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An Analysis of the Taxation of Stock Dividends from 1918 to 1970; Effects of the Tax Reform Act of 1969 on 305 of the Internal Revenue Code

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An Analysis of the Taxation of Stock Dividends
from 1918 to 1970; Effects of the Tax Reform
Act of 1969 on § 305 of the
Internal Revenue Code

INTRODUCTION

On December 10, 1969, the most massive and controversial piece of tax legislation ever proposed was enacted by Congress. One small portion of this act, § 421, has substantially altered the tax status of stock dividends by amending § 305 of the Internal Revenue Code of 1954. As a result, § 305 now covers a wide variety of situations where the receipt of stock dividends previously nontaxable will give rise to income taxable at ordinary rates.

The history of attempts to tax stock dividends is quite long. It begins with the Revenue Act of 1913, proceeds through a long line of decisions and statutory changes leading to the enactment of the 1954 Code, continues through changes in the Regulations, and comes to an end, at least for the present, with the enactment of § 421. Prior to the 1954 Code, stock dividends were taxed only where the shareholder's proportionate interests were thereby increased. Due to the difficulty in applying this test, the 1954 code provided that a stock dividend would be taxed when any shareholder had a choice between receiving stock or cash, or when the distribution was in discharge of certain preference dividends. The regulations attempted to extend these exceptions, and by 1969 the Treasury's interpretation seemed clearly beyond that contemplated by Congress when § 305 was enacted. Since the regulations could not legally be extended to cover all the situations which the Treasury felt gave rise to taxable income, amendments to the Code were proposed and recently enacted.

The new law appears to have serious impact upon corporations and their shareholders, as it is aimed directly at many of the attractive plans offered to investors. In addition, the law has constitutional implications, especially if the earlier decisions of the Supreme Court are to be respected. In order to understand the problems raised by the

1969 amendment of § 305, it is first necessary to take a look at the evolution of the law.

EARLY HISTORY

One of the earliest attempts to impose a tax on stock dividends arose in connection with the Revenue Act of 1913.¹ The Supreme Court declared that a true stock dividend was capital rather than income, and was not subject to tax. The decision was based on the fact that there was no change in the interest held by the shareholder, but merely an increase in the evidence representing that interest.²

Two years later, the Supreme Court declared unconstitutional an express provision of the 1916 Revenue Act³ which considered a stock dividend taxable income to the extent of its cash value. The Court stated that where a stock dividend did not change the proportionate interest of the recipient, it could not be taxed, since nothing of value was taken from the assets of the corporation and given to the shareholder. The Court felt that neither under the 16th Amendment, nor otherwise, did Congress have the power to tax as income a stock dividend made lawfully and in good faith.⁴

As a result of the decision in *Eisner v. Macomber*,⁵ the Treasury within five months, issued a decision wherein they stated their position that stock dividends were not taxable.⁶ Congress also specifically provided for nontaxability in the Revenue Act of 1921,⁷ and reenacted

1. Income Tax Act, act of October 3, 1913, ch. 16, § II, 38 Stat. 114. The act provided that net income should include dividends and also gains or profits and income derived from any source. Note—there was no express wording regarding stock dividends in the 1913 act.

2. *Towne v. Eisner*, 245 U.S. 418, 38 S. Ct. 158, (1918). The corporation transferred \$1,500,000 of profits to capital and issued 15,000 shares of stock to its shareholders. The taxpayer received his proportion of holdings, 4174.5 shares and was taxed on \$417,450. The Court said the old shares plus the new shares were still only worth what the old shares had been before.

3. Revenue Act of September 8, 1916, ch. 463, § 2a, 39 Stat. 756. "Net income shall include gains, profits and income . . . from . . . dividends. . . . Provided that the term dividends shall be held to mean any distribution made or ordered to be made by a corporation out of earnings or profits accrued, payable either in cash or stock, which shall be considered income to the extent of its cash value."

4. *Eisner v. Macomber*, 252 U.S. 189 (1920). In order to readjust the capitalization, the corporation issued a 50% stock dividend. The taxpayer received 198.77 shares of common stock on like holdings, and was taxed upon a supposed income of \$19,877.

5. *Id.*

6. T.D. 3052, 3 CUM. BULL. 38 (1920).

7. Revenue Act of November 23, 1921, ch. 136, § 201(d), 42 Stat. 228. "A stock dividend shall not be subject to tax." Note—The Committee reports stated that the section was included to conform to existing law by exempting stock dividends as required by the decision in *Eisner v. Macomber*. H.R. Rep. No. 350, 67th Cong., 1st Sess. 8 (1921); S. Rep. No.

similar provisions through 1934.⁸ While this action should have prevented further litigation on the matter, the regulations issued under the 1921 Act and subsequent acts contained a controversial provision allocating the basis of the old stock,⁹ which gave the Supreme Court further opportunity to determine whether Congress had correctly interpreted the decision in *Eisner v. Macomber*.¹⁰

In *Koshland v. Helvering*,¹¹ the Court noted that while *Eisner v. Macomber*¹² dealt only with a common on common stock dividend, the Treasury broadly interpreted that decision to include all stock dividends. Congressional approval was granted this interpretation when the definition of stock dividends was modified to include all forms of stock distributions.¹³ Prior decisions had distinguished between those stock dividends which worked no change in corporate equity, the same interest being represented after the distribution by more shares of the same character, and those dividends where a change in either the corporate entity or in the nature of the shares issued occurred, whereby the proportionate interests of the shareholders were altered. However, neither the statute nor the regulations made such a distinction. The Court concluded that whenever a dividend has the result of giving a shareholder an interest which differs from that which he formerly had—a change in proportionate interest—then income is realized and is taxable under the 16th Amendment.

Because of the decisions in *Koshland*¹⁴ and a similar case, *Helvering v. Gowran*,¹⁵ the Revenue Act of 1936 included a provision which removed the blanket exemption for stock dividends.¹⁶ Its effect was to

275, 67th Cong., 1st Sess. 95 (1921); Conf. Comm. Rep. No. 486, 67th Cong., 1st Sess. 16 (1921).

8. Revenue Act of 1921, § 201(d); Revenue Acts of 1924, 1926, § 201(f); Revenue Acts of 1928, 1932, 1934, § 115(f).

9. Regs. 65, Arts. 1547 and 1548; Regs. 74, Arts. 627 and 628; Regs. 77, Arts. 627 and 628; Regs. 86, Arts. 115-7 and 115-8.

10. 252 U.S. 189 (1920).

11. 298 U.S. 441 (1936). The corporation made a distribution of common stock to preferred shareholders, both classes of stock previously outstanding. In accordance with the regulations the Commissioner said the taxpayer had to dilute the basis of the preferred to determine his gain upon sale. The taxpayer claimed that even though the dividend was not taxable, it still constituted taxable income within the 16th Amendment. The Court agreed with the taxpayer saying the common stock dividend was income when received, and therefore could not sustain the regulations, since to compute gain on a reduced basis of the preferred stock would be a capital levy.

12. 252 U.S. 189 (1920).

13. Revenue Act of November 23, 1921, ch. 136, § 201(d), 42 Stat. 228.

14. 298 U.S. 441 (1936).

15. *Helvering v. Gowran*, 302 U.S. 238 (1937). The corporation made a distribution of preferred stock to common stockholders, both classes previously outstanding. The Court said the dividend was income rather than a return of capital.

16. Revenue Act of June 22, 1936, ch. 690, § 115(f)(1), 49 Stat. 1648. A distribution

make the question of taxability depend upon whether or not income was realized within the meaning of the 16th Amendment. This provision was repeated in subsequent revenue acts and eventually became § 115(f)(1) of the 1939 Code.

In an attempt to settle once and for all the confusing and controversial situations wherein shareholders were given an election to receive cash or stock, Congress at the same time enacted § 115(f)(2).¹⁷ This subsection was based on a long line of cases involving not only the most simple election, but also very elaborate plans calling for endorsement and return of dividend checks in payment of previously subscribed stock. Some of these decisions were based upon whether there was a binding obligation on the shareholders to return the dividend checks,¹⁸ some upon whether or not there was a resolution by the corporation governing the arrangement,¹⁹ and others upon whether the corporation had sufficient funds upon which cash dividend checks could be drawn.²⁰ While the results in these cases are far from consistent, they do have one thing in common; each dealt with an election as to a particular declaration and distribution, rather than a choice as to future dividends. In addition, not one of the cases responsible for the enactment of § 115 deals with an election pursuant

made by a corporation to its shareholders in stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the 16th Amendment to the Constitution.

17. Revenue Act of June 22, 1936, ch. 690, § 115(f)(2), 49 Stat. 1648. Whenever a distribution by a corporation is, at the election of any of the shareholders [whether exercised before or after the declaration thereof], payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without the election would be exempt from tax under paragraph (1), or (B), in money or any other property [(whether including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1))], then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

18. See, e.g., *Jackson v. Commissioner*, 51 F.2d 650 (3d Cir. 1931), holding that a definite understanding plus insufficient cash showed intent to grant stock dividend. Appeal of *W.J. Hunt*, 5 B.T.A. 356 (1926) holding no agreement plus segregation of funds showed intent to grant cash dividend.

19. See, e.g., *J. E. Brading v. Commissioner*, 17 B.T.A. 436 (1929), holding that since there was no resolution making mandatory an agreement to return dividend checks in payment for stock, the shareholder constructively received cash.

20. See, e.g., *U.S. v. Mellon*, 279 F.910 (1919), aff'd, 281 F.645 (3d Cir. 1922); *U.S. v. Davison*, 1 F.2d 465 (1924), aff'd, 9 F.2d 1022 (3d Cir. 1926); *Irving v. Commissioner*, 44 F.2d 246 (1930), holding that since the corporation did not have sufficient funds to pay the dividend checks, a stock dividend had been declared. But, see *Luthe Hardware v. Commissioner*, 6 B.T.A. 53 (1927), holding that where the corporation had sufficient funds to pay the dividend, but had no authority to increase capital, a cash dividend had been declared. Cf. *G.C.M. 6709*, VIII-2 CUM. BULL. 132 (1929); *I.T. 2538*, IX-1 CUM. BULL. 144 (1930) holding that a shareholder who did not exercise his option to take cash would not be taxable on receipt of the stock dividend. This was later revoked by *G.C.M. 23202*, 1944 CUM. BULL. 536, *I.T. 3673*, 1944 CUM. BULL. 321; *Lamberth v. Commissioner*, 120 F.2d 101 (9th Cir., 1941); Compare *Joseph Paper*, 29 B.T.A. 56 (1927), referring to an election as to a particular distribution.

to a reorganization or an incorporation. In fact the statements before the House Ways and Means Committee in 1936 indicate that it was not the intent of Congress to include within the provisions of the statute such a situation where, pursuant to a transaction, acceptance of one class of stock over another class of stock would constitute an election between cash or stock as to future distributions.²¹

Partly due to the decisions in *Koshland*²² and *Gowran*,²³ and partly because of the 1936 enactment of § 115(f), which removed the tax exemption of all stock dividends, litigation was again renewed in an effort to determine the scope of the *Macomber*²⁴ decision. *Helvering v. Griffiths*²⁵ contained the same facts as those in the *Macomber*²⁶ case, and provided the Treasury with an excellent vehicle with which to push for an overruling of the earlier decision. The Court never reached the constitutional issue since it decided that under a proper interpretation of the statute, the dividend was not taxable. Relying on the statements of congressional leaders,²⁷ as well as remarks by members of the Internal Revenue Service,²⁸ the Court said it was not the intent of Congress in enacting the statute to question the principle announced in *Eisner v. Macomber*.²⁹ In addition, the Court pointed out that since the Treasury had accepted the view that the dividends were not subject to tax, any decision to the contrary would make many dividends declared in good faith and in reliance on that decision now taxable.³⁰ Distinguishing *Koshland* and

21. Ways and Means Committee, H.R. Rep. No. 2475, 74th Cong., 2d Sess. (1936).

22. 298 U.S. 441 (1936).

23. 302 U.S. 238 (1937).

24. 252 U.S. 189 (1920).

25. 318 U.S. 371 (1943), aff'g 129 F.2d 321 (2d Cir. 142), aff'g B.T.A. Memo Op. Dkt. 110035 (1942). The corporation declared a common stock dividend with common stock outstanding. The tax was asserted under § 22(a) of the Internal Revenue Code, 26 U.S.C. § 22(a) which stated that income included dividends; and also under the Revenue Act of 1936, ch. 690, § 115(f)(2), 49 Stat. 1648. (See footnote 16).

26. 252 U.S. 189 (1920).

27. Statements of Congressman Vinson, 80 Cong. Rec. 6214-6215. "There are many dividends received in stock and stock rights that are distinguishable from the dividends in the *Macomber* case . . . and are actual realized taxable income. As we see it a stock dividend that is not taxable is one in which the relative interest of each shareholder of a corporation is unchanged in his stock ownership."

28. Statements of Arthur Kent, Acting Chief Counsel of the Internal Revenue Service, Hearings on the Revenue Act, 1936, House Ways and Means Committee, 74th Cong., 2d Sess. 592 (1936) where he pointed out that there were some stock dividends which could be taxed and some which could not. The Constitutional immunity of the true stock dividend as declared in *Eisner v. Macomber* does not apply to all types and varieties of so called stock dividends.

29. 252 U.S. 189 (1920).

30. Article 115-7 of Regs. 94, issued under the Revenue Act of 1936 stated "A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same propor-

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Macomber, the Court recognized that while certain dividends produce no change in proportionate interest, there are other dividends which do, and are subject to tax.

Prior to the Supreme Court's decision in the *Koshland* case,³¹ the Board of Tax Appeals had been following the proportionate interest test, which they subsequently abandoned in favor of a more stringent rule.³² However, upon review these decisions were reversed in favor of a return to the earlier, more liberal rule.³³ Even though the Supreme Court had decided what rule was to be applied, litigation did not cease, as two additional questions remained to be answered: What kind of distributions changed a shareholder's proportionate interest,³⁴ and were there any circumstances surrounding a particular distribution which affected the operation of the rule?³⁵

THE 1954 CODE AND REGULATIONS THAT FOLLOWED

When Congress undertook to amend the internal revenue laws in 1954, they were fully aware of the complexities surrounding the application of the rules determining the taxability of stock dividends.³⁶

tionate interests in the assets of the corporation as did the old." Three examples followed this statement, one identical to the situation in *Griffiths*. The Treasury concluded by saying; "The stock so distributed does not constitute a taxable stock dividend to the shareholder. See also I.T. 3037, 1937-1 CUM. BULL. 90.

31. 298 U.S. 441 (1936).

32. Frank J. Kelly Trust, 38 B.T.A. 1014 (1938) where a dividend of preferred stock was made to common shareholders when prior to the dividend only common stock was outstanding. Cf. *Lamberth v. Commissioner*, 120 F.2d 101 (9th Cir. 1941); *Emil Strassburger*, B.T.A. Op. Dkt. 100303 (1941), aff'd 124 F.2d 315 (2d Cir. 1941). *John M. Keister*, 42 B.T.A. 484 (1940) where a nonvoting common stock dividend to common stockholders was declared where some shareholders had, and others did not have voting rights, and no other classes of stock were outstanding. A dividend in nonvoting preferred was also declared on both classes.

33. *Sprouse v. Commissioner*, 318 U.S. 604 (1943); *Strassburger v. Commissioner*, 318 U.S. 604 (1943). In *Sprouse* a dividend of nonvoting common stock was distributed equally to the holders of voting and nonvoting common stock. In *Strassburger*, a dividend of preferred stock was declared when only common stock was outstanding. The Court held that there was no change in ownership, the taxpayer owned both before and after the dividend exactly the same interest in the net value of the corporation as before.

34. *Edwin L. Weigard*, 14 T.C. 196 (1950), where the corporation had two classes of stock, and declared a 50% dividend to each class in like stock. The Commissioner claimed that while there was no immediate change in proportionate interest, there would be such a change in the future. The Court said the dividend was taxable, but the 7th Circuit reversed, stating while one class was better off, the other class became worse off, and the sum total of the shareholder's rights did not change. *rev'd on other grounds sub nom. Tourtelot v. Commissioner*, 189 F.2d 167 (7th Cir. 1951); Tax Court decision *rev'd*, 194 F.2d 479 (3d Cir. 1952).

35. See, e.g., *Frank J. Kelly Trust*, 38 B.T.A. 1014 (1938).

36. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. (1954), p. 33. "The existing law with respect to corporate distributions . . . is so confused that taxpayers can not plan transactions with any degree of certainty."

In an effort to liberalize those rules, and eliminate future litigation, the law was returned to the state in which it existed between 1921 and 1936. Section 305(a) of the 1954 code provided that, subject to the two exceptions provided in § 305(b) where a distribution was "in lieu of money," neither stock dividends nor stock rights would be subject to tax.³⁷ This change expressed congressional recognition of the principle that so long as the shareholder's interest remained in corporate solution, there was no appropriate occasion to impose a tax.³⁸ With the elimination of the proportionate interest test, the imposition of any tax was postponed through the application of the pertinent basis provisions.³⁹

Section 305(b) provides two exceptions to the general rule, so that any distributions of stock or rights to acquire stock in lieu of money (either in discharge of certain preference dividends, or at the election of any shareholder) renders the dividend taxable.⁴⁰ Section 305(b)(2) had its origin in § 115(f)(2) of the 1936 Revenue Act and was substantially identical to that earlier provision.⁴¹ It provided that an option given to any shareholder to receive either cash or property in kind, rather than stock distributions, destroyed the exemption provided in § 305(a). Section 305(b)(1) on the other hand was a new provision in 1954, and stated that any distribution in discharge of

37. Int. Rev. Code of 1954, § 305(a), 68 Stat. 90, (1954). (a) General Rule.—Except as otherwise provided in subsection (b), gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock.

38. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. (1954), p. 35. "Your committee's policy is implemented by allowing the distribution or exchange of equity interests in a corporation to the greatest extent possible. As long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax."

39. S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954), p. 44. Generally restating the language of the House Report in note (38) above, and adding "Accordingly the general rule is that no tax is imposed upon the distribution of stock right and stock dividends whether or not a particular shareholder's proportionate interest in the corporation is varied, but rather is postponed through application of the pertinent basis provisions."

40. INT. REV. CODE OF 1954 § 305(b), 68 Stat. 90, (1954).(b) *Distributions in lieu of money*—Subsection (a) shall not apply to a distribution by a corporation of its stock (or rights to acquire its stock), and the distribution shall be treated as a distribution to which section 301 applies—

(1) to the extent the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year; or

(2) if the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either—

A) in its stock (or in rights to acquire its stock), or

B) in property.

41. Revenue Act of June 22, 1936, ch. 690, § 115(f)(2), 49 Stat. 1648, (1954). Reproduced at note (16).

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preference dividends for the taxable year or the preceeding taxable year also destroyed the exemption provided in § 305(a).⁴²

Subsequent to the enactment of the 1954 Code, the Treasury Department issued proposed regulations under § 305(b)(2) relating to an election of the medium of payment.⁴³ These regulations were substantially identical to those issued under § 115(f)(2) of the 1936 Act,⁴⁴ and clearly limited taxation of stock dividends to those situations where the shareholder had an election to receive stock or cash in any particular distribution. In determining the existence of an election, the

42. INT. REV. CODE OF 1954, § 305(b), 68 Stat. 90, (1954). Reproduced at note 40.

43. Reg. § 1.305-2(a).

§ 1.305-2 Election of shareholders as to medium of payment

(a) If any shareholder has the right to an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire stock of the distributing corporation, then, with respect to all shareholders, the distribution of stock or rights to acquire stock shall be considered as a distribution of property to which section 301 applies regardless of—

(1) Whether the distribution is actually made in whole or in part in stock or in stock rights;

(2) Whether the election or option is exercised or exercisable before or after the declaration of the distribution;

(3) Whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other; or

(4) Whether all or part of the shareholders have the election.

(b) The application of the above rule may be illustrated by the following example:

Example. Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus \$12 principal amount of securities of Corporation Y owned by Corporation X. The fair market value of the stock of Corporation X on the distribution date was \$10 per share. The fair market value of \$12 principal amount of securities of Corporation Y on the distribution date was \$11 but such securities had a cost basis to Corporation X of \$9. The distribution of the second share of stock of Corporation X to those shareholders who do not elect to receive securities of Corporation Y will constitute a distribution of property to which section 301 applies whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies will be \$10 per share of stock of Corporation X held on the record date (the fair market value of the stock of Corporation X on the distribution date). The distribution of securities of Corporation X in lieu of the second share of stock of Corporation X to the shareholders of Corporation X, whether individuals or corporations, who elect to receive such securities, will also constitute a distribution of property to which section 301 applies. Thus, in the case of the individual shareholders of Corporation X who elect to receive such securities, the amount of the distribution to which section 301 applies will be \$11 per share of stock of Corporation X held on the record date (the fair market value of the \$12 principal amount of securities of Corporation Y on the distribution date). In the case of the corporate shareholders of Corporation X elected to receive such securities, the amount of the distribution to which section 301 applies will be \$9 per share of stock of Corporation X held on the record date (the basis of the securities of Corporation Y in the hands of Corporation X). The receipt by either an individual or corporate shareholder of the one additional share of stock of Corporation X (with respect to which no election applies) for each share held will not result in a distribution of property to such shareholder to which section 301 is applicable.

44. Reg. 94, Art. 115-8. (1936).

regulations provided that it made no difference whether the distribution was made in whole or in part, in stock or in rights, whether exercised or exercisable before or after the declaration, whether the declaration provided that payment would be made in one designated medium if an election was not made, and whether all or part of the shareholders had the election.

Shortly after these regulations were announced, the Revenue Service issued a private ruling to the Citizens Utility Company wherein they took the position that even though the shareholders in question were given an election as to the medium of payment of the dividend they would receive, the stock dividends so declared would not be subject to tax under the provisions of § 305. Citizens Utility had reorganized its common stock into two classes, identical but for the fact that management in its discretion could declare, in respect to either class, or both classes, cash, property or stock dividends in class A common stock. Management indicated that it intended to declare only cash dividends with respect to the class B stock, and only stock dividends with respect to the class A stock, although there were no restrictions with respect to dividends on either class. In addition the plan permitted the present shareholders to elect which class they would take in the exchange. The stock dividend payable on the class A would be equated annually to the cash dividend payable on the class B; the class A was convertible into class B at any time, but not vice-versa; and no exchange could be made during the period between the declaration date and the date of record for the cash dividends.⁴⁵ This ruling, which was widely publicized, provided quite a stimulus to the sale of the corporation's securities, which now offered a very attractive package to high bracket taxpayers. In addition to the conversion privilege and tax free dividend, the stock provided a great deal of flexibility in permitting an expansion or change in ownership.

Following the announcement of the Citizens Utility ruling, many other corporations applied for approval of similar plans, but the Service refused to issue any further rulings under § 305. They even threatened to reverse their position in the earlier private ruling, but to this day it has not been revoked.

After further consideration, new regulations were proposed on July 10, 1956 which clearly indicated that the Service would take the opposite position in any situation similar to that in the Citizens

45. 5 Journal of Taxation 312 (1956); Lee, *The Stock Dividend*, 37 Taxes 959 (1959).

Utility ruling.⁴⁶ These proposed regulations provided that § 305(b) would apply to those distributions where there is or was an election of the medium of payment before or after the declaration date. Where there was such an election, the distribution had the effect of a dividend of property which the shareholder could have received, and a purchase of stock with that property. Accordingly, the dividend was taxable. Section 1.305-2(b) describing the nature of the election provided as follows:

(1) Section 305(b)(2) refers to every election whether express or implied, regardless of how or when exercised or exercisable. An election is a choice to receive payment in one medium or another. It is immaterial when such choice arises and when it is exercisable. Thus, for example, § 305(b)(2) applies when any shareholder is given his choice as to medium of payment of dividends by the terms of the corporate charter even though, as to any particular distribution, this choice cannot be exercised after the declaration date. A choice to receive payment in one medium or another may arise out of the terms of the declaration, the provisions of the corporate charter, the provisions of the stock certificates or the circumstances of the transaction. A choice may be exercisable directly or indirectly through action by the shareholder or through his failure to act. Accordingly, there is an election where (i) a dividend is paid in cash to some holders of common stock and in stock of the corporation to the remaining holders of common stock and (ii) the shareholders who receive stock have the right to demand cash or have waived this right. It is immaterial whether the right to demand cash was waived before or after the declaration date, by private agreement, by the terms of the charter, or otherwise. Where a corporation having two classes of common stock outstanding, with respect to which dividends may be paid in stock on one class and in money (or other property) on the other class, makes a distribution (or a series of related distributions) in money (or other property) as to one class and in stock as to the other, the distribution of the stock is not under § 305(a) since there is a choice as to the medium of payment of any distribution by virtue of the existence of the two classes of common stock.

Apparently the Commissioner felt that the mere existence of a two class stock arrangement gave the shareholder an election as to the medium of payment when he purchased his stock. As a result of

46. 21 Fed. Reg. 5104.

the Commissioner's interpretation, these regulations received much criticism⁴⁷ and remained in proposed form for almost four years.

On July 1, 1960, the Federal Register announced that, after consideration of all of the relevant matters concerning the proposed regulations, certain amendments were adopted.⁴⁸ The amendments adopted did not relate to the proposed regulations pertaining to the election provisions as set forth in the earlier proposals, but rather amended § (c) of Reg 1.305-2.⁴⁹ The notice went on to provide that both para-

47. See, e.g., Lee, *The Stock Dividend*, 37 *Taxes* 959 (1959).

48. 25 Fed. Reg. 6183. "The amendments adopted do not include regulations pertaining to the election by shareholders as to the medium of the payment of a dividend and the nature of an election as set forth in proposed paragraph (a) and (b) of § 1.305-2 of . . . (21 Fed. Reg. 5104) . . . except the last sentence in subparagraph (1) thereof and paragraph (b) of § 1.305-2 continue in effect and will be given further consideration before final action is taken thereon.

49. Proposed Reg. 1.305-2(c).

§ 1.305-2 Election of shareholders as to medium of payment.

(a) *General.* * * *

(b) [Reserved]

(c) *Amount of distribution.* (1) Where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b)(2) the amount of the distribution, in accordance with section 301(b) and § 1.301-1, is the fair market value of such stock or rights on the date of distribution. Accordingly, where a corporation makes a distribution, to which section 305(b)(2) is applicable, which is payable either in property or in its own stock or rights to acquire its stock the amount distributed with respect to all shareholders receiving stock or rights is the fair market value, on the date of distribution, of the stock or rights received. The amount distributed with respect to shareholders receiving property is the fair market value, on the date of distribution, of such property received or, in the case of corporate distributees, the adjusted basis of such property in the hands of the distributing corporation if less than its fair market value. Where a corporation which regularly distributes its earnings and profits such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value and, on a date shortly before the distribution, there is a determination of the amount of stock to be distributed to those shareholders who elect to receive stock equal in value to the amount of money that could be received instead, the amount of the distribution of the stock received by any shareholder will be considered to equal the amount of the money which could have been received instead.

(2) The application of section 305(b) may be illustrated by the following examples:

Example (1). (i) Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus \$12 principal amount of securities of Corporation Y owned by Corporation X. The fair market value of the stock of Corporation X on the distribution date was \$10 per share. The fair market value of \$12 principal amount of securities of Corporation Y on the distribution date was \$11 but such securities had a cost basis to Corporation X of \$9.

(ii) The distribution to all shareholders of one additional share of stock of Corporation X (with respect to which no election applies) for each share outstanding is not a distribution to which section 301 applies.

(iii) The distribution of the second share of stock of Corporation X to those shareholders who do not elect to receive securities of Corporation Y is a distribution of property to which section 301 applies, whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies is \$10 per

Comments

graphs (a) and (b) were to continue in effect under the earlier proposals, and that they would be given further consideration before final action would be taken. It appears that the proposals were merely an effort to frighten off any attempts to implement plans similar to Citizens Utility, and since they clearly were not supported by the law, they remained in proposed form for about 8 years.

After the proposed regulations were published, the Mills Advisory Group on Subchapter C commenced a study of the various revenue provisions. In 1957, and again in 1958, the Advisory Group recommended amendments to § 305 which provided for the imposition of a tax on stock dividends paid on common stock in any case where cash dividends were also paid on common stock of the same corporation, regardless of whether or not any shareholder had an election as to the medium of payment. In response to the substantial amount of criticism regarding their original proposals, the final recommendation was a return to the proportionate interest test in order to avoid any constitutional issue. Throughout the course of their investigation, the Advisory Group maintained the position that the entire area was one for Congress to consider as a matter of legislative policy, rather than to be left to the Treasury as an administrative decision.⁵⁰ At no time, however, did Congress act upon the recommendations of this Advisory Group.

share of stock of Corporation X held on the record date (the fair market value of the stock of Corporation X on the distribution date).

(iv) The distribution of securities of Corporation Y in lieu of the second share of stock of Corporation X to the shareholders of Corporation X, whether individuals or corporations, who elect to receive such securities, is also a distribution of property to which section 301 applies.

(v) In the case of the individual shareholders of Corporation X who elect to receive such securities, the amount of the distribution to which section 301 applies is \$11 per share of stock of Corporation X held on the record date (the fair market value of the \$12 principal amount of securities of Corporation Y on the distribution date).

(vi) In the case of the corporate shareholders of Corporation X electing to receive such securities, the amount of the distribution to which section 301 applies is \$9 per share of stock of Corporation X held on the record date (the basis of the securities of Corporation Y in the hands of Corporation X).

Example (2). On January 10, 1960, Corporation X, a regulated investment company, declared a dividend of \$1 per share on its common stock payable on February 11, 1960, in cash or in stock of Corporation X of equivalent value determined as of January 22, 1960, at the election of the shareholder made on or before January 22, 1960. The amount of the distribution to which section 301 applies is \$1 per share whether the shareholder elects to take cash or stock and whether the shareholder is an individual or a corporation. Such amount will also be used in determining the dividend paid deduction of Corporation X and the reduction in earnings and profits of Corporation X.

50. Ways and Means Committee, 86th Cong., 1st Sess. (1959) Report of Advisory Group Committee on Subchapter C, December 24, 1957. Revised Report of Advisory Group Committee on Subchapter C, December 11, 1958. Summary of Advisory Group Committee on Subchapter C (1959).

THE 1968 PROPOSED REGULATIONS

The next development came in September 1968 when the Treasury issued new proposed regulations, broader in scope than those which they replaced.⁵¹ Section 1.305-2(a) was amended but retained in substance the provisions of the earlier proposals. Subsection (1) provided that under § 305(b)(2) any distribution with respect to which there is or has been an election by any shareholder as to medium of payment, made either before or after the declaration date, would be treated as if the shareholder received a dividend in property and used the property to purchase stock; a taxable transaction.⁵² Subsection (2) basically remained the same.⁵³ One major change occurred in § 1.305-2(b), which was altered to read as follows:

(b) *Nature of election.* (1) Section 305(b)(2) refers to every election, whether express or implied, regardless of how or when exercised or exercisable. An election is a choice to receive payment in one medium or another. The point in time at which such choice is made, whether before or after the declaration, is immaterial as long as at some point in time any shareholder, either by action or inaction, has made a choice which permitted the corporation to distribute stock or stock rights with respect to some shares and money or other property with respect to other shares. A choice to receive payment in one medium or another may arise out of the terms of the declaration, the provisions of the corporate charter, the provisions of the stock certificates, or the circumstances of the transaction. A choice may be exercisable directly or indirectly through action by the shareholder or through his failure to act. For example, if some of the shareholders agree, expressly or impliedly, to accept distributions in stock or stock rights with respect to their common stock notwithstanding the distribution of money or other property with respect to other common stock, any distributions of stock or stock rights with respect to some but not all of the corporation's common stock would be outside § 305(a). Similarly, it is immaterial whether the right to demand cash was waived before or after the declaration date, by private agreement, by terms of the charter, or otherwise. Where a corporation having two types of common stock outstanding with respect to which dividends may be paid in stock to one type and in money (or other property) on the other type, makes a distribution (or series of related distributions) in money (or other property) as to one type and in stock (or

51. 33 Fed. Reg. 12744.

52. Proposed Reg. 1.305-2(a)(1).

53. Proposed Reg. 1.305-2(a)(2).

rights to acquire stock) as to the other, the distribution of stock is not under § 305(a) since, in substance, there is a choice as to the medium of payment by virtue of the existence of the two types of common stock shares of either of which may be exchanged for shares of the other under § 1036 without recognition of gain or loss.⁵⁴

The other major change occurred in § 1.305-3, which was revised to read as follows:

§ 1.305-3 Distribution in discharge of preference dividends.

(a) A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a distribution of property to which § 301 applies to the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year.

(b) If, in the case of a corporation having two or more classes of outstanding stock, the terms of class require, in all events, annual distributions with respect to it of stock or rights to acquire stock, then the stock of such class is preferred stock. Such a distribution of stock or rights to acquire with respect to the preferred stock is a distribution made in discharge preference dividends.⁵⁵

Section 1.305-2(b)(1) made the election exception applicable whenever a corporation with two types of common stock outstanding, and as part of a series of related distributions, declared stock dividends on one type, and cash dividends on the other, whether or not a shareholder (not necessarily the one receiving stock) had at any time any choice which enabled the corporation to pay the two types of dividends. Under the proposals this rule could also be extended to include a shareholder who at any time either purchased or inherited the type which paid stock dividends, even though he never actually exercised any election as to the medium of payment.

The operation of the election rules may be illustrated by the following examples:

1. A corporation pursuant to a recapitalization under § 368(a)(1)(E) gave its shareholders a choice between taking either class A or class B common stock in exchange for their shares. Dividends were to be paid in stock or cash on either class without regard to the medium of payment of dividends on the other class. In any case where a stock divi-

54. Proposed Reg. 1.305-2(b)(1).

55. Proposed Reg. 1.305-3.

dend was declared on one class and a cash dividend was declared on the other class, the stock dividend was taxable.⁵⁶

2. The ABC corporation, pursuant to a stock for stock exchange under § 368(a)(1)(B), acquires all the stock of XYZ corporation in exchange for class B common stock, convertible at the shareholder's election into one share of class A stock. At the beginning of each subsequent year the conversion ratio is increased by a fixed percentage (e.g., .04: year 1 = 1.04 shares; year 2 = 1.08 shares; etc.). Whenever the cash dividend paid on class A is less than \$1.00, the increase in conversion ratio is decreased by an amount proportionate to the difference between the cash dividend and \$1.00. At any time the conversion ratio is increased, the shareholder is deemed to have received a taxable right to acquire stock.⁵⁷

3. ABC corporation, pursuant to a stock for stock exchange under § 368(a)(1)(B), acquires all of the outstanding stock of corporation XYZ in exchange for new class B voting stock, convertible into one share of class A stock. In accordance with a specific formula, the conversion ratio is decreased each time a cash dividend is paid on either class by an amount which reflects that cash dividend. Whenever the conversion ratio on the class B stock is decreased, a taxable distribution is considered as having been made to the holders of the class A stock, reflecting each share's increased equity.⁵⁸

Section 1.305-3 provided that the preference dividend exception applied whenever a corporation had more than one class of stock outstanding and one of the classes was in all events entitled to receive annual dividends in stock or stock rights. For example, where the terms of one class of stock provided that a dividend of the other stock would be made annually, regardless of whether the other class was entitled to receive a dividend in any form, the former class is preferred; and any distribution is taxable as made in discharge of preference dividends.⁵⁹ In addition, if the class B stock is convertible at any time into class A stock at an increasing conversion ratio, any increase in that ratio is considered to be a distribution of rights to acquire class A stock; and since class B is considered to be preferred that distribution is taxable.⁶⁰

56. Proposed Reg. 1.305-2(b)(2). Examples 1 and 2.

57. Proposed Reg. 1.305-2(b)(2). Example 3.

58. Proposed Reg. 1.305-2(b)(2). Example 4.

59. Proposed Reg. 1.305-3. Example 1.

60. Proposed Reg. 1.305-3. Example 2.

The Treasury's new proposals were severely criticized⁶¹ on the ground that they were not authorized by the statutory language of § 305(b)(2).⁶² The regulations gave the broadest definition possible to the term "election"; and as a result, the statute was extended to cover a variety of situations where in fact the shareholder had no choice whatsoever as to the medium of payment. The regulations stated the Treasury's position to be that the mere existence of two classes of stock gave the shareholder the election contemplated by the statute because he could purchase one class or the other. However, there are many situations where a shareholder may have acquired his stock without the ability to make that choice. For example, suppose the shareholder inherited the stock or unknowingly purchased it, unapprised of the fact it was "tainted" because someone before him decided to purchase the class which paid stock rather than cash dividends.

The term "election" presupposes a choice; and a more appropriate reading of the statute would seem to be that the election referred to was one made with respect to a particular distribution of stock or property, the only distribution which can occur at a dividend declaration. This interpretation is supported by the history of § 305 which shows the source of the clause "whether exercised before or after the declaration thereof" and refers to the election of a shareholder to be paid in either cash or stock with respect to a particular distribution only. The regulations imply that the mere existence of two classes of stock are sufficient to impute the election to receive stock or cash dividends, but there are some situations where a corporation may have two classes of stock yet the shareholder has no choice. For example,⁶³ suppose that pursuant to a merger the shareholders of the acquiring corporation do not want to give the shareholders of the acquired corporation the same stock as is presently outstanding. A new stock is created, class B, which pays an annual stock dividend of class B stock which is equivalent to the cash dividend paid on the class A stock. The only choice the shareholders of the acquired corporation have is whether to take the stock or abandon the merger. "An election is a choice to receive payment in one medium or another,"⁶⁴ and an

61. See generally Comments against the proposed regulations submitted by Levenfeld, Kanter, Baskes & Lippitz, dated Oct. 7, 1968; Covington and Burling, dated Oct. 7, 1968; Miller and Chevalier, dated Oct. 15, 1968, on file with the Internal Revenue Service. See also Levin, *New 305 Regs limit tax advantages of 2-class common stock, but alternatives exist*, *Journal of Taxation*, Jan. 1969 at 2.

62. INT. REV. CODE OF 1954, § 305(b)(2).

63. Levin, *supra*, note 61.

64. Proposed Reg. 1.305-2(b)(1).

exchange of stock pursuant to a reorganization is not a distribution but an exchange; and the election requirement is satisfied if at any time any shareholder of the corporation made a choice, either by action or inaction which permitted the corporation to distribute stock or stock rights with respect to some shares and cash or property with respect to others.⁶⁵ Thus, was a choice necessary, or did the mere existence of the two classes invoke the exception?

The regulations seemed to reinstate the proportionate interest test in direct contravention to Congressional policy when § 305 was enacted. Congress had specifically rejected the idea of taxing all changes in proportionate interest and instead provided that so long as the shareholder's interest remained in corporate solution no tax would be imposed. Under the regulations the exceptions became the general rule; and a return to prior law taxing any distribution of stock or change in conversion ratio of one class of stock, which, when coupled with a cash dividend on another class, worked a change in proportionate interest. The basis for this tax appears to be that the shareholder has an increased but unliquidated share in the corporation's retained assets. This appears to resemble the amendments of the Mills Advisory Committee, suggested in 1958 and 1959, but rejected as being a return to the pre-1954 law—the proportionate interest test.

In addition, the regulations disregarded the principles announced in *Towne v. Eisner*⁶⁶ and *Eisner v. Macomber*,⁶⁷ which have never been overruled either judicially or legislatively and which must be respected. These cases announced the principle that a common stock dividend on common stock could not be taxed because there was no change in proportionate interest. The regulations provided that the requisite election may be made by the terms of the corporate charter. If these terms constituted an election under 305(b)(2), then any declaration of stock dividends on one class and of cash dividends on the other would be taxed even though the dividend did not change the proportionate interest of the shareholder, an interpretation which is clearly unconstitutional.

As previously mentioned, it appeared that the new regulations would have great impact on the shareholder who unknowingly purchased or otherwise obtained "tainted" stock. This shareholder would

65. Proposed Reg. 1.305-2(b)(1).

66. 245 U.S. 418 (1918).

67. 252 U.S. 189 (1920).

be taxed on his stock even though he never made any election; but at some point in time someone made a choice which created the two classes of stock, one of which paid stock dividends. For example, assume that a closely held corporation has two classes of stock, neither of which is convertible into the other. Class B stock is only entitled to dividends in like stock. The corporation decides to offer the class B stock to the public, and an investor purchases the stock. Assuming that a cash dividend is paid to the holders of class A stock, any dividend to the investor is taxable. Those who were shareholders prior to the public offering made the election at the time of incorporation, and the investor made the election by choosing to purchase that class of stock.⁶⁸ "A choice may be exercisable directly or indirectly through action by the shareholder or through his failure to act."⁶⁹

In addition, according to the regulations all stock dividends became subject to tax without regard to the timing of the corresponding cash dividend merely because of the existence of two classes of common stock. For example, suppose a corporation has two classes of stock, class A and B, neither of which is convertible. Class A is entitled to cash at the discretion of the directors, and class B is entitled to either cash or stock at the director's discretion. At the end of year one, a cash dividend is paid on class A and a stock dividend is paid on class B, and is taxable according to the regulations. However, suppose that only class A received a dividend, but at the end of the second year class B received a stock dividend; or that no dividends were paid to either class until the 15th year, when only the holders of class B received a stock dividend. Or, suppose the reverse; cash dividends were paid on class A the second year, and no stock dividends were paid on class B until the fifth year. Under the regulations all stock dividends were taxable without regard to the timing of the corresponding cash dividend, deemed an election by the existence of two classes of stock, where in fact the only choice was exercised by the board of directors.⁷⁰

On January 10, 1969, the proposals made by the Treasury to amend the regulations under § 305 were adopted.⁷¹ Only minor changes oc-

68. Levin, *supra*, note 61.

69. Proposed Reg. 1.305-2(b)(1).

70. See comments against proposed regulations submitted by Levenfeld, Kanter, Baskes and Lippitz, Oct. 7, 1968, on file with I.R.S.

71. T.D. 6990, approved January 10, 1969.

"§ 1.305-2 Election of shareholders as to medium of payment.

(a) *General.* (1) Section 305(b)(2) describes certain distributions by a corporation to its shareholders of its stock or rights to acquire its stock which are not within the terms of section 305(a). The distributions described in section 305(b)(2) are distribu-

curred in § 1.305-2, but two paragraphs were added to § 1.305-3. The general rule of § 1.305-3 was retained. It provided that where a

tions with respect to which there is or has been an election as to the medium of payment by any shareholder before or after the declaration date. Where such an election exists, the distribution of the corporation's stock or rights to acquire its stock is not a distribution under section 305(a).

"(2) A distribution by a corporation to its shareholders of its stock or rights to acquire its stock is not under section 305(a) if any shareholder may exercise or has exercised an election or option with respect to whether a distribution shall be made either in money or any other property, or in stock or rights to acquire the stock of the corporation, regardless of—

"(i) Whether the distribution is actually made in whole or in part in stock or in stock rights;

"(ii) Whether the election or option governing the nature of the distribution is exercised or exercisable before or after the declaration of the distribution;

"(iii) Whether the declaration of the distribution provides that the distribution will be made in one medium unless the shareholder specifically requests payment in the other;

"(iv) Whether the election governing the nature of the distribution is provided in the declaration of the distribution or in the corporate charter or arises from the circumstances of the distribution; or

"(v) Whether all or part of the shareholders may exercise or have exercised an election that will determine the nature of the distribution.

"(b) *Nature of election.* (1) Section 305(b)(2) refers to every election, whether express or implied, regardless of how or when exercised or exercisable. An election is a choice to receive payment in one medium or another. The point in time at which such choice is made, whether before or after the declaration, is immaterial as long as at some point in time any shareholder, either by action or inaction, has made a choice which permitted the corporation to distribute stock or stock rights with respect to some shares and money or other property with respect to other shares. A choice to receive payment in one medium or another may arise out of the terms of the declaration, the provisions of the corporate charter, the provisions of the stock certificates, or the circumstances of the transaction. A choice may be exercisable directly or indirectly through action by the shareholder or through his failure to act. For example, if some shareholders agree, expressly or impliedly, to accept distribution in stock or stock rights with respect to their common stock notwithstanding the distribution of money or other property with respect to other common stock, any distributions of stock or stock rights with respect to some but not all of the corporation's common stock would be outside the provisions of section 305(a). Similarly, it is immaterial whether the right to demand cash was waived before or after the declaration date, by private agreement, by the terms of the charter, or otherwise. Where a corporation having two types of common stock outstanding, with respect to which dividends may be paid in stock on one type and in money (or other property) on the other type, makes a distribution (or series of related distributions) in money (or other property) as to one type and in stock (or rights to acquire stock) as to the other, the distribution of the stock is not under section 305(a) since, in substance, there is a choice as to the medium of payment of any distribution by virtue of the existence of the two types of common stock, shares of either of which may be exchanged for shares of the other under section 1036 without recognition of gain or loss.

"(2) The application of the above rules may be illustrated by the following examples:

"*Example (1).* Pursuant to a recapitalization (to which section 368(a)(1)(E) applies) all of the outstanding shares of common stock of corporation X are surrendered in exchange for Type A common stock and Type B common stock. Some shareholders choose to receive only Type A stock, some shareholders choose to receive only Type B stock, and some shareholders choose to receive some of each. Dividends may be paid in stock or in cash on either type of stock without regard to the medium of payment of dividends on the other type. A dividend is declared upon the Type A stock payable in additional shares of Type A stock and a dividend is declared on the Type B stock payable in cash. Section 305(a) does not apply to the stock distributed to the Type A shareholders.

corporation had two or more classes of stock outstanding, and the terms of one class required in all events, a periodic distribution of

“Example (2). Pursuant to a recapitalization (to which section 368(a)(1)(E) applies) all of the outstanding shares of common stock of corporation *Y* are surrendered in exchange for Type A common stock and Type B common stock, every shareholder receiving one share of Type A stock and one share of Type B stock in exchange for each share of the common stock surrendered by him. Dividends may be paid in stock or in cash on either type of stock without regard to the medium of payment of dividends on the other type. After the recapitalization, and before any of the Type A or Type B stock has been transferred, a dividend is declared on the Type A stock payable in additional shares of Type A stock and a dividend is declared on the Type B stock payable in cash. Section 305(a) does not apply to any of the stock distributed to the Type A shareholders. The same result would follow if, before the dividend declaration, some of the Type A or Type B stock had been transferred.

“Example (3). (i) On January 1, 1969, pursuant to a reorganization to which section 368(a)(1)(B) applies, corporation *N*, which has only Type A common stock outstanding, acquires all of the outstanding stock of corporation *M* solely in exchange for its newly issued Type B voting common stock. Each Type B share may be converted, at the option of the holder, into Type A shares. During the first year following the reorganization, the conversion ratio is one share of Type A stock for each share of Type B stock. At the beginning of each subsequent year, the conversion ratio is increased by 0.04 shares of Type A stock for each share of Type B stock. Thus, during the second year the conversion ratio would be 1.04 shares of Type A stock for each share of Type B stock, during the third year the ratio would be 1.08 shares, etc. However, if the cash dividend paid on the Type A stock in any one year is less than \$1.00 per share, then the increase in the conversion ratio that would otherwise occur at the beginning of the following year will be reduced by an amount which is proportionate to the amount by which such dividend falls short of the \$1.00 per share.

(ii) During 1969, a \$0.50 cash dividend per share is declared and paid on the Type A stock of corporation *N*. On January 1, 1970, when the conversion ratio is increased to 1.02 shares of Type A stock for each share of Type B stock, a distribution is considered as made with respect to each share of Type B stock of a right to acquire 0.02 shares of Type A stock. Section 305(a) does not apply to the distribution of this right.

“Example (4). (i) On January 1, 1969, pursuant to a reorganization to which section 368(a)(1)(B) applies, corporation *P*, which has only Type A common stock outstanding, acquires all of the outstanding stock of corporation *O* solely in exchange for its newly issued Type B voting stock. Each Type B share is convertible, at the option of the holder, into one share of Type A stock. However, in accordance with a specified formula, this ratio is decreased each time a cash dividend is paid on the Type B stock to reflect the amount of the cash dividend. The conversion ratio is also adjusted in the event that cash dividends are paid on the Type A stock.

(ii) On December 31, 1969, a \$1.00 cash dividend per share is declared and paid on the Type B stock of corporation *P*. On such date, when the conversion ratio is decreased, a distribution of stock is considered as made with respect to each share of Type A stock reflecting each such share's increased equity in *P*. Section 305(a) does not apply to this distribution.

(3) If any corporation having two or more types of common stock outstanding makes a distribution (or series of related distributions) in money (or other property) as to one type and in stock (or rights to acquire stock) as to the other, the provisions of this section shall not apply to a distribution made on or before—

(i) December 31, 1968, or

(ii) December 31, 1990, if made with respect to stock outstanding on September 7, 1968 (including stock distributed, directly or indirectly, with respect to stock outstanding on September 7, 1968, if this section would have applied to the distribution but for the application of this subdivision).”

PAR. 2. Section 1.305-3 is revised to read as follows:

§ 1.305-3 Distributions in discharge of preference dividends.

(a) A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a distribution of property to which section 301 applies to the extent that the distribution is made in discharge of preference dividends

stock or stock rights, then that class of stock was a preferred stock, and any dividends (i.e., stock or stock rights) paid on that stock were considered as paid in discharge of preference dividends.⁷²

Three exceptions were hewed from this general rule. Subparagraph

for the taxable year of the corporation in which the distribution is made or for the preceding taxable year.

"(b) (1) If, in the case of a corporation having two or more classes of outstanding stock, the terms of one class require, in all events, periodic distributions with respect to it of stock or rights to acquire stock, then the stock of such class is preferred stock. Such a distribution of stock or rights with respect to the preferred stock is a distribution made in discharge of preference dividends.

"(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). On January 1, 1969, corporation X, a calendar year taxpayer, is organized. On such date, X has outstanding Class A and Class B stock. The terms of the Class B stock require that a distribution of one share of Class A stock be made annually with respect to each 20 shares of Class B stock. The Class A stock is not preferred as to dividends. During 1969, the required dividend in Class A shares is declared and paid on the Class B stock. The Class B stock is preferred stock, and the distribution of Class A shares is a distribution made in discharge of preference dividends for 1969.

Example (2). (i) On January 1, 1969, corporation Y, a calendar year taxpayer, is organized. On such date, Y has outstanding Class A and Class B stock. The Class A stock is not preferred as to dividends. The Class B stock may be converted, at the option of the holder, into Class A stock. During 1969, the conversion ratio is one share of Class A stock for each share of Class B stock. At the beginning of each subsequent year, the conversion ratio is increased by 0.05 shares of Class A stock for each share of Class B stock. Thus, during 1970 the conversion ratio would be 1.05 shares of Class A stock for each share of Class B stock, during 1971 the ratio would be 1.10 shares, etc.

"(ii) On January 1, 1970, when the conversion ratio is increased to 1.05 shares of Class A stock for each share of Class B stock, a distribution is considered as made with respect to each share of Class B stock of a right to acquire 0.05 shares of Class A stock. The Class B stock is preferred stock, and the distribution of rights on January 1, 1970 is a distribution made in discharge of preference dividends for 1970.

"(3) An increase in the conversion ratio with respect to convertible stock shall not be considered as a distribution for purposes of subparagraph (1) of this paragraph if—

"(i) Such increase is made solely to take account of a stock dividend or stock split with respect to the class of stock into which the convertible stock may be converted, or

"(ii) (a) The increase occurs within three years after the issuance of such convertible stock,

"(b) All such increases with respect to such stock must, under the terms of its issuance, occur within three years after its issuance, and

"(c) Such stock was not acquired, directly or indirectly, in exchange for stock which qualified for the benefits of this subdivision.

"(4) Subparagraph (1) of this paragraph shall not apply to a distribution with respect to stock transferred by the distributing corporation in exchange for the assets or stock of another corporation, provided that (i) such distribution represents an adjustment of the consideration transferred in the exchange, and (ii) all distributions reflecting such an adjustment must, under the terms of the exchange, be made within five years after the date of such exchange.

"(5) Subparagraph (1) of this paragraph shall not apply to a distribution made on or before—

"(i) December 31, 1968, or

"(ii) December 31, 1990, if made with respect to stock outstanding on September 7, 1968 (including stock distributed, directly or indirectly, with respect to stock outstanding on September 7, 1968, if this section would have applied to the distribution but for the application of this subdivision)."

72. Reg. 1.305-3(a) and (b).

§ 3 was added to provide an antidilution provision so that any increase in conversion ratio with respect to convertible stock would not be treated as a distribution in discharge of preference dividends, so long as the increase was made solely to account for a stock dividend or stock split with respect to the class into which the stock could be converted. A similar result obtained so long as 1) the increase occurred within three years after the convertible stock was issued, 2) all such increases were required by the terms of issuance to occur within three years of issue, and 3) the stock was not acquired directly or indirectly in exchange for convertible stock which was similarly qualified under the terms of this paragraph.⁷³

Subparagraph 4 was also added and provided that where the distributions were made with respect to stock transferred in exchange for the assets or stock of another corporation as an adjustment of the consideration transferred in the exchange and the distribution was made within five years of the exchange, the distribution would not be considered a discharge of preference dividends.⁷⁴

Subparagraph 5 provided the transitional rules by which the new regulations under § 1.305-3 would be implemented. The general rule of § 1.305-3 was not to apply to a distribution made on or before December 31, 1968, or December 31, 1990, if made with respect to stock outstanding or issued pursuant to a contract binding upon the distributing corporation on September 7, 1968.⁷⁵

CHANGES MADE BY THE TAX REFORM ACT OF 1969

The final regulations issued in January 1969 did not cover all the arrangements by which cash dividends could be paid to some shareholders while others received corresponding increases in their proportionate interests, such as in the case of a periodic redemption plan whereby a small portion of stock is redeemed annually at the shareholder's election. In addition, Congress was concerned with certain methods devised to give shareholders the equivalent of tax-free dividends. Congress felt that that these dividends should not go untaxed regardless of whether they were received in cash, stock, rights to acquire stock, or increased amounts upon redemption, and regardless

73. Reg. 1.305-3(b)(3).

74. Reg. 1.305-3(b)(4).

75. Reg. 1.305-3(b)(5).

of whether the dividend was attributable to current or preceding taxable years.⁷⁶

Recognizing that current law was ineffective to reach these methods and that any further attempt to extend the regulations would exceed the authority granted to the Commissioner, Congress enacted § 421 of the Tax Reform Act of 1969⁷⁷ to amend the provisions of § 305.

Section 305(a) retains the general rule of prior law:

Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation with respect to its stock.⁷⁸

The exceptions to the general rule are stated in § 305(b). Subsection 1 retains the rule of prior law relating to distributions in lieu of money and provides that whenever any shareholder had an election, either before or after the declaration, to take either cash or stock, the stock dividend will be taxed.⁷⁹ Subsection 2 deals with disproportionate distributions and provides that where there is an increase in a shareholder's proportionate interest in assets, earnings or profits resulting from a distribution in property to other shareholders, the stock dividend is taxed.⁸⁰ In its report, the Senate Finance Committee stated:

In determining whether there is a disproportionate distribution, any security convertible into stock is to be treated as outstanding stock. In addition, in determining whether there is a disproportionate distribution with respect to a shareholder, each class of stock will be considered separately.⁸¹

76. H.R. Rep. 91-413, p. A-120 (1969).

Example: A corporation may issue preferred stock for \$100 per share which pays no dividends but which may be redeemed in 20 years for \$200. The net effect is the same as if the corporation distributed preferred stock equal to 5% of the original stock each year during the 20 year period in lieu of cash.

77. The Tax Reform Act of 1969, P.L. 91-172, § 421 (1969).

78. INT. REV. CODE of 1954, § 305(a).

79. INT. REV. CODE of 1954, § 305(b)(1).

80. INT. REV. CODE of 1954, § 305(b)(2). H.R. Rep. 91-413, p. A-120 (1969).

Example: A corporation has two classes of common stock, one paying regular cash dividends, the other paying regular stock dividends equated to the cash dividends. The stock dividends will be taxable. On the other hand, if a corporation has a single class of common stock and a class of preferred stock which pays cash dividends and is not convertible, and it distributes a pro rata common stock dividend with respect to its common stock, the stock distribution is not taxable because the distribution does not increase the proportionate interests of the common stockholders.

81. S. Rep. P.L. 91-172, p. A-542 (1969).

Example: If a corporation has common stock and convertible debentures outstanding and it pays interest on the convertible debentures and stock dividends on the common stock, there is a disproportionate distribution and the stock dividends are taxable under § 301.

The House Report stated that for purposes of determining whether a distribution is in lieu of money or whether it is a disproportionate distribution, § 306 stock would be treated as property which is not stock.⁸² However there were problems with defining property in terms of § 306 stock. In addition, the inclusion of § 306 also created a problem under the election provisions of § 305(b)(1). If § 306 stock was treated as property, then only cash and property may be distributed, and there could be no election to take stock.

Since the Senate Committee was also trying to reach those situations where both preferred and common stock was issued, they added § 305 (b)(3), which provides that where some common shareholders receive a common stock dividend and other common stockholders receive a preferred stock dividend, the distribution is taxed.⁸³

Subsection 4 was also added by the Senate Finance Committee and provides that any distribution made on preferred stock, other than antidilution distributions on convertible preferred shares, will be taxed. The House also tried to reach distributions on preferred stock, but they had amended the general rule to provide that gross income did not include the amount of any distribution with respect to the *common* stock of such corporation. The Senate clarified their intentions by knocking the word common, and adding subsection 4.⁸⁴

Subsection 5 provides that any distributions of convertible preferred stock, except those which can be shown not to result in a disproportionate distribution, will also be taxed.⁸⁵

82. H.R. Rep. P.L. 91-172, p. A-120 (1969).

Example: If a corporation has two classes of common stock and a common stock dividend is declared with respect to one class, while a § 306 stock dividend is distributed with respect to the other class, both stock dividends are taxable.

83. INT. REV. CODE of 1954, § 305(b)(3), added by § 421, P.L. 91-172.

84. INT. REV. CODE of 1954, § 305(b)(4), added by § 421, P.L. 91-172. Note: According to Senator Long, in answer to a question regarding the classic type of Recapitalization to effectuate a change of control through § 368(a)(1)(E), as where an older shareholder exchanges some or all of his common voting stock for nonvoting preferred, and retires from the business while younger shareholders exchange preferred shares for voting common, and continue to be active in the business, this type of arrangement was not affected by the new provisions.

85. INT. REV. CODE of 1954, § 305(b)(5), added by § 421, P.L. 91-172, H.R. Rep. P.L. 91-413, p. A-120 (1969).

Example: Where a corporation makes a pro rata distribution on its preferred stock convertible into common stock at a price slightly higher than the market price of the common on the date of distribution and the period during which the stock may be converted is 4 months, it is likely that a distribution would have the result of a disproportionate distribution. These shareholders who wish to increase their interest in the corporation would convert their stock into common stock at the end of the 4 month period and those who wish to receive cash would sell their stock. On the other hand, if the stock is convertible for a period of 20 years after the date of issuance, there would be a likelihood that substantially all of the stock would be converted into

Section 305(c) has been added to give the Treasury authority over transactions which have the effect of distributions but in which no stock is issued.⁸⁶ Under regulations to be prescribed by the Treasury, any change in conversion ratio, redemption price, any difference between redemption price and issue price, any redemption treated as a § 301 distribution, or any other transaction (including a recapitalization) having a similar effect on the interests of any shareholder will be treated as a distribution which increases the shareholder's proportionate interests and will be taxed.⁸⁷ There are many ways in which the proportionate interests of the shareholder may be increased including the payment of stock dividends to some shareholders; an increase in the ratio at which stock, convertible securities or stock rights may be converted into stock of the same class presently held; and by the systematic redemption of stock owned by other shareholders. Since prior law did not govern the extent to which these increases were considered distributions of stock or rights to acquire stock, the Treasury is now authorized to prescribe regulations outlining when such transaction will be taxable, thereby eliminating the confusion and uncertainty in this area.⁸⁸

Congress also anticipates that rules will be established to determine when and to what extent the automatic increases in proportionate interests which accrue to a shareholder under a periodic redemption plan (to which § 301 applies) will be taxable. For example, such a plan exists where the corporation agrees to redeem a small portion of the shareholder's common stock at his annual election. Those shareholders who redeem their stock receive cash, while those who do not redeem receive an increase in their proportionate interests. The Senate Finance Committee Report indicates that by enacting § 305(c) Congress was not expressing the intention that the regulatory power be used to bring isolated redemptions within the disproportionate distribution rule of § 305(b)(2). For example, a 30% shareholder will not be

common stock, and there would be no change in the proportionate interest of the common shareholder.

86. INT. REV. CODE OF 1954, § 305(c), added by § 421, P.L. 91-172.

87. S. Rep. P.L. 91-172, p. A-543 (1969).

88. H.R. Rep. P.L. 91-413, p. A-120 (1969).

Example: If a corporation has one class of common stock outstanding paying no dividends and a class of preferred stock outstanding paying regular cash dividends, which is convertible into the common stock at a conversion ratio that decreases each year to adjust for the payment of the preferred dividends, it is anticipated that regulations will provide in appropriate circumstances that the holders of the common stock will be treated as receiving stock in a disproportionate distribution under § 305(b)(2).

treated as having received a constructive dividend because a 70% shareholder causes 15% of his stock to be redeemed.⁸⁹

The regulatory authority of § 305(c) is intended to apply to distributions on preferred as well as on common stock. Thus, where a corporation has issued a non-dividend preferred stock, convertible into common stock at an annually increasing ratio, it is anticipated the regulations will provide that the increase in conversion ratio constitutes a taxable distribution of a right to acquire stock to the convertible preferred shareholder. In addition, unless the increase is a reasonable call premium, it will be treated as a constructive dividend received by the shareholder over the period during which the preferred stock can not be called for redemption.⁹⁰

It is also intended that the regulations will provide that if pursuant to a recapitalization, a preferred shareholder receives an increase in proportionate interest by the receipt of additional shares of preferred stock in satisfaction of dividend arrearages, or by a constructive dividend resulting from payment of current dividends or arrearages, then § 305(b)(4) will apply whether or not the recapitalization is an isolated transaction and the distribution will be taxed.⁹¹

Section (c) was not intended to affect the characterization of any non-pro rata distribution made or considered made as compensation, an adjustment of purchase price, or as a gift to the recipient from the other shareholders.⁹²

The new provisions of § 305 become effective for new disproportionate distributions made or considered made after January 10, 1969, in tax years ending after that date. Where the stock distributed would not have been taxable under the existing regulations, April 22, 1969 is to be substituted for the January date.

In any case where stock was either outstanding or issued pursuant to a contract binding on January 10, 1969, § 305 will not apply to any dividends made with respect to that stock before January 10, 1991. A contract is considered binding if it binds the management on that date even though shareholder approval is not obtained until later. In addition, the disproportionate distribution rules do not apply to any dividends of stock or rights to acquire stock made or considered made before January 1, 1991, with respect to: a) stock which is additional

89. S. Rep. P.L. 91-172, p. A-544 (1969).

90. S. Rep. P.L. 91-172, p. A-543-4 (1969).

91. S. Rep. P.L. 91-172, p. A-544 (1969).

92. S. Rep. P.L. 91-172, p. A-544 (1969).

stock of the class having as of January 10, 1969, the largest fair market value of all outstanding classes of the corporation (including all outstanding stock or stock issued pursuant to a contract binding on January 1, 1969); b) preferred stock, convertible into stock meeting the requirements of (a) above, at a fixed conversion ratio which accounts for all stock splits and dividends with respect to the stock into which the convertible shares may be converted; and c) any stock issued in a prior distribution either outstanding or issued pursuant to a contract binding on January 10, 1969, or described in either (a) or (b) above.

If at any time after October 9, 1969, a corporation issues any stock (other than in a distribution of stock of the same class) which is not 1) non-convertible preferred; 2) additional stock of the class having the largest fair market value of the class subject to the transitional rules; or 3) preferred stock convertible into the class referred to in 2) above if it has full antidilution protection, any increase in conversion ratio of the convertible stock made before January 10, 1969 is not taxed if the stock was issued pursuant to terms in effect on January 10, 1969.⁹³

ANALYSIS OF THE 1969 CHANGES

The apparent purpose of § 305 is to place all the shareholders of a corporation on an equal footing so that a shareholder who has an option to take a dividend in stock or cash, or a shareholder who receives stock in discharge of a cash obligation no longer gains a tax advantage over the shareholder who receives cash. Formerly, the shareholder who received stock could turn around and sell that stock and whatever income he realized would generally be subject to tax at the favorable capital gains rates. This result was possible because the shareholder was able to "tack" the holding period of his old shares to the new shares, as well as allocate the basis of the old shares over the total shares now held. On the other hand, the shareholder who received cash realized ordinary income upon receipt and was taxed accordingly. In addition, the Treasury was also concerned about the potential revenue loss which results from the fact that a two class stock structure permits issuance of a stock which does not pay a cash dividend. Where the corporation has only one class of stock, and some of

93. S. Rep. P.L. 91-172, p. A-545-6 (1969).

the shareholders want cash while others want stock dividends, the corporation will generally pay cash dividends to all shareholders. With the two class stock structure, the problem is solved. The wealthy taxpayer buys a stock which gives him a tax free dividend, and the corporation distributes about one half of the cash it did under the one class arrangement. While there may be grounds for concern over this supposed revenue loss, a question remains as to whether the complexities created by the changes in the law are justified by this concern.

Much of the criticism directed toward the Treasury's proposed regulations in 1968 may similarly be directed toward the amended Code provisions. Section 305(b)(1) retains the language of the old provision regarding an election to take cash or stock. As pointed out earlier, this provision was originally thought to relate to an election as to a particular distribution only. However, the regulations gave the provision a much broader interpretation and extended the exception to include any distribution. Since the language of prior law has been retained, it is suggested that the regulations to be issued will no doubt be identical to the provisions of the 1969 regulations.

One of the reasons that § 305 was enacted in 1954 was to eliminate the complexities and the litigation which resulted from the attempts to apply the proportionate interest test. Section 305(b)(2) reinstates the proportionate interest test and will return us to problems which were faced under its administration prior to 1954. The first problem to be overcome concerns the meaning of the phrase "proportionate interest." The Committee reports offer no suggestion as to its interpretation. The statute provides that a change in proportionate interest is taxable only when it is related to a cash or property distribution, but the question remains when and to what extent will that relation be deemed to exist? And, where the relationship is found, to what extent will the change in proportionate interest be taxed and how will it be valued? Will it be the full value of the change, or only to the extent of the cash distributed? Changes in proportionate interest may come about in many ways, and while realized, may never be liquidated. In addition, while there may in fact be a change in proportionate interest, in reality the shareholder will receive nothing whatsoever. For example, how can taxable gain result from imputing a stock dividend to a shareholder who has 10 shares out of 35,000,000? If every change in proportionate interest now becomes taxable, such as when there is an increase in conversion ratio, what happens when

the conversion ratio goes down? Does the shareholder now get a loss? If conversion does not occur and the shareholder was taxed on the assumption that it would, does he now receive a loss? Or, what if he sold his stock during the interim?⁹⁴

In addition to the litigation which is sure to result from efforts to determine changes in proportionate interests, the amendments to § 305 have raised some constitutional issues which will have to be resolved. Under the decisions which were discussed earlier, stock dividends could not be taxed validly unless the result was a change in the shareholder's proportionate interest. Therefore, a common stock dividend to common shareholders could not be taxed where the common stock was the only class outstanding.⁹⁵ Neither could a tax be imposed on a distribution of preferred stock to common shareholders where the common stock was the only class previously outstanding.⁹⁶ In addition, a distribution of common stock to common shareholders where non-convertible preferred stock is outstanding can not be taxed.⁹⁷ Section 305 raises some new issues. Holders of convertible securities are treated as shareholders so that the interest paid on these securities can be equated to a cash dividend. Thus, where a common stock dividend is distributed to the common shareholders and interest is paid on the convertible securities, the stock dividend can be subject to tax. Where the convertible security is the only stock or security outstanding other than common stock, is this result valid? Similarly, if the convertible security is considered a convertible preferred stock, can a distribution of common stock to common shareholders validly be taxed? If the decisions of the Supreme Court are to be respected, it appears the answer in both cases should be "no." This conclusion is supported by the decision in *Choate v. Commissioner*, which held a distribution of rights to convertible preferred stock given to a common shareholder, there being preferred stock outstanding, were taxable.⁹⁸ If the convertible preferred had been treated as though it were actually common stock, it could not have been taxed validly.

Under §§ 305(b)(2) and 305(c), the Treasury is given a great deal of authority to determine whether certain transactions will give rise to

94. See, Tax Reform Act of 1969, P.L. 91-172, Hearings before the Committee on Finance, 91st Cong., 1st Sess. 2282 (1969). Statements of the Chairman of the Board of Litton Industries, dated September 16, 1969.

95. *Eisner v. Macomber*, 252 U.S. 189 (1920).

96. *Strassburger v. Commissioner*, 318 U.S. 604 (1943).

97. Treasury Department's Tax Reform Proposals of April 22, 1969, Example (2), p. 223.

98. *Choate v. Commissioner*, 129 F.2d 684 (1942).

taxable distributions. For example, a redemption which is treated as a distribution under § 301 may be determined to also give rise to a constructive dividend to any shareholder whose proportionate interests are thereby increased. The House Report gives an example of a periodic redemption plan which permits an annual election to have a small portion of stock redeemed. The language of the statute might permit the Treasury to go beyond an across the board election and determine that a 40% shareholder receives a constructive dividend when a 60% shareholder causes the corporation to redeem 10% of his stock. A similar result might obtain where in the case of a non-pro rata spin off or an "A" type reorganization some of the remaining shareholders take stock and the others take cash. This authority coupled with the lack of standards to guide or determine the propriety of the Treasury's actions will produce much uncertainty and risk of administrative overreaching in an area affecting many taxpayers. Since the issuance of regulations under a complex provision is long delayed, and without regulations it is usually not possible to obtain rulings on proposed transactions, the Treasury should not have been granted this broad regulatory authority.⁹⁹

In its comments on the House version of the Tax Reform Bill, the Section on Taxation of the A.B.A. pointed out that there is a lack of coordination between § 305 and the other provisions of Subchapter C. The Senate recognized this and intends for the Treasury to deal with these problems. Due to the increased number of stock dividends which will become taxable as a result of the amendments, this lack of coordination will be greatly aggravated. For example, while a recapitalization and a stock dividend might be substantive equivalents, under certain circumstances the recapitalization may be tax free and the dividend taxable. If preferred dividend arrearages were satisfied through a distribution of preferred stock (or common stock) to the preferred shareholders, under the new law the distribution is taxable to the preferred shareholders. However, if the corporation recapitalized and additional preferred stock (or common stock) were issued in exchange for the dividend arrearages, the exchange would ordinarily be tax free under Reg. 1.368-2(e)(5). While the same was true under prior law with respect to a distribution in lieu of cash for current year or preceding year dividend arrearages on preferred stock,

99. Report of Section on H.R. 13270, Tax Reform Act of 1969, 23 *The Tax Lawyer* 43, at 107 (1969).

the extension of taxable treatment to preferred arrearages prior to the immediately preceding year will increase the impact of the artificial distinction between a stock dividend and a recapitalization having the same effect.¹⁰⁰ The Regulations under § 368 will have to be changed to conform with regulations under § 305(c) and all stock received in payment of dividend arrearages whether or not in connection with a recapitalization will be taxed. Since the Senate used the word recapitalization, and the rule provides all stock received in payment of arrearages is taxable, it is clear the intent was to tax arrearages paid in connection with recapitalizations.

It would be possible to go on and on discussing the problems raised by the amendments to § 305. As it may be some time until regulations are issued, questions such as what is the effect of an isolated transaction which results in the increase of a shareholder's proportionate interest, and what are the consequences of a preferred stock recapitalization to effectuate a change in control must remain unanswered. As was pointed out at the beginning of this discussion, the amendments have serious impact on corporations and their shareholders; and it is necessary that anyone who becomes involved with stock distributions be aware of the implications of the changes in § 305.

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100. *Id.* at 108.