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A number of important tax questions arise when a shareholder receives boot in addition to stock as consideration in a reorganization under section 368 of the Internal Revenue Code of 1954. Under section 356 of the Code the shareholder recognizes any gain up to the amount of boot received. This Article analyzes the application of section 356(a)(2), which determines whether the gain is treated as ordinary income or capital gain. The Article first discusses amalgamating reorganizations where the corporations had no common ownership prior to the reorganization and then examines those reorganizations where there was common ownership. The author advocates utilization of the principles of Code sections 302 and 346 in interpreting section 356(a)(2) and argues that for this purpose the distribution of boot should generally be viewed as a distribution by the transferor corporation prior to the reorganizaion. In certain reorganizations, however, the author concludes that the boot should be taxed as a distribution by an ongoing corporation under Code section 301. The Article concludes by suggesting some amendments to Code section 356.

UNDER Internal Revenue Code section 368 certain combinations of two or more corporations qualify as "reorganizations." The tax consequences for a shareholder who exchanges stock in a reorganization depend on the nature of the property received as consideration. If the shareholder receives only stock of the acquiring corporation as consideration, section 354 of the Code provides that any gain or loss realized in the exchange will not be recognized. If the shareholder receives other consideration, usually referred to as "boot,"[1] in addition to stock of the acquiring

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1. The term "boot" is used because shareholders of the transferor corporation have received stock or securities of the acquiring corporation plus money (or other property) to boot. *See* Liddon v. Commissioner, 230 F.2d 304, 306 (6th Cir. 1956); 64 CONG. REC. 2852 (1923) (remarks of Rep. Green).

corporation, section 354 does not apply.[2] When boot is received, the shareholder recognizes under section 356(a) any gain realized in the exchange up to the value of the boot received.[3] Whether this recognized gain is ordinary income or capital gain is usually determined by section 356(a)(2). If the exchange has the "effect of the distribution of a dividend," the amount of the recognized gain not in excess of the shareholder's ratable share of earnings and profits "of the corporation" will be treated as a dividend.[4]

There are a number of unresolved issues in the interpretation and application of section 356(a) to the exchange by the shareholder. First, it is unclear what standards should be used to determine if the exchange has the effect of the distribution of a dividend under section 356(a)(2). A related issue is which corporation's earnings and profits—those of the transferor corporation, the acquiring corporation, or both—operate as the limit on the amount of boot which will be treated as a dividend.[5] A third issue arises in reorganizations where the section 356 limitation of taxable income to the amount of realized gain seems particularly inappropriate. This occurs when the same shareholders control both corporations prior to the reorganization.[6] In these situations, the issue is whether the total amount of boot distributed should be

2. It is assumed that the shareholder did not own any notes or bonds of the transferor corporation that qualified as securities. If he or she did, the exchange would still qualify under I.R.C. § 354(a) so long as the shareholder received securities of the acquiring corporation with a principal amount no larger than that of the securities surrendered.

3. For example, if a shareholder's basis in stock of the transferor corporation was $150 and the reorganization resulted in the shareholder's receiving boot and stock worth $200, an amount of income equal to the lesser of the amount of boot or $50 would be recognized. The amount of boot would be the sum of money and fair market value of any property other than stock of the acquiring corporation received in the reorganization.

4. A shareholder receiving only cash or other nonqualifying property as consideration in a reorganization will be taxed under § 302 rather than § 356. Treas. Reg. § 1.354-1(d) Ex. 3 (1979); Rev. Rul. 74-515, 1974-2 C.B. 118; I.R.C. § 302. Section 356 is applicable only if there is an exchange that would qualify under § 354 except that nonqualifying property is also present.

5. The status of the earnings and profits account does not determine whether the exchange has the effect of the distribution of a dividend. Rather, once that effect has been found, the amount of earnings and profits determines how much of the recognized gain will be treated as a dividend. *See* Treas. Reg. § 1.356-1(b) (1955). *See also* I.R.C. § 302(b)(1); Treas. Reg. § 1.302-2(a) (1955).

6. The transaction is then similar to a sale by shareholders of their stock in one corporation to another corporation when the selling shareholders controlled both corporations. Under appropriate circumstances the sales proceeds are treated as a distribution by an ongoing corporation and are taxed as ordinary income if there are sufficient earnings and profits. I.R.C. § 304. *See* Kempf, *Section 304 of the Internal Revenue Code: Unmasking Disguised Dividends in Related Corporation Transactions*, 33 U. CHI. L. REV. 60 (1965).

taxed as a dividend under Code sections 301 and 316, rather than only having the gain included in income under section 356.

The proper resolution of these issues can be critically important to shareholders. The tax treatment of any boot can affect such matters as how the transaction should be structured and even whether the transactions should qualify as a reorganization.[7] Because of the complexity of these issues, their proper resolution requires careful analysis of the nature of reorganizations and of the basic principles governing the taxation of corporate distributions.

This Article will focus on the taxation of boot in reorganizations involving the combination of two or more corporations—amalgamating reorganizations[8]—and will offer resolutions of the questions raised by the three issues presented above. The Article concludes that, for purposes of interpreting section 356, the distribution of boot should be viewed as a substitute for a distribution by the transferor corporation prior to the reorganization. Therefore, whether the exchange has the "effect of the distribution of a dividend" should be determined by an application of the principles of sections 302 and 346 of the Code to a hypothetical distribution of the boot by the transferor corporation prior to the reorganization. Similarly, the amount taxed as a dividend should be limited by the shareholder's ratable share of the earnings and profits of the transferor corporation. These conclusions will not be applicable, however, when the corporations had identical ownership prior to the reorganization and there was a pro rata distribution of boot to the shareholders. In such cases the boot should be taxed as a distribution by an ongoing corporation under section 301 of the Code, rather than being taxed under section 356.

Sections I and II furnish some necessary background, discuss-

7. For example, an individual shareholder may have gain on an exchange of stock that is less than the amount of boot received. Here, the shareholder will typically be better off when the transaction does not qualify as a reorganization than when the transaction is a reorganization and the boot is taxed at ordinary income rates.

8. The Article does not directly discuss distributions of cash or other nonqualifying property in other types of reorganizations. The other types of reorganizations would be divisive reorganizations under §§ 368(a)(1)(D) & 355 of the Code, and reorganizations involving a transformation of a single corporation such as a recapitalization under § 368(a)(1)(E). When there is a combination of two corporations qualifying as a reorganization and one of the corporations was merely a shell prior to the combination, the reorganization would not for purposes of this Article be considered an amalgamating reorganization.

The Article also does not discuss the situation when the shareholder's stock in the transferor corporation is section 306 stock. *See* I.R.C. § 356(e).

ing the consequences of boot in amalgamating reorganizations and providing a detailed introduction to section 356. Section III explores the role of Code sections 302 and 346 when deciding upon the criteria to be used in determining whether an exchange has the effect of the distribution of a dividend under section 356(a)(2). Sections IV and V discuss the proper resolution of the three issues presented above. Section IV focuses on amalgamating reorganizations where the corporations had no common shareholders prior to the reorganization, while section V discusses situations where the corporations had some common shareholders. The Article concludes by suggesting certain amendments to section 356.

I. THE ROLE OF BOOT IN AMALGAMATING REORGANIZATIONS

If a combination of two or more corporations qualifies as a reorganization, gain or loss will usually not be recognized by the corporations[9] or by shareholders who only receive stock of the acquiring corporation.[10] The tax attributes of the corporations involved in the combination, such as earnings and profits or net operating loss carryovers, will generally survive the reorganization.[11] Furthermore, the acquiring corporation will assume a carryover basis for the transferred assets.[12] Thus, the corporate existence of the transferor corporation is, in a sense, continued in the acquiring corporation.

If boot is distributed in the reorganization, it will have only a limited effect on these tax consequences. The distributees of boot will recognize gain to the extent that they receive boot,[13] and the earnings and profits account of the transferor corporation will be affected by the distribution.[14] These effects are similar to the consequences of a distribution of property by an ongoing corporation to its shareholders. On the other hand, the transferor corporation will generally still not recognize any gain or loss in the reorganization[15] and the acquiring corporation will still have a carryover ba-

9. I.R.C. §§ 361(a), 1032. The transferor corporation will recognize gain to the extent it receives boot and does not distribute the boot to its shareholders. I.R.C. § 361(b).

10. *Id.* § 354. For the tax consequences if securities are received, see note 2 *supra*.

11. I.R.C. § 381.

12. *Id.* § 362(b).

13. *Id.* § 356.

14. Treas. Reg. § 1.381(c)(2)-1(c)(1) (1961).

15. I.R.C. § 361. If the transferor corporation receives boot and does not distribute the boot to its shareholders, then it will recognize gain to the extent of the boot.

sis for the transferred assets.[16] The carryover of corporate attributes other than earnings and profits will also not be affected by the boot.[17] Therefore, the presence of boot will not cause the transaction to be viewed as part reorganization and part taxable exchange of stock for the boot. The transaction is viewed instead as a reorganization with a distribution by the corporations to their shareholders. The distribution of an excessive amount of boot, however, can have a great effect on the tax consequences. Too much boot will cause the transaction to be treated as a taxable exchange and not as a qualified reorganization.[18]

A. *Continuity of Shareholder Interest*

The shareholders of the transferor corporation in an amalgamating reorganization are not viewed as liquidating their interest in the corporation; rather they continue their interest in it through ownership of the acquiring corporation.

> The underlying assumption of these exceptions [to recognition of the gain or loss under present section 1001(c)] is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure and the new property are substantially continuations of the old still unliquidated.[19]

It is therefore crucial to the concept of a reorganization that the shareholders of the transferor corporation retain a substantial in-

16. *Id.* § 362(b). If the transferor corporation recognizes gain on the exchange (*see* note 15 *supra*), the basis to the acquiring corporation will be increased by the amount of such recognized gain.

17. I.R.C. § 381.

18. *See* notes 19-37 *infra* and accompanying text.

19. Treas. Reg. § 1.1002-1(c) (1957). Note, however, that I.R.C. § 1002 has been repealed and replaced by I.R.C. § 1001(c). *See* Bazley v. Commissioner, 331 U.S. 737, 740 (1947).

Congress has never definitively stated its reasons for the nonrecognition of the gain or loss realized in reorganizations. Two separate justifications for the tax treatment of reorganizations can be gleaned from the legislative history. First, exchanges which take place in connection with a reorganization are "changes in form and not in substance." H.R. REP. No. 179, 68th Cong., 1st Sess. 16 (1924). *Accord*, S. REP. No. 398, 68th Cong., 1st Sess. 17-18 (1924); H.R. REP. No. 704, 73d Cong., 2nd Sess. 13 (1934); S. REP. No. 1622, 83d Cong., 2d Sess. 42 (1954). Second, gain should not be recognized on exchanges taking place pursuant to reorganizations so that ordinary business transactions are not prevented. H.R. REP. No. 179, 68th Cong., 1st Sess. 13 (1924). *Accord*, S. REP. No. 398, 68th Cong., 1st Sess. 14-15 (1924). *Compare* Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A.J. 40 (1969), and Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957) *with* Turnier, *Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation*, 64 CALIF. L. REV. 902, 912-16 (1976).

terest in that corporation by obtaining an interest in the acquiring corporation.[20] This continuity of shareholder interest requirement limits the amount of boot that can be distributed in a reorganization; shareholders of the transferor corporation will not retain the requisite continuity of interest if they receive excessive boot.

The doctrine of continuity of shareholder interest originated in Judge Augustus Hand's opinion in *Cortland Specialty Co. v. United States*[21] and in the Supreme Court's opinion in *Pinellas Ice & Cold Storage Co. v. Commissioner*.[22] In both cases a corporation transferred substantially all its assets to another corporation for cash and short-term notes which were then distributed to its shareholders. Although nothing in the statutory definition of a reorganization referred to the consideration received by the transferor corporation or its shareholders,[23] the courts in each case concluded that the corporation or its shareholders must obtain a more definite interest in the acquiring corporation for the transaction to qualify as a reorganization.[24] Judge Hand in *Cortland Specialty* concluded:

> In defining "reorganization," section 203 of the Revenue Act . . . does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its shareholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate form.[25]

In 1934 Congress enacted a statutory continuity of shareholder interest requirement in stock-for-stock and stock-for-asset reorganizations.[26] This statutory requirement was severe, since it did not allow the distribution of any consideration other than vot-

20. There is also the judicial doctrine of continuity of business enterprise. For a discussion of this doctrine, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 14.51 at 14-129 to 14-130 (4th ed. 1979).

21. 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

22. 287 U.S. 462 (1933). *See also* the lower court decision in Pinellas Ice & Cold Storage Co. v. Commissioner, 57 F.2d 188 (5th Cir. 1932).

23. Revenue Act of 1926, ch. 27, § 203(h)(1), 44 Stat. 14.

24. In both *Cortland Specialty* and *Pinellas* the conclusion that continuity of shareholder interest in the acquiring corporation is a requirement for a transaction to qualify as a reorganization was not the only ground for the decision. Both courts also concluded that the short-term notes were not "securities." Therefore, the shareholders had not received property that would qualify for nonrecognition under § 203(e) of the Revenue Act of 1926, the predecessor of § 354 of the Internal Revenue Code of 1954, even if the transaction had qualified as a reorganization. Revenue Act of 1926, ch. 27, § 203(e), 44 Stat. 14.

25. 60 F.2d 937, 940 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

26. Revenue Act of 1934, ch. 277, § 112(g), 48 Stat. 705. The reorganizations affected correspond to reorganizations defined by I.R.C. § 368(a)(1)(B)-(C).

ing stock of the acquiring corporation. Although liberalized somewhat since 1934, the statutory continuity of interest test continues to be quite strict for both types of reorganizations.[27] Because cases that were governed by the pre-1934 law continued to arise and because not all reorganizations were subject to the statutory continuity of interest test, the courts continued to develop a judicial continuity of interest test. The standard that evolved for the judicial test requires that a "substantial" portion of the total consideration received by all the shareholders in the reorganization must be in the form of an equity interest in the acquiring corporation.[28] What constitutes a "substantial" portion is unclear, although a one-half interest in the acquiring corporation would clearly qualify.[29] Under the present Internal Revenue Code, the statutory and judicial doctrines of continuity of shareholder interest coexist.

B. *Types of Reorganizations and Distribution of Boot*

If boot will be distributed in a combination of two or more corporations and classification as a reorganization is desired, the

27. Congress has liberalized the statutory continuity of interest requirement for "B" and "C" reorganizations in several respects. One aspect concerns "remote continuity of interest." Stock of the parent of the acquiring corporation can now satisfy the statutory continuity of interest test. I.R.C. § 368(a)(1)(B)–(C). Similarly assets or stock of the acquired corporation can be transferred by the acquiring corporation to a subsidiary without destroying continuity of interest. I.R.C. § 368(a)(2)(C). (Analogous rules apply to statutory mergers and consolidations. I.R.C. § 368(a)(2)(C)–(E).) For a thorough discussion of these provisions and an account of how they changed the law, see Ferguson & Ginsburg, *Triangular Reorganizations*, 28 TAX. L. REV. 159 (1973).

In "C" reorganizations, assumptions of debt will generally not be treated as nonqualifying consideration for continuity of interest purposes. I.R.C. § 368(a)(1)(C). A limited amount of consideration other than voting stock and assumption of debt can be used in a "C" reorganization, but assumption of debt is then treated as nonqualifying consideration. I.R.C. § 368(a)(2)(B). *See* note 32 *infra*.

28. This standard was developed in a series of Supreme Court decisions. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Helvering v. Watts, 296 U.S. 387 (1935); LeTulle v. Scofield, 308 U.S. 415 (1940). Thorough discussions of this development can be found in Brookes, *The Continuity of Interest Test in Reorganizations—A Blessing or a Curse*, 34 CALIF. L. REV. 1 (1946), and Griswold, *"Securities" and "Continuity of Interest"*, 58 HARV. L. REV. 705 (1945).

29. In John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935), continuity of interest was satisfied where approximately 38% of the total consideration in the reorganization was stock (valuing the preferred stock at par value) and 62% was cash.

The Internal Revenue Service will issue a ruling that a transaction qualifies as a reorganization only if at least 50% of the consideration is stock of the acquiring corporation or its parent. The test is applied with respect to total consideration received by all shareholders, not with respect to each shareholder individually. Rev. P. 77–37, 1977–2 C.B. 568. *See also* Rev. Rul. 66–224, 1966–2 C.B. 114.

transaction will often be cast in the form of a statutory merger or consolidation, so as to qualify as a reorganization under section 368(a)(1)(A) of the Code ("A" reorganization). Only the judicial doctrine of continuity of interest is applicable to an "A" reorganization. Consequently, shareholders of the transferor corporation can receive at least half their consideration in a form other than stock of the acquiring corporation.[30] Boot can also be distributed in a reorganization involving a merger of a corporation with a controlled subsidiary of the corporation whose stock is distributed as consideration, but there may be statutory limits on the amount of boot that can be used.[31] The statutory continuity of interest requirement precludes the use of boot in a reorganization involving a stock-for-stock exchange under section 368(a)(1)(B) ("B" reorganization) and severely restricts the use of boot in a reorganization involving a stock-for-assets exchange under section 368(a)(1)(C) ("C" reorganization).[32] In the discussion below it will often be assumed that the reorganization is in the form of a statutory merger or consolidation. Nevertheless, the conclusions arrived at will generally be valid for other types of reorganizations in which boot can be distributed.

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30. *See* notes 28-29 *supra* and accompanying text.

31. I.R.C. § 368(a)(2)(D)-(E). In a "triangular" merger under § 368(a)(2)(D), stock of the parent of the acquiring corporation can be distributed in exchange for stock of the transferor corporation. The transferor corporation must transfer, by means of the merger, substantially all of its properties to the acquiring corporation. The only statutory restriction on the type of consideration that can be used is the prohibition against using any stock of the acquiring corporation. The judicial doctrine of continuity of interest applies, with the stock of the acquiring corporation's parent "carrying" the necessary continuity. Treas. Reg. § 1.368-2(b)(2) (1973).

In a "reverse triangular merger" under § 368(a)(2)(E), voting stock of the parent of the merged or acquired corporation can be exchanged for stock of the surviving or acquiring corporation if the surviving corporation, immediately after the reorganization, holds substantially all of its properties and substantially all of the properties of the merged corporation. Former shareholders of the surviving corporation must exchange an amount of stock constituting control (as defined in § 368(c), note 33 *infra*) in that corporation for voting stock of the parent of the merged corporation. This statutory continuity of interest requirement is much stricter than the judicial doctrine.

32. Sections 368(a)(1)(B) and 368(a)(1)(C) allow only voting stock of the acquiring corporation or of the parent of the acquiring corporation to be used. For "C" reorganizations, however, § 368(a)(2)(B)(iii) mitigates this requirement allowing boot to be used if at least 80% of the fair market value of all properties of the transferor corporation is acquired for voting stock. For the purpose of determining whether this clause applies, the amount of any liability which is assumed by the acquiring corporation, or to which property transferred to the acquiring corporation is subject, will be treated as money paid for the property. Therefore, if liabilities transferred to the acquiring corporation exceed 20% of the value of the assets of the transferor corporation, boot cannot be used in a "C" reorganization.

In very limited situations, two or more corporations can combine in a transaction qualifying as a reorganization under sections 368(a)(1)(D) and 354(b) of the Code (a nondivisive "D" reorganization). For the transaction to qualify as a nondivisive "D" reorganization, the transferor corporation, its shareholders, or both, must be in control of the acquiring corporation immediately after the transaction.[33] Because of the control requirement continuity of shareholder interest is generally not an issue in "D" reorganizations, and there are no limitations on the amount of boot that can be distributed.[34] A combination of two or more corporations can also qualify as a reorganization under section 368(a)(1)(F) ("F" reorganization),[35] but any combination qualifying as an "F" reorganization would also qualify as a "D" reorganization.[36] Classification as an "F" reorganization may, however, arguably affect the taxation of boot.[37]

II. SECTION 356

Subsections (a) and (c) of section 356 contain the basic rules governing the taxation of boot distributed in reorganizations. They provide for the same tax treatment as did subsections (d)

33. "Control" is defined in the Code as "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." I.R.C. § 368(c).

34. In other respects, however, continuity of shareholder interest could be an issue. For example, if the former shareholders of the transferor corporation sold their stock in the acquiring corporation immediately after the reorganization as part of a pre-arranged plan, such continuity of shareholder interest would probably be violated. *See* B. BITTKER & J. EUSTICE, *supra* note 20, § 14.11 at 14-24 to 25.

35. *See* Rev. Rul. 75-561, 1975-2 C.B. 129, and cases cited therein. *See also* Rev. Rul. 78-287, 1978-2 C.B. 146. *But see* Berger Machine Products, Inc. 68 T.C. 358, 363-65 (1977). Section 368(a)(1)(F) defines a "reorganization" as consisting of "a mere change in identity, form, or place of organization, however effected."

36. *See* Breech v. United States, 439 F.2d 409 (9th Cir. 1971); Commissioner v. Berghash, 361 F.2d 257 (2d Cir. 1966); Estate of Lammerts, 54 T.C. 420 (1970), *aff'd on other grounds*, 456 F.2d 681 (2d Cir. 1972); Joseph C. Gallagher, 39 T.C. 144 (1962).

37. The Fifth Circuit in an alternative holding has stated that boot distributed in an "F" reorganization should be taxed under § 301 as a distribution by an ongoing corporation rather than under § 356. Davant v. United States, 366 F.2d 874, 890 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). *See* notes 184-85 *infra* and accompanying text.

The issue of whether a "D" reorganization is also an "F" reorganization usually arises when an acquiring corporation seeks to carry back the losses of the transferor corporation from a post-acquisition year to a pre-acquisition year. I.R.C. § 381(b). *See, e.g.*, Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968); Associated Mach. v. Commissioner, 403 F.2d 622 (9th Cir. 1968). *See also* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (validity of notice of deficiency affected by whether the transaction qualified as an "F" reorganization).

and (f) of section 203 of the Revenue Act of 1924.[38] Various attempts have been made to modify these provisions, but none has been successful.[39]

38. Revenue Act of 1924, ch. 234, § 203(d) & (f), 43 Stat. 253.

The earliest identifiable predecessor of § 356 is § 202(e) of the Revenue Act of 1921, ch. 136, § 202(e), 42 Stat. 227. Section 202(e) applied to nonqualifying property or boot received in like-kind exchanges and in exchanges with controlled corporations (exchanges in which gain or loss would not be recognized if no boot were distributed) as well as to boot received by owners of stock or securities in reorganizations. If boot were distributed in any of these exchanges, no gain would be recognized until the value of the boot exceeded the basis of the property given up in the exchange. The boot would first reduce the basis of the property received in the exchange. In 1923, § 202(e) was amended to provide that the distributee of boot would recognize any gain realized, but not in excess of the amount of boot received in the exchange. Act of March 4, 1923, ch. 294, § 2, 42 Stat. 1560. Present § 356(a)(1) of the Internal Revenue Code contains the same rule.

In the Revenue Act of 1924 §§ 203(d) and 203(f) provided for the taxation of boot. Section 203(d)(1), which again applied to boot received in several types of nonrecognition exchanges, adopted the same tax treatment of boot which had been established by amended § 202(e) of the Revenue Act of 1921. Section 203(d)(2), which was a new provision in 1924, applied only to boot distributed to owners of stock or securities in a reorganization. It provided that, if the distribution of boot had the effect of the distribution of a taxable dividend, then the distributee's gain would be "taxed as a dividend" to the extent of the distributee's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." Present § 356(a)(2) of the Code is almost identical to former § 203(d)(2). Section 203(f) of the Revenue Act of 1924, which was also new, provided that persons who received boot in several types of nonrecognition exchanges, including reorganizations, could not recognize any loss realized in the exchange. Present § 356(c) of the Code contains this provision for distributees of boot in reorganizations.

39. In particular, the House of Representatives, in the bill that was eventually to become the Internal Revenue Code of 1954, provided for significantly different tax treatment of boot. H.R. 8300, 83d Cong., 2d Sess. § 306 (1954). The House bill provided that boot distributions which were "not substantially disproportionate" would be taxed in a manner similar to any corporate distribution with respect to stock. The dividend within gain limitation was removed. Whether a boot distribution was substantially disproportionate would be determined by applying the rules for redemptions by ongoing corporations to the shareholders of the transferor corporation. *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. A85–A86. These changes were, however, rejected by the Senate, and the House subsequently agreed with this decision. *See* H.R. REP. No. 2543, 83d Cong., 2d Sess. 34 (1954).

For other attempts to change § 356, see H.R. 4459, 86th Cong., 1st Sess. § 21 (1959) (revised amendments of Advisory Group on Subchapter C of Internal Revenue Code of 1954); *Subchapter C Advisory Group Report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Proposed Amendments, Hearings on Topics Pertaining to the General Revision of the Internal Revenue Code Before the House Comm. on Ways and Means*, 85th Cong., 2d Sess., pt. 3 at 2549 (1958) [hereinafter cited as *Subchapter C Report]; Revised Report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Proposed Amendments as Revised, Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 554 (1959) [hereinafter cited as *Subchapter C Revised Report*]; AMERICAN LAW INSTITUTE FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS, REPORT OF WORKING VIEWS OF STUDY BY THE AMERICAN LAW INSTITUTE AND STAFF AND AMERICAN BAR ASSOCIATION SECTION OF TAXATION LIAISON COMMITTEE 308-14 (1958).

This section of the Article sets out the basic provisions of Code section 356 and compares the taxation of distributions of boot in a reorganization to distributions of property by ongoing corporations. Under either section 302 or 346, a distribution by an ongoing corporation might be found to be "not essentially equivalent to a dividend."[40] Hence, the standards developed under these sections will aid in determining whether a distribution of boot has the effect of a dividend within the meaning of section 356(a)(2). It must be noted, however, that substantial differences exist between taxation of property distributed by ongoing corporations and the taxation of boot distributed in reorganizations. Therefore, rules from section 302 or 346 cannot mechanically be transferred to section 356.

Gain Limitation. Section 356(a) provides that boot received in a reorganization will be taxed only to the extent of gain. If a distribution of boot has the effect of a dividend and is made from the distributee's share of accumulated earnings and profits, the boot will be treated as a dividend only to the extent of gain. The dividend within gain limitation is, at the very least, anomalous and is significantly different from the tax treatment accorded distributions by ongoing corporations. A shareholder of an ongoing corporation who receives a dividend, or who receives a distribution in redemption of stock that is taxed as a dividend, must include the total distribution in income.[41]

The dividend within gain limitation may have been a drafting error when Congress passed section 203(d)(2) of the Revenue Act of 1924.[42] The Committee Reports to the Revenue Act of 1924 seem to indicate that the effect of the gain limitation was not understood.[43] However, in enacting the Internal Revenue Code of 1954, Congress seemingly made a conscious decision to retain the limitation. The House of Representatives had provided that a dis-

40. I.R.C. §§ 302(b)(1), 346(a)(2).

41. *Id.* §§ 301(c), 302(d).

42. Revenue Act of 1924, ch. 234, §§ 203(d), (f), 43 Stat. 253. *See* Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573, 578–79 (1965).

43. In an attempt to explain § 203(d)(2), the House and Senate Reports contained the example of a corporation with earnings and profits of $50,000 that transfers its assets to a newly formed corporation with the same ownership and distributes $50,000 as boot in the reorganization. The Reports equated the effect of the distribution of $50,000 with the declaration of a dividend and concluded that the distribution should be subject to the full tax applicable to dividends. However, § 203(d)(2) of the Revenue Act of 1924 (as well as present § 356(a)(2)) taxed boot only to the extent of gain. Therefore, some or all the boot in the example could escape the tax applicable to dividends. H.R. REP. No. 179, 68th Cong., 1st Sess. 14–15 (1924); S. REP. No. 398, 68th Cong., 1st Sess. 15–16 (1924).

tribution of boot that was not "substantially disproportionate" would be fully taxed as a dividend to the extent of earnings and profits.[44] The Senate, rejecting the House's approach, reinstated the dividend within gain limitation.[45] The House subsequently concurred.[46]

The computation of gain when boot is distributed in a reorganization will not be analogous to the computation when there is a partial liquidation or a redemption treated as an exchange. When boot is distributed, gain is generally computed on the entire exchange; particular shares of the transferor corporation are not exchanged for boot.[47] In a redemption or partial liquidation, particular shares are exchanged for cash or other property, and gain is computed accordingly.

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44. H.R. 8300, 83d Cong., 2d Sess. § 306 (1954). *See also* H.R. 4459, 86th Cong., 1st Sess. § 21 (1959).

45. As the Senate Report noted:

> Under the House bill, if the distribution is otherwise to be taxed as a dividend, it will be taxed as such regardless of whether the shareholder had a gain on the transaction as a whole. Your committee returns to existing law in taxing a dividend only to the extent of the amount of "boot" received which is not in excess of the particular shareholder's gain.

S. REP. NO. 1622, 83d Cong., 2d Sess. 51 (1954). In enacting § 356(b) of the Code in 1954, Congress provided that the dividend within gain limitation should not apply when there is a distribution of boot in an otherwise tax-free pro rata distribution of stock under § 355. Such a provision is further evidence that retention of the dividend within gain limitation for distributions of boot in other transactions was not an oversight. *See also* I.R.C. § 356(e). However, Norris Darrell in testimony before the House Ways and Means Committee commented that there were no particular objections to the treatment of boot in H.R. 8300 but that it "fell by the wayside" because of the objections to other portions of Subchapter C in the House bill. *Hearings on Topics Pertaining to the General Revision of the Internal Revenue Code Before the House Comm. on Ways and Means*, 85th Cong., 2d Sess., pt. 3 at 2602 (statement of Norris Darrell). The haste with which the House bill was rewritten supports the view that the rejection of the provisions governing boot in the House bill did not necessarily reflect considered opposition to the approach. *See* Darrell, *Internal Revenue Code of 1954—A Striking Example of the Legislative Process in Action*, 1955 U. S. CAL. TAX INST. 1.

46. H.R. REP. NO. 2543, 83d Cong., 2d Sess. 34 (1954).

47. The Internal Revenue Service feels that the shareholder generally receives a proportionate amount of stock of the acquiring corporation and boot for each share of the same class in the transferor corporation. *See* Rev. Rul. 68–23, 1968–1 C.B. 144. If the shareholder had the same basis in each of the shares surrendered in the exchange, the gain recognized pursuant to § 356(a) would be limited by the shareholder's gain on the whole transaction. However, if the shareholder had different bases for different shares, there could be gain on some shares and losses on others; the shareholder could not offset the gain on some shares with losses on others. *Id.* In H.R. 4459, 86th Cong., 1st Sess. § 21 (1959) gain would be computed by comparing a portion of the basis of the stock exchanged in the reorganization with the amount of boot. The relevant portion of the basis would be that fraction equal to the boot received, divided by total consideration received in the reorganization.

Earnings and Profits. Section 356(a)(2) provides that a distribution of boot can be taxed as a dividend only to the extent that it does not exceed the distributee's ratable share of accumulated earnings and profits. In contrast, the amount of dividend income resulting from a distribution by an ongoing corporation will be limited only by the total amount of both current and accumulated earnings and profits.[48]

It has been suggested that the limitation of ordinary income to the distributee's ratable share of earnings and profits provided by section 356(a)(2) follows directly from the dividend within gain limitation.[49] It is argued that without the limitation of ordinary income to the distributee's ratable share of earnings and profits, the amount of ordinary income recognized by a distributee would depend on the amount of gain realized by other distributees of boot. This position assumes that earnings and profits will be reduced only by the amount of gain recognized by a distributee of boot.[50]

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48. I.R.C. §§ 301, 316. It is interesting to note that § 333(e) of the Code, which applies to proceeds received in certain types of corporate liquidations, has a rule similar to that of § 356(a)(2). *See also* I.R.C. §§ 1246, 1248.

A court could hold that the language of § 356(a)(2) should not be taken literally and the distributee of boot should have ordinary income to the extent of the ratable share of current or accumulated earnings and profits. *See* Vesper Co. v. Commissioner, 131 F.2d 200, 205 (8th Cir. 1942); W.H. Weaver, 25 T.C. 1067, 1083-84 (1956). Both cases interpreted the phrase "distribution of earnings or profits accumulated after February 28, 1913" in § 115(g) of the 1939 Code, which is the predecessor of current § 302(d), to include current and accumulated earnings and profits. According to the courts, this phrase only emphasized that earnings and profits accumulated prior to February 28, 1913 are excluded. This issue is no longer relevant for § 302(d) of the Code, which refers directly to § 301 (and therefore indirectly to § 316) for qualification as a dividend, but the courts' holdings could be applied to § 356(a)(2).

In James Armour, Inc., 43 T.C. 295 (1964), the Tax Court included earnings and profits of the year of a distribution with accumulated earnings and profits from previous years in determining the appropriate amount of a distribution under § 356(a)(2) that should be taxed as a dividend. This conclusion is clearly correct, for accumulated earnings and profits should include earnings and profits of the current year. A completely separate issue is raised when there is a deficit in accumulated earnings and profits but a surplus in current earnings and profits.

49. Shoulson, *supra* note 42, at 579; Wittenstein, *Boot Distributions and Section 112(c)(2): A Re-examination*, 8 TAX L. REV. 63, 68 n.14 (1952). However, in the proposed amendments submitted by the Advisory Group of Subchapter C, the dividend within gain limitation was removed, while the limitation of the distributee's ratable share of earnings and profits was retained. H.R. 4459, 86th Cong., 1st Sess. § 21 (1959).

50. Treas. Reg. § 1.381(c)(2)-1(c)(1) does not help resolve this issue. It provides that the earnings and profits of the transferor corporation on the date of transfer shall be computed by taking into account the amount of earnings and profits "properly applicable" to the distribution of boot. The Tax Court in Sidney S. Munter, 5 T.C. 108 (1945), held that earnings and profits would be reduced by a distribution of boot only to the extent of gain,

Recognition of Loss. Section 356(c) does not allow the distributee of boot to recognize any loss on the exchange.[51] The investment in any of the shares is not considered to have been liquidated.[52] In contrast, a shareholder who sells stock to the corporation pursuant to a redemption qualifying as an exchange or pursuant to a partial liquidation can recognize loss even though an interest in the corporation is retained.[53]

In Kind Transfer to Corporate Distributees. If property other than cash is distributed as boot to a corporate shareholder and if the boot has the effect of a dividend, the corporation will take the fair market value of the property as its basis[54] and will qualify for the eighty-five percent dividend received deduction.[55] Therefore, any previously unrecognized gain on the property will largely escape taxation unless the distributor of the property recognizes gain on the distribution. If the property originates in the transferor corporation, gain will probably not be recognized.[56] In contrast, a corporation that receives a dividend of property other than cash will carry over the distributor's basis, increased by the amount of gain recognized to the distributing corporation, so long as this total amount is lower than the fair market value.[57]

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and no decrease in earnings and profits was allowed. Neither the Third Circuit nor the Supreme Court reached this issue on appeal, but the Supreme Court seemed to indicate that it agreed with the Tax Court. Munter v. Commissioner, 157 F.2d 132 (1946), *rev'd*, 331 U.S. 210 (1947). *But see* Rev. Rul. 72-327, 1972-2 C.B. 197, where the Internal Revenue Service ruled that earnings and profits should decline by the total amount of distribution which has the effect of a dividend, even though the distributee's ratable share of earnings and profits was less than the amount of boot received. For a good general discussion of effect of boot on earnings and profits, see Halperin, *Carryovers of Earnings and Profits*, 18 TAX L. REV. 289, 310-17 (1963).

51. *See generally* H.R. 4459, 86th Cong., 1st Sess. § 21 (1959). In the proposed bill, the distribution of boot would have allowed some of the realized loss to be recognized if the boot did not have the effect of a dividend. The amount of boot would be compared with a portion of the basis of the stock exchanged in the reorganization to determine the amount of gain or loss. The relevant portion of the basis would be that fraction equal to the boot received divided by total consideration received in the reorganization.

52. When nonqualifying property is distributed in other exchanges where gain or loss is generally not recognized, the boot will not cause any realized loss to be recognized. *See, e.g.*, I.R.C. §§ 1031(c), 361(b)(2).

53. *Id.* §§ 302(a), 331(a)(2).

54. *Id.* § 358(a)(2); Treas. Reg. § 1.356-1(d) (1955).

55. I.R.C. § 243. *See* King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 72-327, 1972-2 C.B. 197.

56. *See* I.R.C. § 311(a); Treas. Reg. § 1.311-2(a)(2) (1972). If the property originated in the acquiring corporation, then the acquiring corporation will recognize gain or loss. Rev. Rul. 72-327, 1972-2 C.B. 197.

57. I.R.C. § 301(d)(2). In general, the distributor of a dividend of property other than

III. THE ROLE OF SECTIONS 302 AND 346 IN REPLACING THE AUTOMATIC DIVIDEND RULE

The basic issue in interpreting section 356 is what criteria should be used to determine whether the exchange has the effect of the distribution of a dividend. For many years, controversy centered around the Internal Revenue Service's position that the exchange should always have the effect of the distribution of a dividend.[58] Boot would then be taxed as a dividend to the extent of gain so long as there were sufficient earnings and profits.[59] This position, known as the automatic dividend rule, originated in the Supreme Court decision of *Commissioner v. Estate of Bedford*.[60]

In *Estate of Bedford*, cash was distributed to shareholders pursuant to a recapitalization.[61] The Court's holding that the cash had the effect of a dividend under the predecessor to section 356 was clearly correct. There had been no contraction of the corporate enterprise, and the Estate's relative interest in the corporation was not shown to have declined. However, the Supreme Court seemed to say that boot would always be taxed as a dividend so long as there were sufficient earnings and profits: "[A] distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within § 112(c)(2)."[62] The Court reasoned that section 115(i) of the Revenue Act of 1936, which defined "partial liquidation," had no relevance to the boot provision of section 112(c)(2).[63]

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cash does not recognize gain or loss, although there are significant exceptions. *See, e.g., id.* §§ 311(b), (c), 1245, 1250.

58. *See* Rev. Rul. 56-220, 1956-1 C.B. 191; Hawkinson v. Commissioner, 235 F.2d 747, 750 (2d Cir. 1956). The Internal Revenue Service would, however, argue against this position in particular cases when it was to its advantage. *See* Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958).

59. *See* note 5, *supra*.

60. 325 U.S. 283 (1945).

61. The Estate of Edward T. Bedford owned 3,000 shares of 7% cumulative preferred stock in the Abercrombie and Fitch Company. The corporation adopted a plan of recapitalization to effect a reduction of capital and remove from its books a surplus book deficit, which under state law prevented it from paying dividends. The Estate exchanged its preferred stock for 3,500 shares of $6 cumulative preferred stock, 1,500 shares of common stock, and $45,240 in cash pursuant to the plan of reorganization.

62. 325 U.S. at 292.

63. The Court said:

> [T]he classifications of § 115 . . . do not apply to a situation arising within § 112. The definition of a "partial liquidation" in § 115(i) is specifically limited to use in § 115. To attempt to carry it over to § 112 would distort its purpose. That limitation is not true of § 115(a) which defines "dividend" for the purpose of the whole title. Accordingly, this definition is infused into § 112(c)(2). Under § 115(a) a distribution out of accumulated earnings and profits is a "dividend," thus con-

The automatic dividend rule was not well received by the courts,[64] and in 1974 the Internal Revenue Service formally abandoned it.[65] Until 1974, much effort was expended attacking the automatic rule, but comparatively little attention was devoted to considering an appropriate alternative.[66] It seemed clear, however, that the courts should refer in some fashion to the principles of sections 302 and 346 of the Code for guidance.[67]

A. *Guidance from Section 346*

Under section 346 of the Internal Revenue Code and the Regulations a distribution from a corporation to its shareholders will be in partial liquidation of the corporation if the distribution re-

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firming the conclusion that a distribution of earnings and profits has the "effect of the distribution of a taxable dividend" under § 112(c)(2). *Id.* at 291–92.

64. In several cases the validity of the automatic dividend rule was questioned, but the courts considered it unnecessary to rule on the issue of validity because they found the distributions had the effect of a dividend even without the automatic dividend rule. *See* Hawkinson v. United States, 235 F.2d 747 (2d Cir. 1956); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); King Ent., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959); Wilson v. Commissioner, 46 T.C. 334, 349 (1966).

The first case in which the automatic dividend rule was explicitly rejected was Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958). Ironically, the Government argued against the automatic dividend test and won the case. *See also* Bateman v. Commissioner, 40 T.C. 408 (1962), in which *Commissioner v. Estate of Bedford* was distinguished.

The government suffered its first clear defeat on the automatic dividend rule before the district court in Wright v. United States, 29 A.F.T.R.2d 72–1466 (E.D. Ark. 1972), *aff'd*, 482 F.2d 600 (8th Cir. 1973). The Internal Revenue Service did not argue the automatic dividend rule in the appeal to the Eighth Circuit.

65. Rev. Rul. 74–515, 1974–2 C.B. 118. *See also* Rev. Rul. 75–83, 1975–1 C.B. 112.

66. *See* Darrell, *The Scope of* Commissioner v. Bedford's Estate, 24 TAXES 267 (1946); Gerson, *Boot Dividends and the Automatic Rule:* Bedford *Revisited*, 11 WM. & MARY L. REV. 841 (1970); Moore, *Taxation of Distributions Made in Connection with a Corporate Reorganization*, 17 TAX. L. REV. 129 (1961); Shoulson, *supra* note 42; Wittenstein, *supra* note 49; note 64 *supra*. To the extent that courts considered an alternative, they treated the boot as being distributed by the transferor corporation prior to the reorganization and characterized the boot accordingly. *See* note 90 *infra*.

67. *See* Moore, *supra* note 66; Shoulson, *supra* note 42.

In a recent article the position is taken that, in reorganizations where the corporations had not been commonly controlled, the principles of § 302 and § 346 should *not* be applied in determining whether boot has the effect of a dividend. In such reorganizations, it is argued, the boot should never be taxed under § 356(a)(2). Golub, *"Boot" in Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)*, 58 TAXES 904 (1980). One of the problems with this argument is that the major function of § 356(a)(2) then is to tax boot in reorganizations involving commonly controlled corporations and in recapitalizations. The dividend within gain limitation of § 356(a)(2) makes no sense in such situations since there is no real exchange taking place. *See* note 6 *supra*.

sults from a bona fide contraction of the corporation.[68] A shareholder who receives a portion of such a distribution is treated as exchanging an appropriate amount of stock and will normally realize capital gain or loss.[69] Since there has been a major adjustment in the business of the corporation, distributions emanating from such an adjustment are not regarded as equivalent to a dividend.

Section 346 is relevant in interpreting the phrase "effect of the distribution of a dividend" found in section 356(a)(2), but only in very limited circumstances. A corporation may distribute assets of a business to its shareholders immediately prior to a merger with a second corporation. Alternatively, as part of the reorganization plan, the corporation could sell the assets to an unrelated third party, and the shareholders of the transferor corporation would receive the proceeds from the sale, as well as stock of the acquiring corporation. If the distribution of assets or proceeds would have qualified as a distribution in partial liquidation absent the reorganization, it follows that the distribution would not have the effect of a dividend when it took place simultaneously with a reorganization.[70] The subsequent reorganization would not cause the distribution to appear more like a dividend distribution.

On the other hand, the boot may emanate from contraction of the acquiring, rather than the transferor, corporation. Although the distribution of assets to the shareholders of the acquiring corporation might qualify as a partial liquidation, this result should not affect the determination of whether the boot distributed to the transferor corporation's shareholders has the effect of a dividend. The assets (or the proceeds from sale of the assets) are not being distributed to shareholders of the corporation that carried on the business. The distribution of boot in this instance is not similar to a distribution in partial liquidation.

B. *Guidance from Section 302*

Section 302(a) of the Internal Revenue Code treats distributions in redemption of stock as payment in exchange for the stock when the distribution meets any of the requirements of section

68. I.R.C. § 346; Treas. Reg. § 1.346–1 (1955). For a discussion of the requirements of a partial liquidation, see B. BITTKER & J. EUSTICE, *supra* note 20, at §§ 9.52–9.53.

69. I.R.C. § 331.

70. *See* H.R. 4459, 86th Cong., 1st Sess. § 21 (1959). *But see* H.R. 8300, 83d Cong., 2d Sess. § 306 (1954) (characterization of boot did not depend at all on whether the distribution of boot could qualify as a partial liquidation).

302(b).[71] The distribution would generally then give rise to capital gain or loss. Otherwise, the distribution falls under section 301 and therefore is treated as a dividend to the extent of earnings and profits.[72]

In order for a distribution in redemption of stock to qualify under section 302(a), the shareholder must usually give up a significant interest in the corporation.[73] One or more of the three attributes of a shareholder's interest in a corporation—voting rights, rights to a share of dividend distributions, and rights to a share of liquidation proceeds—must be reduced for the redemption to qualify under section 302(a).[74] The redemption would then be analogous to a sale from the point of view of the shareholder because a relative interest in the corporation is being exchanged for cash or other property. On the other hand, a distribution in redemption of stock which does not result in the shareholder giving up a significant ownership interest is analogous to a dividend.[75] For example, a pro rata redemption leaves all the shareholders with the same proportionate interest in the corporation, and it is taxed as a dividend if there are sufficient earnings and profits.

Section 302 determines the tax effects of redemptions according to whether they are more like sales or dividends. This section does not, however, give much direct guidance for determining when a boot distribution in an amalgamating reorganization should have the effect of a dividend. The shareholder of the trans-

71. Section 302(b) provides three separate situations in which a redemption can qualify as an exchange under § 302(a). Section 302(b)(1) is a general test which states that the redemption must not be "essentially equivalent to a dividend." Sections 302(b)(2) and (3) are safe harbors. Section 302(b)(3) provides for exchange treatment if the redemption is in "complete redemption of all stock owned by the shareholder." Section 302(b)(2) provides for exchange treatment if the distribution is "substantially disproportionate with respect to the shareholder" and "if the shareholder owns less than 50% of the total combined voting power" in the corporation immediately after the redemption. The distribution will be substantially disproportionate if the shareholder's interest in the corporation is reduced by a sufficient amount so that the numerical test in § 302(b)(2) is satisfied. Section 318, which provides for constructive ownership of stock, is generally applicable to § 302, but family attribution can be waived in certain cases for complete redemptions.

72. I.R.C. § 302(d).

73. The safe harbor provision of § 302(b)(2) requires the shareholder to give up enough voting power to satisfy a numerical test. Section 302(b)(3) requires the shareholder to give up all stock interest. For a redemption to qualify under § 302(b)(1), there must be a "meaningful reduction of the shareholder's proportionate interest in the corporation." Davis v. United States, 397 U.S. 301, 313 (1970).

74. *See* Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964).

75. I.R.C. § 302(d).

feror corporation is receiving boot as part of a transaction in which shares in the transferor corporation are being exchanged for shares in the acquiring corporation plus boot. From this perspective, the transaction is always analogous to a sale or exchange. On the other hand, a pro rata redemption is an exchange only in a formal, nonsubstantive way.

It is not clear how the principles of section 302 should be used to interpret section 356(a)(2). Changes in relative ownership are taking place while the corporations are combining. Even if the boot can be traced to one of the corporations, it should not necessarily be treated as emanating from the assets of that corporation for the purpose of applying section 302. The two corporations are combining into one entity as part of the reorganization; therefore, determining which corporation is the source of the boot has no economic significance.[76]

Because redemptions involve a distribution of assets from a corporation to its shareholders, Congress could have chosen not to treat any redemptions as sales to the corporation.[77] An examination of the congressional motivation for treating a redemption that reduces a shareholder's interest in the corporation as an exchange of stock by the shareholder provides little guidance for interpreting section 356. In the words of one commentator, the motivation is "notoriously uncertain."[78] A commonly suggested theory is that Congress wanted to provide an opportunity for shareholders of closely held corporations to sell their stock for capital gain, and that the only potential purchaser normally would be the corporation.[79] Although provision for this market may have been the un-

76. The conclusion that § 302 is not, without further analysis, directly helpful in interpreting § 356(a)(2), even when the boot can be traced to the assets of the transferor corporation, contrasts with the opposite conclusion reached above for § 346. *See* text accompanying note 70 *supra*. The liquidation of a discrete business activity, which is the essence of a partial liquidation under § 346, retains significance when the remaining corporate activities are transferred to another corporation. On the other hand, the change in ownership of the transferor corporation, which is measured by § 302, has no inherent significance when the shareholder interests are, in any event, being radically changed by the reorganization.

77. *See* Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739 (1969). For example, the tax consequences of a redemption could be determined as if there had been a pro rata distribution by the corporation followed by constructive sales of stock among the shareholders.

78. Bacon, *Share Redemptions by Publicly Held Companies*, 26 TAX. L. REV. 283, 300 (1971).

79. *See* Chirelstein, *supra* note 77, at 740; Hobbett, *The New Attack on Stock Redemptions*, 35 TAXES 830, 838–39 (1957); Pedrick, *Some Latter Day Developments in the Taxation of Liquidating Distributions*, 50 MICH. L. REV. 529, 530 (1952).

derlying objective, section 302 is not, in letter or spirit, limited to distributions by closely held corporations.[80]

IV. COMBINATIONS OF CORPORATIONS THAT DO NOT HAVE COMMON OWNERSHIP

This section examines the taxation of boot distributed in "acquisitive reorganizations"—transactions in which the shareholders of the transferor corporation owned no interest in the acquiring corporation prior to the reorganization. The analysis presented will be applicable to all amalgamating reorganizations, but a discussion of the complications that arise from common ownership of the corporations will be deferred until the next section.

The major issue with respect to boot in acquisitive reorganizations is what standards are to be used to determine when the exchange has the "effect of the distribution of a dividend" within the meaning of section 356(a)(2). A related issue is which corporation's earnings and profits should be considered the source of the boot. Although the dividend within gain limitation may be anomalous, it is not necessarily illogical in the context of acquisitive reorganizations. The shareholder is exchanging stock in one corporation for stock in a different corporation plus boot, and gain is recognized to the extent of the boot.[81] Recovery of basis is typically allowed when an asset is exchanged for something else in a taxable transaction.[82] The anomaly arises because the boot is treated as received in exchange of stock for purposes of recovery of basis, but not for purposes of characterizing the gain. The Internal Revenue Service's view is that the boot always emanates from a transferor corporation.[83] This view is probably consistent

80. *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92.

81. *Cf., e.g.*, § 1031(b) (recovery of basis when boot received in a like-kind exchange); § 351(b) (same for boot received in connection with contribution to controlled corporation).

82. I.R.C. § 1001.

The dividend within gain limitation was defended on this ground by the Committee on Taxation of the Philadelphia Bar Association in hearings before the House Ways and Means Committee concerning H.R. 4459, 86th Cong., 1st Sess. § 21 (1959). Alfred McDowell, who testified on behalf of the Committee on Taxation, also defended the dividend within gain limitation for "F" reorganizations but was unconvincing. *Hearings on Advisory Group Recommendations on Subchapter C, J, K of the Internal Revenue Code Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess., 787-90. The dividend within gain limitation is much harder to defend in the context of "F" reorganizations than in the context of acquisitive reorganizations. *See also* testimony of Crane Hauser of the Committee on Federal Taxation of the Chicago Bar Association, *id.* at 740, 773.

83. *See* Treas. Reg. § 1.382(c)(2)-1(c)(1) (1963); Rev. Rul. 72-327, 1972-2 C.B. 197.

with congressional intent,[84] but it highlights the anomaly of the gain limitation.

If the distribution of boot emanating from a contraction of the transferor corporation's business would, absent the reorganization, qualify as a partial liquidation, then the distribution would not have the effect of a dividend.[85] The distribution of boot would not, however, typically qualify as a partial liquidation, and whether boot will have the effect of a dividend will usually depend on the proper application of the principles of section 302 in interpreting section 356(a)(2). Consequently, in the remainder of this section it is assumed that the distribution of boot would not qualify as a partial liquidation.

With some oversimplification, three separate approaches can be identified for applying the principles of section 302 to interpretation of the phrase "effect of the distribution of a dividend" in section 356(a)(2): (1) the "before and after" test which compares the distributee's ownership of stock before the reorganization with the ownership of stock after the reorganization; (2) the "after" test which compares the distributee's actual ownership in the surviving corporation after the reorganization with what it would have been if only stock had been distributed as consideration in the reorganization; (3) the "before" test which compares the distributee's ownership in the transferor corporation as if the boot had been distributed by the transferor corporation in redemption of its stock prior to the reorganization with the distributee's actual ownership in the transferor corporation prior to the reorganization.[86]

A simple example can be used to illustrate the different tests. Suppose A owns all 100 shares of the stock of corporation X, which is merging into corporation Y. Before the reorganization Y had 100 shares outstanding, each of which was equal in value to one share of X stock. In the reorganization A receives 80 shares of Y and $20 of boot, with Y then having 180 shares outstanding. If A had received additional stock rather than boot, A would have owned 100 shares of Y, which would have had 200 shares outstanding. (1) Applying the "before and after" test, A's one hundred percent ownership of X before the reorganization is compared with a forty-four percent interest (80/180) in Y after the

84. *See* notes 137–44 *infra* and accompanying text.

85. *See* notes 68–70 *supra* and accompanying text.

86. If there were a consolidation, both corporations would be considered transferor corporations and these tests could be applied to shareholders receiving boot from either corporation.

reorganization. In this instance, the boot would probably not have the effect of a dividend.[87] (2) Applying the "after" test, A's forty-four percent interest in Y is compared with the fifty percent interest that A would have had if there had been no boot. In this situation, the boot might or might not have the effect of a dividend.[88] (3) Applying the "before" test, A's one hundred percent interest in X, if the boot had been distributed by X in a redemption prior to the reorganization, is compared with A's actual one hundred percent interest in X before the reorganization. Clearly, the boot here has the effect of a dividend.

The "before and after" test is the most advantageous to individual shareholders in acquisitive reorganizations because the distributee's position in the transferor corporation would be compared with a diminished interest in the larger surviving corporation. The "after" test would be more advantageous to individual shareholders than the "before" test, since a distribution of a fixed amount of cash or property will cause a greater relative decline in a shareholder's proportionate interest when the shareholder starts with a smaller proportionate interest in a larger corporation.[89]

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87. The standards of § 302 indicate that a decline in ownership in a corporation from 100% to 44% would not have the effect of a dividend. I.R.C. § 302(b)(2). Of course, § 302 would normally be applied to a shareholder's interest in a single corporation.

88. Section 302(b)(2) would not be satisfied. The redemption might not be essentially equivalent to a dividend under § 302(b)(1).

89. It can be illustrated algebraically that the "after" test will always result in a greater relative decline than the "before" test when the distributee of boot had not owned any stock in the acquiring corporation before the reorganization. Let: S = value of the interest of distributee of boot in the transferor corporation, C = value or worth of transferor corporation, G = value or worth of acquiring corporation before the merger, B = value of boot distributed to all shareholders, and R = value of boot distributed only to the shareholder owning S. The relative decline in value caused by the boot according to the "before" test is:

(1)
$$\frac{\frac{S-R}{C-B}}{\frac{S}{C}}$$

The numerator of this fraction is the shareholder's relative interest in the transferor corporation after the hypothetical redemption; the denominator, the shareholder's relative interest before the hypothetical redemption. The relative decline in value caused by the boot according to the "after" test is:

(2)
$$\frac{\frac{S-R}{C+G-B}}{\frac{S}{C+G}}$$

The numerator of this fraction is the shareholder's actual relative interest in the surviving

The earlier cases support the "before" test, but the other two possibilities did not seem to have been considered.[90] Not surprisingly, the Internal Revenue Service has ruled that the "before" test is correct.[91] Recent commentary, on the other hand, has generally supported the "after" or the "before and after" tests.[92] The most recent cases dealing with this issue seem to reflect a split in the circuits over whether the "before" or "after" test is appropriate.[93] Notably, the most significant case using the "before and after" test was reversed.[94] None of the three tests is completely satisfactory, but the "before" test appears most consistent with congressional intent.[95]

A. *The "Before and After" Test*

The major case adopting the "before and after" test is the district court opinion in *Shimberg v. United States*.[96] Taxpayer Shimberg owned 90,517 shares of the total 135,521 shares (approximately sixty-six percent) of common stock of LaMonte-

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corporation; the denominator, the shareholder's relative interest in the surviving corporation had no boot been distributed. It can be shown that (1) is always larger than (2). Therefore, the fraction represented by (2) will show a greater relative decline.

90. *See* Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934); King Ent., Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959); Isabella M. Sheldon, 6 T.C. 510 (1946); George Woodward, 23 B.T.A. 1259 (1931). *See also* Shoulson, *supra* note 42.

91. Rev. Rul. 75-83, 1975-1 C.B. 112.

92. Cohen, *Receipts Related to Corporate Equity*, 53 TAXES 824, 840-44 (1975); Fassler, *Fifth Circuit's* Shimberg Jr. *Decision—Automatic Dividend Treatment of Boot in Acquisitive Reorganizations*, 57 TAXES 159 (1979); Horwood, *Clarified I.R.S. Position Enhances Planning for Stock Redemptions With New Shareholders*, 46 J. TAX. 338 (1977); Hurley, *Capital Gain Possibilities for Boot in Acquisitive Reorganizations Lessened by* Shimberg *Case*, 50 J. TAX. 334 (1979); Levin, Adess & McGaffey, *Boot Distributions in Corporate Reorganizations*, 30 TAX LAW. 287 (1977). *See also* Battle, *Dividends, Redemptions, and Stock Purchases in Connection with Reorganizations*, 53 TAXES 845, 852 (1975).

For a student note that supports the "before" test, see Note, *Boot Hill—Characterizing Property Distributed with Corporate Reorganizations*, 4 J. CORP. L. 711 (1979). Also of interest is Note, *Boot Distributions in Corporate Reorganizations: Dividend Equivalence and the Continuity of Interest Doctrine*, 32 U. FLA. L. REV. 119 (1979).

93. *Compare* Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979), *with* Wright v. United States, 482 F.2d 600 (8th Cir. 1973). The court in *Shimberg* attempted to distinguish *Wright*. It is argued, however, that the decisions are irreconcilable. *See* text accompanying notes 153-59 *infra*.

94. Shimberg v. United States, 415 F. Supp. 832 (M.D. Fla. 1976), *rev'd*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979). *See also* Sellers v. United States, 42 A.F.T.R.2d 78-6195 (D.C. Ala. 1977), *rev'd*, 615 F.2d 1066 (5th Cir. 1980).

95. *See* notes 126-45 *infra* and accompanying text.

96. 415 F. Supp. 832 (M.D. Fla. 1976), *rev'd*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979). *See also* Sellers v. United States, 42 A.F.T.R.2d 78-6195 (D.C. Ala. 1977), *rev'd*, 615 F.2d 1066 (5th Cir. 1980).

Shimberg Corporation (LSC). His wife owned less than two percent of the common stock, and the remaining stock was owned by nineteen unrelated shareholders. LSC was acquired by MGIC Investment Corporation (MGIC), a publicly held corporation traded on the New York Stock Exchange, in a transaction which qualified as an "A" reorganization. The shareholders of LSC received pro rata 32,132 shares of MGIC common stock outright, 32,132 shares of MGIC common stock in escrow, and $625,000 in cash. Shimberg received 21,461 shares of MGIC common outright, 21,461 shares in escrow, and $417,449 in cash. Earnings and profits of LSC and MGIC were each in excess of $625,000.

In determining that the cash received by Shimberg did not have the effect of a dividend, the district court relied on *United States v. Davis*.[97] The Supreme Court in *Davis* held that a redemption must cause "a meaningful reduction of the shareholder's proportionate interest in the corporation" for the redemption not to be essentially equivalent to a dividend under section 302(b)(1).[98] In *Shimberg* the court found that there had been such a reduction because the taxpayer's interest had decreased from approximately two-thirds of a closely held corporation to less than one percent of a publicly held corporation.

> It is clear that the merger resulted in a radical change and meaningful reduction in the nature of the Plaintiff's interest in the continuing business. The net effect of the transaction was a sale by the Plaintiff and the other LSC stockholders of their LSC stock to MGIC for cash and marketable securities in a publicly owned corporation.[99]

Taxing boot at capital gain rates because there was a "radical change and meaningful reduction" in the taxpayer's interest conflicts with the theory underlying the special tax treatment for reorganizations. The rationale for the special treatment is that the taxpayer is continuing to have an interest in the transferor corporation, albeit in a modified corporate form.[100] Qualification as a reorganization proceeds upon the theory that there has not been a radical change in the taxpayer's position and that the transaction does not have the effect of a sale. The taxpayer in *Shimberg* did not recognize any gain on the receipt of MGIC stock and thereby

97. 397 U.S. 301 (1970).

98. *Id.* at 313. For a discussion of *United States v. Davis*, see Postlewaite & Finneron, *Section 302(b)(1): The Expanding Minnow*, 64 VA. L. REV. 561, 569–74 (1978).

99. Shimberg v. United States, 415 F. Supp. 832, 836–37 (M.D. Fla. 1976), *rev'd*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979).

100. *See* notes 9–29 *supra* and accompanying text.

probably benefited from the qualification of the transaction as a reorganization. He should not have been able to treat the boot as capital gain on a rationale inconsistent with the qualification of the transaction as a reorganization.

The "before and after" test should not, however, be summarily rejected. In Revenue Ruling 75–447, a corporation redeemed some of the stock owned by its two shareholders at the same time it sold additional stock to a third party. The Internal Revenue Service ruled that a redeemed shareholder's original interest in the corporation should be compared with his or her interest after the completed transaction to determine if the redemption qualified as an exchange under section 302(b)(2).[101] This ruling can be extended to distributees of boot in reorganizations, whose position is analogous to that of the redeemed shareholders in the ruling. Distributees of boot defer gain or loss to the extent that they receive stock of the acquiring corporation; their interest in the acquiring corporation is treated as a continuation of their interest in the transferor corporation. Like the shareholders in Revenue Ruling 75–447, they can be considered to be exchanging part of their interest in the corporate entity for cash or other property while a simultaneous transformation occurs in that corporate entity. Consequently, it might be argued that the distributees of boot should be able to qualify for exchange treatment by comparing their interest before and after the transaction as the shareholders covered under the Revenue Ruling are able to do.[102]

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101. Rev. Rul. 75–447, 1975–2 C.B. 113. Two similar fact situations were presented in the ruling. Two shareholders of a corporation, each owning 50% of the stock, wanted to bring in a third person with an equal stock interest. In one set of facts the corporation sold shares of stock to the third party, and the existing shareholders had some of their stock redeemed. Under the second fact situation the third party purchased some stock from the two existing shareholders who also had some of their remaining stock redeemed. In order to meet § 302(b)(2) requirements, each shareholder's 50% interest prior to disposition of the stock was compared with the 33% interest each owned after the complete transaction.

The discussion in the text assumes that Revenue Ruling 75–447 is correct. This assumption, however, could be questioned. Section 302(b)(2) could be applied by comparing what the shareholder's interest would be after the sale to the third party but before the redemption, with the shareholder's actual interest after the redemption. With this treatment of the redemption, any analogy to a reorganization with boot becomes more attenuated. *See* text accompanying notes 122–24 *infra*.

102. *See* Horwood, *supra* note 92. *See also* Golub, *supra* note 67.

In Arthur D. McDonald, 52 T.C. 82 (1969), the equivalent of the "before and after" test was applied to a redemption immediately prior to a "B" reorganization. The issue in *McDonald* was the proper taxation of $43,500 in redemption proceeds that were distributed to the majority shareholder immediately before the redeeming corporation was acquired in a "B" reorganization. The proceeds were financed by a loan incurred in connection with the reorganization, which was repaid by the acquiring corporation. The Internal Revenue

The analogy between a redemption that takes place at the same time as a sale to a third party and a distribution of boot in a reorganization, however, should not be followed. The basis for this conclusion is essentially the same rationale used to determine that the district court opinion in *Shimberg* was inadequate. In a reorganization the shareholders of the transferor corporation do not recognize any realized gain (except to the extent that they receive boot) on the ground that their investment in the transferor corporation is continuing.[103] A decline in voting power is a necessary consequence of an acquisitive reorganization. If realized gain is not recognized despite the decline in voting power, the decline in voting power should not be the basis for qualifying proceeds as capital gain.[104]

Often the distribution of boot will be totally unrelated to concerns about voting power. It is inappropriate in such cases to use the rationale of Revenue Ruling 75–447 to justify capital gain treatment, because the additional decline in voting power caused by the boot is irrelevant to the reasons for distributing the boot.[105]

Service did not argue that the $43,500 used to redeem the taxpayer's stock was consideration other than voting stock and that consequently the transaction did not meet the requirements of a tax-free reorganization under § 368(a)(1)(B). Instead, the Service's position was that the $43,500 should be taxed as ordinary income to McDonald because it was a redemption which did not qualify under § 302(b). The Tax Court held that the redemption was not essentially equivalent to a dividend because the taxpayer's interest was significantly altered by the redemption and reorganization. The taxpayer's interest had changed from owning almost all the stock of a corporation to being a small shareholder in a publicly held corporation. *Id.* at 87–88.

Since boot cannot be distributed in a "B" reorganization, *McDonald* seems to be a weak precedent for interpreting § 356. In Rev. Rul. 75-360, 1975-2 C.B. 110, the Internal Revenue Service stated that it should have argued in *McDonald* that the transaction did not qualify as a reorganization and that it does not consider the case as precedent.

103. *See* notes 19–25 *supra* and accompanying text.

104. The consequence of this conclusion is that transferor corporation shareholders receiving boot would presumably be taxed differently than acquiring corporation shareholders receiving proceeds in redemption of their stock immediately prior to the reorganization. Under Rev. Rul. 75–447, 1975–2 C.B. 113, shareholders of the acquiring corporation should be able to qualify for capital gain by comparing their interests in the corporation before the reorganization with their interests after the reorganization. It is anomalous to treat these shareholders differently. Because of the realization requirement for taxing gain, however, the two groups of shareholders are not in a similar position. If the transaction does not qualify as a reorganization, only shareholders of the transferor corporation would recognize gain or loss on the exchange of stock.

105. Revenue Ruling 75–447 should not apply when a shareholder sells some stock after a pro rata redemption and the redemption is not, except possibly for tax reasons, connected with the sale. For example, if a public corporation instead of paying its regular dividend redeems stock in a pro rata redemption and a shareholder sells some stock immediately after the redemption, the redemption proceeds should not thereby be treated as received in exchange for stock.

Yet, any rule based on the motives for distributing the boot would be virtually impossible to enforce. The "before and after" test applied to reorganizations would allow great opportunity for shareholders of closely held corporations to bail out earnings and profits at capital gain rates whenever the corporations merged with larger corporations. It is unlikely that Congress intended the double benefit of nonrecognition and capital gain for such shareholders.

B. *The "After" Test*

A second approach to the interpretation of the phrase "effect of the distribution of a dividend" in section 356(a)(2) is illustrated by *Wright v. United States*.[106] Both the district court and the Eighth Circuit applied the principles of section 302 by comparing the shareholder's actual ownership in the surviving corporation to what the ownership would have been had the shareholder received additional stock rather than boot. Although the taxpayer owned significant amounts of stock in both corporations consolidated in the reorganization, the approach used by both the district and appellate courts did not depend on this common ownership.

In *Wright v. United States*, two corporations, F & G Construction Company (F & G) and World-Wide, Inc., were consolidated into the newly formed Omni Corporation in a transaction that qualified as an "A" reorganization. The taxpayer owned approximately 56% of World-Wide and virtually 100% of F & G.[107] He received approximately 62% of Omni and Omni's ten-year interest-bearing note for $102,002. Leonard Dunn, a field superintendent of the taxpayer, owned approximately 30% of World-Wide. Dunn contributed $7,006 in cash to Omni, and, in consideration for his cash and World-Wide stock, Dunn received a 27.8% interest in Omni.[108] The taxpayer and Dunn also owned 71.5% and 27.9% respectively of another corporation, Danco Construction

106. 482 F.2d 600 (8th Cir. 1973), *aff'g* 29 A.F.T.R.2d 72-1466 (E.D. Ark. 1972).

107. The taxpayer's mother owned 13.9% of World-Wide. The Internal Revenue Service did not argue that constructive ownership of stock should be taken into account, and thus the court considered only the taxpayer's direct ownership of stock. 482 F.2d at 607 n.14. Judge Bright, in dissent, maintained that the mother's stock should be attributed to the taxpayer. *Id.* at 610.

108. At the time of the consolidation, F & G's total accumulated earnings and profits were $101,802 and World-Wide's were $38,365. Because the district and appellate courts held that the distribution of the note did not have the effect of the distribution of a dividend, they did not reach the issue of whether the $102,002 note would have been out of the earnings and profits of F & G, World-Wide, or both corporations.

Company. The taxpayer received the note from Omni, and Dunn made the capital contribution, so that their relative interests in Omni would be the same as their relative interests in Danco Construction.[109]

The only issue before the Eighth Circuit was whether the note issued to the taxpayer had the effect of a dividend under section 356(a)(2).[110] The Eighth Circuit started its analysis by agreeing "with the Commissioner that section 356(a)(2) should be read *in pari materia* with section 302 for the purpose of determining whether a distribution had the effect of a dividend."[111] The Court then disagreed with the Commissioner's contention that the "effect . . . was the same" as if F & G had issued its note prior to the consolidation in redemption of its own stock or that a portion of the note was issued in redemption of F & G stock and a portion in redemption of World-Wide stock.[112] The court deemed it "artificial" to consider that the note was issued for any stock other than that of Omni because the note was part of the entire reorganization and because section 302 assumes a continuing corporation.[113]

According to the court, the note reduced the taxpayer's ownership of Omni from approximately 85% to 61.7%. Under the relevant state law a two-thirds vote was required in order to amend the articles of incorporation and to approve a merger, consolidation, or liquidation. Therefore, the court considered this decline in voting power to be significant. Citing *United States v. Davis*,[114] the Eighth Circuit held that the boot did not have the effect of a dividend.[115]

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109. The court did not give any explanation for the discrepancy between the taxpayer's interest in Omni and in Danco. Judge Bright in dissent in the Eighth Circuit speculated that the taxpayer included the Omni stock owned by his mother in determining that his interest in Omni was the same as it was in Danco. 482 F.2d at 610.

110. In considering this issue, the district court noted that if the taxpayer had received additional Omni stock rather than the note, he would have owned 85% of Omni instead of 61.7%. The court then held that this substantial reduction meant that the note did not have the effect of a dividend. The district court did not explain its reasoning further or give any citations.

111. Wright v. United States, 482 F.2d 600, 605 (8th Cir. 1973). Other cases have also stated that sections 356(a)(2) and 302 are *in pari materia*. *See, e.g.*, Hawkinson v. Commissioner, 235 F.2d 747, 751 (2d Cir. 1956); Ross v. United States, 173 F. Supp. 793, 797 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959).

112. 482 F.2d at 606–07. Because the taxpayer had owned virtually 100% of F & G, the distribution of the note in redemption of F & G stock would clearly have had the effect of a dividend.

113. *Id.* at 607.

114. 397 U.S. 301 (1970). *See* text accompanying note 97 *supra*.

115. 482 F.2d at 608–09.

The Eighth Circuit was misled by the statement that section 356(a)(2) should be read *"in pari materia"* with section 302.[116] Section 302 can be helpful in interpreting the phrase "effect of the distribution of a dividend," but section 356(a)(2) does not mechanically incorporate section 302. Because of the corporate transformation in an amalgamating reorganization, the distribution of boot is not equivalent to a redemption.[117] Additionally, there are many discrepancies between the taxation of a redemption that is essentially equivalent to a dividend and the taxation of boot that has the effect of a dividend.[118] Therefore, the issue should not be approached by considering whether the application of section 302 to a hypothetical redemption by the transferor or by the acquiring corporation is less artificial.[119]

The "after" test, judged on its own merits, is not appropriate.[120] It is unreasonable to characterize boot according to a result that would have occurred had there been no boot in the reorganization and in an unrelated transaction the surviving corporation had then distributed the boot in redemption of its own shares. The stock which the boot supposedly replaced never existed. It is mere guesswork to predict the quantity and type of stock that would have existed if not for the existence of boot. Furthermore, a distributee of boot may never have had the option of receiving this hypothetical stock in the surviving corporation; the original shareholders of the acquiring corporation may have insisted that boot be distributed.[121] To assume that the distributee of boot gave

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116. *See* note 111 *supra* and accompanying text.

117. *See* text accompanying notes 76–77 *supra*.

118. *See* notes 41–57 *supra* and accompanying text.

119. The Eighth Circuit buttressed its holding in *Wright* by using a variation of the "before and after" test.

> Also, viewing the transaction as a realistic whole, the taxpayer has reduced his holding in one corporation, F & G, from almost complete ownership in F & G to 61.7 per cent ownership in Omni. In contrast, his ownership in World Wide was 56 per cent in relation to his 61.7 per cent ownership in Omni, which either before or after the redemption would make no difference under the above two-thirds requirements of Arkansas law.

482 F.2d at 609–10. The discussion of the "before and after" test can be considered dictum.

120. *But see* Levin, Adess & McGaffey, *supra* note 92; Moore, *supra* note 66 at 147-49. Levin, Adess, and McGaffey in their article argue that Rev. Rul. 75–447, 1975–2 C.B. 113 (*see* note 101 *supra*) and Arthur D. McDonald, 52 T.C. 82 (1969) (*see* note 102 *supra*), provide direct support for the "after" test. Actually, these authorities more directly support the "before and after" test. *See* notes 96–105 *supra* and accompanying text. *See also* Horwood, *supra* note 92.

121. It would not be appropriate to use the "after" test in only those cases where it can be demonstrated that the distributee of boot had the choice of boot or additional stock. If beneficial tax consequences will follow, parties to a transaction will almost invariably be

up stock for the boot will often be pure fiction. For example, in *Wright* it is possible that the other shareholders in World-Wide would have refused to allow consolidation with F & G had the taxpayer not agreed to accept a note rather than additional stock.

A test similar to the "after" test can be formulated from the concept that the acquiring corporation in an amalgamating reorganization is in many respects treated as the continuation of the transferor corporation.[122] Accordingly, a shareholder of the transferor corporation prior to the reorganization might be viewed as a shareholder of both corporations considered together. The shareholder's proportionate interest in the acquiring corporation after the reorganization could then be compared with his or her proportionate interest in the transferor and acquiring corporations considered together before the reorganization. The results of this comparison would show what portion of his or her interest had been exchanged for boot and could be used to determine if the boot had the effect of a dividend. The "after" test uses basically the same comparison; the shareholder's interest after the reorganization is compared with what his or her interest would have been in the acquiring corporation if no boot had been distributed. If no boot had been distributed, the acquiring corporation, after the reorganization, would be comprised of itself and the transferor corporation as they existed before the reorganization. This alternative formulation of the "after" test emphasizes the extent to which the boot causes a change in value of the shareholder's interest, rather than a change in voting power. Although the previous formulation of the "after" test focused on the change in voting power, this change was based on a hypothetical distribution of voting stock.[123]

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ready to demonstrate that it was the transferor corporation shareholders who wanted boot distributed. Additionally, it would be anomalous for shareholders to receive preferential capital gain rates (assuming there was a gain) when those shareholders wanted the cash or other property, but for the shareholders to have ordinary income when compelled by others to take the boot in lieu of additional stock.

122. For some ways in which the surviving corporation is treated as a continuation of both corporations, see text accompanying notes 9–17 *supra*. In other respects, however, the two corporations continue to be treated as separate entities. The transferor corporation ends its taxable year on the date of the reorganization. I.R.C. § 381(b)(1). This can affect the carryforward of items such as net operating losses. In addition, losses of the surviving corporation cannot be carried back to a pre-reorganization year of the transferor corporation. I.R.C. § 381(b)(2). If the combination of corporations qualifies as an "F" reorganization, however, these conclusions would have to be modified. I.R.C. § 381(b). *See* note 37 *supra*.

123. *See* text accompanying notes 120–21 *supra*.

This alternative justification for the "after" test should, however, be rejected. It is overly artificial and carries a theoretical concept too far.[124] Two corporations, which existed as separate legal, tax, and accounting entities, should not be treated as a single entity without a special reason. No such reason appears here.

Nothing can be gleaned from the policy behind section 302 that would justify taxing boot as capital gain on the basis of a hypothetical redemption by the acquiring corporation.[125] There is no reason to suppose that congressional concern for shareholders of closely held corporations should be extended beyond the nonrecognition provisions generally applicable in reorganizations. The adjustment of interests inherent in a reorganization need not be subsidized further by allowing boot to be taxed as capital gain pursuant to the "after" test.

C. *The "Before" Test*

The third method of interpreting the phrase "effect of the distribution of a dividend" in section 356(a)(2) is the "before" test. Under this approach a comparison is made between the distributee's ownership in the transferor corporation as if the boot had been distributed by the transferor corporation in redemption of its stock prior to the reorganization and the distributee's actual ownership in the transferor corporation prior to the reorganization. Some early cases support the application of the "before" test.[126] These decisions do not discuss why the boot is regarded as having been distributed by the transferor corporation, despite the obvious fact that the transaction is not a simple distribution by the transferor corporation.[127] These cases, therefore, are subject to the

124. *See* note 122 *supra*.

125. *See* text accompanying notes 77–80 *supra*.

126. As one opinion stated: "The distribution on a pro rata basis, entailing no substantially disproportionate change in the continuing equity interests of the [transferor corporation's] shareholders, constitutes a classic example of a transaction having the effect of the distribution of a dividend." King Ent., Inc. v. United States, 418 F.2d 511, 521 (Ct. Cl. 1969). *Accord*, Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956); Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959). The automatic dividend test was rejected or distinguished in Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958), and William H. Bateman, 40 T.C. 408 (1963). In determining whether the boot had the effect of a dividend in these cases, the courts used criteria which are not generally relevant.

127. *See, e.g.*, Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959). The court stated that the cash distributed in the reorganization (which had its origin in the acquiring corporation) should be considered as a distribution from the transferor corporation because the distribution had the same effect as a distribution by the trans-

same type of criticism that was leveled at *Wright v. United States*.[128] The boot is not simply being distributed by the transferor corporation, and it is not clear why section 356 should be interpreted as if it were.

The opinion of the Fifth Circuit, reversing the district court in *Shimberg v. United States*,[129] also supports the application of the "before" test. The Fifth Circuit held that the pro rata distribution of boot to shareholders of the transferor corporation, when a closely held corporation was merged into a publicly owned corporation, had the effect of a dividend for the majority shareholder. The court viewed the distribution of boot as a substitute for a distribution by the transferor corporation.

Judge Thornberry, writing for the court, relied on the concept of a reorganization.

> The 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. . . ."
>
> If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a "continuance of the proprietary interests in the continuing enterprise under modified corporate form," it follows that the pro rata distribution of "boot" to shareholders of one of the participating corporations must certainly have the "effect of the distribution of a dividend" within the meaning of § 356(a)(2).[130]

The distribution is pro rata, however, only with respect to a corporation that, as part of the transaction, is terminating its separate

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feror corporation. However, the distribution also had the same effect as a redemption by the acquiring corporation after the reorganization.

128. 482 F.2d 600 (8th Cir. 1973). *See* text accompanying notes 116–19 *supra*.

129. 415 F. Supp. 832 (M.D. Fla. 1976), *rev'd*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979). *See also* General Housewares Corp. v. United States, 615 F.2d 1056 (5th Cir. 1980); Sellers v. United States, 615 F.2d 1066 (5th Cir. 1980).

For comments on *Shimberg*, all of which are critical of the Fifth Circuit's decision, see Fassler, *supra* note 92; Hurley, *supra* note 92; Note, *Treatment of Cash Distributions to Shareholders Pursuant to Corporate Reorganization*, 20 B.C.L. REV. 601 (1979); Note, *Distribution of Boot to Shareholders of Merged Corporation Taxable as Dividend, Not Capital Gain*, 1978 B.Y.U.L. REV. 1059; Note, *Taxation of Boot Distributions: A Return to* Bedford*?*, 7 HOFSTRA L. REV. 987 (1979); Note, *Reorganization and Capital Gains—A Forgotten Concept?*, 41 U. PITT. L. REV. 291 (1980); Note, *Taxation of Boot Received During Acquisitive Reorganization: Dividend v. Capital Gains*, 13 U. RICH. L. REV. 621 (1979); Note, *Determining Dividend Equivalence of "Boot" Received in a Corporate Reorganization*, 32 TAX LAW. 834 (1979).

For a student comment approving the Fifth Circuit decision, see Note, *Boot Hill—*, *supra* note 92.

130. 577 F.2d at 288.

existence. Thus, Judge Thornberry's opinion that the distribution is pro rata is more conclusion than fact.

Judge Thornberry also cited portions of the Committee Reports for the Revenue Act of 1924, which discussed the predecessor to section 356(a)(2).[131] The bulk of the discussion in both the House and Senate reports concerns a transfer by a corporation of all its assets to a newly formed corporate shell with the same ownership—a transaction very different from the one before the court. This difference was ignored; Judge Thornberry stated simply that the example in the legislative history was "virtually the same fact situation" as the case he was considering.[132] In any event, the invocation of this example without analysis is not helpful. Since the cited example indicates that the House and Senate Committees did not fully understand the bill they were enacting,[133] its persuasiveness is not compelling.

The underlying reason for the court's decision was that the distribution of boot was viewed as a substitute for a distribution by the transferor corporation before the merger. As the court stated, "[t]he taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a 'boot' rather than before the merger in the form of a dividend."[134] Judge Thornberry created a presumption, apparently irrebuttable, that the boot is payment to the transferor corporation shareholders of any earnings and profits retained by the transferor corporation.

> It is apparent that taxpayer, who controlled [the transferor corporation] made a considered decision to utilize the corporation's retained earnings for purposes other than payment of a dividend. It cannot be said that [the transferor corporation] was unable to pay a dividend; rather, *for reasons not revealed in the record*, it chose not to do so. Moreover, despite taxpayer's protestations to the contrary, it seems clear that the merger operated as a device for "bailing out" [the transferor corporation's] retained earnings, which were evidently tied up in certain aspects of the business' operation.[135]

Apparently, Judge Thornberry created this presumption because he considered the pro rata distribution of boot to the shareholders

131. H.R. REP. No. 179, 68th Cong., 1st Sess. 14–15 (1924); S. REP. No. 398, 68th Cong., 1st Sess. 15–16 (1924). For the history of § 356, see note 38 *supra*.

132. 577 F.2d at 289.

133. *See* notes 42–43 *supra* and accompanying text.

134. 577 F.2d at 289.

135. *Id.* (emphasis added).

of the transferor corporation to be a device for bailing out earnings and profits. Given the various ways in which earnings and profits can be extracted from a corporation at capital gains rates, however, it is not clear why the boot distributed to Shimberg should be condemned as a device for a bailout.[136]

Despite the apparent shortcomings of the *Shimberg* opinion, the court's conclusion that the boot should be viewed as a substitute for distributions by the transferor corporation prior to the merger is not necessarily an unacceptable approach. In reaching its conclusion, the court should have probed congressional intent more deeply. Under such an examination, it appears that, for the purpose of determining whether the boot has the effect of a dividend, Congress intended the boot to be viewed as a substitute for a distribution by the transferor corporation prior to the reorganization.[137] An analysis of the language and legislative history behind section 356 supports this view.

A literal reading of section 356 suggests that in an acquisitive reorganization the transferor corporation must be considered the source of any earnings and profits that are distributed. Section 356(a)(2) provides that if the exchange has the effect of a dividend, the recognized gain shall be treated as a dividend to the extent of the distributee's ratable share of earnings and profits of *"the corporation."*[138] The term, "the corporation," must refer to the transferor corporation.[139] It would be very awkward to refer to a distributee's ratable share of earnings and profits in a corporation of which he or she was becoming a shareholder in the same transaction in which the distribution of earnings and profits was made. If the transaction were viewed as a distribution of the acquiring

136. For example, a pro rata redemption made at the same time that some or all of the remaining stock is sold to a third party can be used to extract earnings and profits at capital gain rates. *See* Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 54–458, 1954–2 C.B. 167; Rev. Rul. 55–745, 1955–2 C.B. 223; Rev. Rul. 75–447, 1975–2 C.B. 113.

137. *See* text accompanying notes 138–42 *infra*.

138. I.R.C. § 356(a)(2) (emphasis added).

139. Treas. Reg. § 1.381(c)(2)–1(c)(1) (1963). *See also* Shimberg v. United States, 577 F.2d 283, 289 n.15 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979); Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934); Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959); American Mfg. Co. v. Commissioner, 55 T.C. 204, 230–31 (1970); Rev. Rul. 72–327, 1972–2 C.B. 197; Rev. Rul. 56–220, 1956–1 C.B. 191; Rev. Rul. 56–345, 1956–2 C.B. 206. In Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), the Fifth Circuit concluded that the boot is distributed from the earnings and profits of both the transferor and acquiring corporations. *See* notes 168–70 *infra* and accompanying text. That conclusion can probably be limited to situations where the transferor and acquiring corporations had the same shareholders. *See* Shimberg v. United States, 577 F.2d at 289 n.15.

corporation's earnings and profits, it would not be clear whether the shareholder's ratable share would be based on actual stock ownership in the acquiring corporation after the merger or on hypothetical ownership as if only stock and no boot had been received in the reorganization. On the other hand, "ratable share of undistributed earnings and profits of the corporation" has a natural and unambiguous meaning when the term, "the corporation," refers to the transferor corporation. It would be the shareholder's proportionate share of the transferor corporation's earnings and profits prior to the transaction. Support for this position can also be derived from the Regulations for section 381, which assume that the boot is distributed from the earnings and profits of the transferor corporation.[140] Furthermore, the 1924 Committee Reports for section 203(d)(2), the predecessor of section 356(a)(2), indicate that Congress was concerned with the distribution of the transferor corporation's earnings and profits.[141]

Because Congress viewed the boot as a distribution of the transferor corporation's earnings and profits, Congress would probably have considered it an abuse if the boot distributed in a reorganization were taxed as capital gain when a distribution by the transferor corporation without a reorganization would be taxed as ordinary income. Shareholders of the transferor corporation should not be able to use a reorganization to convert what would be ordinary income into capital gain. Similarly, there would be no abuse if boot were taxed at capital gain rates when, prior to the reorganization and judged by the standards of section 302, the same distribution by the transferor corporation would also have qualified as capital gain. Thus, for purposes of interpreting section 356(a), the distribution of boot should be viewed as a substitute for a distribution by the transferor corporation prior to the reorganization.[142]

The "before" test, as applied in this situation, is both reasonable and fair. The distributee of boot realizes some or all of the value from earnings of the transferor corporation at the time of the reorganization rather than realizing it at a prior time. In con-

140. Treas. Reg. § 1.381(c)(2)-1(c)(1) (1963). *See* Rev. Rul. 72-327, 1972-2 C.B. 197; American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970).

141. *See* note 43 *supra*.

142. Both the House bill in 1954 and the proposed amendments of the Advisory Group on Subchapter C of the Internal Revenue Code of 1954 would have made explicit the "before" test. H.R. 8300, 83d Cong., 2d Sess. § 306 (1954); H.R. 4459, 86th Cong., 1st Sess. § 21 (1959).

trast, neither the "after" test nor the "before and after" test seems to produce a satisfactory result in these reorganization cases. It must be noted, however, that the significant differences which exist between the taxation of boot and the taxation of distributions by ongoing corporations are inconsistent with the "before" test.[143] It might be possible to formulate arguments rationalizing these differences,[144] but the differences should rather be accepted simply as anomalies that are at variance with the basic view of the transaction held by Congress. Despite these problems, the argument that the "before" test best reflects congressional intent remains strong.

The "before" test allows boot to be taxed at capital gain rates when appropriate. If prior to the reorganization the shareholder could have sold to the transferor corporation in a qualified 302(a) redemption the amount of stock that was actually exchanged for boot, the shareholder should still generally be entitled to exchange treatment when the sale occurs as part of a reorganization. That the shareholder is exchanging an interest in one corporation for a smaller proportionate interest in a larger corporation at the same time as the sale does not cause the proceeds to more closely resemble a dividend.

Furthermore, there is no policy reason for extending the preferential tax treatment of boot beyond the level permitted by the "before" test. The distribution of boot is a distribution by a corporation or its successor to its shareholders. Normally distributions to a shareholder are taxable as dividends to the extent of earnings and profits. In some situations, such as for redemptions qualifying under section 302(a), Congress has provided for the more favorable capital gain treatment. The reasons for extending capital gain treatment to these distributions, however, do not readily apply to distributions of boot.[145]

D. *Application of the "Before" Test*

In order to determine whether boot in an acquisitive reorgani-

143. *See* notes 41–57 *supra* and accompanying text.

144. For example, the distributee of boot can be viewed as exchanging an interest in the transferor corporation for stock of the acquiring corporation plus boot. To the extent the interest in the transferor corporation is comprised of an interest in earnings and profits, any recognized gain can be viewed as recognized in connection with a noncapital asset. This formulation would explain the dividend within gain limitation in acquisitive reorganizations.

145. *See* text accompanying notes 71-80 *supra*.

zation has the effect of a dividend under section 356(a)(2), the principles of section 302 should be applied to a hypothetical distribution of the boot by the transferor corporation in redemption of its own stock. The relevant factor in applying the principles of section 302 is, therefore, the degree of interest in the transferor corporation that the distributee would have to give up for the boot.[146] More emphasis than is normal under section 302 should be placed on the value of the interest that the distributee is exchanging for the boot because changes in voting power have no future significance. Simlarly, it would be overly artificial to place any significance on the absolute level of the distributee's interest in a corporation that is losing its separate existence.

Therefore, if the hypothetical redemption would have caused a sufficient decline in the distributee's interest in the transferor corporation, so that the redemption would have been substantially disproportionate within the meaning of section 302(b)(2), the boot would normally not have the effect of a dividend, even though the distributee would have held more than fifty percent of the voting power in the transferor corporation after the hypothetical redemption.[147] Furthermore, rulings which hold that redemptions are not essentially equivalent to a dividend under section 302(b)(1) because the shareholder's voting control is reduced below some critical point would not be relevant to the boot distribution.[148]

It is not clear whether the constructive ownership rules of section 318 should be used in applying the "before" test. Section 356 is not one of the sections to which section 318 is made expressly applicable.[149] Nevertheless, section 318 could be subsumed in the principles of section 302 which are utilized to determine whether boot has the effect of a dividend under section 356(a)(2).[150] It ap-

146. Naturally, there will be problems when this test is applied to specific situations. For example, if the distributee of boot owned shares in more than one class of stock in the transferor corporation, it could make a difference which shares are considered to have been redeemed. Shares in each class of stock should probably be considered to be redeemed in the proportion equal to the relative values of each class owned by the distributee.

147. Section 302(b)(2) requires both that the distribution be disproportionate and that the distributees, after the redemption, own less than 50% of the voting power.

148. *See* Rev. Rul. 75-502, 1975-2 C.B. 111 (reduction in voting power from 57% to 50%); Rev. Rul. 75-512, 1975-2 C.B. 112 (reduction in voting power from 30% to 24.3%); Rev. Rul. 76-364, 1976-2 C.B. 91 (reduction in voting power from 27% to 22.7%). *See also* Wright v. United States, 482 F.2d 600, 609-10 (8th Cir. 1973).

149. I.R.C. § 318(b). *See* Hurley, *supra* note 92, at 338; note 107 *supra*. The Internal Revenue Service in a private ruling has taken the position that § 318 is not applicable to distributions of boot. IRS, Priv. Letter Rul. 7912101 (1978).

150. *See* Shoulson, *supra* note 42, at 608.

pears inconsistent to apply rules from section 302 without taking account of the constructive ownership principles. Therefore, the rules of section 318 should probably be applied to distributions of boot in reorganizations.

V. COMBINATIONS OF CORPORATIONS THAT HAVE AT LEAST SOME COMMON OWNERSHIP

This section examines the taxation of boot distributed in amalgamating reorganizations in which the corporations had at least some common shareholders prior to the reorganization. One major issue is whether the proposed interpretation of section 356 is still valid when there are common shareholders. A second issue in transactions where there is complete or nearly complete identity of shareholders of the corporations involved is whether the form of the transaction should be disregarded and the boot taxed as a distribution by an ongoing corporation under section 301, rather than under section 356.

A. *Interpretation of Section 356*

1. *The Continuing Validity of the "Before" Test*

Congress enacted the predecessor of section 356(a)(2) because it was concerned that a reorganization should not provide an opportunity to distribute the transferor corporation's earnings and profits at capital gain rates.[151] This concern did not depend on the absence of common ownership between the corporations involved in the reorganization. When such common ownership exists, the intent of Congress would still be that boot should not be taxed at capital gain rates unless a distribution of the property prior to the reorganization would also have been taxed at capital gain rates.[152] Therefore, the general approach of the "before" test should remain valid.

The Fifth Circuit, which used the "before" test in *Shimberg v. United States*,[153] suggested, however, that it might alter its basic approach depending on certain characteristics of the amalgamating reorganization, including common ownership of the corporations prior to the reorganization. The court took the position that its decision in *Shimberg* did not conflict with *Wright v. United*

151. *See* text accompanying notes 138–42 *supra*.

152. *Id.*

153. 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979).

States,[154] in which the Eighth Circuit used the "after" test. The transaction in *Wright* was "as if there had been only one corporation all along and as if one shareholder had redeemed his stock."[155] With this recasting of the transaction by the Fifth Circuit, the taxpayer in *Wright* was viewed as owning 85% of the two corporations considered together before the reorganization.[156] The Fifth Circuit then identified three factors that made it inappropriate to consider the distribution in *Shimberg* in this way: (1) the corporations in the merger were of much different size, (2) there was no common ownership between the two corporations, and (3) the boot was distributed pro rata to all shareholders of the transferor corporation rather than to a single individual.[157]

For purposes of characterizing the boot, the taxpayer in *Shimberg* could also have been viewed as a shareholder of both the acquiring corporation and the transferor corporation considered as one entity prior to the merger. Shimberg's interest in the transferor corporation relative to the value of both corporations prior to the reorganization would be compared with his interest in the acquiring corporation after the reorganization to determine if the boot had the effect of a dividend. This approach is the alternative formulation of the "after" test, which was rejected in the previous section as too artificial.[158] None of the factors mentioned by the Fifth Circuit in distinguishing *Shimberg* from *Wright* makes it more appropriate to use this approach in *Wright* than in *Shimberg*. Thus, this approach should not be used in either case. Neither the relative size of the corporations involved nor the proportionality of the distribution of boot affects the propriety of viewing the two corporations as a single entity prior to the reorganization. Similarly, common ownership of the two corporations prior to the reorganization is not a basis for ignoring the separate existence of the two entities. The corporations were distinct tax, legal, and accounting entities, and the shareholders may have benefited by the existence of the two entities.[159]

In a case such as *Wright* it is particularly inappropriate to tax

154. 482 F.2d 600 (8th Cir. 1973).

155. Shimberg v. United States, 577 F.2d 283, 287 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979).

156. *Id.* at 287 n.12.

157. *Id.* at 287.

158. *See* text accompanying notes 122-24 *supra*.

159. For example, only one of the corporations may have had earnings and profits. Therefore, distributions from the other corporation would not have been taxable to the extent of the shareholder's basis in the stock and, to the extent it was in excess of basis, the

the boot at capital gain rates on the ground that common ownership of the two corporations should cause them to be viewed as a single entity. If the distributee of boot owns an interest in more than one party to the reorganization, the joint ownership should probably cause the boot to be less qualified for preferential treatment as capital gain. Since the distributee owns an interest in both corporations, the reorganization involves less of an exchange than if he or she owned an interest in only one corporation. The existence of an exchange is normally a prerequisite for gain to qualify as capital gain.

2. *The "Before" Test Should Not Be Modified*

The "before" test represents a particular interpretation of section 356 that was formulated with regard to reorganizations in which there had been no common ownership of the corporations. The issue remains whether that interpretation should be modified when some common ownership exists. For distributees of boot who had owned an interest in the acquiring corporation as well as in the transferor corporation, the most likely modification would entail tax treatment of part or all of the boot as if there had been a distribution prior to the reorganization by the acquiring corporation rather than the transferor corporation.[160] It is suggested below that this modification of the "before" test should not be adopted. Treating some or all of the boot as if there had been a distribution by the acquiring corporation would place too great a strain on the language of section 356 and lead to undesirable results.

It would be inconsistent with the statutory language to treat some boot as if there had been a distribution by the transferor corporation and other boot as if there had been a distribution by the acquiring corporation.[161] Section 356(a)(2) states that some amount (depending on gain and earnings and profits) will be taxed as a dividend "if an exchange . . . has the effect of the dis-

distribution would have been taxable as capital gain. I.R.C. § 301(c)(3)(a). If the two corporations had been combined, all distributions may have been taxable as a dividend.

160. The same corporation would be looked to both for a determination of whether the boot had the effect of a dividend and for the amount of earnings and profits.

161. For an example of such treatment, suppose that a distributee of boot owned all the stock of the acquiring corporation and 10% of the stock of the transferor corporation. If no other shareholders received boot, some of the boot would be considered as originating in the acquiring corporation and would probably have the effect of a dividend. The rest of the boot distribution would be considered as originating in the transferor corporation and would probably not have the effect of a dividend.

tribution of a dividend." The statute contemplates that for a particular shareholder the whole exchange either has the effect of a distribution of a dividend or does not.[162]

For a particular distributee of boot who had owned an interest in both the acquiring and transferor corporations, the possibility still remains that the exchange could have the effect of the distribution of a dividend by hypothesizing that there was a redemption by the acquiring corporation, rather than by the transferor corporation, prior to the reorganization. For example, suppose A, B, and C own all the stock of corporation *X*, and A owns all the stock of corporation Y. If X merges into Y and if A and B receive boot, it might seem appropriate to conclude that the exchange made by A has the effect of the distribution of a dividend by hypothesizing that the boot received by A had been distributed in a redemption by Y, rather than being distributed by X. This is not an appropriate interpretation, however. The determination of whether boot received by A or B is taxed as a dividend should not be made by looking at a distribution of earnings and profits by different corporations. Both A and B are exchanging stock in X for stock in Y plus boot, and both should be treated alike by having the same standards applied to determine if the boot should be taxed as a dividend.

More generally, if the "before" test can be applied by looking solely to the acquiring corporation for some shareholders, the resulting inconsistency among shareholder as to which corporation is the source of the boot will be troublesome. Such an approach would also appear incongruent with taxing the boot only to the extent of the shareholder's gain on the exchange of stock in the transferor corporation. Finally, any inquiry into which corporation is the actual source of the boot would not be appropriate because it would be inconsistent with taxation of boot in reorganizations in which there had been no common ownership prior to the reorganization.[163]

The "before" test should be applied by examining the effects of a hypothetical redemption by only the transferor corporation prior to the reorganization. This approach is consistent with congressional intent and leads to a reasonable, untortured interpretation of section 356. The sole interpretive problem might arise

162. If the exchange has the effect of the distribution of a dividend, the portion of the boot that is actually treated as a dividend will, of course, depend on the amount of earnings and profits.

163. *See* text accompanying notes 76, 137–42 *supra*.

when two corporations consolidate into a newly formed corporation and a distributee of boot owned an interest in both corporations.[164] In such a situation, there are two transferor corporations. Thus, the distributee should probably be considered as receiving boot from each corporation in proportion to the relative value of his or her interest in the respective corporations. Section 356 would then be applied separately with respect to each transferor corporation.

The relevant cases have involved combinations of identically owned corporations with a pro rata distribution of boot.[165] There was a sale of assets by the transferor corporation to the acquiring corporation, followed by the liquidation of the transferor corporation. Despite this form, the transactions were found to be "D," and possibly "F," reorganizations,[166] and in each of these cases, the boot clearly had the effect of a dividend. The courts, however, have disagreed on whether the boot arose from earnings and profits of only the transferor corporation or from earnings and profits of both transferor and acquiring corporations.[167]

In *Davant v. United States*,[168] the Fifth Circuit gave several reasons why the pro rata distribution of cash in a reorganization of identically owned corporations should be taxed as a dividend to the extent of earnings and profits of both corporations. One of the reasons[169] was that in such reorganizations "earnings and profits of the corporation" in section 356(a)(2) should be interpreted as referring to earnings and profits of both corporations.[170] On the other hand, the Tax

164. This was exactly the situation in Wright v. United States, 482 F.2d 600 (8th Cir. 1973). *See* notes 106–19 *supra* and accompanying text.

165. *See* Atlas Tool Co., 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980); Estate of Bell 30 T.C.M. (CCH) 1221 (1971); American Mfg. Co., 55 T.C. 204 (1970); South Tex. Rice Warehouse Co. v. Commissioner, 43 T.C. 540 (1965), *rev'd sub nom*. Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). *See also* James Armour, Inc., 43 T.C. 295 (1964).

166. *See* notes 33–37 *supra* and accompanying text.

167. This issue usually arises because the distributee's share of accumulated earnings and profits in the transferor corporation is less than the amount of recognized gain. In American Mfg. Co., 55 T.C. 204 (1970), there was a different reason. The sole shareholder of the transferor and acquiring corporations was a corporation, and the acquiring corporation was incorporated in a foreign country. Any distribution emanating from its earnings and profits would not have qualified for the dividend received deduction under § 243. *See generally* note 55 *supra* and accompanying text.

168. 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

169. For a discussion of the other reasons, see text accompanying notes 181–85 *infra*.

170. In Rev. Rul. 70–240, 1970–1 C.B. 81, the Internal Revenue Service agreed with this alternative holding in *Davant*. In the ruling, a single shareholder owned all the stock

Court[171] and the Third Circuit[172] have held that the term, "the corporation," in section 356(a)(2) refers only to the transferor corporation.[173] It is argued in the following subsection that the boot in these cases should have been taxed under section 301, not section 356.[174] The approach of the Tax Court and the Third Circuit, however, is consistent with the interpretation of section 356 that is being advocated in this Article[175] and should be followed whenever taxation of the boot under section 301 is not appropriate.

If there is a reorganization involving corporations with common ownership and if the boot is taxed under section 356, the proposed interpretation of section 356 does leave a loophole. The

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of corporations X and Y. X transferred its operating assets to Y for their fair market value in cash and liquidated. The transaction was held to qualify as a "D" reorganization and property received by the shareholder was out of earnings and profits of both corporations. The ruling also held that, for purposes of computing gain under § 356(a), the shareholder had constructively received an amount of Y stock equal to the value of assets transferred by X to Y. Apparently, the form of the cash being paid for these assets was disregarded. The Tax Court has rejected these conclusions in American Mfg. Co., 55 T.C. 204, 299–31 (1970).

171. Atlas Tool Co., 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980); Paul Altenpohl, 36 T.C.M. (CCH) 1377 (1977); Estate of Bell, 30 T.C.M. (CCH) 1221 (1971); American Mfg. Co., 55 T.C. 204 (1970); South Tex. Rice Warehouse Co., 43 T.C. 540 (1965), *rev'd sub nom.* Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

172. Atlas Tool Co., 614 F.2d 860 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980).

173. The reasons for this conclusion were most fully set forth in the Tax Court's opinion in American Mfg. Co., 55 T.C. 204 (1970). The Tax Court cited as support the example contained in the Committee Reports to the Revenue Acts of 1924 which illustrated the operation of the predecessor to section 356(a)(2). H.R. REP. No. 179, 68th Cong., 1st Sess. 14–15 (1924); S. REP. No. 398, 68th Cong., 1st Sess. 15–16 (1924). The example involved the transfer of assets by a corporation to a newly formed corporate shell with the same ownership. In this situation, the statute prevented boot from being taxed at capital gain rates. This legislative history does indicate that Congress was concerned primarily with preventing a bailout of earnings and profits by the transferor corporation. *See* notes 131–33 *supra* and accompanying text. Because the acquiring corporation in the example obviously had no earnings and profits prior to the reorganization, however, the example does not by itself demonstrate that Congress would not have been concerned with a bailout of earnings and profits by the acquiring corporation under other circumstances. The Tax Court also stated that the interrelation of § 356 with § 354 shows that the boot arises out of earnings and profits only of the transferor corporation. The court's reasoning was that since the parties to the exchange in § 354 are the shareholder and the transferor corporation, it is logical to limit "the corporation" in § 356 to the transferor corporation only. It is, however, not clear why the transferor corporation, rather than the acquiring corporation, is a party to the exchange in § 354. Furthermore, even if the transferor corporation is a party to the exchange, the conclusion that boot arises out of earnings and profits of the transferor corporation does not necessarily follow. The holding in *American Manufacturing* should simply be justified by the general arguments in the text for the "before" test. *See* notes 161–63 *supra* and accompanying text.

174. *See* notes 193–97 *infra* and accompanying text.

175. *See* notes 161–63 *supra* and accompanying text.

characterization of boot depends upon a hypothetical redemption by only the transferor corporation. Under certain circumstances, the choice of which corporation will survive the merger can affect whether boot is taxed as a dividend.[176] Furthermore, when the combining corporations are controlled by the same shareholders, it appears artificial to conclude that the distribution is out of the earnings and profits of only one of the corporations. The possibility of abuse in the most egregious situation, however, should not be present. When corporations with identical ownership are combined and there is a pro rata distribution of boot to shareholders, the boot should be taxed under section 301 rather than section 356.[177]

B. *Taxation of Boot Under Section 301*

An important question presently unresolved is whether it is ever appropriate to tax boot under section 301, rather than under section 356, on the ground that the boot is functionally unrelated to the reorganization. If the boot were taxed under section 301, there would be no dividend within gain limitation and any distributed property would be taxed as a dividend to the extent of current or accumulated earnings and profits.

The two most significant cases on this issue are the Fifth Circuit decision in *Davant v. United States*[178] and the Tax Court decision in *American Manufacturing Co.*,[179] both of which involved a combination of identically owned corporations with pro rata distributions of cash to shareholders. In addition to its interpretation of section 356(a)(2) discussed in the previous subsection,[180] the Fifth Circuit in *Davant* gave two other reasons for taxing the cash as a dividend to the extent of earnings and profits of both corporations. One reason was that the distribution of cash had no functional relationship to the reorganization; both events merely occurred at the same time.[181] Therefore, the court held that the cash should be taxed under sections 301 and 316, rather than

176. This problem, however, is inherent in the structure of § 356. Boot is taxed to the extent of gain, and choice of a corporation as the transferor can affect the amount of gain realized.

177. *See* notes 193–97 *infra* and accompanying text.

178. 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

179. 55 T.C. 204 (1970). The Third Circuit did not consider this argument in Atlas Tool Co. v. Commissioner, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980).

180. *See* text accompanying notes 168–70 *supra*.

181. *See also* Morris v. United States, 441 F. Supp. 76 (N.D. Tex. 1977).

under section 356, because its tax treatment should not have been affected by the reorganization.[182] The other reason involved the court's finding that the combination of corporations qualified as an "F," as well as a "D," reorganization.[183] The court stated that any cash distributed to a shareholder in an "F" reorganization—defined as a "mere change in identity, form, or place of incorporation"—should be taxed under section 301.[184] Although stated as a separate reason, this position should probably be viewed as an application of the court's functionally unrelated test. Because of the nature of an "F" reorganization, any cash distribution could be considered functionally unrelated to the reorganization.[185] The court discussed these theories only in relation to whether the distributions were out of earnings and profits; the dividend within gain limitation of section 356 was not mentioned.

In *American Manufacturing Co.*[186] and other cases,[187] the Tax Court has rejected the functionally unrelated approach of *Davant*.[188] The Tax Court felt that this approach would make sec-

182. The Fifth Circuit cited Bazley v. Commissioner, 331 U.S. 737 (1947), which involved a transaction that purported to be a recapitalization qualifying under the predecessor to § 368(a)(1)(E). The shareholders of a corporation had exchanged their stock for new stock plus debentures. The Supreme Court described the distribution of debentures as "unrelated" to the exchange of stock and held the debentures were taxable as a dividend.

The Supreme Court concluded that the exchange of stock did not qualify as a recapitalization under the predecessor to § 368(a)(1)(E). The conclusion concerning the absence of any relation between the distribution of debentures and exchange of stock, however, was not dictum because the predecessors to §§ 1036 and 1031(b) might still have been applicable. If there had not been a reorganization and if the distribution of the debentures had been connected with the exchange of stock, the debentures would have been treated as boot distributed in a stock-for-stock exchange and therefore taxable at capital gain rates.

183. *See* notes 35–37 *supra* and accompanying text.

184. 366 F.2d at 890.

185. *But see Subchapter C Report, supra* note 39, at 2550-51; *Subchapter C Revised Report, supra* note 39 at 545; J. Weingarten, Inc. v. Commissioner, 44 B.T.A. 798 (1941).

186. 55 T.C. 204 (1970). Judge Sterrett dissented from the court's rejection of the functionally unrelated approach. *Id.* at 233. Judge Quealy agreed with Judge Sterrett. *Id.* at 234, 238.

187. Atlas Tool Co. v. Commissioner, 70 T.C. 86 (1978), *aff'd* 614 F.2d 860 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980); Estate of Bell, 30 T.C.M. (CCH) 1221 (1971); *cf.* Estate of Hill, 10 T.C. 1090 (1948) (on merger of corporation into newly formed shell, boot taxed under predecessor of § 356(a)(2). *See generally* Rose v. United States, 47 A.F.T.R.2d 81-1070, — F.2d — (9th Cir. 1981); Commissioner v. Carman, 189 F.2d 363 (2d Cir. 1951); Love v. Commissioner, 113 F.2d 236 (3d Cir. 1940).

188. It is possible (but unlikely) that the Tax Court will consider boot functionally unrelated to the reorganization if the combination of identically owned corporations qualifies as an "F" reorganization. The Tax Court has never been presented with this issue in an "F" reorganization. Prior to Rev. Rul. 75-561, 1975-2 C.B. 129, the Tax Court agreed with the Internal Revenue Service that the combination of two or more active corporations could never be an "F" reorganization. In that ruling the Internal Revenue Service an-

tion 356(a)(2) "all but superfluous."[189] It reasoned that the cash would be considered functionally unrelated whenever it could have been distributed as a dividend before the reorganization, and such a distribution would almost always have been possible. The court also relied on the example in the Committee Reports to the Revenue Act of 1924 dealing with the predecessor of section 356(a)(2).[190] Although the Tax Court correctly decided that the example supports the applicability of section 356 to boot distributed in a combination of identically owned corporations, it is questionable how much weight should be given to fifty-year-old legislative history which illustrated that the Committees did not understand the bill they enacted.[191] The example should probably not be used for anything more than to demonstrate that Congress enacted the predecessor of section 356(a)(2) to prevent a bailout of earnings and profits by the transferor corporation.[192]

Although more recent cases have not followed the functionally unrelated approach of *Davant*,[193] the result in *Davant* seems correct. The form of the transaction—a cash distribution in connection with the reorganization—is disregarded so that the transaction can be taxed in accordance with its substance.[194] When the cash is distributed pro rata to shareholders in connection with combinations of identically owned corporations, the substance of the transaction involves no relationship between the cash

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nounced its position that certain combinations of two or more active corporations could qualify as "F" reorganizations if the corporations had related businesses.

Atlas Tool Co. v. Commissioner, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980), was a case where identically owned corporations combined and boot was distributed. It arose after the publication of Revenue Ruling 75-561. The Internal Revenue Service had raised the issue of the existence of an "F" reorganization, but abandoned it in its brief. 70 T.C. at 97 n.4. The business of one of the corporations was not continued after the reorganization, and the Service presumably concluded that for this reason the requirements of Revenue Ruling 75-561 had not been met.

189. American Mfg. Co., 55 T.C. 204, 228 (1970).

190. H.R. REP. NO. 179, 68th Cong., 1st Sess. 14-15 (1924); S. REP. NO. 398, 68th Cong., 1st Sess. 15-16 (1924). For an account of the example, see note 43 *supra*.

191. *See* notes 42-43 *supra* and accompanying text.

192. *See* text accompanying notes 137-42 *supra*.

193. *See* notes 186-87 *supra*. The Internal Revenue Service mentioned, but did not strongly advocate, the functionally unrelated approach in a recent case before the Third Circuit. Atlas Tool Co. v. Commissioner, 614 F.2d 860, 864 n.2 (3d Cir.), *cert. denied*, 101 S. Ct. 110 (1980).

For authority supporting the functionally unrelated approach, see Bazley v. Commissioner, 331 U.S. 737 (1947); Treas. Reg. §§ 1.301-1(*l*) (1955), 1.331-1(c) (1955); Rev. Rul. 61-156, 1961-2 C.B. 62.

194. *See* Nicholson, *Liquidation-Reincorporation*, 335 TAX MANAGEMENT PORTFOLIO A-18 to A-23 (1976).

and the reorganization. The cash is not a part of an arm's length business deal. It has no effect on the relative interests of the shareholders in the surviving corporation. The dividend within gain limitation seems particularly illogical in this situation.[195]

The form of a transaction is more likely to be disregarded when there is self-dealing, such as between a corporation and its shareholders.[196] Thus, the functionally unrelated approach should be limited to reorganizations involving combinations of corporations with the same shareholders. When the reorganization involves corporations with different shareholders, the boot will be part of an arm's length agreement and should not be considered functionally unrelated to the reorganization. The Tax Court was not necessarily correct when it stated that the functionally unrelated approach would make section 356(a)(2) "all but superfluous."[197]

Furthermore, the functionally unrelated approach should be applicable only if the cash or other property is distributed pro rata to the shareholders. Otherwise, the distribution causes a change in the relative ownership of the surviving corporation and should be considered to have become an integral part of the reorganization for this reason.[198] If the boot has this effect on the relative ownership, the motives of the shareholders in distributing the boot should be irrelevant.[199]

In summary, the boot distributed in amalgamating reorganizations should be taxed under section 301 only when the corporations involved had identical ownership and the boot was distributed pro rata to shareholders. Because the boot is then taxed under section 301, it will be a dividend to the extent of the total amount of current or accumulated earnings and profits. The

195. In contrast, the dividend within gain limitation does not appear illogical when the corporations combining had no common shareholders. *See* text accompanying notes 81–84 *supra*. *See also* I.R.C. § 304(a).

196. *See* Bittker, *Persuasive Judicial Doctrines in the Construction of the Internal Revenue Code*, 21 How. L.J. 694, 707 (1979); Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 469 (1968). *See generally* Gilbert v. Commissioner, 248 F.2d 339, 410 (1957) (Hand, J., dissenting).

197. *See* text accompanying note 189 *supra*.

198. The legislative history of the Internal Revenue Code of 1954 indicates that boot distributed in recapitalizations should be taxed under § 356. S. REP. No. 1622, 83d Cong., 2d Sess. 437 (1954). *See also* Rev. Rul. 78-351, 1978-2 C.B. 148. Perhaps boot in recapitalizations should be taxed under § 301, rather than § 356, when the boot is pro rata. This method would be similar to the rule used for combinations of identically owned corporations.

199. *See* Gunn, *Tax Avoidance*, 76 MICH. L. REV. 773 (1978).

distribution should be considered to be out of the earnings and profits of any of the corporations involved in the reorganization. Since the corporations are becoming one entity simultaneously with the distribution of boot, it seems artificial to conclude that the distribution is from the earnings and profits of only one of the corporations.[200]

Unless the boot is distributed pro rata to shareholders in a combination of identically owned corporations, it will be taxed under section 356. If the boot has the effect of a dividend, the dividend within gain limitation will be applicable even though the corporations being combined have common ownership. In this situation, the limitation seems clearly inappropriate, but there seems to be no alternative under present law.[201]

VI. CONCLUSION

The statutory provisions for taxing boot distributed in reorganizations have remained basically unchanged since 1924.[202] A critical congressional examination of these provisions is overdue. If such an examination should occur, the analysis in this Article presents several suggestions for amending section 356.

The intent of Congress has been that, for the purpose of interpreting section 356, the distribution of nonqualifying property or boot should be viewed as a substitute for a distribution prior to the reorganization. As this Article has attempted to demonstrate, this view of boot should not be changed.[203] Section 356 should, in fact, be amended to remove any ambiguity on this matter. The amendment would demonstrate that the Fifth Circuit's holding in *Shimberg v. United States*[204] was correct, and that the approach of the Eighth Circuit in *Wright v. United States*[205] was incorrect.

A second amendment to section 356 would make the taxation of distributions in amalgamating reorganizations consistent with the taxation of property distributions by ongoing corporations. If the distribution of boot in a reorganization has the effect of the distribution of a dividend, it should be taxed under sections 301

200. *But see* Baker, *Recent Developments in the Service War Against Liquidation—Reincorporations*, 49 J. TAX. 82, 83 (1978).

201. *See* note 6 *supra*.

202. Changes in related areas, such as the addition of § 306 to the Internal Revenue Code, have caused changes in the taxation of boot, but the basic provisions affecting the taxation of boot have been unaffected.

203. *See* text accompanying notes 143–145 *supra*.

204. 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979).

205. 482 F.2d 600 (8th Cir. 1973).

and 316. The dividend within gain limitation of section 356(a)(2) would be removed, and the question of whether a distribution of boot is made out of earnings and profits would be answered in the same way that it is answered for a distribution by an ongoing corporation. If the distribution of boot does not have the effect of the distribution of a dividend, then gain or loss should be calculated in a manner analogous to that employed when there is an exchange under section 302(a) or section 346(a)(2). For this calculation, the boot could be considered as exchanged for that proportion of the distributee's stock in the transferor corporation which equals the proportion of the boot to the total consideration received by the distributee.[206]

Under the present section 356, boot is considered a substitute for a distribution prior to the reorganization by only the transferor corporation.[207] This limitation should be changed when there is substantial overlap in the ownership of the corporations combining in a reorganization.[208] For example, a third amendment to section 356 might provide that if the combination qualified as a reorganization under section 368(a)(1)(D) and if the distributee owned stock in both corporations prior to the reorganization, then the boot could be considered a substitute for a distribution prior to reorganization made by either or both corporations. The Internal Revenue Service would be able to allocate the boot between both corporations. That allocation would be effective both for determining whether that portion of the boot had the effect of a dividend and whether it was out of earnings and profits. Because the transaction is a combination of corporations with substantially the same ownership, it is appropriate that the form of the transaction be largely disregarded.[209] Such a provision, in combination with the other changes suggested, would eliminate the need for the substance-over-form approach advocated in this Article for certain combinations of identically owned corporations.[210]

When a combination of corporations does not qualify as a "D" reorganization, the boot should continue to be considered a substi-

206. This provision was contained in H.R. 4459, 86th Cong., 1st Sess. § 21 (1959) (revised amendments of Advisory Group on Subchapter C of Internal Revenue Code of 1954). *See* notes 47, 51 *supra*.

207. *See* text accompanying notes 161–64 *supra*.

208. If the distribution qualified as a partial liquidation absent the reorganization, then, of course, the distribution would not in any event have the effect of a dividend. *See* text accompanying notes 69–71 *supra*.

209. *See* note 195 *supra* and accompanying text.

210. *See* text accompanying notes 193–200 *supra*.

tute for a distribution made by only the transferor corporation prior to the reorganization. This should be the case even when the distributee had previously owned some stock of the acquiring corporation. The form of the transaction is that the shareholders are exchanging their stock in the transferor corporation for stock in the acquiring corporation plus boot. Except for "D" reorganizations, this form comports with the substance and should be respected for tax purposes.