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Tax Techniques of Bootstrap Acquisitions

David W. Rees

Mr. Rees carefully analyzes the many possible alternative bootstrapping techniques from the standpoint of the general practitioner and discusses among other methods the simple stock acquisition and subsequent corporate redemption or assumption, the sale of unwanted assets and the use of preferred stock dividends, corporate separations, downstream mergers, liquidations, and intercorporate dividends.

THE CONCEPT of the "bootstrap acquisition" is not new. In its pure sense it refers to the acquisition of some kind of property with the obligation to pay the purchase price dependent or contingent solely upon the earning capacity of that property.

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In other words, if the property produces no income (or income in excess of some agreed-upon amount), there is no liability to pay for it. In present-day parlance the concept of bootstrapping is used to describe any ac-

quisition in which the purchase price is to be borne in whole or in part by the value or earning capacity of the acquired property, regardless of whether the obligation to pay the purchase price is fixed or contingent.¹

It is the purpose of this article to discuss the various methods utilized both successfully and unsuccessfully to require acquired properties to prove their mettle — to pay for themselves. It is probably helpful to note that "bootstrap acquisitions" are the progeny of corporate acquisitions and that this discussion will be so limited.

While techniques for successfully (at least tax-wise) making properties pay for themselves are limited only by the Revenue Code and counsel's imagination, certain techniques have been more repeatedly used than others and are generally divisible into areas of activity: pre-sale activity on the part of the seller, and post-sale activity on the part of the purchaser. They will be treated in that order. Some aspects of pre-sale activity will require discussion of

¹ Freling, *The Boot-Strap Purchase*, N.Y.U. 24TH INST. ON FED. TAX 1229, 1231 (1966).

post-sale activity in order to maintain a proper perspective,² but this general division of the activities at least allows for an orderly presentation. It is also necessary to recognize that bootstrapping can be utilized to acquire either the stock or the assets of a corporation, and the following should be taken to apply to both types of acquisitions unless the contrary is specifically indicated.

I. PRE-SALE ACTIVITY

An important element in understanding the bootstrap acquisition is a recognition that the purchaser usually is in one or both of the following positions: either he does not desire all the assets of the seller or he cannot afford all the assets the seller is willing to sell. For these reasons sellers often are required to create as marriageable a bride as possible prior to the final commitment of the purchaser. These antenuptials must, of course, be carried out with a minimum of tax cost to the seller. Bear in mind also that all the pre-sale activity is designed to accord the purchaser the opportunity to engage in effective post-sale activity.

A. *The Direct Approaches*

(1) *Simple Stock Acquisition Followed by Redemption.*—It requires no expertise to propose the most direct method, the acquisition of a controlling stock interest in the corporation. Unless the purchaser is sufficiently liquid to pay cash, he will give notes for the purchase price. But on the early assumption that the purchaser can ill afford to meet those notes when they come due, the purchaser is faced with a crisis virtually as soon as he assumes control. The quick solution is to utilize his controlling interest and cause the corporation to declare a dividend, but this action entails the prospect of incurring ordinary income treatment. It is at this point that forcing the corporation to pay for itself has great appeal. Utilizing his controlling interest, the purchaser causes a redemption of a sufficient number of his shares to generate a cash distribution in an amount equal to his liability to the sellers.

Certainly a fine solution — the purchaser has satisfied his obligation to purchase the stock of the corporation by using the assets of the corporation, and he has received those assets at capital gain rates, *i.e.*, in redemption and in exchange for his shares. Right? Wrong in most cases! Redemptions, unless they meet one of the

² See text accompanying notes 3-28 *infra*.

specific tests found in section 302,³ are treated as dividends under section 301.⁴ In most situations the purchaser, because he retains a continuing share interest⁵ and/or because his holdings are such that the redemption will not be substantially disproportionate,⁶ will not have effected any sort of worthwhile bootstrapping.⁷ He will have met his obligation to pay for the shares but at the tax cost of having the amounts necessary to make the payments treated as ordinary income.

For taxpayers who find themselves in the position of having no choice but to respond as the purchaser above, there is a glimmer of hope which stems from the possibility that the purchaser will have made the original stock purchase on behalf of the corporation rather than for his personal benefit. The leading decision in the area, *Fox v. Harrison*,⁸ involved a minority shareholder faced with a majority shareholder heavily indebted to the corporation and threatening to cause the corporation to be liquidated unless his shares were redeemed at par. The corporation could not redeem his shares due to lack of funds, and it was unable to borrow on its own credit. Fox was personally able to borrow the necessary funds, using the proceeds to purchase the majority interest and thereby forestalling liquidation of the corporation. At a later date when the corporation was in a more healthy condition, it purchased the acquired shares from Fox who used the proceeds of that sale to pay off his loan.

The Commissioner argued that this purchase of two thirds of the shares of the now sole shareholder amounted to a dividend.⁹ The court held otherwise, finding that Fox had acted as an agent for the corporation and that the purchase from the majority share-

³ INT. REV. CODE OF 1954, § 302 [hereinafter cited as CODE]. The tests most germane to this discussion are: constituting substantially disproportionate redemptions, CODE § 302(b)(2), and constituting a complete termination of a shareholder's interest, CODE § 302(b)(3).

⁴ CODE § 301.

⁵ This negates a complete termination under CODE § 302(b)(3).

⁶ The shareholder will, in most cases of purchasing all the shares of a corporation followed by redemption of a portion of those shares, fail to meet the fifty-percent test under CODE § 302(b)(2)(B) and the eighty-percent test under CODE § 302(b)(2)(C).

⁷ The shareholder in such a situation will be forced to predicate his case for non-dividend equivalency upon the "not essentially equivalent" test as found in CODE § 302(b)(1), which section is not a useable planning tool. See Cavitch, *Costly Traps in Corporate Stock Purchases From Shareholders*, 15 W. RES. L. REV. 338 (1964).

⁸ 145 F.2d 521 (7th Cir. 1944).

⁹ *Id.* at 521.

holder and later sale to the corporation was one transaction undertaken to prevent the liquidation of the corporation.¹⁰

A 1963 decision¹¹ involved the redemption of shares from a shareholder who had acquired the shares from the other shareholders only because the corporation could not do so at the time it became vital to the interests of the corporation that the purchase take place. When the corporation later disposed of certain unnecessary assets and purchased the shares from the interim purchaser, the Tax Court held that no dividend resulted because the purchaser had acted as a conduit for the corporation.¹²

An even more recent decision has held that the acquisition of the shares of an incompetent officer in order to assure his removal, a portion of which shares are later redeemed from the purchaser, results in no dividend.¹³

Lest these decisions lead one to believe that any sort of imagined corporate ills can permit one to act as the corporation's good-samaritan agent, the decision of *Diana D. Gloninger*¹⁴ should serve to prompt an extreme sense of caution.

The taxpayer asserted that the acquisition of minority interests served to eliminate a competitor as a shareholder and to purchase the interest of another, a customer the corporation could not afford to offend.¹⁵ The transactions were completed by the majority shareholder's purchase of the lesser interests, which interests he later caused to be redeemed. The Tax Court found both business reasons insubstantial and upheld the Commissioner's determination of a dividend.¹⁶

The narrow scope of the good-samaritan cases should indicate that the technique of first acquiring a controlling interest and then causing a portion of that interest to be redeemed will not be an effective bootstrapping tool.

(2) *Simple Stock Acquisition Followed by Corporate Assumption*.—Another instance in which direct thinking has led to the undoing of a bootstrap acquisition arises when the purchaser, rather than tempting fate by using a redemption, simply causes the cor-

¹⁰ *Id.* at 522-23.

¹¹ John McShain, 32 P-H Tax Ct. Mem. 1835 (1963).

¹² *Id.* at 1840.

¹³ Robert N. Peterson, 33 P-H Tax Ct. Mem. 68 (1964). See also John A. Decker, 32 T.C. 326 (1959), *aff'd per curiam*, 286 F.2d 427 (6th Cir. 1960).

¹⁴ 32 P-H Tax Ct. Mem. 1859 (1963), *aff'd*, 339 F.2d 211 (3d Cir. 1964).

¹⁵ *Id.* at 1860.

¹⁶ *Id.* at 1862.

poration of which he has acquired control to assume or completely discharge his obligation to the selling shareholder. This must be bootstrapping in the pure sense — one acquires control of a corporation through an acquisition of its stock and then foists onto the corporation the obligation to pay for the shares. Right? Wrong again!

It is, of course, an elementary proposition of tax law that if a corporation discharges the obligation of a shareholder, such discharge results in a dividend.¹⁷ The landmark decision in *Wall v. United States*¹⁸ is often mentioned, but a discussion of it here is appropriate due to the degree to which its mandate affects any further discussion of bootstrap transactions. Wall owned one half the stock in a dairy operation, the remaining interest falling into the hands of a competitor. Wall purchased the competitor's stock under a contract which personally obligated him to pay for the shares. Wall made the down payment, paid the first note, and then caused the corporation to agree to pay the balance of the notes. The court held that this resulted in a dividend to Wall as he was relieved of his personal obligation to pay for the shares.¹⁹ It should be noted that Wall's purchase was motivated by the best interests of the corporation (removal of an undesirable shareholder), but this motivation could not overcome the fact of his personal obligation, the court specifically finding the rationale of *Fox v. Harrison*²⁰ inapplicable.²¹

The desire of the majority shareholders to settle a dispute with a one-sixth interest by acquiring that minority interest by a purchase contract upon which they were personally obligated has also been unsuccessful when the corporation later assumed the obligation. In *Schalk Chem. Co.*²² the reimbursement of the down payment and assumption of the final payment under the contract both resulted in dividends despite the good intentions of the purchasing shareholders.²³

¹⁷ See Treas. Reg. § 1.301-1(m) (1955), as amended, T.D. 6752, 1964-2 CUM. BULL. 84 [hereinafter cited as Reg.].

¹⁸ 164 F.2d 462 (4th Cir. 1947).

¹⁹ *Id.* at 464.

²⁰ 145 F.2d 521 (7th Cir. 1944).

²¹ 164 F.2d at 466.

²² 32 T.C. 879 (1959), *aff'd*, 304 F.2d 48 (9th Cir. 1962). For other instances in which corporate assumption was not found to be motivated by substantial business interests see *Sullivan v. United States*, 244 F. Supp. 605 (W.D. Mo. 1965), *aff'd*, 363 F.2d 724 (8th Cir. 1966); *William F. Wolf, Jr.*, 43 T.C. 652 (1965), *aff'd*, 357 F.2d 483 (9th Cir. 1966); *Robert Deutsch*, 38 T.C. 118 (1962).

²³ 32 T.C. at 891.

It should come as no great surprise that a few taxpayers, either through remarkable planning or extremely fortunate after-the-fact grasping, have avoided the *Wall* rationale. Their techniques have been ingenious and are worthy of detail here partly because of their comparative youth.

In the first of these cases,²⁴ a minority shareholder agreed to purchase the shares of the ill majority shareholder. The agreement provided that the shares, to be placed in escrow as security for the payment of notes, could be assigned by the purchaser if the assignee agreed to assume a pro rata portion of the purchase price. The purchaser later assigned the shares to the corporation which assumed the obligation to pay for them. The court held that the minority shareholder's desire to preserve the corporation's business resulted in no dividend, basing its decision on a rationale akin to *Fox v. Harrison*.²⁵

An even more ingenious plan is found in *Milton F. Priester*²⁶ where the taxpayer agreed to purchase the shares held by the widow of the majority shareholder and did so, assuming a personal obligation to pay for the shares by way of periodic notes. He realized very soon that he could not meet the notes, and having been advised that the widow would grant no extension, he sought the advice of his accountant who interested a third party in acquiring the shares. Priester assigned his purchase contract to the third party. Six months after the third party's purchase, the corporation bought the third party's shares, leaving Priester in full control. The Commissioner attacked the transaction under the *Wall*²⁷ doctrine, but the Tax Court found the transaction bona fide²⁸ and thus was unable to equate the assignment of an executory contract with the corporate assumption of a personal obligation.

As in the case of the purchase followed by a redemption of the purchased shares, the assumption by a corporation of a shareholder's obligation will under the *Wall* rationale result in dividend equivalency and therefore cannot be considered an effective bootstrapping technique.

²⁴ William A. Green, 32 P-H Tax Ct. Mem. 1409 (1963).

²⁵ *Id.* at 1415.

²⁶ 38 T.C. 316 (1962).

²⁷ The Commissioner's theory evidently was that the third party was a sham and that, if his presence were disregarded or viewed as the *alter ego* of Priester, the purchase would be deemed to have been made by Priester and the later payment for those shares by the corporation would be the equivalent of a dividend.

²⁸ The third party was a well-known and successful businessman who testified that he viewed the arrangement as guaranteed long term gain.

(3) *Pre-Sale Dividend*.—There are instances in which the purchaser does not want or cannot afford the entirety of the present assets of the corporation. In other instances, the sellers do not desire to dispose of all the corporate assets. Again, certain direct routes commend themselves to one who desires simplicity. The purchaser urges the present shareholders to declare a dividend either in cash or in kind. This, of course, gives the selling shareholders the right to withdraw as a dividend those assets that they do not wish to sell or those assets the purchaser cannot afford to buy. It also gives rise to a taxable dividend to the selling shareholders, but the real impact of that unusual increment of ordinary income can be the subject of negotiation with respect to the price to be paid for the shares representing the post-dividend assets.

As usual, caution must be exercised in order that the purchaser does not become so inextricably involved in the pre-sale dividend that its advantage is lost. For example, if the agreement provides that the purchase price is X dollars but that if the selling shareholders declare a pre-sale dividend the purchase price is X dollars less the amount of the dividend, the purchasing party will be deemed to be in receipt of the dividend and to have paid the full purchase price of X dollars.²⁹

(4) *Sales of Unwanted Assets*.—If the prospect of haggling over the allocation of ordinary income does not commend itself to the parties and they have not become sufficiently devious, at least two other direct alternatives will occur to them. The assets the purchaser either does not want or cannot afford can be sold³⁰ to outsiders or to one or more of the selling shareholders, in either case preferably in an arm's length transaction. Having done so, it must be recognized that only part of the problem has been solved, *i.e.*, it eliminates only those assets that the purchaser does not want — since he simply cannot afford the assets, he also cannot afford to acquire the proceeds of the sale of those assets — cash or other receivables.

If the problem posed is simply one of inability to pay for assets that are desired, and the shareholders of the selling corporation desire to liquidate the corporation, the appropriate plan would be

²⁹ Compare *Rupe Inv. Corp. v. Commissioner*, 266 F.2d 624 (5th Cir. 1954), *Estate of Arthur L. Hobson*, 17 T.C. 854 (1951), and *William B. Aull, Jr.*, 26 B.T.A. 862 (1932), *with Steel Improvement & Forge Co.*, 36 T.C. 265 (1961), *rev'd*, 314 F.2d 96 (6th Cir. 1963).

³⁰ This alternative, of course, can lead to a sale on which gain or loss will be recognized; tax consequences to the selling corporation must be taken into account.

to cause the corporation to sell the desired assets to the purchaser — in a true bootstrap situation they will be sold for a small amount down plus notes — after it has adopted a plan of complete liquidation pursuant to section 337³¹ of the Code.³²

This discussion of pre-sale activities which has necessarily overlapped into sales techniques and post-sales activities such as redemptions after purchase and corporate assumption of personal obligations³³ makes it apparent that bootstrapping does not occur easily.³⁴ Certain techniques would have resulted in very obvious economic bootstrapping, but except in those cases where the taxpayers were said to be acting as the agent of a corporation,³⁵ the techniques did not prevent a finding of dividend equivalency. This being so, it is necessary to turn to some more elaborate pre-sale activities³⁶ (herein termed indirect) and then to take up in greater detail those post-sale activities that have enjoyed success and which, in large part, make bootstrapping possible.

B. *The Indirect Approaches*

It might be more advisable to refer to the following alternatives as more devious than indirect or even sophisticated, except that their use does not depend so much upon sophistication as upon the facts of a given situation.

(1) *Preferred Stock Dividend*.—In situations where the transaction is to be effectuated through the sale of the voting common stock but the assets of the corporation, particularly cash, are so substantial that the purchaser cannot afford the common stock, a preferred stock dividend may be desirable. The corporate mechanics of a preferred stock dividend capitalize all or a portion of earned surplus and thus lessen by a like amount the value of the assets in corporate solution represented by the common shares.

³¹ CODE § 337. This section provides for non-recognition at the corporate level of gain or loss arising from sales of its assets if the adoption of a plan of complete liquidation precedes the sales and all of the assets of the corporation are distributed in complete liquidation within a twelve-month period.

³² Installment obligations can be distributed without recognition of gain or loss to the corporation if they have been received by the corporation upon the sale of inventory to one person in one transaction or upon the sale of other property after adoption of the plan of complete liquidation. See Reg. § 1.337-3 (1956).

³³ See text accompanying notes 3-28 *supra*.

³⁴ The most apparent methods have been held, absent special factual situations, to result in a taxable dividend to the purchasing shareholder.

³⁵ See authorities cited notes 8-13, 24-26 *supra* and accompanying text.

³⁶ These activities are designed to permit a sale to be made of the desired assets but do not dictate the form of the post-sale activity to be undertaken.

With the common and the preferred shares in the hands of the selling shareholders, they can sell the common shares for a lesser amount, retaining the preferred stock for income purposes. But before this method commends itself to use, it is essential to note the character of the preferred stock in the hands of the selling shareholders. It is section 306³⁷ stock or "hot stock," which gives rise, upon its disposition, including disposition by way of redemption, to ordinary income.³⁸ Lest one believe that all the maneuvering to capitalize a substantial portion of the corporate net worth was for the sole purpose of benefiting the purchaser at the expense of the seller, it is important to note that section 306 stock does not give rise in all cases to a dividend upon its redemption or disposition. Dividend treatment is entirely avoided if the disposition or redemption is of the entire amount of the preferred stock.³⁹

Upon such disposition of the preferred stock, the selling shareholder will have received the full value of the assets prior to the stock dividend and will report the gain on the sale of both the common and preferred shares as capital gain. He has also made it possible to realize that gain in different taxable years if disposition is deferred until a later taxable period.

Of course, a selling shareholder would be ill advised to accept preferred stock that was not attractive to outside investors because after disposition of his voting shares, redemption of the preferred shares would be subject to both the whim of the voting shareholders and the ability of the corporation to effect the redemption. Therefore, since the preferred stock to be issued as a stock dividend will be issued at a time when he is a part of the controlling group it should at that time be made sufficiently attractive so as to interest private or institutional investors in acquiring the taxpayer's entire preferred interest in order that any profit arising from the disposition of the preferred shares will be treated as capital gain rather than ordinary income.

(2) *Partial Liquidation.*—Another pre-sale device, one even more dependent upon the facts of a given situation, is the partial liquidation. The Code⁴⁰ permits the distribution, either in kind or of the sale proceeds, of a segment of the corporation's assets if said

³⁷ CODE § 306. "Section 306 stock" is stock received by way of a tax-free stock dividend or another transaction on which gain or loss is not recognized. CODE § 306(c)(1).

³⁸ See CODE §§ 306(a)(1), (2).

³⁹ See CODE §§ 306(b)(1), (2).

⁴⁰ CODE § 346.

assets or proceeds arising from the sale of such assets represent a corporate contraction.⁴¹ This method allows the shareholders to sell only those assets that they either desire to dispose of (either directly after a distribution in kind or through causing the corporation to do so) or that the purchaser wants or can afford. Specifically, a partial liquidation can occur when a corporation sells the assets of a separate business⁴² and distributes those proceeds to its shareholders in exchange for a part of each shareholder's interest. Or, in the alternative, the shareholders can cause the corporation to distribute the assets of the discontinued business⁴³ to themselves in partial liquidation of their shares and then sell to others the balance of their interest representing ownership in a corporation with only the assets desired to be sold or purchased.

Treatment of partial liquidation proceeds as capital gain cannot be lightly assumed, and strict compliance with the statutory and regulatory requirements must be achieved. If the tests can be met and the purchaser's desires can be brought into line with the hard facts of the corporate contraction,⁴⁴ a partial liquidation preceding the disposition of a portion of the assets or stock will make it possible for the purchaser to bootstrap that which he desires to acquire.

(3) *Corporate Separations.*—The last of the indirect approaches to the creation of a more purchasable corporate structure is the spin-off of corporate assets under section 355.⁴⁵ Again, bear in mind that the purchaser will either condition his promise to pay upon its productivity or he will seek to satisfy his obligation out of the assets acquired. For this reason, as in almost all instances previously discussed, the seller will be under pressure to segregate certain assets or to offer for sale shares that represent only those

⁴¹ A partial liquidation is defined as: (1) one of a series of distributions in redemption of all of the stock of a corporation, or (2) a distribution not essentially equivalent to a dividend and in most cases representing a corporate contraction. CODE §§ 346(a) (1), (2) & (b).

⁴² A corporate contraction occurs when a corporation makes a distribution in exchange for a part of its stock. The distribution is attributable to the corporation's ceasing to conduct a trade or business which has been actively conducted for a five-year period, or consists of the assets constituting that business, and after said distribution the corporation is engaged in the conduct of a trade or business which meets the same tests. Reg. §§ 1.346-1(b), (c).

⁴³ See note 42 *supra*. See also Rev. Rul. 60-232, 1960-2 CUM. BULL. 115; Rev. Rul. 56-513, 1956-2 CUM. BULL. 191.

⁴⁴ Obviously, if the purchaser does not wish to acquire the assets of one of the two actively conducted businesses necessary to qualify under § 346(b), this approach has no application.

⁴⁵ CODE § 355.

desired assets. The format of section 355 permits a corporation, operating more than one distinct business within itself,⁴⁶ to transfer the assets of one of those businesses to a subsidiary in exchange for its stock.⁴⁷ The parent then distributes its shares in the subsidiary as a tax-free stock dividend to its shareholders,⁴⁸ thereby creating two corporations, each owning a separate aggregate of business assets that can be disposed of either through a sale by the corporation or a sale by the shareholders of either corporation's stock.

It should be apparent that in effectuating a valid spin-off, the assets desired to be retained can be kept in the parent or transferred to the subsidiary (and the same is true of the assets desired to be sold) and that the shareholders thereafter have a choice between causing the sale of assets or of stock. As in the case of a partial liquidation, the threshold consideration is determining whether a valid spin-off can be accomplished and whether the assets subject to transfer in the course of a spin-off correspond to the business unit desired by the purchaser. If this can be accomplished, the spin-off can be a helpful tool in preparing the corporation for sale through the sale of its stock or assets.

II. POST-SALE ACTIVITY

The essence of present-day bootstrap acquisitions is the ability to acquire only what one wants or can afford and then to make that which he has acquired pay for itself. The prior discussion was directed to techniques employable by sellers to segregate desired assets or to create a stock interest that represents only desired assets or assets which the purchaser can afford. The purchaser then acquires the shares or assets either with the obligation to pay being contingent upon their earning capacity (the pure bootstrap) or with a fixed obligation to pay a stated amount over an extended period. The obligation to pay in this latter fashion presents the purchaser with an opportunity to combine the earning capacity of the assets

⁴⁶ Section 355 in this respect is much like § 346 requiring each of two or more separate businesses to have been actively conducted by the corporation for five years. See CODE § 355(b).

⁴⁷ Depending upon the nature of the procedure employed, the techniques are known as "spin-offs," "split-offs," or "split-ups" and all accomplish a tax-free corporate separation. With respect to corporate separations of distinct businesses, see *Mary Archer W. Morris Trust*, 42 T.C. 779 (1964); *H. Grady Lester, Jr.*, 40 T.C. 947 (1963). With respect to division of a *single* business, see *Edmund P. Coady*, 33 T.C. 771 (1960), *aff'd*, 289 F.2d 490 (6th Cir. 1961); Rev. Rul. 64-147, 1964-1 CUM. BULL. 136.

⁴⁸ The distribution could also be made in exchange for its shares or securities.

with the obligation to pay — the present-day concept of bootstrapping. Part II will focus upon the chief methods by which a purchaser can blend his purchase liability with the earnings or value of the acquired property.

A. Purchase of Less Than Control With Selling Shareholders Causing a Redemption of the Balance of the Shares

Perhaps the best-known manner of accomplishing the present-day concept of the bootstrap acquisition is for the purchaser to acquire at a price he can afford a small block of shares from those presently in control of the corporation. The selling shareholders, who are presumably still in control of the corporation then cause the redemption⁴⁹ of their remaining voting interest. As earlier stated,⁵⁰ a complete termination of a shareholder's interest results in capital gain treatment of the proceeds of the redemption,⁵¹ and, of course, the sellers report as capital gain any profit received from the sale of the initial block. In substance, the purchaser has acquired one hundred percent of the shares because his previously acquired block now represents the entirety of the outstanding stock interest in the corporation, and the corporation which he now controls has, through the redemption process, paid for those shares which he did not directly acquire. The obvious disadvantage to the purchaser is that the corporation which he now controls has substantially reduced assets, the assets either in cash or in kind having been used to make the redemption.⁵²

As might be expected, the Revenue Service has attacked this technique from both sides — that is, the Service has attempted to find a dividend to either the selling or purchasing shareholders. The leading decision treating the tax consequences to the seller is *Zenz v. Quinlivan*,⁵³ in which the widow of the former controlling shareholder sold a portion of her interest, the balance being redeemed for an amount roughly comparable to the earnings and profits of the corporation. The district court agreed with the government's contention that the redemption of the widow's remaining

⁴⁹ See note 3 *supra*.

⁵⁰ See text accompanying note 39 *supra*.

⁵¹ CODE § 302(b)(3).

⁵² The fact that the corporation has been diminished in value by use of the redemption has substantial importance with respect to the discussion incident to notes 62-76 *infra*.

⁵³ 213 F.2d 914 (6th Cir. 1954).

shares resulted in a dividend,⁵⁴ but the Sixth Circuit Court of Appeals reversed⁵⁵ in reliance upon the Regulations issued under section 115 of the 1939 Code.⁵⁶ These Regulations were the basis for the enactment of section 302(b)(3)⁵⁷ of the present Code, and the Commissioner in Rev. Rul. 55-745⁵⁸ has asserted that the rationale of *Zenz* is applicable to 1954-Code years.⁵⁹ This favorable disposition of the Commissioner toward *Zenz* effectively protects the selling side of the transaction in which the redemption technique is employed.⁶⁰

Having been largely unsuccessful in attacking the seller, the emphasis switched to ascribing dividend treatment to the remaining shareholder after the redemption — the purchaser. The basis of this attack was known as the “economic benefit”⁶¹ theory which reasoned in effect that the remaining shareholder reaped substantial economic benefit from the redemption of the other shareholders’ stock and that the value of the benefit is taxable as a dividend. This theory has had a checkered existence, and the leading decisions are deserving of discussion here.

One of the earlier attacks on the remaining shareholder was *Ray Edenfield*,⁶² which involved fundamentally the same kind of transaction presented in *Zenz*. The sole shareholder, an estate, sold one third of its stock to Edenfield and caused the redemption of the remaining two thirds, taking in exchange for its shares notes secured by a second mortgage on the corporate property, a hotel. The Commissioner urged that, in spite of the fact that Edenfield had no personal obligation on the notes, the corporation was acting for his benefit and on his behalf in acquiring the balance of the outstanding shares.⁶³ The Tax Court held that, absent a personal obligation on the part of the taxpayer to pay the notes, which

⁵⁴ *Zenz v. Quinlivan*, 106 F. Supp. 57, 61 (N.D. Ohio 1952), *rev'd*, 213 F.2d 914 (6th Cir. 1954).

⁵⁵ *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954).

⁵⁶ INT. REV. CODE OF 1939, § 115, 53 Stat. 46, 48.

⁵⁷ See note 3 *supra*.

⁵⁸ 1955-2 CUM. BULL. 223.

⁵⁹ *Id.* at 224.

⁶⁰ See *United States v. Carey*, 289 F.2d 531 (8th Cir. 1961), in which the taxpayer first purchased the stock and then had a portion thereof redeemed, successfully arguing that in substance the opposite was accomplished.

⁶¹ Lange, *Bootstrap Financing: The Redemption Technique*, 18 TAX L. REV. 323, 329 (1963).

⁶² 19 T.C. 13 (1952).

⁶³ *Id.* at 20.

would have placed the case squarely within the *Wall* doctrine, the remaining shareholder was not in receipt of a dividend.⁶⁴

The Commissioner, however, was far more successful in *Louis H. Zipp*⁶⁵ when two sons owning two of the fifty outstanding shares agreed to acquire their father's forty-eight shares in order to settle a bitter family dispute. The corporation borrowed the necessary cash, redeeming the father's shares for an amount virtually identical to the corporate net worth. The Commissioner contended that the sons had received an economic benefit from the redemption, a benefit which must be assumed to be no more than corporate control, as the value of the corporation had been stripped by the redemption.⁶⁶ The real substance of the decision would appear to be that inasmuch as all three shareholders were members of the same family, the corporation was in fact the agent⁶⁷ of the sons, and in that posture the case would not be far removed from *Wall*.

The decision which precipitated the severe circumscription of the economic benefit doctrine is *Niederkrone v. Commissioner*.⁶⁸ The purchasers could afford to acquire only approximately four hundred of the 750 shares available for sale. The sellers insisted on the immediate disposition of their shares in one sale, and the prospective purchasers had no choice but to find a buyer for the remaining 350 shares. An uncle was brought forward, who, through the use of borrowed funds, acquired the 350 shares, and within two months his shares were redeemed in order to permit him to retire his loan.

The Commissioner attacked the uncle as a sham or straw man and asserted the theory of economic benefit to the remaining shareholders as if the shares had been redeemed while still in the hands of the sellers.⁶⁹ The Tax Court⁷⁰ accepted this line of reasoning despite *Edenfield*, but the Ninth Circuit remanded the case with instructions that the economic benefit test would not be favorably

⁶⁴ *Id.* at 20-21.

⁶⁵ 28 T.C. 314 (1957).

⁶⁶ *Id.* at 324. The price paid by the corporation was equal to the corporate net worth at the time of distribution. The nature of the "economic" benefit was not made clear.

⁶⁷ *Id.* at 328-29. The court held, in effect, that the acquisition had been made by the sons' using the corporation for their own ends and, more important, to pay the purchase price. To that extent an "economic" benefit is discernible, but only if one accepts the theory that the corporation was in fact the sons' agent.

⁶⁸ 266 F.2d 238 (9th Cir. 1958), *reversing* 25 P-H Tax Ct. Mem. 1067 (1956).

⁶⁹ Fred C. Niederkrone, 25 P-H Tax Ct. Mem. 1067, 1073 (1956).

⁷⁰ Fred C. Niederkrone, 25 P-H Tax Ct. Mem. 1067 (1956).

viewed if used on rehearing.⁷¹ The Tax Court heeded the dictum, and on remand no dividend was found.⁷²

Even more important than *Niederkrone* is the previously discussed *Priester*⁷³ decision in which, in addition to his argument that the assignment of the purchase contract and later redemption of those shares from a third party resulted in a dividend under *Wall*,⁷⁴ the Commissioner argued that the redemption gave rise to a dividend to *Priester* on the economic benefit theory.⁷⁵ The attack upon such transactions by the Commissioner and the Tax Court had been blunted by the *Niederkrone* decision, and the Tax Court dismissed this contention almost out of hand.⁷⁶

Following *Priester* it would appear to be a safe conclusion that the remaining shareholder, after a complete redemption of the shares of another, will not be found to be in receipt of a dividend unless that redemption represents the assumption of the remaining shareholder's personal obligation to buy those shares,⁷⁷ the conferral of an economic benefit other than simple ascension to corporate control, or an instance in which the redeeming corporation is in fact the agent of the remaining shareholder.⁷⁸

It is important to note the difference between the technique discussed above which, barring a procedural error, yields capital gain to the sellers and the technique first discussed, according to which the acquisition of all or at least a controlling share interest is followed by the redemption of a portion of those shares. In the end the purchasing shareholder is identically situated — he is in control of a corporation of diminished value. By purchasing all of the shares first and then redeeming a portion in order to pay for the balance, a clear-cut dividend is generated.⁷⁹ However, by buying a few shares and allowing the sellers to redeem the balance, the purchaser incurs no tax liability. If one ever doubted the importance of adhering to formality when dealing with the redemption provisions of the Code, his doubts should be assuaged.

⁷¹ 266 F.2d at 243-44.

⁷² Fred C. *Niederkrone*, 29 P-H Tax Ct. Mem. 516 (1960).

⁷³ Milton F. *Priester*, 38 T.C. 316 (1962). *Priester* is discussed fully in text accompanying note 26 *supra*.

⁷⁴ *Id.* at 323.

⁷⁵ *Id.* at 326.

⁷⁶ *Id.* at 326-27.

⁷⁷ This is the *Wall* rationale, which is discussed fully in text accompanying notes 18-22 *supra*.

⁷⁸ See *Zipp* case discussed in text accompanying notes 63-65 *supra*.

⁷⁹ See text accompanying notes 3-14 *supra*.

B. Liquidation Under 334(b)(2)

The utilization of this technique presupposes a corporate purchaser of the stock. This means only that the party seeking to acquire the stock causes a corporation to be formed which will acquire at least a controlling interest. The corporation may borrow the money to purchase the shares, or it may give a note to the sellers in the amount of the purchase price. This newly formed corporation will have few free assets to meet its obligations, absent a substantial contribution to capital by its shareholders which would, of course, destroy the entire scheme of the acquisition.

Section 334(b)(2)⁸⁰ provides in essence that if a corporation acquires the stock of another corporation and then liquidates that corporation into itself within two years after the acquisition, the acquisition of the shares will be treated as being for the purpose of obtaining the assets. This being so, the assets take the basis of the amount paid for the stock plus liabilities assumed, a situation which often results in a substantial step-up in basis.⁸¹ In the case at hand, the added benefit to the bootstrapper is that the assets and earning capacity of the acquired company have been combined with the purchase obligation. The acquiring corporation can then use the assets to make a lump sum payment of its indebtedness or utilize the earnings to meet periodic note payments.

Cases in which this method of bootstrapping has been upheld include *American Steel & Pump Corp.*,⁸² wherein the taxpayer borrowed the funds necessary to acquire the stock of certain other corporations. These corporations, which had been chosen with an eye toward their favorable cash and receivables position, were then liquidated into the taxpayer and their quick assets were used to discharge the loan incurred to purchase the stock. The balance of the working assets were then retransferred to new corporate entities which continued the businesses.⁸³ The Tax Court held that the

⁸⁰ CODE § 334(b)(2). This section is a codification of the rationale advanced in *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

⁸¹ The basis of the assets in corporate solution would not be affected by a simple change in stock ownership. When one indulges in the fiction that the stock was acquired to obtain the assets, a new basis equal to the amount paid for the shares will almost certainly exceed the adjusted basis of the assets at the time of the change in stock ownership.

⁸² 31 P-H Tax Ct. Mem. 133 (1962).

⁸³ A transfer to a controlled corporation is one on which no gain or loss is recognized under § 351.

*Kimbell-Diamond*⁸⁴ rationale, as presently embodied in section 334(b)(2), was not affected by the purchaser's desire to utilize the cash and receivables in discharging its purchase money loan.⁸⁵

Likewise, in *North Am. Servs. Co.*⁸⁶ the Tax Court held that the failure to integrate the assets acquired on the liquidation into the going business of the purchasing corporation is not necessarily fatal to the application of section 334(b)(2).⁸⁷ There the business acquired on liquidation was continued as a new corporation,⁸⁸ but the Tax Court held that the aim of the purchasing corporation was to acquire the assets⁸⁹ rather than the business of the acquired company and that this frame of mind was not to be discounted simply because the business of the acquired company was continued.⁹⁰

These decisions would seem to make use of section 334(b)(2)'s step-up in basis while combining the purchase money debt with the value or earning capacity of the assets, a procedure even more flexible than is commonly believed. If the subsidiary is merely liquidated and the assets kept by the parent, no problem should arise.⁹¹ However, if the parent desires to continue the business, it can then transfer the assets that are not needed to meet the purchase obligation to a subsidiary, retaining in itself the assets necessary to pay for the shares.⁹²

C. *The Downstream Merger*

At that point in time when a corporate acquirer of a controlling stock interest must pay for those shares and it has no means to do so, the next post-sale technique becomes available. Instead of drawing the subsidiary up into the parent, when the subsidiary may be the larger enterprise with a well-known name and established business relationships, the reverse has in some cases been done.

⁸⁴ *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

⁸⁵ 31 P-H Tax Ct. Mem. at 138-39.

⁸⁶ 33 T.C. 677 (1962).

⁸⁷ *Id.* at 691-92.

⁸⁸ This was accomplished by a retransfer of the assets to a subsidiary.

⁸⁹ *Id.* at 692. In this case certain assets were held in the parent corporation while others were retransferred. The intent to keep a portion of the assets and to retransfer others was not held to show an intent to acquire stock rather than assets.

⁹⁰ *Ibid.*

⁹¹ Such a liquidation within the prescribed time period is the classic § 334(b)(2) situation.

⁹² This, of course, is not the classic situation, but apparently an intent to make use of some of the assets is sufficient. See authorities cited notes 82, 86 *supra*; *United States v. M.O.J. Corp.* 274 F.2d 713 (5th Cir. 1960).

The parent has been merged downstream into the subsidiary. In such a situation the use of statutory merger creates a tax-free reorganization pursuant to section 368(a)(1)(A),⁹³ and, as in the case of the 334(b)(2) liquidation, the value or the earning capacity of the assets becomes combined with the obligation of the purchaser to pay for the shares.

The Revenue Service has been adamant on occasion that the downstream merger gives rise to a dividend, but at least two decisions have found this avenue to be a safe one, provided the acquiring corporation is not a sham. In *Arthur Kobacker*,⁹⁴ the petitioner was desirous of purchasing all the outstanding capital stock of a department store, Reiner's, Inc. The selling shareholders insisted upon selling their entire interest for \$475,000 and would not accept any portion of the price in the form of a redemption. As Arthur Kobacker could not raise more than \$125,000, he caused the creation of a corporation, Alfred Investment Company, to which he and other family interests advanced \$352,500 in exchange for its stock and debenture bonds. Another family member, Jerome Kobacker, loaned an additional \$125,000, taking a note from the corporation. Arthur Kobacker then assigned his contract to purchase the shares of Reiner's, Inc. to the investment corporation which exercised the option, thus creating a parent-subsidiary relationship.

After more than a year, the Alfred Investment Company was merged into its subsidiary, and the subsidiary, now the continuing entity, issued a note to Jerome identical to the one originally issued by the Alfred corporation. Reiner's, Inc. made payments on the note and retired it in 1955 by paying \$90,000 which the Commissioner asserted to be a dividend to Arthur Kobacker and the other shareholders of Reiner's, Inc.⁹⁵ The Commissioner argued that the Alfred Investment Company was to be disregarded as a mere "sham." This would mean that Jerome Kobacker had loaned the \$125,000 to Arthur Kobacker directly, and the note was paid by Reiner's, Inc. — clearly a dividend would result.⁹⁶

The Tax Court held that the Alfred Company was not without substance in light of the \$175,000 invested in its stock, the maintenance of corporate indicia, the operation of one of the leased

⁹³ CODE § 368(a)(1)(A).

⁹⁴ 37 T.C. 882 (1962), *acq.*, 1964-2 CUM. BULL. 6.

⁹⁵ *Id.* at 892-93.

⁹⁶ Such a result would be pursuant to the reasoning in *Wall*.

departments prior to the merger, and the payment of interest on its notes.⁹⁷ The court specifically found that it was not a subterfuge.⁹⁸ Based upon this finding the court felt constrained to hold that Reiner's, Inc. had not paid a personal obligation of the shareholders nor had the payment of the note given rise to an economic benefit to the shareholders.⁹⁹ Significantly, the court cited only *Ray Edenfield*¹⁰⁰ and *Niederkrone v. Commissioner*¹⁰¹ as supporting authority.¹⁰²

An almost identical transaction was consummated in *Princess Coals, Inc. v. United States*¹⁰³ where a coal company desired the mining assets but not the liquid assets of another coal company, but the shareholders of that company would consider only the sale of their stock. The prospective purchaser was reluctant to assume the mining leases of the acquired company and for that reason caused the shares to be purchased by a newly formed subsidiary, which acquisition was financed in part by a loan.

The leases were to be assigned, if possible, but, in the event that this proved impossible, the subsidiary was to be merged downstream into the acquired company which would assume the subsidiary's indebtedness with respect to the purchase price. This eventually transpired, owing to the nonassignability of the leases. The Commissioner urged that the subsidiary was a sham and that the payment of the loan by the acquired corporation was a constructive dividend to the parent.¹⁰⁴ The court held that the parent had never been obligated to acquire the shares of the acquired company and that the subsidiary served a valid business purpose in protecting the parent from lease liability; therefore, no dividend was said to have resulted.¹⁰⁵

Two observations appear to be in order: first, this method has little chance of success if the formation of the acquiring corporation is not dictated by valid business considerations and if its existence is not replete with the maintenance of corporate indicia,¹⁰⁶ and,

⁹⁷ 37 T.C. at 895.

⁹⁸ *Ibid.*

⁹⁹ *Id.* at 896.

¹⁰⁰ 19 T.C. 13 (1952).

¹⁰¹ 266 F.2d 238 (9th Cir. 1958).

¹⁰² 37 T.C. at 896.

¹⁰³ 239 F. Supp. 401 (S.D.W. Va. 1965).

¹⁰⁴ *Id.* at 411.

¹⁰⁵ *Ibid.*

¹⁰⁶ Both *Kobacker* and *Princess Coals* clearly embody a finding that the corporation utilized to acquire the shares was so utilized for substantial business reasons.

second, the form of the merger must negate all doubt that the acquired corporation is the continuing entity — that the corporate shareholder in fact moves “down” instead of the subsidiary’s moving “up.” If these requirements are met, the downstream merger is an extremely viable method of combining a purchase obligation with the earning capacity of the acquired assets.

D. The Dividends Received Credit

Here again, reference must be made to that point in time at which a corporation which has purchased a controlling interest in another corporation must arrange payment for those shares. Instead of liquidating the subsidiary into itself or causing itself to be merged downstream into the subsidiary, the acquiring corporation can simply use its controlling position to cause the declaration of a dividend by the subsidiary. The proceeds of the dividend can then be used to meet the purchase obligations, and the process can be repeated as often as notes become due, assuming that the subsidiary has earnings and profits with which to pay a dividend.

There are at least two advantages inherent in the dividend technique: first, the intercorporate dividend is taxable only to the extent of fifteen percent;¹⁰⁷ and, second, both corporate entities are left intact, which in some situations could be a substantial business advantage. An almost certain prerequisite for using the dividend technique is a parent corporation that has a more substantial reason for continuing in existence than merely acquiring shares. If the parent corporation has little or no business activity during a taxable year other than to receive a dividend and to make payment for its stock, it is almost certain to run afoul of the personal holding company tax,¹⁰⁸ as a substantial portion of its income will be composed of dividends. This pitfall is amply demonstrated by *McKinley Corp.*¹⁰⁹ In that case the stock of a corporation having a substantial earned surplus was acquired largely with borrowed funds by a newly formed corporation which in order to repay its loan, caused the acquired corporation to declare a dividend. The taxpayer argued that it was not in receipt of a true dividend since, in substance, the dividend went to the selling shareholders;¹¹⁰ but the court held

¹⁰⁷ CODE § 243(a)(1). In specialized cases the dividend may be entirely offset by a deduction. CODE §§ 243(a)(2), (3).

¹⁰⁸ See CODE §§ 541-47.

¹⁰⁹ 36 T.C. 1182 (1962).

¹¹⁰ *Id.* at 1189.

that what was done, that is, the payment of a dividend in form, would be controlling.¹¹¹ The purchasing corporation was thus found to be subject to the personal holding company surtax.

A further hazard may be a contention by the Commissioner that the acquisition was made in order to secure an additional credit which should be disallowed under section 269¹¹² of the Code. Suffice to say here that proof of a bona fide business reason for the acquisition of the stock will negate any reference to section 269,¹¹³ which requires that the principal purpose be to secure the additional credit. It stretches the imagination to say that a corporation would acquire shares for the sole purpose of paying a tax on fifteen percent of the dividends received, especially when the corporation will almost certainly be an operating company because of the possible application of the personal holding company provisions.¹¹⁴

E. Consolidated Returns

Finally, corporations that are members of an affiliated group of corporations, as defined in section 1504,¹¹⁵ and which file a consolidated return can utilize the earnings of the acquired corporation to satisfy the obligation of the acquiring corporation because the filing of a consolidated return permits the free intercorporate flow of funds without incidence of taxation.¹¹⁶

This technique has been successful as exemplified by the case of *Cromwell Corp.*¹¹⁷ which arose when the Commissioner attacked the use of the consolidated return under section 269. Four individuals desired to acquire the shares of Cornwell Quality Tools, an operating company which also owned all of the shares of Kennedy Service Tools Co. In order to do so the Cromwell Corporation borrowed \$400,000 for one week with the understanding that, after the stock of Cornwell Quality Tools was purchased, Cornwell would borrow \$400,000 secured by a mortgage on its assets and

¹¹¹ *Id.* at 1188.

¹¹² CODE § 269.

¹¹³ Section 269 provides that if control of a corporation is acquired and the *principal purpose* of that acquisition is to evade or avoid tax through obtaining a deduction, credit, or other allowance which the acquiring entity would not otherwise enjoy, such deduction, credit, or other allowance may be disallowed in whole or in part.

¹¹⁴ *McKinley Corp.*, 36 T.C. 1182 (1962).

¹¹⁵ CODE § 1504.

¹¹⁶ See CODE §§ 243(a)(3), (b).

¹¹⁷ 43 T.C. 313 (1965), *acq.*, 1966 INT. REV. BULL. NO. 1, at 7.

pay a dividend of that amount to Cromwell Corporation which would then discharge its short-term loan. By filing a consolidated return, the intercompany dividend was eliminated from consolidated income. The Tax Court held that Cromwell had not secured any advantage that it could not otherwise have obtained and stated:¹¹⁸

The result of the above transactions was that the assets of Cornwell became primarily liable on the loan, and the principals had, in effect, financed in part the acquisition of Cornwell with funds other than their own. . . . We agree with petitioners that the use of purchased assets to finance part of the purchase price need not result in the imposition of a tax.¹¹⁹

The court specifically mentioned *Kobacker, Priester, and Niederkrome* as embodying the same result,¹²⁰ an observation that is of no small moment to bootstrappers.

III. CONCLUSION

There has been no attempt in the course of this article to exhaust every possibility of causing properties to pay for themselves. It has been demonstrated that there are a variety of tax techniques that can be employed first to tailor the properties that are to be sold and second, and most important, to bring the value and earning capacity of those properties to bear directly on the purchase obligation. Strict adherence to statutory rules is a necessity, and arguments that the substantive result of an out-of-statutory-sequence technique is the same as could have been otherwise accomplished are unreliable.¹²¹

This is not to say that there is any degree of artificiality in the basic concept of accomplishing a bootstrap acquisition. The Commissioner should have no objection to according statutory tax treatment to the proceeds of sales, redemptions, liquidation, mergers, intercorporate dividends, or the free flow of funds within an affiliated group, *if the transaction is otherwise bona fide*. If the acquisition and the post-sale activity have business and economic substance and follow one of the accepted modes, the bootstrap objective should be obtainable.

Although taxpayers who have arrived at the same result through

¹¹⁸ *Id.* at 318.

¹¹⁹ *Ibid.*

¹²⁰ *Id.* at 318-19.

¹²¹ *E.g.*, compare the results reached by use of redemptions, text accompanying notes 3-16 *supra*, with text accompanying notes 49-79 *supra*.

a transaction that may be procedurally out of sequence should not be denied an equitable decision based on substance over form, there is little question that the decisions treating this many-faceted area have tended to exalt form over substance in the name of strict statutory interpretation.¹²² This approach may be more than mildly disconcerting to those who are arguing substance; however, it does create a degree of certainty with respect to planning. If one strictly follows the Code and each step of the transaction is bona fide and can be fully documented, the art of bootstrapping can be utilized with a substantial degree of safety.

¹²² Substance has been found controlling to the benefit of the taxpayer in *United States v. Carey*, 289 F.2d 531 (8th Cir. 1961) and has been found controlling to the detriment of a taxpayer who complied with formality in *Sullivan v. United States*, 244 F. Supp. 605 (W.D. Mo. 1965).