Duquesne Law Review

Volume 12 | Number 3 | Article 16

1974

Taxation Law - Federal Income Taxation - Redemptions and Reorganizations

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Recommended Citation

Charles J. Goldblum, *Taxation Law - Federal Income Taxation - Redemptions and Reorganizations*, 12 Duq. L. Rev. 678 (1974).

Available at: https://dsc.duq.edu/dlr/vol12/iss3/16

a new frame of reference within which to resolve and remedy landlord-tenant problems.

Maureen Ellen Lally

TAXATION LAW—FEDERAL INCOME TAXATION—REDEMPTIONS AND REORGANIZATIONS—The Courts of Appeals for the Sixth and Ninth Circuits are in conflict on the question of whether section 351 or section 304 of the Internal Revenue Code of 1954 governs a transfer of the stock of a brother corporation to a sister corporation by the common controlling shareholder in return for stock of the sister corporation and cash.

Coates Trust v. Commissioner of Internal Revenue, 480 F.2d 468 (9th Cir.), *cert. denied*, 94 S. Ct. 551 (1973).

Commissioner of Internal Revenue v. Stickney, 399 F.2d 838 (6th Cir. 1968).

Section 304(a)(1)[1] of the Internal Revenue Code (Code) provides

However, by viewing the covenant of habitability as the essence of the lease, the court avoided this conceptual inconsistency of the Uniform Commercial Code approach and established a legal foundation in contract law for its mandate against disclaimer.

1. INT. REV. CODE OF 1954, § 304 states:
Redemption through use of related corporations
(a) Treatment of certain stock purchases.—
(1) Acquisition by related corporation (other than subsidiary).—For purposes of sections 302 and 303, if—
(A) one or more persons are in control of each of two corporations, and
(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,
then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.
(2) Acquisition by subsidiary.—For purposes of sections 302 and 303, if—
(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and
(B) the issuing corporation controls the acquiring corporation,
then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.
(b) Special rules for application of subsection (a).—
(1) Rule for determinations under section 302 (b).—In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to

that for purposes of sections 302[2] and 303[3] of the Code, if one or more persons are in control of two corporations and, in return for property,

constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.
(2) Amount constituting dividend.—
(A) Where subsection (a)(1) applies.—In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.
(B) Where subsection (a)(2) applies.—In the case of any acquisition of stock which subsection (a)(2) of this section applies, the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation.
(c) Control.—
(1) In general.—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.
(2) Constructive ownership.—Section 318(a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

All section references are to the INT. REV. CODE OF 1954 unless otherwise provided.

2. *Id.* § 302 provides:
Distributions in redemption of stock
(a) General rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part of full payment in exchange for the stock.
(b) Redemptions treated as exchanges.—
(1) Redemptions not equivalent to dividends. —Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
(2) Substantially disproportionate redemption of stock.—
(A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.
(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.
(C) Definitions.——For purposes of this paragraph, the distribution is substantially disproportionate if—
(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time.
is less than 80 percent of—
(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.
For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

one of the corporations acquires stock in the other corporation from a controlling shareholder, that property shall be treated as a distribution in redemption of the acquiring corporation. The stock acquired is treated as a contribution to capital from the transferor. The amount of dividend is determined by looking to the earnings and profits of the acquiring corporation as provided by section 304(b)(2)(A).

Section 304(a)(2) provides that for purposes of sections 302 and 303 if the issuing corporation controls the acquiring corporation and in return for property the subsidiary acquires stock in the controlling corporation, the property shall be treated as a distribution in redemption of the stock of the issuing corporation. Section 304(b)(2)(B) states that the amount of dividend is determined as if the property were distributed by the acquiring corporation to the issuing corporation, and then immediately distributed by the issuing corporation.

"Control" for purposes of section 304 is defined by section 304(c)(1) as ownership of no less than 50 per cent of the total combined voting power of all classes of stock entitled to vote, or at least 50 per cent of the total value of shares of all classes of stock.

Section 304(c)(2) provides that the constructive ownership rules of section 318[4] will be applied in determining "control." Section 304(c)(2) further provides that corporate attribution will be applied without

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(D) Series of redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder's interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder. . . .

(c) Constructive ownership of stock.—

(1) In general.—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) For determining termination of interest.—

(A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

3. *Id.* § 303.
4. *Id.* § 318.

regard to the 50 per cent stock ownership requirement of section 318 (a)(2)(C).

Section 304(b) tests redemptions for dividend equivalance. It lays down the specific "safe harbors" through which redemptions can pass and receive sale or exchange treatment. The "safe harbors" relevant to this discussion are redemptions that are not equivalent to dividends, substantially disproportionate redemptions, and redemptions that terminate the shareholder's interest.[5]

Section 315(a)[6] provides that if one or more persons transfer property to a corporation solely in exchange for stock or securities in the corporation, and if the transferor or transferors are in control of the corporation immediately after the exchange, the transferor or transferors will not recognize any gain or loss.

Section 368(c)[7] defines "control" for purposes of section 351 as ownership of at least 80 per cent of the total voting power of all stock classes entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation.

Section 351(b) provides that if the transferor or transferors receive money or other property not falling within the stock or securities ambit of section 315(a) the transferor or transferors shall recognize a gain on the transaction up to the amount of money and the fair market value of the other property. Such other property and money are commonly referred to as "boot."[8]

There are certain factual situations to which both sections 304 and

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5. *Id.* § 302.
6. *Id.* § 351 states:
Transfer to corporation controlled by transferor.
(a) General rule.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.
(b) Receipt of property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—
(1) gain (if any) to such recipient shall be recognized, but not in excess of—
(A) the amount of money received, plus
(B) the fair market value of such other property received; and
(2) no loss to such recipient shall be recognized.
7. *Id.* § 368.
8. Many corporate reorganizations do not involve an exchange of property for stock or securities only. In many instances there is involved other property or money. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 3-19 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

351 can apply. There is a vast difference in the tax treatment given by these sections. If section 304 applies, and if the transaction does not pass through one of the safe harbors of section 302(b), then the whole amount of property received (other than stock in the acquiring corporation) is a dividend. The basis of the stock transferred is allocated to the remaining shares attributable to the transferor.[9] If section 351 applies, then section 358[10] provides that the transferor's basis in the stock and securities he receives will be the same as the basis he had in the property he transferred to the corporation. Section 351(b) provides that the transferor will pay capital gains on any gain he makes on the transaction up to the amount of boot he receives.

Two cases have come down from the Sixth and Ninth Circuits which illustrate the conflict between these overlapping sections and its practical effect.

In *Commissioner of Internal Revenue v. Stickney*,[11] three corporations were involved: Northport Cherry Factory, Inc., Gypsum Canning Company and Haserot Company. Northport and Gypsum were primarily fruit growers and packers. Almost all of their products were sold to the Haserot Company which marketed the merchandise.

In the transaction the taxpayer transferred 1,999 shares of Northport stock and 4,486 shares of Gypsum stock in return for 2,432 shares of Haserot stock and $64,850 cash.[12]

Before the transaction the percentage of stock registered in the taxpayer's name was as follows:

Northport—43.8 per cent
Gypsum —68.2 per cent
Haserot —57.2 per cent[13]

After the transaction the percentage of stock registered in the taxpayer's name was as follows:

Northport— 0 per cent
Gypsum — 0 per cent
Haserot —82.3 per cent[14]

9. Treas. Reg. § 1.304-2(a), T.D. 6533, 1961-1 CUM. BULL. 71; T.D. 6969, 1968-2 CUM. BULL. 127. Treas. Reg. 1.304-3 (1954).
10. INT. REV. CODE OF 1954, § 358.
11. 399 F.2d 828 (6th Cir. 1968), *aff'g sub nom.* Haserot v. Commissioner of Int. Rev., 46 T.C. 864 (1966), *on remand from* Commissioner of Int. Rev. v. Haserot, 355 F.2d 200 (6th Cir. 1965), *remanding* Haserot v. Commissioner of Int. Rev., 41 T.C. 562 (1964).
12. 41 T.C. at 566.
13. 46 T.C. at 866.
14. *Id.* at 866.

This transaction took place in 1958. In his tax return the taxpayer made no reference at all to this transaction. The Commissioner took the position that sections 304, 302, and 301 applied, and that the cash ($64,850) was a dividend taxable as ordinary income. The taxpayer contended that the exchange was covered by section 351 which accords capital gain treatment to any gain on the transfer to the extent of the cash portion of the transaction.

The first Tax Court decision,[15] holding for the taxpayer, recognized that *either* section 351 or 304 *could* govern the transaction.[16] The court further recognized that Congress had never considered this situation and never clearly indicated its intention with respect to the issue.[17] The court resolved the controversy by referring to the "except as otherwise provided" language of sections 301(a)[18] and 302(d).[19] This language was taken as an indication that Congress intended that dividend treatment should result from the application of section 302 only if no other relevant provision in chapter one or subchapter C of the Code applies.[20] The court further noted that section 351 is not limited in this fashion,[21] and therefore section 351 overrode section 304. The court recognized that this decision would produce the unusual result that a taxpayer or taxpayers with less than 80 per cent control after the transfer would be subject to section 304 treatments and that a taxpayer or taxpayers with more than 80 per cent control after the transfer would be automatically accorded capital gains treatment under the protection

15. Haserot v. Commissioner of Int. Rev., 41 T.C. 562 (1964).
16. *Id.* at 568, where the court stated:
This case involves one of those unusual situations where a transaction comes within the literal language of two sections of the Code—351 and 304. For purposes of section 351(a), (b), there was a transfer of property (Northport and Gypsum stock) in exchange for stock in a corporation (Company) that was controlled (owned at least 80 percent of the stock) immediately thereafter by the transferor (petitioner). For purposes of section 304(a)(1), one person (petitioner) was in control (direct or constructive ownership of at least 50 percent of the stock) of three corporations (Northport, Gypsum, and Company) and in return for property (money) one of the corporations (Company) acquired stock in the other corporations (Northport and Gypsum) from the person in control (petitioner).
17. *Id.* at 570.
18. INT. REV. CODE OF 1954, § 301 provides:
(a) In General—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).
19. *Id.* § 302(d) provides:
—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.
20. 41 T.C. at 570.
21. *Id.*

of section 351. But feeling that the express language of the statute left them no alternative, the court found that Congress had chosen to subordinate sections 304, 302 and 301 to section 351.

Because of the court's decision to accord capital gain treatment to the transaction and the fact that the Commissioner conceded that the shares of stock were not taxable income by virtue of section 317(a),[22] the court did not decide whether or not there was dividend equivalence for purposes of section 302.[23]

On appeal, the United States Court of Appeals for the Sixth Circuit[24] remanded the case to the Tax Court for a determination of dividend equivalency. It would seem that the court of appeals realized that the Commissioner was asking them to make a difficult choice between sections 304 and 351, but if the Tax Court did not find dividend equivalency the sections 304-351 dilemma would not have to be faced. On remand the Tax Court found dividend equivalance[25] because the Haserot Company owned a substantial number of shares in both Gypsum and Northport before the transaction. Also, through use of the attribution rules of section 318, the transaction could not be afforded the repose of the "safe harbors" of section 302(b). The taxpayer had 91.5 per cent of the Haserot Company stock attributable to him before the transfer and 92.1 per cent of the Haserot Company stock after the transfer. His percentage in Gypsum and Northport dropped from 96 to 91 per cent attributable to him. This certainly would not be a meaningful change in his ownership unless the taxpayer could show that the transaction was not essentially equivalent to a dividend, *i.e.*, that there was a legitimate business purpose for the transfer.[26] This the taxpayer was unable to do.[27] His claim that his desire to unify the three

22. INT. REV. CODE OF 1954, § 317(a) provides:
(a) Property—For purposes of this part, the term property means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

23. 41 T.C. at 572, where the court stated:
Since there is no dispute as to the amount of the gain and since that amount will in either event be taxed as a long term capital gain, it is not necessary for us to determine in this proceeding whether that result is arrived at via section 351 or via sections 304 and 302(a).

24. Commissioner of Int. Rev. v. Haserot, 355 F.2d 200 (6th Cir. 1965).

25. Haserot v. Commissioner of Int. Rev., 46 T.C. 864 (1966).

26. Under section 302(b)(1) a redemption will be treated as an exchange through section 302(a) if it is not essentially equivalent to a dividend. *Haserot* was decided before United States v. Davis, 397 U.S. 301 (1970), which adopted the strict net effect test. Thus, after *Davis* the business purpose of a redemption is irrelevant in determining dividend equivalence under section 302(b)(1). See note 50 *infra*.

27. 46 T.C. at 869, where the court stated:
Even if we ignore (as petitioner does) the leverage of the Company over Northport

corporations provided a sufficient business purpose was inconsistent with the fact that he already had unity of control. The taxpayer was also unable to demonstrate any significance at all in the slight change in control that occurred in the transaction. The Tax Court, however, refused to reconsider its prior decision that section 351 controlled the transfer because the remand was only for the purpose of determining whether dividend equivalency existed.

Judge Tannenwald, dissenting on the remand, looked to the purpose of sections 304 and 302 and applied his own interpretation of their legislative history when he observed that to hold section 351 controlling would effectively emasculate these redemption sections.[28] According to the dissent, the majority opinion made it far too easy to evade section 304 treatment.[29] Judge Tannenwald also felt that the distinction between section 304 treatment of 50 to 79 per cent control and section 351 treatment of greater than 80 per cent control would produce an absurd result.[30]

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and Gypsum, arising from the Company's position as a substantial and the principal creditor, common ownership by petitioner of all three corporations assured *unity of success or of failure* of operations. The 1958 transaction neither enhanced nor lessened this possibility. Indeed, if petitioner's position is sound regarding the consequence of a brother-sister to a parent-subsidiary relationship, a valid business purpose could be imported into every section 304 transaction involving interrelated business operations. We doubt that Congress intended to provide such an extensive safe harbor in enacting that section.

28. *Id.* at 876 (Tannenwald, J., dissenting):

I think, however, that petitioner's narrow reading of the statute imputes a dragnet exclusion from dividend equivalence of types of distributions which Congress intended to be included. As has been pointed out, the Senate made it clear that, although its rewrite of the House version of H.R. 8300 was occasioned principally by a desire to preserve "terms and concepts of existing law," such rewrite was still directed at "the use of avoidance devices which have proved successful under the existing Code." The transfer of stock of brother-sister corporations was precisely such a device.

If petitioner's view were adopted, it would to a large degree negate the long-standing efforts to deal legislatively with problems of the type involved herein. Commencing in 1950, when the predecessor of section 304 was enacted to control redemptions by a subsidiary from a parent (sec. 208 of the Revenue Act of 1950, which added sec. 115(g) to the Internal Revenue Act of 1939), Congress has shown concern for the possibilities of mischief arising from dealings between related corporations and their controlling shareholders in such corporations' stock. In 1954, in order to minimize further the possibilities of mischief, it enacted section 304, which requires "brother-sister" participants to walk the tightrope of section 302(b) in order to qualify for capital gains treatment when the same person or persons control 50 percent of each corporation.

Id. (citations omitted).

29. *Id.* at 877, where Judge Tannenwald said:

Moreover, under petitioner's interpretation, section 351 would control even where only a peppercorn of stock is issued by the acquiring corporation. Perhaps petitioner is correct when he suggests that such a result could be obviated by treating the transaction as "sham." But I see no need to expand the fertile field of argument as to what transactions are "real" or "sham," if such a course can be avoided.

30. *Id.* at 876-77, which stated:

Petitioner would have us modify the requirement of control from "fifty percent" to "fifty percent *but less than eighty percent.*" Such a result would enable an 80-percent-

The Commissioner again took an appeal to the Sixth Circuit. The court, through Judge Peck, affirmed the Tax Court's original holding that section 351 governed the transaction[31] and its finding of dividend equivalence on the remand.[32]

The court of appeals, like the Tax Court, rejected the Commissioner's argument concerning legislative intent.[33] Judge Peck felt that the express language of the statute, *i.e.*, the "except as otherwise provided" language, gave the court no alternative. The court felt that section 351 by itself covered the whole transaction while section 304 required reference to many other sections.[34] The court further felt that the re-

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or-more shareholder to play fast and loose with section 304 to a degree not permitted to the holder of a lesser percentage but nevertheless majority control. The instant situation is not comparable, as petitioner suggests, to those where one receives favorable or unfavorable treatment because he owns less than a *statutorily specified* percentage of the outstanding stock, as, for example, in sections 318 and 368, as well as in sections 304 and 351. In each of those sections, Congress has consciously, for policy reasons, established a self-contained mathematical trigger to provide taxpayers with some certainty in the planning of their affairs. If Congress had specifically provided that section 351 did not apply where the transferor owed 79 percent but did apply where he owned 20 percent or that section 304(a)(1) did not apply where common control was 49 percent but did apply where it was 10 percent, we would be bound by such limits, however bizarre we might judge them to be. But it does not follow that we should *infer* such an eccentric choice for the purpose of providing a safe harbor under section 304 in situations where there is an 80 percent or more, as well as less than 50 percent ownership.

31. Commissioner of Int. Rev. v. Stickney, 399 F.2d 828 (6th Cir. 1968). Prior to this decision Henry McK. Haserot died. His executor John M. Stickney was therefore substituted as party.

32. *Id.* at 832.

33. *Id.* at 834. Judge Peck stated:

In reaching this conclusion we are not unmindful of the argument advanced by the Commissioner concerning legislative intent. As a background for this argument, he presents the illustrations of a stockholder controlling two or more corporations who arranges to have one corporation purchase the stock of another for cash in order to bail out (at the cost of no more than a capital gains tax) corporate earnings which would otherwise be taxed as dividends at ordinary rates. Against this background the Commissioner urges that Congress could not have intended such bailing out practices to be denied shareholders owning control in the 50-79% bracket while they remained available to the stockholder whose control exceeded 80%. While this is concededly an oversimplification of his argument, the fact remains that the applicable section is not to be determined solely on the basis of the extent of control. The application of Section 304 is limited to sales and sales alone. Section 351 contains no such limitation, and by its express provisions extends its application to exchanges, with which we are engaged in the present situation.

Particularly able arguments were heard in this case, and counsel stopped just short of agreeing that Commissioner was contending his construction of statutes to be correct because that was what Congress should have said. If our logic seems to support that contention it is sufficient to respond that Congress did not say it, but did utter the clearly applicable language enacted as Section 351. Had Congress intended the Section 304(a) treatment to apply to such situations as the present one that end could have been accomplished by a specific affirmative enactment, or by a negation of 351 application.

34. *Id.* at 833-34, where the court stated:

Taxpayer urges that the case fits within the provisions of section 351, and the Commissioner's brief in this court opens with a statement of the question involved, which strictive language of sections 304 and 302 as compared to the permissive language of section 351 reflected a legislative intent pointing to section 351 treatment. In rejecting the Commissioner's argument over the 50 to 79/80 and above percentage distinction, the court answered by ruling that section 304 was restricted to "sales and sales alone."[35] On this premise the court could avoid a holding that "control" was the sole determining factor.

While the answer given by the *Stickney* court appears to be simple and clear, it does create problems. It is true that the ruling follows the express language of the statute, but the decision also make it extremely easy to avoid section 304.

There are two major policy considerations involved. First, redemptions that are in substance dividends regardless of form ought to be taxed at ordinary income rates. Secondly, the taxpayer should be able to rely upon the statute as written. The argument can be made that regardless of legislative intent, the statute is what the taxpayer must rely on in planning his transactions. Certainly internal consistency and certainty of outcome are goals to strive for in the area of taxation. It would seem that Congress would be best suited to resolve this conflict. However, since 1968 when *Stickney* was decided there has been no remedial action by Congress.

The Commissioner did not acquiesce to the *Stickney* ruling.[36] To do so would have allowed a great number of redemptions to receive favor-

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contains the statement that the transaction "fits within the literal terms of section 351."

The court then quoted sections 351(a) and 351(b). The court then stated:

In view of the agreement of the parties as to the application of this section to the factual pattern of this case it would serve no useful purpose to further labor the point, particularly since a comparison of the foregoing quotation from Section 351 and the facts clearly demonstrates the applicability. In marked contrast, if Section 304(a) also applies, that can only be determined by laboring through a labyrinth of related sections. Section 304 is not self-executing in any sense, and where it has application the tax liability can only be determined by reading other sections in *pari materia.* One of the sections which must be so read, and to which specific reference is made in 304, is Section 301. That section is the initial section of the chapter which contains all of the sections quoted in this opinion, and it begins with the words, "Except as otherwise provided in this Chapter * * * ." To hold that the tortured construction of Section 304(a) urged by the Commissioner causes it to fit the situation in issue is difficult, and to conclude that it is controlling is to entirely ignore the existence of the opening language of the chapter, "Except as otherwise provided in this Chapter." The only reasonable explanation for the presence of those words (we are unable to agree with the tenuous explanation offered by Commissioner) is that when another section of the chapter has application the Section 301 treatment is to be excluded; as previously indicated, this includes the Section 304(a) formula. We decline to follow the devious approach urged by the Commissioner, and conclude that Section 351 applies.

35. *Id.*

36. Rev. Rul. 73-2, 1973-1 CUM. BULL. —.

able capital gains treatment under section 351 without meeting the standards of section 302(b) and this for no legitimate policy reason.

Coates Trust v. Commissioner of Internal Revenue,[37] gave the Commissioner the opportunity to relitigate the issue. The Coates family owned all of the shares of two corporations. CAM Industries Inc. and Washington Industrial Products Inc. On May 20, 1965, the family effected a merger of the two corporations through a purchase of Washington Industrial by CAM Industries.[38] Under the terms of the agreement, the purchase price was to be paid over a ten year period, with four per cent annual interest on the diminishing balance.[39]

In 1965, all of the family group reported the transaction as a sale in their tax returns, thus entitling them to capital gain treatment. The Commissioner in his notice of deficiency did not treat the transaction as a sale. The Commissioner took the position that the transaction was a redemption by a related corporation under section 304(a)(1); that the whole amount under the agreement was a dividend.

Although the Tax Court found in favor of the Commissioner, it did so without reaching the 304-351 issue.[40]

The Tax Court decided that section 304 applied rather than section 351 because of the stock or security requirement of section 351(a). Following the decision in *Brown v. Commissioner of Internal Revenue*,[41] the court in *Coates* ruled that the agreement to pay cash and interest over a ten year period did not constitute a security.[42] Therefore, the Tax Court felt the case was distinguishable from *Stickney* and saw no need to decide which section should take precedence.[43]

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37. 480 F.2d 468 (9th Cir.), *cert. denied*, 94 S. Ct. 551 (1973). This case affirmed the Tax Court's decision in Coates Trust v. Commissioner of Int. Rev., 55 T.C. 501 (1970).
38. 480 F.2d at 470.
39. *Id.* at 470-71.
40. Coates Trust v. Commissioner of Int. Rev., 55 T.C. 501 (1970).
41. Brown v. Commissioner of Int. Rev., 27 T.C. 27 (1956). The court stated:

> The question whether an evidence of indebtedness constitutes a security does not depend for its resolution upon a simple determination of the length of time the obligation is to run, but depends rather upon an over-all evaluation of the nature of the debt so as to ascertain whether or not the instrument issued evidences a continuing interest in the affairs of the corporation.

Id. at 36.
42. The trust for Rose Ann Coates received the obligations in return for the stock. Because of this lack of continuity of interest the Tax Court felt that the agreement did not constitute a security. 55 T.C. at 512.
43. *Id.* at 512, where the court stated:

> We agree with respondent that section 351 is inapplicable to this transaction. Section 351 applies where "property is transferred to a corporation * * * by one or more persons solely in exchange for stock or securities in such corporation." Petitioners transferred their shares to a corporation for an agreement to pay an amount of cash plus interest in installments over a 10-year period. Petitioners do not contend that

On appeal the United States Court of Appeals for the Ninth Circuit, through Judge Wright, affirmed the decision of the Tax Court but reversed its reasoning. The court of appeals expressly stated that in a situation where both sections 304 and 351 apply, section 304 should take precedence. The Tax Court did not rule on the 304-351 issue because of its preliminary ruling on the question of whether or not the agreement was a "security." The court of appeals did not rule on whether or not there was a "security" because of its preliminary ruling in favor of section 304.[44] The court of appeals, however, made itself "perfectly clear" that it disagreed with the decision in *Stickney*. The court rejected that decision and adopted the viewpoint put forward by Judge Tannenwald's dissent in that case.[45]

Neither *Coates* nor *Stickney* adequately solve the problem, as each decision reflects valid but conflicting policy considerations. Also, both decisions do not solve all the problems raised by the facts.

If the *Stickney* ruling were followed, section 304 would become a dead letter. Complete reliance on section 351 would render the requirements of section 302(b) ineffective.[46] Thus, the *Stickney* ruling ignores to a great degree some of the apparent Congressional intent regarding the tax treatment of redemptions.

The decision also makes a distinction for which there is no rational

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the agreement is a "security," and we think it is not. See *Warren H. Brown*, 27 T.C. 27 (1956). For the same reason, we think that petitioners did not do "exactly what Mr. Haserot did" in *Stickney*. In combining his businesses, Haserot received for his shares a cash credit *plus stock*. Thus, without considering whether section 351 or section 304 takes precedence when both apply, it is plain here that section 351 does not apply.

44. 480 F.2d at 472, where the court stated:
Petitioners argue that the *Brown* decision creates an invalid distinction between an installment sales contract and other long term corporate obligations. *See* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 3-55 (3d Ed. 1971); Comment, Section 351 Transfers to Controlled Corporations: The Forgotten Term—"Securities," 114 U. Pa. L. Rev. 314 (1965). We do not reach that issue, however, for even assuming *arguendo* that these agreements are "securities" under § 351, we are convinced that the provisions of § 351 are overridden by those of § 304 and that, accordingly, § 304 and not § 351 applies to this transaction. *See* Henry McK. Haserot, 46 T.C. 864, 872 (1966) (Tannenwald, J.) (separate opinion).

45. *Id.* at 472-73, where the court stated:
In Commissioner v. Stickney 391 F.2d 828 (6th Circuit 1968), *aff'g* Henry McK. Haserot, *supra*, the Sixth Circuit reached a contrary result. While the statutory language and legislative history reveal that Congress did not provide for or contemplate the possible conflict between the permissive policy of § 351 and the preventive policy of § 304, we are convinced that our decision "best achieves the underlying legislative intent and policy and . . . more nearly reflects the manner in which Congress would have 'straightened this ruck out if they had come across it.'" *Haserot, supra*, 46 T.C. at 878 (Tannenwald, J.). Accordingly, we decline to follow the Sixth Circuit for the reasons so cogently set forth by Judge Tannenwald.

46. Section 302(b) lays down the safe harbors through which redemptions may be given capital gains treatment via section 302(a).

basis. Why would Congress wish to give favorable treatment to those who can pass the 80 per cent threshold requirement of section 351 and leave those in the 50 to 79 per cent bracket within the strict requirements of sections 304 and 302? It would seem that the clear policy of these redemption provisions is that unless one is willing to make a meaningful reduction in the percentage of stock attributable to him or completely terminate his interest, the transaction is essentially equivalent to a dividend. One cannot pass through the "substantially disproportionate redemption" "safe harbor" of section 302(b)(2) unless after the transaction he has less than 50 per cent of the total combined voting power of all classes of stock entitled to vote. Yet, if one increases his control to 80 per cent and redeems shares for cash and stock he will receive capital gains treatment.

The contrasting holding of *Coates*, however, also leaves problems unattended. As presented above, section 304 treatment contradicts the policies underlying section 351 in much the same way that section 351 can frustrate the policies underlying section 304. Section 351 was enacted to facilitate business readjustments.[47] When a transfer of property to a corporation which has appreciated or depreciated is no more than a change in form, there seems to be no reason to consider the transfer a taxable event.

But an argument can be made that section 351(b) (which gives sale or exchange treatment to boot) goes beyond this nonrecognition purpose and brings under section 351 transactions which ought to be treated as sales because the taxpayer has realized some gain in liquid form.[48] But query whether section 351 would not be a dead letter without the added flexibility of section 351(b)? It is doubtful that many corporate reorganizations could fit any one exact formula. Further, under 304 and 302 treatment there could be situations where the taxpayer might be completely deprived of using his basis.[49]

It is submitted that there cannot be any meaningful coexistence between sections 304 and 351 as long as each section exists in a vacuum. The congressional desire to tax what is in substance a dividend is a

47. *See* BITTKER & EUSTICE, *supra* note 8, at 3-4.
48. *Id.*
49. Treas. Reg. § 1.304-2(a), T.D. 6533, 1961-1 CUM. BULL. 71; T.D. 6969, 1968-2 CUM. BULL. 127 and Treas. Reg. § 1.304-3 (1954), provide that if a redemption does not fall within one of the safe harbors of section 302(b) and is taxable as a dividend the basis of such stock will be allocated to the taxpayer's remaining shares. But what would happen if the taxpayer redeemed all of his shares and yet failed to fall within section 302(b)(3)? *See* Coyle v. United States, 415 F.2d 488 (6th Cir. 1968), where the court noted that this basis could be allocated to the basis of the transferee.

legitimate one indeed. A recognition of the need of businesses to make necessary ownership adjustments for legitimate business purposes is also valid. The mechanics of the redemption sections and the reorganization sections are not consistent because of these divergent policies. Section 302 looks basically to the net effect of a transaction.[50] Section 351 is geared to facilitate business readjustments by using a two-pronged test: (1) there must be transfer of property for stock or securities; and (2) there must be a post transfer 80 per cent control in the hands of the transferor or transferors. Section 351(b) gives extremely useful, if not necessary, flexibility to enable these transactions to fit within section 351. The argument can be made that if the "boot" received in a section 351 transfer were completely taxed at ordinary income rates without regard to gain or loss, many of these transactions would not take place.

It is obvious that the treatment given by each of these sections alone does not render a satisfactory result. Section 351 treatment allows the taxpayer to take disguised dividends at capital gain rates while not giving up any measure of control. Section 304 would tax all cash at ordinary income rates even if the taxpayer were taking a large loss on the transaction. Therefore neither section renders a result which acknowledges all the policy considerations involved.

Through what alternative routes can proper treatment of this type of transaction be achieved? To begin with, the transfer could be treated as a "D" reorganization.[51] Instead of a direct sale of stock as occurred in the *Stickney* and *Coates* cases, the taxpayer would direct one corporation to buy all the assets of the other corporation for cash and shares in the acquiring corporation. The selling corporation would then distribute the cash and stock to its shareholders. As long as the distribu-

50. In determining for purposes of section 302(b)(1) whether a redemption is essentially equivalent to a dividend, a court hypothesizes the declaration of a dividend, instead of the redemption of stock, in the same amount as the redemption, and determines (from the standpoint of each stockholder—taxpayer) if the results from the hypothetical dividend and the actual redemption are essentially the same. Any business purpose for the redemption is irrelevant. *See* United States v. Davis, 297 U.S. 301 (1970).

51. INT. REV. CODE OF 1954, § 368 provides:

(a) Reorganization

(1) In General—for purposes of parts I and II and this part, the term reorganization means—

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one of more or its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

tion to the shareholders compiled with sections 354[52] and 356,[53] which it normally would, the transaction would be a valid "D" reorganization. If under section 356(a)(2) the transaction has the effect of the distribution of a dividend, then the gain would be taxed at ordinary rates up to the amount of the shareholder's ratable share of the undistributed earnings and profits. But even if the transaction is viewed as falling within section 356(a)(2), only the gain would be taxed, while section 304 would impose a tax without reference to gain or loss. Thus, while section 304 dividend policy is given consideration via the check of section 356(a)(2), only real gains are taxed and mere changes in form are not subject to section 304 and 302 treatment.

Applying this proposal to the facts in either *Stickney* or *Coates* requires the imposition of a fiction, since there must be an actual liquidation before a transaction can qualify as a valid "D" reorganization. Though this proposal affords the practitioner assistance in planning future transactions, it does not give the courts a direct answer to *Coates* and *Stickney* (since in these cases there were no liquidations).

Another alternative would be to separate or bifurcate the transaction to treat the cash under section 304[54] and the stock under section 351 (if applicable) rather than section 305[55] as suggested by the Commis-

52. *Id.* § 354.
53. *Id.* § 356.
54. The stock could not be treated under section 304 in any event because of section 317(a). It would therefore seem that the argument against bifurcation is not a valid one. If section 304 is used, the transaction must be bifurcated. It should be noted that exclusive section 351 treatment would not necessitate bifurcation.
55. *Id.* § 305.
Distributions of stock and stock rights
(a) General rule.—Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.
(b) Exceptions.—Subsection (a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which section 301 applies—
(1) Distributions in lieu of money.—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
(B) in property.
(2) Disproportionate distributions.—If the distribution (or a series of distributions of which such distribution is one) has the result of—
(A) the receipt of property by some shareholders, and
(B) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.
(3) Distributions of common and preferred stock.—If the distribution (or a series of distributions of which such distribution is one) has the result of—
(A) the receipt of preferred stock by some common shareholders, and
(B) the receipt of common stock by other common shareholders.
(4) Distributions on preferred stock.—If the distribution is with respect to preferred stock, other than an increase in the conversion ratio of convertible preferred

sioner. Such a liberal construction of section 305, however, takes this section completely out of context[56] and creates additional problems. It gives nonrecognition treatment to contributed stock where the taxpayer or taxpayers have only 50 to 79 per cent control of the acquiring corporation, whereas if a combination of section 304 and 351 were used this would not occur. The stock would only receive nonrecognition treatment if the taxpayer or taxpayers had 80 per cent control. Hence, the stock would receive section 351 treatment and any cash received would be treated by sections 304, 302 and 301 and taxed accordingly.

If section 351 is used, sections 358[57] and 362[58] become applicable in determining the basis of stock for the distributee and the corporation. The distributee's basis in his new stock will be the same as in the property he exchanged, decreased by the fair market value of any property he received and increased by the amount of dividend and recognized gain. The corporation's basis in the property will be the same as it was in the hands of the transferor, increased by the amount of gain recognized by him. Thus, while the distributee will receive ordinary income treatment through section 304 for the amount of cash, this is offset by the basis provisions in part III of subchapter C (giving this method great advantage over the section 304-305 combination).[59]

Due to their inherent contradictions and inconsistencies, the redemption and reorganization provisions presently make tax planning difficult. The *Stickney* and *Coates* decisions should serve to make it obvious that these provisions must be integrated in order to reconcile divergent policies. It would seem that section 304 creates the most problems for many reasons (some of which have not been dealt with

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> stock made solely to take account of a stock dividend or stock split with respect to the stock into which such convertible stock is convertible.
> (5) Distributions of convertible preferred stock.—If the distribution is of convertible preferred stock, unless it is established to the satisfaction of the Secretary or his delegate that such distribution will not have the result described in paragraph (2).

Upon reading the statute one can readily see that section 305 deals primarily with stock dividends.

56. While it is true that the language of section 305 provides that "any distribution" is excluded, the legislative history indicates the language should not be taken literally. *See* Marans, *The Shadowy World of Redemption Through Related Corporations*, 22 TAX L. REV. 161, 192 (1965), *quoting* S. REP. No. 1622, 83d Cong., 2d Sess. 240 (1954).

57. INT. REV. CODE OF 1954, § 358.

58. *Id.* at 362.

59. Under section 305(b)(2) these transactions would not have received nonrecognition treatment. Further, there would be no regard for basis or amount of gain or loss.

here) and should be rewritten. In any event, some kind of integration of sections 304 and 351 would be in order. The aforementioned divergent alternatives of either complete taxation of the cash at ordinary rates regardless of gain or loss, or sale or exchange treatment to extent of "boot" do not present adequate solutions.

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CONSTITUTIONAL LAW—EQUAL PROTECTION—AFFIRMATIVE ACTION PROGRAMS—REVERSE DISCRIMINATION—The Supreme Court of Washington has held that the University of Washington Law School may, without any showing of past discriminatory practices on its part, apply separate and distinct admissions criteria to its minority applicants in order to achieve a racial balance within the school.

DeFunis v. Odegaard, 82 Wash. 2d 11, 507 P.2d 1169, *cert. granted*, 94 S. Ct. 538 (1973).

The plaintiff, Marco DeFunis Jr., was a white applicant to the University of Washington Law School for the 1971-1972 academic year. Pursuant to the law school's admissions procedure, plaintiff's credentials were rated against those of other prospective students, and upon this basis of competition,[1] he was ultimately denied acceptance. The applications of Black, Chicano, and American Indian students, however, were excluded from the "majority" process, and were analyzed separately. Admissions of students within this preferred "minority" group were granted without any comparison of their credentials to those of other

* Special thanks is given by the author of this note to Thomas Arbogast, Esq., Adjunct Professor of Law, Duquesne University School of Law; Member of the law firm of Reed, Smith, Shaw & McClay of Pittsburgh, Pennsylvania.

1. Each applicant's junior-senior collegiate grade point average and Law School Aptitude Test (LSAT) scores were combined according to a formula determined by the law school to yield a "predicted first year average" (PFYA). Plaintiff's PFYA was calculated to be 76.23 based on his junior-senior grade point average of 3.71; average LSAT score of 582 (on three separate test dates he had received scores of 512, 566, and 668); and average writing test score component of 61.

Each applicant was placed into one of three categories based upon his or her relative PFYA. The vast majority of applicants with PFYA's above 77 were accepted; the vast majority of applicants with PFYA's below 74.5 were rejected; and the students with PFYA's in the median range along with the applicants from the other two categories who had not been summarily accepted or rejected, were placed in a separate classification for personal review by the faculty-student admissions committee. Plaintiff's PFYA score fell within the parameters of this third category. After personal review of his application, plaintiff was placed on the lowest priority waiting list and was subsequently denied admission. DeFunis v. Odegaard, 82 Wash. 2d 11, 507 P.2d 1169, *cert. granted*, 94 S. Ct. 538 (1973).