

BAIL-OUTS AND THE INTERNAL REVENUE CODE OF 1954

JOHN H. ALEXANDER † and WILLIAM B. LANDIS, JR. ††

WHEN the House bill that subsequently became the Internal Revenue Code of 1954 was first unveiled to public view, among the provisions that excited the most comment were those relating to corporate distributions and adjustments, particularly the sections containing a radical approach to the so-called "bail-out" problem.¹ It was quite apparent that the architects of the House bill intended this tax avoidance device for converting potential dividend income into capital gains to become a matter of no more than historical interest. Although the bail-out provisions of the Code bear little resemblance to those first devised in the bill, they are themselves so novel and of such importance that they merit detailed study.

Ordinarily, the shareholders of a corporation that has earnings and profits may expect to receive dividends taxable at ordinary income rates.² On the other hand, a sale or redemption of all or part of the shareholder's stock may be treated as a capital transaction giving rise to no more than capital gains tax, even though a part of the purchase or redemption price represents payment for a pro rata share in the earnings and profits of the corporation. A bail-out is an attempt to use corporate funds to provide for shareholder payments taxable at favorable capital gains rates without adversely affecting the shareholder's relative interest in the corporation. Prior to the 1954 Code a bail-out might theoretically take one of two forms: an upgrading of a proportion of each shareholder's stock into bonds or other securities through the medium of a tax-free exchange and a subsequent disposition of the securities

†Member of the New York Bar.

††Member of the New York Bar.

1. For contemporary comments by professional associations on the bail-out provisions proposed in the House bill, see *Hearings Before the Committee on Finance of the Senate on H.R. 8300*, 83d Cong., 2d Sess., pt. 1, at 334-35, 359-65 (Section on Taxation, American Bar Association), 500-01, 520-23 (Committee on Taxation, The Association of the Bar of the City of New York), pt. 2, at 968-69 (Wisconsin Bar Association), pt. 3, at 1533-34 (New York State Bar Association).

2. Under the 1954 Code individual shareholders other than nonresident aliens not engaged in trade or business in the United States are allowed a credit against the tax of up to 4% of dividends from most domestic corporations and an exclusion from gross income of the first \$50 of such dividends received. INT. REV. CODE OF 1954, §§ 34, 116. (Sections of the 1954 Code are hereinafter referred to simply by section number; sections of the 1939 Code, 53 STAT. 1, in effect immediately prior to repeal, are referred to by section numbers, preceded by the word "old.")

through sale or redemption; or a similarly proportionate upgrading of a common stock interest to a preferred stock interest by means of a stock dividend or a tax-free exchange followed by sale and, ultimately, redemption from the purchaser.

A dividend of securities paid on stock generally afforded no means of tax relief, for such a direct payment was subject to ordinary tax on the same basis as if payment were made in cash.³ Furthermore, the *Bazley* and *Adams* cases had established substantial barriers to the use of the reorganization provisions for avoiding the results of a direct distribution of securities.⁴ The decisions left, however, an undefined area in which the position of a stockholder might be converted, at least in part, to that of a creditor through the operation of the tax-free exchange provisions.⁵ It is open to serious question whether the opportunities for tax avoidance were so substantial as to justify any change in the law, but the Treasury Department's long battle in reorganization cases to deny completely the tax-free upgrading of a stock to a creditor interest was finally won when the 1954 Code became law.⁶

The preferred stock bail-out was a far more serious threat to tax revenue, and in the light of the long continued existence of high tax rates, it is perhaps

3. *Doerschuck v. United States*, 274 Fed. 739 (E.D.N.Y. 1921), T.D. 3170, 4 CUM. BULL. 25 (1921) (debenture bonds); O.D. 471, 2 CUM. BULL. 26 (1920) (promissory notes).

4. *Bazley v. Commissioner and Adams v. Commissioner*, 331 U.S. 737 (1947).

5. Cf. *Penfield v. Davis*, 105 F. Supp. 292 (N.D. Ala. 1952), *aff'd*, 205 F.2d 798 (5th Cir. 1953); *Daisy Seide*, 18 T.C. 502 (1952); *Wolf Envelope Co.*, 17 T.C. 471 (1951), *nonacq.*, 1952-1 CUM. BULL. 6, *appeal dismissed*, 197 F.2d 864 (6th Cir. 1952); *H. Grady Manning Trust*, 15 T.C. 930 (1950), *nonacq.*, 1951-2 CUM. BULL. 5. In the *Penfield* and *Seide* cases exchanges of preferred stock for bonds or debentures pursuant to plans of recapitalization were held tax-free. There was in each case substantially disproportionate ownership of preferred and common stock so that the exchange could not be regarded as having the effect of a pro rata dividend to the controlling shareholders. The bonds and debentures received in exchange had remote maturity dates. In *Penfield* the district court observed that the bonds received in exchange were no more marketable than the preferred which was surrendered, and in *Seide* the Tax Court found that the debentures were not readily marketable. In *Wolfe Envelope Co.* Class A Stock, which had voting rights and a substantial dividend preference, was exchanged for debentures, while Class B stock was exchanged for new common. The court held the exchange tax-free, pointing out that inactive and absentee shareholders were principally interested in the Class A stock while the active managers were principally interested in the Class B stock. The recapitalization therefore accomplished a change in the corporation's capital structure affecting voting control and the carrying charges ranking prior to the common stock. Moreover, the debentures were not callable at will and therefore not "virtually cash" as in *Bazley v. Commissioner*. In *H. Grady Manning Trust* an exchange of preferred stock for common stock and debenture bonds in a corporate merger with a valid business purpose was held not to give rise to a taxable dividend.

The *Bazley* case was distinguished in all four decisions cited above, but in *Heady v. Commissioner*, 162 F.2d 699 (7th Cir. 1947), an exchange of all the outstanding shares of a corporation for new common stock and debentures was held to result in a taxable dividend even though an agreement to sell all of the stock over a period of time and subject to certain contingencies was entered into as part of the transaction.

6. Sections 354(a)(2), 356(a). For discussion, see text at pp. 913-15 *infra*.

surprising that the problem did not become acute until recently. Years ago, of course, a statutory provision was adopted to prevent a primitive form of bail-out—redemption of preferred stock that had been issued to the holder as a tax-free dividend on his common stock. The amount received was taxed as a dividend if the redemption of preferred stock was held to be essentially equivalent to a dividend.⁷ But stock dividends themselves, until the *Koshland* case in 1936,⁸ were deemed exempt from tax;⁹ and there was never much doubt, at least after the *Strassburger* case, that a dividend of preferred stock on common stock was not taxable when no other stock was outstanding.¹⁰ Yet, in spite of the tax

7. The familiar language of old § 115(g) providing for dividend taxation upon cancellation or redemption of stock "at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend," was extended by the 1926 act to stock that had not been received as a stock dividend. Revenue Act of 1926, § 201(g), 44 STAT. 11. Prior to 1926 the phrase was operative only if the cancellation or redemption was in connection with a stock dividend. Revenue Act of 1921, § 201(d), 42 STAT. 228-29; Revenue Act of 1924, § 201(f), 43 STAT. 255. The approach under the 1954 Code is somewhat different. Section 302(a) provides that a redemption which comes within any of the four paragraphs of the succeeding subsection is to be treated as an exchange rather than a dividend. Section 302(b) (1) then provides the general rule that subsection (a) is to apply if a redemption is "not essentially equivalent to a dividend," and succeeding paragraphs add specific instances which are to come within subsection (a). Subsection (d) provides that if subsection (a) does not apply, the redemption shall be treated as a distribution of property to which § 301 applies, resulting in dividend treatment to the extent the distribution is "out of earnings and profits" within the meaning of § 316.

8. *Koshland v. Helvering*, 298 U.S. 441 (1936).

9. The acts of 1916, 1917 and 1918 provided that stock dividends were to be considered income. Revenue Act of 1916, § 2(a), 39 STAT. 757; Revenue Act of Oct. 3, 1917, § 1211, 40 STAT. 336-38; Revenue Act of 1918, § 201(c), 40 STAT. 1059. Following the decision in *Eisner v. Macomber*, 252 U.S. 189 (1920), that a dividend of common on common did not constitute income to the shareholders of a corporation, the 1921 and later acts exempted stock dividends from tax. Revenue Act of 1921, § 201(d), 42 STAT. 228. Committee reports and discussion on the floor of the House indicate that the Supreme Court decision was believed to require this sweeping exemption. H.R. REP. No. 350, 67th Cong., 1st Sess. 8 (1921). However, in *Koshland* the Supreme Court accepted the taxpayer's argument that dividends of common stock on preferred stock, while exempt from tax under the statute, had nevertheless constituted income rather than a split-up of capital so that the basis of the preferred stock was not to be reduced by any allocation to the dividend stock. Following this decision, the statute was amended to provide that a stock dividend should be exempt only to the extent that it did not constitute income to the shareholder within the meaning of the Sixteenth Amendment. Revenue Act of 1936, § 115(f), 49 STAT. 1688. The provision remained unchanged until enactment of the 1954 Code. As interpreted by the Supreme Court in *Helvering v. Griffiths*, 318 U.S. 371 (1943), the statutory language did not require a constitutional decision by the Court in each case as to whether the stock dividend in question constituted income under the Sixteenth Amendment, but was intended simply to adopt the rule of *Eisner v. Macomber*, as delimited by the Court in the *Koshland* case.

10. *Strassburger v. Commissioner and Helvering v. Sprouse*, 318 U.S. 604 (1943). In *Strassburger* the dividend of preferred was to the sole stockholder of the corporation, but it was immediately assumed that the rule should apply to a case where the common stock was owned by more than one shareholder. *Stern v. Commissioner*, 43-1 U.S.T.C.

avoidance possibilities, there is little published evidence that extensive use was made of a preferred stock dividend, sale and redemption before the late 1940's. Only then did the practice become sufficiently widespread to lead to the adoption by the Treasury Department of a policy designed to curb this type of bail-out.¹¹

The final development that made legislative attack on the preferred stock bail-out almost inevitable was the decision of the Court of Appeals for the Sixth Circuit in *Chamberlin v. Commissioner*.¹² A preferred stock dividend had been paid pursuant to a pre-arranged plan for its immediate sale to an insurance company. A sinking fund had been provided for the retirement of the preferred stock over a period of seven years from the date of issuance, and the preferred stock had protective features which the Tax Court described as being equivalent to those

¶ 9840 (7th Cir. 1943), reversing by stipulation, 46 B.T.A. 416 (1942); cf. Estate of Joseph E. Sorg, 1 CCH Tax Ct. Mem. 879 (1943); Charles M. Cooke, Ltd., 2 T.C. 147 (1943). *Helvering v. Sprouse*, decided at the same time as *Strassburger*, held nontaxable a dividend of nonvoting common to holders of voting and nonvoting common.

A careful reading of the Supreme Court decisions might, however, have led to some uncertainty about the tax-free nature of a dividend which was followed by sale of the dividend stock as part of a preconceived plan. In *Strassburger*, for example, the Court pointed out that "petitioner still holds the preferred stock." 318 U.S. at 607. In *Griffiths*, the Court noted that "the dividend stock was not sold, redeemed, or in any way realized upon." 318 U.S. at 372. In *Eisner v. Macomber*, the Court limited its holding to "a true stock dividend made lawfully and in good faith." 252 U.S. at 219.

11. Darrell, *Recent Developments in Nontaxable Reorganizations and Stock Dividends*, 61 HARV. L. REV. 958 (1948); DeWind, *Preferred Stock "Bail-Outs" and the Income Tax*, 62 HARV. L. REV. 1126 (1949). Under the Treasury Department policy, as outlined in the Darrell article, rulings of nontaxability and closing agreements were to be refused in most cases where it appeared that common stockholders of a corporation with earnings and profits might be in a fair way to realize cash or its equivalent from a preferred stock dividend or from a reorganization exchange involving pro rata acquisition of new preferred stock. At the very least, any ruling or closing agreement would be conditioned on an intent to retain the preferred stock. It was proposed to issue no rulings in the ordinary case of receipt of bonds by common shareholders in a reorganization exchange. If there were prior arrangements for sale of the new preferred stock, or if a sale occurred under such circumstances that it could be deemed a step in the transaction, the stockholder would be considered taxable in respect of the preferred stock or its proceeds—either as a dividend, or as "boot" taxable as a dividend not exceeding the gain, to the extent of the earnings and profits of the corporation available for distribution as a dividend. If there was present a mandatory sinking fund provision in the case of preferred stock, any ruling of nontaxability would provide that it was of no effect as to any stockholder who at any time sold or transferred (except by hypothecation) the preferred stock. Even in cases where there was no sinking fund provision or intent to sell, rulings and closing agreements were to provide that they did not cover the tax treatment of sale or transfer by the stockholder (other than by hypothecation) or the redemption of the stock in the hands of the original holder or a transferee. Darrell, *supra* at 961-62. To Mr. Darrell it seemed that by its change in policy the Treasury was attempting "to bring about further drastic changes in tax law in an ex post facto fashion without clear Congressional sanction" in such manner as unduly to impede economic transactions. *Id.* at 973-77. Mr. DeWind's answering article defended the Treasury policy and hoped for a successful attack through the courts that might lead to the overruling of the *Sprouse* and *Strassburger* decisions. DeWind, *supra* at 1142-54.

12. 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954).

usually accorded bonds. The stockholders had set up the plan for the purpose of getting funds out of the corporation without paying surtax. In an opinion that related the distribution and the disposition of the stock, the Tax Court held that the dividend was not a true stock dividend and that the shareholders were subject to surtax.¹³ The Court of Appeals refused to follow this reasoning and held that the presence of the plan of disposition and subsequent redemption did not render taxable a stock dividend that would clearly have been nontaxable had there been no sale or redemption.

It is by no means clear that the *Chamberlin* case represents the definitive answer to the problems there posed, but it is not difficult to understand the Treasury's deep concern with the outcome. The factual situation was most unfavorable to the taxpayers and presented a bail-out in simplest form. The shareholders had realized value on their preferred stock without permanently impairing their equity position or surrendering control, and no purpose other than tax avoidance was served by the transaction. Despite these circumstances the Government had suffered an unequivocal defeat. Since intensive work on the revision of the revenue laws was then in progress, inclusion of provisions to meet the bail-out problem was the obvious answer.

THE CONVERSION OF STOCK INTO SECURITIES UNDER THE INTERNAL REVENUE CODE OF 1954

Under the 1939 Code tax avoidance by the conversion of stock into bonds or other securities could be accomplished only by means of a tax free exchange in a corporate reorganization, for all dividends of the distributing corporation's securities were generally treated in the same manner as the distribution of money or property. The only problem facing Congress in this area, therefore, lay in the tax-free exchange provisions which seemed to permit the exchange of stock for securities or for stock and securities in reorganization cases.¹⁴ Under the solution adopted in the 1954 Code, securities received in exchange, in whole or in part, for stock in pursuance of a plan of reorganization are treated in the same manner as money or other property, and dividend treatment may result.¹⁵ A similar result follows if the transaction represents a distribution, otherwise qualifying under section 355, to a stockholder of securities or stock and securities of a "controlled corporation" (a so-called "separation" distribution).¹⁶ If securities are received in a reorganization or separation transaction and other securities are surrendered, the amount to be treated as "other property," or

13. *C. P. Chamberlin*, 18 T.C. 164 (1952). The court reviewed the Supreme Court decisions at some length and concluded that they did not cover the circumstances of an accomplished bail-out. See note 10 *supra*.

14. None of the cases which had permitted tax-free exchange of stock for securities since *Bazley v. Commissioner* and *Adams v. Commissioner*, 331 U.S. 737 (1947), had involved what could fairly be called a bail-out. See note 5 *supra*.

15. Sections 354, 356. Certain railroad reorganizations are given special treatment. Section 354(c).

16. Sections 355, 356.

"boot," possibly subject to tax as a dividend if the exchanging taxpayer is also a shareholder, is the market value of any excess principal amount received.¹⁷

In the case of exchanges in connection with a reorganization or separation, the statutory provisions for treatment of boot do not differ in substance from those in the reorganization exchange sections of the 1939 Code.¹⁸ In order for the transaction to be subject to tax, there must be a "gain"—the value of the stock and boot, including securities, received must exceed the basis of the stock and securities exchanged. The gain is recognized to the extent of the value of the boot received; but if the exchange "has the effect of the distribution of a dividend," the gain is taxed as a dividend only to the extent of the shareholder's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder of any recognized gain is treated as gain from the exchange of property.

A separation transaction may involve a distribution without an exchange. In such a case an amount equal to the value of the boot received, including securities, is to be treated as a distribution of property to which section 301 applies.¹⁹ As a result, the distribution will be taxed as a dividend to the extent of earnings and profits without reference to whether the overall transaction results in gain or loss to the shareholder.²⁰

A new Treasury Regulation, without counterpart in the regulations under the 1939 Code, seeks to avoid in certain transactions the limitations of the boot provisions of section 356 applicable to exchanges. It provides that a distribution to shareholders may be subject to tax as a dividend under section 301 to the extent of earnings and profits although the distribution "takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense."²¹ The type of transaction in which "this is most likely to occur" is a recapitalization, reincorporation or merger of a corporation with a newly organized corporation having substantially no property. The example is given of a corporation with only common stock outstanding that exchanges one share of newly issued common and one bond in the principal amount of \$10 for each share of outstanding common stock, and it is stated that the distribution of the bond will be a distribution of property to which section 301 applies even though the exchange of common stock for common may be a tax-free recapitalization exchange.²² The obvious result is that

17. Thus, if \$1,000 principal amount of securities is surrendered in exchange for a security in the principal amount of \$1,200 with a fair market value of \$1,080, the fair market value of the \$200 excess principal amount, or \$180, is treated as other property. U.S. Treas. Reg. § 1.356-3(b), Example (5) (1955).

18. Compare § 356(a) with old § 112(c).

19. Section 356(b), (d).

20. It may be doubted that there is sufficient distinction between an exchange and a distribution without exchange to justify the difference in treatment of the boot received. For basis purposes, a distribution under § 355 (and so much of § 356 as relates to § 355) is treated as an exchange in which the stock and securities retained are considered surrendered, and received back, in exchange. Section 358(c).

21. U.S. Treas. Reg. § 1.301-1(l) (1955).

22. *Ibid.*

the amount of the bond will be taxed as a dividend without regard to the shareholder's gain or loss on the transaction.

The regulation apparently attempts to achieve the result of the *Bazley* and *Adams* cases, although by a different rationale. In those cases, the courts held that because there was no valid reorganization the distribution of the securities pursuant to the recapitalization was to be treated as the simple payment of a dividend.²³ The regulation, on the other hand, contemplates that there may be a valid reorganization involving an exchange of stock for stock, but that the distribution of securities in connection therewith may be singled out and taxed as a dividend distribution. Conceivably such a theory might be invoked in a number of situations where it would not have been thought that the doctrine of the *Bazley* case had any application. For example, in a perfectly straightforward business reorganization involving a statutory merger the Government might argue that there is no adequate business reason for the receipt of bonds in addition to stock for certain exchanged stock, and that the bonds should be taxed as a dividend distribution, quite without reference to the amount of gain realized by the shareholder. It remains to be seen, however, whether the Commissioner will attempt to apply the regulation in other than rather flagrant cases. If he does, he will almost certainly face litigation if no gain is realized on the exchange or the gain is less than the value of the securities received.

There remains one tax-free exchange provision of the law where securities might be issued for stock on a tax-free exchange basis. Under section 351, the counterpart of section 112(b)(5) of the 1939 Code, property may be transferred tax-free to a controlled corporation in exchange for stock or securities of the controlled corporation. Assume, for instance, X and Y own all the stock of A Corporation and Z owns patents. The three organize a new corporation, B, transferring to it the stock of A Corporation and the patents owned by Z in exchange for B's stock and bonds. Although none of the reorganization provisions would apply, section 351 could render the exchange tax-free. If any substitution of securities for stock is bad per se, as the new organization provisions suggest, why were restrictions not placed on the use of section 351 to upgrade a stock interest to a creditor's position? It may have been considered that the possibilities of use for tax avoidance were not sufficiently great to require restrictions.

SECTION 306 TREATMENT OF THE PREFERRED STOCK BAIL-OUT

The formulation of legislative provisions to solve the preferred stock bail-out device proved to be one of the thorniest problems faced by the draftsmen of the 1954 Code. No solution would be satisfactory unless it achieved a delicate balance between protecting the revenue and permitting legitimate

23. In the *Adams* case the taxpayer claimed a loss on the transaction, but since all three courts which considered the matter held that the formal reorganization should be denied effect, the question of gain or loss was irrelevant. *Adam A. Adams*, 5 T.C. 351, 352, 360 (1945), *aff'd*, 155 F.2d 246, 247 (3d Cir. 1946), *aff'd*, 331 U.S. 737, 744 (1947).

business transactions. One possibility was to tax all stock dividends except common stock paid on common stock. Such a solution was deemed to have the two major defects of interfering with proper and approved transactions and of presenting a constitutional question.²⁴ There should be little doubt, however, that the Supreme Court would uphold the constitutionality of such a tax. The argument that a common stockholder who received a dividend in preferred stock had not changed his position would ignore the record in the *Chamberlin* case; it is hardly likely that such a contention would succeed. Nevertheless, the proposal might well have involved the subject in litigation that would have raised some constitutional doubts until a favorable decision of the Supreme Court could be obtained. More important was the possible interference with legitimate transactions. Representatives of both the administrative and the legislative bodies were satisfied that there was an area in which preferred stock dividends served a useful purpose. The example most frequently cited was that of the corporation closely held by one or more stockholders who had reached an age when they would like to pass an equity interest to the next generation or to outsiders brought in to manage the business, without, however, surrendering their security and income. A dividend in preferred stock followed by a gift or sale of the common stock would bring about the desired result. An objection to taxing stock dividends was also made on the ground that a stock dividend itself furnishes no cash to pay the tax, but this point, if sound, is equally valid to require elimination of tax on any property dividend. As a practical matter, if Congress had adopted a provision taxing all stock dividends except common on common, probably few taxable stock dividends would have been declared unless the dividend stock had a ready market.

It is difficult to understand how this reluctance to extend the taxation of stock dividends could be accompanied by the acceptance, initially at least, of the drastic remedy for the bail-out embodied in section 309 of the bill as approved by the House. This section imposed under some circumstances a tax of 85 per cent on the transfer by a corporation of securities or property in redemption of "nonparticipating stock." This proposed remedy survived only a brief time after it was released to the public, and was buried with few admitted mourners. The problem then presented to the Senate Finance Committee and its advisers was either to return to existing law or to develop a workable remedy for the preferred stock bail-out within the relatively short time available before enactment of the 1954 Code. There was little or no disposition to return to existing law, and attention was promptly turned to drafting provisions embodying the only other approach which had been seriously advanced—permitting stock dividends to be issued without tax liability but taxing the recipient upon his disposition or redemption of the dividend stock. The result is contained in sections 305 and 306 of the 1954 Code.²⁵

24. See note 9 *supra*, for discussion of the constitutional problem.

25. The general approach is that adopted by The American Law Institute in its draft of a model federal income tax statute. ALI FED. INCOME TAX STAT. §§ 500, 505, 510, 511, 519, 531 (Feb. 1954 draft).

Section 305 fixes the tax consequences of the issuance of stock dividends and stock rights and, with certain limited exceptions, excludes from gross income all stock dividends and stock rights. The exceptions are distributions made in discharge of preference dividends for the current or preceding taxable year of the corporation, and distributions which, at the election of any of the stockholders, are payable either in stock (or rights), or in property. Section 306 creates a new type of stock, "section 306 stock," which is tainted at birth but which creates no tax liability in the holder until he disposes of it. The section defines the term "section 306 stock" to cover most preferred stock dividends, certain common stock dividends and, generally, preferred stock received in tax-free corporate readjustment exchanges or distributions if the effect is substantially the same as the receipt of a stock dividend or if the stock is received in exchange for section 306 stock. The section prescribes the tax consequences of a nonexempt sale, exchange or redemption, in many cases treating part or all of the amount realized as gain from the sale of property which is not a capital asset, or, in case of a redemption, as a dividend. The section, although occupying only three printed pages, is highly complex and requires detailed study for its understanding.

Definition of Section 306 Stock

To be classified as section 306 stock, stock must fall into one of three categories: (A) dividend stock, other than common stock issued with respect to common stock, (B) stock, other than common stock, that is received under vaguely described conditions in reorganization and separation transactions, and (C) stock with a basis determined by reference to the basis of section 306 stock. Each of these constitutes an important category, and at least the first two present many novel and baffling problems.

Stock Received as a Dividend

"Other than common stock issued with respect to common stock." To fall within the classification prescribed by subparagraph (A) of section 306(c)(1), the stock distributed must be "other than common stock issued with respect to common stock."²⁶ Stock received before June 22, 1954, is excluded from the operation of subparagraph (A) and, it is believed, of the other subparagraphs defining section 306 stock.²⁷ The statute affords no criterion by which to deter-

26. For the purposes of § 306, "stock rights shall be treated as stock." Section 306(d). For the purposes of the provisions relating to tax-free corporate organization, reorganization and separation exchanges of stock or securities, the regulations provide that stock rights or stock warrants are not included in the term "stock or securities." U.S. Treas. Reg. §§ 1.351-1(a), 1.354-1(e), 1.355-1(a) (1955). Treasury stock distributed as a dividend on common will be considered as "common stock issued with respect to common stock," at least if the stock distributed is the same in all respects as the common stock outstanding. Rev. Rul. 55-746, 1955 INT. REV. BULL. No. 52, at 10.

27. "Section 306 shall be inapplicable to stock received before June 22, 1954, and to stock received on or after June 22, 1954, in transactions subject to the provisions of the

mine whether the distributed stock is other than common stock, and the recently issued regulations do not attempt a definition.

Corporate law has not developed any generally accepted definition of common stock,²⁸ although there is authority suggesting that any preference with respect to earnings and liquidation may be sufficient to bring the stock within the category of preferred stock.²⁹ In view of the uncertainty of the definitions, it could be urged that the problem should be considered simply in the light of the purpose of the statute to prevent bail-outs, but it may be doubted that this argument will prevail when there is an actual preference. For example, stock that is voting, that is not redeemable and that shares equally in dividends after a priority payment to it of \$5 a share is not particularly appropriate for use as a bail-out device, but it may nevertheless be held to be other than common stock because of the preference.

The purpose of section 306 to prevent bail-outs cannot, however, simply be ignored. Stock that is subject to a right in the corporation to redeem at a fixed price or at a price to be determined by a formula may be classified as "other than common stock" for the purposes of subparagraph (A), even if it

1939 Code." U.S. Treas. Reg. § 1.306-3(i) (1955). This regulation is a conclusion derived from a number of statutory provisions. Section 306(c)(1)(A), defining the conditions under which dividend stock may be section 306 stock, imposes as a condition that "by reason of section 305(a)" some part of the distribution "was not includible in the gross income of the shareholder." Section 391 stipulates that the effective date of part I, which includes § 305, is June 22, 1954. It follows that only those distributions which occur on or after June 22, 1954, can be within subparagraph (A). Section 306(c)(1)(B), which brings stock received in corporate reorganizations and separations within the orbit of § 306, applies only if gain or loss with respect to the receipt of preferred stock "was to any extent not recognized by reason of part III." The general effective date for part III is also June 22, 1954. Section 393(a). Under § 393(b)(2), however, corporations may elect to continue the application of the 1939 Code if a ruling was issued on a plan of reorganization submitted before June 22, 1954; if the election is made, stock which would otherwise be section 306 stock under subparagraph (B) does not have that character. A second exception is provided in § 393(b)(3), which grants an election under limited circumstances to have the 1954 Code apply to a pre-June 22, 1954 reorganization; in this case the new Code is to determine "the tax treatment of such reorganization." Is treatment as section 306 stock, which has tax consequences only on subsequent sale or redemption, part of the tax treatment of the reorganization within the meaning of this phrase? Apparently the answer of the Treasury is in the negative. There is some ambiguity in the sentence from the regulation quoted above, but the intended meaning appears to be that § 306 is not to apply to any stock received before June 22, 1954. Subparagraph (C) of § 306(c)(1) provides for section 306 stock only where the stock has a basis determined by reference to section 306 stock; ultimately, therefore, the origin of the stock must be traced to subparagraph (A) or (B).

28. "It is a matter of judicial comment that no satisfactory definition of 'common stock' can be found." 11 FLETCHER, PRIVATE CORPORATIONS § 5086 (perm. ed. rev. 1932), citing *General Inv. Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 100 Atl. 347 (Ch. 1917).

29. 11 FLETCHER, PRIVATE CORPORATIONS § 5283 (perm. ed. rev. 1932), where the preference as to dividends is emphasized as the distinguishing characteristic. The New York statute provides that shares entitled to preference in the distribution of dividends or assets shall not be designated as common stock or shares. N.Y. STOCK CORPORATION LAW § 11.

has full voting rights and rights on a parity with the other stock to participate in earnings and in assets on liquidation. In the case of such a stock, even though its sale would reduce the control and equity of the seller, sufficient control could be retained to cause the corporation to redeem the stock. If the distributed stock was issued with a condition that it must be redeemed by the corporation under a sinking fund arrangement, the stock would probably be classified as other than common stock.³⁰ Mere absence of voting rights by itself should not subject dividend stock to section 306 treatment.³¹ While such stock may be sold without surrender of control of the corporation, it would not as a rule be sufficiently marketable for use as bail-out stock in the absence of redemption or preference features.

The draftsmen of section 306 foresaw the possibility that means might be found to issue a dividend of common stock on common stock under conditions such that the holder could convert the stock into preferred stock. It is therefore provided in section 306(e)(2) that common stock with respect to which there is a privilege of converting into stock other than common stock, or into property, shall not be treated as common stock; this is so whether or not the conversion privilege is contained in the stock. The clearest form of transaction covered by this provision would be a dividend of common on common accompanied by an undertaking by the corporation to exchange preferred for the new common stock. Although subparagraph (B) would probably have tainted preferred stock issued to the recipient in exchange for his common stock dividend, it is doubtful whether sale of the dividend by the holder and subsequent conversion by the buyer would have been within section 306 in the absence of (e)(2). The inclusion of the provision, however, suggests that the statute might be circumvented by an alternative approach. Assume, for example, a closely held corporation with only common stock outstanding. Instead of receiving additional stock as a dividend, the shareholders arrange for the corporation to stamp part of their stock with an agreement to exchange preferred stock of a like value for the stamped stock. The shareholders then sell the stock to an insurance company or other third person, and in due course the purchaser ex-

30. Redeemable common stock is something of an anomaly in corporate law. Certainly, when there are two classes of stock designated as "common" and only one of the classes is redeemable, it would do little violence to ordinary definitions to hold that the redeemable stock was not properly designated as common stock. The Delaware statute provides that "preferred or special" stock may be redeemed. DEL. CODE ANN. tit. 8, § 151(b) (1953). This provision has been construed as preventing redemption of stock designated as common whose only "special" features were the right to vote and the provision for redemption. *Starring v. American Hair & Felt Co.*, 21 Del. Ch. 380, 191 Atl. 887, *aff'd on opinion below*, 21 Del. Ch. 431, 2 A.2d 249 (Sup. Ct. 1937); *cf. Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 2 A.2d 249 (Ch. 1938), 25 VA. L. REV. 489 (1939). Under the Massachusetts statute a provision for the call of common stock has been upheld. *Lewis v. H. P. Hood & Sons*, 331 Mass. 670, 121 N.E.2d 850 (1954). See Note, *Callable Common Stock*, 68 HARV. L. REV. 1240 (1955).

31. The mere absence of voting rights would not ordinarily cause stock to be considered "other than common stock" under corporate law. See *General Inv. Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 100 Atl. 347 (Ch. 1917).

changes the stamped stock for the preferred stock. Although this transaction would ultimately result in a close parallel to the facts of the *Chamberlin* case, it is not easy to find language that would constitute a deterrent.³² The courts would, no doubt, be unsympathetic to attempts to avoid the statute, but provisions directed so specifically at particular transactions, as are most of those contained in section 306, do not readily expand to cover different transactions.

The treatment of stock rights under section 306 presents certain difficulties. Subsection (d) provides: for purposes of section 306, stock rights shall be treated as stock, and stock acquired through the exercise of stock rights shall be treated as stock distributed at the time of the distribution of the stock rights, to the extent of the fair market value of the rights at the time of distribution. The necessity for such a provision is apparent. For example, a corporation might issue with respect to each share of common stock a right to acquire one share of preferred for \$25. If the share of preferred stock was worth \$100, the major portion of the value, \$75, would have been distributed in the form of the right. Since the distribution of the right would be tax-free by virtue of section 305, a substantial loophole would be available in the absence of provisions such as those contained in subsection (d).

In practice, however, stock rights have been principally used by publicly held corporations as a financing device, and usually the value of the right issued with respect to each share of stock is relatively low. Ordinarily, in such cases, the stock and the rights have a ready market, and bail-out elements are completely absent. But unless the rights are issued on common stock and are to purchase common stock, they will be classified as section 306 stock. A sale of the rights will be within the purview of section 306; and proceeds from the sale of stock purchased by exercise of the rights will also be subject to the ordinary income treatment of the section, to the extent of the value of the rights at the time of the distribution. It is too much to expect that the average shareholder will be easily educated to the intricacies of the allocation

32. An attack on the transaction outlined in the text might be made under subparagraph (B) on the theory that the common stockholders should be deemed to have effected the exchange of common stock for preferred stock, that this exchange was in connection with a recapitalization, and that the sale was therefore of section 306 stock. A less strained argument than this failed in the *Chamberlin* case. A more realistic interpretation of the transaction is that the stamping of the stock constituted a distribution of a right to acquire preferred stock and should be considered section 306 stock. However, the right presumably would have little if any value, since its exercise would require the use of common stock of equal value. Indeed, an alternative method of handling the transaction outlined in the text would be for the corporation to issue rights to the common stockholders exercisable by surrendering common stock in exchange. In either case, no more than the value of the right would be subject to tax as on a sale of section 306 stock.

Whether or not the transaction escaped § 306, the purchaser of the common stock would appear to have no tax troubles, since his purchase price for the common stock would presumably represent the fair value of the preferred stock exchangeable for the common stock. There would, therefore, be no reason for taxing the exchange. A subsequent redemption should be treated as a distribution in full payment for the stock under § 302(a), and only the excess, if any, received over the basis would be treated as gain.

of basis formula and the division between ordinary income and capital gain that is required upon sale of the stock acquired through exercise of the rights. The only escape under the present law is to satisfy the Commissioner of Internal Revenue "that the distribution, and the disposition . . . was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."³³ In such a situation, however, only a blanket ruling would be useful.³⁴ It is unfortunate that no clear cut statutory exemption is accorded the distribution of stock rights in cases of the nature under consideration, but it must be conceded that the drawing of proper lines in the area is a formidable, if not impossible, task.

"Distributed to the shareholder selling or otherwise disposing of such stock if, by reason of section 305(a), any part of such distribution was not includible in the gross income of the shareholder." Subparagraph (A) does not classify any dividend stock as section 306 stock unless part or all of the distribution was excluded from gross income by reason of section 305(a).³⁵ If exemption from income tax of a dividend of preferred on common, with no other stock outstanding, could be supported on constitutional grounds, it would be arguable that the dividend was not excluded from gross income "by reason of section 305(a)" and that subparagraph (A) would therefore not include such stock in the definition of section 306 stock. But the possibility of sustaining the constitutional exemption seems rather remote,³⁶ and at any rate, a court would probably hold that Congress did not intend to leave unaffected the preferred stock bail-out problem in such a case.³⁷

Subparagraph (A) makes the entire stock dividend section 306 stock if "any part" of the distribution was nontaxable by reason of section 305. At first blush the provision might seem to cover the case of a distribution of a common stock dividend in satisfaction of preference dividend arrearages for the current or preceding year and for other years. By reason of section 305(b), the part that was a distribution in respect of arrearages for the cur-

33. Section 306(b)(4).

34. It is believed that blanket rulings, similar in form to those issued in corporate reorganizations discussed in text at note 60 *infra*, will be issued in appropriate cases of distributions of rights by publicly held corporations. It is unlikely, perhaps, that a ruling will be issued if the value of the rights is substantially in excess of that normal in stock right distributions.

35. It should be noted that no stock can be section 306 stock if issued on original incorporation (at least if the corporation is not organized in connection with a reorganization or separation transaction falling under subparagraph (B)). The Senate Finance Committee attributes this conclusion to the fact that on original incorporation a corporation has no earnings and refers to § 306(c)(2) in this connection. S. REP. No. 1622, 83d Cong., 2d Sess. 245 (1954). It is equally attributable to the complete absence from the defined categories of any provision which would catch stock issued on original incorporation.

36. For discussion of the constitutional decisions see note 9 *supra*.

37. The Senate Finance Committee report states that the purpose is to close the "possible loophole of existing law" represented by the preferred stock bail-out and cites the *Chamberlin* case, which involved a dividend of preferred stock on common stock when no other stock was outstanding. S. REP. No. 1622, 83d Cong., 2d Sess. 46 (1954).

rent or the preceding year would (assuming the presence of earnings and profits) be includible in gross income. The other part, the distribution in respect of arrearages for other years, would not be includible in gross income, by reason of section 305(a). Literal application of the provision to such a case would seem to require that all the dividend stock be classified as section 306 stock. This construction would have the absurd result of tainting stock received as a taxable dividend, and the regulations specifically provide that in such a case only the stock distributed for the earlier years is section 306 stock.³⁸

Subparagraph (A) apparently relates to stock of foreign corporations as well as to stock of domestic corporations. The exclusion provisions of section 305(a) are not limited to stock of domestic corporations; it follows that in the case of stock of a foreign corporation the distribution may be excluded from gross income of a citizen or resident of the United States "by reason of section 305(a)." If the corporation is publicly held, it is unlikely that the distribution will be made to enable a bail-out, and there is little reason to impose section 306 sanctions on the American shareholder. But the only escape is by satisfying the Commissioner that the distribution and disposition did not have tax avoidance as a principal purpose.³⁹

The subparagraph may also apply to stock received by a nonresident alien shareholder. Assume that 60 per cent of a foreign corporation's income for the three preceding years has been derived from sources within the United States. If the corporation were to pay a cash dividend, 60 per cent of the dividend would be taxable to a nonresident alien shareholder and 40 per cent would be free from United States income tax.⁴⁰ If the corporation pays a

38. U.S. Treas. Reg. § 1.306-3(c) (1955). The example in the regulations foreshadows accounting complications in the area: "For example, if 100 shares of common stock are distributed in payment of all dividends due on preferred stock, one-tenth of such stock applying to the current and immediately preceding year's dividends and nine-tenths to arrearages, only nine-tenths of each share may be section 306 stock." If the corporate resolutions provide that ten shares are paid in respect of current and preceding year's dividends and ninety shares in respect of arrearages, may the shareholder label ten shares as taxable dividend stock and ninety shares as section 306 stock? If both cash and stock are paid on arrearages, may the cash be allocated to the current and preceding year and the stock to other years? There is no clear answer to these questions but it would seem that the allocation by the corporation or the shareholder in such cases should be allowed.

39. Section 306(b)(4).

40. Under § 872 gross income in the case of a nonresident alien individual includes only the gross income from sources within the United States. See also § 871. Section 882 contains a similar restriction with respect to a foreign corporation. See also § 881. Section 861(a)(2) provides that there shall be treated as income from sources within the United States

"The amount received as dividends . . . (B) from a foreign corporation unless less than 50 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the pro-

preferred stock dividend on its common stock, 60 per cent of the distribution would thus be excluded from gross income "by reason of section 305(a)," and because at least part of the distribution was excluded for this reason, the entire stock dividend would be section 306 stock.⁴¹ On the other hand, if the percentages had been reversed, no part of a cash distribution would have been subject to United States income tax in the hands of a nonresident alien individual,⁴² and therefore no part of the stock dividend would have been excluded from gross income "by reason of section 305(a)." In the latter case, the dividend stock would not be section 306 stock.

Stock Received in a Corporate Reorganization or Separation

Under what conditions should stock received pursuant to a tax-free reorganization or separation be treated as section 306 stock? Once the policy problem is decided, by what legislative means can that policy be best implemented? These questions proved to be as difficult as any that faced the draftsmen of section 306. The solution adopted was to incorporate certain general signposts in the statutory language but to leave a large part of the responsibility for development of a workable formula to the administrative and judicial departments. The Treasury Department has now adopted its formula, and a necessary part of the present discussion is to consider that formula in some detail. It may be helpful before proceeding with that consideration to review some of the factors entering into the section 306 treatment of stock issued in reorganizations and separations.

The issuance of preferred stock in a transaction bearing the guise of a tax-free reorganization or separation exchange may be merely a substitute for a dividend of preferred stock on common stock and therefore may be a preliminary step to a sale and redemption without loss of equity position. An exchange of common stock for preferred and common stock in a recapitalization, and a direct dividend of preferred stock on common stock are alternate routes to the same destination. In the tax world of today, a blanket exemption from the taint attached to dividend stock is quite inconceivable for preferred stock issued in a recapitalization. There could also be little disagreement with the conclusion that the substitution of a new corporation for the old with no change in stockholders does not offer an appropriate occasion for the issuance to the old common stockholders of preferred stock free from the penalties of section 306 treatment. Other situations where policy considerations would require attaching section 306 consequences to stock received in a reorganization can be readily foreseen. One, for example, might be the merger

visions of this part; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the United States bears to its gross income from all sources. . . ."

41. For the taxation of the sale of the stock by the nonresident alien, see subsection (f) of § 306, discussed in text at note 104 *infra*.

42. Section 861.

of two closely held corporations, each with only common stock outstanding, followed by the exchange of the old common stock for preferred and common stock.

Agreement could also be generally obtained that preferred stock should not automatically be subject to the liabilities imposed on section 306 stock merely because it was received by a common stockholder in a reorganization. Assume that a well established, listed corporation acquires by merger a smaller corporation and issues to the stockholders of the latter common and preferred stock in exchange for the single class of outstanding stock. The preferred stock is used at the insistence of the acquiring corporation, which does not want to dilute the position of its stockholders unduly. No bail-out device is involved. In most cases the transferring shareholders would prefer to have a readily marketable common stock of the acquiring corporation with a chance for appreciation rather than a preferred stock with a limited market and, at the best, modest appreciation possibilities. Why should the preferred stock be classified as section 306 stock?

Solutions acceptable in a great many cases would probably have been developed if the statute had simply omitted all reference to stock received in reorganization or separation transactions. Armed with such concepts as the business purpose requirement,⁴³ the continuity of interest rule,⁴⁴ and the doctrine of the *Bazley* case,⁴⁵ the courts and the Treasury Department would have

43. *Gregory v. Helvering*, 293 U.S. 465 (1935); cf. U.S. Treas. Reg. § 1.368-1(c) (1955):

"A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be ordinary and necessary incidents of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of a tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization."

44. *Le Tulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); cf. U.S. Treas. Reg. § 1.368-1(b) (1955):

"The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and (except as provided in section 368(a) (1) (D)) a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization."

45. In the *Bazley* case the receipt of bonds in exchange for preferred stock was held to constitute distribution of a dividend although the transaction had the form of a reorganization. Cf. U.S. Treas. Reg. § 1.368-1(b) (1955):

"[U]nder the Code, a short term purchase money note is not a security of a party

been in a position to develop lines that separated transactions representing disguised stock dividends from those involving readjustments of interests incident to normal corporate reorganizations.⁴⁶ Such a process is a slow one, however, and the results may not be those anticipated. In addition, there undoubtedly are genuine reorganizations in which a bail-out possibility is present despite a legitimate purpose for both the reorganization and the incidental issue of preferred stock to common stockholders.⁴⁷ While the courts might find themselves able to reach even these cases without statutory sanction, the outcome would remain in doubt.⁴⁸ The conclusion was that Congress should incorporate in section 306 language that would serve as a guide to the Treasury Department, the courts and the taxpayers.⁴⁹ Subparagraph (B) is the final result of that decision.

to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up."

46. Under the rules cited in the text, purported reorganization exchanges have been held to be taxable exchanges or dividend distributions. If the statute had omitted to specify that stock received on a reorganization might be section 306 stock, the rules might as readily have been applied to find that a distribution of preferred stock was in fact a stock dividend, giving rise to section 306 stock under the stock dividend provisions of § 306(c)(1)(A).

47. See *Wolf Envelope Co.*, 17 T.C. 471 (1951), *nonacq.* 1952-1 CUM. BULL. 6, *appeal dismissed*, 197 F.2d 864 (6th Cir. 1952), discussed in note 5 *supra*, where a purpose of the exchange of a class of voting stock for debentures was to shift control of the corporation to active management, and the court noted that the result would not have been accomplished by an outright dividend of debentures. In an appropriate case an exchange of common for preferred with a similar purpose might well be upheld; yet if the exchanging shareholders retained a large proportion of common, and particularly if they were related by blood or marriage to the active managers who acquired majority control of the voting stock, Congress and the Treasury might be inclined to feel that bail-out possibilities were present.

48. Compare *Wolf Envelope Co.*, *supra* note 47, with *Marion Heady*, 4 CCH Tax Ct. Mem. 800 (1945), *aff'd*, 162 F.2d 699 (7th Cir. 1947). In *Heady* it was held that there was no corporate business purpose in an exchange by the stockholders of common stock for debentures and common stock. The transaction was designed, however, to permit the only likely prospect for management of a corporation (which was dependent on experienced management for continued successful operation) to acquire ownership of the corporate stock, a concession which the prospective manager had demanded for his entering the corporation's employ. The Seventh Circuit relied heavily on *Bazley* and the assertion that the "net effect" of the transaction was that of a dividend.

49. The American Law Institute draft of a Federal income tax statute, which served as an important precedent to those charged with drafting subchapter C of the 1954 Code, contained provisions specifying the types of exchange transactions that would result in the receipt of stock to be treated on a basis similar to that of dividend stock. ALI FED. INCOME TAX STAT. § 519 (providing, with certain limitations, for dividend treatment of proceeds of redemption or sale of preferred stock received as stock dividend or in recapitalization exchange for common stock), § 601(b) (providing that stock received in certain stock-for-stock reorganizations should be treated as if received in recapitalization exchange), § 602(b) (containing similar provisions for certain acquisition-of-assets reorganizations), and § 603(b) (containing similar provisions for certain corporate divisions) (Feb. 1954 Draft).

The initial point to be noted is that although common stock distributed as a dividend may be section 306 stock under subparagraph (A), common stock received in a reorganization or separation exchange or distribution under subparagraph (B) cannot be classified as section 306 stock, even if it is received in exchange for section 306 stock.⁵⁰ The reason for the distinction is not clear, but the approach of subparagraph (B) to common stock seems sounder than that of subparagraph (A). Preferred stock that is section 306 stock can be recapitalized into common stock that is not section 306 stock.⁵¹ Presumably, common stock that is section 306 stock can be recapitalized into new common stock that is not section 306 stock.⁵² Under the circumstances, the provisions of subparagraph (A) contemplating common stock that may be section 306 stock are anomalous.

The rule that common stock received in a recapitalization exchange will not be section 306 stock does not mean, of course, that the transaction will necessarily escape all unfavorable tax consequences. An important use of common stock in recapitalization exchanges of preferred stock is to eliminate dividend arrearages. Even though none of the common stock received in such an exchange is section 306 stock, stock issued in respect of the arrears for the current year and the preceding year may be taxable on an ordinary dividend basis under section 305(b)(1).⁵³

50. Section 306(c)(1)(B); U.S. Treas. Reg. § 1.306-3(d) (1955). The statutory basis for the statement that common stock received in a reorganization exchange for section 306 stock is not section 306 stock is not free from some ambiguity. Under subparagraph (C), stock which has a basis determined by reference to the basis of section 306 stock is generally section 306 stock "except as otherwise provided in subparagraph (B)." Subparagraph (B) merely provides that stock "which is not common stock" may be section 306 stock if received in exchange for section 306 stock in a described reorganization or separation exchange and makes no provision for common stock received in such exchanges. It is only by construing subparagraph (B) as exclusive in the area of reorganization and separation exchanges that it can be said that subparagraph (C) does not catch common stock received in such an exchange. The Senate Finance Committee Report makes it clear that subparagraph (B) is intended to be exclusive: "Subparagraph (C) however, is limited to cases other than those to which subparagraph (B) is applicable, that is, the reorganization type of case which would otherwise be within this subparagraph." S. REP. No. 1622, 83d Cong., 2d Sess. 244 (1954). The cited regulation is not so broad and provides: "Common stock received in exchange for section 306 stock in a *recapitalization* shall not be considered section 306 stock." (Emphasis added.)

51. The regulation and Senate Finance Committee comments mentioned in note 50 *supra* make the point abundantly clear. The Senate Finance Committee report is unequivocal: "[T]he shareholder is always permitted an opportunity to downgrade preferred stock characterized as section 306 stock in his hands by causing a recapitalization and exchange of such stock for common stock." S. REP. No. 1622, 83d Cong., 2d Sess. 244 (1954).

52. See the language of the regulation quoted at the end of note 50 *supra*. U.S. Treas. Reg. § 1.306-3(d) (1955). If the only purpose of the "recapitalization" was to eliminate the § 306 status of the common stock, the transaction might be denied effect.

53. U.S. Treas. Reg. § 1.368-2(e) (1955). Under this provision, the stock received is treated as a distribution under § 305(b)(1) "if such exchange is made solely for the purpose of effecting the payment of dividends for the current and immediately preceding taxable years upon the preferred stock exchanged." This language represents a dilution of the position taken in the tentative regulations. See Proposed U.S. Treas. Reg. §

To be classified as section 306 stock under subparagraph (B), stock must be not only other than common stock but must be stock

“(i) which was received, by the shareholder selling or otherwise disposing of such stock, in pursuance of a plan of reorganization (within the meaning of section 368(a)), or in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applied, and

“(ii) with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of part III, but only to the extent that either the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock.”

Part III of subchapter C contains all the sections cited in clause (i), including, as indicated by the language of both clauses, provisions exempting certain exchanges and distributions from tax. The provisions of particular interest are section 354(a), providing for nonrecognition of gain or loss on stock and security exchanges in connection with reorganizations; section 355, providing for similar nonrecognition in exchanges and distributions in connection with separations of controlled corporations; and section 356, providing for the treatment of boot in transactions which would qualify for section 354 or 355 treatment had boot not also been received.⁵⁴

1.368-2(e), 19 FED. REG. 8279 (1954), which provided: “Such an exchange, however, is not a recapitalization if the total effect is substantially similar to the payment of the dividends due for the current and immediately preceding year upon the preferred stock exchanged.”

54. The nonrecognition of gain or loss provisions cited are derived from provisions contained in old § 112(b). The derivation of § 355 from old § 112(b)(11), the spin-off provision, is rather remote, however, as § 355 is far broader than old § 112(b)(11). Part III contains tax-free exchange provisions in addition to those mentioned in the text. Section 354(c) extends the provisions of § 354(a) to exchanges in a railroad reorganization even though the plan of reorganization does not fall within the definition of reorganization under § 368(a). Clause (i) of subparagraph (B), however, does not expand the concept of “reorganization” beyond that used in § 368(a). Section 361 prescribes nonrecognition of gain or loss to exchanges of property by a corporation a party to a reorganization, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization. It might be argued that a corporation received section 306 stock in a transaction to which § 361 applied, but it is hardly likely that the point will arise frequently. The question might arise in a case in which the reorganization transaction stopped at the corporate level.

Part III also contains § 351, which provides for nonrecognition of gain or loss if property is transferred by one or more persons to a corporation solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation. Subparagraph (B) does not, however, impose section 306 stock status on stock received in a § 351 transaction. It appears, therefore, that the shareholders of a corporation which has only common stock outstanding may be free, for example, to put their holdings into a new corporation in exchange for common and nonvoting preferred stock without realizing taxable gain and without having the preferred tainted as section 306 stock. This transaction may well set the stage for a subsequent bail-out. However, just as in the case of bonds, which may also be received tax-free in a corporate organization, the area of tax avoidance is limited. Liquidation of the old corporation

The limitation in subparagraph (B), to the effect that the gain or loss in respect of the receipt of the stock must have been to some extent not recognized, is an important one. If, for example, in a statutory merger qualifying as a reorganization under section 368(a), an exchanging common stockholder receives preferred stock, common stock and cash, the preferred stock can not be section 306 stock if the stockholder's gain is less than the amount of cash received. On the other hand, if the gain exceeds the cash, the limitation does not apply.⁵⁵

The legislative history of section 306 affords little aid in the difficult task of interpreting subparagraph (B), particularly the provision that (except in case of stock received in exchange for section 306 stock) classifies stock as section 306 stock "only to the extent . . . that the effect of the transaction was substantially the same as the receipt of a stock dividend."⁵⁶ The tentative regulations issued by the Treasury Department in 1954 were equally noncommittal.⁵⁷ By December, 1955, when the final regulations were issued, the unwillingness of the Treasury to take a position was gone, and it released the following regulation:

"Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a dividend under

might well be required for the completion of the bail-out. Unless a substantial period of time elapsed between the transfer of stock and the liquidation, the step transaction theory might be invoked to bring the arrangement under the reorganization provisions (perhaps as a § 368(a)(1)(D) reorganization), with section 306 consequences. In some situations the transfer to a controlled corporation may be dictated by business necessity and may represent a more substantial change in the substance and control of the incorporated enterprise. The transaction cannot then properly be treated as a reorganization or a stock dividend, and preferred stock received in exchange should probably not be classified as section 306 stock, since the elements of a bail-out would be absent. There remains, however, an area for conflict between the Treasury and the taxpayer.

For a more complete description of the provisions of subchapter C dealing with exchanges and distributions in connection with corporate readjustments, see Cohen, et al., *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 411-32 (1955); and Peterson, *Subchapter C of the Internal Revenue Code of 1954, Corporate Organizations and Reorganizations*, 30 NOTRE DAME LAW. 617 (1955).

55. If the transaction bore the guise of a reorganization under § 368(a) but failed to meet the business purpose requirement, it would seem that any gain on the transaction should be recognized. In such a case, however, if the primary purpose of the transaction was to upgrade common stock, § 306 sanctions might be attached to the preferred stock and the exchange treated as tax-free. The case could present the Treasury Department with something of a dilemma. If the transaction resulted in recognized gain, this gain would be taxable in the year in which the transaction was effected; until disposition of the stock received, however, no liability for tax would arise through application of § 306.

56. The Senate Finance Committee paraphrased the language in its report without any interpretative comment. S. REP. No. 1622, 83d Cong., 2d Sess. 244 (1954).

57. Proposed U.S. Treas. Reg. § 1.306-3(d), 19 FED. REG. 8245 (1954).

section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of section 356(b) or section 302(d)."⁵⁸

The regulation then states that the application of the preceding sentence is illustrated by two examples. The first of these reads as follows:

"Corporation A, having only common stock outstanding, is merged in a statutory merger (qualifying as a reorganization under section 368(a)) with Corporation B. Pursuant to such merger, the shareholders of Corporation A received both common and preferred stock in Corporation B. The preferred stock received by such shareholders is section 306 stock."

The importance of this example lies more in the omission of limitations than in the facts stated.⁵⁹ It must be assumed that all facts deemed material are included and that any facts omitted not inconsistent with those stated are considered immaterial. It follows that Corporation B may be a publicly held corporation with listed stock; that the stock interest received by the shareholders of Corporation A may represent a relatively minor interest in Corporation B; that the preferred stock may be a legitimate means employed at the insistence of Corporation B to measure certain asset values of Corporation A; and that on the exchange some of the shareholders of Corporation A have gain realized but not recognized and other shareholders have loss realized but not recognized. For purposes of discussion, therefore, it will be assumed that these supplemental facts are present.

Consideration of the problem in the light of the underlying purpose of section 306 may be useful before a detailed discussion is attempted. The section was, of course, designed to frustrate the preferred stock bail-out. In developing the provisions it proved necessary in some cases to go beyond that design and to classify certain stock as section 306 stock although a prospective bail-out situation would not be present. Thus, the clear, unequivocal language of 306(c)(1)(A) classifies as section 306 stock preferred stock issued by a publicly held, listed corporation to its common stockholders, even though the common stock is widely distributed and there is no stock interest to which the element of control is of any importance. When the problem presented is the application of the ambiguous language of subparagraph (B), however, there is no justification for subjecting to the rigors of section 306 every stock that represents an upgrading from the shareholder's former position. Stock should not be brought within 306(c)(1)(B) unless there are

58. U.S. Treas. Reg. § 1.306-3(d) (1955). The shift by the Treasury to a more definite regulation may have represented an attempt to meet the complaints directed by some members of the public at the vague nature of the proposed regulation.

59. It is not regarded as important that there is omitted from the example any statement as to the earnings and profits of Corporation A. In U.S. Treas. Reg. § 1.306-3(a) (1955), it is stated that "except as provided in section 306(g), if the distributing corporation has no earnings and profits at the time of distribution, pursuant to section 306(c)(2), the stock distributed will not constitute section 306 stock." There must be read into the example in paragraph (d), therefore, the condition that Corporation A has earnings and profits.

bail-out possibilities in the situation. If a common stock holder in a relatively small corporation has exchanged his stock for widely distributed and readily marketable common and preferred stock in a publicly held corporation, how can it be said that he has received a dividend of the preferred stock? It might be more realistic to say that he has sold his old stock and gain should be recognized. That, however, is not the issue, for Congress has decided to defer recognition. The question is whether "the effect of the transaction was substantially the same as the receipt of a stock dividend" of the preferred stock. The answer to that question should be in the negative. It is no answer that the Treasury Department might rule in such a case, as it has in some situations, that

"The provisions of Section 306(a) (1) [relating to sales and other dispositions not redemptions] of the 1954 Code shall not be applicable to the proceeds of the disposition of the preferred stock of [a named corporation] which will be issued in accordance with the plan of reorganization unless such disposition is in anticipation of a redemption shortly after the issuance of such preferred stock."⁶⁰

Aside from the point that such a ruling does not cover redemptions, it should not be necessary if the stock is not section 306 stock.

We turn now to a more detailed discussion of the application of the test prescribed in the regulation to the facts of Example (1), supplemented by the facts assumed previously. For convenience, the discussion is divided into two parts: the first dealing with shareholders who had *gain* realized but not recognized, and the second with those who had *loss* realized but not recognized.

Shareholders with Gain Realized but Not Recognized. The test prescribed by the regulation involves the conceptual substitution of cash for the preferred stock, presumably in an amount equal to the fair market value of the stock, and the determination, by application of the appropriate statutory provisions, whether the cash would have been taxed as a dividend.

If cash had been received instead of preferred stock and if the particular exchanging shareholder had gain on the transaction equal to the cash, there can be little doubt that under section 356(a) (2), which would be the applicable provision,⁶¹ the cash would have been treated as a dividend. It has been the

60. See the unpublished paper by D. Nelson Adams. ADAMS, SECTION 306—DEFENSE AGAINST THE "PREFERRED STOCK BAIL-OUT" 21 (1955) (unpublished pamphlet, Tax Forum No. 169, on file in the Yale Law Library). Cf. Rev. Rul. 56-116, 1956 INT. REV. BULL. No. 13, at 6, allowing a similarly limited exemption from section 306 consequences on disposition of preferred stock received in exchange for common in the case of a merger of two widely held corporations, but specifically holding the preferred stock to be section 306 stock.

61. Section 356(a) (1) provides that if § 354 or § 355 would apply to an exchange except for the receipt of boot, then any gain on the exchange shall be recognized to the extent of the boot received. Section 356(a) (2) provides for dividend treatment of the gain as follows:

"Treatment as dividend.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a

consistent and unrelenting view of the courts that if there are sufficient earnings and profits, cash or other boot received in an otherwise tax free reorganization exchange is treated as a dividend to the extent of the gain.⁶² The courts may have gone too far in their application of section 112(c)(2) of the 1939 Code, the predecessor of section 356(a)(2) of the 1954 Code.⁶³ Until there

dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property."

62. A provision closely paralleling § 356(a)(2) was introduced by the 1924 act. Revenue Act of 1924, § 203(d)(2), 43 STAT. 257. The provision was continued without relevant change in subsequent acts. See old § 112(c)(2). Decisions under the 1924 and subsequent acts must therefore be regarded as precedents for the interpretation of § 356(a)(2).

An early decision is *George Woodward*, 23 B.T.A. 1259 (1931), *nonacq.*, XI-2 CUM. BULL. 18 (1932), where it was held that boot received on a bank merger by a shareholder of the merged bank was taxable as a dividend. In a brief opinion, the Board held that the distribution of cash and stock by the continuing bank to shareholders of the merged bank in exchange for their stock had in practical result the effect of a distribution of a taxable dividend by the merged bank. There was a similar holding as to the effect of a distribution in connection with a bank merger in *Commissioner v. Owens*, 69 F.2d 597 (5th Cir. 1934). In *John S. Woodard*, 30 B.T.A. 1216 (1934), *nonacq.* XIII-2 CUM. BULL. 38 (1934), the corporation transferred all its assets to a large publicly held corporation in exchange for stock and cash and then distributed the stock and cash to its shareholders in complete liquidation. A majority of the Board held that the distribution of cash was taxable as a dividend. Member Murdock, dissenting, noted that the effect of the distribution was "just about as different from that of a taxable dividend as well could be in the case of a distributor having earnings accumulated after February 28, 1913." *Id.* at 1231.

Other early cases firmly established the principle that dividend effect was to be assumed whenever boot was distributed in a tax-free reorganization exchange and there were earnings and profits available. See, *e.g.*, *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Commissioner v. Kolb*, 100 F.2d 920 (9th Cir. 1938); *Rose v. Little Inv. Co.*, 86 F.2d 50 (5th Cir. 1936); *Commissioner v. Forhan Realty Corp.*, 75 F.2d 268 (2d Cir. 1935); *Hazelton Corp.*, 36 B.T.A. 908 (1937).

In *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), it was held that cash received pursuant to a recapitalization exchange of preferred stock for common stock and cash was to be taxed as a dividend. In so holding the Court cited several of the earlier cases with apparent approval and stated its conclusions broadly enough to permit the inference that the availability of earnings and profits was the sole test of dividend effect. Subsequent cases have followed the same rule. *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955); *John L. Hawkinson*, 23 T.C. 933 (1955); *Estate of Hill*, 10 T.C. 1090 (1948); *Isabella M. Sheldon*, 6 T.C. 510 (1946). In *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), the court applied dividend treatment, noting, however, that the taxpayer had not argued for capital gain treatment under old § 112(c), but had instead alleged that there was no valid reorganization. For more extended discussion of the *Bedford* case and its aftermath, see Wittenstein, *Boot Distributions and Section 112(c)(2): A Re-examination*, 8 TAX L. REV. 63 (1952); Schorr, *Taxable Dividends in Reorganization Cases*, N.Y.U. 7TH INST. ON FED. TAX. 507 (1949); Darrell, *The Scope of Commissioner v. Bedford Estate*, 24 TAXES 266 (1946).

63. Wittenstein, *supra* note 62.

is a retreat from their present position, however, the Treasury is surely justified in considering that if cash were delivered in lieu of preferred stock the cash would be taxable as a dividend in the case of gain.

It has been assumed that the gain realized on the exchange is equal to the fair market value of the preferred stock received. Suppose, however, that the gain realized is less than the fair market value of the preferred stock. There is nothing in the regulation to suggest that anything more than the gain is to be tested by section 356(a)(2) for the purpose of the stock dividend equivalency determination. The statute provides that the stock is to be section 306 stock "only to the extent" that the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for section 306 stock. It might therefore be argued that because the regulation provides for a cash substitution test, preferred stock will be section 306 stock thereunder only to the extent of the gain. However, the conclusion in the regulation that the preferred stock received by the shareholders of Corporation A in Example (1) is section 306 stock is not premised on any condition as to the amount of gain. It must be assumed, therefore, that the Treasury Department does not regard the quantum of gain as important.⁶⁴

Shareholders with Loss Realized but Not Recognized. In applying a cash substitution test to a shareholder of Corporation A who had loss realized but not recognized on the receipt of the preferred and common stock, we would normally turn to section 356(c). Under this provision, as under its predecessor, section 112(e) of the 1939 Code, loss is not recognized on a reorganization exchange involving boot; but neither is dividend treatment prescribed, and cash received in such a case would therefore normally be considered not subject to tax. Moreover, an argument that a cash substitution test is applicable in the case of a loss to exclude stock received on the exchange from section 306 classification may be based on the provisions of section 306(c)(2):

*"Exception where no earnings and profits.—*For purposes of this section, the term 'section 306 stock' does not include any stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock."

64. The substitution of cash test suggests another problem. In a boot case, dividend treatment cannot attach to any part of the boot which exceeds the shareholder's ratable share of the undistributed earnings and profits accumulated after February 28, 1913. Does the same rule apply in the case of the preferred stock? Although the regulation under discussion is silent, it must be assumed that if there are any earnings the stock will be deemed section 306 stock under the regulation. The following statement in a prior paragraph of the regulations is no doubt applicable:

"Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, provided the distributing corporation has earnings and profits at the time of distribution and for this purpose the total amount of the earnings and profits is immaterial."

U.S. Treas. Reg. § 1.306-3(a) (1955).

Although this paragraph was no doubt primarily designed to exempt from section 306 stock classification any stock distributed by a corporation that has no earnings or profits, it is not so limited by its plain words.⁶⁵ Furthermore, although the paragraph uses the word "distribution," which might be deemed not to include stock received in an exchange, any such construction seems foreclosed by the language of the final sentence of subparagraph (B) providing that for the purposes of section 306 "a receipt of stock to which the foregoing provisions of this subparagraph apply shall be treated as a distribution of stock."

Example (1), however, apparently gives no weight to a possible operation of subsection (c) (2) in the loss case; nor does the regulation mention section 356(c). The conclusion must be that the Treasury Department relies on some other statutory provision to subject the conceptual cash to dividend treatment. The only other provision mentioned in the regulation which could be applicable is section 301, if made applicable by section 302(d).⁶⁶ The Treasury Department must necessarily maintain, therefore, that the "essentially equivalent to a dividend" provisions of section 302 are to be applied, even though the specific section designed to deal with boot in reorganization exchanges, section 356, would not provide for dividend treatment. This argument is not novel; it has been advanced under prior law with a uniform lack of success. Thus, in *Isabella M. Sheldon*, where both parties tried to rely on provisions of section 115 of the 1939 Code instead of section 112, the Tax Court said:

"We think that both err in this respect, and that the inescapable characterization of this transaction as one covered by the reorganization requires that it be dealt with under section 112 and limits any applicability of section 115 accordingly."⁶⁷

65. The Senate Finance Committee Report paraphrases the statutory language and concludes:

"Thus, preferred stock received at the time of original incorporation would not be section 306 stock. Also, stock issued at the time an existing corporation had no earnings and profits would not be section 306 stock."

S. REP. NO. 1622, 83d Cong., 2d Sess. 245 (1954).

66. U.S. Treas. Reg. § 1.306-3(d) (1955).

67. 6 T.C. 510, 517 (1946). The argument that the provision taxing boot as a dividend did not apply because the exchange was equivalent to a partial liquidation rather than a dividend was advanced by the taxpayer and rejected by the Court in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). In that case the taxpayer maintained that the effect of the transaction was that of a partial liquidation rather than a dividend; but he did not argue that it should be taxed as on a partial liquidation, a conclusion that would have resulted in ordinary income treatment under the statute then applicable. Revenue Act of 1936, § 115(c), 49 STAT. 1687-88. In certain of the earlier cases either the Commissioner or the taxpayer maintained unsuccessfully that the liquidation provisions of the Code should apply despite the presence of a reorganization. See *Clarence J. Schoo*, 47 B.T.A. 459 (1942); *R. C. Love*, 39 B.T.A. 172 (1939, *aff'd*, 113 F.2d 236 (3d Cir. 1940); *John S. Woodard*, 30 B.T.A. 1216 (1934). More recent cases include *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), where two branches of a business had been sold by a corporation and a third transferred to a new corporation for stock. The corporation then liquidated, distributing to its shareholders cash and the stock of

There is nothing new in the 1954 Code to indicate a firmer foundation for the argument that the boot provisions are not exclusive in their area; unless there is a reversal of the existing decisions, then, it must be concluded that section 356 furnishes the touchstone of taxability in boot cases of the type under discussion. If this conclusion is correct, the example in the regulation cannot be accepted as a completely correct interpretation, even if the cash substitution test is the proper one.⁶⁸

the new corporation. The presence of a tax-free reorganization exchange of assets of the old corporation for stock of the new corporation resulted in taxation of the cash as boot and an ordinary dividend to the shareholder. A similar result was reached in *Estate of Hill*, 10 T.C. 1090 (1948), where 44% of the assets of the old corporation were transferred to a new corporation for stock and the old corporation was then liquidated. In *William M. Liddon*, 22 T.C. 1220 (1954), *rev'd on other grounds*, 230 F.2d 304 (1956), the old corporation had completely liquidated, but the controlling shareholders had formed a new corporation to carry on the same business and some of the old corporation's assets had been transferred to the new. The transaction was held in substance a reorganization, with the boot taxable under old § 112(c)(2) rather than old § 115(c) or (g). See also *John L. Hawkinson*, 23 T.C. 933 (1955), where the forgiveness of indebtedness in a reorganization was held to have the effect of a dividend under old § 112(c)(2) against the taxpayer's contention that there had been a partial redemption of his stock.

In *Standard Realization Co.*, 10 T.C. 708 (1948), and *George D. Graham*, 37 B.T.A. 623 (1938), new corporations acquired assets of old in exchange for stock and the boot provisions were held not to apply. In each case, however, the new corporation was formed merely to proceed with orderly liquidation and sale of the assets rather than to continue a business, and it was held that there was no reorganization because the purpose of the tax-free exchange provisions was not met. The cases can therefore not be regarded as exceptions to the rule that the boot provisions are exclusive when the exchange is in connection with a reorganization. The same may be said of *Rufus Riddlesbarger*, 16 T.C. 820 (1951), *rev'd*, 200 F.2d 165 (7th Cir. 1952), where the Tax Court found a dividend under old § 115(a) and (g) but only after holding that the reorganization failed to meet the statutory purpose. The Seventh Circuit, upon reinstating the reorganization, refused to apply old § 115. 200 F.2d at 175; *cf. F. K. Ketler*, 17 T.C. 216 (1951), *rev'd on other grounds*, 196 F.2d 822 (7th Cir. 1952). However, in *Ernest F. Becher*, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955), the Tax Court held that a cash distribution subsequent to adoption of a plan of complete liquidation was to be treated as a liquidating dividend, although operating assets of the old corporation had been transferred to a new corporation in a tax-free reorganization on the following day. The Tax Court held the cash distribution equivalent to a taxable dividend and therefore taxable as one under old § 115(g); but the Second Circuit, in affirming the dividend treatment, held that the cash distribution resulted directly from and as a part of the reorganization, so that old § 112(c)(2) applied to the exclusion of old § 115(g).

The Commissioner, therefore, can derive little comfort from the decided cases if he attempts to apply the redemption provisions of the Code to achieve dividend treatment of so much of the boot received as exceeds gain realized on a reorganization exchange. However, no case has been found involving a shareholder with a loss on a reorganization exchange, and it remains possible, though unlikely, that a court might in such a case revert to the redemption provisions in order to find a dividend. See *Wittenstein*, *supra* note 62, at 76-80.

68. The wording of § 306(c)(2) seems to require application of a cash substitution test to determine whether stock may be section 306 stock. It does not, of course, require classification as section 306 stock merely because cash received in lieu thereof would have been treated as a dividend.

Another unsatisfactory feature of the regulation is that it does not furnish a basis for treating transactions of substantially similar nature in a similar manner. To avoid the problem presented by shareholders with loss realized but not recognized, assume that in the merger case of Example (1) all shareholders had gain equal to the value of the preferred stock received; but continue to assume the other supplemental facts as to the relative sizes of Corporation A and Corporation B, the public nature of Corporation B, the relatively minor interest the shareholders of Corporation A receive in Corporation B, and the reason for the use of preferred stock. There can be no question that the cash substitution test would result in classifying the preferred stock received as section 306 stock. Instead of assuming a merger transaction, however, suppose Corporation B issues to the shareholders of Corporation A voting preferred and common stock of Corporation B. The exchange by the shareholders of Corporation A is an exchange in connection with a reorganization under section 368(a)(1)(B), and gain is not recognized by reason of section 354. The test of the regulation now requires that the effect of a substitution of cash for the preferred stock must be considered. Had cash been used there would have been no reorganization, since, under section 368(a)(1)(B), only voting stock may be used. There is no other provision of section 368 that would include the transaction in the definition of "reorganization," and therefore section 354 and section 356 would be inapplicable. There appears to be no theory under which the cash could be treated as a dividend; the exchange of stock of Corporation A for cash and common stock of Corporation B would doubtless be treated as a transaction in which the gain realized would be recognized and taxed as gain from the sale or exchange of a capital asset.⁶⁹ It would follow that under the cash substitution test the preferred stock of Corporation B would not be section 306 stock, and there is no suggestion in the regulation of any further test to be applied once the transaction passes the cash substitution hurdle.

It is not intended to suggest that the transaction described in the preceding paragraph should result in section 306 stock. Neither that transaction nor the merger transaction should, in the writers' opinion, be burdened by the penalties of section 306; but it is not easy to justify the imposition of different consequences for the two situations.

A cash substitution test might lead to harsh results in the separation area. Corporation A has a value of \$1,000,000, half of which is represented by preferred and common stock of Corporation B. In a transaction qualifying under section 355, Corporation A distributes all of the preferred stock, with a value of \$225,000, and approximately 9 per cent of the common stock of Corporation B to X, in exchange for the stock of Corporation A owned by X, amounting to 25 per cent of the total stock. The remaining stock of Corporation B is distributed to Y, the other stockholder of Corporation A, without the surrender of

69. If the acquiring corporation were a "related" corporation within the meaning of § 304, the money received might be treated as a dividend, and by application of the test the preferred stock would be section 306 stock.

any stock. The earnings of Corporation A exceed \$900,000, and X has a gain on the exchange of \$230,000. The transaction meets the requirements of section 355. If X had received cash instead of the preferred stock, there is little doubt that the Treasury would have asserted a taxable dividend under the provisions of section 356(a)(2) and would therefore claim that the preferred stock was section 306 stock.

The case is an extreme one for treatment of cash as a dividend to X, and it is conceivable that the new separation provisions, unlike the reorganization provisions, will not be construed as resulting in dividends in every case where boot is received in an exchange and there are earnings in the picture. If the transaction were regarded as a redemption as to shareholder X, dividend treatment might be avoided.⁷⁰ Assuming, however, that the precedents with respect to boot are followed, application of the cash substitution test would result in section 306 stock, a result that seems wrong even though cash would have been taxed as a dividend. There has been a complete shift in stockholders' relative interests, and it is unrealistic to suggest that X received the equivalent of a stock dividend from Corporation A.

Problems and illustrations of problems could be multiplied almost endlessly. Perhaps enough ground has been covered to justify some conclusions. If the form of the reorganization is such that there is no substantial shift in the common stock ownership of the corporation and the common stockholders receive preferred stock in the reorganized corporation, the preferred stock should be section 306 stock unless there is an absence of earnings and profits. This result should follow whether the transaction is a recapitalization or a new corporation reorganization.⁷¹ In such a case it should not matter that a share-

70. Unless caught by the rules for constructive ownership of stock in § 318, the redemption of X's stock in Corporation A for cash and 9% of the common stock of Corporation B should be treated as a termination of interest under § 302(b)(3), or a substantially disproportionate redemption under § 302(b)(2). It might in any case be a redemption not essentially equivalent to a dividend within the meaning of § 302(b)(1).

71. If the cash substitution test is dropped, it should not be difficult to find that a pro rata recapitalization or reincorporation had an effect "substantially the same as the receipt of a stock dividend" without reference to varying amounts of gain realized by different shareholders. On the subject of dividend equivalency in the case of receipt of bonds in a recapitalization, the Court said in *Bazley v. Commissioner*, 331 U.S. 737, 742 (1947):

"In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization."

On the same subject the regulations contain the following:

"[I]f a corporation having only common stock outstanding, exchanges one share of newly issued common stock and one bond in the principal amount of \$10 for each share of outstanding common stock, the distribution of the bonds will be a distribution of property (to the extent of their fair market value) to which section 301 applies, even though the exchange of common stock for common stock may be pursuant to a plan of reorganization under the terms of section 368(a)(1)(E) (re-

holder has a loss on the transaction, and section 306(c)(2) should perhaps be amended to limit its operation to cases where there are no earnings and profits.

No mechanical rule can or should be used in other cases. If the shareholder finishes the transaction in a position substantially similar to the position he would have enjoyed had he received a stock dividend on his old stock in the old corporation, he should be treated, provided earnings are available, as having received section 306 stock. If two closely held corporations with only common stock merge and the common stockholders of both receive common and preferred stock in the surviving corporation, it is hard to see why the transaction should not be treated as having substantially the effect of a stock dividend. Again, it would not seem important whether the exchange resulted in gain or loss to the shareholders—a common stockholder whose basis before receipt of a preferred stock dividend is more than the value of the common and preferred stock after the dividend has received substantially the same stock dividend as the shareholder who had a gain.

It is a far cry from such transactions to the situation where a common stockholder in a small closely held corporation receives common and preferred stock in a large publicly held listed corporation into which the other has merged. His position does not faintly resemble the position he would have been in had he continued in the old corporation and received a preferred stock dividend from it. A test that fails to distinguish between these situations does not offer an acceptable construction of subparagraph (B). The test prescribed in the regulation goes too far in branding some stock as section 306 stock; in other cases, the test does not appear to operate satisfactorily to include stock within the category of section 306 stock. It is believed that there should be reconsideration of the regulation before it attains the sanctity that sometimes attaches from the mere passage of time.

Stock Having Transferred or Substituted Basis

Section 306 stock may taint stock for which it is exchanged. Furthermore, in certain cases section 306 stock may retain its character in the hands of a transferee. These results are accomplished by a provision of subparagraph (B) and by subparagraph (C). The former provides that stock "received in exchange for section 306 stock" in a reorganization or separation exchange is section 306 stock, if gain or loss to the shareholder was to any extent not recognized by reason of part III.⁷² The classification of section 306 stock under subparagraph (C) is as follows:

"Stock Having Transferred or Substituted Basis.—Except as otherwise provided in subparagraph (B), stock the basis of which (in the hands of the shareholder selling or otherwise disposing of such stock) is determined by reference to the basis (in the hands of such shareholder or any other person) of section 306 stock."

capitalization) and even though the exchange of common stock for common stock may be tax free by virtue of section 354."

U.S. Treas. Reg. § 1.301-1(l) (1955).

72. See text at p. 927 *supra* for the complete text of subparagraph (B).

The relationship of subparagraphs (B) and (C) may be illustrated by the example of a stock for stock exchange. Shareholders of Corporation A receive section 306 stock in the form of a preferred stock dividend on their common stock. Subsequently, in a transaction which is not within section 351 (relating to tax-free transfers of property to controlled corporations) but which qualifies as a reorganization under section 368(a)(1)(B), all the stock of Corporation A is exchanged for stock of Corporation B, and the shareholders of Corporation A receive for their section 306 stock preferred stock of Corporation B. The new preferred stock so received falls within the provisions of subparagraph (B) and is section 306 stock. The basis of the old preferred stock transferred to Corporation B is the same as its basis in the hands of the exchanging shareholders,⁷³ thereby satisfying the requirement that it be determined by reference to the basis of section 306 stock. Subparagraph (C) is not intended to apply, however, since the reference to the basis of section 306 stock is made only because the transaction qualifies as a reorganization within the scope of subparagraph (B). The language "except as otherwise provided in subparagraph (B)" seems peculiarly inept to express such a result, but there can be little doubt that subparagraph (B) is intended to be exclusive in its area.⁷⁴

If, in the foregoing example, the stockholders of Corporation A were in control of Corporation B after exchanging their stock for stock of Corporation B, a more difficult problem of interpretation would be involved.⁷⁵ The exchange would still qualify as an exchange pursuant to a reorganization as defined in section 368(a)(1)(B). The exchange could also be sustained as a tax-free exchange under section 351. Subparagraph (B) does not cover section 351 exchanges;⁷⁶ but under subparagraph (C), in an appropriate case, a transfer of section 306 stock to a controlled corporation in a section 351 exchange will result in both the transferor and the transferee holding section 306 stock.⁷⁷ Can the Commissioner, therefore, ignore the reorganization feature of the transaction and classify as section 306 stock not only the preferred stock received by the shareholders of Corporation A but also the preferred stock of Corporation A in the hands of Corporation B? The rule that both the transferor and transferee may have section 306 stock is a harsh one and should not be ex-

73. Section 362(b).

74. The Senate Finance Committee stated:

"Subparagraph (C) however, is limited to cases other than those to which subparagraph (B) is applicable, that is, the reorganization type of case which would otherwise be within this subparagraph."

S. REP. No. 1622, 83d Cong., 2d Sess. 244 (1954).

75. "Control" is used, of course, in the technical sense of § 368(c):

"[T]he 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."

76. See note 54 *supra*.

77. U.S. Treas. Reg. § 1.306-3(e) (1955). The regulation makes the point that common stock may be section 306 stock if received in exchange for section 306 stock in a transaction to which § 351 applies.

tended beyond the clear requirements of the statute; but it cannot be said with any certainty that in the case postulated only the stock received by the exchanging shareholders will be section 306 stock.⁷⁸

Subparagraph (C) is, of course, not limited to section 351 exchanges. One of its principal purposes is to continue in a donee's hands the section 306 status the stock had in the donor's hands.⁷⁹ The death of the donor will not free the stock from such status in the hands of the donee, unless the gift was in contemplation of death and the value of the stock was includible in the gross estate of the donor for estate tax purposes. In the latter case, the basis of the stock is apparently no longer the basis to the donor,⁸⁰ and subparagraph (C) therefore becomes inapplicable. It is rather curious, although explicable, that the recipient of a gift of section 306 stock whose donor acted in contemplation of death may be in a preferred position to the donee of section 306 stock not transferred in contemplation of death.⁸¹

Section 356(e) provides for ordinary dividend treatment of boot received in a reorganization or separation exchange of section 306 stock that otherwise would have been tax-free under section 354 or 355.⁸² The regulations follow the views of the Senate Finance Committee that ordinarily boot should be treated as received first in exchange for the section 306 stock rather than the other exchanged property.⁸³

78. It has been suggested that upon transfer of section 306 stock in a tax-free exchange only the stock received in exchange should be characterized as section 306 stock. COMMITTEE ON TAXATION, THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, RECOMMENDATIONS FOR REVISION OF INTERNAL REVENUE CODE OF 1954 at 20 (1955).

79. Another case encompassed by subparagraph (C) is a common stock for common stock or preferred stock for preferred stock exchange under § 1036. U.S. Treas. Reg. § 1.306-3(e) (1955). The basis in such exchanges is determined by reference to the basis of the stock exchanged. Section 1031(d).

80. Section 1014(b)(9). For a criticism of the language in this provision and a recommendation for its clarification, particularly in the contemplation of death area, see COMMITTEE ON TAXATION, *op. cit. supra* note 78, at 55-57.

81. It is not a complete answer to say that estate tax must be paid with respect to the value of the stock in the contemplation of death case. One method of relieving the donee in such a case would be not to apply the provisions of § 306 on disposition if he paid the higher of: (1) the capital gains tax, measured by the difference between the donor's basis and the proceeds of sale; (2) the estate tax that would have been payable by the donor's estate on the section 306 stock had the stock been included in the gross estate. If he paid the latter, he should be allowed to take as basis for the stock the value at the date of the donor's death. The obvious objection to such a modification is the further complication of a complicated statute.

82. There is no similar provision relating to exchanges of section 306 stock in § 351 transactions. The reason for the presence of § 356(e) and the absence of a counterpart in § 351 is not clear. Perhaps it was felt that an exchange of section 306 stock in a § 351 transaction did not so necessarily involve dividend equivalency that the usual rules on the disposition of section 306 stock should be modified. Even in a reorganization or separation exchange, however, it may be doubted that boot should always be treated as a distribution to which § 301 should apply.

83. U.S. Treas. Reg. § 1.356-4 (1955); S. REP. No. 1622, 83d Cong., 2d Sess. 269 (1954).

Exception Where No Earnings and Profits

Section 306(c)(2) has been discussed above for its possible relationship to problems of gain or loss on reorganization and separation exchanges.⁸⁴ The ostensible purpose for including paragraph (2), however, was to provide that section 306 stock did not include stock distributed when the corporation had no earnings and profits.⁸⁵

The feature of paragraph (2) that is the most difficult to rationalize is the concept that if there are no earnings the stock cannot be section 306 stock, but if there are *any* earnings, no matter how small, the stock may be section 306 stock. It would be understandable, perhaps, if the statute contained no exemption from section 306 stock classification even in the complete absence of earnings; but if the exemption in this situation is recognized as proper, a more reasonable statutory approach to the problem would be to limit the section 306 stock to a ratable portion based on the corporation's earnings.⁸⁶ Such a modification would also eliminate the peculiar result obtained in the following situation: A corporation with no accumulated earnings or profits earns \$100,000 during the year. In the same year it distributes on its outstanding capital stock cash of \$200,000 and preferred stock with a value of \$1,000,000. Under paragraph (2) the preferred stock would be exempt only if no part of the distribution would have been a dividend had money been distributed in lieu of the stock. If cash were substituted for the stock, then from the total distribution of \$1,200,000, only an amount equal to earnings and profits, \$100,000, would be taxed as dividend.⁸⁷ Accordingly, since 1/12th of the dividend would have been taxable had money been distributed in lieu of stock, no exemption from section 306 stock classification would be provided by paragraph (2). This result seems to follow despite the fact that the entire earnings of \$100,000 would actually be taxed as dividends paid in cash as part of the distribution, of \$200,000.

84. See text at note 65 *supra*.

85. The question might arise as to which corporation's earnings are to be looked to in an exchange of stock for stock in connection with the reorganization of two corporations. Even though the stock received is the stock of a different corporation, it would seem that the test for the application of paragraph (2) should be made by reference to the earnings of the corporation the stock of which is surrendered in exchange. In substance, the stock received is treated as section 306 stock because it is received in lieu of a stock dividend of the corporation the stock of which is surrendered. This has been the conclusion in cases decided under old § 112(c)(2) and its predecessors, which hold that dividend treatment of boot depends on the earnings of the corporation whose stock is surrendered, though the boot is actually paid by another corporation a party to the reorganization. *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Commissioner v. Owens*, 69 F.2d 597 (5th Cir. 1934); *George Woodward*, 23 B.T.A. 1259 (1931).

86. This is the recommendation of the Committee on Taxation of The Association of the Bar of the City of New York. COMMITTEE ON TAXATION, *op. cit. supra* note 78, at 20-21. The suggested change would not affect the treatment of the proceeds of dispositions other than redemptions. See text at notes 90 & 91 *infra*.

87. U.S. Treas. Reg. § 1.316-2(c) (1955).

Convertible Stock

The reason for the inclusion of paragraph (1) of subsection (e) is not clear. This paragraph provides that if section 306 stock was issued with respect to common stock and later the section 306 stock was exchanged for common stock in the same corporation, the common stock so received shall not be treated as section 306 stock. It has been mentioned that an exchange of section 306 stock for common stock in a recapitalization will result in freeing from section 306 status the common stock received in exchange.⁸⁸ Paragraph (1) therefore appears to be unnecessary in a recapitalization case.

It may have been inserted principally for the purpose of covering the case of a conversion pursuant to a conversion privilege contained in the section 306 stock.⁸⁹ There is some difficulty in identifying the statutory basis for the conclusion that a tax-free exchange is effected on a conversion of stock by a shareholder into stock of a different class pursuant to a privilege contained in the stock.⁹⁰ Although the term "recapitalization" should be broad enough to cover the transaction, perhaps it was felt that there was sufficient doubt to indicate the advisability of a special provision.

Rules Governing Dispositions and Redemptions of Section 306 Stock

General Rule Governing Dispositions Other Than Redemptions

Subsection (a)(1) provides that the amount realized on the disposition of section 306 stock other than by way of redemption shall be treated as gain from the sale of property which is not a capital asset, and hence as ordinary

88. See text at note 50 *supra*.

89. The rule is stated to apply "whether or not such exchange is pursuant to a conversion privilege contained in the section 306 stock." The paragraph excepts from the rule a case to which paragraph (2) of subsection (e) is applicable. Paragraph (2) provides that "common stock with respect to which there is a privilege of converting into stock other than common stock (or into property), whether or not the conversion privilege is contained in such stock, shall not be treated as common stock." This provision has already been commented on. See text at pp. 919-20 *supra*. The Senate Finance Committee comment is that the rule of paragraph (1) "would apply in cases to which subsection (c)(1)(B) does not apply, that is, any exchanges which may not be considered recapitalizations." S. REP. No. 1622, 83d Cong., 2d Sess. 245 (1954). No hint is offered as to the type of exchange which might qualify as tax-free without the aid of the reorganization or separation sections. The regulation comment is that the application of the rule is to "exchanges not coming within the purview of section 306(c)(1)(B)." U.S. Treas. Reg. § 1.306-3(f) (1955).

90. A special ruling, dated February 23, 1945, and printed at 4 CCH 1945 STAND. FED. TAX REP. ¶ 6151, holds that the exercise of a privilege provided for in a preferred stock certificate to convert into common stock of the same corporation results in no taxable income or deductible loss to the shareholder. The ruling cites no reason for the holding nor is any reason cited for similar holdings as to convertible bonds. See G.C.M. 18436, 1937-1 CUM. BULL. 101; I.T. 2347, VI-1 CUM. BULL. 86 (1927); I.T. 2216, IV-2 CUM. BULL. 19 (1925); Mim. 3156, II-2 CUM. BULL. 24 (1923); U.S. Treas. Reg. 45, Art. 1563 (1920).

income, unless certain exceptions apply. This treatment is limited to the stock's ratable share of the amount which would have been a dividend at the time of its distribution if the corporation had distributed money in an amount equal to the fair market value of the stock at that time. Amounts in excess of such ratable share are applied against basis, and any further excess is treated as gain from the sale of the stock. No loss is recognized in any event.⁹¹ There are three exceptions in the case of dispositions other than redemptions: certain dispositions terminating the entire interest of the shareholder in the corporation,⁹² tax-free exchanges,⁹³ and dispositions in which it is established to the satisfaction of the Secretary of the Treasury or his delegate that federal income tax avoidance was not one of the principal purposes.⁹⁴

In the case of the disposition of section 306 stock not falling within an exception, the first point of importance requiring determination is the fair market value of the stock at the time of distribution.⁹⁵ Since the amount to be treated as gain from the sale of property which is not a capital asset cannot exceed the stock's ratable share of the earnings and profits at the time of distribution, it is also important to ascertain the earnings and profits at that time.⁹⁶ Furthermore, if a change has been made in the terms and conditions of the stock since its receipt, subsection (g) requires that consideration be given to the fair market value and the amount of earnings at the time of the change, since, if the value is higher or the stock's ratable share of the earnings is greater at the date of change, the higher value or the greater earnings must be substituted.

The determination of fair market value would seem to involve no more than the usual problems presented when values are in issue. It may be, of course, that attempts will be made to limit the value by placing restrictions on the stocks. To block such attempts, subsection (g) states that the fair market

91. Section 306(a) (1).

92. Section 306(b) (1).

93. Section 306(b) (3).

94. Section 306(b) (4).

95. Of course, before reaching consideration of the points mentioned in the text, it must be determined that there has been a "disposition." Since the tax is payable only with respect to proceeds of the disposition, it would not seem that there should be much room for controversy as to the meaning of "disposition." There is no definition suggested in the congressional committee reports and the regulations. The Senate Finance Committee Report and the regulations state that the term includes pledges of stock under certain circumstances, particularly where the pledgee can look only to the stock itself as his security. S. REP. No. 1622, 83d Cong., 2d Sess. 242 (1954); U.S. Treas. Reg. § 1.306-1(b) (1) (1955). There is no statutory warrant for the statements, but they are obviously designed to block a possible tax avoidance step. Certainly, an ordinary loan and pledge arrangement should not constitute a "disposition." See ADAMS, *op. cit. supra* note 60, at 15.

96. Section 306(a) (1) refers not to earnings and profits but to the "stock's ratable share of the amount which would have been a dividend at the time of distribution if (in lieu of section 306 stock) the corporation had distributed money. . . ." This language is construed as a limitation to the stock's ratable share of the earnings and profits at the time of distribution of the stock. S. REP. No. 1622, 83d Cong., 2d Sess. 242 (1954).

value may be assessed as of the time of any change in the terms and conditions of the stock, if the value at that time is higher. Whether the provisions of subsection (g) will be adequate must await the test of time. For example, assume that preferred stock distributed as a dividend on common stock and falling within the section 306 category is issued under a charter provision providing that it may be redeemed at 50 the first year, at 60 the second year and at a corresponding increase in each successive year until the redemption price reaches 100. At time of issue the fair value of the stock would probably be less than 60. Would each year's increase in redemption price constitute "a substantial change . . . in the terms and conditions" of the stock? Even if the answer were in the affirmative, the recipient might in the first year sell the stock for 55 to a relative whom he wished to benefit. The sale would appear to terminate the stock's character as section 306 stock, and when the stock subsequently increased in value the purchaser could sell to an outsider, realizing capital gain on the increase over 55.⁹⁷

Neither the distribution of section 306 stock nor its sale reduces earnings and profits.⁹⁸ There is, of course, good reason for not reducing earnings on the distribution—the revenue may never be enriched by application of the section 306 provisions. The recipient may hold the stock until he dies, he may give it to charity, or it may be sold or redeemed under such circumstances that one of the statutory exceptions will apply. No such considerations are involved if the stockholder sells and realizes ordinary income under subsection (a)(1), and it would seem that earnings and profits should be reduced by the amount treated as gain from the sale of property which is not a capital asset. In the case of a redemption, earnings and profits are reduced by the amount treated as a distribution under section 301.⁹⁹ It has been pointed out that the administrative difficulty of adjusting earnings on a sale of section 306 stock is not a serious stumbling block, for the burden would be on any taxpayer desiring to benefit by such an adjustment to establish the operative facts in connection with the sale.¹⁰⁰

97. Even if the transaction were sustained, however, the original recipient, if sufficient earnings are assumed, would have ordinary income in the amount of the sale price of 55—a substantial deterrent to the transaction.

98. It is expressly provided in § 312(d) that if a distribution of stock by a corporation is not subject to tax in the hands of the distributee by reason of § 305(a), or if no gain to a distributee from the receipt of stock or securities distributed by a corporation is recognized under the 1954 Code, the distribution has no effect on earnings and profits. There is no express provision dealing with the effect on earnings of a disposition of section 306 stock which is not a redemption; but since such disposition does not involve the corporation, it could have no effect on earnings unless express provision therefor were made. The regulations state that "no reduction of earnings and profits results from any disposition of stock other than a redemption." U.S. Treas. Reg. § 1.306-1(b)(1) (1955).

99. Section 312(a).

100. COMMITTEE ON TAXATION, *op. cit. supra* note 78, at 19. The proposals of the American Law Institute were to treat sales of dividend stock as redemptions of the stock by the issuer. ALI FED. INCOME TAX STAT. § 519(g) (Feb. 1954 Draft). Under § 519(f)

One of the most objectionable features of section 306 is that although its basic purpose is to impose the equivalent of dividend treatment on dispositions of bail-out stock, it fails, in the case of dispositions not redemptions, to treat the bail-out portion of the proceeds as a dividend. The result is that the dividends-received deduction allowed to corporations,¹⁰¹ and the dividends-received credit and exclusion allowed to individuals¹⁰² are denied. There does not appear to be any justification for failure to give dividend status to the tainted portion of the proceeds.¹⁰³

The postponement of tax until disposition of the stock and the treatment of the proceeds of the tainted portion as gain from the sale of a noncapital asset have led to the inclusion of subsection (f). The intended effect of this provision is to tax the noncapital asset portion of the proceeds of a sale of section 306 stock by a nonresident alien individual or foreign corporation, if a dividend distributed to such a seller would have been taxable at the time the stock was distributed.¹⁰⁴ The characterization of the proceeds of sale as income from sources within the United States is therefore determined as of the time of distribution. The results of the application of the subsection could be rather extraordinary. Assume that a foreign corporation, which receives 60 per cent of its gross income from United States sources, distributes a preferred stock dividend on its common stock and such dividend stock is section 306 stock. Some of the dividend stock is received by a nonresident alien individual. Shortly after the distribution of the stock dividend the corporation makes a change in its business, and thereafter only 40 per cent of its income is from sources within the United States. Five years after the shift the alien stockholder sells his stock abroad. Under subsection (f), 60 per cent of the portion of the proceeds subject to noncapital asset gain treatment would be deemed income from United States sources. On the other hand, if the stock had been redeemed instead of sold, or if the stock had been retained and the corporation had paid an ordinary dividend, no United States tax would have been pay-

of the draft, earnings and profits would be charged in the year of actual or constructive redemption.

101. The 85% dividends-received deduction generally allowed corporations is contained in § 243.

102. The 4% dividends-received credit for individuals is allowed by § 34 and the \$50 exclusion by § 116.

103. See COMMITTEE ON TAXATION, *op. cit. supra* note 78, at 19. See also the American Law Institute method of handling the matter, referred to in note 100 *supra*.

104. The language of subsection (f) is as follows:

“Source of Gain.—The amount treated under subsection (a)(1)(A) as gain from the sale of property which is not a capital asset shall, for purposes of part I of subchapter N (sec. 861 and following, relating to determination of sources of income), be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If under the preceding sentence such amount is determined to be derived from sources within the United States, such amount shall be considered to be fixed or determinable annual or periodical gains, profits, and income within the meaning of section 871(a) or section 881(a), as the case may be.”

able. In such case, the distribution would have been from sources outside the United States.¹⁰⁵

The criticisms advanced so far suggest that the basic approach of subsection (a)(1) to treatment of proceeds from the sale of section 306 stock may be wrong. Since the bail-out problem arises from the prospective use of corporate funds to retire some part of the equity of the shareholders, the analogy to a redemption is close, and the tax treatment should be no more onerous than that accorded a redemption. A reasonable modification of the statute might be to provide that the amount to be treated as ordinary income from the sale of section 306 stock should not exceed the amount which would have been treated as a dividend if the stock had been redeemed at the time of the sale. This limitation would be in addition to the present one that restricts ordinary income treatment to the stock's pro rata share of earnings at the time of distribution. Dividend characteristics should in any case be assigned to the amount treated as ordinary income. Such modifications would meet the problems discussed in the three preceding paragraphs.¹⁰⁶

General Rule Governing Redemptions

If the disposition of section 306 stock is a redemption, "the amount realized shall be treated as a distribution of property to which section 301 applies."¹⁰⁷ Exceptions are redemptions to which section 302(b)(3) applies,¹⁰⁸ distributions in partial or complete liquidation to which part II applies,¹⁰⁹ tax-free exchanges,¹¹⁰ and transactions not in avoidance of federal income tax.¹¹¹

The basic approach of section 301 is dividend treatment at the time of redemption. It is therefore immaterial that the earnings and profits of the corporation may have been small at the time of the distribution of the stock.¹¹²

105. See note 40 *supra*. In passing, it is perhaps worth noting that the concept of imposing United States tax on a nonresident alien individual or foreign corporation selling property in a foreign country and, in certain cases, even if the property is stock of a foreign corporation, might raise some interesting problems of jurisdiction. As a practical matter, only those nonresidents cautious enough to consult United States tax advisers are likely to know of the possibility of the tax.

106. The proposal approaches the solution in the American Law Institute draft. ALI FED. INCOME TAX STAT. § 519 (Feb. 1954 Draft). Certain differences arise from the constructive redemption treatment proposed in the draft, however. For example, § 519(e) of the draft bases dividend treatment on earnings at the date of issue of the tainted stock or the date of redemption, whichever would result in the lesser dividend, but the former limitation apparently relates to total earnings at the date of issue rather than to the pro rata share of earnings attributable to the stock sold.

107. Section 306(a)(2).

108. Section 306(b)(1)(B). Section 302(b)(3) provides in effect that a redemption of all the stock of the corporation owned by the shareholder is to be treated as a distribution in full payment in exchange for the stock.

109. Section 306(b)(2).

110. Section 306(b)(3).

111. Section 306(b)(4).

112. It is important that some earnings exist at the time of the stock dividend; otherwise the stock will not be section 306 stock. Section 306(c)(2).

Since the important date for the determination of earnings in the case of a disposition other than a redemption is the date of the distribution of the stock, the shareholder is given a virtual option to choose a sale in lieu of redemption if the sale will result in less tax because of the difference in treatment.¹¹³ A reasonable modification of the provisions dealing with redemptions might be to limit dividend treatment by reason of section 306 to the stock's ratable share of the earnings and profits at the date of receipt of the stock, as in the case of sales not redemptions, and leave to the provisions of section 302, governing redemptions in general, the issue as to whether any additional amount should be treated as a dividend distribution.¹¹⁴

Treatment of Basis of Section 306 Stock Sold or Redeemed

Upon the issuance of a stock dividend, the basis of the old stock must be allocated between the old and new stocks in proportion to the fair market values of each on the date of distribution.¹¹⁵ The basis of stock surrendered in a tax-free reorganization or separation exchange is normally assigned to the stock received, and if more than one stock is received, the basis is allocated among them in accordance with values.¹¹⁶ It follows, therefore, that if the stock from which section 306 stock derived its origin had any basis, the section 306 stock will normally have part of that basis allocated to it.¹¹⁷ The Code contains no provisions preserving that basis, even though the entire proceeds of the sale or redemption of the stock may be subject to ordinary income tax treatment. In the case of a sale, however, the regulations under section 306 contemplate that so much of the basis of the section 306 stock as is not in ex-

113. It does not necessarily follow that a redemption will be more advantageous than a sale simply because earnings are less at the redemption date than at the dividend distribution date. In the case of a sale, the amount taxed as a sale of a noncapital asset is an amount equal to the stock's "ratable share" of the amount which would have been a dividend had money been distributed in lieu of the stock. There is no "ratable share" limitation on a redemption. For example, a corporation distributes on its common stock a dividend of preferred stock with a value of \$200,000 when its earnings and profits amount to \$100,000. A shareholder who received \$20,000 of the preferred stock, or 10% thereof, has the problem of whether he would prefer a redemption of his stock at a time when the earnings are \$50,000. If he turns in the preferred stock to the corporation for \$20,000, the entire amount will be taxable as a dividend (assuming, of course, that no exception is applicable). On the other hand, if he sells to a third person for \$20,000, only \$10,000 will be treated as ordinary income, since this represents the "ratable share" which would have been taxed as a dividend at the time of distribution.

114. Adequate protection against bail-outs would seem to be afforded by the "essentially equivalent to a dividend" provision of § 302. See ADAMS, *op. cit. supra* note 60, at 16.

115. Section 307(a); U.S. Treas. Reg. § 1.307-1(a) (1955). An exception is provided if the dividend is in stock rights and the fair market value of the rights is less than 15% of the fair market value of the old stock at the time of distribution. In such a case there is no allocation of basis to the rights, and their basis is zero unless the taxpayer affirmatively elects to allocate. Section 307(b); U.S. Treas. Reg. § 1.307-2 (1955).

116. Section 358; U.S. Treas. Reg. § 1.358 (1955). Adjustments to basis may be required if boot is received on the exchange. *Ibid.*

117. There may be an exception in the case of certain stock rights. See note 115 *supra*.

cess of the proceeds treated as gain from sale of a noncapital asset may be added back to the basis of the stock with respect to which the section 306 stock was distributed.¹¹⁸ In the case of a redemption, there is no provision in the regulations under section 306, but similar results would appear to follow from a provision of the regulations dealing with redemptions generally under section 302.¹¹⁹

Exceptions to the General Rules Relating to Dispositions and Redemptions

Termination of Shareholder's Interest. The adverse tax consequences of section 306 may be avoided if the disposition of the section 306 stock terminates the interest of the shareholder in the corporation. There are separate statutory provisions covering redemptions and dispositions not in redemption. To qualify in the case of a disposition not in redemption the disposition must be to a person whose ownership would not be attributable to the shareholder and must terminate the entire stock interest of the shareholder in the corporation. In determining whether the disposition is to a person whose ownership would be attributable to the shareholder and in determining whether the entire stock interest has been terminated, the constructive ownership rules of section 318(a) are applicable. To qualify in the case of a redemption, section 302(b)(3), relating to complete redemption of all the stock of the shareholder, must be applicable.¹²⁰

The application of the provisions may be illustrated by the following example: All of the stock of Corporation A is owned by one individual, X. The corporation distributes a preferred stock dividend on its common stock, thereby creating section 306 stock. X gives the common stock to his son, Y, and terminates all his interest in the corporation except his ownership of the preferred stock. Subsequently X sells the preferred stock to a third party. Because Y's ownership of the common stock would be attributed to X under section 318(a), the sale of the section 306 stock would not constitute termination of X's interest in Corporation A under the exemption. If instead of being sold the preferred stock were redeemed from X within ten years after the gift of the common stock to Y, the transaction would not qualify as a complete termination under Section 302(b)(3) unless the gift of common stock to Y could be shown not to have as a principal purpose the avoidance of federal income tax.¹²¹ If, however, prior to the sale or redemption of the preferred stock, Y sold or otherwise disposed of the common stock to an

118. U.S. Treas. Reg. § 1.306-1(b)(2), Examples (2) and (3) (1955).

119. U.S. Treas. Reg. § 1.302-2(c) (1955). Suppose a holder of section 306 stock transfers it by way of gift, retaining the stock in respect of which the section 306 stock was distributed, and the section 306 stock is subsequently redeemed. May the basis of the section 306 stock, to the extent of the amount treated as a dividend distribution, be added to the basis of the donor's retained stock? Example (2) of the cited regulation would suggest an affirmative answer. See U.S. Treas. Reg. § 1.306-1(b)(2), Example (2) (1955).

120. Section 306(b)(1).

121. Section 302(b)(3), (c)(2)(B).

unrelated interest, the disposition of the preferred stock by X would qualify under the termination of interest exception. If troubles arise under this exception, it will probably be because of difficulties with section 302 and section 318(a).¹²²

Liquidations. "If the section 306 stock is redeemed in a distribution in partial or complete liquidation to which part II (sec. 331 and following) applies," the general rule of section 306 relating to redemptions does not apply.¹²³ If the corporation is completely liquidated, there is no sound basis for treating the payments in respect of section 306 stock on any different plane from payments in respect of other stock in the corporation. Amounts distributed in complete liquidation of the corporation will be treated as a distribution in full payment in exchange for the stock and may give rise to long-term capital gain or loss unless one of the special provisions of part II is applicable by reason of factors unrelated to the section 306 status of the stock.¹²⁴

Amounts received in partial liquidation of the corporation are also treated as in full or part payment in exchange for the stock.¹²⁵ In explanation of this exception the Senate Finance Committee said:

"In the case of a partial liquidation your committee contemplates a contraction of the corporate business so that it is immaterial that the distribution in partial liquidation is with respect to section 306 stock. A bona fide contraction of the corporate business is not considered a means of distributing corporate earnings to shareholders at capital gains rates."¹²⁶

It is true that the only type of transaction specifically classified in the defining section as a partial liquidation is a distribution in connection with the termination of a business.¹²⁷ The statute expressly provides, however, that the definition is not limited to this specific type of transaction, and it must be assumed that other distributions will qualify. For example, the redemption by a publicly held corporation of an issue of preferred stock should meet the require-

122. A problem as to application of the termination of interest exception might arise in the following case: X owns all the common stock of Corporation A. The corporation sells to the son of X some new common stock. X converts his common stock into preferred stock, which is redeemed some time later. X has no other interest in Corporation A. The redemption falls within the exception if it qualifies under § 302(b)(3). It will be under § 302(b)(3) unless, under § 302(c)(2)(B)(ii), X's son is deemed to have acquired the new common stock from X. The same problem would be present in a "redemption equivalent to a dividend" problem if X had not converted his common stock after the sale by Corporation A to X's son, and Corporation A had redeemed X's common stock.

123. Section 306(b)(2).

124. Section 331. The special provisions are: § 332, providing for tax-free liquidations of subsidiaries; § 333, the one calendar month liquidation provision (successor to old § 112(b)(7)); § 341, relating to collapsible corporations; and § 342, relating to liquidation of certain foreign personal holding companies.

125. Section 331.

126. S. REP. No. 1622, 83d Cong., 2d Sess. 243 (1954).

127. Section 346.

ments of the statute. This, of course, is not the type of situation where section 306 stock is likely to be present, unless in connection with a reorganization; and it may well be that in most cases where section 306 stock is present, the partial liquidation exception will offer little escape from the general rules of section 306 except through the termination of business provisions.¹²⁸

Where Gain or Loss is Not Recognized. The redemption or other disposition of section 306 stock is excepted from the general rules "to the extent that, under any provision of this subtitle, gain or loss to the shareholder is not recognized with respect to the disposition of the section 306 stock."¹²⁹ This provision permits the tax-free exchange provisions of the Code to operate with respect to section 306 stock.¹³⁰ The revenue is protected in such cases by the imposition of section 306 stock status on the stock received unless, in certain cases, it is common stock.¹³¹

Transactions Not in Avoidance. In drafting section 306, it was recognized that cases would inevitably arise where none of the express exceptions to the operation of the section would relieve a transaction which had no tax avoidance connotations and which should be saved from the heavy penalties of section 306. It was to provide an escape hatch for such cases that paragraph (4) was added to the exceptions. The paragraph stipulates that the general rules do not apply

"If it is established to the satisfaction of the Secretary or his delegate—
 "(A) That the distribution, and the disposition or redemption, or
 "(B) In the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,
 was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax."

This provision has been mentioned in connection with the discussion of distributions of stock rights.¹³² It should be noted at the outset that paragraph (4) does not contemplate a ruling that stock within the definition of section 306

128. In cases not involving termination of a business, a distribution cannot qualify as in partial liquidation (except as one of a series of distributions in redemption of all the stock of the corporation) unless, among other things, "the distribution is not essentially equivalent to a dividend. . . ." Section 346.

129. Section 306(b)(3).

130. In explanation of the exception, the regulations state:

"(b) Section 306(a) does not apply to— . . .

"(2) Exchanges of section 306 stock solely for stock in connection with a reorganization or in an exchange under section 351, 355, or section 1036 (relating to exchanges of stock for stock in the same corporation) to the extent that gain or loss is not recognized to the shareholder as the result of the exchange of the stock (see § 1.306-3(d) relative to the receipt of other property). . . ."

U.S. Treas. Reg. § 1.306-2(b) (1955).

131. Section 306(c)(1)(B) and (C). See text at pp. 937-39 *supra*. The exception for common stock is provided in subparagraph (B) and is discussed in text at note 50 *supra*.

132. See text at notes 33 & 34 *supra*.

stock shall not be classified as section 306 stock if it is shown that no tax avoidance was involved in the creation of the stock. Subparagraph (B) clearly presupposes the existence of section 306 stock. Subparagraph (A) is not so clear, but it too seems to assume that the stock involved is section 306 stock; but it may be argued that the point is rather academic, since the subparagraph contemplates in any event that both the distribution and the disposition or redemption must be considered.¹³³ After an initial unwillingness to issue rulings under subparagraph (A) until a proposed disposition of stock was presented, the Commissioner has adopted a more liberal attitude; in appropriate reorganization and separation cases at least, he has issued rulings at the time of distribution. The nature of these rulings has already been mentioned.¹³⁴ Specific statutory authority to give a favorable ruling at the time of distribution if the distribution was not motivated by tax avoidance would be helpful, particularly in reorganization and separation cases, for the Commissioner has not been willing to rule on the effect of redemptions.¹³⁵

The application of subparagraph (B) is probably rather limited. If the shareholder has no other stock than the section 306 stock and the stock in respect of which the section 306 stock was distributed, the disposition of the section 306 stock immediately after or simultaneously with the disposition of the other stock should be within the termination of interest exception created by subsection (b)(1), unless the constructive ownership rules of section 318(a) would apply to destroy the exception. However, subparagraph (B) permits a favorable ruling even if the constructive ownership rules of section 318(a) would so apply. Furthermore, if the shareholder holds other stock in the corporation after the disposition of the section 306 stock and the stock with respect to which the section 306 was issued, a ruling may be issued under this subparagraph.¹³⁶

133. Subparagraph (A) is intended, the Senate Finance Committee said, "to apply to the case of dividends and isolated dispositions of section 306 stock by minority shareholders who do not in the aggregate have control of the distributing corporation." S. REP. No. 1622, 83d Cong., 2d Sess. 243 (1954). The regulations refer to minority shareholder transactions but do not indicate that the subparagraph is restricted to such transactions. U.S. Treas. Reg. § 1.306-2(b)(3) (1955).

134. See text at note 60 *supra*.

135. See ADAMS, *op. cit. supra* note 60, at 21-24.

136. Neither the committee reports nor the regulations contain much helpful material on this subparagraph. The Senate Finance Committee said with respect to it:

"Subparagraph (B) of subsection (b)(4) applies to a case where the shareholder has made a prior or simultaneous disposition (or redemption) of the underlying stock with respect to which the section 306 stock was issued. Thus if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a tax avoidance disposition since he has previously parted with the stock which allows him to participate in the ownership of the business. However, variations of the above example may give rise to tax avoidance possibilities which are not within the exception of subparagraph

*Rules Governing Stock Received in Distributions and Reorganizations
to Which 1939 Code Applied*

Under subsection (h), the rules of section 306 do not apply to the disposition or redemption of stock if it was received in a distribution or reorganization to which the 1939 Code (or corresponding provisions of prior laws) applied, and such stock was disposed of or redeemed on or after June 22, 1954, even though the stock would have been section 306 stock if the 1954 Code had applied to the distribution or reorganization. The subsection further provides:

“The extent to which such disposition or redemption shall be treated as a dividend shall be determined as if the Internal Revenue Code of 1939 (as modified by the provisions of this Code other than the foregoing subsections of this section) continued to apply in respect of such disposition or redemption.”

The concept is a confusing one, but speaking in broad terms, it apparently means that the post-June 21, 1954 disposition or redemption of pre-June 22, 1954 stock, which would have been section 306 stock if issued subject to the 1954 Code, will be treated as if the provisions of the 1954 Code were in effect, except for subsections (a) to (g) of section 306. It would seem to follow, for example, that if a redemption could qualify under the partial liquidation provision of the 1954 Code, tax treatment as a dividend distribution would be avoided. With minor exceptions, however, it would appear that the problem of the proper tax treatment of redemptions and dispositions of the pre-June 22, 1954 stock should not be substantially different after June 21, 1954, than if effected prior to that date. Faced with a redemption or disposition of such pre-June 22, 1954 stock or with a pre-June 22, 1954 disposition, a court may be affected by the knowledge that Congress and the Treasury Department felt that the 1939 Code needed considerable strengthening in the bail-out area.¹³⁷

CONCLUSION

The 1954 Code adopts a rather simple and effective barrier to any bail-out possibilities inherent in upgrading a stockholder interest to a creditor position. It is arguable that the risks to the revenue under prior law were not sufficiently great to justify treating securities received in respect of stock as boot in prac-

(B). Thus if a corporation has only one class of common stock outstanding and it issues stock under circumstances that characterize it as section 306 stock, a subsequent issue of a different class of common having greater voting rights than the original common will not permit a simultaneous disposition of the section 306 stock together with the original common to escape the rules of subsection (a) of section 306.”

S. REP. No. 1622, 83d Cong., 2d Sess. 244 (1954).

137. The Senate Finance Committee tried to avoid any implications helpful to taxpayers, saying:

“The removal, in effect, of existing stock issues from the application of section 306 is not intended as a commentary upon existing law in the preferred stock bail-out area.”

S. REP. No. 1622, 83d Cong., 2d Sess. 246 (1954).

tically all cases, but the statutory expression of the Congressional policy is relatively clear and should not lead to prolonged litigation or a period of uncertainty as to interpretation.

The preferred stock bail-out provisions in section 306, however, should be modified in a number of particulars, as suggested in the foregoing pages. The most troublesome problems are those presented by reorganizations and separations. The ideal in this area would be to allow maximum freedom for legitimate corporate readjustments and minimum opportunity for conversion of corporate earnings to capital gains through the preferred stock bail-out device. It is believed that the present statutory language permits a reasonable approximation of this ideal, and that the Treasury regulation should be revised to achieve such an approximation. The cash substitution test should be eliminated and replaced by an interpretation that would allow the use of preferred stock except in those cases where its issue truly resembles a stock dividend. In the absence of such a change, the statutory language should be amended to make it clear that preferred stock received in reorganizations and separations is section 306 stock in those cases where it is in substance a stock dividend having bail-out potentialities, and only in those cases. A further desirable amendment of the statute would be to authorize the Commissioner of Internal Revenue to grant rulings exempting stock from section 306 at the time of issue.