.

4. When a distribution is made from a C corporation to a shareholder who is an individual in exchange for the shareholder's stock, the shareholder often prefers that the distribution be given sale or exchange treatment. Why? Why might a shareholder of an S corporation prefer that a

distribution in redemption of her stock *not* be given sale or exchange treatment? *See, e.g.*, Rev. Rul 95-14, 1995-1 C.B. 169.

V. S Corporation Taxes

Section 1363(a) provides that "[e]xcept as otherwise provided in [subchapter S], an S corporation shall not be subject to the taxes imposed by this chapter." Subchapter S *does* "otherwise provide" in some instances where an S corporation was previously a C corporation.

A. Tax Imposed on Built-in Gains

Prior to repeal of the *General Utilities* rule, a C corporation with substantial built-in gain in its assets could avoid payment of the corporate level of income tax by distributing assets in kind to its shareholders. Repeal of the *General Utilities* rule now makes such distributions into recognition events at the corporate level. § 311(b)(1). However, avoidance of the corporate level of income tax on built-in gains would appear possible by conversion of the C corporation into an S corporation. Theoretically, the built-in gain on assets would not be taxed at the corporate level – which was the very essence of the *General Utilities* rule. Section 1374 closes this loophole for those corporations that were not always S corporations. § 1374(c)(1). Section 1374(a) imposes the maximum corporate rate of § 11(b) on an S corporation's "net recognized built-in gain" derived in a taxable year during "the recognition period." §§ 1374(a), 1374(b)(1). The "recognition period" is the five-year period commencing with the first day that the corporation is an S corporation. § 1374(d)(7)(A); Reg. § 1.1374-1(d).

We work our way through some definitions to get to the tax base of this tax:

Net *unrealized* built-in gain: "Net unrealized built-in gain" is the total fair market value of the S corporation's assets MINUS the aggregate adjusted bases of such assets on the first day of the first taxable year for which an S corporation election is in effect. § 1374(d)(1). Reg. § 1.1374-3(a) instructs how to compute "net unrealized built-in gain." Read it.

> *Before converting from C to S:* When examining the rules of § 1374, you should conclude that a C corporation should inventory its assets and determine their bases. Such an inventory and appraisal will probably save tax liability later. See § 1374(d)(3)(A) ("recognized built-in gain" does not include gain on disposition of assets not held at the beginning of the first taxable year the corporation was an S corporation).

- "Recognized built-in gain" does *not* include the appreciation in value of assets that occurs after conversion to S corporation status. § 1374(d)(3)(B). The same rules apply to "recognized built-in loss". § 1374(d)(4).
- The burden is on the S corporation to establish the values and bases of assets necessary to make these determinations. § 1374(d)(3).

The corporation must pay tax on the gain it recognizes during the "recognition period" from the disposition of any asset that it held when it converted to an S corporation. Section 1374(c)(2) requires that the corporation keep a running total of what unrealized built-in gain it has previously recognized until it has recognized all its built-in gains or the five-year "recognition

period" elapses.

Net *recognized* built-in gain: "Net recognized built-in gain" is the amount of recognized gains derived in a taxable year from the disposition of assets the corporation held when it converted to an S corporation MINUS the amount of recognized losses in the same taxable year or the corporation's taxable income for the year if it is less than such gain. § 1374(d)(2). *This is the amount on which the S corporation must pay the § 1374 tax*.

•The S corporation's taxable income for this purpose is the S corporation's taxable income PLUS deductions allowed by §§ 241 to 249 (other than § 248 (organizational expenditures) PLUS deductions allowed by § 172 (net operating loss). § 1374(d)(2)(A)(ii), *referencing* § 1375(b)(1)(B).

•In the event that "taxable income," as defined, is less than net recognized built-in gain for any taxable year, then

(excess of recognized built-in gain) MINUS ("taxable income")

is to be treated as a "recognized built-in gain" in the next succeeding taxable year. § 1374(d)(2)(B). The amount recognized and the amount deferred is to be apportioned ratably among the items of income, gain, loss, and deduction. Reg. § 1374-2(c and d). *See also* Reg. § 1.1374-2(e), Example.

•The S corporation *may* deduct against its "net recognized built-in gain" net operating loss carryforwards from its time as a C corporation. § 1374(b)(2). The S corporation may also reduce the amount of the § 1374 tax by certain business credits under § 39. § 1374(b)(3).

•Income items and deduction items that the S corporation takes into account during the "recognition period" attributable to periods before the first taxable year for which the corporation is an S corporation are to be treated as a recognized built-in gain or recognized built-in loss. § 1374(d)(5)(A and B). This will necessitate an adjustment to the S corporation's "net unrealized built-in gain." § 1374(d)(5)(C).

•The regulations make the predecessor C corporation into an accrual method taxpayer for purposes of determining "recognized built-in gain or loss." Reg. § 1.1374-4(b) provides in part:

(b) Accrual Method Rule –

(1) Income Items. Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

(2) Deduction Items. Except as otherwise provided in this section, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was

a C corporation). In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, § 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

•If the basis of an asset that the S corporation holds at the beginning of the first taxable year in which it is an S corporation is determined by reference to the basis of another asset that the taxpayer holds (e.g., the result of a like-kind exchange), determinations of "recognized built-in" gain or loss are made with reference to the asset that the S corporation *did* hold at the beginning of its first S corporation year. § 1374(d)(6).

•If the exchange occurs after the S corporation's first day as an S corporation, the tax on "net recognized built-in gain" will be assessed on the disposition of those assets. § 1374(d)(8)(A). In such a case, the five-year recognition period commences on the day the S corporation acquired the asset in a § 1374(d)(8) transaction. Reg. § 1.1374-1(d).

•Reg. § 1.1374-1(a) provides an outline of the statutory scheme for computing the § 1374 tax. Read it.

•The § 1374 tax is treated as a loss that the S corporation sustained during the taxable year. § 1366(f)(2). The character of the loss is determined by allocating the tax proportionately among the recognized built-in gains that gave rise to the tax. § 1366(f)(2).

Do the CALI exercise: S Corporation Taxation: Taxation of the S Corporation: S Corporation Built-in Gains: General.

•Some of the questions may raise issues that we do not cover. Roll with it.

Problem:

X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	$1,050,000	$900,000

Liabilities	Amount
Mortgage	$200,000

Accounts Payable	100,000
Total	$300,000

Further: X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under § 481(a) – an adjustment resulting from its accounting method in X corporation's C corporation period. § 1374(d)(5).

What is X corporation's "net unrealized built-in gain" in 1995? *See* Reg. § 1.1374-3(c), Example 1.

B. Tax on Passive Investment Income

In addition to risking termination of S corporation status, an S corporation that has *any* accumulated earnings and profits may have to pay a tax equal to the highest corporate tax rate on its "excess net passive income." §§ 1366(d)(3), 1375(a). Section 1375(b) provides the key definitions that work towards identifying "excess net passive income," and Reg. § 1.1375-1(b)(1) provides workable abbreviations:

- "passive investment income ("PII"):" § 1375(b)(3), incorporates the definition of that phrase at § 1362(d)(3)(C). The phrase means gross receipts derived from royalties, rents, dividends, interest, and annuities. § 1361(d)(3)(C)(i). There are exceptions to this definition, most notably for interest on obligations acquired in the ordinary course of business from the sale of inventory. § 1361(d)(3)(C)(ii). "Passive investment income" does not include capital gains, § 1362(d)(3)(C)(i).
- "net passive income ("NPI")," § 1375(b)(2): NPI is "passive investment income" MINUS deductions directly connected with the production of such income.
- "gross receipts ("GR"):" The following adjustments are made to "gross receipts:"
  - Dispositions of capital assets that are *not* stock or securities: The S corporation measures its "gross receipts" by *netting gains and losses* ("capital gain net income," § 1222(9)) from the disposition of assets that are not stock or securities. § 1362(d)(3)(B)(i).
  - Sales or exchanges of capital assets that *are* stock or securities: The S corporation measures its "gross receipts" derived from the sales or exchanges of capital assets that are stock or securities by taking into account *only gains* from such sales or exchanges. § 1362(d)(3)(B)(ii).

- "excess net passive investment income ("ENPI")," i.e., the amount which is taxed: ENPI is derived by performing some calculations as prescribed in § 1375(b)(1)(A):

  ENPI = NPI * [(PII − (0.25 * GR)]/PII

  - ENPI cannot be more than the S corporation's taxable income PLUS deductions allowed by §§ 241 to 249 (other than § 248 (organizational expenditures) PLUS deductions allowed by § 172 (net operating loss). § 1375(b)(1)(B).

  - *Observation*: If GR (as specially defined) is more than four times as much as PII,

there will be no § 1375 tax, and "passive investment income" will not exceed 25% of the corporation's "gross receipts," thereby breaking the string of potentially three successive years where "passive investment income" exceeds 25% of the S corporation's "gross receipts."

•The § 1375 tax reduces the shareholders' share of the corporation's passive investment income that passes through the shareholders according to the following formula:

(item of passive investment income)/(total passive investment income) * (§ 1375 tax)

•§ 1366(f)(3).

•Naturally an S corporation can avoid the § 1375 tax by not having any accumulated earnings and profits. If the S corporation establishes to the satisfaction of the Secretary that it in good faith believed that it had no accumulated earnings and profits when in fact it did have such earnings and profits and within a reasonable time distributes those earnings and profits, the Secretary may waive the § 1375 tax. § 1375(d).

If § 1374 and § 1375 are both applicable to a transaction, § 1374 alone applies. § 1375(b)(4).

Example (Reg. § 1.1375-1(f), Example 1: Assume Corporation M, an S corporation, has for its taxable year total gross receipts of $200,000, passive investment income of $100,000, $60,000 of which is interest income, and expenses directly connected with the production of such interest income of $10,000. Assume also that at the end of the taxable year Corporation M has subchapter C earnings and profits. Since more than 25% of Corporation M's total gross receipts are passive investment income, and since Corporation M has subchapter C earnings and profits at the end of the taxable year, Corporation M will be subject to the tax imposed by § 1375. The amount of "excess net passive income" is $45,000, i.e.,

$90,000 * [$100,000 − ($200,000 * 0.25)]/$100,000

The § 1375 tax would be 21% of $45,000 = $9450.

*Of course, M Corporation's taxable income must be more than $45,000. Otherwise, its ENTI would be M Corporation's taxable income.

Problem:

Assume an S corporation with subchapter C earnings and profits has tax-exempt income of $400, its only passive income, gross receipts of $1,000 and taxable income of $250 and there are no expenses associated with the tax-exempt income. What is the S corporation's "excess net passive income" for the taxable year? Does it matter that the S corporation's only passive income is otherwise tax-exempt? *See* Reg. 1.1375-1(f), Example 2.

Do the CALI exercise: S Corporation Taxation: Taxation of the S Corporation: S Corporation Tax on Passive Investment Income.

C. LIFO Recapture Tax

In a market where the value of inventory is increasing, a taxpayer may pay less in taxes for income derived from the sale of inventory if she accounts for such income using the LIFO (last in, first out) method of accounting rather than FIFO (first in, first out) method of accounting. This will continue unless the taxpayer sells all its inventory and does not replace it before the end of a taxable year. Thus, there is built-in gain that can increase over time. Section 1363(d) provides that a C corporation that converts to an S corporation that used the LIFO method in its last taxable year as a C corporation must include a LIFO recapture amount in its gross income (with appropriate adjustments to basis) for its last taxable year as a C corporation. § 1363(d)(1).

- Taxpayer may pay the increased income tax over four years in equal installments without interest. § 1363(d)(2)
- The LIFO recapture amount is the amount by which the inventory amount under FIFO exceeds the inventory amount under LIFO on the last day of the taxable year in which the corporation was a C corporation.

Do the CALI exercise: S Corporation Taxation: Taxation of the Shareholder: S Corporation Entity Level Determinations.

Do the CALI exercise: S Corporation Taxation: Taxation of the S Corporation: S Corporation LIFO Recapture Rules.

VI. Fringe Benefits, Employee Matters

With respect to employee fringe benefits in the context of a subchapter S corporation, § 1372 provides that the S corporation is to be treated as a partnership. A 2%-shareholder is to be treated as a partner. § 1372(a)(2). The attribution rules of § 318 apply in determining whether a shareholder holds "more than" 2% of the total combined voting power of the S corporation. § 1372(b).

For purposes of health and accident insurance, the IRS has determined that an S corporation that provides a "more than 2% shareholder" such insurance is treated the same as a partnership that makes a guaranteed payment to a partner under § 707(c), i.e., deduction for the employer and taxable income to the shareholder. Rev. Rul. 96-21, 1991-1 C.B. 184. Very little additional guidance on fringe benefits is available.

What should the rule about employment taxes, i.e., social security, medicare, unemployment? Why might an S corporation's shareholders who are also employees prefer to characterize a distribution as a dividend rather than the payment of salary? *See David E. Watson v. United States*, 668 F.3d 1008 (8th Cir.), *cert. denied*, 133 S. Ct. 364 (2012).

VII. Termination Matters

Several income tax consequences follow from termination of a corporation's S corporation status.

A. Termination of Election: S Short Year and C Short Year

Section 1362(d) provides three means by which an S corporation election is terminated:

1. Revocation;
2. Ceasing to be a "small business corporation;"
3. Having passive investment income that is more than 25% of gross receipts for three consecutive taxable years when the S corporation has accumulated earnings and profits.

Tax Cuts and Jobs Act, § 11(b): The TCJA eliminated progressivity in the corporate tax rates. The corporate tax rate is now a flat 21%. Thus, a § 1362(e)(5)(A) "gross-up" of C short-year income no longer has any effect.

An S corporation that no longer has a valid election in effect remains a corporation and so becomes a C corporation. A termination may occur at any time during a taxable year and so *a fortiori* there will be a short S corporation year followed by a short C corporation year. In the S termination year, the portion of the year before the first day for which the S termination is effective is the "S short year." § 1362(e)(1)(A). The portion that begins on the first day for which the S termination is effective is the "C short year." § 1362(e)(1)(B). The due date for the "S short year" and the "C short year" are the same, i.e., the due date for the "C short year." § 1362(e)(6)(B).

The corporation first determines its separately stated items[169] of income, loss, deduction, or credit and nonseparately computed income and loss. § 1362(e)(2)(A). A pro rated amount of each is assigned to each day of the S termination year.[170] § 1362(e)(2)(B). The price of the workability of the pro rata method is some inaccuracy. The balance of income items is assigned to the "C short year."

- The income attributable to the C short year is "annualized," as per the formula of § 1362(e)(5)(A). The result is that the C corporation loses the benefit of annual progressive rates applied to a short year. *But see* accompanying text box.
- If all the shareholders who are or were shareholders during the S corporation's short year and all the persons who are shareholders of the C corporation on the first day of the "C short year" consent, the S corporation may assign separately and nonseparately stated items under normal tax accounting rules. § 1362(e)(3).
- If there is a sale of 50% or more of the stock of the S corporation during the S short year,

[169] ... i.e., those that "could affect the liability for tax of any shareholder," § 1366(a)(1)(A).

[170] The "S termination year" is *not* a short year, but rather the taxable year during which an election to revoke takes effect, other than on the first day of such year. § 1362(e)(4).

normal tax accounting rules apply rather than a pro rata allocation. § 1362(e)(6)(D).

•The pro rata method also does not apply to any "item" resulting from application of § 338, i.e., when the S election is terminated because the corporation becomes part of a "consolidated group." § 1362(e)(6)(C).

•The "S short year" does not count as a year for carryover purposes in determining the number of years an item may be carried back or forward. § 1362(e)(6)(A). A carryforward or carryback is not allowed from an S corporation to a C corporation. § 1371(b)(2).

B. Post Termination Transition Period

After termination of the S election, the corporation enters a "post termination transition period" during which shareholders of the S corporation continue to enjoy some of the benefits of holding shares in an S corporation rather than a C corporation. Otherwise, such benefits would (in all likelihood) be lost. The "post-termination transition period" are the following three periods:

1. the period commencing the day after corporation's last day as an S corporation and ending on the later of
   - •one year after such day or
   - •the due date for filing the return for such last year, including extensions. § 1377(b)(1)(A).

and

2. the 120-day period commencing on the date of any "determination" pursuant to an audit following the termination of the corporation's S election and which adjusts a subchapter S item of income, loss, or deduction of the corporation during the S period. § 1377(b)(1)(B).

and

3. the 120-day period commencing on the date of a "determination" that the corporation's S election had terminated for a previous taxable year. § 1377(b)(1)(C).

A "determination" is a(n) –

- •decision of the Tax Court or another court of competent jurisdiction that has become final,
- •closing agreement under § 7121 (agreement of Secretary with respect to any internal revenue tax),
- •final disposition of the Secretary of a claim for a refund, or
- •agreement of the Secretary and the taxpayer in respect of an income tax. § 1377(b)(2)(A), *cross-referencing* 1313(a), OR
- •agreement between the Secretary and the corporation that fails to qualify as an S corporation. § 1377(b)(2)(B).

Thus, there are three different ways to measure the "post termination transition period," and a former S corporation and its shareholders are entitled to rely on any and all that apply.

C. Suspended Losses and Distributions During the Post-Termination Transition Period

Suspended Losses: In the event a shareholder's loss or deduction was not allowed during the corporation's last year as an S corporation for lack of sufficient basis, either in her stock or indebtedness, the loss is treated as incurred on the last day of any post-termination transition period. § 1366(d)(3)(A).

- •Observe: The loss is treated as a loss of the S corporation in a year in which the corporation is not actually and S corporation.

The amount of losses and deductions taken into account may not exceed the shareholder's adjusted basis in her stock, also as determined on the last day of the post-termination transition period, § 1366(d)(3)(B), and the amount allowed as a loss or deduction reduces the shareholder's adjusted basis in her stock, § 1366(d)(3)(C).

- •The shareholder therefore has the opportunity to increase her basis in her stock (but not indebtedness basis, § 1366(d)(3)(B)) in order to utilize suspended losses that will, in all likelihood, otherwise disappear. These rules also apply to the shareholder's amount at risk under § 465. § 1366(d)(3)(D).
  - •The 120-day post termination transition period following an audit, i.e., § 1377(b)(1)(B) (#2, *supra*), does not apply to the rules outlined in this paragraph. § 1371(b)(3)(A).
  - •The audit will increase taxpayer's basis in her stock. She may deduct suspended losses against that increase.

Distributions: The corporation may also distribute cash, *infra*. Any distribution of money during the S corporation's post-termination transition period with respect to its stock is tax free and reduces the corporation's AAA to the extent thereof. § 1371(e)(1).

- •If the termination of S status resulted from an audit that caused an adjustment of an S corporation item of income, loss, or deduction (i.e., § 1377(b)(1)(B), #2, *supra*), a distribution of money reduces the corporation's AAA only to the extent that the adjustment resulted in an increase of the corporation's AAA. § 1377(b)(3)(B). Any excess is treated as a dividend and reduces the corporation's accumulated earnings and profits.
- •If all shareholders agree and the post-termination transition period follows a revocation (i.e., as described in § 1377(b)(1)(A) (#1, *supra*), the corporation may elect to count distributions of money first against accumulated earnings and profits rather than AAA. § 1371(e)(2).
- •Reg. § 1.1377-2(b) provides in part that distributions of money with respect to the corporation's stock during the post termination transition period is available only to "those shareholders who were shareholders in the S corporation at the time of the termination." It is not clear what happens to any balance in a corporation's AAA once the post termination transition period ends.

Do the CALI exercise: S Corporation Taxation: Termination of the S Election: The Termination of S Election: Consequences.

Do the CALI exercise: S Corporation Taxation: Termination of the S Election: The Post-Termination Transition Period of an S Corporation.

Chapter 8: Taxable Acquisitions

I. Introduction

Suppose that a corporation wishes to acquire control of another corporation or to acquire all the assets of another corporation. A corporation may purchase the stock of the other corporation from its shareholders or purchase its assets directly from it. Compare the income tax consequences of the following:

Some standard vocabulary: Both in tax literature and in the regulations, the corporation that acquires another corporation is referred to as "Acquiring," "Acquiring Corporation," or simply as "A." The corporation that is being acquired is referred to as "Target," "Target Corporation," or simply as "T."

Suppose: T Corporation owns Blackacre, and Blackacre is T's only asset. R owns all the stock of T Corporation. T Corporation's basis in Blackacre is $10. The fmv of Blackacre is $100. R's basis in his stock is $10, and the fmv of R's stock is $100. A Corporation wishes to own Blackacre – or at least to control its use. How might it go about acquiring Blackacre, and what would be the income tax consequences of doing so?

•The corporate purchaser of the assets (A Corporation) of a corporation may alternatively –

•Option 1: purchase all the *shares* of the corporation and continue the business of the corporation as a subsidiary. In our example, R must pay income tax on $90 of capital gain. T Corporation never goes out of existence and retains all its assets and liabilities. The bases of corporate assets carries over, or more accurately, continues. A Corporation owns a corporation that owns Blackacre.

•Should A Corporation be willing to pay $100 for R's stock? After all, that is the stock's fmv. Why not? How should A Corporation determine the value of T Corporation stock to *it*?

Tax-deferred reorganizations: When a corporation uses its own stock, or the stock of a corporation that it controls or that controls it as a medium of exchange to gain control or ownership of another corporation, the Code may defer income tax consequences. Such tax deferral will usually be the preferred course. Tax-deferred reorganizations is the subject of the next chapter. There are conditions on such favorable tax treatment – and the parties may regard satisfying those conditions as too onerous.

•Option 2: purchase all the *assets* of the corporation. In such a case, A Corporation would purchase Blackacre from T Corporation. T Corporation must recognize gain or loss on the sale of its assets. (Moreover, there is no preferential rate on the capital gains of a corporation.) The purchaser takes a cost basis in all the assets that it purchased. Thus, future cost recovery allowances (assuming that the assets A Corporation purchased are subject to cost recovery allowances) will be higher than if A had purchased stock of T.[171] Since the purchaser has acquired assets rather than

[171] Recall that in *Intermountain Lumber Co.*, the higher basis associated with a taxable formation of a corporation was in those particular *taxpayers*' interest.

stock of a corporation, the purchaser can probably shed the corporation's liabilities. After the purchase, the selling corporation (T Corporation) has only cash. T Corporation can either purchase other assets or liquidate. If T Corporation liquidates, R (the shareholder) must recognize taxable capital gain. § 331. Thus, a corporate sale of assets followed by liquidation involves two levels of tax.

•From R's standpoint, this double tax is often costly and may impel R to prefer a stock sale. What must R do to convince Acquiring Corporation to purchase his stock rather than Target Corporation's assets?

While a reorganization offers taxpayers the advantages of tax deferral, there are occasions when a taxable acquisition of assets provides sufficient advantages to make it the preferred course. In a taxable transaction, the purchaser takes a cost (presumably fmv) basis in all the assets that it purchases – which can provide tax benefits in future years. If a fmv basis is obtainable at little or no current tax cost, the taxable transaction might be attractive. Now suppose –

•T is carrying a substantial amount of NOLs. An NOL is a tax attribute that functions only to reduce *future* taxable income (and so, tax liability). Thus, its present value is less than its undiscounted face amount. The corporation may not be profitable. A taxable acquisition is a means of facilitating and accelerating use of the NOL. OR

•T is an S corporation. A purchase of assets would result in a single layer of income tax, i.e., at the shareholder level. Shareholders of the S corporation have increased the basis in their stock every time they paid income tax on the corporation's income – an event that occurs annually. It also occurs in our example when T Corporation sold Blackacre. A distribution in liquidation may result in very little additional taxable gain to R.

•Furthermore, since a C corporation may not own shares of an S corporation, a taxable acquisition may be the only way for any acquisition to occur. OR

•T is a controlled corporation. A can purchase the assets of T. T liquidates, but § 332 permits T's parent to take the proceeds of the sale without another level of income tax liability.

These points suggest some matters to consider in the context of taxable acquisitions. Not surprisingly, some important considerations will be –

•whether T Corporation has NOLs;

•the time value of money, including the time value of deferring tax liabilities or accelerating loss recognition;

•the availability of cost recovery or amortization deductions, their amount, and their present and future values;

•whether shareholders would have recognizable losses in a taxable transaction;

•the tax brackets of the parties;

•the character of any taxable gain or recognizable loss; and

•others.

We should expect that parties to a taxable acquisition will negotiate with an eye towards the tax consequences of any deal. They can in essence buy and sell tax benefits or detriments so as to achieve the most tax efficient bargain.

II. The Immediate Tax Consequences of an Acquisition of Assets for Cash

The immediate tax consequences of an acquisition for cash will turn on a determination of just what the purchaser has purchased and what the seller has sold. Consider this old but controlling case:

Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945)

L. HAND, Circuit Judge

....

Williams, the taxpayer, and one, Reynolds, had for many years been engaged in the hardware business in the City of Corning, New York. On the 20th of January, 1926, they formed a partnership, of which Williams was entitled to two-thirds of the profits, and Reynolds, one-third. ... The business was carried on through the firm's fiscal year, ending January 31, 1940, in accordance with this agreement, and thereafter until Reynolds' death on July 18th of that year. Williams settled with Reynolds' executrix on September 6th in an agreement by which he promised to pay her $12,187.90, and to assume all liabilities of the business; and he did pay her $2,187.98 in cash at once, and $10,000 on the 10th of the following October. On September 17th of the same year, Williams sold the business as a whole to the Corning Building Company for $63,926.28 its agreed value as of February 1, 1940 "plus an amount to be computed by multiplying the gross sales of the business from the first day of February, 1940 to the 28th day of September, 1940," by an agreed fraction. This value was made up of cash of about $8100, receivables of about $7000, fixtures of about $800, and a merchandise inventory of about $49,000, less some $1000 for bills payable. To this was added about $6,000 credited to Williams for profits under the language just quoted, making a total of nearly $70,000. Upon this sale Williams suffered a loss upon his original two-thirds of the business, but he made a small gain upon the one-third which he had bought from Reynolds' executrix; and in his income tax return he entered both as items of "ordinary income," and not as transactions in "capital assets." This the Commissioner disallowed and recomputed the tax accordingly; Williams paid the deficiency and sued to recover it in this action. The only question is whether the business was "capital assets" ...

It has been held that a partner's interest in a going firm is for tax purposes to be regarded as a "capital asset." ... When Williams bought out Reynolds' interest, he became the sole owner of the business, the firm had ended upon any theory, and the situation for tax purposes was no other than if Reynolds had never been a partner at all, except that to the extent of one-third of the "amount realized" on Williams' sale to the Corning Company, his "basis" was different. The judge thought that, because upon that sale both parties fixed the price at the liquidation value of the business while Reynolds was alive, "plus" its estimated earnings thereafter, it was as though Williams had sold his interest in the firm during its existence. But the method by which the parties agreed upon the price was irrelevant to the computation of Williams' income. The Treasury, if that served its interest, need not heed any fiction which the parties found it convenient to adopt; nor need Williams do the same in his dealings with the Treasury. We have

to decide only whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition in § 117(a) (1) [i.e., § 1221(a)], or whether the whole business is to be treated as if it were a single piece of property.

... [E]ven though we might agree that under the influence of the Uniform Partnership Act a partner's interest in the firm should be treated as indivisible, and for that reason a "capital asset" within § 117(a)(1) [§ 1221(a)], we should be chary about extending further so exotic a jural concept. Be that as it may, in this instance the section itself furnishes the answer. It starts in the broadest way by declaring that all "property" is "capital assets," and then makes three[[172]] exceptions. The first is "stock in trade *** or other property of a kind which would properly be included in the inventory"; next comes "property held *** primarily for sale to customers"; and finally, property "used in the trade or business of a character which is subject to *** allowance for depreciation." In the face of this language, ... by no possibility can a whole business be so treated; and the same is true as to any property within the other exceptions. Congress plainly did mean to comminute the elements of a business; plainly it did not regard the whole as "capital assets."

As has already appeared, Williams transferred to the Corning Company "cash," "receivables," "fixtures" and a "merchandise inventory." "Fixtures" are not capital because they are subject to a depreciation allowance; the inventory, as we have just seen, is expressly excluded. So far as appears, no allowance was made for "good-will" ... There can of course be no gain or loss in the transfer of cash; and, although Williams does appear to have made a gain of $1072.71 upon the "receivables," the point has not been argued that they are not subject to a depreciation allowance. That we leave open for decision by the district court, if the parties cannot agree. The gain or loss upon every other item should be computed as an item in ordinary income.

Judgment reversed.

FRANK, Circuit Judge (dissenting in part).

....

... I do not agree that we should ignore what the parties to the sale, Williams and the Corning Company, actually did. They did not arrange for a transfer to the buyer, as if in separate bundles, of the several ingredients of the business. They contracted for the sale of the entire business as a going concern. ...

To carve up this transaction into distinct sales of cash, receivables, fixtures, trucks, merchandise, and good will is to do violence to the realities. I do not think Congress intended any such artificial result. ... Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize; so, too, I think, did Congress. Interpretation of our complicated tax statutes is seldom aided by saying that taxation is an eminently practical matter (or the like). But this is one instance where, it seems to me, the practical aspects of the matter should guide our

[172] [Now there are eight exceptions.]

guess as to what Congress meant. I believe Congress had those aspects in mind and was not thinking of the nice distinctions between Roman and Anglo-American legal theories about legal entities.

Questions and comments:

1. Section 1221 provides that a "capital asset" is "property" – *except* for the items listed in § 1221(a)(1 to 8). The list is longer than it was at the time *Williams* was decided, but the holding is still the prevailing rule. The sale of property that is a capital asset gives rise to capital gains or losses. The sale of property that is not a capital asset gives rise to ordinary gains or losses.

2. comminuted: reduced to minute particles or fragments.

3. How did taxpayer measure his gain/loss on the sales of two different interests to the Corning Building Company? How did the Commissioner measure such gain/loss? What did the court decide?

- Why did taxpayer want to treat the sale as giving rise to "ordinary income?" Why would the Commissioner be opposed to this?

4. When firms enter negotiations for the purchase of the assets of one by the other, we expect – consistent with the view of Judge Frank – that they agree to an overall price. The price of each item may only come up later, at tax time. At one time, the rules were the following:

- corporations enjoyed a preferential tax rate on their capital gains;
- goodwill was a non-depreciable capital asset;
- other assets were subject to allowances for depreciation or amortization, but not at the same rate as current cost recovery allowances; depreciation or amortization allowances reduce a taxpayer's ordinary income;
- investment in inventory is deductible only upon sale of the item;
- gain or loss from the sale of non-capital assets is ordinary gain or loss.

How would these rules affect the characterization of the assets that buyers and sellers desired for the "comminuted" assets of the corporation? If firms did negotiate over the prices of each asset, do you think that their positions were usually adverse?

- If their positions were adverse, should the fact that they agreed on valuations be treated as highly significant? Why?

5. In 1981, Congress enacted the Economic Recovery Tax Act of 1981, P.L. 97-34. This statute created the "accelerated cost recovery system" (ACRS). ACRS (later MACRS (M is for Modified) and later still, ACRS) accelerated depreciation so considerably that we do not even call it "depreciation" anymore. In 1986, Congress further changed the landscape by eliminating the capital gains preference for corporations.

- Articulate the change in incentives that such legislation would cause corporate buyers and sellers in characterizing the assets that they bought and sold.

6. In 1993, Congress enacted P.L. 103-66 – the Omnibus Budget Reconciliation Act of 1993. Section 13261(a) added § 197 to the Code. That section made the basis of "§ 197 intangibles"

subject to 15-year straight-line amortization. § 197(a).

•Read § 197(c and d). How do you think this should alter the incentives of buyers and sellers in characterizing the assets that they bought and sold?

7. In 1986, Congress enacted § 1060. Read it.

•Section 1060(a) provides that the consideration received in an "applicable asset acquisition" will be allocated according to certain rules, i.e., § 338(b)(5).

•Notice the presumption that § 1060(a) creates when the parties agree as to valuation.

•Notice when § 1060 applies. § 1060(c).

8. Reg. § 1.1060-1(c)(2) kicks the rules governing allocation of consideration among assets over to Regs. § 1.338-6 and § 1.338-7. The most important provision for our immediate purposes is Reg. § 1.338-6(b). It establishes a "residual method" of valuing goodwill and going-concern-value in an "applicable asset acquisition." The consideration that the purchaser paid for goodwill and going concern value is what remains after subtracting the value of all the business's other assets. Begin with the total consideration paid and received and then subtract in order amounts allocated to seven classes of assets:

•Class I assets: Class I assets are "cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions." Reg. § 1.338-6(b)(1).

•Class II assets: Class II assets are "actively traded personal property" "for which there is an established financial market." Reg. § 1.1092-1(a) (by cross-reference). This includes "certificates of deposit and foreign currency even if they are not actively traded personal property. ... Examples of Class II assets include U.S. government securities and publicly traded stock." Reg. § 1.338-6(b)(2)(ii).

•Class III assets: Class III assets are "assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable)." Reg. § 1.338-6(b)(2)(iii) (exceptions for certain related-party debts, contingent obligations, and convertible debt).

The §§ 1060/338 regulations provide a framework for determining the measurement of gain/loss and the basis of assets in a taxable acquisition of assets. We note here that valuation questions in asset acquisitions are important but quickly become complex – more so than we can consider at this point. Do note the income tax consequences of placing an asset in one class rather than another.

•Class IV assets: Class IV assets are "stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business." Reg. § 1.338-6(b)(2)(iv).

•Class V assets: Class V is a default classification. Class V assets are assets that do not fall within any of the other classes of assets. Reg. § 1.338-6(b)(2)(v).

•Class VI assets: Class VI assets are "all section 197 intangibles, as defined in section 197, except goodwill and going concern value." Reg. § 1.338-6(b)(2)(vi).

•Class VII assets: Class VII assets are "goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a § 197 intangible)." Reg. § 1.338-6(b)(2)(vii).

The IRS may add items to any of these classes upon sufficient notice. Reg. § 1.338-6(b)(3).

9. § 1060 (continued): Notice that the progression from classes I through VII is from assets most-easy and certain of valuation to those whose valuation would be most subject to dispute.

10. An "applicable asset acquisition" is a transfer of a group of assets that constitute a "trade or business" either to the buyer or to the seller. Reg. § 1.1060-1(b)(1).

Problem:

Corporation K purchased all of Corporation J's assets for $300,000. As part of the deal, Corporation J promised to liquidate. Its founder and guiding light (Ms. L) agreed not to compete with Corporation K anywhere in the state for five years. Corporation J's assets were the following:

> Depreciable Equipment with cost recovery periods of 5, 7, and 10 years: $?
> Inventory on hand: $?
> Cash in the bank: $?
> Trademark: $?
> Goodwill: $?

Identify the issues that would arise in negotiations between Corporation K, Corporation J, and (for that matter) Ms. L.[173]

III. Purchase of Stock Treated as Asset Purchase and the § 338 Election

Consider: rather than purchase the assets of a target corporation, the acquiring corporation might find it advantageous simply to buy all the stock of the target corporation (Option 1 *supra*). This would make the target corporation into a subsidiary of the acquiring corporation. The target corporation would still exist and the bases of its assets would be what they were prior to the stock purchase. The purchasing corporation could then proceed with a liquidation of the subsidiary. Under § 334(b), the purchasing corporation would take a carryover basis in the assets that it had acquired. We might expect the bases of assets subject to cost recovery allowance to be lower than their fmv. The parties should adjust the purchase price of the stock accordingly.

What should be the rule if the bases of the target's assets is more than the fmv of all the outstanding stock of the corporation? [When would this occur?] This early case presented such an issue.

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[173] Don't forget the lessons of *Norwalk v. Commissioner*, *supra* chapter 6.

Kimbell-Diamond Milling Company v. Commissioner, 14 T.C. 74 (1950), *aff'd* 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951)

BLACK, Judge

This proceeding involves deficiencies in income, declared value excess profits, and excess profits taxes for the fiscal years ended May 31, 1945 and 1946...

The deficiencies are primarily due to respondent's reduction of petitioner's basis in assets acquired by it in December, 1942, through the liquidation of another corporation known as Whaley Mill & Elevator Co. (sometimes hereinafter referred to as Whaley). By reason of this reduction respondent has adjusted petitioner's allowable depreciation ... By appropriate assignments of error petitioner contests these adjustments. ...

....

Petitioner is a Texas corporation, engaged primarily in the business of milling, processing, and selling grain products, and has its principal office in Fort Worth, Texas. ...

On or about August 13, 1942, petitioner sustained a fire casualty at its Wolfe City, Texas, plant which resulted in the destruction of its mill property at that location. The assets so destroyed, and the adjusted basis thereof, were as follows:

	Cost	Depreciation, allowed or allowable	Adjusted Basis
....			
Total:	$56,771.70	$37,849.80	$18,921.90

This property was covered by insurance, and on or about November 14, 1942, petitioner collected insurance in the amount of $124,551.10 ($118,200.16 as a reimbursement for the loss sustained by the fire and $6,350.94 as a premium refund). On December 26, 1942, petitioner's directors approved the transaction set forth in the minutes below:

> ....
>
> … BE IT RESOLVED:
>
> 1. That the proper officers of Kimbell-Diamond Milling Company be, and they are hereby, authorized, empowered and directed to purchase the entire authorized, issued and outstanding capital stock of Whaley Mill & Elevator Company ... for a sum not in excess of $210,000.00; that payment for the said stock of Whaley Mill & Elevator Company be made, to the extent possible, from the insurance proceeds ..., and that the balance of the agreed consideration for the stock of Whaley Mill & Elevator Company be paid out of the general funds of Kimbell-Diamond Milling Company.
>
> 2. That as soon as practicable after the purchase of the Whaley Mill & Elevator Company

> stock hereby authorized has been consummated, all necessary steps be taken to completely liquidate the said corporation by transferring its entire assets, particularly its mill and milling equipment, to Kimbell-Diamond Milling Company in cancellation and redemption of the entire issued and outstanding capital stock of Whaley Mill & Elevator Company, and that the charter of said corporation be forthwith surrendered and cancelled.

On December 26, 1942, petitioner acquired 100 per cent of the stock of Whaley Mill & Elevator Co. of Gainesville, Texas, paying therefor $210,000 in cash which payment, to the extent of $118,200.16, was made with the insurance proceeds received by petitioner ...

On December 29, 1942, the stockholders of Whaley assented to the dissolution and distribution of assets thereof. On the same date an "Agreement and Program of Complete Liquidation" was entered into between petitioner and Whaley, which provided, inter alia:

> THAT, WHEREAS, KIMBELL-DIAMOND owns the entire authorized issued and outstanding capital stock of WHALEY ..., which said stock was acquired by KIMBELL-DIAMOND primarily for the purpose of enabling it to secure possession and ownership of the flour mill and milling plant owned by WHALEY, the parties herewith agree that the said mill and milling plant shall forthwith be conveyed to KIMBELL-DIAMOND by WHALEY under the following program for the complete liquidation of WHALEY ...

On December 31, 1942, the Secretary of State of the State of Texas certified that the Whaley Mill & Elevator Co. was dissolved as of that date.

The assets so distributed to petitioner, the cost of same to Whaley, the depreciation sustained thereon while owned by Whaley, and Whaley's adjusted basis therefor, as of December, 1942, were as follows:

	[Whaley's Cost	Depreciation, allowed or allowable	Whaley's Adjusted Basis
Depreciable Assets ...			
Total	$375,962.16	$236,440.54	$139,521.62

> Other Assets ...
> Adjusted Basis of all of Whaley's assets: $328,736.59
> fmv of all of Whaley's assets: $314,715.69]

In filing its tax returns for the fiscal year ended May 31, 1943, petitioner did not include in net taxable income the amount of the insurance proceeds, less the adjusted basis of the destroyed assets, a net amount of $99,278.26. Respondent ... determined that petitioner realized a gain of $99,278.26. ... [P]etitioner alleged that it came within the provisions of § 112(f) of the Internal Revenue Code [now § 1033], pertaining to involuntary conversions, and realized no gain on the conversion of its assets. ... Respondent alleged that, if petitioner had not complied with § 112(f) [§ 1033(a)(2)], its basis in these assets would be $224,020.90, and if petitioner had complied with § 112(f) its basis would be $110,721.94. Respondent's allegations were based on the theory

that what petitioner really acquired was not stock in Whaley, but rather the assets of Whaley. ...

[In an earlier decision, the court determined that petitioner did comply with § 112(f).]

There is no dispute that the petitioner's adjusted basis in its depreciable assets which were destroyed by fire was $18,921.90; nor that the depreciable assets which it received from Whaley had an adjusted basis in the hands of Whaley of $139,521.62. Petitioner, in the years herein involved, proceeded under the theory that it was entitled to Whaley's basis. Respondent takes the position that petitioner's cost is its basis in the assets acquired from Whaley. ... As to the depreciable assets purchased to replace those involuntarily converted, respondent contends that petitioner's basis is limited by § 113(a)(9) of the Internal Revenue Code[,][174] [which is now the essence of § 1033(b).]

....

... Petitioner argues that the acquisition of Whaley's assets and the subsequent liquidation of Whaley brings petitioner within the provisions of § 112(b)(6)[[175]] [now § 332(a)] and, therefore, by reason of § 113(a)(15),[[176]] [now essentially § 334(b)(1)] petitioner's basis in these assets is

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[174] SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY. – The basis of property shall be the cost of such property; except that—

* * * * *

(9) INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in § 112(f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

[175] SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) EXCHANGES SOLELY IN KIND.—

* * * * *

(6) PROPERTY RECEIVED BY CORPORATION ON COMPLETE LIQUIDATION OF ANOTHER. – No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

[176] SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY. – The basis of property shall be the cost of such property; except that—

* * * * *

(15) PROPERTY RECEIVED BY A CORPORATION ON COMPLETE LIQUIDATION OF ANOTHER. – If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of § 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor. The basis of property with respect to which election has been made in pursuance of the

the same as the basis in Whaley's hands. In so contending, petitioner asks that we treat the acquisition of Whaley's stock and the subsequent liquidation of Whaley as separate transactions. It is well settled that the incidence of taxation depends upon the substance of a transaction. *Commissioner v. Court Holding Co.*, 324 U.S. 331. It is inescapable from petitioner's minutes set out above and from the "Agreement and Program of Complete Liquidation" entered into between petitioner and Whaley, that the only intention petitioner ever had was to acquire Whaley's assets.

....

We hold that the purchase of Whaley's stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of Whaley's assets which was petitioner's sole intention. ... [P]etitioner's basis in these assets, both depreciable and nondepreciable, is, therefore, its cost, or $110,721.74 ($18,921.90, the basis of petitioner's assets destroyed by fire, plus $91,799.84, the amount expended over the insurance proceeds). ...

....

Decision will be entered for the respondent.

Questions and comments:

1. The tax consequences of involuntary conversions is now governed by § 1033. Taxpayer used insurance proceeds to purchase property that cost more than the basis of the property that it lost to the fire plus the insurance proceeds. Taxpayer may elect not to recognize the gain realized on the "involuntary" sale of the property for the amount of the insurance proceeds (§ 1033(a)(2)(A)), but it may not increase its basis in the replacement property (§ 1033(b)(2) (cost basis reduced by amount of gain not recognized)). Hence, taxpayer was entitled to a basis equal to the basis of the property lost to the fire plus the funds it had to spend over and above the insurance proceeds.

2. Involuntary conversions (more): Section 1033(b)(3) governs basis adjustments to property when taxpayer uses insurance proceeds to purchase stock of a corporation that holds replacement property when taxpayer acquires replacement property by purchasing sufficient stock (80% vote and value, § 1033(a)(2)(E)(i)) to control a corporation that owns the property that taxpayer wants – as occurred in *Kimbell-Diamond*. Taxpayer must reduce the bases of properties held by the corporation by the same reduction in its cost basis of the stock that it made by reason of § 1033(b)(2), *supra* note 1, i.e., by the amount of its unrecognized gain. § 1033(b)(3)(A).

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last sentence of § 113(a)(15) of the Revenue Act of 1936, as amended, shall in the hands of the corporation making such election, be the basis prescribed in the Revenue Act of 1934, as amended.

3. When the dust settled: Kimbell-Diamond had purchased stock of a corporation (Whaley), which of course made that corporation a subsidiary. It liquidated that corporation. Kimbell-Diamond wanted the same basis in the corporation's properties that Whaley had. It would happily give up $210,000 of basis in stock in exchange for nearly $330,000 of basis in (perhaps depreciable) assets.

•The Commissioner succeeded in limiting Kimbell-Diamond to its original adjusted basis in properties that it held ($18,000) plus the funds that it paid over and above insurance proceeds ($92,000) for stock (total: $110,000). It paid $210,000 for stock to have bases in assets of $110,000.

•Kimbell-Diamond had of course received $125,000 from the insurance company without payment of income tax, so naturally that amount should not be included in its basis. [Basis is how we keep score with the Government.]

•*The basis Kimbell-Diamond had in the assets previously owned by the Whaley Corporation was determined (in part) by the amount it paid for Whaley's stock.* Because Kimbell-Diamond always planned to liquidate Whaley, it had no choice in the matter. Only income on which taxpayer has paid income tax can become basis – unless excluded from gross income.

General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935): In 1927, General Utilities purchased 20,000 shares of Islands Edison Company stock for $2000. Another utility company wished to procure the shares of Islands Edison in 1928. After some negotiating over precisely how to accomplish this, General Utilities declared a dividend of $1,071,426.25 and then distributed 19,090 shares to its shareholders as a stock dividend and retained the other 910 shares. The other utility subsequently agreed with the owners of Islands Edison stock (i.e., mostly General Utilities' shareholders) to purchase all 20,000 shares from the shareholders. The Commissioner argued that General Utilities should be taxed on the fmv of the stock minus its basis. The Tax Court held "that the declaration and payment of the dividend resulted in no taxable income." *Id.* at 204. The Fourth Circuit reversed. The Supreme Court upheld the positions of the lower courts that the distribution of property as a dividend gave rise to no taxable income to the corporation. "This was no sale; assets were not used to discharge indebtedness." *Id.* at 206.

Congress incorporated the holding in *General Utilities* into what was § 311 (corporation recognizes no gain or loss on distribution of property to shareholders with respect to their stock), § 333 (electing distributee corporation in complete liquidation recognizes gain only on the greater of money or securities received, or ratable share of earnings and profits), § 336 (corporation recognizes no gain or loss upon distribution of all its assets in a complete liquidation), and § 337 (liquidating corporation recognizes no gain or loss from the sale of assets during 12-month period of distribution in complete liquidation of all its assets).

4. When would the purchaser of a target corporation's stock want the purchase price of stock to be the basis of the assets it owns after a liquidation, and when would the purchaser *not* want the basis of assets that it owns to be the purchase price of the stock?

5. From 1954 until 1982, the rule of § 334(b)(2) was that Acquiring Corporation's purchase of the stock of Target Corporation (which became Acquiring Corporation's subsidiary) followed by liquidation of Target Corporation was to be treated as Acquiring Corporation's purchase of

Target Corporation's assets. (*See* note 4 following *Norwalk v. Commissioner*, *supra* chapter 6: III). The purchase price of the stock was allocated among the subsidiary's assets and became their bases. The Acquiring Corporation (i.e., parent) did not get Target Corporation's (i.e., subsidiary's) basis in its assets – which is what the taxpayer in *Kimbell-Diamond* wanted.

•Section § 334(b)(2) set forth conditions concerning the timing of the purchase and the timing of the liquidation that led to such treatment, i.e., purchase of at least 80% of the target's stock within a 12-month period followed by liquidation of the target within two years following completion of the purchase.

•By its terms, § 334(b)(2) required liquidation of the subsidiary. The outcome was a stock cost basis for the target's assets. The purchasing corporation did not take the target's earnings and profits or its other tax attributes.

6. Congress replaced § 334(b)(2) with § 338 in 1982. Section 338 made irrelevant the purchaser's intent (or lack thereof) to liquidate the target corporation. The purchase of all the stock of a corporation followed by a liquidation was no longer automatically treated as the purchase of the assets of the target corporation. Instead, § 338 gives the purchasing corporation the option of adjusting its basis in the target corporation's assets to the price it paid for the target corporation's stock.

•Section 338 accomplishes this step-up or step-down in basis by hypothesizing a sale of the target corporation's assets for their fmv at the close of the acquisition date followed a day later by the acquiring corporation's purchase of the target corporation's assets for their fmv.

•Before the *General Utilities* doctrine was laid to rest in 1986, old § 337 permitted the sale of a liquidating corporation's assets during a 12-month distribution period following adoption of a plan of liquidation without recognition of gain or loss – except for gain derived from sales of stock in trade, inventory, and installment obligations acquired before liquidation. 26 U.S.C. § 337(b) (1982 ed.), (*repealed* 1986) (*see* text box). AND: old § 337 applied to hypothetical sales under § 338.

•Thus, the acquiring corporation could obtain a stepped-up basis in target's assets without paying any income tax. Not surprisingly, purchasing corporations would opt for a tax-free step up in the basis of the target's assets to the purchase price of target's stock whenever the purchase price of the target's stock exceeded the bases of the target's assets.

•Congress repealed the *General Utilities* doctrine in 1986. This changed the landscape dramatically.

7. Now consider the following: Corporation B owns assets, and Corporation C wishes to acquire all of them. We assume that the adjusted basis of Corporation B's assets is less than their fair market value. There are two ways Corporation C might go about a taxable acquisition.

Option 1: Corporation C can buy all the stock of Corporation B so that Corporation B becomes a wholly-owned subsidiary of Corporation C. The shareholders of Corporation B would recognize gain/loss on the sale of their stock. Corporation B would not recognize gain on the disposition of its assets as the corporation remains intact. Corporation C can then liquidate Corporation B. Corporation C will own all the assets that Corporation B formerly owned with the same basis that Corporation B had when it

owned the assets.

•Basis reduces income taxes in the future. More basis results in greater future tax savings. An important determinant in those future tax savings is the (remaining) cost recovery period of Corporation B's assets.

•Of course, $1 saved today is worth more than $1 saved in the future.

•Therefore, as a general matter, Corporation C should take into account the fact that it takes Corporation B's bases in its assets and that the bases are less than fair market value when establishing a purchase price for Corporation B's stock.

Option 2: Corporation C can buy all the assets of Corporation B from Corporation B. Corporation B would recognize gain/loss on the sale of each of its assets, as per *Williams v. McGowan*. Corporation B would no longer own any assets; it would have cash. Corporation C would have a cost basis in the assets that it purchased from Corporation B rather than a carryover basis. Corporation C's cost recovery allowances would be greater than they are under option 1.

•Corporation B could use its cash to acquire other assets – perhaps another business.

•Or it could liquidate. If it liquidates, shareholders of Corporation B would recognize gain/loss on the sale of their stock. In the event of liquidation, there would be two levels of tax.

•Corporation C does not inherit Corporation B's tax attributes, including Corporation B's earnings and profits.

•Under this option, every $1 of taxable gain to Corporation B is offset by $1 of basis increase to Corporation C. Every $1 of taxable gain to Corporation B will be subject to income tax to Corporation B and again to Corporation B's shareholders upon distribution.

•Corporation B should take into account the fact that sale of its assets followed by liquidation will trigger two levels of income tax – to the detriment of its shareholders.

S corporations: Why is the generalization in note 7A more problematic in the case of an S corporation target than in the case of a C corporation target? Consider –

•the likely difference in purchase price between a stock purchase and an asset purchase;

•the basis the acquiring corporation gets in the assets it receives in a stock purchase as compared to an asset purchase;

•the character of income to the shareholder in a stock purchase rather than an asset purchase.

7A. Assuming the parties in these hypotheticals get the valuations right, there would seem to be no reason to want to incur an immediate increase in tax liability. There would be *two* levels of income tax. We would expect most taxable acquisition of assets to follow the pattern of option 1.

7B. BUT suppose that –

1. The increase in the value of Corporation B's stock value is more than the increase in the value of Corporation B's assets, *and*

2. Corporation B possesses tax attributes (aside from basis) that will reduce its income tax liability in the future, e.g., net operating loss carryovers, capital loss carryovers. These attributes will "eat" taxable income – if and when there is taxable income.

7C. If these two conditions prevailed and Corporation C could "purchase" basis in assets that it (or a newly-purchased subsidiary) owns by paying the income tax liability on such an increase, Corporation C should be interested in such a "purchase" – so long as applicable tax attributes swallow up the tax liability on such a basis increase. The purchase of basis would accelerate use of tax-reducing attributes. Those tax-reducing attributes of course reduce, if not eliminate, one level of income tax.

- "Basis is how we keep score with the government." We simply want to increase our score by paying income tax on a basis increase, AND
- we want to do this without the shareholders of Corporation B incurring additional income tax, as would occur under option 2.
- Corporation C would have the same basis in the assets that it acquired through its purchase of Corporation B that it would have under option 2 (i.e., fmv) with an outlay of only the tax on the increase in basis – not an actual outlay of that amount of income.

8. So: suppose that Corporation C has pursued option 1 (purchase of stock from shareholders). It may or may not wish to liquidate Corporation B. Because it paid more for the stock than the bases of Corporation B's assets, it may wish to obtain bases in Corporation B's assets equal to the price it paid for Corporation B's stock.

- § 338 makes this possible, albeit at the cost of an immediate income tax liability.
- § 338 gives a corporation the option of "buying" an increase in the bases of assets that it acquires through a purchase of the stock of another corporation. The corporation does this by paying the income tax on the basis increase.
- Moreover, whatever advantages there were in the old § 334(b)(2), § 338 provides them without requiring that the subsidiary be liquidated.

> We have conveniently assumed that the acquiring corporation purchases 100% of the target corporation's stock during the acquisition period. But § 338 applies to a purchase of as little as 80% of the stock of the target. Section 338's technical rules treat "recently purchased stock" and non-recently purchased stock differently. The acquiring corporation may limit the basis step-up to only the stock acquired during the acquisition period. Implementing this limitation requires creation of terms and phrases as well as arithmetic formulas. The acquiring corporation may also elect to step up the basis of non-recently purchased stock. This of course entails more terminology and formulas. Remaining text boxes in this chapter explain some of these technicalities – and some may choose to skip over them.

9. The following provides an overview of the mechanics of "buying" an increase in basis under § 338.

- Section 338(a) applies to a "qualified stock purchase." A "qualified stock purchase" is one or more transactions occurring within a 12-month acquisition period whereby[177] the purchasing corporation[178] acquires by purchase at least 80% of the total voting power of the target corporation's stock and at least 80% of the total value of all the target corporation's stock.

[177] Section 338(d)(3) requires that the purchasing corporation actually acquire 80% of the target's stock (vote and value) during the 12-month acquisition period.

[178] The purchaser must be a corporation, not an individual. Reg. § 1.338-3(b)(1).

§ 338(d) (*cross-referencing* § 1504(a)(2)).[179]

•The purchasing corporation's "recently purchased stock" is the stock that it purchased during the 12-month acquisition period. § 338(b)(6)(A). The remainder of the purchasing corporation's stock that it owns in the target corporation is "nonrecently purchased stock." § 338(b)(6)(B).

•The "12-month acquisition period" is a twelve-month period that begins on the date of the first acquisition of stock that is included in a "qualified stock purchase." § 338(h)(1). The "acquisition date" is the first day on which there is a "qualified stock purchase" with respect to the stock of the target corporation. § 338(h)(2).

The sales price: Actually, the sale price is what the regulations call the "aggregate deemed sale price" (ADSP). *See* Reg. § 1.338-4(a). The ADSP is the sum of the grossed-up price of the purchasing corporation's recently purchased stock of the target corporation plus the "old target's" liabilities minus the selling shareholders' selling costs. Regs. § 1.338-4(b)(1), 1.338-4(c)(1)(iii). The "old target's" liabilities include the very tax liability determined under § 338. Reg. § 1.338-4(d)(1).

•The "grossed-up" price (herein "G") of the purchasing corporation's recently purchased stock (herein "RPS") is the amount realized on the sale of that stock divided by the percentage of stock attributable to that purchase. Reg. § 1.338-4(c)(1)(i and ii).

•So: "grossed up" price = RPS/(% of shares acquired during acquisition period)

•Thus, the actual "amount realized" is

$G + L + \lambda\,(ADSP - AB)$, where

λ = tax rate; AB = adjusted basis of assets; L = liabilities.

9A. (Note 8 continued): When a corporation makes a "qualified stock purchase" of a "target corporation" and so elects, the target corporation ("old target") is treated as having sold all its assets at the close of the acquisition date for the fair market value[180] of the assets and is then treated as a new corporation ("new target") at the beginning of the day following the acquisition date. § 338(a). The putative sale will trigger an income tax liability (i.e., a recognition event) on the difference between the fmv of the target corporation's assets and their bases.

•The "old target's" earnings and profits disappear.

•The "old target's" tax liability does not affect the income tax liability of the former shareholders of the target corporation who sold their shares to the purchasing corporation. However, the "new target" is responsible for the "old target's" income tax liabilities. Reg. § 1.338-1(b)(3)(i).

9B. (Note 8 continued): The "new target" comes into existence the day after the "acquisition

[179] If a § 336(e) election is made to treat the sale, exchange, or distribution of stock in a corporation as a distribution of its assets, no election under 338 may be made. Reg. § 1.338-1(a)(1).

[180] This is what the statute provides. However, the fair market value of assets is determined with reference to the price of *stock* that the purchasing corporation purchased, no matter when it purchased that stock, plus the liabilities of the target corporation.

date." § 338(a)(2). The "new target" will have bases in its assets equal to their fmv.

9C. The purchasing corporation may also elect to gross up the basis of its nonrecently purchased stock. § 338(b)(3)(A). This election requires recognition of the gain that it would recognize if it were to sell its nonrecently purchased stock for a grossed-up amount. § 338(b)(3)(A).

Fmv bases: The "new target" actually takes an "adjusted grossed-up basis" (AGUB) in its assets.

- AGUB is the sum of
  - the "grossed-up" basis of the purchasing corporation's recently purchased stock,
  - the purchasing corporation's basis in its nonrecently purchased stock, AND
  - the liabilities of the new target. § 338(b)(1 and 2); Reg. § 1.338-5(b)(1).
- ADSP and AGUB are not the same in that ADSP does not take account of the purchasing corporation's nonrecently purchased stock. The grossing up formula for ADSP in essence treats the nonrecently purchased stock the same as recently purchased stock.
  - Bear in mind that ADSP is determined for the purpose of determining taxable gain on a hypothetical sale of assets – not for the purpose of determining basis in assets that the purchaser purchased.
- "Grossed-up *basis*:" "Grossing up" of the basis of the purchasing corporation's "recently purchased stock" involves creation of a ratio. The purchasing corporation must identify the percentage by value of all the target corporation's stock that it owns as "recently purchased stock" (RPS) and as "nonrecently purchased stock" (herein NPS). *Cf.* § 338(b)(4). The gross up ratio is –

  (100 – NPS)/RPS

- The "grossed-up basis" of the corporation's "recently purchased stock" is the basis of that stock multiplied by this ratio. § 338(b)(4).
  - Notice: if the purchasing corporation owns 100% of the target corporation's stock, whether or not recently purchased, the ratio will equal 1, and AGUB will simply be the sum of the corporation's basis in its nonrecently purchased stock plus its basis in its recently purchased stock.

10. The § 338 election is to be made in the manner prescribed by the Secretary of the Treasury no later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. § 338(g)(1 and 2). The purchasing corporation makes the election. The election is irrevocable. § 338(g)(3).

11. Section 338(e) deems an election to have been made by the purchasing corporation if at any time during the "consistency period" it procures any asset of the target corporation unless the acquisition was in the ordinary course of the target's (or an affiliate's) trade or business, or the purchasing corporation takes a carryover basis in the asset. § 338(e)(1 and 2).

11A. (Note 11 continued): The "consistency period" is the period beginning one year before the 12-month acquisition period and ending one year (plus one day) after the end of the acquisition period. § 338(h)(4)(A). The Secretary may include in the consistency period any time for which there was a plan in effect to make a "qualified stock purchase" plus one or more stock purchases with respect to the target or an affiliate. § 338(h)(4)(B)

- While § 338 makes *Kimbell-Diamond* treatment elective rather than automatic, § 338(e) assures an arm's-length relationship between

the purchasing corporation and the target corporation during the "consistency period."

•The purchasing corporation may not pick and choose the assets in which it wants a higher basis by purchasing them in transactions separate from its purchase of stock.

12. Section 338 has rules requiring that corporate affiliates be treated as one corporation. An "affiliated group" is one or more chains of corporations connected through 80% stock (vote and value) ownership with a common parent corporation. §§ 338(h)(5), *referencing* 1504(a)(1). An election with respect to one target affiliate applies to purchases of other affiliates during the "consistency period," and the purchasing corporation may not make an election with respect to an affiliate if it did not make an election with respect to an earlier acquisition of an affiliate. § 338(f). Stock and asset acquisitions made by members of an affiliated group are treated as made by one corporation. § 338(h)(8).

13. Suppose: parent corporation X is the parent of a "consolidated group," i.e., corporations linked to X Corporation through its 80% ownership by vote and value of the shares of these corporations.

•A "consolidated group" may elect to file a "consolidated return." As the terms imply, the idea is to "consolidate" income and loss of the constituent entities. This is particularly advantageous if some of the subsidiaries have taxable income and others have losses. One can be currently matched against the other.

Basis of non-recently purchased stock if election is made: The purchasing corporation determines this amount by multiplying its grossed-up basis in its recently purchased stock (*supra*) by the ratio –

NPS/(100 – NPS)

The relationship between ADSP and AGUB: the ADSP and the AGUP do not have to be the same. The methodology of computing ADSP treats all the stock of the old target as "recently purchased." The methodology of computing AGUP grosses up the purchase price of "new target" corporation *nonrecently* purchased stock as "recently purchased" only if the purchasing corporation elects to do so.

13A. (Note 13 continued): Continue supposing:[181] one of the corporations that X Corporation owns is T Corporation. P Corporation wants to purchase the assets of T Corporation. How might it go about this?

•First alternative: T Corporation could sell all its assets directly to P Corporation. T Corporation would then distribute after-tax proceeds to X Corporation in a tax-free liquidation of a subsidiary, § 332. X Corporation would retain all T Corporation's tax attributes including earnings and profits. OR

•Second alternative: T Corporation could first liquidate and distribute all its assets to X Corporation. No gain/loss would be recognized. X Corporation would take a carryover basis. If X Corporation then sold those assets to P Corporation, X Corporation would recognize gain on the sale of those assets. P Corporation would take a cost basis in the assets presumably equal to their fair market value. X Corporation would retain all the Target Corporation's tax attributes, including its earnings and profits. OR

•Third alternative: P Corporation could purchase the stock of T Corporation from X Corporation. X Corporation would incur the tax consequences of having sold stock. P

[181] Suggestion: diagram fact patterns as necessary.

Corporation would own all the stock of T Corporation, which of course would retain all its tax attributes, e.g., basis in assets, earnings and profits, loss carryovers.

•If the basis of T Corporation's assets was low but their fair market value was high – there would be a second layer of income tax when P Corporation disposed of those assets. Similarly, cost recovery deductions for P Corporation would be low – another way of "taxing" P Corporation on the transaction.

•Furthermore, *other members of X Corporation's consolidated group* might have tax attributes that could – if allowed – swallow up gain to be recognized on a step-up in basis of T corporation's assets.

•Under either of the first two alternatives, there is one level of tax – *and* P obtains a fmv basis in the assets that it purchased. Under the third alternative, there is one level of tax *and* potentially a second level of tax when P disposes of the assets and/or realizes very little advantage from cost recovery allowances.

•It might be advantageous for P Corporation to make a § 338 election.

13B. (Note 13 continued): Section 338(h)(10) provides that a corporation that sells the target's *stock* may elect jointly with the purchaser to treat the sale of the stock as an asset sale in certain circumstances, namely if the purchasing corporation acquires the target from –

•a selling "consolidated group," i.e., a consolidated group of which the target is a member;

•a selling "affiliate," i.e., a corporation that owns 80% of the stock by vote and value of the target but which does not file a consolidated return with the target; or

•an S corporation.

Reg. § 1.338(h)(10)-1(c).

13C. (Note 13 continued): It might be that the best outcome would be for T to recognize gain on the disposition of its assets to P Corporation and for X Corporation not to recognize gain on the disposition of stock – but to retain T's tax attributes.

•Perhaps X Corporation's built-in gain on its stock is more than T Corporation's built-in gain on its assets.

•Moreover, other members of the consolidated group might have losses that could offset T Corporation's gains on the sale of its assets.

14. The election made under § 338(g) is made by the purchasing corporation. But if –

•the target corporation was a member of a consolidated group (i.e., a subsidiary), and

•the target corporation recognizes gain or loss with respect to the transaction as if it sold all its assets in a single transaction,

•then –

the purchasing corporation *and* the target corporation may jointly (Reg. § 1.338-(h)(10)-1(c)(3)) elect to have the target corporation treated as a member of the selling consolidated group with respect to the sale, and no gain or loss is recognized by members of the selling consolidated group on the sale or exchange of the stock. § 338(h)(10)(A).

14A. (Note 14 continued): The consequences of a § 338(h)(10) election are –

•The purchasing corporation is deemed to have made a gain recognition election for its nonrecently purchased stock, Reg. § 1.338(h)(10)-1(d)(1);
•The "new target" takes a grossed-up basis for its assets under the rules of § 338, Reg. § 1.338(h)(10)-1(d)(2);
•The "old target" is treated as transferring all its assets to an unrelated person in exchange for consideration that includes discharge of liabilities and so recognizes all gain realized from a sale for ADSP, Reg. § 1.338(h)(10)-1(d)(3)(i);
•Immediately after the deemed sale of its assets, the "old target" is treated as if it transferred all its assets to members of the consolidated group *while still a member of the selling consolidated group* (or owned by the selling affiliate or by the S corporation's shareholders) – and ceased to exist. Reg. § 1.338(h)(10)-1(d)(4)(i). The transfer will be treated for tax purposes as whatever an actual transfer would be, often a liquidation to which either § 336 (non-subsidiary) or § 337 (subsidiary) would apply. Reg. § 1.338(h)(10)-1(d)(4)(i).
•Thus, T's tax attributes remain within the consolidated group.

14B. When the dust settles after a § 338(h)(10) election, there is no difference in tax treatment between a purchase of stock and a purchase of assets.

15. Section 336(e): Section 336(e) provides that a parent corporation that sells, exchanges, or distributes stock of a subsidiary may elect to treat the sale, exchange, or distribution as a disposition of the subsidiary's assets. The tax consequences of such an election will be the same as they are for an election made under § 338(h)(10).
•§ 336(e) applies to stock purchased by individuals as well as to stock purchased by corporations.
•A § 338 (or § 338(h)(10)) election may not be made if a § 336(e) election is made.

IV. Introduction to Triangular Mergers: Forward and Reverse Cash Mergers

When the PBS program *Nightly Business Report* – or whatever business program you may watch – airs a report that one corporation is acquiring another corporation in an "all-cash deal," it is fairly certain that the acquisition is either a "forward triangular" merger or a "reverse triangular" merger. It is quite unlikely that the deal is a straight-forward acquisition of one corporation by another for cash.

The discussion to this point has dealt with the basic aspects of taxable acquisitions, and perhaps that is sufficient for the simplest of deals, e.g., where one closely held corporation acquires another closely held corporation. The objectives of the parties to such transactions are apt to be easily attained. For example, in *Williams v. McGowan*, the sole owner of a hardware business, which was not even a corporation, sold out his assets for cash to a corporation. The "target" did not have to concern himself with his right to make such a sale without putting the matter to the vote of shareholders, with the rights of dissenting shareholders, or (evidently) with liabilities. But, when matters are not so simple, such non-tax matters can derail a merger.

A matter of utmost concern to Acquiring Corporation is that it does not want its assets to be

subject to the claims of Target Corporation's creditors – some of whom may not even be known at the time of the acquisition. Furthermore, Acquiring Corporation, especially a publicly held corporation, may not want to incur the expense of a shareholder vote. And, dissenting shareholders may have appraisal rights, i.e., the right to have the corporation purchase their shares for fair value.

The triangular merger has emerged to deal with such matters, and we consider such a transaction in the next chapter. For now, we note that in a triangular merger, Acquiring Corporation forms a subsidiary corporation to acquire (or be acquired by) the Target Corporation – and hence the term "triangular." The Acquiring Corporation is insulated from the Target Corporation's liabilities because it is the subsidiary into which the Target Corporation has merged that assumes the liabilities of the Target Corporation. Acquiring Corporation's subsidiary also succeeds to all the rights that Target Corporation had, e.g., contract rights. Shareholder voting rights on the merger, particularly those of Target Corporation, must still be honored. *See, e.g.*, DEL. GEN. CORP. LAW 251(c); MODEL BUS. CORP. ACT (2016) § 11.04(b). However, shareholders of Acquiring Corporation usually have more limited voting rights – or none at all. *See, e.g.*, DEL. GEN. CORP. LAW 251(f) (voting rights only if Acquiring Corporation's certificate of incorporation is amended *and* Acquiring Corporation issues more than 20% of the number of its outstanding shares of common stock in the merger). In such a "forward triangular merger," the Target Corporation will cease to exist.

Perhaps the Target Corporations possesses various assets that are not transferable, e.g., licenses, non-transferable contract rights such as franchises. The parties do not want the Target Corporation to cease to exist. In that case, the merger may take the form of a "reverse triangular merger." In a reverse triangular merger, the Acquiring Corporation's newly formed subsidiary is merged into the Target Corporation so that Target Corporation survives but is nevertheless controlled by Acquiring Corporation. Target Corporation shareholders receive stock of Acquiring Corporation's subsidiary – which they may exchange for cash or Acquiring Corporation stock.

While triangular forward and reverse mergers dominate tax-deferred reorganizations, a triangular merger can be structured as a taxable *cash* acquisition. Such a transaction would be subject to the tax consequences described in this chapter, but such a transaction would also give parties the non-tax advantages of triangular mergers.

Chapter 9: Reorganizations

I. Introduction

Several Code provisions work together to provide tax-deferred treatment[182] of certain specifically-defined transactions that work a change in structure or ownership of one or more corporations. Such transactions are "reorganizations." Congress does not wish to inhibit taxpayers from engaging in these types of transactions by immediately taxing the gains realized. Its reasons are similar to the ones that support tax-free incorporations under § 351, i.e., that the property received essentially continues the old investment in a different form. Without these Code provisions, such transactions would be recognition events.[183] Failure to meet the Code's conditions of tax deferred reorganizations results in recognition of gain or loss.

The Code identifies and defines transactions that are different forms of a "reorganization" in § 368(a)(1) – to which tax deferral principles can apply. The Code adds conditions of tax deferral to some of these transactions in § 368(a)(2) through draftsmanship that might appear to be after-thought. In a rough sense, reorganizations are transactions in which a corporation may accomplish one of three things, i.e. –

1. Acquire another corporation;
2. Divide itself into two or more corporations; and
3. Adjust its capital structure.

In addition to definitional requirements of § 368, certain common law requirements of tax deferral have emerged that apply to all reorganizations. Irrespective of parties' objectives, they must structure their transaction in a manner that meets both common law and statutory requirements.

The Code provides tax-deferred treatment to reorganizations in §§ 354, 355, 356. and 361 – again with conditions. We can observe, however, that reorganizations are transactions where stock of one or more corporations is a medium of exchange. A payment of money or other property is outside the scope of a reorganization and so will immediately either reduce the basis of what the recipient receives or constitute taxable income. Deferral of recognition of gain or loss of qualifying exchanges occurs through the transfer of basis from the property exchanged to the property received. The Code states basis rules in §§ 358 and 362(b).

Section 368(a) defines "reorganization" and so the applicability of §§ 354, and 356 – which describe the tax-deferral consequences (and their limits) of reorganizations. Section 355

[182] Tax-deferred reorganizations are often referred to as "tax-free" reorganizations. This is not strictly accurate.

[183] On the other hand, taxpayers who fulfill the conditions of a tax-deferred reorganization must accept the tax-deferred treatment. Such treatment is not elective.

describes the conditions when so-called divisive reorganizations[184] result in tax-deferral. Tax deferral occurs through non-recognition of gain/loss on the initial transaction and transfer of basis from what was given up to was received. The doctrines of "substance over form" and "step-transaction" also shape the law of reorganizations.

The regulations state the following purpose of the reorganization provisions of the Code:

> The purpose of the reorganization provisions of the Code is to except from the general rule [that exchanges are recognition events] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate form.

Reg. § 1.368-1(b) (second sentence). Thus, reorganizations are non-recognition events that involve an adjustment of the corporate structure in one of the ways that the Code specifies. They result in a readjustment of a continuing interest in property in a modified corporate form. Section 368(a)(1) names seven types of "reorganizations." These are transactions that are at least partially tax-free to shareholders and the corporations.

There is a "seamless web" character to the Code provisions governing reorganizations. We break into this "seamless web" by briefly describing in broad terms what the relevant Code sections provide. The remainder of the chapter will provide some details to this broad picture:

- § 368: Section 368(a)(1) names seven types of transactions that constitute a "reorganization." Section 368(b) defines a "party to a reorganization." Section 368(c) defines "control of a corporation."
- § 354: Section 354(a)(1) provides that "a party to [a] reorganization" does not recognize gain or loss in an exchange "in pursuance of the plan of reorganization." There are conditions and limitations to such non-recognition treatment.
- § 355: Section 355(a)(1) provides that gain or loss is not recognized on a corporation's distribution of all the stock or securities that it holds of a "controlled corporation." Section 355 applies to divisions of a corporation, and the conditions and limitations to such non-recognition treatment should assure that such distributions are not bailouts of corporate earnings. The focus of § 355 is distributions, not reorganizations.
- § 356: Section 356(a) provides that if §§ 354 or 355 would apply to an exchange but for the receipt of boot, the boot or gain – whichever is less – must be recognized. Section 356(b) provides that certain distributions are subject to the dividend rules of § 301.
- § 357(a): Section 357(a) provides that when § 361 provides a corporation that is a party to a reorganization non-recognition treatment, another's assumption of a liability is not to be treated as money received and does not affect the exchange from being accorded non-recognition treatment under § 361.
- § 358: Section 358(a) provides the same basis carryover rule applicable to distributees in § 351 transactions to distributees in transactions to which §§ 354, 355, 356, or 361 apply. Moreover, §§ 357(c) and 358(d) provide that unloading a liability onto another party is

[184] Section 355 does not by its terms limit its applicability to "reorganizations."

not equivalent to receiving cash but rather reduces the basis that the exchanging party takes in the property received – except that a reduction to less $0 is taxable gain to that extent.

•§ 361: Section 361(a) provides that a corporation that "is a party to a reorganization" that exchanges property for stock or securities in another corporation "in pursuance of the plan of reorganization" does not recognize gain or loss on the exchange. The corporation does not recognize gain or loss from the receipt of boot if it distributes the boot in pursuance of the plan of reorganization. § 361(b)(1)(A). If the corporation does not distribute such boot, it must recognize the amount of boot or gain, whichever is less. § 361(b)(1)(B). Section 361(c) provides that a corporation that is a "party to a reorganization" that distributes pursuant to "the plan of reorganization" its own stock, or the stock or obligation of "another corporation which is a party to the reorganization" that it received in the exchange recognizes no gain or loss.

•§ 362: Section 362(b) provides that a corporation that receives property in connection with a reorganization has the same basis that the transferor of the property had.

•§ 381 provides that an acquiring corporation that acquires the assets of another corporation pursuant to a reorganization to which § 361 applies succeeds – within limits and conditions – to the tax attributes of the target corporation.

•§ 1032: Section 1032(a) provides that a corporation that receives money or property in exchange for its stock does not recognize gain or loss on the exchange.

Now suppose – we want to "do a deal" of the sort noted above.[185] We may want to merge one corporation into another[186] or we may want to divide a corporation into two or more corporations and distribute stock of one of those corporations to some or all shareholders. The parties themselves must work out the terms of the deal, but their discussions and negotiations will occur in the shadow of the rules we consider in the remainder of this chapter. Hopefully we can work with these rules to structure the deal in a way that accommodates the interests of all the parties.

II. Common Law Requirements

A cursory examination of § 368(a)(1) shows that the term "reorganization" applies to transactions whereby

•two corporations merge or consolidate into one, or one corporation acquires the stock or assets of another corporation by exchanging its own stock – so-called acquisitive reorganizations;

[185] We defer until the end of the chapter discussion of so-called "one party reorganizations," i.e., those that involve such matters as alteration of the corporation's capital structure or a change in the corporation's "identity, form, or place of organization."

[186] State statutes often treat mergers and "consolidations" in the same paragraph. A "consolidation" occurs when two corporations consolidate to form a new corporation and then individually go out of existence. Nowadays, one corporation will more likely simply merge into the other.

•a corporation adjusts its corporate structure, e.g., recapitalizes, changes its identity, form, or place of incorporation – so-called non-acquisitive reorganizations; or
•a corporation divides itself into two or more separate entities – so-called divisive reorganizations.

From an early date, taxpayers found that they might structure a transaction to appear to be one of the statutory reorganizations in form – but in substance pursue a purpose that Congress did not intend to occur without the payment of income tax. Notable among such transactions are payment of a dividend and a sale of property. Furthermore, §368(a)(1) includes a "statutory merger or consolidation" as a "reorganization" and so (potentially) subject to tax-deferred treatment – even if a particular merger or consolidation is clearly not the type of transaction to which Congress wished to accord such treatment, e.g., an all-cash acquisition by one corporation of another. To restrict tax deferral to the types of transactions that Congress intended, the *courts* created certain requirements – apart from statutory requirements – that apply to *all* reorganizations. Treasury has adopted and embellished these common law requirements. Treasury has also proposed adoption of yet another requirement. We examine these doctrines here.

A. Continuity of Business Enterprise (COBE)

The regulations governing reorganizations require that there be a "continuity of business enterprise" between the acquiring corporation and the target corporation.

> Continuity of business enterprise (COBE) requires that the issuing corporation (*P*) ... either continue the target corporation's (*T*'s) historic business or use a significant portion of *T*'s historic business assets in a business. ... The application of this general rule to certain transactions, such as mergers of holding companies, will depend on all facts and circumstances. The policy underlying this general rule, which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form, provides the guidance necessary to make these facts and circumstances determinations.

Reg. § 1.368-1(d)(1). *See, e.g.*, *Honbarrier v. Commissioner*, 115 T.C. 300, 311-14 (2000) (transfer of valueless ICC operating license, tax-exempt bonds, and tax-exempt funds met neither requirement). An issuing "corporation is treated as holding all of the businesses and assets of all of the members of" a "qualified group," Reg. § 1.368-1(d)(4)(i), i.e., a group of corporations linked by 80% ownership of stock by vote and value, Reg. § 1.368-1(d)(4)(ii). Hence parent corporation does not have to be the entity that continues the business or uses the assets.

COBE is met either through *business continuity* or *asset continuity*.

1. Business Continuity

The regulations do not specifically define what "business continuity" is, but rather offer considerations and examples. "The continuity of business enterprise requirement is satisfied if *P* continues *T*'s historic business. The fact that *P* is in the same line of business as *T* tends to establish the requisite continuity, but is not alone sufficient." Reg. § 1.368-1(d)(2)(i). "In general, a corporation's historic business is the business it has conducted most recently." Reg. § 1.368-1(d)(2)(iii). The regulations address the situation where the target has more than one line of business. "If *T* has more than one line of business, continuity of business enterprise requires only that *P* continues a significant line of business." Reg. § 1.368-1(d)(2)(ii). In determining whether the business *P* is continuing is "significant," all "facts and circumstances are considered[.]" Reg. § 1.368-1(d)(2)(iv).

Problems:

1. *T* conducts three lines of business: manufacture of synthetic resins, manufacture of chemicals for the textile industry, and distribution of chemicals. The three lines of business are approximately equal in value. On July 1, 20Y1, *T* sells the synthetic resin and chemicals distribution businesses to a third party for cash and marketable securities. On December 31, 20Y1, *T* transfers all its assets to *P* solely for *P* voting stock. *P* continues the chemical manufacturing business without interruption. Does it matter that *P* continues only one of *T*'s three roughly equal businesses? *See* Reg. § 1.368-1(d)(5), Example 1.

2. *T* is a manufacturer of boys' and men's trousers. On January 1, 2013, as part of a plan of reorganization, *T* sold all its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. As part of the plan *T* operates an investment business until July 1, 2016. On that date, the plan of reorganization culminates in a transfer by *T* of its assets to *P*, a regulated investment company, solely in exchange for *P* voting stock. Has the COBE requirement been met because *P* uses *T*'s investment portfolio in its business? Reg. § 1.368-1(d)(5), Example 3.

2. Asset Continuity

COBE is met by *P*'s use of "a significant portion of *T*'s historic business assets in a business." Reg. § 1.368-1(d)(3)(i). "A corporation's historic business assets are the assets used in its historic business." Reg. § 1.368-1(d)(3)(ii). Such assets "may include stock and securities and intangible operating assets such as good will, patents, and trademarks, whether or not they have a tax basis." Reg. § 1.368-1(d)(3)(ii). Whether the portion of *T*'s assets that *P* uses are "significant" is generally "based on the relative importance of the assets to operation of the business." Reg. § 1.368-1(d)(3)(iii). The determination of "significance" requires consideration of all "facts and circumstances, such as the net fair market value of those assets[.]" Reg. § 1.368-1(d)(3)(iii).

Problems:

1. *P* manufactures computers and *T* manufactures components for computers. *T* sells all its output to *P*. On January 1, 20Y1, *P* decides to buy imported components only. On March 1, 20Y1, *T* merges into *P*. *P* continues buying imported components but retains *T*'s equipment as a backup source of supply. Should such use of *T*'s asset satisfy the COBE requirement? *See* Reg. § 1.368-1(d)(5), Example 2.

2. *T* manufactures children's toys and *P* distributes steel and allied products. On January 1, 20Y1, *T* sells all its assets to a third party for $100,000 cash and $900,000 in notes. On March 1, 20Y1, *T* merges into *P*. Should the use of the sales proceeds in *P*'s business satisfy the COBE requirement? *See* Reg. § 1.368-1(d)(5), Example 4.

The intersection of the tax code and state corporation laws: Incorporation occurs (for our purposes) under state laws. State statutes provide outer limits of a corporation's allocation of responsibilities among shareholders, directors, and officers. While boards of directors and officers can make the decisions necessary to the corporation's day-to-day operation, shareholders have the final say in deciding whether the corporation should make a fundamental change. Among the changes that are so fundamental that shareholders should have the final say are mergers, consolidations, and sales of all the corporation's assets. Certainly, shareholders of a target corporation have the right to vote on a merger, and in some states shareholders of the acquiring corporation also have that right. When a shareholder vote is necessary to implement the board's recommendation of a fundamental change, the corporation must bear the expense of holding the vote. This can be expensive and time-consuming. A corporation will also have to consider the rights of dissenting shareholders.

A purpose of state corporation laws governing mergers is protection of shareholder interests. A merger resolution may involve any consideration, including money, that accommodates the interests of different shareholders. This is not necessarily consistent with the Internal Revenue Code's policies of providing tax-deferred treatment only to reorganizations that "effect only a readjustment of continuing interest in property under modified corporate form." Accommodation of state corporation law and federal income tax reorganization law has occurred through the emergence of common law constraints on the tax-deferred treatment of reorganizations.

B. Continuity of Proprietary Interest (COPI)

The "continuity of proprietary interest" (COPI) requires that "a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization." Reg. § 1.368-1(e)(1)(i). The purpose of the COPI requirement "is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations." *Id.* Shareholders as a whole who give up their stock in a corporation must retain a sufficient proprietary interest in the acquiring corporation. Clearly the receipt of stock is the receipt of a proprietary interest, and the receipt of cash is not. Moreover, the consideration given in a reorganization is usually not exclusively the same type of stock (e.g., voting common, non-voting common, preferred) as the stock surrendered. The contours of the COPI test have evolved.

The Supreme Court has determined that short term notes[187] and long-term

[187] *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933) (cash plus notes consideration for a sale).

bonds[188] do not constitute a sufficient proprietary interest to support a tax-deferred reorganization. On the other hand, non-voting preferred stock is a sufficient proprietary interest.[189] More than half the consideration may be cash.[190] Reg. § 1.386-1(e)(2)(v), Examples 1, 2(ii), and 6 assumed that an exchange in which target shareholders receive 40% of their consideration in the form of stock and 60% in the form of cash was sufficient to satisfy the COPI requirement. Examples 2(i) and 4 assume that an exchange in which target shareholders receive 25% of their consideration in the form of stock and 75% in the form of cash is not sufficient to satisfy the COPI requirements.

Should the sufficiency of the equity interest be measured shareholder-by-shareholder or by the overall transaction?

Rev. Rul. 66-224, 1966-2 C.B. 114

Corporation X was merged under state law into corporation Y. Corporation X had four stockholders (A, B, C, D), each of whom owned 25 percent of its stock. Corporation Y paid A and B each $50,000 in cash for their stock of corporation X, and C and D each received corporation Y stock with a value of $50,000 in exchange for their stock of corporation X. There are no other facts present that should be taken into account in determining whether the continuity of interest requirement of § 1.368-1(b) of the Income Tax Regulations has been satisfied, such as sales, redemptions or other dispositions of stock prior to or subsequent to the exchange which were part of the plan of reorganization.

Held, the continuity of interest requirement of § 1.368-1(b) of the regulations has been satisfied. It would also be satisfied if the facts were the same except corporation Y paid each stockholder $25,000 in cash and each stockholder received corporation Y stock with a value of $25,000.

Questions and comments:

1. The overall transaction is what matters. This is true even if a minority shareholder receives only shares in a transaction that otherwise is all-cash. *See Kass v. Commissioner*, 60 T.C. 218, 227 (1973), *aff'd without opinion*, 491 F.2d 749 (3d Cir. 1974).

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[188] *See* LeTulle v. Scofield, 308 U.S. 415, 420-21 (1940) (owner of bonds is creditor, not one with proprietary interest).

[189] *See* John A. Nelson Co. v. Helvering, 296 U.S. 374, 377 (1935) ("definite and substantial interest" in affairs of corporation; "statute does not require participation in" management).

[190] *See* Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935) (focus belongs on proprietary interest received, not cash received; proprietary interest must be "substantial part" of "value of the thing transferred").

1. Timing

The COPI requirement is applied by focusing only on the actual exchanges of shareholders of the target with the acquirer. Sales or dispositions to unrelated parties before or after such exchanges do not affect application of the COPI requirement. Reg. § 1.368-1(e)(1)(i) provides in part:

> For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related ... to the target corporation or to persons not related ... to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related ... to the issuing corporation is disregarded.

With stark simplicity, Treasury mooted litigation over the question of whether the proprietary interests of *previously* cashed out shareholders mattered in meeting (or not meeting[191]) the continuity of proprietary interest standard; they do not. However, pre-exchange or post-exchange dispositions to corporations within the same affiliated group of either the target or the acquirer are treated as sales to related persons, so those shares will not count in determining compliance with the COPI requirement. For example, the acquiring corporation stock that a target shareholder receives does not count towards the 40% threshold if the target shareholder sells the acquiring corporation stock to a member of the acquiring corporation's affiliated group or the acquiring corporation redeems the stock. Reg. § 1.368-1(e)(4)(A). The same is true if the purchase of one corporation's stock by another corporation would fall within § 304(a)(2) (acquiring corporation's purchase of stock of issuing corporation from shareholder where issuing corporation controls of acquiring corporation). Reg. § 1.368-1(e)(4)(B).

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[191] In *J.E. Seagram v. Commissioner*, 104 T.C. (1995), Seagram, DuPont, and others made tender offers to gain control of Conoco, Inc. Seagram purchased many shares that Conoco shareholders tendered to it. As part of its tender offer, DuPont offered to exchange 1.6 (later 1.7) shares of DuPont stock for one share of Conoco stock. Seagram lost its bid to take control of Conoco and tendered the shares it purchased to DuPont in exchange for DuPont stock. Seagram sought to claim a loss on the exchange; this would require that the acquisition be treated as taxable. Seagram argued that there was no continuity of proprietary interest because the shares it (and others) – which amounted to 78% of Conoco's stock – exchanged had been recently purchased for cash. The Tax Court did not agree and with Seagram's contention, and said:

> [W]e must look not to the identity of the target's shareholders, but rather to what the shares represented when the reorganization was completed. In this case, a majority of the old shares of Conoco were converted to shares of DuPont in the reorganization, so that in the sense, at least, that a majority of the consideration was the acquiring corporation's stock, the test of continuity was met. In this aspect of the case step transaction and continuity questions would have arisen only had there been some preexisting intention or arrangement for the disposal of the newly acquired DuPont shares, but there were none.

Id. at 103. While 78% of Conoco stock had been recently purchased, 54% remained in corporate solution – certainly enough to satisfy the continuity of proprietary interest standard. *But see Yoc Heating Corp. v. Commissioner*, 61 T.C. 168, 177-78 (1973) (comparing ownership of target immediately before and after transfer of assets; no reorganization).

2. An Equity Interest

Common stock and preferred stock count as a proprietary interest. Bonds do not. What about securities that fall between stocks and bonds.

Rev. Rul. 69-91, 1969-1 C.B. 106

Corporation X entered into an agreement with the shareholders of corporation Y to acquire all of the stock of Y in exchange solely for voting stock of X. Corporation X also agreed with O, an insurance company, which did not own any of the stock of Y, to purchase for cash an entire issue of convertible debentures of Y that O held. The debentures are convertible at any time into the common stock of Y until their due date in 1982.

The debentures, which have all the indicia of valid indebtedness, confer upon the holder no rights or liabilities as a shareholder of Y unless and until the holder exercises the conversion privilege.

Pursuant to agreement between X and O, O will not exercise the conversion privilege of the debentures prior to the actual purchase by X. Such purchase is conditioned upon the simultaneous acquisition by X of all the stock of Y. After the date of purchase, X intends to hold the debentures until their maturity.

Section 368(a)(1)(B) of the Code provides in part that the term "reorganization" means the acquisition by one corporation, in exchange solely for all or part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

The Supreme Court of the United States, in *Helvering v. Southwest Consolidated Corporation*, 315 U.S. 194 (1942), held that contract rights to purchase stock in the form of stock warrants did not constitute voting stock for purposes of § 112(g)(1) of the Revenue Act of 1934, which corresponds in pertinent part to § 368(a)(1) of the Internal Revenue Code of 1954. The opinion states:

> "* * * [T]he warrants which were issued were not 'voting stock.' Whatever rights a warrant holder may have 'to require the obligor corporation to maintain the integrity of the shares,' covered by the warrants * * * he is not a shareholder. * * * His rights are wholly contractual. As stated by Holmes, J., in *Parkinson v. West End Street Ry.* (173 Mass., 446, 448), he 'does not become a stockholder by his contract in equity any more than at law.' * * * If at the time he exercises his right there are no authorized and unissued shares to satisfy his demand, he will get damages not specific performance. * * * Thus he does not have, and may never acquire, any legal or equitable rights in shares of stock. * * * And he can not assert the rights of a shareholder." 315 U.S. at 200-01.

Southwest Consolidated did not involve convertible debentures. However, the opinion does refer to such securities in comparing them to warrants. The opinion states:

> "And it makes no difference that in the long run the unexercised warrants expired and nothing but voting stock was outstanding. The critical time is the date of the exchange. In that posture of the case it is no different than if other convertible securities had been issued, all of which had been converted within the conversion period." 315 U.S. at 201.

Since the convertible debentures of Y do not confer upon the holder any rights or liabilities as a shareholder prior to the conversion of the debentures into stock of Y, such debentures resemble the warrants described in *Southwest Consolidated*. Therefore, the rationale of that decision is applicable to the present case. *See also Commissioner v. Neustadt Trust et al.*, 131 F.2d 528 (1942), which treated convertible debentures as securities rather than as stock for purposes of § 112(g)(1)(E) of the Revenue Act of 1936, which corresponds to § 368(a)(1)(E) of the 1954 Code.

Accordingly, the convertible debentures do not constitute stock of Y for purposes of § 368(a)(1)(B) of the Code. Furthermore, under the facts described, X's purchase of the debentures for cash from O will not constitute additional consideration for the acquisition of the stock of Y. Therefore, since the stock of Y will be acquired solely in exchange for voting stock of X, the transaction meets the requirements of section 368(a)(1)(B) of the Code.

Questions and comments:

1. Non-qualified preferred stock of course resembles debt in many respects. Nevertheless, while § 351(g) treats non-qualified stock as boot, Congress intended that it be treated as stock for other purposes. *See* H.R. CONF. REP. NO. 105-220, at 544 (1997) ("Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the Code.").

C. Business Purpose

Gregory v. Helvering, 293 U.S. 465 (1935)

Certiorari to review a judgment reversing a decision of the Board of Tax Appeals, 27 B.T.A. 223, which set aside an order of the Commissioner determining a deficiency in income tax.

Justice SUTHERLAND delivered the opinion of the Court.

Petitioner, in 1928, was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under § 112(g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 816, 818, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of

Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation, as capital net gain, the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that, if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the latter decision, the Circuit Court of Appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F.2d 809. Petitioner applied to this Court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ.

Section 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

> "Sec. 112(g) Distribution of Stock on Reorganization. If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock of securities shall be recognized. ..."
>
> > "(i) Definition of Reorganization. – As used in this section . . ."
> >
> > > "(1) The term 'reorganization' means ... (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. ..."

It is earnestly contended on behalf of the taxpayer that, since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected, and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that, if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United*

States v. Isham, 17 Wall. 496, 84 U.S. 506; *Superior Oil Co. v. Mississippi*, 280 U.S. 390, 395-396; *Jones v. Helvering*, 63 App. D.C. 204, 71 F.2d 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [§ 112(g)] of corporate business, and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves, and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction, upon its face, lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

Questions and comments:

1. In its consideration of this case, the United States Court of Appeals for the Second Circuit provided the language that is perhaps the most-quoted in all of tax law:

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

69 F.2d 809, 810 (2d Cir. 1934) (Hand, J.). Of course, a taxpayer must still fulfill the Code's requirements, and the taxpayer lost this case.

2. In the second-to-last paragraph of the Supreme Court's opinion, the Court weighed in explicitly or implicitly on "plan of reorganization," business purpose, device, and step transaction.

3. Reorganizations are not tax-free if they lack "business or corporate purpose." Transferring property from a corporation to a shareholder in a manner that taxpayer elects solely because it reduces federal income tax is not a valid business purpose.

> •Distribution of Monitor Corporation stock would have been a dividend. The fair market value of the Monitor stock – not reduced by basis – would be subject to income tax as ordinary income.

4. The Court applied a step-transaction approach – without specifically calling it the "step transaction" doctrine.

5. While an inquiry into motive may be outside the scope of a reorganization, isn't it motive that made these transactions fail to constitute a "reorganization?"

6. The "business purpose" of which the Court spoke in *Gregory* is now embodied in regulations prescribing that a tax-free reorganization depends upon the existence of a "plan of reorganization." Reg. § 1.368-1(c) (tax deferral provisions governing reorganizations inapplicable "unless there is a plan of reorganization"). The regulations offer little in the way of guidance on what constitutes a "plan of reorganization" other than to make continuance of the business of a corporation the touchstone of relevance.

> [T]he transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of § 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

Reg. § 1.368-2(g). At another place, the Regulations provide that –

> A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in § 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

Reg. § 1.368-1(c). Naturally, the step-transaction doctrine will have a prominent role in "business purpose" cases as the existence of a "disguise" will only emerge by its application.

7. Should a valid "business purpose" be neither more nor less than a non-tax purpose? Should a valid business purpose be a purpose that can only be accomplished through a tax-deferred reorganization?

- A corporation that structures an acquisition of or merger with a corporation unrelated to it surely has a business purpose for doing so. "Business purpose" is not apt to be a significant constraint on mergers and acquisitions between unrelated parties.
- More problematic are cases resulting in distributions to shareholders – as occurred in *Gregory*. Section 355 is the successor to § 112(g), the Code provision upon which Mrs. Gregory relief. When § 355 controls such distributions, § 355's conditions of tax deferral include a business purpose. *See* chapter 9-IV *infra* (discussion of "device" in § 355).

III. Acquisitive Reorganizations

As noted earlier, corporate taxpayers may engage in reorganizations to pursue different purposes. One of those purposes is to acquire another corporation, whether through acquisition, merger, or otherwise. In chapter 8, we examined taxable acquisitions. We now examine the rudiments of how one corporation may acquire another in a tax-deferred transaction.

In any corporate acquisition, there are interests that do not always align – and they must be accommodated to one degree or another.[192] It doesn't require any great foresight to see that there may be –

- shareholders, whether of the acquiring corporation or of the target corporation, who oppose any acquisition;
- shareholders who do not oppose the acquisition but want to terminate their interest and be bought out;
- shareholders who want to pass their shares on to the next generation and get a stepped-up basis under § 1014.

Furthermore, an acquiring and target corporation must consider –

- who will assume the target's liabilities;
- whether there are licenses, contractual rights, permits, etc. that cannot easily be transferred to a different corporation;
- whether shareholders should have a right to vote on the acquisition;
- whether certain securities laws will apply;
- whether shareholders of the target corporation should be able to participate in corporate affairs;

[192] Recall that in *INDOPCO*, the shareholders of the target corporation had different wishes. The parties incurred fees in order the give the different parties what they wanted.

•whether the acquiring corporation wants *all* of the target's assets – or are there some assets it simply does not want;
•whether the target corporation is to survive or to dissolve;
•whether shareholders of the target want stock of the acquiring corporation, the acquiring corporation's parent, or the acquiring corporation's subsidiary.

A so-called triangular reorganization might enable the interested parties to achieve the results they desire. A triangular reorganization, as the name implies, involves three corporations – one of which might be formed for the occasion. Upon its formation, the new corporation can be used to perform any number of functions, e.g. –

•insulate the acquiring corporation from the liabilities of the target. As a separate corporation, the subsidiary's assumption of liabilities insulates the parent from the liabilities of the target corporation;
•separately continue a business and separately hold rights and properties;
•allow target shareholders to receive what may be more desirable stock of the parent rather than of the subsidiary that their corporation will become;
•allow acquired assets to be placed in an operating subsidiary without giving any control to (former) shareholders of the target corporation.

A triangular acquisitive reorganization can be "forward," i.e., target into subsidiary, or "reverse," (subsidiary into target). Code provisions that permit the use of stock of a corporation other than that of the acquiring corporation to acquire another corporation or its assets contemplate triangular reorganizations.

Section 368(a)(1) contemplates several different means by which one corporation may acquire another without payment of income tax on gain. Each offers certain advantages as well as naming conditions. We consider each:

A. "A" Reorganizations

An "A" reorganization is a "statutory" merger or consolidation. § 368(a)(1)(A). In a merger, one corporation merges into another. In a consolidation, two (or more) corporations consolidate into a newly created corporation. The old corporations disappear. The new corporation assumes the liabilities of the old corporations. The statutory merger or consolidation occurs under state (or other, Reg. § 1.368-2(b)(ii)) corporate law. Thus, the corporation statutes of a state which may have as their focus the protection of the interests of shareholders, officers, directors, fiduciaries, the corporation itself, and others – dictate the necessary, but not always sufficient, conditions of tax-deferred treatment of a merger or consolidation. Under state law, the shareholders of the target corporation and perhaps of the acquiring corporation must approve the merger or consolidation.

A significant advantage of an A reorganization is that it is not subject to conditions that apply to other reorganization forms. There is greater flexibility in structuring an A reorganization than there is in structuring another type of reorganization. State law may permit a transfer of some consideration that is not a proprietary interest in a corporation. An A reorganization is not subject

to the "substantially all" or the "voting stock" requirements of the other reorganization forms. *See* chapter 9-IIIC and IIID. It is in such cases that the common law requirements noted in chapter 9-II *supra* have their greatest significance. The continuity of proprietary interest that these doctrines prescribe might otherwise be lost because state laws may permit consideration other than stock (or some other proprietary interest) to effectuate the acquisition.

In addition to meeting the requirements of a merger statute, Reg. § 1.368-2(b)(1)(ii) names certain requirements of any A merger. By operation of law, the following must occur:

- the assets and liabilities of all members of the "combining unit" "become the assets and liabilities of one or more members of one other combining unit (the transferee unit);
- the "combining entity" (i.e., corporation) of each transferor unit ceases its separate legal existence for all purposes – except that it may act or be acted against in connection with activities that arose prior to the transactions.

Reg. § 1.368-2(b)(1)(i)(B) defines a "combining entity" to be a corporation. Reg. § 1.368-2(b)(i)(C) defines a "combining unit" to be a "combining entity" (corporation) and any disregarded entity the assets of which are treated as owned by the "combining entity." Thus, if state law permits, a corporation can merge into a disregarded entity in an A reorganization. Reg. § 1.368-2(b)(1)(ii)

Rev. Rul. 2000-5, 2000-1 C.B. 436

Application of § 368(a)(1)(A) to divisive mergers. The ruling holds that a state law merger will not qualify as a reorganization under § 368(a)(1)(A) of the Code if the merger does not result in one corporation acquiring the assets of a target corporation and the target corporation ceasing to exist.

ISSUES:
Whether a transaction in which (1) a target corporation "merges" under state law with and into an acquiring corporation and the target corporation does not go out of existence, or (2) a target corporation "merges" under state law with and into two or more acquiring corporations and the target corporation goes out of existence, qualifies as a reorganization under § 368(a)(1)(A) of the Internal Revenue Code?

FACTS:
Situation (1). A target corporation transfers some of its assets and liabilities to an acquiring corporation, retains the remainder of its assets and liabilities, and remains in existence following the transaction. The target corporation's shareholders receive stock in the acquiring corporation in exchange for part of their target corporation stock and they retain their remaining target corporation stock. The transaction qualifies as a merger under state X corporate law.

Situation (2). A target corporation transfers some of its assets and liabilities to each of two acquiring corporations. The target corporation liquidates and the target corporation's shareholders receive stock in each of the two acquiring corporations in exchange for their target corporation stock. The transaction qualifies as a merger under state X corporate law.

DISCUSSION:
The purpose of the reorganization provisions of the Code is to provide tax-free treatment to certain exchanges incident to readjustments of corporate structures made in one of the specified ways described in the Code. Reg. § 1.368-1(b). In 1921, Congress defined a reorganization as including "... a merger or consolidation (including the acquisition by one corporation ... of substantially all the properties of another corporation)." In 1934, Congress separated this rule into two distinct provisions. In the predecessor of current § 368(a)(1)(C), an "acquisition by one corporation ... of substantially all the properties of another corporation" continued to be a reorganization where payment was effectuated with the acquiror's voting stock. In the predecessor of current § 368(a)(1)(A), the terms "merger or consolidation" were qualified by requiring that they be "statutory" mergers and consolidations. The word "statutory" was added to the definition of a reorganization so that the definition "will conform more closely to the general requirements of [state] corporation law." *See* H.R. REP. NO. 704, 73d Cong., 2d Sess. 14 (1934).

Historically, corporate law merger statutes have operated to ensure that "[a] merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives." *Cortland Specialty Co. v. Commissioner,* 60 F.2d 937, 939 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); for other cases that describe mergers as requiring that the target corporation transfer its assets and cease to exist, *see, e.g.*, *Vulcan Materials Company v. U.S.*, 446 F.2d 690, 694 (5th Cir. 1971), *cert. denied*, 404 U.S. 942 (1971); *Fisher v. Commissioner*, 108 F.2d 707, 709 (6th Cir. 1939), *cert. denied*, 310 U.S. 627 (1939). Thus, unlike § 368(a)(1)(C), in which Congress included a "substantially all the properties" requirement, it was not necessary for Congress to explicitly include a similar requirement in § 368(a)(1)(A) because corporate law merger statutes contemplated an acquisition of the target corporation's assets by the surviving corporation by operation of law.

Compliance with a corporate law merger statute does not by itself qualify a transaction as a reorganization. *See, e.g.*, *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir. 1951), *cert. denied*, 342 U.S. 860 (1951) (holding that a state law merger was not a reorganization under § 368(a)(1)(A)); *Roebling v. Commissioner*, 143 F.2d 810 (3d Cir. 1944), *cert. denied*, 323 U.S. 773 (1944) (same holding). In addition to satisfying the requirements of business purpose, continuity of business enterprise and continuity of interest, in order to qualify as a reorganization under § 368(a)(1)(A), a transaction effectuated under a corporate law merger statute must have the result that one corporation acquires the assets of the target corporation by operation of the corporate law merger statute and the target corporation ceases to exist. The transactions described in Situations (1) and (2) do not have the result that one corporation acquires the assets of the target corporation by operation of the corporate law merger statute and the target corporation ceases to exist. Therefore, these transactions do not qualify as reorganizations under § 368(a)(1)(A).

In contrast with the operation of corporate law merger statutes, a divisive transaction is one in which a corporation's assets are divided among two or more corporations. Section 355 provides tax-free treatment for certain divisive transactions, but only if a number of specific requirements are satisfied. Congress intended that § 355 be the sole means under which divisive transactions

will be afforded tax-free status and, thus, specifically required the liquidation of the acquired corporation in reorganizations under both §§ 368(a)(1)(C) and 368(a)(1)(D) in order to prevent these reorganizations from being used in divisive transactions that did not satisfy § 355. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 274 (1954); S. REP. NO. 169, 98th Cong., 2d Sess. 204 (1984). No specific liquidation requirement was necessary for statutory mergers because corporate law merger statutes contemplated that only one corporation survived a merger. The transaction described in Situation (1) is divisive because, after the transaction, the target corporation's assets and liabilities are held by both the target corporation and acquiring corporation and the target corporation's shareholders hold stock in both the target corporation and acquiring corporation. The transaction described in Situation (2) is divisive because, after the transaction, the target corporation's assets and liabilities are held by each of the two acquiring corporations and the target corporation's shareholders hold stock in each of the two acquiring corporations.

HOLDING:
The transactions described in Situations (1) and (2) do not qualify as reorganizations under § 368(a)(1)(A). However, the transactions described in Situations (1) and (2) possibly may qualify for tax-free treatment under other provisions of the Code.

Questions and comments:

1. What purpose is served by requiring that the target corporation cease to exist?

2. Why did the acquisition in Situation (1) fail as an A reorganization?

3. Why did the acquisition in Situation (2) fail as an A reorganization?

4. An A reorganization cannot be a divisive reorganization. As the IRS explained:

> Congress intended that § 355 be the sole means under which divisive transactions will be afforded tax-free status and, thus, specifically required the liquidation of the acquired corporation in reorganizations under both §§ 368(a)(1)(C) and 368(a)(1)(D) in order to prevent these reorganizations from being used in divisive transactions that did not satisfy § 355.

See § IV *infra* ("divisive D reorganizations).

5. *Disregarded Entities*: The IRS in Rev. Rul. 2000-5 stated that state "corporate law merger statutes have operated to ensure that '[a] merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives.'" (citations omitted). The regulations now permit the merger of a target corporation into an LLC. *See* Reg. § 1.368-2(b)(1). There are conditions to such a merger, which regulations establish in part through definitions and in part through requirements of what state merger statutes must provide.

•A *combining entity* is a *corporation*. Reg. § 1.368-2(b)(1)(i)(B).

•A *combining unit* is a combining entity and all disregarded entities whose assets are treated as owned by the combining entity.

•The merger or consolidation occurs pursuant to state statute(s), and the following occur by operation of those merger or consolidation statutes: all assets and liabilities of each combining unit (i.e., transferor unit), with limited exceptions, become the assets and liabilities of one or more members of "one other combining unit," i.e., the transferee unit, Reg. § 1.368-2(b)(1)(ii)(A), *and* the combining entity of each transferor ceases its separate legal existence, Reg. § 1.368-2(b)(1)(ii)(B).

•A merger involving an LLC can only be an A reorganization. We shall see that a B, C, or D reorganization requires transactions between "corporations."

•Some observations: The regulations contemplate that the acquiring corporation will own the LLC into which the target will merge. The target corporation will not be related to the acquiring corporation. The acquiring corporation will transfer consideration to the target corporation (or its shareholders), which the target corporation will distribute to its shareholders upon its liquidation. The target corporation will merge into the LLC that is a part of the acquiring corporation's "combining unit." When the dust settles, the acquiring corporation will have acquired the target corporation's assets. *See generally* Reg. § 1.368-2(b)(1)(iii) (examples).

6. An A reorganization can be one part of a larger plan.

•Section 368(a)(2)(C) permits the acquiring corporation to transfer the stock or assets that it acquired to a corporation that it controls, i.e., to drop down assets.

•Section 368(a)(2)(D) permits use of a corporate parent's stock to acquire "substantially all" the properties of another corporation so long as no stock of the acquiring subsidiary corporation is used in the transaction and the transaction would otherwise have qualified as an A merger if the other corporation had merged into the parent. No stock of the acquiring subsidiary may be used.

•Section 368(a)(2)(E) permits the use of a parent corporation's stock to merge a subsidiary corporation into another corporation so long as (i) the corporation surviving the merger holds "substantially all" its properties and the properties of the merged corporation (other than the parent corporation's stock) and (ii) shareholders of the surviving corporation exchanged sufficient stock constituting control of the surviving corporation for voting stock of the parent corporation.

7. Notice the occasions when the statutory merger must result in acquisition of "substantially all" the assets of another corporation. Notice also the use of the same phrase in § 368(a)(1)(C). Do you expect the phrase to have the same meaning in both contexts?

•If Target Corporation sells 50% of its assets immediately prior to an acquisitive A reorganization, can Acquiring Corporation successfully execute a triangular A reorganization?

8. As between A, B, and C reorganizations, notice which ones require use of "voting" stock and which ones do not.

9. Section 368(a)(1)(A) will prove useful in executing triangular mergers, *infra*.

10. Suppose that Acquiring Corporation owns some stock of Target Corporation that it acquired many years ago for cash. Now it wants to acquire Target Corporation through an acquisitive A reorganization. Should the "old and cold" stock of Target Acquiring already owns count against it when determining whether it meets the continuity of proprietary interest standard?

Problems:

1. Z is a C corporation and Y is a disregarded entity separate from Y. Under State W law, Z transfers some of its assets and liabilities to Y, retains the remainder of its assets and liabilities, and remains in existence for Federal income tax purposes following the transaction. The transaction qualifies as a merger under State W corporate law. What will be the federal income tax treatment of Z's transfer of some of its assets and liabilities to Y? *See* Reg. §1.368-2(b)(1)(iii), Example 1.

2. Z is a C corporation. X is a domestic LLC and wholly owned by Y, a C corporation. Under State W law, Z merges into X. Pursuant W state corporation law, the following events occur simultaneously at the effective time of the transaction: all the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y. What will be the federal income tax treatment of Z Corporation, of Y Corporation, of Z's shareholders, and of Y's shareholders? *See* Reg. § 1.368-2(b)(1)(iii), Example 2.

3. Y Corporation are Z Corporation are C corporations. Z operates two unrelated businesses, Business P and Business Q, each of which represents 50% of the value of the assets of Z. Y desires to acquire and continue operating Business P, but does not want to acquire Business Q. Pursuant to a single plan, Z sells Business Q for cash to parties unrelated to Z and Y in a taxable transaction, and then distributes the proceeds of the sale pro rata to its shareholders. Then, pursuant to W state corporation law, Z merges into Y. Pursuant to W state corporation law, the following events occur simultaneously at the effective time of the transaction: all the assets and liabilities of Z related to Business P become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their Z stock for Y stock. What are the federal income tax consequences to Z Corporation, Z Corporation's shareholders, and to Y Corporation? *See* Reg. § 1.368-2(b)(iii), Example 8.

Review the basic rules of §§ 356, 357, 361, and 381. Then:

Do the CALI exercise: Corporate Taxation: Reorganizations: A Reorganizations: Definition.

Do the CALI exercise: Corporate Taxation: Reorganizations: Tax Consequences of A Reorganizations.

- As always, do not be afraid of learning something when doing these exercises.

B. "B" Reorganizations

A "B" reorganization is a "stock-for-stock" acquisition. The acquiring corporation must exchange *solely* voting stock[193] of itself or its parent for the stock of the target corporation – and immediately after the exchange have control of the target, i.e., ownership of at least 80% of the total combined voting power of all the classes of stock entitled to vote *and* of at least 80% of the total number of shares of each and every other class of non-voting stock of the corporation. §§ 368(a)(1)(b), 368(c). This includes non-qualified preferred stock. The stock so acquired may be transferred to another subsidiary of the parent/acquiring corporation. § 368(a)(2)(C). *Only* voting stock may be used in a B acquisition. "If, for example, corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock corporation Y, the transaction is not a reorganization under § 368(a)(1)(B)." Reg. § 1.368-2(c). And while the acquiring corporation may exchange the stock of its parent, when it does so it must exchange *solely* stock of its parent. "[I]f stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation," the acquisition is not a B reorganization. *Id.*

There may be more than one exchange of stock-for-stock, but the exchanges themselves must take "place over a relatively short period of time such as 12 months." *Id.* The acquiring corporation may execute a B reorganization to acquire control of a corporation in which it already owns (a not insubstantial) amount of stock, a so-called "creeping acquisition." *See id.* Stock that is "old and cold" may count towards "control" – no matter whether acquired for consideration other than voting stock.

Since the acquiring corporation may not use boot to acquire the target corporation,[194] the statutory requirements of a B reorganization themselves assure that there will be a sufficient continuity of proprietary interest. There is still a "continuity of business enterprise" requirement. Notice that the target corporation does not exchange anything, i.e., the exchanges all occur at shareholder levels. However, the acquiring corporation and the target corporation may have dealings independent of the exchanges of stock. The target corporation continues to exist, so the rights of creditors are not affected by a B reorganization. However, Prop. Reg. § 1.368-1(f) requires that there be an exchange of net value. Target shareholders may sell their stock in target prior to the exchange or sell their acquiring stock immediately after the exchange. *Cf.* Reg. § 1.368-1(e)(i) (continuity of proprietary interest not lost; proprietary interests in corporation preserved as such and not sold to the acquiring corporation). In like manner, the target corporation may adjust its holdings – perhaps distributing assets to shareholders that the acquiring corporation does not want.

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[193] Thus, a B reorganization will involve dilution of the voting interest of existing shareholders of the acquiring corporation.

[194] The "solely for stock" requirement is still met when shareholders of the target who receive fractional shares may either top up their holdings by purchasing the complementary fraction or sell the fractional share. If the acquiring corporation pays cash to target shareholders to redeem fractional shares, the cash payment is treated as a redemption and the acquisition still qualifies for §§ 368(a)(1)(B) and 354(a)(1) treatment. *See* Rev. Rul. 66-365, 1966-2 C.B. 116.

Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980)

Opinion by: CAMPBELL

This appeal by the Internal Revenue Service from a decision of the Tax Court calls for the construction of certain corporate reorganization provisions of the Internal Revenue Code, 26 U.S.C. §§ 354(a)(1) and 368(a)(1). [footnote omitted]. We must decide whether the requirement of § 368(a)(1)(B) that the acquisition of stock in one corporation by another be solely in exchange for voting stock of the acquiring corporation is met where, in related transactions, the acquiring corporation first acquires 8% of the acquiree's stock for cash and then acquires more than 80% of the acquiree in an exchange of stock for voting stock. The Tax Court agreed with the taxpayers that the latter exchange constituted a valid tax-free reorganization.

The Facts

Appellees were among the more than 17,000 shareholders of the Hartford Fire Insurance Company who exchanged their Hartford stock for shares of the voting stock of International Telephone and Telegraph Corporation pursuant to a formal exchange offer from ITT dated May 26, 1970. [footnote omitted]. On their 1970 tax returns, appellees did not report any gain or loss from these exchanges. Subsequently, the Internal Revenue Service assessed deficiencies in the amounts of $15,452.93 (Chapman), $43,962.66 (Harry), $55,778.45 (Harwood), and $4,851.72 (Ladd). Appellees petitioned the Tax Court for redetermination of these deficiencies, and their cases were consolidated with those of twelve other former Hartford shareholders. The Tax Court, with five judges dissenting, [footnote omitted] granted appellees' motion for summary judgment, and the Commissioner of Internal Revenue filed this appeal.

The events giving rise to this dispute began in 1968, when the management of ITT, a large multinational corporation, became interested in acquiring Hartford as part of a program of diversification. In October 1968, ITT executives approached Hartford about the possibility of merging the two corporations. This proposal was spurned by Hartford, which at the time was considering acquisitions of its own. In November 1968, ITT learned that approximately 1.3 million shares of Hartford, representing some 6% of Hartford's voting stock, were available for purchase from a mutual fund. After assuring Hartford's directors that ITT would not attempt to acquire Hartford against its will, ITT consummated the $63.7 million purchase from the mutual fund with Hartford's blessing. From November 13, 1968 to January 10, 1969, ITT also made a series of purchases on the open market totalling 458,000 shares which it acquired for approximately $24.4 million. A further purchase of 400 shares from an ITT subsidiary in March 1969 brought ITT's holdings to about 8% of Hartford's outstanding stock, all of which had been bought for cash.

... [O]n April 9, 1969 a provisional plan and agreement of merger was executed by the two corporations. ...

... By private letter ruling, the Service notified the parties on October 13, 1969 that the proposed merger would constitute a nontaxable reorganization, provided ITT unconditionally sold its 8% interest in Hartford to a third party before Hartford's shareholders voted to approve or disapprove the proposal. On October 21, the Service ruled that a proposed sale of the stock to

Mediobanca, an Italian bank, would satisfy this condition, and such a sale was made on November 9.

On November 10, 1969, the shareholders of Hartford approved the merger, which had already won the support of ITT's shareholders in June. On December 13, 1969, however, the merger plan ground to a halt, as the Connecticut Insurance Commissioner refused to endorse the arrangement. ITT then proposed to proceed with a voluntary exchange offer to the shareholders of Hartford on essentially the same terms they would have obtained under the merger plan.[195] After public hearings and the imposition of certain requirements on the post-acquisition operation of Hartford, the insurance commissioner approved the exchange offer on May 23, 1970, and three days later ITT submitted the exchange offer to all Hartford shareholders. More than 95% of Hartford's outstanding stock was exchanged for shares of ITT's $2.25 cumulative convertible voting preferred stock. The Italian bank to which ITT had conveyed its original 8% interest was among those tendering shares, as were the taxpayers in this case.

In March 1974, the Internal Revenue Service retroactively revoked its ruling approving the sale of Hartford stock to Mediobanca, on the ground that the request on which the ruling was based had misrepresented the nature of the proposed sale. Concluding that the entire transaction no longer constituted a nontaxable reorganization, the Service assessed tax deficiencies against a number of former Hartford shareholders who had accepted the exchange offer. Appellees, along with other taxpayers, contested this action in the Tax Court, where the case was decided on appellees' motion for summary judgment. ... The taxpayers ... conceded, solely for purposes of their motion for summary judgment, that the initial cash purchases of Hartford stock had been made for the purpose of furthering ITT's efforts to acquire Hartford.

The Issue

Taxpayers advanced two arguments in support of their motion for summary judgment. Their first argument related to the severability of the cash purchases from the 1970 exchange offer. Because 14 months had elapsed between the last of the cash purchases and the effective date of the exchange offer, and because the cash purchases were not part of the formal plan of reorganization entered into by ITT and Hartford, the taxpayers argued that the 1970 exchange offer should be examined in isolation to determine whether it satisfied the terms of § 368(a)(1)(B) ... The Service countered that the two sets of transactions – the cash purchases and the exchange offer – were linked by a common acquisitive purpose, and that they should be considered together for the purpose of determining whether the arrangement met the statutory requirement that the stock of the acquired corporation be exchanged "solely for ... voting stock" of the acquiring corporation. The Tax Court did not reach this argument; in granting summary judgment it relied entirely on the taxpayers' second argument.

For purposes of the second argument, the taxpayers conceded arguendo that the 1968 and 1969 cash purchases should be considered "parts of the 1970 exchange offer reorganization." Even so, they insisted upon a right to judgment on the basis that the 1970 exchange of stock for stock

[195] Apparently, the insurance commissioner was concerned, among other things, about the rights of dissenting shareholders, who could have been forced to exchange their Hartford shares under the merger plan. ...

satisfied the statutory requirements for a reorganization without regard to the presence of related cash purchases. The Tax Court agreed with the taxpayers, holding that the 1970 exchange in which ITT acquired more than 80% of Hartford's single class of stock for ITT voting stock satisfied the requirements of § 368(a)(1)(B), so that no gain or loss need be recognized on the exchange under § 354(a)(1). The sole issue on appeal is whether the Tax Court was correct in so holding. [footnote omitted].

I.

We turn first to the statutory scheme under which this case arose. [footnote omitted]. The basic rule governing exchanges was imported from § 1002 of the 1954 Code, 26 U.S.C. § 1002. Section 1002 stated that, except as otherwise provided, gain or loss on the exchange of property should be recognized and taken into account in computing a taxpayer's taxable income. [footnote omitted]. One exception to that rule appears in § 354(a)(1), which provides that gain or loss shall not be recognized if stock or securities in a corporation are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in another corporation which is a party to the reorganization. [footnote omitted]. ... Section 354(a)(1) does not apply to an exchange unless the exchange falls within one of the six categories of "reorganization" defined in Section 368(a)(1). [footnote omitted]. The category relevant to the transactions involved in this case is defined in § 368(a)(1)(B):

> (T)he term "reorganization' means
>
> > (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock ... of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition). [footnote omitted].

The concept of "control" is defined in § 368(c) as "the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation."[196] Subsection (B) thus establishes two basic requirements for a valid, tax-free stock-for-stock reorganization. First, "the acquisition" of another's stock must be "solely for ... voting stock." Second, the acquiring corporation must have control over the other corporation immediately after the acquisition.

The single issue raised on this appeal is whether "the acquisition" in this case complied with the requirement that it be "solely for ... voting stock." It is well settled that the "solely" requirement is mandatory; if any part of "the acquisition" includes a form of consideration other than voting stock, the transaction will not qualify as a (B) reorganization. *See Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 198 (1942) ("'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement"). The precise issue before us is thus how broadly to read the term "acquisition." The Internal Revenue Service argues that "the acquisition ... of stock of another corporation" must be understood to encompass the 1968-69

[196] The parties do not contest the fact that ITT had control of Hartford, as defined by § 368(c), immediately after the 1970 exchange, whether or not the cash purchases were included in ITT's holdings.

cash purchases as well as the 1970 exchange offer. If the IRS is correct, "the acquisition" here fails as a (B) reorganization. The taxpayers, on the other hand, would limit "the acquisition" to the part of a sequential transaction of this nature which meets the requirements of subsection (B). They argue that the 1970 exchange of stock for stock was itself an "acquisition" by ITT of stock in Hartford solely in exchange for ITT's voting stock, such that after the exchange took place ITT controlled Hartford. Taxpayers contend that the earlier cash purchases of 8%, even if conceded to be part of the same acquisitive plan, are essentially irrelevant to the tax-free reorganization otherwise effected.

The Tax Court ... plurality opinion stated its "narrow" holding as follows:

> We hold that where, as is the case herein, 80% or more of the stock of a corporation is acquired in one transaction, [footnote omitted] in exchange for which only voting stock is furnished as consideration, the "solely for voting stock" requirement of § 368(a)(1)(B) is satisfied.

The plurality treated as "irrelevant" the 8% of Hartford's stock purchased for cash, although the opinion left somewhat ambiguous the question whether the 8% was irrelevant because of the 14-month time interval separating the transactions or because the statute was not concerned with transactions over and above those mathematically necessary to the acquiring corporation's attainment of control.[197]

II.

For reasons set forth extensively in section III of this opinion, we do not accept the position adopted by the Tax Court. [footnote omitted]. Instead we side with the Commissioner on the narrow issue presented in this appeal, that is, the correctness of taxpayers' so-called "second" argument premised on an assumed relationship between the cash and stock transactions. As explained below, we find a strong implication in the language of the statute, in the legislative history, in the regulations, and in the decisions of other courts that cash purchases which are concededly "parts of" a stock-for-stock exchange must be considered constituent elements of the "acquisition" for purposes of applying the "solely for ... voting stock" requirement of § 368(a)(1)(B). We believe the presence of non-stock consideration in such an acquisition, regardless of whether such consideration is necessary to the gaining of control, is inconsistent with treatment of the acquisition as a nontaxable reorganization. It follows for purposes of taxpayers' second argument which was premised on the assumption that the cash transactions were part of the 1970 exchange offer reorganization that the stock transfers in question would not qualify for nonrecognition of gain or loss.

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[197] If the holding rested on the former basis, it would be difficult to credit the Tax Court's repeated assertions that it was not reaching or deciding the severability issue. As the taxpayers conceded their cash purchases were "parts of the 1970 exchange offer reorganization," the Tax Court had no reason to consider the actual lapse of time which occurred as a factor in treating the cash purchases as legally irrelevant. We assume, therefore, that any indications in the Tax Court's opinion that the separation in time was necessary to its holding were inadvertent, and that the holding actually rests on the Tax Court's reading of the statute. If the Tax Court wishes explicitly to articulate a rule regarding the time period which will suffice to separate two transactions for purposes of § 368(a)(1)(B), we think it will have an adequate opportunity to do so in considering on remand the issue of severability raised by taxpayers' first argument.

Our decision will not, unfortunately, end this case. The Tax Court has yet to rule on taxpayers' "first" argument. To be sure, appellees urge that in the event of our reversing the Tax Court on the single issue it chose to address, we should consider upholding its judgment on the alternative ground that the prior cash purchases in the instant case were, as a matter of law, unrelated to the exchange offer. ... Taxpayers' so-called first argument deserves, however, a more focused and deliberate inquiry than we can give it in the present posture of the case. ... The question of what factors should determine, for purposes of § 368(a)(1)(B), whether a given cash purchase is truly "related" to a later exchange of stock requires further consideration by the Tax Court, as does the question of the application of those factors in the present case. We therefore will remand this case to the Tax Court for further proceedings on the question raised by the taxpayers' first argument in support of their motion for summary judgment.

We view the Tax Court's options on remand as threefold. It can hold that the cash and stock transactions here in question are related as a matter of law – the position urged by the Commissioner – in which case, under our present holding, there would not be a valid (B) reorganization. On the other hand, the Tax Court may find that the transactions are as a matter of law unrelated, so that the 1970 exchange offer was simply the final, nontaxable step in a permissible creeping acquisition. Finally, the court may decide that, under the legal standard it adopts, material factual issues remain to be decided, so that a grant of summary judgment would be inappropriate at this time. [footnote omitted].

III.

A.

Having summarized in advance our holding, and its intended scope, we shall now revert to the beginning of our analysis, and, in the remainder of this opinion, describe the thinking by which we reached the result just announced. We begin with the words of the statute itself. The reorganization definitions contained in § 368(a)(1) are precise, technical, and comprehensive. They were intended to define the exclusive means by which nontaxable corporate reorganizations could be effected. *See* Treas. Reg. § 1.368-1 (1960); 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 20.86 at 364 (1972). In examining the language of the (B) provision, [footnote omitted] we discern two possible meanings. On the one hand, the statute could be read to say that a successful reorganization occurs whenever Corporation X exchanges its own voting stock for stock in Corporation Y, and, immediately after the transaction, Corporation X controls more than 80% of Y's stock. On this reading, purchases of shares for which any part of the consideration takes the form of "boot" should be ignored, since the definition is only concerned with transactions which meet the statutory requirements as to consideration and control. To take an example, if Corporation X bought 50% of the shares of Y, and then almost immediately exchanged part of its voting stock for the remaining 50% of Y's stock, the question would arise whether the second transaction was a (B) reorganization. Arguably, the statute can be read to support such a finding. In the second transaction, X exchanged only stock for stock (meeting the "solely" requirement), and after the transaction was completed X owned Y (meeting the "control" requirement).

The alternative reading of the statute – the one which we are persuaded to adopt – treats the (B) definition as prescriptive, rather than merely descriptive. We read the statute to mean that the

entire transaction which constitutes "the acquisition" must not contain any nonstock consideration if the transaction is to qualify as a (B) reorganization. In the example given above, where X acquired 100% of Y's stock, half for cash and half for voting stock, we would interpret "the acquisition" as referring to the entire transaction, so that the "solely for ... voting stock" requirement would not be met. We believe if Congress had intended the statute to be read as merely descriptive, this intent would have been more clearly spelled out in the statutory language. [footnote omitted].

We recognize that the Tax Court adopted neither of these two readings. For reasons to be discussed in connection with the legislative history which follows, the Tax Court purported to limit its holding to cases, such as this one, where more than 80% of the stock of Corporation Y passes to Corporation X in exchange solely for voting stock. The Tax Court presumably would assert that the 50/50 hypothetical posited above can be distinguished from this case, and that its holding implies no view as to the hypothetical. The plurality opinion recognized that the position it adopted creates no small problem with respect to the proper reading of "the acquisition" in the statutory definition. In order to distinguish the 80% case from the 50% case, it is necessary to read "the acquisition" as referring to at least the amount of stock constituting "control" (80%) where related cash purchases are present. Yet the Tax Court recognized that "the acquisition" cannot always refer to the conveyance of an 80% bloc of stock in one transaction, since to do so would frustrate the intent of the 1954 amendments to permit so-called "creeping acquisitions."[198]

The Tax Court's interpretation of the statute suffers from a more fundamental defect, as well. In order to justify the limitation of its holding to transactions involving 80% or more of the acquiree's stock, the Tax Court focused on the passage of control as the primary requirement of the (B) provision. This focus is misplaced. Under the present version of the statute, the passage of control is entirely irrelevant; the only material requirement is that the acquiring corporation have control immediately after the acquisition. As the statute explicitly states, it does not matter if the acquiring corporation already has control before the transaction begins, so long as such control exists at the completion of the reorganization. Whatever talismanic quality may have attached to the acquisition of control under previous versions of the Code, see Part III B *infra*, is altogether absent from the version we must apply to this case. In our view, the statute should be read to mean that the related transactions that constitute "the acquisition," whatever percentage of stock they may represent, must meet both the "solely for voting stock" and the "control immediately after" requirements of § 368(a)(1)(B). Neither the reading given the statute by the Tax Court, nor that proposed as the first alternative above, adequately corresponds to the careful language Congress employed in this section of the Code.

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[198] In the typical creeping acquisition situation, Corporation X acquires a portion of Corporation Y's stock, let us say 40%, for cash or other nonstock consideration. If (B) reorganizations were limited to those encompassing 80% or more of Y's stock in one transaction, X would thereafter be barred, as a practical matter, from acquiring the remainder of Y's shares in a tax-free (B) reorganization. The 1954 Code, however, clearly permits X to trade voting stock for 40% or more of Y's remaining stock so long as the stock acquisition is sufficiently separated from the prior cash purchase. *See* 1954 Senate Report, supra note 17 at 273. In these circumstances, therefore, "the acquisition" must be interpreted as referring to an amount of stock less than 80%. [citation omitted].

B.

The 1924 Code defined reorganization, in part, as "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)." Pub. L. No. 68-176, c. 234, § 203(h)(1), 43 Stat. 257. Although the statute did not specifically limit the consideration that could be given in exchange for stock or assets, courts eventually developed the so-called "continuity of interest" doctrine, which held that exchanges that did not include some quantum of stock as consideration were ineligible for reorganization treatment for lack of a continuing property interest on the part of the acquiree's shareholders. *See, e.g.*, *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); *Pinellas Ice Co. v. Commissioner*, 287 U.S. 462, 470 428 (1933).

Despite this judicial development, sentiment was widespread in Congress that the reorganization provisions lent themselves to abuse, particularly in the form of so-called "disguised sales." *See, e.g.*, "Prevention of Tax Avoidance," REPORT OF SUBCOMM. OF HOUSE COMM. ON WAYS AND MEANS, 73d Cong., 2d Sess. (Dec. 4, 1933). In 1934, the House Ways and Means Committee proposed abolition of the stock-acquisition and asset-acquisition reorganizations which had appeared in the parenthetical section of the 1924 Act quoted above. *See* H.R. REP. NO. 704, 73d Cong., 2d Sess. 12-14 (1939-1 Cum. Bull. (Part 2) 554, 563-65). The Senate Finance Committee countered with a proposal to retain these provisions, but with "restrictions designed to prevent tax avoidance." S. REP. NO. 558, 73d Cong., 2d Sess. 15 (1939-1 Cum. Bull. (Part 2) 586, 598).[199] One of these restrictions was the requirement that the acquiring corporation obtain at least 80%, rather than a bare majority, of the stock of the acquiree. The second requirement was stated in the Senate Report as follows: "the acquisition, whether of stock or of substantially all the properties, must be in exchange solely for the voting stock of the acquiring corporation." *Id.* at 17. The Senate amendments were enacted as § 112(g)(1) of the Revenue Act of 1934, 48 Stat. 680, which provided in pertinent part:

> (1) The term "reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation ....

Congress revised this definition in 1939 in response to the Supreme Court's decision in *United States v. Hendler*, 303 U.S. 564 (1938), which held that an acquiring corporation's assumption of the acquiree's liabilities in an asset-acquisition was equivalent to the receipt of "boot" by the acquiree. Since virtually all asset-acquisition reorganizations necessarily involve the assumption of the acquiree's liabilities, a literal application of the "solely for ... voting stock" requirement would have effectively abolished this form of tax-free reorganization. In the Revenue Act of 1939, Congress separated the stock-acquisition and asset-acquisition provisions in order to

[199] The Senate's purpose in retaining these provisions was apparently to make available an alternative to statutory merger or consolidation in those states where merger statutes were overly restrictive or nonexistent. *See Howard v. Commissioner*, 238 F.2d 943, 946 (7th Cir. 1956).

exempt the assumption of liabilities in the latter category of cases from the "solely for ... voting stock" requirement. [footnote omitted]. Section 112(g)(1) of the revised statute then read, in pertinent part, as follows:

> (1) the term "reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to liability, shall be disregarded ....

The next major change in this provision occurred in 1954. In that year, the House Bill, H.R. 8300, would have drastically altered the corporate reorganization sections of the Tax Code, permitting, for example, both stock and "boot" as consideration in a corporate acquisition, with gain recognized only to the extent of the "boot." *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. A118-A119, A132-A134, *reprinted in* (1954) U.S. CODE CONG. & ADMIN. NEWS, pp. 4017, 4256-4257, 4269-4271. The Senate Finance Committee, in order to preserve the familiar terminology and structure of the 1939 Code, proposed a new version of § 112(g)(1), which would retain the "solely for ... voting stock" requirement, but alter the existing control requirement to permit so-called "creeping acquisitions." Under the Senate Bill, it would no longer be necessary for the acquiring corporation to obtain 80% or more of the acquiree's stock in one "reorganization." The Senate's proposal permitted an acquisition to occur in stages; a bloc of shares representing less than 80% could be added to earlier acquisitions, regardless of the consideration given earlier, to meet the control requirement. The Report of the Senate Finance Committee gave this example of the operation of the creeping acquisition amendment:

> Corporation A purchased 30% of the common stock of corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, corporation A offers to exchange its own voting stock, for all the stock of corporation W tendered within 6 months from the date of the offer. Within the 6 months period corporation A acquires an additional 60% of the stock of W for its own voting stock. As a result of the 1955 transactions, corporation A will own 90% of all of corporation W's stock. No gain or loss is recognized with respect to the exchanges of the A stock for the W stock.

1954 SENATE REPORT, *supra* note 17, at 273, U.S. CODE CONG. & ADMIN. NEWS 1954, p. 4911. *See also* Treas. Reg. § 1.368-2(c) (1960).

At the same time the Senate was revising the (B) provision, (while leaving intact the "solely for ... voting stock" requirement), it was also rewriting the (C) provision to explicitly permit up to 20% of the consideration in an asset acquisition to take the form of money or other nonstock property. *See* 26 U.S.C. § 368(a)(2)(B). The Senate revisions of subsections (B) and (C) were ultimately passed, and have remained largely unchanged since 1954. ... Proposals for altering the (B) provision to allow "boot" as consideration have been made, but none has been enacted. [footnote omitted].

As this history shows, Congress has had conflicting aims in this complex and difficult area. On the one hand, the 1934 Act evidences a strong intention to limit the reorganization provisions to prevent forms of tax avoidance that had proliferated under the earlier revenue acts. This intention arguably has been carried forward in the current versions through retention of the "solely for ... voting stock" requirement in (B), even while the (C) provision was being loosened. On the other hand, both the 1939 and 1954 revisions represented attempts to make the reorganization procedures more accessible and practical in both the (B) and (C) areas. In light of the conflicting purposes, we can discern no clear Congressional mandate in the present structure of the (B) provision, either in terms of the abuses sought to be remedied or the beneficial transactions sought to be facilitated. At best, we think Congress has drawn somewhat arbitrary lines separating those transactions that resemble mere changes in form of ownership and those that contain elements of a sale or purchase arrangement. In such circumstances we believe it is more appropriate to examine the specific rules and requirements Congress enacted, rather than some questionably delineated "purpose" or "policy," to determine whether a particular transaction qualifies for favorable tax treatment.

To the extent there is any indication in the legislative history of Congress' intent with respect to the meaning of "acquisition" in the (B) provision, we believe the intent plainly was to apply the "solely" requirement to all related transactions. In those statutes where Congress intended to permit cash or other property to be used as consideration, it made explicit provision therefor. *See, e.g.*, 26 U.S.C. § 368(a)(2)(B). It is argued that in a (B) reorganization the statute can be satisfied where only 80% of the acquiree's stock is obtained solely for voting stock, so that additional acquisitions are irrelevant and need not be considered. In light of Congress' repeated, and increasingly sophisticated, enactments in this area, we are unpersuaded that such an important question would have been left unaddressed had Congress intended to leave open such a possibility. We are not prepared to believe that Congress intended either when it enacted the 1934, the 1939, or the 1954 statutes to permit a corporation to exchange stock tax-free for 80% of the stock of another and in a related transaction to purchase the remaining 20% for cash. The only question we see clearly left open by the legislative history is the degree of separation required between the two transactions before they can qualify as a creeping acquisition under the 1954 amendments. This is precisely the issue the Tax Court chose not to address, and it is the issue we now remand to the Tax Court for consideration.

C.

Besides finding support for the IRS position both in the design of the statute and in the legislative history, we find support in the regulations adopted by the Treasury Department construing these statutory provisions. We of course give weight to the statutory construction contemporaneously developed by the agency entrusted by Congress with the task of applying these laws. *See, e.g.*, *Norwegian Nitrogen Products Co. v. United States*, 288 U.S. 294, 315 (1933); *Edwards' Lessee v. Darby*, 25 U.S. (12 Wheat.) 206, 210 (1827); 2 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 7:14 (2d ed. 1979). The views of the Treasury on tax matters, while by no means definitive, undoubtedly reflect a familiarity with the intricacies of the tax code that surpasses our own.

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D.

Finally, we turn to the body of case law that has developed concerning (B) reorganizations to determine how previous courts have dealt with this question. Of the seven prior cases in this area, all to a greater or lesser degree support the result we have reached, and none supports the result reached by the Tax Court. We recognize that the Tax Court purported to distinguish these precedents from the case before it, and that reasonable persons may differ on the extent to which some of these cases directly control the question raised here. Nevertheless, after carefully reviewing the precedents, we are satisfied that the decision of the Tax Court represents a sharp break with the previous judicial constructions of this statute, and a departure from the usual rule of stare decisis, which applies with special force in the tax field where uncertainty and variety are ordinarily to be avoided.

....

IV.

We have stated our ruling, and the reasons that support it. In conclusion, we would like to respond briefly to the arguments raised by the Tax Court, the District Court of Delaware, and the taxpayers in this case against the rule we have reaffirmed today. The principal argument, repeated again and again, concerns the supposed lack of policy behind the rule forbidding cash in a (B) reorganization where the control requirement is met solely for voting stock. It is true that the Service has not pointed to tax loopholes that would be opened were the rule to be relaxed as appellees request. We also recognize, as the Tax Court and others have highlighted, that the rule may produce results which some would view as anomalous. For example, if Corporation X acquires 80% of Corporation Y's stock solely for voting stock, and is content to leave the remaining 20% outstanding, no one would question that a valid (B) reorganization has taken place. If Corporation X then decides to purchase stock from the remaining shareholders, the *Howard* rule[200] might result in loss of nontaxable treatment for the stock acquisition if the two transactions were found to be related. The Tax Court asserted that there is no conceivable Congressional policy that would justify such a result. Further, it argued, Congress could not have felt that prior cash purchases would forever ban a later successful (B) reorganization since the 1954 amendments, as the legislative history makes clear, specifically provided that prior cash purchases would not prevent a creeping acquisition. [footnote omitted].

While not without force, this line of argument does not in the end persuade us. First of all, as already discussed, the language of the statute, and the longstanding interpretation given it by the courts, are persuasive reasons for our holding even in the absence of any clear policy behind Congress' expression of its will. Furthermore, we perceive statutory anomalies of another sort which the Tax Court's rule would only magnify. It is clear from the regulations, for example, that a corporation which already owned as much as 80% of another's stock, acquired solely for cash, could in some circumstances acquire all or a part of the remainder solely for voting stock as a valid (B) reorganization. [footnote omitted]. Why, then, could not as little as 10% of an acquisition constitute a (B) reorganization, if made solely for voting stock, even though the

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[200] [The court reviewed *Howard v. Commissioner*, 238 F.2d 943 (7th Cir. 1956), *rev'g*, 24 T.C. 792 (1955), a case supporting the Commissioner's view, in part IIID of its opinion.]

remaining transactions totaling more than 80% were made for nonstock consideration? If it is true that Congress did not view related cash transactions as tainting a stock-acquisition reorganization, why would it enact a "solely for ... voting stock" requirement at all, except to the extent necessary to prevent mixed consideration of the sort employed in the "disguised sales" of the twenties?

Possibly, Congress' insertion of the "solely for ... voting stock" requirement into the 1934 Act was, as one commentator has suggested, an overreaction to a problem which could have been dealt with through more precise and discriminating measures.[201] But we do not think it appropriate for a court to tell Congress how to do its job in an area such as this. If a more refined statutory scheme would be appropriate, such changes should be sought from the body empowered to make them. While we adhere to the general practice of construing statutes so as to further their demonstrated policies, we have no license to rework whole statutory schemes in pursuit of policy goals which Congress has nowhere articulated. Appellees have not shown us any reason to believe that reaffirmation of the settled rule in this area will frustrate the Congressional purpose of making the (B) reorganization provision generally available to those who comply with the statutory requirements. [footnote omitted].

A second major argument, advanced primarily by the district court in *Pierson* [*v. United States*, 472 F. Supp. 957 (D. Del. 957 (D. Del. 1979)], is that the previous cases construing this statute are suspect because they did not give proper weight to the changes wrought by the 1954 amendments. In particular, the court argued the liberalization of the "boot" allowance in (C) reorganizations and the allowance of creeping (B) acquisitions showed that Congress had no intent or desire to forbid "boot" of up to 20% in a (B) reorganization. As we have discussed earlier, we draw the opposite conclusion from the legislative history. Liberalization of the (C) provision shows only that Congress, when it wished to do so, could grant explicit leeway in the reorganization rules. Nor do the creeping acquisition rules mark such a departure from a strict reading of the "solely" requirement as to persuade us that Congress intended to weaken it with respect to related transactions. One has only to look at the illustration given in the legislative history, with its separation of 16 years between the cash and stock transactions, to see that Congress did not indicate positive approval of the type of acquisition covered by the district court's holding. [footnote omitted].

A third argument asserts that reliance on the literal language of the 1954 Code, and in particular a focus on the interpretation of "acquisition," is unjustified because the 1954 Code was not intended to alter the status of (B) reorganizations under the 1934 and 1939 Codes. According to this argument, the acquisition of at least 80% of the acquiree's stock solely for voting stock was allowed under the pre-1954 version, and must still be allowed even though the present statute refers only to "the acquisition ... of stock" with no percentage specified. This argument assumes the answer to the question that is asked. As *Howard* and *Southwest Consolidated*[202] illustrate, it has been the undeviating understanding of courts, until now, that the pre-1954 statutes did not

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[201] See Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 TAX L. REV. 725, 731 (1971); Pierson v. United States, 472 F. Supp. 957, 968 n.37 (D. Del. 1979).

[202] [Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942).]

allow cash or other "boot" in a (B) reorganization. It cannot be inferred that Congress left intact a rule which never existed by enacting language inconsistent with such a rule.

Finally, we see no merit at all in the suggestion that we should permit "boot" in a (B) reorganization simply because "boot" is permitted in some instances in (A) and (C) reorganizations. Congress has never indicated that these three distinct categories of transactions are to be interpreted in *pari materia*. In fact, striking differences in the treatment of the three subsections have been evident in the history of the reorganization statutes. [footnote omitted]. We see no reason to believe a difference in the treatment of "boot" in these transactions is impermissible or irrational.

Accordingly, we vacate the judgment of the Tax Court insofar as it rests on a holding that taxpayers were entitled to summary judgment irrespective of whether the cash purchases in this case were related by purpose or timing to the stock exchange offer of 1970. The case will be remanded to the Tax Court for further proceedings consistent with this opinion.

Vacated and remanded.

Questions and comments:

1. The court's opinion provides a very good statement of the law of B reorganizations – complete with illustrative hypotheticals.

2. What is a "creeping acquisition?" How does § 368(a)(1)(B) apply to "creeping acquisitions?" *See* the fourth footnote of the court's opinion.

3. The court also accounted for the relative leniency of "C" reorganizations with respect to the use of boot.

4. In the last paragraph of part IIIB, the court states its view of what Congress intended. What is it?

5. In light of the relatively permissive nature of A reorganizations and C reorganizations, *infra*, with respect to matters of boot, do you think that the relative rigidity of B reorganizations is warranted?

6. In light of this holding, do you think that in planning a B reorganizations, *target* corporations should be permitted to make themselves into the corporation that the acquiring corporation wants?

- For example, the target corporation might redeem the shares of dissenting shareholders prior to the exchange of voting stock for stock.

- Or the target corporation might distribute assets that the acquiring corporation does not want to its shareholders.

Rev. Rul. 79-4, 1979-1 C.B. 150

….

ISSUE
Is the "solely for *** voting stock" requirement of §368 (a)(1)(B) of the Internal Revenue Code of 1954 violated in the situation described below where an acquired corporation's debt that is treated for federal income tax purposes as a debt of its guarantor-shareholder is repaid by the acquired corporation with funds furnished to it by the acquiring corporation?

FACTS
A, an individual, was the sole shareholder of corporation Y, and was the guarantor on an unsecured note of Y in the principal amount of 200x dollars issued to Z, an unrelated party, in exchange for a loan. Because of Y's inadequate capitalization, Z required that A guarantee the note as to principal and interest. The facts and circumstances, including but not limited to Y's thin capitalization, resulted in Z being treated for federal income tax purposes as having made the loan to A rather than Y and A being treated as having made a capital contribution of the 200x dollar loan proceeds to Y. A's initial basis in A's Y stock (100x dollars) was therefore increased to 300x dollars pursuant to § 1.118-1 of the Income Tax Regulations. Payments of principal and interest by Y to Z with respect to the loan were treated as discharging A's obligation to Z, and such amounts were taxable to A as constructive distributions under § 301 of the Code. In addition, Y's interest payments on the loan were considered as having been made by A. *See Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (1972), *aff'g* T.C.M. 1970-182. For financial accounting purposes, however, the loan was considered as made to Y and listed among its liabilities. At the time of the situation described below, Y had made all previous principal and interest payments on the loan as they became due.

In accordance with an agreement and plan of reorganization, X acquired all of the outstanding stock of Y from A in exchange for voting stock of X. The fair market value of the Y stock was calculated at 400x dollars with the 180x dollar remaining indebtedness on the Z loan being included in such calculation as an indebtedness of Y. A received 390x dollars of X stock, an amount equal to the 400x dollar fair market value of the Y stock at the date of the exchange less 10x dollars consideration for X's agreement to contribute 180x dollars to Y to satisfy the indebtedness to Z. The satisfaction of such indebtedness would eliminate A's potential liability as guarantor and would improve A's borrowing ability. X was willing to satisfy the indebtedness immediately to strengthen Y's financial position and to prevent a suit for reimbursement that would have arisen if A, as guarantor, had been required to pay the indebtedness on Y's default.

LAW AND ANALYSIS
Because the contribution of cash by X to Y and the repayment by Y of the indebtedness plus accrued interest was a condition for the exchange of the Y stock for the X stock, such contribution and repayment constitute additional consideration for the Y stock within the meaning of § 1.368-2(c) of the regulations and the "solely for * * * voting stock" requirement contained in § 368(a)(1)(B) of the Code is not satisfied. Consequently, the nonrecognition provisions of § 354(a)(1) are inapplicable and gain or loss realized on the exchange is recognized under § 1001.

In addition, because under *Plantation Patterns*, the indebtedness of Y to Z is considered as indebtedness of A to Z despite Y's timely payment of principal and interest to Z, and because the repayment of the outstanding indebtedness by Y was a condition for exchange of stock, A has received income in the amount of such repayment. [citations omitted]. Therefore, pursuant to § 1001, A will realize and recognize a gain on the exchange to the extent such income and the fair market value of the X stock received exceeds A's basis in the Y stock:

income from Y's repayment of indebtedness	180x
fair market value of X stock received	390x
Total	570x
Less A's basis in Y stock	300x
gain realized by and recognized to A	270x

A will therefore realize and recognize a gain of 270x dollars on the exchange, and A's basis in the X stock received will be 400x dollars, its cost in Y stock exchanged. Section 1012 of the Code.

HOLDING

The "solely for *** voting stock" requirement of § 368(a)(1)(B) of the Code is violated when the debt of Y (which is treated for federal income tax purposes as the debt of A) is repaid by Y with funds furnished by X, if such repayment is a condition for the exchange of the X and Y stock.

Questions and comments:

1. What if the liability were not made the obligation of shareholder A because of the rule of *Plantation Patterns* and repayment of the acquired corporation's liability were not a condition of the acquisition? As part of the plan, the acquiring corporation contributes cash to the acquired corporation to discharge the corporation's indebtedness to a third party that a shareholder had guaranteed. HELD: §§ 368(a)(1)(B) and 354(a)(1) apply. Gain or loss on exchange is not recognized. *See* Rev. Rul. 79-89, 1979-1 C.B. 152.

- What facts are critical to the difference in result?
- Payment of the obligation may not have been a condition of the reorganization, but what might make the guarantor-shareholder insist on such a condition?

Rev. Rul. 98-10, 1998-1 C.B. 643

ISSUE
Where a stock for stock acquisition otherwise qualifying under § 368(a)(1)(B) of the Internal Revenue Code is accompanied by an exchange of securities, how should the transaction be treated?

FACTS
....

Corporation X acquires all of the outstanding capital stock of Corporation Y in exchange for voting stock of X. Corporation Y is a solvent corporation. Prior to the exchange, Y has an issue of six percent fifteen-year debentures outstanding. Pursuant to the plan of reorganization, X acquires all the outstanding debentures of Y in exchange for an equal principal amount of new six percent fifteen-year debentures of X. Some of the debentures of Y are held by its shareholders, but a substantial proportion of the Y debentures are held by persons who own no stock.

X is in control of Y immediately after the acquisition of the Y stock. The X and Y debentures constitute "securities" within the meaning of § 354(a)(1) and, thus, do not represent an equity interest. Disregarding the exchange of debentures, the transaction meets the requirements of § 368(a)(1)(B).

LAW AND ANALYSIS
Section 368(a)(1)(B) provides that a reorganization includes the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation.

Section 1.368-2(c) of the Income Tax Regulations provides:

> In order to qualify as a "reorganization" under § 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation ..., and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, preferred stock or bonds in addition to all or a part of its voting stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of Corporation Y, the transaction is not a reorganization under § 368(a)(1)(B).

Section 354(a)(1) provides that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in another corporation a party to a reorganization.

In the circumstances set forth above, the Y shareholders receive exclusively voting stock of X as consideration for the exchange of their Y stock. The fact that a substantial proportion of the Y debentures is held by bondholders who own no stock in Y has the effect of ensuring that the

value of the debentures issued by X in exchange for the debentures of Y realistically reflects the value of the Y debentures alone and does not constitute indirect nonqualifying consideration for the Y stock. Because the Y shareholders, in their capacity as shareholders, receive only X voting stock, the transaction constitutes a reorganization within the meaning of § 368(a)(1)(B).

Although the acquisition by X of the debentures of Y in exchange for debentures of X occurs as part of the overall transaction, it is not a part of the stock-for-stock exchange which qualifies as a reorganization. It is, however, an exchange of securities in parties to a reorganization which occurs in pursuance of the plan of reorganization, and, therefore, meets all the conditions of § 354(a)(1). Accordingly, any gain or loss realized by the debenture holders of Y as a result of their exchange of their Y debentures for an equal principal amount of debentures of X will not be recognized. § 354(a)(1). If, under different facts, the principal amount of the debentures of X was greater than the principal amount of the debentures of Y, §§ 354(a)(2) and 356(d) would apply to require the debenture holders of Y to recognize some or all of any gain realized.

HOLDING

The exchange of Y stock for X stock is a reorganization described in § 368(a)(1)(B); and any gain or loss realized by the shareholders of Y as a result of the exchange will not be recognized. § 354(a)(1).

The separate exchange of Y debentures for X debentures is an exchange in pursuance of the plan of reorganization described in § 368(a)(1)(B). Thus, any gain or loss realized by the debenture holders of Y as a result of their exchange of their Y debentures for an equal principal amount of debentures of X will not be recognized. § 354(a)(1).

In certain cases, rights to acquire stock of a party to a reorganization are "securities" for purposes of § 354. *See* § 1.354-1(e) (as amended by T.D. 8752, 1998-9 I.R.B. 4, effective for exchanges occurring on or after March 9, 1998). An exchange of such rights, although separate from a § 368 exchange, may also be in pursuance of the plan of reorganization. In such cases, any gain or loss realized by the holder of such rights as a result of the exchange will not be recognized. § 354(a)(1).

EFFECT ON OTHER REVENUE RULINGS

....

Rev. Rul. 70-41, 1970-1 C.B. 77, deals with a stock-for-stock exchange accompanied by an exchange of Acquired debentures for Acquiring stock. It is modified such that § 354 applies to the exchange of debentures for stock.

Rev. Rul. 78-408, 1978-2 C.B. 203, deals with a stock-for-stock exchange accompanied by a warrant-for-warrant exchange. It is modified such that § 354 applies to the exchange of warrants provided that the warrants constitute securities. *See* § 1.354-1(e).

Rev. Ruls. 68-637, 1968-2 C.B. 158, and 70-269, 1970-1 C.B. 82, similarly deals [*sic*] with reorganization exchanges accompanied by exchanges of warrants or options. Each is amplified

such that § 354 applies to the exchange of warrants or options, provided that, as in Rev. Rul. 78-408 above, the warrants or options constitute securities.

....

Questions and comments:

1. In Rev. Rul. 98-10, there was a stock-for-stock exchange and a debenture-for-debenture exchange.

2. Suppose:
•Corporation X procures 80% of the stock of Corporation Y by exchanging voting stock with the shareholders of Corporation Y. As part of the plan, Corporation X procures the other 20% of the stock of Corporation Y by purchasing it from Corporation Y shareholders. Corporation X procured control of Corporation X "solely for voting stock." HELD: This is not a tax-free reorganization pursuant to § 368(a)(1)(B). Why not? *See* Rev. Rul. 75-123, 1975-1 C.B. 11.

•Corporation X acquired all of the outstanding stock of Y corporation from the shareholders of Y in exchange for voting stock of X. X was in control of Y immediately after the exchange within the meaning of § 368(c) of the Code. Y was a solvent corporation but had need of additional working capital for expansion purposes. At the time of the exchange of the Y stock for X stock, and as part of the overall plan, X purchased authorized but unissued shares of Y stock for cash as a means of providing additional capital to Y. None of the cash received by Y was distributed or otherwise paid out to its former shareholders. Is this a tax-free exchange under §§ 368(a)(1)(B) and 354(a)(1)? What did the shareholders of Corporation Y receive? *See* Rev. Rul. 72-522, 1972-2 C.B. 215.

•Corporation P and Corporation Y are publicly owned corporations. Y had outstanding various classes of preferred stock and 9,000,000 shares of common stock of which 300,000 shares were owned by Corporation P. P had purchased its Y stock for cash, on the open market, within a short period of time before the transactions described below. P wished to acquire the stock of Y in a transaction that would qualify as a reorganization defined in § 368(a)(1)(B). Because of its prior purchase of Y stock, P wished to preclude the possibility that such purchase, and the subsequent exchange of Y stock for voting stock of P, would be treated as a single transaction which would violate the "solely for voting stock" requirement of § 368(a)(1)(B). Prior to the offer by P to the shareholders of Y to exchange their Y stock for voting stock of P, P unconditionally sold for cash all of its Y stock to X, an unrelated third party. P had no agreement or other arrangement to reacquire the stock of Y. P thereafter acquired all of the outstanding stock of Y, which was sufficient to gain control of Corporation Y, in exchange for voting stock of P. HELD: The prior purchase for cash by Corporation P of the shares of Corporation Y will not violate the "solely for voting stock" requirement of § 368(a)(1)(B), since such stock was unconditionally sold to an unrelated third party prior to the offer by Corporation P to the shareholders of Corporation Y. Rev. Rul. 72-354, 1972-2 C.B. 216.

•How is this different from *Chapman*?

•Corporation X wants to acquire all of the stock of Corporation Y in a stock-for-stock B acquisition. Shareholders owning 25% of the outstanding stock of Corporation Y elect not to participate. Corporation Y establishes an escrow account and provides enough funds to pay the shareholders of Corporation Y who wish not to participate in the exchange. Corporation X made no payments to Corporation Y or to the shareholders of Corporation Y. Is this a tax-free exchange under §§ 368(a)(1)(B) and 354(a)(1)? *See* Rev. Rul. 68-285, 1968-1 C.B. 147.

•What if Corporation X had funded the escrow account? *See id*.

Do the CALI exercise: Corporate Taxation: Reorganizations: B Reorganizations: Definition.

Do the CALI exercise: Corporate Taxation: Reorganizations: Tax Consequences of B Reorganizations.

C. "C" Reorganizations

Section 368(a)(1)(C) provides that a "C" reorganization occurs when the acquiring corporation acquires "*solely*" for its (or its parent's) *voting* stock "*substantially all*" of the target corporation's properties. In contrast to a B reorganization, i.e., stock-for-stock, a C reorganization is a stock-for-assets acquisition. The acquiring corporation's assumption of a liability "shall be disregarded." However, the acquiring corporation's assumption of liabilities, including taking property subject to a liability, is treated as money paid. § 368(a)(2)(B) (carryout ¶). The acquiring corporation may exchange consideration other than voting stock, but voting stock must account for at least 80% of the fmv of all of the target's assets. § 368(a)(2)(B)(iii). The terms of the exchange must comply with the requirements of § 354 in order for it to be a non-recognition event. The focus of a C reorganization is the acquisition of assets.[203] The court in *Chapman* gave us some background of how C reorganizations emerged in their current form.

> *Voting Stock*: In B and C reorganizations, the acquiring corporation may exchange *solely voting stock*. This means the voting interest of existing shareholders will be diluted. The acquiring corporation can execute an A reorganization with exchanges of other forms of equity.

The target corporation parts with assets and acquires stock. Lest it retain that stock and realize gain without payment of income tax, § 368(a)(2)(G)(i) requires the acquired corporation to distribute "the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization." Any distribution to creditors in connection with a liquidation which is pursuant to the plan of reorganization is treated as "pursuant to the plan of reorganization." § 368(a)(2)(G)(i). The Secretary may waive this distribution requirement upon conditions that she may prescribe. § 368(a)(2)(G)(ii).

[203] By contrast, the focus of a "D" reorganization is "control" of the transferee corporation.

"Substantially all" is hardly a precise standard – something that those who plan reorganizations naturally want. The phrase appears elsewhere in the reorganization rules. The Service has issued a revenue procedure that sets forth a litmus test of what constitutes "substantially all" of a corporation's assets for purposes of receiving an advance ruling. Rev. Proc. 77-37, 1977-2 C.B. 568 provides at 3.01:

> The "substantially all" requirement of §§ 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i) of the Code is satisfied if there is a transfer (and in the case of a surviving corporation under § 368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the *net assets* and at least 70 percent of the fair market value of the *gross assets* held by the corporation immediately prior to the transfer. All payments to dissenters and all redemptions and distributions (except for regular, normal distributions) made by the corporation immediately preceding the transfer and which are part of the plan of reorganization will be considered as assets held by the corporation immediately prior to the transfer.

[emphasis added].

•note that: (fmv of assets) − liabilities = (net assets)

With adequate information of the value of a target's assets, cash, and liabilities, an acquiring corporation can mechanically determine the minimum value of assets that it must acquire in exchange for voting to effectuate a C reorganization.[204] For example, if Target Corporation owns assets with a fair market value of $500,000 that are subject to liabilities of $150,000, 70% of the gross value of its assets is $350,000 and 90% of the net value of its assets is $315,000. To satisfy the Service's guidelines, an acquiring corporation must acquire at least $350,000 worth of Target's assets for stock.

•Now suppose that Target Corporation's assets are subject to liabilities of $100,000. To satisfy the Service's guidelines, an acquiring corporation must acquire at least $360,000 of Target Corporation's assets for stock.

•Can you make any generalizations concerning meeting Rev. Proc. 77-37's requirements and the amount of the target's debt that the acquiring corporation may assume? At some point, doesn't assumption of debt look more like a purchase than a mere "readjustment of corporate structure?"

Problem:

Suppose Acquiring Corporation exchanged $750K worth of voting stock for Target Corporation's assets worth $850K and subject to $100K of liabilities. Immediately prior to this exchange, Target exchanged $50K for the stock of dissenting shareholders.

•What were Target's gross assets and net assets immediately prior to Target's distributions to its dissenting shareholders?

•Under the guidelines of Rev. Proc. 77-37, would the exchange be treated as a C reorganization?

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[204] The same is true of an acquisitive "D" reorganization or a "G" reorganization. Note the inclusion of § 354(b)(1)(A) in the first sentence of the quoted excerpt of the revenue procedure.

The purchase of stock from a shareholder of the target or from the corporation itself for money property (i.e., boot) is treated as giving money or property as consideration for acquiring the target corporation's properties. Reg. § 1.368-2(d)(4)(i). It is treated for the "substantially all" determination the same as an assumption of liabilities. Such treatment of *purchases* of stock from minority shareholders inhibits an acquiring corporation's acquisition of substantially all of the target corporation's assets *solely* for *voting* stock.

Rev. Rul. 70-107, 1970-1 C.B. 78

The "solely for voting stock" requirement of § 368(a)(1)(C) of the Code is not met where a wholly-owned subsidiary acquires the assets of an unrelated corporation in exchange for voting stock of its parent that assumed part of the liabilities of the acquired corporation.

Corporation X owned all of the stock of corporation Y. Pursuant to a plan of reorganization intended to meet the requirements of § 368(a)(1)(C) of the Internal Revenue Code of 1954, Y directly acquired all the assets of corporation Z using voting stock of X previously transferred to it. Part of the liabilities of Z were assumed by Y and part were assumed by X.

Held, in view of the assumption by X of some of Z's liabilities, the exchange does not meet the "solely for voting stock" requirement of § 368(a)(1)(C) of the Code because that section provides in part that in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other shall be disregarded. Since X (the parent of Y) is not the acquiring corporation, its assumption of Z's liabilities will not be disregarded.

Questions and comments:

1. The acquiring corporation may transfer some or all of the assets it acquires from the target corporation to a subsidiary that it controls, i.e., a drop-down. § 368(a)(2)(C). But as the revenue ruling states, the parent and the drop-down may not share the target corporation's liabilities.

2. Read § 368(a)(1)(D) and § 368(a)(2)(A). D reorganizations (*infra*) also involve transfers of stock in exchange for assets. Section 368(b)(2)(A) provides that a reorganization described both by § 368(a)(1)(C) and § 368(a)(1)(D) is to be treated only as described by § 368(a)(1)(D). This provision is important in the context of divisive "D" reorganizations (rather than acquisitive "D" reorganizations). This is made clear in Rev. Rul. 88-48, *infra*.

3. Section 368(a)(2)(B) permits the acquiring corporation to transfer boot ("money or other property") to the target corporation provided that voting stock is exchanged for property that has a fair market value equal to 80% of the fair market value of all of the target's properties.

- •Notice: § 368(a)(1)(C) provides that liabilities are to be disregarded when determining whether the acquiring corporation has acquired "substantially all" of the assets of the target corporation.
  - •Section 368(a)(2)(B) creates a distinction between "non-liability boot" and "liability boot."
- •If the target corporation receives *no boot other than* relief from liabilities ("liability boot"), the analysis never moves past § 368(a)(1)(C).

•Section 368(a)(2)(B) states the rule when *boot other than* relief from liabilities ("non-liability boot") is included in the exchange. In such cases, relief from liabilities is *not* disregarded, but rather treated as money paid. Boot that includes "non-liability boot" cannot amount to 20% of the fair market value of all of the target's property. Stated differently, the acquiring corporation must acquire at least 80% of the fair market value of the target's properties "solely" for voting stock.

•Thus: analysis under § 368(a)(2)(B) requires that we count the assumption of liabilities in making the 80%-determination *when* non-liability boot is included in the exchange.

•Reg. 1.368-2(d)(3) provides in part: "[I]f the properties of Corporation A worth $100,000, were subject to $50,000 in liabilities, an acquisition of all the properties, subject to the liabilities, for *any* consideration *other than* solely voting stock would not qualify as a reorganization under this section since the liabilities alone are in excess of 20% of the fair market value of the properties."

•

4. *Too much liability?*: Reg. § 1.368-2(d)(1) provides that while an assumption of the target's liabilities may still be an exchange of assets "solely for voting stock," "it may in some cases ... so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 368(a)(1)(C) does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirement that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities."

5. Reg. § 1.368-2(d)(2) provides that the stock of both parent and subsidiary may not be exchanged for the assets of the target corporation.

Rev. Rul. 88-48, 1988-1 C.B. 117

ISSUE

If a transferor corporation sold 50% of its historic assets to unrelated parties for cash and immediately afterwards transferred to an acquiring corporation all of its assets (including the cash from the sale), did the subsequent transfer meet the "substantially all" requirement of § 368(a)(1)(C) of the Internal Revenue Code?

FACTS

X and Y were unrelated corporations that for many years were engaged in the hardware business. X operated two significant lines of business, a retail hardware business and a wholesale plumbing supply business. Y desired to acquire and continue to operate X's hardware business but did not desire to acquire the other business. Accordingly, pursuant to an overall plan, the following steps were taken. First, in a taxable transaction, X sold its entire interest in the plumbing supply business (constituting 50% of its total historic business assets) to purchasers unrelated to either X or Y or their shareholders. Second, X transferred all of its assets, including the cash proceeds from the sale, to Y solely for Y voting stock and the assumption of X's liabilities. Finally, in pursuance of the plan of reorganization, X distributed the Y stock (the sole asset X then held) to the X shareholders in complete liquidation.

Except for the issue relating to the "substantially all" requirement, the transfer of assets form X to Y constituted a corporate reorganization within the meaning of § 368(a)(1)(C) of the Code.

LAW AND ANALYSIS

Section 368(a)(1)(C) of the Code defines a corporate reorganization to include the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation.

Section 368(a)(1)(C) of the Code is intended to accommodate transactions that are, in effect, mergers, but which fail to meet the statutory requirements that would bring them within § 368(a)(1)(A). *See* S. REP. NO. 558, 73d Cong., 2d Sess. 16, 17, (1939), 1939-1 C.B. (Pt. 2) 586, 598.

Congress intended that transactions that are divisive in nature not qualify under § 368(a)(1)(C) of the Code, but, instead, be subject to the tests under § 368(a)(1)(D). *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 274 (1954). The enactment of § 368(a)(2)(G) indicates the continuing interest in furthering this underlying objective of preventing divisive C reorganizations.

Rev. Rul. 57-518, 1957-2 C.B. 253, concerns whether, in a C reorganization, assets may be retained to pay liabilities. The ruling states that what constitutes "substantially all" for purposes of § 368(a)(1)(C) of the Code depends on the facts and circumstances in each case. Rev. Rul. 57-518 exemplifies the Service's longstanding position that where some assets are transferred to the acquiring corporation and other assets retained, then the transaction may be divisive and so fail to meet the "substantially all" requirement of § 368(a)(1)(C). *See also* Rev. Rul. 78-47, 1978-1 C.B. 113.

In the present situation, 50% of the X assets acquired by Y consisted of cash from the sale of one of X's significant historic businesses. Although Y acquired substantially all the assets X held at the time of transfer, the prior sale prevented Y from acquiring substantially all of X historic business assets. The transaction here at issue, however, was not divisive. The sale proceeds were not retained by the transferor corporation or its shareholders, but were transferred to the acquiring corporation. Moreover, the prior sale of the historic assets was to unrelated purchasers, and the X shareholders retained no interest, direct or indirect, in these assets. Under these circumstance, the "substantially all" requirement of § 368(a)(1)(C) was met because all of the assets of X were transferred to Y.

HOLDING

The transfer of all of its assets by X to Y met the "substantially all" requirement of § 368(a)(1)(C) of the Code, even though immediately prior to the transfer X sold 50% of its historic business assets to unrelated parties for cash and transferred that cash to Y instead of the historic assets.

Questions and comments:

1. Did the C reorganization in this ruling violate any of the policies we expect to be pursued in a reorganization?

•Do you think it significant that X sold its interest in the plumbing supply business in a *taxable* transaction rather than a tax-deferred transaction?

2. What requirement does § 368(a)(2)(G) prescribe? Compare § 368(a)(2)(G) with the last clause of § 368(a)(1)(D).

3. Cash used by the target corporation "to pay the regular quarterly dividend prior to the reorganization exchange is not taken into account in determining whether [the acquiring corporation] acquired "substantially all of the properties" of [the target corporation] within the meaning of § 368(a)(1)(C) ... However, if payment of the dividend occurs after the reorganization exchange, both the cash to pay the dividend and the amount of the liability for payment of the dividend will be taken into account in determining whether [the acquiring corporation] acquired 'substantially all the properties' of [the target corporation]." Rev. Rul. 74-457, 1974-2 C.B. 122.

4. Creeping C reorganization: The regulations now specify that a creeping C reorganization does not fail the "solely for voting stock" requirement so long as –

1. money and other property distributed to target shareholders – counting neither distributions of money or property to the acquiring corporation nor to creditors of the target, PLUS
2. liabilities of the target corporation that the acquiring corporation acquires

do not exceed 20% of the value of the target's assets. Reg. § 1.368-2(d)(4)(i).

Problem:

1. Corporation P (P) holds 60% of the Corporation T (T) stock that P purchased several years ago in an unrelated transaction. T has 100 shares of stock outstanding. The other 40% of the T stock is owned by Corporation X (X), an unrelated corporation. T has properties with a fair market value of $110 and liabilities of $10. T transfers all of its properties to P. In exchange, P assumes the $10 of liabilities, and transfers to T $30 of P voting stock and $10 of cash. T distributes the P voting stock and $10 of cash to X and liquidates. *See* Reg. § 1.368-2(d)(4)(ii), Example 1.

Do the CALI exercise: Corporate Taxation: Reorganizations: C Reorganizations: Definition.

Do the CALI exercise: Corporate Taxation: Reorganizations: Tax Consequences of C Reorganizations.

D. Acquisitive "D" Reorganizations

Read § 354(a)(1)(D) and § 354(a, b).

A "D" Reorganization can effectuate a corporate acquisition.[205] An acquisitive D reorganization is subject to the strictures of § 354. It occurs when a corporation transfers "all or a part of its assets to another corporation if immediately after the transfer the transferor, one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred[.]" § 368(a)(1)(D).[206] "Control" means at least 50% stock ownership by vote *or* by value. § 368(a)(2)(H)(i) (cross-referencing § 304(c)). Recall that § 304(c) enlarges the relationships among which there is attribution of ownership.

- The stock or securities of the corporate transferee of assets must be distributed in a transaction qualifying under §§ 354, 355, or 356. § 368(a)(1)(D). [We defer until later distributions that qualify for tax-deferred treatment under § 355. Such distributions occur in the context of divisive reorganizations. Section 356 states boot rules about which we initially have some intuition].

The phrase "all or a part" in § 368(a)(1)(D) when referring to the assets that must be transferred generally has the same meaning as "substantially all" as used in § 368(a)(1)(C). Thus, for private letter ruling purposes, the guidelines of Rev. Proc. 77-37 apply to acquisitive D reorganizations as well as to C reorganizations. Section 354(b)(1)(A) uses the phrase "substantially all" of the assets when conditioning tax-deferred treatment of acquisitive reorganizations.

In A, B, or C reorganizations, shareholders of the target corporation typically surrender their shares and therefore surrender control of the target corporation. Section 368(a)(1)(D), by contrast, does not require an "exchange" and does not specify the type of consideration (e.g., voting stock) that must be given. Section 368(a)(1)(D) requires only a "transfer" of "assets." The statute does not preclude an all cash D reorganization. A continuity of proprietary interest is assured by the requirement that the transferor corporation or one or more of its shareholders "control" the transferee corporation. As noted above, the "control" requirement of D reorganizations is met by only 50% ownership of the target corporation's stock by vote *or* value.

The IRS has used the non-divisive D reorganization to attack taxpayer efforts to recognize losses without disposing of assets.

- Before repeal of the *General Utilities* rule, corporations paid no income on their distribution of property to their shareholders. Suppose –
  - Corporation X has substantial e&p and appreciated assets. Corporation X could liquidate and distribute its appreciated assets to its shareholders. Corporation X

[205] It can also effectuate a division of a single corporation into two or more corporations – a matter considered *infra*.

[206] In contrast to this focus on "control," the focus of C reorganizations is the *acquisition* of "substantially all" the target's assets "solely for voting stock."

paid no income tax. Corporation X's shareholders paid income tax at capital gains on the difference between their bases in their stock and the fmv of the assets that they received. Corporation X's e&p was wiped clean. Corporation X's shareholders would then transfer the assets that they received to a newly formed corporation, Corporation Y.

- Shareholders would have a stepped-up basis in their Corporation Y stock. Corporation Y would have a stepped-up basis in its assets with a fresh depreciation schedule.
- Without e&p, Corporation Y's distributions to shareholders would not be subject at the shareholder level to income tax at ordinary income rates. Essentially, there had been a bailout of the corporation's e&p.
- Corporation Y could issue preferred stock proportionately to holders of common stock, and the preferred stock would not § 306 stock.
- If shareholders did not retransfer all of the assets they received in the liquidation, they effectively received a dividend of the retained assets upon which they paid income tax at only capital gain rates.

Or suppose –

- Corporation X owns assets whose fmv is less than the shareholders' bases in their stock. Corporation X liquidates. Corporation X recognizes losses on its distribution of assets in a liquidation. Shareholders also recognize losses. Shareholders then transfer the assets to a new corporation Y in a § 351 transaction.

Repeal of the *General Utilities* doctrine eliminated at least some, but not all, of these tax avoidance possibilities. The IRS can characterize the substance of these transactions as D reorganizations. The 50% vote-or-value threshold of control, coupled with attribution under § 318, makes this easier.

Nevertheless, there is a role for non-divisive D reorganizations. When you read Rev. Rul. 2002-85, pay very close attention to the summaries of the *Groman* and *Bashford* cases – and congressional reaction to those cases. The United States Supreme Court decided those cases in 1937 and 1938 – before there was § 368(a)(2)(C). This is the background to triangular reorganizations, *infra*.

Rev. Rul. 2002-85, 2002-2 C.B. 986

SECTION 368(a)(1)(D) REORGANIZATION

Section 368. – Definitions Relating to Corporate Reorganizations, 26 CFR § 1.368-1, Purpose and scope of exception for reorganization exchanges.

....

ISSUE

Whether an acquiring corporation's transfer of a target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will prevent a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) of the Internal Revenue Code from so qualifying.

FACTS

A, an individual, owns 100% of T, a state X corporation. A also owns 100% of P, a state Y corporation. For valid business reasons and pursuant to a plan of reorganization, (i) T transfers all of its assets to P in exchange for consideration consisting of 70% P voting stock and 30% cash, (ii) T then liquidates, distributing the P voting stock and cash to A, and (iii) P subsequently transfers all of the T assets to S, a preexisting, wholly owned state X subsidiary of P, in exchange for stock of S. S will continue T's historic business after the transfer and P will retain the S stock. Without regard to P's transfer of all the T assets to S, the transaction qualifies as a reorganization under § 368(a)(1)(D).

LAW

Section 368(a)(1)(D) provides that the term reorganization means a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under §§ 354, 355, or 356.

Section 354(a) provides that, in general, no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354(b)(1) provides that § 354(a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of § 368(a)(1) unless (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 368(a)(2)(A) provides that if a transaction is described in both §§ 368(a)(1)(C) and 368(a)(1)(D), then, for purposes of subchapter C (other than for purposes of § 368(a)(2)(C)), such transaction shall be treated as described only in § 368(a)(1)(D).

Section 368(a)(2)(C) provides that a transaction otherwise qualifying under § 368(a)(1)(A), (B), (C), or (G) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled (as defined in § 368(c)) by the corporation acquiring such assets or stock.

Section 368(b) provides that the term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations in the case of a reorganization resulting from the acquisition by one corporation of the properties of another.

Congress enacted § 368(a)(2)(C) in response to the Supreme Court decisions in *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938). In *Groman*, the shareholders of one corporation (Target) entered into an agreement with another corporation (Parent) pursuant to which Target would merge into Parent's newly formed subsidiary (Sub). In the transaction, the Target shareholders transferred their Target shares to Sub in exchange for shares of Parent, shares of Sub, and cash, and Target liquidated. The Court concluded that, even though the statutory definition of "party to a reorganization" was not exclusive, Parent was not a party to the reorganization because it received nothing in the exchange. The Court then stated that an exchange that is pursuant to a plan of reorganization is not taxable to the extent the interest of the stockholders of a corporation continue to be definitely represented in substantial measure in a new or different corporation. The stock of Parent, however, did not represent a continued substantial interest in the assets conveyed to Sub. Because Parent was not a party to the reorganization, the Court held that the receipt of the stock of Parent was taxable.

In *Bashford*, a corporation (Parent) wished to acquire three competitors (Targets). Pursuant to a plan, Parent formed a new corporation (Sub) and acquired all the preferred shares and a majority of the common shares of Sub. Sub became the owner of the stock and assets of the Targets. The former stockholders of the Targets exchanged their shares in the Targets for shares of Sub, shares of Parent, and cash. Because any direct ownership by Parent of the Targets was transitory and without real substance, the Court saw no significant distinction between this transaction and the transaction in *Groman*. Therefore, the Court concluded that Parent was not a party to the reorganization. Hence, the Parent stock received by the shareholders of the Targets did not confer the requisite continuity of interest.

In 1954, Congress enacted § 368(a)(2)(C) in response to *Groman* and *Bashford*. *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 52, 273, 275 (1954). As originally enacted, § 368(a)(2)(C) applied only to reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), but Congress has since amended the statute to apply to other reorganizations. Specifically, Congress amended § 368(a)(2)(C) in 1964 to apply to reorganizations under § 368(a)(1)(B), and, in 1980, to reorganizations under § 368(a)(1)(G).

Section 1.368-2(k)(1) of the Income Tax Regulations restates the general rule of § 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations to be successively transferred to one or more corporations controlled (as defined in § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization.

Section 1.368-2(f) provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368-2(k).

To qualify as a reorganization under § 368, a transaction must satisfy the continuity of business enterprise (COBE) requirement. The COBE requirement is intended to ensure that

reorganizations are limited to readjustments of continuing interests in property under modified corporate form. § 1.368-1(d)(1). Section 1.368-1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business. Pursuant to § 1.368-1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its qualified group. Section 1.368-1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

In Rev. Rul. 88-48, 1988-1 C.B. 117, in a taxable transaction, corporation X sold 50% of its historic business assets to unrelated purchasers for cash. Immediately afterwards, pursuant to an overall plan, X transferred to corporation Y, a corporation unrelated to X and the purchasers, all of its assets, including the cash from the sale. The ruling holds that X's transfer of assets to Y satisfied the substantially all requirement of § 368(a)(1)(C).

In Rev. Rul. 2001-25, 2001-1 C.B. 1291, pursuant to a plan, corporation S, a wholly owned subsidiary of corporation P, merged with and into corporation T in a state law merger. Immediately after the merger and as part of a plan that included the merger, T sold 50% of its operating assets for cash to an unrelated corporation. After the sale of the assets to corporation X, T retained the sales proceeds. Without regard to the requirement that T hold substantially all of the assets of T and S immediately after the merger, the merger satisfied all the other requirements applicable to reorganizations under §§ 368(a)(1)(A) and 368(a)(2)(E). The Service ruled that even though T's post-merger sale of 50% of its operating assets prevented T from holding substantially all of its historic business assets immediately after the merger, because the sales proceeds continued to be held by T, the merger did not violate the requirement of § 368(a)(2)(E) that the surviving corporation hold substantially all of its properties after the transaction.

In Rev. Rul. 2001-24, 2001-1 C.B. 1290, corporation X merged with and into corporation S, a newly organized, wholly owned subsidiary of corporation P, in a transaction intended to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). S continued the historic business of X following the merger. Following the merger and as part of the plan of reorganization, P transferred the S stock to corporation S1, a preexisting, wholly owned subsidiary of P. The Service ruled that the transaction satisfied the continuity of business enterprise requirement of § 1.368-1(d). Analyzing whether P's transfer of the S stock to S1 caused P to fail to control S for purposes of § 368(a)(2)(D) and caused P to fail to be a party to the reorganization, the Service noted that the legislative history of § 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly. Section 1.368-2(k)(2) permits the transfer of stock or assets to a controlled corporation following a reverse triangular merger under §§ 368(a)(1)(A) and 368(a)(2)(E), which supports permitting P to transfer the S stock to S1 without causing the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). Furthermore, although §§ 368(a)(2)(C) and 1.368-2(k) do not specifically address P's transfer of S stock to S1 following a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D), § 368(a)(2)(C)

is permissive rather than exclusive or restrictive. Accordingly, the Service concluded that the transfer of the S stock to S1 would not cause P to be treated as not in control of S for purposes of § 368(a)(2)(D) and would not cause P to fail to be treated as a party to the reorganization.

ANALYSIS

Neither § 368(a)(2)(C) nor § 368(a)(2)(A) indicates that an acquiring corporation's transfer of assets to a controlled subsidiary necessarily prevents a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) from so qualifying. Because § 368(a)(2)(C) is permissive and not exclusive or restrictive, the absence of § 368(a)(1)(D) from § 368(a)(2)(C) does not indicate that such a transfer following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will prevent the transaction from qualifying as such. Furthermore, although § 368(a)(2)(A) contains the parenthetical exception "other than for purposes of [§ 368(a)(2)(C)]," that exception appears to have been provided in the same spirit as § 368(a)(2)(C), i.e., to resolve doubts about the qualification of transactions as reorganizations, and does not indicate that the transfer of assets to a controlled subsidiary necessarily prevents a transaction from qualifying as a reorganization under § 368(a)(1)(D). *See* S. REP. NO. 313, 99th Cong., 2d Sess. 914 (1986).

Accordingly, an acquiring corporation's transfer of assets to a controlled subsidiary following a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) will not cause a transaction to fail to qualify as such, provided that the original transferee is treated as acquiring substantially all of the assets of the target corporation, the transaction satisfies the COBE requirement and does not fail under the remote continuity principle of *Groman* and *Bashford*, and the transfer of assets to a controlled corporation does not prevent the original transferee from being a "party to the reorganization."

Section 354(b)(1)(A) requires that, in a reorganization under § 368(a)(1)(D), the corporation to which the assets are transferred acquire substantially all of the assets of the transferor of such assets. In this case, the requirement that P acquire substantially all of T's assets is satisfied because P retains the stock of S. *See* Rev. Rul. 2001-24; Rev. Rul. 88-48.

To qualify as a reorganization under § 368(a)(1)(D), a transaction must satisfy the COBE requirement of § 1.368-1(d). In the present transaction, P and S constitute a qualified group, and S will continue T's historic business after the transfer. Therefore, the transaction satisfies the COBE requirement.

As described above, Congress enacted § 368(a)(2)(C) in response to the Supreme Court's holdings in *Groman* and *Bashford*. After the enactment of § 368(a)(2)(C), however, the Service continued to apply the principles of *Groman* and *Bashford* to transactions that otherwise qualified as reorganizations under § 368(a)(1)(B). *See* Rev. Rul. 63-234, 1963-2 C.B. 148. In response to this position, Congress expanded the scope of § 368(a)(2)(C) to include reorganizations under § 368(a)(1)(B). Congress' response to the application of the principles of *Groman* and *Bashford* has been to limit the application of those principles. Implicit in Congress' enactment and expansion of § 368(a)(2)(C) is a rejection of the principle that the transfer of acquired stock or assets to a controlled subsidiary of the acquiring corporation creates a remote continuity problem that causes a transaction that otherwise qualifies as a reorganization to fail to

so qualify. *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. A134 (1954) (stating, after citing *Groman* and *Bashford* in reference to proposed legislation that ultimately became § 368(a)(2)(C), "a corporation may not acquire assets with the intention of transferring them to a stranger").

Under the COBE regulations, stock or assets acquired in transactions that satisfy certain provisions of § 368(a)(1) may be transferred without limitation to successive lower-tier controlled subsidiaries within a qualified group. The Preamble to the final COBE regulations states that "the IRS and Treasury believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny. Thus, [the final COBE regulations] do not separately articulate rules addressing remote continuity of interest." T.D. 8760, 1998-1 C.B. 803, Supplementary Information (Explanation of Provisions). Accordingly, a transfer of acquired stock or assets will not cause a transaction to fail for remote continuity if it satisfies the COBE requirement.

Under the facts described above, P's transfer of the T assets to S pursuant to the plan of reorganization satisfies the COBE requirement. Therefore, the transaction does not fail for remote continuity.

Section 368(b) provides that the term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations in the case of a reorganization resulting from the acquisition by one corporation of the properties of another. The use of the word "includes" in § 368(b) indicates that the definition of "party to a reorganization" is not exclusive. *See* § 7701(c); *Groman*, *supra*, at 86 (stating that "when an exclusive definition is intended the word 'means' is employed … whereas [in the definition of "party to a reorganization"] the word used is 'includes'"). Furthermore, § 1.368-2(f), which interprets § 368(b), provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to a reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368-2(k). Section 1.368-2(k) does not reference § 368(a)(1)(D). Nonetheless, because § 1.368-2(k) restates and interprets § 368(a)(2)(C), which is a permissive and not an exclusive or restrictive provision, § 1.368-2(k) also should be viewed as permissive and not exclusive or restrictive. Therefore, because §§ 368(b), 1.368-2(f), and 1.368-2(k) are not exclusive or restrictive provisions, the absence of § 368(a)(1)(D) from § 1.368-2(k) does not prevent a corporation from remaining a party to a reorganization even if the acquired stock or assets are transferred to a controlled subsidiary.

Reorganizations under § 368(a)(1)(D), like reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), are asset reorganizations. In reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C), the original transferee is treated as a party to a reorganization, even if the acquired assets are transferred to a controlled subsidiary of the original transferee. The differences between reorganizations under § 368(a)(1)(D) on the one hand and reorganizations under §§ 368(a)(1)(A) and 368(a)(1)(C) on the other hand do not warrant treating the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under § 368(a)(1)(D) differently from the original transferee in a reorganization under § 368(a)(1)(A) or 368(a)(1)(C) for purposes of § 368(b). Therefore, the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under § 368(a)(1)(D) is treated as a party

to the reorganization, notwithstanding the original transferee's transfer of acquired assets to a controlled subsidiary of the original transferee.

For the reasons set forth above, P's transfer of the T assets to S will not prevent P's acquisition of those assets from T in exchange for P voting stock and cash from qualifying as a reorganization under § 368(a)(1)(D).

HOLDING
An acquiring corporation's transfer of the target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization will not prevent a transaction that otherwise qualifies as a reorganization under § 368(a)(1)(D) from so qualifying.

Questions and comments:

1. In your copy of the Code, you may pencil in (1)(D) to § 368(a)(2)(C).

2. The revenue ruling offers both a statement of the IRS's position on certain acquisitions and an attitude. Note the summaries of several revenue rulings. Cumulatively, you get some idea of the many directions in which reorganizations may go in order to accommodate the wishes of interested parties.

3. The IRS took the position that § 368(a)(2)(C) includes D reorganizations – even though Congress did not so provide. It seems that the scope of triangular D reorganization will be defined by COBE rules.

4. Section 368(a)(2)(A) provides that when both § 368(a)(1)(C) and § 368(a)(1)(D) describe a reorganization, § 368(a)(1)(D) applies. This will make § 355 applicable to such situations, *except when* the requirements of § 354(b)(1) are met – in which case the D reorganization strongly resembles a C reorganization.

5. Under the facts of Rev. Rul. 2002-85, why was a D reorganization superior to a C reorganization?

6. Section 368(a)(1)(D) does not name the type of consideration that must be given in the exchange, i.e., it does not require an exchange of stock or securities. An all-cash D reorganization is therefore possible. Nevertheless, compliance with § 354(b)(2) is necessary, i.e., that "the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization." § 354(b)(1)(B). So long as the "same persons own, directly or indirectly, all the stock of the transferor and transferee corporation in identical proportions," (Reg. § 1.368-2(*l*)(2)(i)), the transaction will be deemed to satisfy the requirements of § 368(a)(1)(D) and § 354(b)(1)(B). Family members under the attribution rule of §318(a)(1) are treated as one individual. Reg. § 1.368-2(*l*)(2)(ii). Examples 1 and 2 from Reg. § 1.368-2(*l*)(3) are reprinted here:

Example 1. A owns all the stock of T and S. The T stock has a fair market value of $100x. T sells all of its assets to S in exchange for $100x of cash and immediately liquidates. Because

there is complete shareholder identity and proportionality of ownership in T and S, under ¶ (*l*)(2)(i) of this section, the requirements of §§ 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to ¶ (*l*)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A. The transaction qualifies as a reorganization described in § 368(a)(1)(D).

Example 2. The facts are the same as in Example 1 except that C, A's son, owns all of the stock of S. Under ¶ (*l*)(2)(ii) of this section, A and C are treated as one individual. Accordingly, there is complete shareholder identity and proportionality of ownership in T and S. Therefore, under ¶ (*l*)(2)(i) of this section, the requirements of §§ 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to ¶ (*l*)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the $100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A. A will be deemed to transfer the nominal share of S stock to C. The transaction qualifies as a reorganization described in § 368(a)(1)(D).

Do the CALI exercise: Corporate Taxation: Reorganizations: D Reorganizations: Definition.

E. Bankruptcy: G Reorganizations

A "transfer by a corporation of all or a part of its assets to another corporation in a title 11 or similar case ... if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, 355, or 356" is a reorganization. § 368(a)(1)(G). Section 368(a)(3)(C) provides that a transaction qualifying as a G reorganization and as any other type of reorganization – or tax-deferred under § 351 or § 332 – is governed by the rules governing "G" reorganizations.

Do the CALI exercise: Corporate Taxation: Reorganizations: G Reorganizations: Definition.

F. Triangular Reorganizations

The A, B, C, D, and G acquisitive reorganizations suffer from their susceptibility to considerations of state corporate laws and of other non-federal income tax considerations. The liabilities of a target corporation do not disappear when the target corporation is acquired, and an acquiring corporation may not be anxious to assume those liabilities. This is particularly true of unknown liabilities – which describes a lot products liability and environmental liability. The complete disappearance of the target corporation may not be something that the acquiring corporation desires, as when the target corporation owns such non-transferable assets as state licenses, franchises, non-compete covenants, or other contract rights. State corporation laws may

require shareholder approval of a corporate acquisition, both of the acquiring corporation and of the target corporation; obtaining such approval can be (prohibitively) costly.

The triangular reorganization emerged to handle these matters. The acquiring corporation forms a subsidiary corporation. The subsidiary corporation will become the acquired corporation or the acquired corporation. A triangular reorganization, as the name implies, involves three parties, *viz.*, the parent corporation that wants to make the acquisition, the parent corporation's subsidiary, and the target corporation. The parties can transfer stock and assets between themselves.

- •The target corporation can merge into the subsidiary corporation. The parent corporation or the subsidiary corporation (not both) can transfer stock to the target corporation or its shareholders. The target corporation or its shareholders can transfer stock or assets to the parent corporation or the subsidiary corporation. If the target corporation transfers assets to the parent corporation, the parent corporation can "drop them down" to the subsidiary corporation. The merger must fit within the rules of an A, B, C, or D reorganization.
  - •IMPORTANTLY: The subsidiary corporation can assume the target corporation's liabilities, thereby insulating the acquiring corporation from those liabilities.
  - •This form, where the parent's subsidiary merges *into* the target corporation is a *forward triangular merger*.

Or

- •The subsidiary corporation can merge into the target. The target corporation becomes the acquiring corporation. Again, there is a transfer of stock and assets between the corporations and their shareholders, and again, the merger must fit within the rules of an A, B, C, or D reorganization.
  - •IMPORTANTLY: The target corporation continues to exist. The target corporation continues to own its non-transferable assets, but is subject to the control of the parent corporation.
  - •This form, where the target merges *into* the parent corporation's subsidiary, is a *reverse triangular merger*.

Moreover

- •The parent corporation is the only shareholder of its subsidiary. Hence, shareholder approval of a corporate subsidiary will not be difficult to obtain. This is particularly useful when the parent corporation is a large, publicly traded corporation. That leaves only the cost of obtaining approval of the target's shareholders must still be incurred.
  - •Eliminating the expense of a shareholder vote at the level of the acquiring corporation would be quite beneficial if the acquiring corporation is a large, publicly traded corporation and the target corporation is a more closely-held corporation.

Before there was § 368(a)(2)(C, D, and E), the Supreme Court held in *Bashford* and *Groman* (discussed in Rev. Rul. 200-85, *supra*) that in the absence of receiving something in an exchange, a transferor was not a "party to a reorganization." Thus, there could not be a tax-deferred triangular merger in which a parent transfers its stock to a target corporation or its shareholders if the parent received nothing in return. The whole point of the triangular reorganization was to place assets into the subsidiary corporation rather than the parent

corporation. The target corporation or its shareholders likely will insist receiving stock of the parent corporation rather than stock of the subsidiary.

Since 1938, Congress responded incrementally by enacting § 368(a)(2)(C, D, and E). *See* Stephanie Hoffer & Dale A. Osterle, *Tax-Free Reorganizations: The Evolution and Revolution of Triangular Mergers*, 108 NW. U. L. REV. 1083, 1086-95 (2014) (recounting history of congressional amendments to § 368(a)(2) and triangular mergers). Treasury has also participated liberalizing the availability of triangular reorganizations. Triangular reorganizations can now occur under any of the reorganization types we have examined to this point. In addition, Reg. § 1.368-2(k)(1) provides that transfers of stock or property subsequent to a reorganization do not disqualify the reorganization, so long as the non-statutory (i.e., "common law") requirements are met and there is a distribution to shareholders. "Drop-downs" and "push-ups" can be tax-deferred, sometimes with reliance upon § 351 instead of § 368, as parties to a reorganization move stocks and assets between themselves.

1. B Triangular Reorganizations

A B reorganization is a voting stock for voting stock exchange. The target corporation does not go out of existence, and there is not strictly speaking a merger.

- The acquiring corporation does not assume the liabilities of the target corporation.
- The applicability of state statutes governing mergers is avoided.
- There can be no boot.
- The strict construction of that the court in *Chapman*, *supra*, gave § 368(a)(1)(B) applies.
- Solely the voting stock of the parent or solely the voting stock of the subsidiary may be used, but not both. Reg. § 1.368-2(c).
- The target corporation may redeem shares of its dissenting shareholders, so long as the funds do not come from the parent.

If a triangular structure is used and the subsidiary acts as the acquiring corporation, the parent will own a subsidiary and a subsidiary of a subsidiary. Section 368(a)(2)(C) and § 368(b)(2) (carryout ¶; acquiring corporation a "party to a reorganization" in straight B or triangular B) permits the parent corporation to exchange its voting stock for voting stock of the target corporation and then to transfer the voting stock of the target corporation to a corporation that it controls, i.e., a subsidiary. The effect of this arrangement is the same as it is for a straight B reorganization and there no second-tier subsidiary is created.

2. C Triangular Reorganization

A C reorganization is a voting stock for "substantially all" assets exchange.

- Solely the voting stock of the parent or solely the voting stock of the subsidiary, but not both. Reg. § 1.368-2(d)(1).
- Boot may be used. The mix of non-liability boot and liability boot is as discussed *supra*.
- The target must go out of existence and distribute the stock, securities, and other properties that it receives to its shareholders. § 368(a)(2)(H).

Section 368(a)(2)(C) and § 368(b)(2) (carryout ¶; acquiring corporation a "party to a reorganization" in straight C or triangular C) permits the parent corporation to exchange its voting stock for "substantially all of the properties" of the target corporation and then to transfer the properties of the target corporation to a corporation that it controls, i.e., a subsidiary.

3. Forward A or G Triangular Reorganizations: § 368(a)(2)(D)

Section 368(a)(2)(D) and § 369(b)(2) (carryout ¶, third sentence) permit a forward triangular merger through the exchange of the stock of the parent of the acquiring corporation for "substantially all of the properties of" the target corporation.

- The parent does not assume the liabilities of the target corporation.
- Non-statutory rules of proprietary interest apply, so up to 60% of the consideration given may be boot.
- The statute requires that only stock of the parent corporation may be used, i.e., that no stock of the acquiring corporation be used.
- Section 368(a)(2)(D)(ii) requires that the transaction would have qualified as an A reorganization if the merger had been into the parent.
- State laws governing mergers, are by definition, applicable.

Problem:

1. V Corporation, Y Corporation, and Z Corporation are C corporations. X is a domestic LLC and is wholly owned Y Corporation. V owns 100 percent of the outstanding stock of Y Corporation. Under State W law, Z merges into X. Pursuant to W state corporation law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z Corporation for stock of V Corporation. What is the federal income tax treatment of Z Corporation, of V Corporation, of Z Corporation shareholders, and of V Corporation shareholders? *See* Reg. § 1.368-2(b)(1)(iii), Example 4; § 368(a)(2)(D).

4. Reverse A Triangular Reorganizations: § 368(a)(2)(E)

Section 368(a)(2)(E) and § 368(b)(2) (carryout ¶, fourth sentence) permit a reverse triangular merger through the exchange of the *voting* stock of the parent of the merged corporation so long as (1) the corporation surviving the merger holds both substantially all of its properties and substantially of the properties of the merged corporation, and (2) former shareholders of the surviving corporation exchange sufficient stock to constitute control of the surviving corporation for voting stock of the parent. Thus, the parent corporation will control the surviving corporation. The number of shares constituting "control" is measured before the transaction. Reg. § 1.368-2(j)(3)(i). The parent's subsidiary, i.e., the merged corporation, does not survive the reorganization.

•While boot may be used, the use of the parent's voting stock to acquire sufficient stock to constitute control of the surviving corporation provides a built-in limitation on the amount of boot that may be used.
•Notice that in form, this reorganization is a stock for stock reorganization with some boot permitted.
•The target corporation survives.
•The exchange must be of a sufficient number of shares to constitute control. Thus, the parent must acquire by vote and value 80% or more of each and every class of stock of the target's stock. If the parent already owned 20% of any class of stock of the target corporation, this form of reverse triangular is not permitted.

Problems:
1. P Corporation owns all the stock of S Corporation. T Corporation has 1000 shares of common stock outstanding. P owns no T stock. On January 1, 2018, S merges into T. In the merger, T's shareholders surrender 950 shares of common stock in exchange for P voting stock. The holders of the other 50 shares (who dissent from the merger) are paid in cash with funds supplied by P. After the transaction, T holds all its own assets and all of S's assets. What are the income tax consequences to P Corporation, to T Corporation, and to the T shareholders who were paid cash for their shares? *See* Reg. § 1.368-2(j)(6), Example 1.

2. Same as #1, except that holders of 100 shares in corporation T, who dissented from the merger, are paid in cash with funds supplied by T (and not by P or S) and in the merger, T's remaining shareholders surrender 720 shares of common stock in exchange for P voting stock and 180 shares of common stock for cash supplied by P. What are the tax consequences to P Corporation, to T Corporation, and to the T shareholders who were paid cash for their shares? *See* Reg. § 1.368-2(j)(6), Example 2.

3. P Corporation owns all the stock of S Corporation. T Corporation has 1000 shares of common stock outstanding. On January 1, 2008, P purchased 201 shares of T's stock. On January 1, 2018 S merges into T. In the merger, T's shareholders (other than P) surrender 799 shares of T stock in exchange for P voting stock. What are the tax consequences to P Corporation, to T Corporation, and T Corporation's shareholders? *See* Reg. § 1.368-2(j)(6), Example 4.
•How difficult would it be to make the acquisition into a B reorganization?

4. P Corporation owns all the stock of S Corporation. The stock of T Corporation has a value of $75,000. On January 1, 2018, S merges into T. In the merger, T's shareholders surrender all their T stock in exchange for P voting stock. As part of the transaction, P contributes $25,000 to T in exchange for new shares of T stock. None of the cash received by T is distributed or otherwise paid out to former T shareholders. After the transaction, T holds all its own assets and all of S's assets. What are the income tax consequences to P Corporation and to T Corporation? *See* Reg. § 1.368-2(j)(6), Example 7.

5. Same facts as #4, except that R Corporation (a C corporation) contributed the $25,000 to T Corporation in exchange for T stock. What are the tax consequences to P Corporation and to T Corporation? *See* Reg. § 1.368-2(j)(6), Example 8.

5. Multi-Step Transactions, Forced B Reorganizations, Double Dummy Transactions, Etc.

Tax law and non-tax objectives do not always mesh perfectly in the context of reorganizations. Suppose that taxpayers desire a certain result, but the transaction they contemplate will not yield that result, and another transaction form would yield that result. Taxpayers may combine successive tax-deferred transactions to achieve their objectives. We consider here a relatively early court pronouncement on multi-step transactions, followed by two examples of multi-step transactions.

Consider first whether the IRS will permit *taxpayers* to invoke the step transaction doctrine.

King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969)

PER CURIAM:

... Judgment is entered for plaintiff ...

OPINION OF COMMISSIONER BERNHARDT, Commissioner:

This is an action to recover Federal income taxes paid by petitioner for the fiscal year ended June 30, 1960. The issues involve the proper characterization for tax purposes of the transaction in question, and the tax treatment of the resulting gain. The facts ... sustain the conclusion that the petitioner is entitled to recover.

Petitioner, King Enterprises, Inc., is a Tennessee corporation presently engaged in the business, inter alia, of holding and managing various investments. Prior to October 30, 1961, petitioner's business, then styled Fleetwood Coffee Company, was the sale of roasted coffee. It was one of 11 shareholders in Tenco, Inc., a corporation organized in 1951 to supply its shareholders with a reliable source of instant coffee for them to market under their own brand names. Tenco was financially successful over the years, and by 1959 had become the second largest producer of soluble coffee in the United States. Despite its financial success there was stockholder discontent.

Minute Maid Corporation had become by 1958 one of the nation's principal producers of frozen concentrated citrus juices. Because of financial reverses in 1957 Minute Maid decided to acquire other businesses in order to stabilize its income. ... A ... proposal was approved by the respective boards on August 25, 1959, and on September 3, 1959, petitioner and other Tenco shareholders signed an agreement with Minute Maid entitled "Purchase and Sale Agreement".

Pursuant to the Agreement providing for the sale of their Tenco stock to Minute Maid, the Tenco shareholders received a total consideration consisting of $3,000,000 in cash, $2,550,000 in promissory notes, [footnote omitted] and 311,996 shares of Minute Maid stock valued at $5,771,926. Petitioner's share of the total consideration consisted of $281,564.25 in cash, $239,329.40 in promissory notes, and 29,282 shares of Minute Maid stock valued at $541,717.

The Minute Maid stock received by Tenco stockholders represented 15.62 percent of the total outstanding Minute Maid shares, and constituted in excess of 50 percent of the total consideration received.

On December 10, 1959, the Minute Maid directors approved the November 24th recommendation of its general counsel to merge the company's four subsidiaries, including Tenco, into the parent company, and authorized that the merger be submitted to its stockholders for approval at a meeting scheduled for February 1960. Minute Maid's annual report to stockholders announced the merger plan about December 3, 1959. On January 5, 1960, Minute Maid requested a ruling from the Commissioner of Internal Revenue whether in the event of the proposed Tenco merger the basis of Tenco assets in Minute Maid's hands would be determined under § 334(b)(2)[207] of the Internal Revenue Code of 1954. This was approved by the Commissioner by ruling of February 25, 1960 that "Under the provisions of § 334(b)(2) that basis of the property received by Minute Maid upon the complete liquidation of Tenco will be determined by reference to the adjusted basis of the Tenco stock in the hands of Minute Maid." On April 30 and May 2, 1960, in accordance with the applicable state laws, Tenco and certain other subsidiaries were merged into Minute Maid.

On its income tax return for the fiscal year ended June 30, 1960, petitioner reported the cash and notes received as dividend income, subject to the 85 percent intercorporate dividends received deduction. The value of the Minute Maid stock received by petitioner was not reported, it being petitioner's position that such stock was received in connection with a nontaxable corporate reorganization. The District Director of Internal Revenue assessed a deficiency on the ground that the gain portion of the total consideration received (cash, notes, and Minute Maid stock) constituted taxable capital gain from the sale of a capital asset. Petitioner paid the deficiency, then sued here.

Petitioner contends that the transfer by the Tenco stockholders of their Tenco stock to Minute Maid in exchange for Minute Maid stock, cash and notes, followed by the merger of Tenco into Minute Maid, were steps in a unified transaction qualifying as a reorganization under § 368(a)(1)(A) of the 1954 Code. Consequently, petitioner continues, the Minute Maid stock was received by it pursuant to the plan of reorganization and is nontaxable as such, while the cash and notes received constitute a dividend distribution to which the 85 percent intercorporate dividends received deduction is applicable. The Government asserts that the transfer of Tenco stock to Minute Maid was an independent sales transaction; therefore, the entire gain realized by petitioner on the payment to it of cash, notes and Minute Maid stock is taxable as gain from the sale of a capital asset.

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[207] [Recall that basis adjustments are now covered by § 338. At the time of this decision, a step-up in basis could occur without payment of income tax.]

I.

The Reorganization Issue

The threshold issue is whether the transfer of Tenco stock to Minute Maid is to be treated for tax purposes as an independent transaction of sale, or as a transitory step in a transaction qualifying as a corporate reorganization. Significant tax consequences turn on which characterization is determined to be proper.

The general rule is that when property is sold or otherwise disposed of, any gain realized must also be recognized, absent an appropriate nonrecognition provision in the Internal Revenue Code. [footnote omitted]. One such nonrecognition provision, § 354(a)(1), [footnote omitted] provides in pertinent part:

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.[208]

By its terms, this exception to the general rule of taxation depends for its operation on the existence of a corporate reorganization. The term "reorganization", moreover, is a word of art in tax law and is specifically defined in § 368(a)(1) as comprising six types of transactions, exclusively.

....

The premise of the corporate reorganization provisions is that certain transactions constitute corporate readjustments and are not the proper occasion for the incidence of taxation. Congressional policy is to free from tax consequences those corporate reorganizations involving a continuity of business enterprise under modified corporate form and a continuity of interest on the part of the owners before and after, where there is no basic change in relationships and not a sufficient "cashing in" of proprietary interests to justify contemporaneous taxation.

It is not disputed that there was a Type A reorganization in April 1960 when Tenco and Minute Maid were merged in accordance with state law. Nor does the Government dispute that Minute Maid continued the business of Tenco following the merger, or that the former Tenco shareholders had a continuity of interest in the enterprise by virtue of their ownership of stock in Minute Maid received in the exchange. The disagreement centers on whether the initial exchange of stock was a step in a unified transaction pursuant to a "plan of reorganization."

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[208] In partial relaxation of this restrictive rule, § 356(a)(1) provides:

(A) § 354 * * * would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by § 354 * * * to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

The underlying theory of the petitioner's claim is that the tax consequences of business transactions are properly determined by their substance and not by the form in which they are cast. Thus petitioner views the substance of the transaction under review to be an acquisition by Minute Maid of Tenco's assets in exchange for transferring Minute Maid stock, cash and notes to Tenco's stockholders. [citations omitted]. The value of the Minute Maid stock received, which exceeded 50 percent of the total consideration, constituted a sufficient continuity of interest to support a Type A reorganization. [footnote omitted]. Petitioner concludes, therefore, that the net result of the entire transaction is a reorganization, not to be altered by splitting the entire transaction into its component transitory steps. [citations omitted]. Petitioner's conclusion is justified in fact and in law.

The problem of deciding whether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction, is a recurring problem in the field of tax law.[209] The principle that even extended business transactions have determinate limits for tax purposes is based on a strong preference for "closed transactions" upon which to impose tax consequences. This preference is tempered, however, with respect for the integrity of an entire transaction. Accordingly, the essence of the step transaction doctrine is that an "integrated transaction must not be broken into independent steps or, conversely, that the separate steps must be taken together in attaching tax consequences". BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, p. 18 (1966); [citation omitted]. The mere recitation of the doctrine, however, does not clarify the necessary relationship between the steps requisite to characterization as an integrated transaction.

Analysis of the reported cases and the diverse business transactions they encompass reveals that there is no universal test applicable to step transaction situations. *See Anheuser-Busch, Inc., v. Helvering*, 40 B.T.A. 1100 (1939), *aff'd*, 115 F.2d 662 (8th Cir. 1940), *cert. denied*, 312 U.S. 699 (1941); *American Bantam Car Co. v. Commissioner of Internal Revenue*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950); *South Bay Corp. v. Commissioner of Internal Revenue*, 345 F.2d 698 (2d Cir. 1965); *Commissioner of Internal Revenue v. Gordon*, 391 U.S. 83 (1968). It has been persuasively suggested that "the aphorisms about `closely related steps' and `integrated transactions' may have different meanings in different contexts, and that there may be not one rule, but several, depending on the substantive provision of the Code to which they are being applied". MINTZ AND PLUMB, STEP TRANSACTIONS 247, 252-253 (1954).

In their attempt to define the criteria upon which application of step transaction principles depend, the courts have enunciated two basic tests. The "interdependence test" requires an inquiry as to "whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series". Paul and Zimet, *Step Transactions*, SELECTED STUDIES IN FEDERAL TAXATION (2d Series, 1938), pp. 200, 254. *See also*, *American Bantam Car Co. v.*

[209] In coping with this and related problems, courts have enunciated a variety of doctrines, such as step transaction, business purpose, and substance over form. Although the various doctrines overlap and it is not always clear in a particular case which one is most appropriate, their common premise is that the substantive realities of a transaction determine its tax consequences.

Commissioner of Internal Revenue, *supra*; *ACF-Brill Motors Co. v. Commissioner of Internal Revenue*, 14 T.C. 263 (1950), *aff'd*, 189 F.2d 704 (3d Cir. 1951); *American Wire Fabrics Corp*., 16 T.C. 607 (1951). The "end result" test, on the other hand, establishes a standard whereby:

> * * * purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.[210]

Despite the real differences between the tests, each is faithful to the central purpose of the step transaction doctrine; that is, to assure that tax consequences turn on the substance of a transaction rather than on its form.

In support of its position that the step transaction doctrine is inapplicable to the facts of this case the Government correctly points out that there was no binding commitment for the merger of Tenco to follow the acquisition of its stock. Defendant erroneously concludes, however, that the absence of such a commitment here renders the step transaction doctrine inapplicable. The binding commitment requirement relied upon by the Government, was enunciated by the Supreme Court in *Commissioner of Internal Revenue v. Gordon*, *supra*, at 96, wherein the Court said "if one transaction is to be characterized as a `first step' there must be a binding commitment to take the later steps". ...

....

The opinion in *Gordon* contains not the slightest indication that the Supreme Court intended the binding commitment requirement as the touchstone of the step transaction doctrine in tax law. Nor is there any indication that the Court intended to overrule any prior decisions applying the step transaction doctrine to other types of transactions where there were no binding commitments. ...[211] Clearly, the step transaction doctrine would be a dead letter if restricted to situations where the parties were bound to take certain steps.

The doctrine derives vitality, rather, from its application where the form of a transaction does not require a particular further step be taken; but, once taken, the substance of the transaction reveals that the ultimate result was intended from the outset. *See Anheuser-Busch, Inc., v. Helvering*, *supra*; *Chase v. Commissioner of Internal Revenue*, 44 B.T.A. 39 (1941), *aff'd*, *Helvering v. Chase*, 128 F.2d 740 (2d Cir. 1942); *Edith G. Goldwasser*, 47 B.T.A. 445 (1942), *aff'd*, 142 F.2d 556 (2d Cir. 1944). In the majority of cases, it is the Government that relies on the step transaction doctrine for tax characterization. General application of the binding commitment

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[210] HERWITZ, BUSINESS PLANNING, p. 804 (1966). [citations omitted].

[211] *See* MINTZ v. [sic &] PLUMB, *supra*, at 285, where in regard to the similarly restrictive interdependence test it is concluded:

> [The interdependence test] applies * * * in cases * * * where the concept of a "plan or reorganization" is not pertinent. In reorganization cases, except possibly in applying the "control" requirement * * * the determinative test seems to be whether the step was intended, or even contemplated as an alternative possibility, under the plan or reorganization, and the test of "interdependence" has not been applied.

requirement would effectively insure taxpayers of virtual exemption from the doctrine merely by refraining from such commitments. Such an untoward result cannot be intended by the *Gordon* opinion ...

In the alternative, the Government asserts that the step transaction doctrine has no application to this case because the merger of Tenco into Minute Maid was not the intended end result from the outset. Although the appropriate standard is invoked, defendant's assertion is inconsistent with the inferences to be drawn from the record.

The operative facts emerging from the record in this case suggest that Minute Maid, desirous of diversifying its operations in order to stabilize its income, was presented with the opportunity to acquire the entire stock of Tenco for a bargain "price". Tenco's record of financial success and its asking price for Tenco stock of seven or eight times its earnings (while other companies were asking 20 times their earnings), without more, constituted an attractive investment. After the stock acquisition, moreover, Minute Maid was at liberty to operate Tenco as a wholly owned subsidiary, if it so desired. ...

....

The operative facts in this case clearly justify the inference that the merger of Tenco into Minute Maid was the intended result of the transaction in question from the outset, the initial exchange of stock constituting a mere transitory step. Accordingly, it is concluded that the initial exchange and subsequent merger were steps in a unified transaction qualifying as a Type A reorganization, and that petitioner received its Minute Maid stock pursuant to the plan of reorganization shown by the facts and circumstances above to have existed.[212]

II

The Dividend Issue

….

There can be little doubt, on the facts of the present case, that the receipt of boot by petitioner was essentially equivalent to a dividend. ... The amount of cash, promissory notes and Minute Maid stock, respectively, received by each of the Tenco stockholders was in direct proportion to his ownership of Tenco stock. …

III

The Deduction Issue

… [P]etitioner is entitled under § 243(a)(1) to a dividends received deduction in the amount of 85 percent of the dividend portion of its recognizable gain.

....

[212] A formal plan or reorganization is not necessary if the facts of the case show a plan to have existed. See William H. Redfield, 34 B.T.A. 967 (1936).

Questions and comments:

1. Here it was *taxpayer* who successfully invoked the step-transaction doctrine.

2. Why did taxpayer *want* the distribution of cash and notes to be treated as a dividend?

3. The Commissioner wanted to characterize the transaction between Tenco and Minute Maid as a sale. In what way(s) would such a characterization have changed the tax consequences of the transactions?

4. In *Intermountain Lumber*, there was a binding commitment that precluded the tax-deferred treatment of § 351.

5. Multi-step transactions are more common. They can be used to achieve results that the statutory reorganization forms appear not to permit, or more accurately, to provide for.

The Forced B Reorganization: A B reorganization is a voting stock for voting stock exchange. Suppose that the acquiring corporation wants to assure itself that it can acquire 100% of the shares of a target, but some target shareholders would do not want to exchange their shares for shares of the acquiring corporation. Consider the following:

Rev. Rul. 67-448, 1967-2 C.B. 144

Where, pursuant to a plan of reorganization, a parent corporation, P, issues some of its voting shares to its new subsidiary, S, and S immediately merges into unrelated corporation, Y, with the result that the shareholders of Y receive shares of P and P receives 80 percent or more of the shares of Y, the substance of the transaction is an acquisition by P, in exchange solely for part of its voting stock, of stock of Y within the meaning of section 368(a)(1)(B) of the Internal Revenue Code of 1954.

Advice has been requested whether the transaction described below qualifies as a reorganization within the meaning of section 368(a)(1)(B) of the Internal Revenue Code of 1954.

Corporation P and Corporation Y, incorporated in the same state, are publicly owned corporations. Corporation P wanted to acquire the business of Corporation Y but could do so with an effective result only if the corporate entity of Y were continued intact due to the necessity of preserving its status as a regulated public utility. P also desired to eliminate the possibility of minority shareholders in the event less than all of the shareholders of Y agreed to the transaction. Since an outright acquisition of stock pursuant to a reorganization as defined in section 368(a)(1)(B) of the Code would not achieve this result, the plan of reorganization was consummated as follows:

(a) P transferred shares of its voting stock to its newly formed subsidiary, S, in exchange for shares of S stock.

(b) S (whose only asset consisted of a block of the voting stock of P) merged into Y in a transaction which qualified as a statutory merger under the applicable state law.

(c) Pursuant to the plan of reorganization and by operation of state law, the S stock owned by P was converted into Y stock. At the same time the Y stock held by its shareholders was exchanged for the P stock received by Y on the merger of S into Y. The end result of these actions was that P acquired from the shareholders of Y in exchange for its own voting stock more than 95 percent of the stock of Y.

(d) Y shareholders owning less than five percent of the stock of Y dissented to the merger and had the right to receive the appraised value of their shares paid solely from the assets of Y. No funds, or other property, have been or will be provided by P for this purpose.

Thus, upon the consummation of the plan of reorganization Y became a wholly owned subsidiary of P.

At the time of the transaction P had no plan or intention to liquidate Y or to merge it into any other corporation.

The transaction described above does not constitute a reorganization within the meaning of either section 368(a)(1)(A) or section 368(a)(1)(C) of the Code because no assets of Y were transferred to nor acquired by another corporation in the transaction but rather all assets (except for amounts paid to dissenting shareholders) were retained in the same corporate entity.

Section 368(a)(1)(B) of the Code provides in part that the term 'reorganization' means the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

It is evident that the shortest route to the end result described above would have been achieved by a transfer of P voting stock directly to the shareholders of Y in exchange for their stock. This result is not negated because the transaction was cast in the form of a series of interrelated steps. The transitory existence of the new subsidiary, S, will be disregarded. The effect of all the steps taken in the series is that Y became a wholly owned subsidiary of P, and P transferred solely its voting stock to the former shareholders of Y.

Accordingly, the transaction will be treated as an acquisition by P, in exchange solely for part of its voting stock, of stock of Y in an amount

Recall: in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), the target (National Starch) corporation's largest shareholders owned 14.5% of the corporation's shares. These shareholders were "getting along in years" and would go along with the Unilever's acquisition plans only if the acquisition were tax-deferred – and tax-free to the extent of a basis step-up upon their deaths – as to them. Ultimately, Unilever acquired 79% of National Starch's shares for cash. The other shares of National Starch were exchanged for preferred stock. For devising what it called a "reverse subsidiary cash merger," the attorneys collected a very nice fee. National Starch was not permitted to deduct the fee.

constituting control (as defined in section 368(c) of the Code) of Y, which qualifies as a reorganization within the meaning of section 368(a)(1)(B) of the Code.

Questions and comments:

1. The acquiring corporation creates a transitory subsidiary to generate a merger under state law in which stock of the acquiring corporation is used. At that point, state merger law defines the rights of dissenting shareholders. They have appraisal rights, but do not have the right to retain their stock.

2. The so-called "double dummy" permits taxpayers to invoke the step transaction doctrine to achieve results that would be difficult if not impossible to achieve in any other manner.

Avoiding the common law requirements: Double Dummy (or Butterfly) Transactions: Back-to-back tax-deferred transactions can be used to avoid the common law requirements of reorganizations and to permit generous distributions of what would otherwise be taxable boot. The key to the transaction is invoke § 351 to provide one level of tax deferral rather than the reorganization provisions.

Acquiring Corporation and Target Corporation set up a New Parent Corporation. New Parent Corporation sets up two wholly-owned subsidiaries ("double dummy"). One of the dummies merges into the target corporation, and the other dummy merges into the acquiring corporation. Target Corporation and Acquiring Corporation are the "surviving" corporations. New Parent owns the two surviving corporations. Shareholders of Target Corporation and of Acquiring Corporation receive stock of New Parent Corporation in exchange for their stock of Target and Acquiring Corporations. They may also receive cash.

- If shareholders of Acquiring Corporation receive only stock of New Parent Corporation, the exchange qualifies as a B reorganization or an A reorganization under ¶ 368(a)(2)(E).

But:

- Shareholders of Target Corporation and shareholders of Acquiring Corporation may receive may exchange their stock for stock of New Parent Corporation plus cash. In the language of § 351, the shareholders would be transferors of property. They would receive stock of New Parent Corporation. So long as transferors own 80% by vote and value of every class of New Parent stock issued, the "transferors" receive tax-deferred treatment. Tax-deferred treatment is provided by § 351, not §§ 368/354.

Moreover:

- The non-statutory (common law) requirements of an acquisitive reorganization are not met. There is not a continuity of proprietary interest.

Rev. Rul. 84-71, 1984-1 C.B. 106

TRANSFER TO CORPORATION CONTROLLED BY TRANSFERORS; CONTINUITY OF INTEREST

Transfer to corporation controlled by transferors; continuity of interest. Upon reconsideration, the Service has concluded that the fact that "larger acquisitive transactions," such as those described in Rev. Ruls. 80-284 and 80-285, fail to meet the requirements for tax-free treatment under the reorganization provisions of the Code does not preclude the applicability of § 351(a) of the Code to transfers that may be described as part of such larger transactions. Rev. Ruls. 80-284 and 80-285 revoked.

The Internal Revenue Service has reconsidered Rev. Rul. 80-284, 1980-2 C.B. 117, and Rev. Rul. 80-285, 1980-2 C.B. 119, in which transfers that satisfied the technical requirements of § 351(a) of the Internal Revenue Code were nevertheless held to constitute taxable exchanges because they were part of larger acquisitive transactions that did not meet the continuity of interest test generally applicable to acquisitive reorganizations.

In Rev. Rul. 80-284, fourteen percent of T corporation's stock was held by A, president and chairman of the board, and eighty-six percent by the public. P, an unrelated, publicly held corporation wished to purchase the stock of T. All the T stockholders except A were willing to sell the T stock for cash. A wished to avoid recognition of gain.

In order to accommodate these wishes, the following transactions were carried out as part of an overall plan. First, P and A formed a new corporation, S. P transferred cash and other property to S in exchange solely for all of S's common stock; A transferred T stock to S solely in exchange for all of S's preferred stock. These transfers were intended to be tax-free under § 351 of the Code. Second, S organized a new corporation, D, and transferred to D the cash it had received from P in exchange for all the D common stock. Third, D was merged into T under state law. As a result of the merger, each share of T stock, except those shares held by S, were surrendered for cash equal to the stock's fair market value and each share of D stock was converted into T stock.

Rev. Rul. 80-284 concluded that if a purported § 351 exchange is an integral part of a larger transaction that fits a pattern common to acquisitive reorganizations, and if the continuity of shareholder interest requirement of section 1.368-1(b) of the Income Tax Regulations is not satisfied with respect to the larger transaction, then the transaction as a whole resembles a sale and the exchange cannot qualify under § 351 because that section is not intended to apply to sales. Rev. Rul. 80-285 reached a similar conclusion with respect to an asset, rather than stock, acquisition in which a purported § 351 exchange was also part of a larger acquisitive transaction.

Upon reconsideration, the Service has concluded that the fact that "larger acquisitive transactions," such as those described in Rev. Rul. 80-284 and Rev. Rul. 80-285, fail to meet the requirements for tax-free treatment under the reorganization provisions of the Code does not preclude the applicability of § 351(a) to transfers that may be described as part of such larger transactions, but also, either alone or in conjunction with other transfers, meet the requirements of § 351(a).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 80-284 and Rev. Rul. 80-285 are revoked.

Questions and comments:

1. Notice that the corporate structure is altered, i.e., there is a permanent holding company now in place.

2. The stock of the acquiring corporation is not diluted through the use of voting stock to acquire shares of the target corporation.

III. The Tax Rules for Acquisition Reorganizations: §§ 354, 356, Boot, and 381

A. Section 354

Read § 354.

Section 354(a) provides that no gain or loss is recognized "if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." Non-qualified preferred stock is not "stock or securities," § 354(a)(2)(C)(i), except for the recapitalization of a family-owned corporation, § 354(a)(C)(ii). Section 354 of course provides for deferral, not exclusion. Deferral occurs transfers of bases.[213] When something in addition to stock or securities is exchanged, we can say that it occurs outside the reorganization – and expect the deferral provisions not to be applicable.

B. Section 356: Boot

Sections 354, 355, and 356 provide for the tax-deferred treatment of reorganizations and name the conditions of such treatment. In many, if not most, reorganizations, there cannot as a practical matter be a perfect exchange of stock (or other indicia of proprietary interests). There will be boot as well. Section 356 names the tax consequences of receiving boot – and they should not be surprising. Read §§ 354 and 356.

[213] Review the review of the applicable statutory provisions at Chapter 9-I.

Commissioner v. Clark, 489 U.S. 726 (1989)

Justice STEVENS delivered the opinion of the Court.

... In the case we decide today, ... the taxpayer [footnote omitted] in an arm's-length transaction exchanged his interest in the acquired corporation for less than 1% of the stock of the acquiring corporation and a substantial cash payment. The taxpayer held no interest in the acquiring corporation prior to the reorganization. Viewing the exchange as a whole, we conclude that the cash payment is not appropriately characterized as a dividend. We accordingly agree with the Tax Court and with the Court of Appeals that the taxpayer is entitled to capital gains treatment of the cash payment.

I

In determining tax liability under the Internal Revenue Code of 1954, gain resulting from the sale or exchange of property is generally treated as capital gain, whereas the receipt of cash dividends is treated as ordinary income. [footnote omitted]. The Code, however, imposes no current tax on certain stock-for-stock exchanges. In particular, § 354(a)(1) provides, subject to various limitations, for nonrecognition of gain resulting from the exchange of stock or securities solely for other stock or securities, provided that the exchange is pursuant to a plan of corporate reorganization and that the stock or securities are those of a party to the reorganization. [footnote omitted]. 26 U.S.C. § 354(a)(1).

Under § 356(a)(1) of the Code, if such a stock-for-stock exchange is accompanied by additional consideration in the form of a cash payment or other property – something that tax practitioners refer to as "boot" – "then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." 26 U.S.C. § 356(a)(1). That is, if the shareholder receives boot, he or she must recognize the gain on the exchange up to the value of the boot. Boot is accordingly generally treated as a gain from the sale or exchange of property and is recognized in the current tax year.

Section 356(a)(2), which controls the decision in this case, creates an exception to that general rule. It provided in 1979:

> "If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation ... The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property." 26 U.S.C. § 356(a)(2) (1976 ed.).

Thus, if the "exchange ... has the effect of the distribution of a dividend," the boot must be treated as a dividend and is therefore appropriately taxed as ordinary income to the extent that gain is realized. In contrast, if the exchange does not have "the effect of the distribution of a dividend," the boot must be treated as a payment in exchange for property and, insofar as gain is realized, accorded capital gains treatment. The question in this case is thus whether the exchange

between the taxpayer and the acquiring corporation had "the effect of the distribution of a dividend" within the meaning of § 356(a)(2).

The relevant facts are easily summarized. For approximately 15 years prior to April 1979, the taxpayer was the president of Basin Surveys, Inc. (Basin). In January 1978, he became sole shareholder in Basin, a company in which he had invested approximately $85,000. The corporation operated a successful business providing various technical services to the petroleum industry. In 1978, N.L. Industries, Inc. (NL), a publicly owned corporation engaged in the manufacture and supply of petroleum equipment and services, initiated negotiations with the taxpayer regarding the possible acquisition of Basin. On April 3, 1979, after months of negotiations, the taxpayer and NL entered into a contract.

The agreement provided for a "triangular merger," whereby Basin was merged into a wholly owned subsidiary of NL. In exchange for transferring all of the outstanding shares in Basin to NL's subsidiary, the taxpayer elected to receive 300,000 shares of NL common stock and cash boot of $3,250,000, passing up an alternative offer of 425,000 shares of NL common stock. The 300,000 shares of NL issued to the taxpayer amounted to approximately 0.92% of the outstanding common shares of NL. If the taxpayer had instead accepted the pure stock-for-stock offer, he would have held approximately 1.3% of the outstanding common shares. The Commissioner and the taxpayer agree that the merger at issue qualifies as a reorganization under §§ 368(a)(1)(A) and (a)(2)(D). [footnote omitted].

Respondents filed a joint federal income tax return for 1979. As required by § 356(a)(1), they reported the cash boot as taxable gain. In calculating the tax owed, respondents characterized the payment as long-term capital gain. The Commissioner on audit disagreed with this characterization. In his view, the payment had "the effect of the distribution of a dividend" and was thus taxable as ordinary income up to $2,319,611, the amount of Basin's accumulated earnings and profits at the time of the merger. The Commissioner assessed a deficiency of $972,504.74.

Respondents petitioned for review in the Tax Court, which, in a reviewed decision, held in their favor. 86 T.C. 138 (1986). The court started from the premise that the question whether the boot payment had "the effect of the distribution of a dividend" turns on the choice between "two judicially articulated tests." *Id.*, at 140. Under the test advocated by the Commissioner and given voice in *Shimberg v. United States*, 577 F.2d 283 (CA5 1978), *cert. denied*, 439 U.S. 1115 (1979), the boot payment is treated as though it were made in a hypothetical redemption by the acquired corporation (Basin) immediately prior to the reorganization. Under this test, the cash payment received by the taxpayer indisputably would have been treated as a dividend. [footnote omitted]. The second test, urged by the taxpayer and finding support in *Wright v. United States*, 482 F.2d 600 (CA8 1973), proposes an alternative hypothetical redemption. Rather than concentrating on the taxpayer's prereorganization interest in the acquired corporation, this test requires that one imagine a pure stock-for-stock exchange, followed immediately by a postreorganization redemption of a portion of the taxpayer's shares in the acquiring corporation (NL) in return for a payment in an amount equal to the boot. Under § 302 of the Code, which defines when a redemption of stock should be treated as a distribution of dividend, NL's

redemption of 125,000 shares of its stock from the taxpayer in exchange for the $3,250,000 boot payment would have been treated as capital gain.[214]

The Tax Court rejected the prereorganization test favored by the Commissioner because it considered it improper "to view the cash payment as an isolated event totally separate from the reorganization." Indeed, it suggested that this test requires that courts make the "determination of dividend equivalency fantasizing that the reorganization does not exist." ... The court then acknowledged that a similar criticism could be made of the taxpayer's contention that the cash payment should be viewed as a postreorganization redemption. It concluded, however, that since it was perfectly clear that the cash payment would not have taken place without the reorganization, it was better to treat the boot "as the equivalent of a redemption *in the course of implementing the reorganization*," than "as having occurred prior *to and separate from the reorganization*." 86 T.C. at 152 (emphasis in original).[215]

The Court of Appeals for the Fourth Circuit affirmed. 828 F.2d 221 (1987). Like the Tax Court, it concluded that although "[s]ection 302 does not explicitly apply in the reorganization context," and although § 302 differs from § 356 in important respects, it nonetheless provides "the appropriate test for determining whether boot is ordinary income or a capital gain." Thus, as explicated in § 302(b)(2), if the taxpayer relinquished more than 20% of his corporate control and retained less than 50% of the voting shares after the distribution, the boot would be treated as capital gain. However, as the Court of Appeals recognized, "[b]ecause § 302 was designed to deal with a stock redemption by a single corporation, rather than a reorganization involving two companies, the section does not indicate which corporation [the taxpayer] lost interest in." Thus, like the Tax Court, the Court of Appeals was left to consider whether the hypothetical redemption should be treated as a prereorganization distribution coming from the acquired corporation or as a postreorganization distribution coming from the acquiring corporation. It concluded:

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[214] [The Tax Court applied § 302(b)(2).] As the Tax Court explained, receipt of the cash boot reduced the taxpayer's potential holdings in NL from 1.3% to 0.92%. 86 T.C. 138, 153 (1986). The taxpayer's holdings were thus approximately 71% of what they would have been absent the payment. *Ibid*. This fact, combined with the fact that the taxpayer held less than 50% of the voting stock of NL after the hypothetical redemption, would have qualified the "distribution" as "substantially disproportionate" under § 302(b)(2).

[215] The Tax Court stressed that to adopt the pre-reorganization view "would in effect resurrect the now discredited 'automatic dividend rule' ..., at least with respect to pro rata distributions made to an acquired corporation's shareholders pursuant to a plan of reorganization." On appeal, the Court of Appeals agreed. 828 F.2d 221, 226-227 (CA4 1987).

The "automatic dividend rule" developed as a result of some imprecise language in our decision in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). Although *Estate of Bedford* involved the recapitalization of a single corporation, the opinion employed broad language, asserting that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within [§ 356(a)(2)]." *Id.*, at 292. The Commissioner read this language as establishing as a matter of law that all payments of boot are to be treated as dividends to the extent of undistributed earnings and profits. *See* Rev. Rul. 56-220, 1956-1 Cum. Bull. 191. Commentators [citations omitted] and courts [citation omitted] however, soon came to criticize this rule. The courts have long since retreated from the "automatic dividend rule," [citation omitted], and the Commissioner has followed suit, *see* Rev. Rul. 74-515, 1974-2 Cum. Bull. 118. As our decision in this case makes plain, we agree that *Estate of Bedford* should not be read to require that all payments of boot be treated as dividends.

> "Based on the language and legislative history of § 356, the change-in-ownership principle of § 302, and the need to review the reorganization as an integrated transaction, we conclude that the boot should be characterized as a post-reorganization stock redemption by N.L. that affected [the taxpayer's] interest in the new corporation. Because this redemption reduced [the taxpayer's] N.L. holdings by more than 20%, the boot should be taxed as a capital gain." *Id.*, at 224-225.

This decision by the Court of Appeals for the Fourth Circuit is in conflict with the decision of the Fifth Circuit in *Shimberg v. United States*, 577 F.2d 283 (1978), in two important respects. In *Shimberg*, the court concluded that it was inappropriate to apply stock redemption principles in reorganization cases "on a wholesale basis." *Id.*, at 287; *see also ibid.*, n. 13. In addition, the court adopted the prereorganization test, holding that "§ 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred." *Id.*, at 288.

To resolve this conflict on a question of importance to the administration of the federal tax laws, we granted certiorari. 485 U.S. 933 (1988).

II

We agree with the Tax Court and the Court of Appeals for the Fourth Circuit that the question under § 356(a)(2) whether an "exchange ... has the effect of the distribution of a dividend" should be answered by examining the effect of the exchange as a whole. We think the language and history of the statute, as well as a commonsense understanding of the economic substance of the transaction at issue, support this approach.

The language of § 356(a) strongly supports our understanding that the transaction should be treated as an integrated whole. Section 356(a)(2) asks whether "*an exchange* is described in paragraph (1)" that "has the effect of the distribution of a dividend." (Emphasis supplied.) The statute does not provide that boot shall be treated as a dividend if its payment has the effect of the distribution of a dividend. Rather, the inquiry turns on whether the "exchange" has that effect. Moreover, paragraph (1), in turn, looks to whether "the property received in *the exchange* consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money." (Emphasis supplied.) Again, the statute plainly refers to one integrated transaction and, again, makes clear that we are to look to the character of the exchange as a whole and not simply its component parts. Finally, it is significant that § 356 expressly limits the extent to which boot may be taxed to the amount of gain realized in the reorganization. This limitation suggests that Congress intended that boot not be treated in isolation from the overall reorganization. *See* Levin, Adess, & McGaffey, *Boot Distributions in Corporate Reorganizations-Determination of Dividend Equivalency*, 30 TAX LAWYER 287, 303 (1977).

Our reading of the statute as requiring that the transaction be treated as a unified whole is reinforced by the well-established "step-transaction" doctrine, a doctrine that the Government has applied in related contexts, *see, e.g.*, Rev. Rul. 75-447, 1975-2 Cum. Bull. 113, and that we have expressly sanctioned, *see Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938);

Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). Under this doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus "linking together all interdependent steps with legal or business significance, rather than taking them in isolation," federal tax liability may be based "on a realistic view of the entire transaction." 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.5, p. 4-52 (1981).

Viewing the exchange in this case as an integrated whole, we are unable to accept the Commissioner's prereorganization analogy. The analogy severs the payment of boot from the context of the reorganization. Indeed, only by straining to abstract the payment of boot from the context of the overall exchange, and thus imagining that Basin made a distribution to the taxpayer independently of NL's planned acquisition, can we reach the rather counterintuitive conclusion urged by the Commissioner – that the taxpayer suffered no meaningful reduction in his ownership interest as a result of the cash payment. We conclude that such a limited view of the transaction is plainly inconsistent with the statute's direction that we look to the effect of the entire exchange.

The prereorganization analogy is further flawed in that it adopts an overly expansive reading of § 356(a)(2). As the Court of Appeals recognized, adoption of the prereorganization approach would "result in ordinary income treatment in most reorganizations because corporate boot is usually distributed pro rata to the shareholders of the target corporation." *[S]ee also* Golub, *"Boot" in Reorganizations – The Dividend Equivalency Test of Section 356(a)(2)*, 58 TAXES 904, 911 (1980); Note, 20 BOSTON COLLEGE L. REV. 601, 612 (1979). Such a reading of the statute would not simply constitute a return to the widely criticized "automatic dividend rule" (at least as to cases involving a pro rata payment to the shareholders of the acquired corporation), but also would be contrary to our standard approach to construing such provisions. The requirement of § 356(a)(2) that boot be treated as dividend in some circumstances is an exception from the general rule authorizing capital gains treatment for boot. In construing provisions such as § 356, in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision. [citation omitted]. *See Phillips, Inc. v. Walling*, 324 U.S. 490, 493 (1945) ("To extend an exemption to other than those plainly and unmistakably within its terms and spirit is to abuse the interpretative process and to frustrate the announced will of the people"). Given that Congress has enacted a general rule that treats boot as capital gain, we should not eviscerate that legislative judgment through an expansive reading of a somewhat ambiguous exception.

The postreorganization approach adopted by the Tax Court and the Court of Appeals is, in our view, preferable to the Commissioner's approach. Most significantly, this approach does a far better job of treating the payment of boot as a component of the overall exchange. Unlike the pre-reorganization view, this approach acknowledges that there would have been no cash payment absent the exchange and also that, by accepting the cash payment, the taxpayer experienced a meaningful reduction in his potential ownership interest.

Once the postreorganization approach is adopted, the result in this case is pellucidly clear. Section 302(a) of the Code provides that if a redemption fits within any one of the four categories set out in § 302(b), the redemption "shall be treated as a distribution in part or full

payment in exchange for the stock," and thus not regarded as a dividend. As the Tax Court and the Court of Appeals correctly determined, the hypothetical postreorganization redemption by NL of a portion of the taxpayer's shares satisfies at least one of the subsections of § 302(b).[216] In particular, the safe harbor provisions of subsection (b)(2) provide that redemptions in which the taxpayer relinquishes more than 20% of his or her share of the corporation's voting stock and retains less than 50% of the voting stock after the redemption shall not be treated as distributions of a dividend. Here, we treat the transaction as though NL redeemed 125,000 shares of its common stock (i.e., the number of shares of NL common stock forgone in favor of the boot) in return for a cash payment to the taxpayer of $3,250,000 (i.e., the amount of the boot). As a result of this redemption, the taxpayer's interest in NL was reduced from 1.3% of the outstanding common stock to 0.9%. Thus, the taxpayer relinquished approximately 29% of his interest in NL and retained less than a 1% voting interest in the corporation after the transaction, easily satisfying the "substantially disproportionate" standards of § 302(b)(2). We accordingly conclude that the boot payment did not have the effect of a dividend and that the payment was properly treated as capital gain.

III

The Commissioner objects to this "recasting [of] the merger transaction into a form different from that entered into by the parties," and argues that the Court of Appeals' formal adherence to the principles embodied in § 302 forced the court to stretch to "find a redemption to which to apply them, since the merger transaction entered into by the parties did not involve a redemption." There are a number of sufficient responses to this argument. We think it first worth emphasizing that the Commissioner overstates the extent to which the redemption is imagined. As the Court of Appeals for the Fifth Circuit noted in *Shimberg*, "[t]he theory behind tax-free corporate reorganizations is that the transaction is merely 'a continuance of the proprietary interests in the continuing enterprise under modified corporate form.' *Lewis v. Commissioner of Internal Revenue*, 176 F.2d 646, 648 (CA1 1949); Treas. Reg. § 1.368-1(b). *See generally* Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A. J. 40 (1969)." As a result, the boot-for-stock transaction can be viewed as a partial repurchase of stock by the continuing corporate enterprise – i.e., as a redemption. It is, of course, true that both the prereorganization and postreorganization analogies are somewhat artificial in that they imagine that the redemption occurred outside the confines of the actual reorganization. However, if forced to choose between the two analogies, the postreorganization view is the less artificial. Although both analogies "recast the merger transaction," the postreorganization view recognizes that a reorganization has taken place, while the prereorganization approach recasts the transaction to the exclusion of the overall exchange.

Moreover, we doubt that abandoning the prereorganization and postreorganization analogies and the principles of § 302 in favor of a less artificial understanding of the transaction would lead to a result different from that reached by the Court of Appeals. Although the statute is admittedly ambiguous and the legislative history sparse, we are persuaded – even without relying on § 302 –

[216] Because the mechanical requirements of subsection (b)(2) are met, we need not decide whether the hypothetical redemption might also qualify for capital gains treatment under the general "not essentially equivalent to a dividend" language of subsection (b)(1). Subsections (b)(3) and (b)(4), which deal with redemptions of all of the shareholder's stock and with partial liquidations, respectively, are not at issue in this case.

that Congress did not intend to except reorganizations such as that at issue here from the general rule allowing capital gains treatment for cash boot. 26 U.S.C. § 356(a)(1). The legislative history of § 356(a)(2), although perhaps generally "not illuminating," *Estate of Bedford*, 325 U.S., at 290, suggests that Congress was primarily concerned with preventing corporations from "siphon[ing] off" accumulated earnings and profits at a capital gains rate through the ruse of a reorganization. *See* Golub, 58 TAXES, at 905. This purpose is not served by denying capital gains treatment in a case such as this in which the taxpayer entered into an arm's-length transaction with a corporation in which he had no prior interest, exchanging his stock in the acquired corporation for less than a 1% interest in the acquiring corporation and a substantial cash boot.

Section 356(a)(2) finds its genesis in § 203(d)(2) of the Revenue Act of 1924. *See* 43 Stat. 257. Although modified slightly over the years, the provisions are in relevant substance identical. The accompanying House Report asserts that § 203(d)(2) was designed to "preven[t] evasion." H.R. REP. NO. 179, 68th Cong., 1st Sess., 15 (1924). Without further explication, both the House and Senate Reports simply rely on an example to explain, in the words of both Reports, "[t]he necessity for this provision." *Ibid.*; S. REP. NO. 398, 68th Cong., 1st Sess., 16 (1924). Significantly, the example describes a situation in which there was no change in the stockholders' relative ownership interests, but merely the creation of a wholly owned subsidiary as a mechanism for making a cash distribution to the shareholders:

> "Corporation A has capital stock of $100,000, and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
>
> "On the other hand, Corporation A may organize Corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of Corporation A in exchange for their stock in Corporation A. Under the existing law, the $50,000 distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain ... The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the ... rate on capital gain." *Ibid.*; H.R. REP. NO. 179, at 15.

The "effect" of the transaction in this example is to transfer accumulated earnings and profits to the shareholders without altering their respective ownership interests in the continuing enterprise.

Of course, this example should not be understood as exhaustive of the proper applications of § 356(a)(2). It is nonetheless noteworthy that neither the example, nor any other legislative source, evinces a congressional intent to tax boot accompanying a transaction that involves a bona fide exchange between unrelated parties in the context of a reorganization as though the payment was in fact a dividend. To the contrary, the purpose of avoiding tax evasion suggests that Congress did not intend to impose an ordinary income tax in such cases. Moreover, the legislative history of § 302 supports this reading of § 356(a)(2) as well. In explaining the "essentially equivalent to a dividend" language of § 302(b)(1) – language that is certainly similar to the "has the effect ... of a dividend" language of § 356(a)(2) – the Senate Finance Committee

made clear that the relevant inquiry is "whether or not the transaction by its nature may properly be characterized as a sale of stock...." S. REP. NO. 1622, 83d Cong., 2d Sess., 234 (1954); *cf. United States v. Davis*, 397 U.S., at 311.

Examining the instant transaction in light of the purpose of § 356(a)(2), the boot-for-stock exchange in this case "may properly be characterized as a sale of stock." Significantly, unlike traditional single corporation redemptions and unlike reorganizations involving commonly owned corporations, there is little risk that the reorganization at issue was used as a ruse to distribute a dividend. Rather, the transaction appears in all respects relevant to the narrow issue before us to have been comparable to an arm's-length sale by the taxpayer to NL. This conclusion, moreover, is supported by the findings of the Tax Court. The court found that "[t]here is not the slightest evidence that the cash payment was a concealed distribution from BASIN." As the Tax Court further noted, Basin lacked the funds to make such a distribution:

> "Indeed, it is hard to conceive that such a possibility could even have been considered, for a distribution of that amount was not only far in excess of the accumulated earnings and profits ($2,319,611), but also of the total assets of BASIN ($2,758,069). In fact, only if one takes into account unrealized appreciation in the value of BASIN's assets, including good will and/or going-concern value, can one possibly arrive at $3,250,000. Such a distribution could only be considered as the equivalent of a complete liquidation of BASIN...."

In this context, even without relying on § 302 and the post-reorganization analogy, we conclude that the boot is better characterized as a part of the proceeds of a sale of stock than as a proxy for a dividend. As such, the payment qualifies for capital gains treatment.

The judgment of the Court of Appeals is accordingly
Affirmed.

White, dissenting. Omitted.

Questions and comments:

1. Under the Commissioner's test, wouldn't the gain on acquisitions of closely held corporations for consideration that included boot (almost) always be treated as a dividend?

2. Consider what would be the characteristics of boot distributions that would be treated as a dividend?

3. Notice: the Court interpreted § 356(a) wherein Congress used the word "exchange." In § 356(b), Congress used the word "distribution." What is the tax treatment of a "distribution" of boot?

4. Reorganizations that meet statutory and common law requirements are tax-deferred transactions. The Court gives us a primer on the misuse of reorganization rules and so a sense of how they will be addressed.

C. Section 381: Tax Attributes

Section 381(c) names twenty-five tax attributes to which an acquiring corporation succeeds in an A, C, D, F, or G reorganization. § 381(a). (Of course, in a B or E reorganization, the corporation does not transfer any assets and does not go out of existence; there is no need for a special carryover provision.) Only in the case of an F reorganization may an acquiring corporation carry back an NOL. § 381(b).

Perhaps the most important tax attributes for our immediate purposes are provisions governing the carryover of net operating losses, earnings and profits (and earnings and profits deficits), and capital loss carryovers. These tax attributes could be particularly attractive features of a target corporation. Congress has acted to curb the emergence of a market in such attributes. We consider the gist of certain key Code sections here:

Section 381(c)(1, 2, and 3):

- *Net Operating Losses*: The acquiring corporation may claim the NOL of the target only to the extent of losses that the transferor or distributing corporation incurred in the year of transfer or distribution. § 381(c)(1)(B). The allowable NOL is limited to the same percentage of the NOL for that year as the percentage of the acquiring corporation's taxable income earned after the date of transfer or distribution. § 381(c)(1)(B). Except for an F reorganization, a loss corporation that acquires a profitable corporation may not carry back an NOL or a net capital loss for a taxable year ending after the date of transfer or distribution to a taxable year of the transferor or distributor. § 381(b)(3).
- *Earnings and Profits*: The acquiring corporation acquires the earnings and profits of the transferor or distributor corporation, whether or not there is a deficit, at the close of the date of distribution or transfer. § 381(c)(2)(A). However, a deficit of the transferor, distributor, or acquiring corporation may be used to offset earnings and profits only accumulated after the date of transfer. § 381(c)(1)(B). The acquiring corporation's earnings and profits for the taxable year of distribution or transfer are pro rated from the date of acquisition until the close of the taxable year. § 381(c)(1)(B).
- *Capital Loss Carryovers*: For purposes of § 1212 (providing for corporate capital losses to carry back three years and forward five years), the acquiring corporation may recognize the capital loss of the distributor or transferor corporation as a STCL (§ 381(c)(3)(B)) in the first taxable year ending after the distribution or transfer. § 381(c)(3)(A). The amount of loss that the acquiring corporation may recognize is its capital gain net income pro rated to the period of the taxable year after the date of transfer or distribution. § 381(c)(3)(B).

Section 382: The purpose of § 382 is to limit the use of a "loss corporation's" NOLs when there is a change in ownership of the corporation – which there most certainly is in the case of an acquisition. § 382(g)(1, 2 and 3) (definition of "ownership change"); § 382(k)(7) (definition of "5% shareholder"). Section 382(c) provides that the new corporation must continue the business of the old corporation, or the pre-acquisition NOL is lost. § 382(c)(1). *If* there is such continuity of business, the taxable income that may be offset by preacquisition NOLs is limited to the value of the old corporation (fmv of its stock, § 383(e)(1)) multiplied by the "tax exempt rate," a rate derived from the "applicable federal rate," (§ 382(f), referencing § 1274(d)). § 382(b)(1). This

amount can be increased under specified circumstances by recognition of the old corporation's built-in gains. § 381(h)(1)(A)(i).

Section 383: Section 383 limits the use of any "excess credit" following an ownership change to the tax on what remains of taxable income after application of § 382 limitations on NOLs. § 383(a). The principles of § 382 also limit the use of capital loss carryovers. § 383(b).

Section 384: Section 384 generally disallows the offsetting of preacquisition losses against recognized built-in gains of another corporation of a controlled group. § 384(a).

Section 269: Section 269 permits the "Secretary" (i.e., IRS) to deny a deduction, credit, or other allowance if the "principal purpose" of the acquisition of control of another corporation is "evasion or avoidance of Federal Income Tax" by acquiring such a deduction, credit, or other allowance. § 269(a). "Control" is ownership of stock possessing at least 50% of the voting power of the corporation *or* at least 50% of the value of all of a corporation's stock.

IV. Divisive ("D") Reorganizations and § 355 Distributions

A corporation that divides itself becomes two corporations. This will require that a transferor corporation transfer assets to a transferee corporation, and the transferor will control the transferee corporation. Shareholders of the original corporation will own the two (or more) corporations in some proportions. Such a transfer may be for purposes that, for policy reasons, should be tax-deferred. However, such tax-deferred treatment may encourage transactions for no purpose *other than* tax-deferral or to change the character of income, and such transactions should be subject to immediate income taxation. Recall the case of –

- *Gregory v. Helvering*, 293 U.S. 465 (1935), *supra*: Mrs. Gregory held all the shares of United Mortgage Corporation (UMC). UMC held 1000 shares of Monitor Corporation. If UMC distributed those shares to Mrs. Gregory, she would be in receipt of a dividend to the extent of UMC's earnings and profits. Mrs. Gregory caused UMC to organize the Averill Corporation, and she transferred the 1000 shares of Monitor to it. Averill issued its stock to Mrs. Gregory. Mrs. Gregory sold the stock, and treated her gain as capital gain. She apportioned her basis in UMC between Averill and UMC. In form, UMC divided itself into two corporations and distributed only stock to Mrs. Gregory. Such divisions and stock distributions might be tax-deferred reorganizations. The Supreme Court held, in essence, that in the absence of a valid business purpose, tax-deferred treatment would not be accorded the transaction. Presumably then, Mrs. Gregory was taxed on receipt of a dividend – the substance of the transaction.

A division of a corporation into two or more corporations may have one of three objectives:

1. The split of an existing corporation in which existing shareholders continue to own their shares of the corporation and of the corporation that it controls. This is "spin-off."
    - Shareholders could of course sell their shares in the corporation that was spun off. Were this to occur, there is a strong similarity between the transactions' forms

and the payment of dividend stock that enables shareholders to bail out earnings and profits with a pro rated reduction for recovery of basis at capital gain rates.

2. The split of an existing corporation in which existing shareholders exchange some or all their shares for shares of the corporation that the existing corporation controls. This is a "split-off."

•Existing shareholders surrender stock in exchange for other stock. They might sell that "other stock." In effect, shareholders have again bailed out earnings and profits at capital gain rates, but they had to surrender shares of their original stock that other shareholders might not have surrendered. When the dust settles, this transaction strongly resembles a redemption.

3. The split of an existing corporation into two (or more) corporations. Existing shareholders exchange their stock for the stock of one (or more) of the corporations into which it has split. This is a "split-up."

•This can resemble in effect a liquidation followed by a reincorporation.

A spin-off, split-off, or split-up may be accomplished in a tax-deferred manner. In such cases, "the corporation to which the assets are transferred" does not acquire "substantially all of the assets of the transferor of such assets" and so § 354 will not apply. § 354(b)(1). Therefore, a divisive D reorganization is subject to the strictures of § 355 – a provision that seems designed to prevent disguising what should be a taxable distribution to or exchange with shareholders as a tax-deferred reorganization. More specifically –

•§ 355: No gain or loss is recognized by a shareholder or security holder when a corporation distributes to a shareholder with respect to its stock OR distributes to a security holder in exchange for its securities solely stock or securities in a corporation that it controls (i.e., 80%-stock ownership by vote and value, § 368(c)) immediately before the distribution, (§ 355(a)(1)(A)) *if* –

•the corporation's distribution is of all the stock or securities that it held prior to the distribution (§ 355(a)(1)(D)(i)), or alternatively of stock constituting control if it establishes that retention of stock or of stock and securities in the controlled corporation was not part of a plan having as "one of its principal purposes" avoidance of federal income tax (§ 355(a)(1)(D)(ii));

•the tax-deferred treatment may apply irrespective of whether the distribution is pro rata with respect to the shareholders of the distributing corporation, whether shareholders of the distributing corporation surrender stock in the distributing corporation, and whether the distribution is in pursuance of a plan of a D-type reorganization. § 355(a)(2). While shareholders of the transferor must be in control of the corporation after the transfer, they do not have to own shares in the transferee corporation in the same proportion that they owned shares of the transferor corporation.

•the distributing corporation does not use the distribution principally "as a device" to distribute its or the controlled corporation's or both the distributing and controlled corporations' earnings and profits (§ 355(a)(1)(B));

•the transaction must be carried out for "one or more corporate business purposes." Reg. § 1.355-2(b)(1). Such a purpose is evidence that the transaction was not used principally as a device to distribute a corporation's earnings and profits. Reg. § 1.355-2(b)(4). Reg. § 1.355-2(b) provides that § 355 only applies if there is an independent business purpose for the transaction. The transaction must be "motivated, in whole or substantial part, by one or more corporate business purposes." *Id.* The potential for avoiding federal taxes is relevant in making this determination. *Id.* "The principal reason for this business purpose requirement is to provide nonrecognition treatment only to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms." *Id*. A shareholder purpose is not a corporate business purpose, although it may not always be possible to distinguish between a shareholder purpose and a corporate purpose. Reg. § 1.355-2(b)(2). Moreover: "If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, ... the separation is not carried out for that corporate business purpose." Reg. § 1.355-2(b)(3).

•whether a distribution of stock is a "device" to distribute earnings and profits turns upon facts and circumstances. Reg. § 1.355-2(d) (examples of evidence tending to show "device," tending to show absence of "device," and presumptively not a "device" ("ordinarily")).

•one or more of the shareholders who owned the original enterprise "own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. Reg. § 1.355-2(c)(1).

•the principal amount of securities in the controlled corporation received does not exceed the principal amount of securities surrendered in connection with the distribution, § 355(a)(3)(A)(i), and distributees do not receive securities in the controlled corporation without a surrender of securities in connection with the distribution, § 355(a)(3)(A)(ii);

•the distributing corporation and the controlled corporation(s) are engaged immediately after the distribution in the active conduct of a trade or business, OR immediately before the distribution(s), the distributing corporation had no assets other than stock or securities of the controlled corporations, all of which engage in the active conduct of a trade or business immediately after the distribution (§ 355(a)(1)(C) (referencing § 355(b));

•both the distributing corporation and the controlled corporation must be engaged in the active conduct or a trade or business immediately after the distribution (§ 355(b)(1)(A));[217]

[217] Sections 355(g and h) limit treating investing or real estate investment trusts as a separate trade or business.

•the trade or business must be one that has been carried on for the five years ending on the date of distribution and one that the controlling corporation did not acquire during that period in a taxable transaction (§ 355(b)(2)(B));
•control of the corporation conducting the trade or business was not acquired by the distributing corporation during the same five-year period through a taxable transaction (§ 355(b)(2)(C, D));
•stock of the controlled corporation that a corporation acquires during the five-year period in a recognition transaction is not treated as stock of the controlled corporation but rather as boot (§ 355(a)(3)(B));
•the stock (including non-qualified preferred stock) and securities may not be attributed to interest that has accrued on the securities on or after the beginning of the holder's holding period (§355(a)(3)(C). However, non-qualified preferred stock is not "stock or securities" unless distributed with respect to non-qualified stock (§ 355(a)(3)(D)).

Section 355's requirements coupled with common law requirements are designed to prevent bailing out earnings and profits. If the formation of the new corporation and the distribution of that corporation's shares are non-recognition events, the shareholders will be in a position to bail out the earnings and profits of the corporation at capital gain rates. Indeed, the stock received is "section 306 stock" "if the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock." § 306(c)(1)(B). Moreover, § 355's 5-year active trade or business requirement should prevent accumulation of relatively liquid assets that might be siphoned off into a separate corporation followed by distribution of that corporation's stock followed by shareholders' sale of it – clearly a device to bail out earnings and profits. Section 355(d and e), *infra*, further limit earnings and profits bailout opportunities.

Tax Consequences to Distributees: In the event a corporation does not transfer "substantially all" its assets to another corporation in a D reorganization, the reorganization must be qualified under § 355 if at all. A corporation that does not transfer substantially all its assets continues in existence. Hence the reorganization is divisive in effect. Section 355(a) establishes that distributees of stock or securities do not recognize gain or loss if the requirements of § 355(a) are met. They apportion the basis in what they exchanged to what they received, § 358(a), and tack the holding period that they had to the holding period of what they received, § 1223(a).

•When there is boot, § 356(a) prescribes the tax consequences of its receipt in an *exchange*, i.e., the recipient of boot must recognize boot or gain, whichever is less. § 356(a)(1). *See* Reg. § 1.356-1(d) Example 1. The distributee may not recognize loss. *See* Reg. § 1.356-1(d) Example 2.

•While § 356(a)(2) appears to make recognized gain on such exchanges dividends to the extent of the exchanging corporation's earnings and profits, the case of *Clark v. Commissioner*, 489 U.S. 726 (1989), *supra*, requires a more nuanced approach. The boot is regarded as the acquiring corporation's consideration for redemption of its shares equal in value to the boot and then tested for redemption treatment with respect to the distributee's interest in the acquiring corporation.

•The distributee's basis in stock is the distributee's basis in the stock exchanged, minus boot received, plus gain recognized. § 358(a). The parties themselves may allocate exchanges of stock, securities, and boot as they wish, "provided that such terms are economically reasonable." Reg. § 1.356-1(b). If they do not so specify, the allocation of bases will be made proportionately to the fair market values of what is received. Reg. § 1.356-2.

•Section 356(b) prescribes the tax consequences of the receipt of boot in a *distribution*. A distribution – without an exchange – occurs in a spin-off. In such cases, the money plus the fair market value of other property distributed is treated as a distribution to which § 301 applies. If the distributee receives boot and such receipt has the effect of the receipt of a dividend, then the distributee is treated as receiving a dividend equal to his/her/its ratable share of the corporation's earnings and profits; any excess is treated as gain from the exchange of property. Reg. § 1.356-1(c).

Tax Consequences to Distributing Corporation: Section 361(a) provides that a corporation that is a "party to a reorganization" that distributes property "in pursuance of the plan of reorganization" solely for stock or securities of another corporation that is a party to the reorganization recognizes no gain or loss. However, the distributing corporation recognizes gain (but not loss) on the distribution of property other than stock that is *not* in pursuance of a plan of reorganization. § 361(c). The distributing corporation also must recognize gain to the extent that liabilities assumed by the distributee exceed the distributing corporation's adjusted basis in the property transferred. § 357(c)(1).

•Section 355(c) prescribes the rules for distributions not made "in pursuance of a plan of reorganization." A corporation that distributes property other than "qualified property," i.e., stock or securities in the controlled corporation (§ 355(c)(2)(B)) must recognize gain as if it had sold the property for its fair market value. § 355(c)(2)(A). The fair market value is not treated as less than the amount of the liability. § 355(c)(2)(C).

•Sections 355(d and e) address situations where spin-offs should more appropriately be treated as sales of a controlled corporation.

•Section 355(d)(1) treats as property not "qualified" under § 355(c)(2)(B) or § 361(c)(2) so-called "disqualified stock," i.e., stock purchased within 5 years prior to the distribution *if* it is the subject of a "disqualified distribution." A "disqualified distribution" is a distribution of "disqualified stock" if immediately after the distribution, "any person holds disqualified stock in the distributing corporation which constitutes a 50% or greater interest in such corporation" (by vote or value, § 355(d)(4), § 355(d)(2)(A)), OR "any person holds disqualified stock in the controlled corporation (or, if stock of more than 1 controlled corporation is distributed, in any controlled corporation) which constitutes a 50% or greater interest in such corporation," § 355(d)(2)(B). The end result is that the *parent* corporation is taxed on a "disqualified distribution" of "disqualified stock."

•Section 355(e) treats as property not "qualified" under § 355(c)(2)(B) or § 361(c)(2) stock or securities in a controlled corporation if its distribution would otherwise fall within § 355 or § 356 but "which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50% or greater interest in the distributing corporation or any controlled corporation." § 355(e)(2)(A). A presumption arises if one or more persons acquire such a stock interest

during the 4-year period commencing two years prior to the distribution and ending two years after the distribution, § 355(e)(2)(B), unless the distributing corporation and controlled corporations are all members of a single affiliated group. § 355(e)(2)(C).[218] The distributing parent is subject to tax. § 355(e)(1). This provision does not apply to distributions within an affiliated group. § 355(f).

Tax Attributes of Distributee Corporation: Unlike the case of other reorganizations, ownership of tax attributes in the case of a divisive D reorganization does not change, except for earnings and profits. § 381(a) (carryout ¶; rule of succession to tax attributes not applicable to D reorganization in which transferee corporation does not acquire substantially all of the assets of the transferor, cross reference to § 354(b)(1)). In the case of a newly created controlled corporation, earnings and profits are allocated in proportion to the fair market value (or alternatively, the net basis of assets assumed) of the business or businesses retained and transferred. Reg. § 1-312-10(a).

Rev. Rul. 2003-79, 2003-29 I.R.B. 80

Part I
Section 355. – Distribution of Stock and Securities of a Controlled Corporation

(Also: §§ 368(a)(1)(D), 368(a)(1)(C) and [Reg.] 1.368-2.)

Section 355 reverse *Morris* trust. The acquisition by an unrelated corporation of all the assets of a newly formed controlled corporation following distribution of the controlled corporation's stock under § 355 will satisfy the "substantially all" requirement of § 368(a)(1)(C) even though the acquired assets represent only half of the assets held by the distributing corporation before it formed the controlled corporation.

ISSUE
Whether the acquisition by an unrelated corporation of all the assets of a newly formed controlled corporation following the distribution of the stock of the controlled corporation by a distributing corporation will satisfy the requirement of § 368(a)(1)(C) of the Internal Revenue Code that substantially all of the properties of the acquired corporation be acquired where the assets of the controlled corporation represent less than substantially all of the assets that the distributing corporation held before it formed the controlled corporation.

FACTS
D, a domestic corporation, directly conducts Business X and Business Y. D's assets are equally divided between the two businesses. A, a domestic corporation unrelated to D, conducts Business X and wishes to acquire D's Business X, but not D's Business Y.

[218] Section 355(e) is not applicable if § 355(d) is applicable.

To accomplish the acquisition, D and A agree to undertake the following steps in the following order: (i) D will transfer its Business X assets to C, a newly formed domestic corporation, in exchange for 100% of the stock of C, (ii) D will distribute the C stock to D's shareholders, (iii) A will acquire all the assets of C in exchange solely for voting stock of A, and (iv) C will liquidate. Apart from the question of whether the acquisition of C's assets by A will satisfy the requirement of § 368(a)(1)(C) that the acquiring corporation acquire substantially all of the properties of the acquired corporation, steps (i) and (ii) together meet all the requirements of § 368(a)(1)(D), step (ii) meets all the requirements of § 355(a), and steps (iii) and (iv) together meet all the requirements of § 368(a)(1)(C).

LAW

Section 355 provides that if certain requirements are met, a corporation may distribute stock and securities in a controlled corporation to its shareholders and security holders without causing the distributees to recognize gain or loss.

Section 368(a)(1)(C) defines a reorganization to include the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all of the properties of another corporation.

Section 368(a)(1)(D) defines a reorganization to include a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under §§ 354, 355, or 356.

In *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605, *reh'g denied*, 305 U.S. 670 (1938), Elkhorn Coal, in anticipation of being acquired by Mill Creek, transferred part of its operating assets to a newly formed subsidiary and distributed the subsidiary's stock to Elkhorn Coal's shareholders. The court concluded that the distribution of subsidiary stock prevented the subsequent acquisition from qualifying under a predecessor of § 368(a)(1)(C) because, as a result of the distribution, Mill Creek did not acquire substantially all of Elkhorn Coal's historical assets.

In *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), *aff'g* 42 T.C. 779 (1964), the taxpayer, in anticipation of a merger with a national bank, contributed its insurance business to a new subsidiary and distributed the subsidiary's stock to its shareholders. The divestiture was necessary to comply with national banking laws. The court held that the distribution satisfied the requirements for nonrecognition under § 355(a) and, therefore, that the contribution qualified as a reorganization under § 368(a)(1)(D).

In Rev. Rul. 68-603, 1968-2 C.B. 148, the Internal Revenue Service announced that it would follow the decision in *Mary Archer W. Morris Trust* to the extent it held that (1) the active business requirements of § 355(b)(1)(A) were satisfied even though the distributing corporation, immediately after the spin-off, merged into the unrelated acquiring corporation, (2) the control immediately after requirement of § 368(a)(1)(D) implies no limitation upon a reorganization of

the transferor corporation (the distributing corporation) after the distribution of the stock of the controlled corporation, and (3) there was a business purpose for the spin-off and the merger.

Rev. Rul. 98-27, 1998-1 C.B. 1159, states that the Service will not apply any formulation of the step transaction doctrine to determine whether the distributed corporation was a controlled corporation immediately before a distribution under § 355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, whether prearranged or not. The holding of Rev. Rul. 98-27 is based on § 1012(a) and § 1012(c) of the Taxpayer Relief Act of 1997 (the "1997 Act"), Pub. L. No. 105-34, 111 Stat. 788, 916-17. Section 1012(c) amended the control requirements of §§ 368(a)(1)(D) and 351 to provide that, generally for transactions seeking qualification after August 5, 1997, under either provision and § 355, the shareholders of the distributing corporation must own stock possessing more than 50% of the voting power and more than 50% of the total value of the controlled corporation's stock immediately after the distribution. *See* §§ 368(a)(2)(H) and 351(c). Section 1012(a) amended § 355 by adding subsection (e), which provides rules for the recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with acquisitions of stock representing a 50% or greater interest in the distributing corporation or any controlled corporation.

The Conference Report accompanying the 1997 Act states, in part, that:

> The ... bill does not change the present-law requirement under § 355 that the distributing corporation must distribute 80% of the voting power and 80% of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the proposal regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80% control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80% controlled subsidiary, but would not generally impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

H.R. REP. NO. 105-220, at 529-30 (1997); 1997-4 C.B. 1457, at 1999-2000.

Section 6010(c)(2) of the Internal Revenue Service Restructuring and Reform Act of 1998 (the 1998 Act), P.L. 105-206, 1998-3 C.B. 145, amended § 1012(c) of the 1997 Act to provide that, in the case of a § 368(a)(1)(D) or § 351 transaction that is followed by a § 355 transaction, solely for purposes of determining the tax treatment of any transfer of property by the distributing corporation to the controlled corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the controlled corporation's stock after the § 355 distribution shall not be taken into account in determining whether the control requirement of either § 368(a)(1)(D) or § 351 has been satisfied.

The Senate Report accompanying the 1998 Act contains three examples in which distributing corporation D transfers appreciated business X to newly created subsidiary C in exchange for at

least 85% of the C stock and then distributes its C stock to the D shareholders. As part of the same plan, C then merges into unrelated acquiring corporation A. Each example concludes that if the distribution satisfies the requirements of § 355, the control immediately after requirement will be satisfied solely for purposes of determining the tax treatment of the transfer of business X by D to C. *See* S. REP. NO. 105-174, at 173-176 (1998); 1998-3 C.B. 537, at 709-712.

ANALYSIS

Section 1012 of the 1997 Act, as amended by § 6010(c) of the 1998 Act, evidences the intention of Congress that a corporation formed in connection with a distribution that qualifies for nonrecognition under § 355 will be respected as a separate corporation for purposes of determining (i) whether the corporation was a controlled corporation immediately before the distribution and (ii) whether a pre-distribution transfer of property to the controlled corporation satisfies the requirements of § 368(a)(1)(D) or § 351, even if a post-distribution restructuring causes the controlled corporation to cease to exist. *See* Rev. Rul. 98-44, 1998-2 C.B. 315; Rev. Rul. 98-27, *supra*; S. REP. NO. 105-174, *supra*. Therefore, the controlled corporation should also be considered independently from the distributing corporation in determining whether an acquisition of the controlled corporation will qualify as a reorganization under § 368. Accordingly, in determining under § 368(a)(1)(C) whether an acquiring corporation has acquired substantially all of the properties of a newly formed controlled corporation, reference should be made solely to the properties held by the controlled corporation immediately following the distributing corporation's transfer of properties to the controlled corporation, rather than to the properties held by the distributing corporation immediately before its formation of the controlled corporation.

Hence, the acquisition by A of all the properties held by C immediately after the distribution will satisfy the requirement of § 368(a)(1)(C) that A acquire substantially all the properties of C. This result obtains even though an acquisition by A of the same properties from D would have failed this requirement if D had retained Business X, contributed Business Y to C, and distributed the stock of C. *See Helvering v. Elkhorn Coal Co.*, *supra*.

HOLDING

The acquisition by an unrelated corporation of all the assets of a newly formed controlled corporation following the distribution of the stock of the controlled corporation by a distributing corporation will satisfy the requirement of § 368(a)(1)(C) that substantially all of the properties of the acquired corporation be acquired where the assets of the controlled corporation represent less than substantially all of the assets that the distributing corporation held before it formed the controlled corporation.

Questions and comments:

1. In what significant way(s) are the facts of Rev. Rul. 2003-79 different from the facts of *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938)?

Do the CALI exercise: Corporate Taxation: Reorganizations: D Reorganizations: Definition.

Do the CALI exercise: Corporate Taxation: Reorganizations: Tax Consequences of Divisive D Reorganizations.

V. Single Entity Reorganizations: Recapitalizations and Changes in Identity, Form, or Place of Organization

Section 368(a)(1) includes two forms of reorganization in which a single corporation survives essentially unchanged. E reorganizations (recapitalizations) are useful when passing a corporation on to the next generation. Holders of common stock may exchange their common shares for preferred shares. They are also useful when restructuring the capital interests of a corporation confronting difficulties, e.g., exchanges of one class of stock for another. F reorganizations are useful when a corporation wishes to change certain aspects of its identity without changing its essential character.

A. "E" Reorganization

An "E" reorganization is a "recapitalization." § 368(a)(1)(E). The regulations do not define "recapitalization,"[219] but the Supreme Court has offered in dictum that a recapitalization is a "reshuffling of a capital structure, within the framework of an existing corporation." *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942). It is a useful transaction when the older generation wishes to pass control of a corporation to the next generation while retaining an interest – e.g., receipt of dividend income – in the corporation, when selling shareholders wish to convert their shares for shares of a different type – e.g., common for preferred – as part of a larger reorganizational plan, when a corporation's shareholders and creditors agree to restructure the corporation's debt by exchanging various stock and debt instruments for existing stock and debt instruments, and others.

While the regulations (Reg. § 1.368-2(e)) do not offer a definition of "recapitalization," they present five transactions or exchanges in which a "recapitalization" takes place. They include a corporation's exchange of preferred stock for bonds,[220] an exchange of common stock for preferred stock,[221] an exchange of preferred for common stock,[222] and an exchange of preferred stock with dividends in arrears for other stock of the corporation.[223] However, in the last case, if there is an increase in the preferred shareholders' proportionate interests in the corporation's assets or earning and profits, the lesser of –

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[219] Reg. § 1.368-2(e) merely offers five examples of transactions that constitute recapitalizations.

[220] Reg. § 1.368-2(e)(1).

[221] Reg. § 1.368-2(e)(2 and 4).

[222] Reg. § 1.368-2(e)(3).

[223] Reg. § 1.368-2(e)(5).

•the amount by which the greater of the fair market value or the liquidation preference of the stock received is greater than the issue price of the preferred stock surrendered OR
•the amount of dividends in arrears

"shall be treated under § 305(c) as a deemed distribution to which §§ 305(b)(4) and 301 apply."[224]

Under § 1036 as well as under § 368(a)(1)(E), an exchange of common for common and an exchange of preferred for preferred other than non-qualified preferred are not recognition events. § 1036(a, b). The use of nonqualified preferred stock in the context of a recapitalization reorganization of a family-owned corporation *does* qualify for tax-free treatment. § 354(a)(2)(C).

Section 354(a)(2) names two conditions of tax-free treatment of a reorganization: receipt of securities whose principal amount equals or exceeds the principal amount of the securities surrendered, and a surrender or securities if the shareholder receives securities.

Rev. Rul. 86-25, 1986-1 C.B. 202

Is the transaction described below a reorganization as defined in § 368(a)(1)(E) of the Internal Revenue Code or is it a distribution of property to which § 301 applies by reason of the application of § 305(b)(3)?

FACTS
X, a closely held domestic corporation, had 3,000 shares of $100 par value voting common stock ("old common") outstanding. For valid business reasons, a plan of reorganization was adopted pursuant to which X authorized the issuance of a new class A no par value voting common stock, a new class B no par value nonvoting common stock, and a new class C $100 par value nonvoting, nonparticipating, nonconvertible preferred stock. The only difference between the class A and class B common stock was the voting rights of the class A stock, and the only difference between the class A common stock and the old common stock was the par values. No terms of the old common stock, such as dividend or liquidation rights, are tied to the par value.

The plan of reorganization provided that each outstanding share of old common stock could be exchanged either for one share of class A common stock plus 99 shares of class B common stock, or for one share of class A common stock plus six shares of class C preferred stock. Pursuant to the plan of reorganization, one group of X shareholders surrendered 2,500 shares of X old common stock in exchange for 2,500 shares of class A common stock and 15,000 shares of class C preferred stock. A second group of shareholders surrendered 500 shares of old common stock in exchange for 500 shares of class A common stock and 49,500 shares of class B common stock. The value of the stock received by each shareholder of X was equal to the value of the stock surrendered by such shareholder in the exchange. The exchange of stock was an isolated transaction and not part of a plan to increase periodically the proportionate interest of any shareholder in the assets or earnings and profits of X.

[224] Reg. § 1.368-2(e)(5).

LAW AND ANALYSIS

Section 368(a)(1)(E) of the Code provides that the term "reorganization" includes a recapitalization. In *Helvering v. Southwest Consolidated Corp*., 315 U.S. 194, 202 (1942), the Supreme Court of the United States defined a recapitalization under a predecessor of § 368(a)(1)(E) as a "reshuffling of a capital structure within the framework of an existing corporation."

Section 354(a) of the Code states that no gain or loss will be recognized if stock in a corporation that is a party to a reorganization is exchanged solely for stock in such corporation.

Section 305(a) of the Code contains the general rule that gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

Section 305(b)(3) of the Code provides that § 305(a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which § 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders.

Section 305(c) of the Code provides that a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which § 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder may be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction.

Section 1.305-7(c)(1) of the ... Regulations provides that a recapitalization (whether or not an isolated transaction) will be deemed to result in a distribution to which § 305(c) of the Code applies if it is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation.

Section 1.305-7(c)(4) of the regulations provides that an example of the application of § 1.307(c) is example (12) of § 1.305-3(e).

In Example (12) contained in § 1.305-3(e) of the regulations, five shareholders owned 300 shares each and five shareholders owned 100 shares each of Corporation R's 2,000 shares of class A stock outstanding. In preparation for the retirement of the five major shareholders, R, in a single and isolated transaction, had a recapitalization in which each share of class A stock was exchanged either for five share of new class B nonconvertible preferred stock plus 0.4 share of new class C common stock, or for two shares of new class C common stock. As a result of the exchanges, each of the five major shareholders received 1,500 shares of class B nonconvertible preferred stock and 120 shares of class C common stock, and the remaining shareholders each received 200 shares of class C common stock. The example concludes that none of the exchanges are within the purview of § 305 of the Code.

In the instant case, had X made an outright distribution of the new preferred stock and new class B common stock on the old common stock, the distribution would have been taxable as a distribution of property under § 301 of the Code by reason of the application of § 305(b)(3).

Nevertheless, a transaction that effects a reshuffling of a corporation's capital structure will be respected as a recapitalization exchange to which § 305(b)(3) of the Code does not apply so long as it has a bona fide business purpose and is an isolated transaction and not part of a plan to increase periodically the proportionate interest of any shareholder in the assets or earnings and profits of a corporation. *See* Example (12) in § 1.305-3(e) of the regulations, discussed above. *Compare Bazley v. Commissioner*, 331 U.S. 737 (1947) (the exchange lacked a bona fide business purpose and was therefore not a reorganization) and § 1.301-1(1) of the regulations (a distribution occurring at the same time as a recapitalization is taxable as a dividend if, in substance, it is not part of the recapitalization).

HOLDING
Under the circumstances set forth above, the exchange of old voting common stock for either class A voting common stock plus class C nonvoting preferred stock or class A voting common stock plus class B nonvoting common stock, will qualify as a tax-free recapitalization under §§ 368(a)(1)(E) and 354(a) of the Code, and will not be treated as distributions of property to which § 301 applies by reason of the application of § 305(b)(3).

Questions and comments:

1. If stock other than common stock is received in a recapitalization, it might be § 306 stock. Reg. § 1.306-3(a) provides that when no gain is recognized on the receipt of stock other than common stock, the stock may be § 306 stock "if a distribution of money by the distributing corporation in lieu of such stock would have been a dividend in whole or in part." The distribution is tested for dividend treatment under § 302(b). The boot rules of § 356(a)(2) may also provide dividend treatment and therefore the stock may be § 306 stock.

2. Reg. § 1.306-3(d) provides in part: "Common stock received in exchange for section 306 stock in a recapitalization shall not be considered section 306 stock."

Do the CALI exercise: Corporate Taxation: Reorganizations: E Reorganizations: Definition.

B. "F" Reorganization

An "F" reorganization is "a mere change in identity, form, or place of incorporation of one corporation, however effected[.]" § 368(a)(1)(F). A "mere change" can be an actual or deemed transfer of property from one transferor corporation to one "resulting corporation." Reg. § 1.368-2(m)(1). A series of transactions may provide the framework against which to apply F reorganization rules. Reg. § 1.368-2(m)(1). Step transactions principles apply. Reg. § 1.368-2(m)(1). The Commissioner used F reorganizations to address liquidation/reincorporation

transactions by claiming that various transactions that were ostensibly recognition events were in fact F reorganizations, and so not recognition events.

Treasury recently promulgated regulations which are summarized here. As the definition of an F reorganization implies, an F reorganization is useful when a corporation wants to change its name, its form, or its state of incorporation. The regulations now provide that an F reorganization must satisfy all six of the following conditions, Reg. § 1.368-2(m)(1):

- all of the stock of the "resulting corporation" must be distributed in exchange for the stock of the transferor corporation,[225] Reg. § 1.368-2(m)(1)(i);
- the same persons must own the stock of the transferor corporation and of the "resulting corporation" in identical proportions,[226] Reg. § 1.368-2(m)(1)(ii);
- the resulting corporation may not have any tax attributes immediately before the potential F reorganization,[227] Reg. § 1.368-2(m)(1)(iii);
- the transferor corporation must completely liquidate for income tax purposes, but it is not required to liquidate under other applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence, Reg. § 1.368-2(m)(1)(iv);
- no corporation other than the resulting corporation may hold properties that the transferor corporation held immediately before the potential F reorganization "if such other corporation would, as a result, succeed to and take into account the" the tax attributes named in § 381(c) of the transferor, Reg. § 1.368-2(m)(1)(v); and
- the resulting corporation may not hold property acquired from any corporation other than the transferor corporation if the resulting corporation would take into account any of the tax attributes named in § 381(c).

However, the continuity of business enterprise and the continuity of interest requirements of other reorganizations do not apply to potential F reorganizations. Reg. § 1.368-2(m)(3).

The regulations state two priority rules.

- "If the potential F reorganization or a step thereof qualifies as a reorganization or part of a reorganization under another provision of § 368(a)(1), and if a corporation in control (within the meaning of § 368(c)) of the resulting corporation is a party to such other reorganization (within the meaning of § 368(b)), the potential F reorganization will not qualify as a reorganization under § 368(a)(1)(F)." Reg. § 1.368-2(m)(3)(iii)(A).

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[225] The resulting corporation may issue a de minimis amount of stock that is not exchanged for the stock of the transferor corporation in order to facilitate organization of the resulting corporation or to maintain its existence. Reg. § 1.368-2(m)(1)(i).

[226] One or more shareholders of the transferor corporation may transfer such stock for stock in the resulting corporation of equivalent value but with different terms from the stock of the transferor corporation, or receive a distribution of money from either corporation whether or not in exchange for stock of either corporation. Reg. § 1.368-2(m)(1)(ii). The receipt of money or other property is treated as a separate transaction unrelated to the reorganization. Reg. § 1.368-2(m)(3)(iii).

[227] The resulting corporation holds a de minimis amount of assets to facilitate its organization or to maintain its existence and has tax attributes related to holding those assets. Reg. § 1.368-2(m)(1)(iii). The resulting corporation may also hold the proceeds of borrowings undertaken in connection with the potential F reorganization. *Id.*

•Except for the immediately foregoing, "if ... the potential F reorganization would [otherwise] qualify as a reorganization under both § 368(a)(1)(F) and one or more of §§ 368(a)(1)(A), 368(a)(1)(C), or 368(a)(1)(D), then for all federal income tax purposes the potential F reorganization will qualify as a reorganization only under § 368(a)(1)(F)." Reg. § 1.368-2(m)(3)(iii)(B).

In an F reorganization, as opposed to other reorganization forms, the corporation acquiring property *may* carry back a net operating loss or a capital loss. § 381(b)(3). Also the taxable year or the distributor or transferor corporation does *not* end on the date of distribution or transfer. § 381(b)(1).

Do the CALI exercise: Corporate Taxation: Reorganizations: F Reorganizations: Definition.