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Section 243 and Bootstrap Sales: The Dilemma of the Corporate Shareholder

Don B. Cannada

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Section 243 and Bootstrap Sales: The Dilemma of the Corporate Shareholder

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I. INTRODUCTION

A party seeking to acquire an interest in a closely held corporation may be unable to pay the full market value of the stock or may not desire to purchase all of the assets owned by the corporation. In these situations the corporation can expedite the sale either by redeeming a portion of the selling shareholder's stock or distributing a dividend prior to sale. The price the buyer must pay for the corporation's stock may then be reduced by an amount equal to the decrease in the net worth of the corporation resulting from the redemption or dividend. These transactions are known as "bootstrap"

stock acquisitions because the purchased corporation makes a distribution to assist the purchaser in financing the acquisition.[1]

Although dividends and redemptions produce equivalent economic results in bootstrap acquistions, the tax treatment of parties participating in such acquisitions often turns upon which form of distribution the parties decide to utilize. The courts have recognized, however, that the two principal tax questions arising in redemption cases and dividend cases are basically identical. The first question is whether the corporate distribution is to be taxed to the seller as a dividend or as a payment received in exchange for stock. The second question is whether the corporate distribution to the seller should be treated as a constructive dividend to the purchaser.[2]

The diverse tax consequences that may result from a bootstrap transaction are best illustrated by means of an example. Assume that *X* corporation is wholly owned by an individual, shareholder *A*. *X* has earnings and profits of $900 and a basis in its assets of $1000. *A*'s basis in the stock of *X* is $100. Now suppose that a buyer would pay $2000 for either the stock or the assets of *X*, but that a sale of the assets is not possible for business reasons. If no bootstrap is effected, *A* will realize capital gain of $1900 on the sale of stock (amount realized of $2000 less adjusted basis of $100). The buyer, however, may be unable to pay the full purchase price and may request that *A* agree to a bootstrap sale in which *X* corporation distributes $900 to *A* and the purchase price is reduced to $1100. From an economic viewpoint, *A* will be indifferent to the form adopted for the transaction because both alternatives provide him with the $2000 sale price. From a tax standpoint, however, a bootstrap sale may result in disaster to the selling shareholder if the distribution is characterized as a dividend rather than a redemption. If the distribution is designated as a redemption, the selling shareholder can qualify for sale or exchange treatment,[3] thereby achieving the same tax consequences as in a nonbootstrap sale. A determination that the distribution constitutes a dividend to the seller, however, denies him this tax equivalence because the dividend will be taxed at ordinary rates instead of the more favorable

1. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.25 at 9-28 (3d ed. 1971).

2. Jassy, *The Tax Treatment of Bootstrap Stock Acquisitions: The Redemption Route vs. the Dividend Route*, 87 HARV. L. REV. 1459, 1460 (1974).

3. Under § 302(b) of the Internal Revenue Code of 1954, a redemption distribution will be treated as payment in exchange for stock if it is (1) not essentially equivalent to a dividend, (2) substantially disproportionate with respect to the shareholder, or (3) in complete redemption of all the stock of the corporation owned by the shareholder.

capital gain rate used for the sale or exchange of a capital asset.[4] Consequently, individual shareholders will seek redemption treatment and avoid dividend treatment. Finally, if the distribution is taxed as a constructive dividend to the buyer, the most undesirable tax consequences will result. The buyer will be taxed at ordinary rates on a $900 dividend that he never actually receives, and the seller will be taxed on a capital gain of $1900. Thus the feasibility of a bootstrap sale by an individual shareholder depends primarily on the availability of capital gain treatment to the seller in a redemptive distribution and the avoidance of constructive dividend treatment to the buyer.

The tax goal sought by a corporate shareholder in structuring a bootstrap sale represents the converse of the tax treatment sought by an individual shareholder. Unlike the individual shareholder, who shuns dividends in favor of the captial gain treatment obtainable through a redemption, a corporate shareholder prefers a dividend distribution over a redemptive distribution. This preference stems from the provisions of section 243 of the Internal Revenue Code, which effectively eliminate the income tax on dividends paid to corporate shareholders by allowing the corporation to deduct either eighty-five or one hundred percent of the amount of the intercorporate dividend received.[5]

If the facts of the previous example are modified so that *A* is a corporation and *X* is *A*'s wholly owned subsidiary, *A* ordinarily will prefer a sale of *X*'s assets over a sale of *X*'s stock. By effecting a sale of assets, *X* can receive the same purchase price that *A* would receive in a stock sale and, at the same time, take advantage of its higher adjusted basis in its assets to report less taxable gain on the sale. *X* then can be liquidated without further tax by distributing the proceeds of the sale to *A*.[6] Thus the parent corporation will ultimately receive $2000 while the total taxable gain on the transac-

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4. I.R.C. §§ 61(a)(7), 64, 1201(b).

5. I.R.C. § 243 states in pertinent part:

Dividends received by corporations.

(a) General rule.—In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter:

(1) 85 percent in the case of dividends other than dividends described in paragraph (2) or (3);

(2) 100 percent, in the case of dividends received by a small business investment company operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following); and

(3) 100 percent, in the case of qualifying dividends (as defined in subsection (b)(1)).

6. I.R.C. § 332.

tion is only $1000 (amount realized of $2000 less adjusted basis of $1000). In some situations, however, a sale of assets is impractical because the subsidiary holds specific assets that cannot be transferred or that the buyer refuses to purchase. This inability to sell assets, coupled with the parent's recognition that its basis in the subsidiary's stock is lower than the subsidiary's basis in the assets, might result in the payment of a dividend to the parent by the subsidiary prior to the sale of stock. This transaction not only will allow the parent to deduct the dividend under section 243, but will also create a corporation bootstrap sale,[7] because the price the buyer must pay for the stock will be reduced by the amount of the dividend. Unless the parent and the subsidiary file consolidated returns, the dividend will have no effect on the parent's basis in the stock. Thus, although a dividend bootstrap will provide the parent with the same economic consideration it would receive in a sale of stock with no accompanying dividend, the bootstrap reduces the parent's income tax on the sale since a lower sale price and an unchanged basis produce less taxable gain.

This result can be illustrated by means of the previous example. A direct sale of stock with no accompanying dividend will cause the parent to realize a gain of $1900 (amount realized of $2000 less adjusted basis of $100). If *X* first declares a dividend of $900 to *A*, however, *A* can escape taxation on the dividend under section 243 and reduce the sale price of the stock to $1100 ($2000 original sale price less the $900 dividend no longer an asset of *X* corporation). *A* will receive $2000 (the sum of the $900 dividend and the $1100 sale price), but its taxable gain will be only $1000 (amount realized of $1100 less adjusted basis of $100). Thus *A* will pay the same tax as in a sale of assets.

Although the payment of a tax-free dividend to a corporate shareholder prior to the shareholder's sale of its stock in the subsidiary meets the literal requirements of section 243, the Internal Revenue Service may deny the use of section 243 under one of two theories. First, the Service might contend that the distribution to the seller is not a real dividend, but a conduit payment from the buyer through the subsidiary, and therefore taxable to the parent as part of the purchase price. Alternatively, the Service can argue that the dividend first was constructively paid to the buyer and then paid by the buyer to the seller as part of the purchase price. This second

7. The situation in which a corporate shareholder utilizes a dividend distribution from its subsidiary to facilitate a sale of the subsidiary's stock shall be referred to in this Note as a "corporate bootstrap sale."

interpretation poses a particularly dangerous trap in using a section 243 corporate bootstrap because a single distribution is taxed twice—first as a constructive dividend to the buyer and then to the seller as part of the purchase price.

The differences in the tax treatment of dividends and redemptions, the tax goals of individual and corporate shareholders, and the characterizations given corporate distributions by the Internal Revenue Service and the courts have combined to create overwhelming confusion for corporate bootstrap sales. The purpose of this Note is to formulate a rational, consistent approach to the tax treatment of corporate bootstrap sales. Accordingly, this Note initially will discuss various lines of cases governing the possible tax treatment of the seller in a bootstrap acquisition. Special emphasis will be placed on the recent line of cases that deny section 243 intercorporate dividend treatment to a parent corporation selling the stock of a subsidiary. The rationale of these corporate bootstrap cases will be challenged on both legal and policy grounds. Finally, this Note will propose that a parent should be permitted to receive a tax-free intercorporate dividend in an amount not in excess of its allocable portion of the undistributed after-tax income reported by the subsidiary since the parent's acquisition of control.

II. The Tax Treatment of the Individual Seller in a Bootstrap Sale

A. *The Redemption Route:* Zenz v. Quinlivan

In the celebrated pre-1954 Code decision of *Zenz v. Quinlivan,*[8] the Sixth Circuit established a safe harbor for taxpayers attempting to negotiate a bootstrap sale. In *Zenz* the taxpayer sought to sell her corporation to a competitor who did not want to purchase the potential taxable dividends represented by the accumulated earnings and profits of the corporation. In order to avoid future taxation on these earnings and profits, the buyer purchased part of the taxpayer's stock for cash. Three weeks later the corporation redeemed the balance of the taxpayer's stock, utilizing substantially all of the accumulated earnings and profits of the corporation. The Internal Revenue Service contended that the redemption part of the transaction constituted a dividend under section 115(g) of the 1939 Code.[9] It

8. 213 F.2d 914 (6th Cir. 1954).

9. Although *Zenz* was decided under the 1939 Code, the Internal Revenue Service has indicated that it will follow *Zenz* in cases arising under § 302(b)(3) of the 1954 code. *See* Rev. Rul. 55-745, 1955-2 C.B. 223. *See also* Auto Fin. Co. v. Commissioner, 24 T.C. 416 (1955), *aff'd per curiam,* 229 F.2d 318 (4th Cir. 1956); Tiffany v. Commissioner, 16 T.C. 1443 (1951), *acq.* 1957-1 C.B. 5.

argued that the redemption of part of the seller's stock would have been a dividend if it had preceded the sale of the remaining shares, and that the result should be the same when the parties prearrange a sale followed by a redemption. Rejecting this argument, the Sixth Circuit refused to reverse the steps of the alleged sham transaction: "[W]e are satisfied that where the taxpayer effects a redemption which completely extinguishes the taxpayer's interest in the corporation, and does not retain any beneficial interest whatever, that such transaction is not the equivalent of the distribution of a taxable dividend . . . ."[10]

In addition to assuring a selling shareholder that a properly planned sale-redemption bootstrap will generate capital gain rather than dividend income, *Zenz* had a significant impact on other kinds of bootstrap sales. The *Zenz* court's reference to "beneficial interest" later became the Sixth Circuit's standard for economic substance in *Steel Improvement & Forge Co. v. Commissioner,*[11] which dealt with a dividend-sale bootstrap. The element of economic benefit also is evident in *Casner v. Commissioner*[12] and in the corporate bootstrap cases. Furthermore, despite its reliance on economic substance, *Zenz* allowed form to rule over substance because it permitted, but did not require, that distribution to a seller in a bootstrap acquisition be characterized as a redemption. As a result, until the issuance of the opinions in *Steel Improvement* and *Casner,* courts displayed the same respect for form when a dividend was distributed to effect a bootstrap sale.[13]

B. The Dividend Route: Steel Improvement *and* Casner

The stability that *Zenz* supplied to the tax treatment of sale-redemption bootstraps has not been paralleled in the dividend-sale bootstrap area. Circuit court opinions in *Steel Improvement & Forge Co. v. Commissioner*[14] and *Casner v. Commissioner*[15] have undermined the tax certainty that once existed with respect to dividend-sale bootstraps. Prior to the issuance of these two decisions, a transaction could be structured so that a dividend declared

10. 213 F.2d at 917.

11. 314 F.2d 96 (6th Cir. 1963), *rev'g* 36 T.C. 265 (1961). *See* notes 20-21 *infra* and accompanying text.

12. 450 F.2d 379 (5th Cir. 1971), *aff'g in part and rev'g in part,* 28 T.C.M. (CCH) 535 (1969). *See* text accompanying note 25 *infra.*

13. Kingson, *The Deep Structure of Taxation: Dividend Distributions,* 85 YALE L.J. 861, 874 (1976); *see, e.g.,* Television Indus., Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960); Wilson v. Commissioner, 27 T.C. 976 (1957), *aff'd per curiam,* 255 F.2d 702 (5th Cir. 1958).

14. 314 F.2d 96 (6th Cir. 1963).

15. 450 F.2d 379 (5th Cir. 1971).

to the selling shareholder after a contract of sale had been entered into, but while the selling shareholder still retained control of the corporation, was taxed solely as a dividend to the seller and not as a constructive dividend to the purchaser.[16] Only if the distribution reduced the purchase price that the buyer was contractually obligated to pay was it taxed as a constructive dividend to the purchaser and as part of the sale proceeds to the seller.[17] Consequently, by structuring the transaction so that the purchaser's legal obligation was not affected by the declaration of a dividend to the seller, parties to a dividend-sale bootstrap as well as parties using a sale-redemption bootstrap were able to rely on the form of the transaction to obtain favorable tax treatment.

Steel Improvement was the first case to establish a change in the law affecting dividend-sale bootstrap transactions. The taxpayer in *Steel Improvement* was an American corporation that had sold all the stock of its Canadian subsidiary. In order for the purchaser of the stock to avoid a Canadian tax on distribution to it of the subsidiary's accumulated earnings, the buyer negotiated to buy the company without earnings. Accordingly, the sale contract provided that prior to closing the subsidiary would pay the parent a dividend of $116,000.[18] Section 243 prohibited any deduction for dividends paid by foreign corporations;[19] nevertheless, the parent consented to the dividend because it expected to receive a foreign tax credit that would offset any federal tax on the distribution.

When the taxpayer determined that the foreign tax credit was not available, it reversed the position taken on its return and claimed that the $116,000 distribution constituted part of the purchase price it had received on the sale of its subsidiary and was therefore taxable at the lower capital gain rate. The Tax Court upheld the Service's contention that the $116,000 constituted dividend income to the seller because the distribution did not relieve the purchaser of an obligation to pay a higher purchase price and because the seller remained in full control of the corporation at the

16. *See, e.g.,* Gilmore v. Commissioner, 25 T.C. 1321 (1956); Coffey v. Commissioner, 14 T.C. 1410 (1950); Diehl v. Commissioner, 1 T.C. 139 (1942), *aff'd per curiam,* 142 F.2d 449 (6th Cir. 1944); Estate of Koepenick v. Commissioner, 2 T.C.M. (CCH) 143 (1943).

17. *See* Miller v. Commissioner, 247 F.2d 206 (7th Cir. 1957), *cert. denied,* 355 U.S. 939 (1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947). *See generally* Jassy, *supra* note 2, at 1469-70; Kingson, *supra* note 13, at 879-81.

18. The contract permitted the subsidiary to pay a dividend up to $180,000, and if the dividend were less than $180,000, the purchase price was to be increased by the greater of the difference between the dividend and $180,000 or $64,000.

19. Section 243 applies only to dividends received from domestic corporations. *See* note 5 *supra.*

time of the distribution.[20]

The Sixth Circuit reversed, holding that the dividend was properly taxable to the party having beneficial ownership of the stock at the time the dividend was declared. Despite the Tax Court's findings, the court of appeals determined that the buyer had acquired beneficial ownership of the stock before the dividend was paid. The court reasoned that after the parties had signed the purchase contract and fixed a purchase price, the buyer bore the operating risks of the business and stood to benefit from its profits.[21] Accordingly, the court held that the dividend represented sale proceeds in the hands of the seller and constituted a constructive dividend to the purchaser, even though the contract price was not reduced by the amount of the dividend. The court did not attempt to distinguish earlier conflicting decisions or to explain the difference between the results reached in *Steel Improvement* and *Zenz.*

The tendency to consider economic substance rather than form in the taxation of dividend-sale bootstraps fully evolved in *Casner v. Commissioner,* which scrutinized bootstrap acquisitions of two separate corporations. Casner and other individual shareholders in the two corporations were compelled to sell their stock to fellow shareholders and third parties.[22] The sellers desired to transfer the stock at book value, but none of the prospective purchasers had sufficient funds to pay that amount. In order to facilitate the sales and furnish the sellers with as much cash as possible, the parties decided to reduce the book value of each corporation by means of a pro rata dividend distribution to all the shareholders of each corporation in an amount equal to each corporation's paid-in capital surplus. The dividends were declared prior to the signing of any binding stock purchase contracts but with an understanding that the stock would be purchased at a price equal to its book value after a reduction for the amount of the declared dividends. Transfer of the control of the corporation occurred within several days of the dividend declaration. Finally, in contemporaneous transactions, the

20. 36 T.C. 265, 273-75 (1961), *rev'd,* 314 F.2d 96 (6th Cir. 1963).

21. Without citing any authority, the court insisted that the taxation of dividends be tested by economic substance:

> [W]e . . . conclude that the disputed dividend is properly taxable as ordinary income to the party having beneficial ownership of the stock at the time when the dividend is established, it being that party who bears the operating risks of the business and stands to benefit from profits or suffer detriment from losses.

314 F.2d at 98.

22. Casner was the principal shareholder of a corporation that had been granted a Chevrolet dealership. At the urging of General Motors Corporation, he agreed to terminate his participation in that company by selling his stock to fellow shareholders and the individuals selected to take over the dealership. 28 T.C.M. (CCH) at 537.

shares were transferred, the pro rata dividends were distributed, and payment was made for the stock.

The facts in *Casner* presented the Fifth Circuit with an ideal opportunity to adopt the formalistic standards developed in previous dividend and redemption cases and thereby limit application of the *Steel Improvement* rationale.[23] The purchasers never contractually obligated themselves to pay an additional amount equal to the dividends distributed to the seller. Moreover, the dividends were declared at a time when no binding stock purchase contracts existed. The transactions included stockholders receiving dividends who neither sold nor purchased any stock. Significantly, because the dividends were declared at a time when subsequent earnings of the corporations would continue to affect the amount of the purchase price to be paid for the subject shares, beneficial ownership would not have passed to the purchasers under the principles set forth in *Steel Improvement.* Relying on these factors, the Tax Court had held that the distributions were taxable as dividends to their respective recipients, emphasizing that beneficial ownership remained with the original shareholders on the date the dividends were declared.[24]

The Fifth Circuit reversed, however, and held that the distributions to both sellers and buyers were includable in the income of the buyers. The court further held that the dividends received by the selling shareholders constituted proceeds from the sale of the stock, entitling them to capital gain treatment. Liberally citing cases involving tax avoidance, the *Casner* court concluded that the economic substance of the parties' multi-step plan was a sale of stock that used cash distributions as a device to provide the purchasers with sufficient cash to pay the full purchase price. Significantly, the court buttressed its holding by noting that the buying shareholders enjoyed "economic benefit" from the cash distributions in the form of a reduction in book value and the receipt of cash needed to pay for the stock.[25] In view of the emphasis placed on form by previous decisions concerning dividends and redemptions in bootstrap acquisitions, *Casner*'s reliance on economic substance and benefit

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23. *See* notes 14-21 *supra* and accompanying text.

24. 28 T.C.M. (CCH) at 541. On appeal, the Fifth Circuit disagreed with the Tax Court's findings as to the parties' intentions and found as a fact that the sales price for the stock "was fixed at hook value including *paid-in capital surplus.*" 450 F.2d at 394 (emphasis by the court). The Tax Court was probably correct, however, because the minutes of the relevant board of directors meeting indicate that the agreed sale price was exclusive of the paid-in capital surplus. 28 T.C.M. (CCH) at 539.

25. 450 F.2d at 399.

marked a radical change in the tax analysis applied to dividend-sale bootstraps.[26]

III. The Tax Treatment of the Corporate Seller in a Bootstrap Sale

A. *Waterman Steamship Corp. v. Commissioner*

Although the requirement that a bootstrap distribution exhibit economic substance has been applied sparingly to individual shareholders, the doctrine has met with unquestioned acceptance by courts confronting bootstrap distributions to corporate shareholders. In *Waterman Steamship Corp. v. Commissioner,*[27] the taxpayer filed a consolidated federal income tax return with its two wholly owned subsidiaries, Pan-Atlantic Steamship Corporation (Pan-Atlantic) and Gulf Florida Terminal Company, Incorporated (Gulf Florida). Waterman initially was offered $3,500,000 for the stock of the two subsidiaries. Although Waterman's total tax basis in the stock of the two subsidiaries was only $700,000, their net assets had a total tax basis in excess of the price offered. Thus Waterman preferred a sale of the subsidiaries' assets rather than their stock. The buyer demanded a stock sale, however, in order to acquire Pan-Atlantic's Interstate Commerce Commission (ICC) certificate without ICC approval.[28] Consequently, Waterman rejected the buyer's offer and counteroffered to sell the stock of the two companies for $700,000 after payment of dividends by them to Waterman of $2,800,000.[29]

The parties agreed to this arrangement, and on January 21, 1955, Pan-Atlantic declared and paid the dividend in the form of a promissory note. Waterman immediately sold the stock of both companies to McLean Securities Corporation (McLean), whose principal shareholder (the buyer) guaranteed the promissory note issued by Pan-Atlantic to Waterman. McLean and its principal

26. This departure from traditional dividend taxation analysis has only recently been reflected in bootstrap cases involving individual shareholders decided since *Casner. See, e.g.*, Walker v. Commissioner, 544 F.2d 419 (9th Cir. 1976); Kuper v. Commissioner, 533 F.2d 152 (5th Cir. 1976).

27. 430 F.2d 1185 (5th Cir. 1970), *cert. denied,* 401 U.S. 939 (1971), *rev'g* 50 T.C. 650 (1968).

28. The buyer's control of another corporation holding an ICC certificate required that he obtain ICC approval for the acquisition. Competitors strongly opposed the granting of an additional ICC certificate to the buyer. To avoid the necessity of ICC approval, the buyer decided to divest himself of control in the other corporation and acquire the stock instead of the assets of Pan-Atlantic and Gulf Florida. 430 F.2d at 1187.

29. There was no dispute that Pan-Atlantic had earnings and profits of at least $2,800,000 at the time of sale. 430 F.2d at 1189 n.10.

shareholder then loaned Pan-Atlantic enough money to pay the note it had just distributed to Waterman. Thus, within a ninety minute period, Waterman had $3,500,000 in cash, all of which came from the buyer, and the buyer had the stock of both subsidiaries.

The Commissioner viewed the execution and delivery of Pan-Atlantic's note to Waterman as a sham, and urged that the $2,800,000 be treated as a capital gain to Waterman rather than a tax-free consolidated intercorporate dividend. The Tax Court upheld the form of the transaction, however, noting that parties may arrange the form of a stock sale transaction in order to reduce or eliminate taxable income.[30] Furthermore, the court stated that substance did not necessarily differ from form solely because an equivalent result might have been accomplished by another method that would have produced a higher tax. As a second ground for its holding, the Tax Court found that no actual acceptance or legally binding contract of sale occurred until after the dividend was declared and the note delivered.[31] Judge Tannenwald's dissent reasoned that no real dividend had been paid because the essence of the transaction was that Waterman received the original offer price of $3,500,000 from funds supplied by the purchaser.[32]

The Fifth Circuit reversed, holding that in substance Pan-Atlantic did not pay a dividend to Waterman, but acted as a conduit for the payment of the purchase price to Waterman. Finding that the issuance of the dividend note prior to the signing of the closing agreement was designed to conceal the true nature of the transaction, Judge Wisdom concluded that the form used by parties to a transaction was relatively unimportant.[33] The court expressed concern that:

> A new horizon of tax avoidance opportunities would be opened by allowing a tax free dividend . . . to result from the transaction here effected. Corporations with wholly-owned subsidiaries would be enabled, without difficulty, to circumvent capital gains treatment through a pre-sale extraction of earnings and profits. . . . [A] corporation could purchase another corporation at its fair market value, receive its new subsidiary's earnings and profits in the form of an inter-corporate dividend, sell the subsidiary, and then claim a loss on the subsequent sale.[34]

30. 50 T.C. at 661-62.

31. 50 T.C. at 664-65. *See generally* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950).

32. 50 T.C. at 666 (Tannenwald, J., dissenting). Judge Tannenwald indicated that the issue was not "to whom a conceded dividend should be taxable as such but rather whether there was any dividend at all."

33. The Fifth Circuit stated: "We concentrate on what the parties did. The form of the transaction used by the parties is relatively unimportant, for the true substance and effect of their agreement was that McLean would pay $3,500,000 for all the assets, rights and liabilities represented by the stock." 430 F.2d at 1195 (citations omitted).

34. *Id.* at 1195-96.

Finally, the court in *Waterman* rejected the taxpayer's argument that the transaction possessed economic substance because of the existence of a business purpose. Waterman contended that it could have employed at least three other legitimate means of avoiding the capital gain on its sale if ICC regulations had not prohibited the buyer from acquiring assets.[35] Judge Wisdom concluded that although the ICC requirements mandated a stock purchase, they did not make the issuance of a dividend necessary; the sale of stock could have been consummated without declaring a dividend.[36]

The *Waterman* court did not hold that a dividend will not be allowed to reduce the seller's tax on the sale of stock, but rather held that no dividend in fact had occurred.[37] Thus *Waterman* did not answer the question whether the payment of an actual dividend by a subsidiary to its parent in conjunction with the sale of the subsidiary's stock would be recognized. Despite *Waterman*'s narrow holding, however, the court's concern with tax avoidance if corporations selling their subsidiaries could reduce the gain on the sale by receiving an untaxed dividend applies equally to the situation in which a dividend is actually paid. Thus, until the appearance in 1977 of *Basic Inc. v. United States*[38] and *TSN Liquidating Corp. v. United States*,[39] the possibility that *Waterman* might be extended to destroy the tax treatment sought by the payment of actual dividends in corporate bootstrap acquisitions discouraged taxpayers from attempting this method of tax reduction.

B. *Basic Inc. v. United States*

The possibilities suggested by *Waterman* became reality in *Basic Inc. v. United States*.[40] In *Basic* the taxpayer, Basic, owned all the stock of the first-tier subsidiary, Falls Industries Incorporated (Falls), which in turn owned all of the second-tier subsidiary,

35. Waterman alleged that it could bave liquidated its subsidiaries under §§ 332 and 334(b)(1) and then sold their assets, or sold their assets and then liquidated the subsidiaries tax-free, or merged Pan-Atlantic into Waterman under § 368(a)(1)(A) and then sold its assets. 50 T.C. at 660.

36. The Fifth Circuit noted:

> [T]here was no requirement imposed hy the ICC for dividing the stock sale into two parts. The only party that required the transaction to be cast as it was, was Waterman. Once McLean divested himself of control of Trucking, he was free to pay $3,500,000 in cash directly to Waterman without any necessity of using Pan-Atlantic as a conduit for the payment of $2,800,000 in the guise of a "dividend."

430 F.2d at 1195.

37. *Id.* at 1196.

38. 549 F.2d 740 (Ct. Cl. 1977).

39. 77-2 U.S. Tax Cas. ¶ 9741 (N.D. Tex. 1977).

40. 549 F.2d 740 (Ct. Cl. 1977).

Basic Carbon Corporation (Carbon). When another corporation offered to purchase the two subsidiaries' assets at a predetermined price,[41] Basic demanded additional compensation for the adverse tax consequences of an asset sale.[42] The buyer then negotiated a purchase of the stock of both Falls and Carbon directly from Basic at substantially the same price.[43] This second proposal, which was accepted by Basic, necessitated a transfer of the Carbon stock from Falls to Basic as a dividend. Basic reported the distribution as a dividend of $501,869.76, the adjusted basis of the Carbon stock in the hands of Falls, and took the eighty-five percent dividends-received deduction allowed by section 243.

The dividend in kind allowed Basic to take over Falls' basis in the Carbon stock almost tax-free because of the section 243 deduction.[44] This increased basis reduced the total gain on Basic's subsequent stock sale. The Internal Revenue Service characterized the entire transaction as "a deal too good to be true."[45] Although the stock distribution fit the literal requirements for a dividend, the Service argued that for tax purposes there was really no dividend at all. It asked the court to ignore the dividend and treat the transferred basis as part of Basic's gain on the sale of Falls and Carbon stock.

41. Basic and the buyer, the Carborundum Company of Niagara Falls, New York, had agreed upon a tentative purchase price of $3,935,000, plus an assurance from the buyer guaranteeing the repayment hy Carbon of $1,000,000 owed to Basic. 549 F.2d at 741-42.

42. The huyer first proposed to buy all the assets of Falls and Carbon. Basic responded that the tentative price would have to be increased $265,000 because of the adverse tax consequences of an asset sale and demanded indemnity for all additional taxes assessed against it in excess of this amount. *Id.* at 742.

43. The buyer planned to liquidate promptly the two purchased corporations under §§ 332 and 334(h)(2). To execute this plan, however, it was necessary for the buyer to purchase the stock of both corporations directly from Basic. If the buyer simply purchased the stock of Falls and then had Falls distribute its Carbon stock to the buyer as a dividend, Carbon could not be liquidated under § 334(b)(2) because it would not have been acquired by "purchase" within the meaning of § 334(b)(3)(A)(i). *See* I.R.C. § 301(d)(2)(B).

44. Section 301(d) of the Internal Revenue Code states tbat the basis of property received as a dividend by a corporate shareholder is the lesser of the fair market value of the property or the adjusted basis in the hands of the distributing corporation.

45. 549 F.2d at 745. One commentator has suggested that Congress could easily have harred the very transaction consummated in *Basic* by making § 269 applicable; Basic unquestionably acquired "control" of Carbon for the "principal purpose" of "avoidance of Federal income tax." However, Congress evidenced no such intention. S. REP. No. 627, 78th Cong., 1st Sess. 60 (1943), 1944 C.B. 973, 1017-18, (dealing with the predecessor of § 269). The Senate report stated:

> A transfer within a controlled or affiliated group frequently occurs by a section [332] liquidation or by a tax-free exchange under the reorganization or consolidated returns provisions of law. . . . [W]hile a section [332] liquidation would change the form of control into a more direct form, it could hardly result in the acquisition of control under section [269]. Transfers within a controlled or affiliated group under the reorganization or consolidated returns provisions of law are more often tban not precisely the same as section [332] liquidations in this respect.

The Court of Claims, concerned with the taxpayer's essentially tax-free receipt of basis, agreed with the Service.[46] The court initially determined that no valid business purpose motivated the transfer. Basic stressed that the stock transfer was necessary in order to enable Basic to meet the purchaser's requirement that the shares of both subsidiaries be purchased directly from the parent. Although conceding that the transfer was necessary to effect the sale by Basic, the court held that a business purpose of the selling shareholder did not satisfy the business purpose requirement as to Falls and required that Falls establish its own business purpose for the transfer.[47] Because Falls had declared a dividend of the Carbon stock for business reasons of its parent rather than to serve its own business interests, the dividend failed.[48]

The court also rejected Basic's argument that the distribution had "independent significance," distinguishing its prior decision in *Dynamics Corp. of America v. United States.*[49] In *Dynamics* a subsidiary tried unsuccessfully to sell an unneeded building in November 1957. Three months later it transferred the building to its parent corporation, which had unutilized capital loss carryovers, and the parent sold the building at a substantial gain within nine months. The Service's attempt to reallocate the gain to the subsidiary under section 482 failed.[50] Despite its obvious tax motivation, the transaction was upheld by the Court of Claims on the ground that the

46. The Court of Claims observed that "[n]ot only would this provide Basic with the advantage of a transferred basis in the Carbon stock . . . but, more importantly, Basic would obtain this transferred basis essentially tax free by virtue of the deduction allowed intercorporate dividends under Section 243(a)(1)." 549 F.2d at 744-45.

47. The *Basic* court stated this requirement as follows:

> However, it is quite anotber matter to offer tbat same argument in explanation and justification for the stock transfer that took place between Basic and Falls. The business interests of Falls were distinct from those of its shareholder, Basic. Hence, it will not do to invoke an explanation that has validity only as to Basic . . . . Indeed, if such an explanation were sufficient then all manner of intermediate transfers could lay claim to "business purpose" simply by showing some factual connection, no matter how remote, to an otherwise legitimate transaction existing at the end of the line.

Id. at 745.

48. The *Basic* court determined that the transaction served the business purpose of effecting the sale of a business and that this business purpose could be attributed only to the selling corporation. Thus, although the transaction furthered Basic's business interests, no business interest of Falls was served by the transfer.

49. 449 F.2d 402 (Ct. Cl. 1971).

50. Although the Service failed in *Dynamics* to reallocate under § 482 the gain derived from property transferred by means of an intercorporate dividend, it has succeeded recently in employing § 482 to combat tax avoidance attempts under § 243. *See* Northwestern Nat'l Bank v. United States, 556 F.2d 889 (8th Cir. 1977) (charitable deduction of property received as intercorporate dividend reallocated); Southern Bancorp. v. Commissioner, 67 T.C. 1022 (1977) (income from sale of United States Treasury notes distributed as intercorporate dividend reallocated).

parent's superior ability to manage the property and effect a sale provided a valid business purpose. The *Basic* court cited the valid business purpose and the time lapse of nine months between transfer and sale of the property in *Dynamics* as evidence that the distribution and sale in *Dynamics* were unconnected events, and therefore clearly distinguishable from those in *Basic.*

Thus *Basic's* requirement that even an actual dividend paid by a subsidiary to its parent as part of a bootstrap sale must manifest economic substance, resolved the issue never reached in *Waterman.* Although this conclusion was not surprising in light of the *Waterman* rationale, the Court of Claims' determination that a business purpose of the subsidiary distributing the dividend satisfied the economic substance standard,[51] while a business purpose of the parent distributee did not, imposed a disturbingly rigid standard.[52] Tax practitioners who questioned whether other courts would adopt the strict view espoused in *Basic* were answered nine months later when *TSN Liquidating Corp. v. United States*[53] addressed this precise issue.

C. *TSN Liquidating Corp. v. United States*

In *TSN* the taxpayer corporation owned over ninety percent of Community Life Insurance Company (CLIC). In 1969, negotiations began between CLIC and Union Mutual Life Insurance Company (Union Mutual) concerning the purchase of CLIC by Union Mutual. Because much of CLIC's investment portfolio adversely affected its ability to obtain licenses in other states, Union Mutual required CLIC to dispose of specific securities.[54] Consequently, on May 5, 1969, TSN and the other CLIC shareholders agreed to sell their CLIC stock to Union Mutual at a purchase price that excluded the value of the unwanted stock. Immediately thereafter, CLIC declared and paid a dividend of these unwanted securities to existing stockholders,[55] who then sold their CLIC stock to Union Mutual.[56]

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51. *See* note 57 *infra,* and accompanying text.

52. *See, e.g.,* Ditkoff, *Intercorporate Dividends and Legitimate Tax Avoidance,* 4 J. CORP. TAX. 5 (1977).

53. 77-2 U.S. Tax Cas. ¶ 9741 (N.D. Tex. 1977).

54. The investment portfolio of CLIC was heavily oriented toward equity investments in closely held over-the-counter securities that seriously affected CLIC's ability to obtain licenses in various states. As early as 1968, CLIC had begun to seek a solution to its investment portfolio problem, but the court found that no definite plan was ever formulated. CLIC tried unsuccessfully to get Union Mutual to take the entire investment portfolio.

55. CLIC could not sell the over-the-counter stocks that Union Mutual did not want, because the stocks had been originally owned by the person who controlled TSN, its predecessor, and CLIC.

56. Taxpayer reported its share of the sale price on the installment basis. It claimed

The taxpayer reported its share of the dividend and claimed the eighty-five percent dividends received deduction of section 243.[57] Predictably, the Commissioner viewed the distribution as part of the sale proceeds received by the taxpayer.[58]

The United States District Court for the Northern District of Texas agreed that the distribution constituted proceeds from the sale of CLIC stock by the taxpayer. Quoting extensively from *Waterman* and *Basic,* the *TSN* court expressed concern that the transaction could be used as a device to enable the seller to treat extraordinary distributions on the eve of the sale of a corporation as tax-free dividends.[59] The court summarily concluded that there was no business reason for CLIC, as a corporation, to desire to clean up its portfolio once the contract of sale had been signed. The court then determined that the distribution's only benefit was to make CLIC saleable and that this benefit inured to CLIC's shareholders rather than to CLIC itself.[60]

The reasoning used by the *TSN* court does not support its result. At all times before and after the sale, CLIC contemplated engaging in the insurance business—a business it could conduct more effectively after disposal of much of its investment portfolio.[61] Therefore, even after the sale, CLIC's business needs mandated that it dispose of these securities. Moreover, the court recognized that securities law restrictions made a dividend in kind the only practical means by which to transfer the stock.[62] Thus the court's conclusion

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an adjusted basis of $612,304, which was computed by subtracting the portion of the dividend in excess of earnings and profits from its original basis in its CLIC stock of $1,082,230.

57. The value of the unwanted stocks was approximately $1.8 million. As a result of the dividend, CLIC was left with assets totaling approximately $300,000. The taxpayer reported its share of the dividend as $701,354.85 and realized a dividend to the extent of its share of CLIC's earnings and profits of $231,429, but claimed an 85% dividends received deduction. It then reduced its basis in the stock of CLIC by the portion of the distrihution in excess of earnings and profits.

58. By treating the distributions as payments for the stock in the year of sale, the Commissioner denied taxpayer the use of the installment reporting method because more than 30% of the proceeds were received in the year of sale.

59. 77-2 U.S. Tax Cas. at 88,526. The court relied heavily on the *Waterman* rationale that the dividends received deduction of § 243 should not he used as a device for tax avoidance. *See* text accompanying note 34 *supra.*

60. The court's brief analysis stated:

> There was no reason for CLIC, as a corporation itself, to desire after the contract of sale was signed to clean up its portfolio. The only benefit to CLIC was that it made itself saleable by declaring the dividend and divesting itself of its over-the-counter stock portfolio. This benefit wás . . . not to CLIC itself, hut, rather, to CLIC's shareholders . . . .

77-2 U.S. Tax Cas. at 88,525.

61. The court expressly found that the makeup of CLIC's investment portfolio adversely affected its ability to obtain licenses in other states. *Id.* at 88,523.

62. *Id.*

that the transfer served only to benefit the parent by making CLIC saleable is unconvincing. CLIC also realized a benefit because the dividend eliminated the objectionable securities in its portfolio.

Despite the inadequacy of its reasoning, *TSN* constitutes an important decision in the corporate bootstrap sale area. The decision reflects the concern expressed in *Waterman* that intercorporate dividends distributed in connection with the sale of subsidiaries can be used as a tax avoidance device. *TSN* also comports with *Basic*'s requirement that a dividend distributed in a corporate bootstrap sale must serve a business purpose of the subsidiary rather than the parent. Thus *Waterman, Basic,* and *TSN* present formidable obstacles for parent corporations seeking to use intercorporate dividends to facilitate the sale of a subsidiary. Each of these three decisions, however, misconstrues the true nature of a dividend, especially an intercorporate dividend, and therefore should not be regarded as conclusively determining the tax treatment of a corporate bootstrap sale.

IV. A Legal and Policy Analysis of the Corporate Bootstrap Sale

A. *A Conceptual Approach to Dividends*

(1) The Elevation of Form over Substance

A dividend does not confer an economic benefit on its recipient.[63] A dividend distribution merely transfers part of the value represented by the shareholder's ownership interest in the corporation out of corporate solution and into his personal possession. The increase in the shareholder's personal assets is exactly offset by the reduction in the value of his corporate interest, thus leaving his overall net worth unchanged. A shareholder's net worth increases only upon the realization of a profit by the corporation, not upon the corporation's decision to distribute those profits. The unfortunate tendency of the courts to link dividends with economic benefit has served only to obscure the true nature of a dividend.[64]

63. For an excellent discussion of the legal and economic consequences of dividend distributions, see Kingson, *supra* note 13. *See also* Eisner v. Macomber, 252 U.S. 189 (1920).

64. As one commentator has noted, the confusion of dividends with economic benefit may result in part from the market behavior of widely owned stocks, because the price of publicly traded shares often rises upon anticipation or declaration of an increased dividend. Kingson, *supra* note 13, at 864 n.22. Tax cases, however, usually involve closely held corporations so that any distinction between corporate and shareholder control over funds narrows. One indication that shareholders of closely held corporations in particular do not regard the purported economic benefit of a dividend as worth its tax cost is the existence of the accumulated earnings penalties imposed by §§ 531 and 541 of the Code. *Id.* at 864.

In *Wall v. United States*[65] the Fourth Circuit correctly perceived what actually constitutes a dividend distribution. *Wall* involved a shareholder of a corporation who had acquired all the stock of the other shareholder in return for a promissory note in the amount of the stock's fair market value. Instead of paying the note himself, the debtor later surrendered the purchased stock to the corporation in consideration of its paying his debt. The Fourth Circuit held that payment of the debtor's note was a dividend distribution to him.[66] The court refused, however, to apply an "economic benefit" analysis, thus rejecting the taxpayer's argument that the usual dividend rule should not apply to him because he had not received any economic benefit as a result of his purchase the corporation's subsequent redemption of those shares.[67] The taxpayer unquestionably did not receive any economic benefit from the corporation's assumption of the debt and cancellation of the redeemed shares because the gain that resulted from causing the corporation to assume his debt was exactly offset by the loss in value of his solely owned company, which had become indebted to a third party without receiving any corresponding asset. The simple result of the transaction was a transfer of assets out of corporate solution and a corresponding increase in the amount of the shareholder's beneficially owned assets outside corporate solution. Thus the *Wall* court correctly determined that the true measure of a dividend is the transfer of assets out of corporate solution, not any economic benefit to the shareholder.

Because a shareholder realizes no economic benefit from a dividend, dividends cannot display economic substance. Rather a dividend is nothing more than a taxable event determined by the shareholders' decision to increase the amount of their assets outside cor-

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65. 164 F.2d 462 (4th Cir. 1947).

66. The court reasoned that a third party's payment of a debt owed by the taxpayer:

> is regarded as the same as if the money had been paid to the taxpayer and transmitted by him to the creditor; and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt.

Id. at 464.

67. He further contended that any economic benefit could be measured only by waiting until he disposed of the shares. To this argument the court responded:

> While this statement may be true, it is entirely beside the point. We are not now concerned with the broad question whether the business . . . will ultimately result to his advantage and show a profit on his investment . . . , but with the much narrower question whether in 1939 the taxpayer in legal effect received a dividend from the corporation through the payment by it of the $5,000 note . . . .

Id. at 465.

porate solution.[68] Thus the decision to declare or not to declare a dividend is inherently one of form that is incapable of possessing economic substance. Nevertheless, courts discuss whether or to whom a dividend distribution has been made in terms of the economic benefit received and the underlying substance of the transaction.[69] This attempt to attribute economic substance to what is only a change in form of asset ownership is primarily responsible for much of the legal confusion surrounding bootstrap acquisitions.

Because a dividend is a purely formal event having no economic substance, the economic benefit rationale used in *Steel Improvement* and *Casner* to characterize a dividend to the seller as a constructive dividend to the buyer must be rejected. The realization by a buyer of an indirect economic benefit in the form of a reduced purchase price should not cause the buyer to recognize a dividend when the form of the transaction is a dividend to the seller that does not relieve the buyer of a contractual obligation. The fallacy of attempting to use economic substance to impute the dividend to the buyer becomes apparent when one realizes that the distributions in these cases neither actually nor constructively increased the buyers' assets.[70] Furthermore, despite the emphasis the *Steel Improvement* and *Casner* opinions placed on the parties' tax avoidance motives, the taxpayers easily could have achieved the desired results under a *Zenz* sale-redemption plan. Logic dictates that a court's acceptance of form in the sale-redemption area also should extend to bootstrap sales preceded by a dividend.

Although none of the opinions in *Waterman, Basic,* and *TSN* considered the possibility of imputing to the buyer the dividend

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68. For an excellent early Supreme Court analysis adopting this definition of a dividend, see Eisner v. Macomber, 252 U.S. 189 (1920).

69. *See* notes 21, 25, 33, 47-48, 60 *supra* and accompanying text.

70. In a flagrant contradiction, the Fifth Circuit opinion in *Casner* admitted that:

> [T]he buying stockholders received the same benefit from the cash distributions as would any other recipient of a dividend distribution. To suggest tbat the proper test is whether the shareholders are better off economically after the cash distributions than before is incorrect since no dividend distribution enlarges the net worth of the shareholders.

450 F.2d at 400. As one commentator has noted, recasting the form of a bootstrap acquisition is particularly objectionable when it unexpectedly reallocates the tax burden. *See* Kingson, *supra* note 13, at 891 n.122. The seller in *Casner* was apparently in a bigh tax bracket so that his tax would be significantly increased by the receipt of a dividend rather than a capital gain; nevertheless he agreed to receive a dividend. If the parties adjusted the sale price to reflect the tax detriment to the seller, inclusion of the dividend in the buyer's income resulted in a capital gain windfall to the seller. This concern clearly expressed in Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967), which said that an attack based on substance "would nullify tbe reasonably predictable tax consequences of the agreement . . . . If unsuccessful, the buyer would lose a tax advantage it had paid the selling-taxpayers to acquire."

paid to the corporate seller, the dangers posed by *Steel Improvement* and *Casner* should not be overlooked in the corporate bootstrap area. Application of this doctrine could produce the worst of all possible worlds. The selling corporate shareholder would lose its section 243 deduction and incur additional capital gain, while the buyer would recognize dividend income on property never actually received. Happily for taxpayers, the Service has stated that it will not follow the reasoning applied in *Casner.*[71]

(2) Dividends and the Business Purpose Doctrine

Although *Waterman, Basic,* and *TSN* refrained from applying economic substance theory to tax a dividend paid to the seller as a constructive dividend to the buyer, *Basic* and *TSN* nevertheless invoked economic substance to disallow dividend treatment to the seller under the business purpose doctrine. The business purpose doctrine states that when the sole purpose of a transaction is tax avoidance, the court will disregard form and give effect to the transaction's economic substance in order to deny the tax benefit achieved by the transaction. If the tax avoidance is but an incident to an otherwise valid business purpose, however, the court will recognize the legitimacy of the transaction.[72]

Because a dividend has no economic substance and the choice of form is ultimately that of the shareholders, "it is naive to suppose that a corporation declares and pays a dividend without regard to the shareholders' interests or that the distribution of a valuable asset can ever benefit the corporate distributor itself."[73] Yet *Basic* and *TSN* both held that a dividend must serve a valid business purpose of the distributing corporation and that a valid business purpose of its shareholders will not suffice.[74] Accordingly, when the

71. Rev. Rul. 75-493, 1975-2 C.B. 109; Rev. Rul. 75-494, 1975-2 C.B. 109. This ruling resulted from intense criticism of the *Casner* decision. This ruling indicates that the Service will follow *Casner* now only in two situations: (1) when the buyer furnishes the distributed funds, as in *Waterman;* and (2) when the dividend is paid after the signing of the purchase contract, as in *Steel Improvement. See* Kingson, *supra* note 13, at 897; Schaffer & Gordon, *Taxing Intercorporate Dividends As Part of the Sale of a Subsidiary,* 30 TAX. LAW. 727, 751-52 (1977) [hereinafter cited as Schaffer & Gordon].

72. For two exhaustive discussions of the business purpose doctrine, see Lipnick, *Business Purpose and Income Taxes: From* Gregory *to* Goldstein, 46 TAXES 698 (1968); Rice, *Judicial Techniques in Combating Tax Avoidance,* 51 MICH. L. REV. 1021, 1041-47 (1953).

73. Ditkoff, *supra* note 52, at 19.

74. Many courts have recognized that it is not only difficult but often purely formalistic to distinguish between corporate and shareholder benefit. *See, e.g.,* Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949); Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947); Bazley v. Commissioner, 155 F.2d 237 (3d Cir. 1946) (dissenting opinion). *See generally* Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966); Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961); Louisville Store of Liberty, Ky. v. United States, 376 F.2d 314 (Ct. Cl. 1967).

Basic court decided to apply this rigid standard to the facts before it, the dividend in kind paid by the subsidiary to the parent was disallowed because it served only a business purpose of the parent.[75] The similar result reached in *TSN* is even more questionable in view of the conspicuous presence of a business purpose of the corporation distributing the dividend.[76]

The reasons why the courts in *Basic* and *TSN* adopted this strict business purpose requirement cannot be easily ascertained. As mentioned before, both practical and theoretical considerations indicate that this standard provides an inappropriate method for testing the validity of dividends distributed in corporate bootstrap transactions.[77] The harsh attitudes evidenced in *Basic* and *TSN* cannot be explained by the facts of the two cases because neither transaction constituted a blatant attempt at tax avoidance.[78] The courts' adoption of this unrealistic business purpose requirement for section 243 bootstrap transactions and the subsequent misapplication of the test when it served to legitimate a section 243 bootstrap sale indicate an underlying judicial concern that section 243 might be used to achieve a degree of tax avoidance far exceeding that achieved in *Basic* and *TSN*. This concern can be gleaned from the concluding paragraph of the discussion in *TSN*,[79] in which the court reiterated *Waterman's* apprehension that one corporation could purchase another corporation at its fair market value, receive its new subsidiary's earnings and profits tax-free under section 243, and then sell the subsidiary, claiming a loss on the subsequent sale.[80] Thus the courts in *Basic* and *TSN* did not seem to view the specific transactions in these cases as particularly outrageous means of tax avoidance; instead, the harsh position adopted appears to stem from a judicial fear that approval of these transactions would open the floodgates and allow section 243 to be used by corporate taxpayers to obtain obviously illegitimate tax benefits.[81]

75. *See* notes 47-48 *supra* and accompanying text.

76. *See* notes 61-62 *supra* and accompanying text.

77. *See* text accompanying note 73.

78. The courts in both *Basic* and *TSN* recognized that the bootstrap dividends issued in each transaction served the primary purpose of effecting a sale of the subsidiaries involved, since neither buyer would have consummated the purchase unless the dividends in kind had been paid. The *TSN* court responded, however, that the business purpose doctrine may apply even if tax avoidance is not the sole purpose for a transaction. 77-2 U.S. Tax Cas. at 88,526.

79. *Id.* at 88,526-27.

80. *See* note 34 *supra* and accompanying text.

81. The *TSN* opinion expressed this fear as follows:

> Since all the parties to an arm's-length contract can, by offer, counter-offer, acceptance, and rejection, shape the terms of the contract so as to be most beneficial to all the parties involved, no single party can be said to dictate any particular requirement.

B. *Section 243 and Tax Avoidance*

Section 243 does not exempt corporate earnings from tax,[82] but it does prevent such earnings from being taxed more than once before distribution to individual shareholders.[83] Thus section 243(a)(1) provides generally that eighty-five percent of the amount received as dividends from a domestic corporation that is subject to federal income taxation may be deducted when received by a corporate shareholder.[84] The requirement that the paying corporation be subject to federal income taxation reflects the deduction's purpose of mitigating multiple taxation of corporate earnings.[85] For corporate groups that are eligible to file consolidated returns but elect to report separately, section 243(a)(3) provides a one hundred percent dividend deduction.

Waterman, Basic, and *TSN* recognized the purpose of section 243's policy of preventing multiple taxation. They did not comprehend, however, that when a corporate parent sells a subsidiary, the subsidiary's earnings and profits, which have already been taxed

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> Were tbis Court to hold that a pre-sale extraction of capital was to be treated as a dividend for federal taxation purposes whenever a prospective buyer "demanded" it, the Court would be opening the door for all sorts of impenetrable contract collusion between the parties.

77-2 U.S. Tax Cas. at 85,526.

82. *See* note 5 *supra.*

83. *See generally* BITTKER & EUSTICE, *supra* note 1, ¶ 5.06; Cohen, *Election of Tax-Free Intercorporate Dividends Under the Revenue Act of 1964,* 42 TAXES 791 (1964).

84. Bittker and Eustice have observed:

> From 1917 to 1935, corporations were not taxed on dividends received from other corporations, in order to prevent the multiple taxation of corporate earnings, as they passed from one corporation to another, possibly within the same chain of beneficial ownership. The law was revised in 1935, however, to exempt only 85 percent of the dividends received, in order to discourage the use of multiple entities for tax avoidance and as a part of the New Deal program which pressed for the simplification of elaborate corporate structures.

BITTKER & EUSTICE, *supra* note 1, ¶ 5.06, at 5-18.

85. The language of § 243 and its legislative history clearly indicate that the purpose of the statute and regulations relieving intercorporate dividends from tax is to prevent multiple taxation of corporate earnings: "There is no reason in the world why a corporation that owns stock in another company should pay a double tax upon those holdings." 44 CONG. REC. 4696 (1909) (remarks of Representative Payne discussing the Payne-Aldrich Tariff Act of 1909); *see* H.R. REP. No. 708, 72d Cong., 1st Sess. 12 (1932) (Revenue Act of 1932). *Cf.* 55 CONG. REC. 2492-94 (1917) (remarks of Rep. Sterling discussing the Revenue Act of 1917); 78 CONG. REC. 6467-71 (1934) (remarks of Senators Borah and Black discussing the Revenue Act of 1934) (congressional discussions leading to rejection of attempts to abolish the exemption for intercorporate dividends). The Treasury agrees with this rationale: "[The proposed 100% dividends-received deduction] would recognize that the earnings of an 80-percent owned-operating subsidiary are more directly the earnings of the parent than is the case where one corporation merely derives investment income from an unrelated corporation." *Hearings on the President's 1963 Tax Recommendations Before the House Ways and Means Comm., Pt. 1,* 88th Cong., 1st Sess. 81 (1963) (statement of C. Douglas Dillon, Secretary of the Treasury).

once, will be taxed again in corporate solution if the parent is denied a dividend deduction and must use its basis in the subsidiary's stock to compute gain. Indeed, one can argue that the Code gives the subsidiary a cost basis in its assets and exempts dividends to its parent from tax for the same multiple tax-avoiding reason.[86] The subsidiary's basis in assets purchased with earnings and profits prevents those earnings and profits from being taxed again if the subsidiary sells the assets. Section 243 also prevents those earnings and profits from being taxed again if the subsidiary distributes them as a dividend.

For example,[87] assume that a parent pays $20 in exchange for stock of a newly incorporated subsidiary and that the subsidiary invests in assets with a basis of $20. The subsidiary then produces after-tax income of $100, which is reinvested in assets with a basis of $100. If the subsidiary sells its assets for $300, the first $120 of proceeds will not be taxed. Only the $180 in excess of the subsidiary's basis will be taxable gain. The undistributed earnings of $100, already taxed once, will not be taxed again. Thus, under these circumstances, the assets' basis performs the function of assuring that income is taxed only once.

Now assume that the parent must for business reasons sell stock instead of assets. The purchase price is still $300, but the parent's basis in the shares is $20 instead of $120. The gain therefore will be $280 instead of $180. An amount equal to the subsidiary's after-tax earnings of $100 is taxed again. It is this second tax on $100, which is not imposed on a sale of assets by the subsidiary, that the parent seeks to avoid by arranging with the buyer for the subsidiary to pay a dividend of $100 to the parent and for the buyer to pay $100 less in purchase price.[88] Thus logical reasoning supports the use of section 243 to equate the corporate parent's gain on a sale of stock with the gain the subsidiary would have on a sale of assets.

The consolidated return regulations,[89] which govern taxable

86. Schaffer & Gordon, *Taxing Intercorporate Dividends Received As Part of the Sale of a Subsidiary*, 30 TAX LAW. 727 (1977).

87. This example is taken in substance from an example in Schaffer & Gordon, *supra* note 71, at 735-36.

88. Note that it is impossible for an intercorporate dividend to reduce the seller's gain below what the subsidiary's gain would have been on a sale of assets. In this example the parent cannot reduce its gain below $180 because tbe subsidiary's distribution constitutes a "dividend" only to the extent of the subsidiary's earnings and profits ($100). A distribution exceeding the subsidiary's earnings and profits would not avoid any gain, since the parent would be required to reduce its basis in the subsidiary's shares. If the distribution exceeded both earnings and profits and the parent's basis in the subsidiary's shares the parent would be required to recognize the amount of excess as gain. *See id.* at 736.

89. The Treasury has promulgated a lengthy and intricate set of regulations, which for

years beginning after December 31, 1965,[90] provide convincing support for this view. These regulations require a corporate parent that files consolidated returns with its subsidiary to increase its basis in its stock of the subsidiary by the amount of the subsidiary's undistributed earnings and profits for the taxable year.[91] The general purpose underlying this adjustment is to reflect increases and decreases in the stock investment corresponding to the subsidiary's results of operations that have been included in the consolidated return, so that a subsequent sale or other distribution of such stock will not result in tax duplication to the parent.[92] For the parent corporation the result is the same as if these earnings and profits had been distributed to it as dividends and then contributed back to the subsidiary's capital.[93] If consolidated returns had been filed in the previous example, the parent's basis in the stock of the subsidiary would have been increased by the amount of the subsidiary's undistributed earnings and profits ($100), and the parent's gain on the sale of stock would have been identical to the gain produced by a sale of assets.

Although eligible to file consolidated returns, the taxpayers in *Basic* and *TSN* had not elected consolidated treatment but sought to achieve a similar result by means of section 243.[94] Because the statutory purpose of both section 243 and the consolidated return regulations is to avoid repeated taxation of corporate earnings until

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practical purposes constitute the law of consolidated returns. *See* Treas. Reg. §§ 1.1501-.1504 (regulations in force as of May 1978). *See generally* BITTKER & EUSTICE, *supra* note 1, ¶¶ 15.20-.24; F. PEEL, JR., CONSOLIDATED TAX RETURNS (2d ed. 1973).

90. These consolidated return regulations were not in effect for the tax year 1955, in which Waterman filed consolidated returns. Beginning in 1966 the regulations have required that a corporate parent filing consolidated returns with its subsidiary increase its basis in its stock of the subsidiary by the amount of the subsidiary's undistributed earnings and profits for the taxable year. Treas. Reg. §§ 1.1502-32(b)(1)(i) (1966); 1.1502-32(b)(2)(iii) (1966); 1.1502-32(c), T.D. 7246, 1973-1 C.B. 381, 390; 1.1502-32(e)(2) (1966). The parent decreases its basis in the subsidiary's shares when the subsidiary distributes earnings and profits whicb the subsidiary accumulated in previous consolidated return years, or in years before the parent acquired the subsidiary.

Were the Waterman Steamship Company to sell its subsidiaries today, having consolidated its return, it would have no gain. Its basis would not be the $700,000 realized under the law in effect in 1955, but would be at least $2,800,000. There would not be gain even if the exact holding of *Waterman* were repeated.

91. Treas. Reg. § 1.1502-32(b)(1)(i) (1966). *See generally* 1 H. LERNER, R. ANTES, R. ROSEN, & B. FINKELSTEIN, FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS (1976) [bereinafter cited as LERNER].

92. *See* PEEL, *supra* note 89, ¶ 15.02a, at 213; LERNER, *supra* note 91, at 21-22.

93. PEEL, *supra* note 89, ¶ 15.02a, at 215.

94. In order to file consolidated returns, a corporate group must meet § 1504's definition of "affiliated group." The most important requirement tbat this definition imposes is that the parent own at least 80% of the voting power of all classes of stock and of each class of nonvoting stock of tbe subsidiary.

they are transferred out of corporate form, sound tax policy dictates that a corporation should not be subjected to double taxation solely because it has elected not to file consolidated returns.[95] Indeed, Congress has indicated that one of the purposes of section 243 is to serve as a substitute for groups that do not elect to file consolidated returns.[96] Thus, although consolidated returns provide one means by which gain on the sale of stock can be eliminated, there is no reason why section 243 should not provide another method by which to eliminate this same amount of gain.

In one situation, however, the application of section 243 would not yield the same tax result provided by consolidation.[97] This would occur when a corporation purchases another corporation at fair market value, receives its new subsidiary's pre-acquisition earnings and profits in the form of an intercorporate dividend, then sells the subsidiary, and claims a loss on the subsequent sale. This is the precise situation first envisioned by the *Waterman* court and later viewed with alarm in *TSN.*[98] Under the consolidated return regulations, the corporate purchaser could not utilize this device to create an artificial tax loss. The present investment rules of the consolidated return regulation require the parent's basis in the stock of the subsidiary to be reduced for purposes of determining gain or loss whenever the subsidiary makes a distribution of pre-affiliation earnings and profits.[99] The regulations assume that pre-affiliation earnings and profits were reflected in the purchase price paid for the stock and therefore constitute part of the basis of the stock.[100] Consequently, a parent could not pay $100,000 for the stock of a subsidiary with $60,000 in earnings and profits, receive the $60,000 as a dividend in a consolidated return year (in which the dividend would be

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95. There are many reasons why an affiliated group might prefer to file separate returns rather than consolidated returns. *See* BITTKER & EUSTICE, *supra* note 1, ¶ 15.23; Salem, *Proposed Section 243 Tax-Free Dividend Rules Answer Many, But Not All, Questions,* 28 J. TAX. 26 (1968); Schaffer & Gordon, *supra* note 86, at 739.

96. *See* Schaffer & Gordon, *supra* note 71, at 739-40. The Senate report on the 1964 legislation that repealed the penalty tax on affiliated groups filing consolidated returns stated:

> Your committee concluded that it would be inequitable to repeal the consolidated return 2-percent tax without also providing a 100-percent intercorporate dividends received deduction for corporations meeting the same tests of common ownersbip, but which for one reason or another cannot or do not want to, file a consolidated return . . . .

S. REP. No. 830, 88th Cong., 2d Sess. 75 (1964), 1964-1 C.B. (pt. 2) 579, *reprinted in* [1964] U.S. CODE CONG. & AD. NEWS 1673, 1747.

97. *See* PEEL, *supra* note 89, ¶ 15.02b.

98. *See* notes 34 & 80 *supra* and accompanying text.

99. Treas. Reg. § 1.1502-32(b)(2), T.D. 7246, 1973-1 C.B. 381, 390. *See* PEEL, *supra* note 89, ¶ 15.029, at 214.

100. *See* PEEL, *supra* note 89, ¶ 15.02a, at 214.

eliminated), sell the stock for its remaining value of $40,000, and claim a $60,000 loss. This artificial tax loss is also denied corporations electing the section 243 one hundred percent dividends received deduction. Section 243(b)(1)(B) denies the one hundred percent deduction to dividends out of earnings and profits of a taxable year in which the distributing corporation and the corporation receiving the dividend were not members of an affiliated group.[101]

The consolidated return regulations' basis adjustment for distributions of pre-acquisition earnings and profits and section 243(b)(1)(B)'s denial of a deduction for such dividends have no functional equivalent in the eighty-five percent dividend deduction provisions of section 243.[102] If no consolidated returns are filed and the one hundred percent dividends received deduction is not elected by the parent in the above example, the parent could deduct eighty-five percent of the $60,000 dividend and retain its $100,000 basis in the subsidiary's stock.[103] The parent would succeed in creating a potential $60,000 capital loss by paying a tax at ordinary income rates on $9000 of the $60,000 dividend.[104] This artificial tax loss results because the parent's deduction of pre-acquisition earnings and profits already reflected in the basis of the stock is not offset by an equal reduction in the basis of the stock.

Thus the dilemma faced by the courts in *Waterman, Basic,* and *TSN* is clear. No valid tax policy supports denying a corporation in a bootstrap sale the use of section 243 to eliminate previously taxed post-acquisition earnings and profits that are not reflected in the basis of the subsidiary's assets. Certainly a corporate shareholder

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101. I.R.C. § 243(b) states:

(b) Qualifying dividends.—

(1) Definition.—For purposes of subsection (a)(3), the term "qualifying dividends" means dividends received by a corporation which, at the close of the day the dividends are received, is a member of the same affiliated group of corporations (as defined in paragraph (5)) as the corporation distributing the dividends, if—

(A) such affiliated group has made an election under paragraph (2) which is effective for the taxable years of its members which include such day, and either

(B) such dividends are distributed out of earnings and profits of a taxable year of the distributing corporation ending after December 31, 1963—

(i) on each day of which the distributing corporation and the corporation receiving the dividends were members of such affiliated group . . . .

102. *See* PEEL, *supra* note 89, ¶ 15.02a, at 214, ¶ 15.02b, at 220.

103. I.R.C. §§ 243(a)(1), 301(d)(2).

104. The taxpayer corporation would be taxed only on the amount of the dividend in excess of 85% (*i.e.*, 15% of $60,000=$9,000). A capital loss of $60,000 would result when the parent sells the stock at its remaining fair market value ($40,000).

should be allowed to achieve the same tax results in a sale of stock that a sale of assets or application of the consolidated return regulations would produce. On the other hand, judicial approval of the use of section 243 in corporate bootstrap sales might be tantamount to recognition of its use as a tax avoidance device when the dividends distributed arise out of pre-acquisition earnings and profits that already are reflected in the basis of the stock.

V. Proposed Solutions

A. *Uniform Tax Treatment of Dividends and Redemptions*

It is clear that bootstrap sales have the same economic effect whether accomplished by dividend or redemption. Nevertheless, the parties are taxed differently depending on whether the transaction includes a dividend or redemption. Neither of the possible tax treatments of a dividend to the seller in a bootstrap sale (dividend to seller and no income to buyer, or constructive dividend to buyer and purchase price to seller) matches the tax treatment of the parties if the seller causes a redemption (purchase price to seller, no income to buyer).[105] Consequently, well-advised sellers generally will pursue the redemption route rather than the dividend route.

Everett Jassy has examined the economic similarity of redemption bootstraps and dividend bootstraps and has suggested a novel reform.[106] Because the taxation of bootstrap sales by way of redemption appears settled in the courts, before the Service, and apparently to the satisfaction of Congress, Jassy advocates that bootstrap sales by way of dividends should be taxed as if they were by way of redemption. Under this proposal, buyers would be spared the expensive surprise of *Casner* and sellers would be taxed the same whether the seller receives corporate funds by means of redemption or dividend.[107]

Although this proposal provides a simple and conceptually appealing solution to the problems raised by *Steel Improvement* and *Casner*, it contains two serious defects. Jassy concedes that the courts are not likely to accept his proposal.[108] Rather, the courts have consistently refused to look beyond the shareholder's charac-

105. Professor Kingson has suggested that courts use the rule of Commissioner v. Court Holding Co., 324 U.S. 331 (1945), in deciding whether the dividend is taxed to the buyer or the seller. *See* Kingson, *supra* note 13, at 881-84. The formalistic nature of the rule and its inequitable application to corporate shareholders are criticized by Schaffer and Gordon, *supra* note 86, at 754.

106. *See* Jassy, *supra* note 2.

107. *Id.* at 1477-81.

108. *Id.* at 1482-83.

terization of a distribution as a dividend in order to determine whether the circumstances and economic effect of the distribution properly require a different characterization for tax purposes.[109] The most important objection to Jassy's proposal is that it ignores the case of the corporate seller.[110] Reclassifying dividends as capital gains certainly benefits individual taxpayers. Corporate sellers, however, prefer dividends that are deductible under section 243 over redemptions that are taxable at capital gain rates.

As discussed above, there are compelling reasons why distributions from a subsidiary to its parent should be tax-free to the extent of post-acquisition earnings and profits.[111] The application of section 243 accomplishes this. If a dividend is recharacterized as a redemption, however, the parent cannot rely on section 243 to achieve legitimate tax avoidance. The proposal to tax such dividends as redemptions seems to have been made without consideration of the purpose of section 243. Thus, this proposed reform should be limited to sellers who are not corporations, or to dividends that do not qualify for the dividends received deduction of section 243.

B. Adjustment of Stock Basis for Distributions from Pre-Acquisition Earnings and Profits

When a parent decides to sell a subsidiary whose income previously has been taxed at the corporate level, a sale of assets will not result in these earnings being taxed twice because the earnings will be reflected in the basis of the assets acquired by the subsidiary with after-tax earnings. If the parent decides to sell stock instead of assets, however, the basis of the stock will not have been increased by the amount of after-tax income earned by the subsidiary subsequent to the parent's purchase of the stock. Consequently, unless the parent is allowed an essentially tax-free receipt of the amount of previously taxed income that is not reflected in the stock's basis, the income earned by the subsidiary will be subjected

109. In Reitz v. Commissioner, 61 T.C. 443 (1974), a dividend was declared just prior to a gift of the stock by the shareholders. The shareholders argued that the transaction should be treated as a redemption of part of their stock. The Tax Court upheld the Commissioner's assertion of dividend treatment to the taxpayers, stating:

> Perhaps petitioners could have fashioned the transaction as a sale, a redemption and gift, or a liquidation and gift. Instead they arranged a dividend followed by a gift. Of course, petitioners were entitled to choose the most favorable arrangement. But having chosen the method they did for accomplishing their goals, petitioners are bound by their choice.

Id. at 449 (citations omitted).

110. Schaffer & Gordon, *supra* note 86, at 756.

111. *See* notes 85-96 *supra* and accompanying text.

to taxation twice before leaving corporate solution. On the other hand, a parent should not be allowed to purchase the stock of another corporation whose pre-acquisition earnings and profits are reflected in the cost of the stock, declare a tax-free dividend of these pre-acquisition earnings, and then manufacture a loss by immediately selling the stock. Thus a rule is needed that will allow the receipt of a legitimate, tax-free dividend in the first situation, while denying tax-free treatment to the illegitimate method of tax avoidance attempted in the second situation.

It is submitted that both of these objectives can be achieved under the following rule: When a parent sells the stock of a subsidiary it may treat an amount (not exceeding the total gain on the sale) equal to its allocable share of the subsidiary's undistributed earnings and profits as a section 243 dividend, provided that it agrees to reduce its basis in the stock of the subsidiary by an amount equal to its allocable share of the subsidiary's pre-acquisition earnings and profits. Under this proposal a corporation selling stock would be permitted to deduct section 243 dividends out of the subsidiary's earnings and profits that are not reflected in the stock's basis. This rule would result in equal tax treatment for sales of stock and sales of assets. Moreover, the requirement that the parent reduce its basis in the stock by the amount of pre-acquisition earnings and profits already reflected in the basis of the stock eliminates the possibility that a parent will be able to construct an artificial tax loss under section 243.[112]

This rule adopts the theory used by the consolidated return regulation to solve the problems posed by corporate bootstrap sales.[113] Essentially, the objective of this proposed rule is to achieve more exact justice in the treatment of dividends than is currently provided by the Internal Revenue Code. Unlike this proposal and the consolidated return regulations, section 243 generally ignores the relationship between the period of stock ownership and the period of accumulation of earnings and profits.[114] Consequently, sec-

112. Ideally, this suggested adjustment to the parent's basis in a subsidiary's stock should apply in the case of any stock held by a corporate shareholder. The problems of allocation are sufficiently complex, however, to warrant a limitation on the rule. The adjustment probably should be made available only to corporations owning more than 50% of the stock of another corporation.

Suggestions similar to the rule proposed here have been made by other commentators. *See* Blum, *Taxing the Corporate Shareholder—Some Old Problems Reconsidered,* 53 TAXES 217, 219 (1975); Cohen, Surrey, Tarleau, & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders,* 52 COLUM. L. REV. 1, 49 (1952).

113. *See* text accompanying notes 99-100 *supra.*

114. *See* PEEL, *supra* note 89, ¶ 15.02a, at 214.

tion 243 contains no provision preventing the original cost basis of the stock of a subsidiary from being used even though the subsidiary has distributed dividends out of pre-acquisition earnings that presumably were reflected in the price paid for the stock. It was this loophole that caused the courts in *Waterman* and *TSN* to place severe restrictions on the use of section 243 in bootstrap sales. A legislative incorporation of the proposed rule into section 243 would prevent use of the dividends received deduction to achieve the illegitimate tax avoidance envisioned in *Waterman* and *TSN* and would provide equivalent tax treatment in a sale of stock and a sale of assets.

VI. Conclusion

Waterman, Basic, and *TSN* present substantial obstacles for a corporate taxpayer attempting to deduct intercorporate dividends received in connection with a bootstrap sale of stock. These dividends are not deductible under section 243 unless they satisfy the judicial requirement that such dividends serve a valid business purpose of the distributing corporation. The restrictive attitude of these opinions stems from judicial concern that section 243 might be used to create artificial tax losses through distributions of pre-acquisition earnings and profits. When the dividend distributions are made from post-acquisition earnings and profits not reflected in the basis of the stock, however, a parent should be permitted to use section 243 as a means of obtaining tax treatment equivalent to that resulting from a sale of assets. By amending section 243 to require a reduction in basis for distributions from pre-acquisition earnings and profits, Congress could prevent the creation of artificial tax losses. Once the possibility of illegitimate tax avoidance under section 243 is eliminated, judicial recognition that section 243 may be used to effect a corporate bootstrap sale should follow.

Unless Congress amends section 243, however, the courts will continue to scrutinize closely bootstrap sales involving intercorporate dividends. Although the opinions in *Waterman, Basic,* and *TSN* offer little encouragement to the corporate taxpayer, they do suggest two possible situations in which section 243 treatment would be allowed. *Basic* implies that an intercorporate dividend satisfying the "independent significance" doctrine of *Dynamics Corp. of America v. United States*[115] will qualify under section 243.[116] Unfortunately, this doctrine seldom would apply to a corporate bootstrap

115. 449 F.2d 402 (Ct. Cl. 1971).

116. *See* notes 49-50 *supra* and accompanying text.

acquisition because the decision to pay a dividend in this situation is almost always dependent on the decision to sell the stock. Finally, all three cases hold that a valid business purpose of the distributing corporation will justify application of section 243. This solution also is extremely limited because the declaration of a dividend as part of a bootstrap sale ordinarily serves a business purpose of the shareholder, not the distributing corporation. Furthermore, even if the distributing corporation has a valid business purpose, the taxpayer assumes the risk that other courts may follow *TSN* and refuse to recognize the existence of the valid business purpose. Unless the parties can structure a corporate bootstrap sale of stock within these limited boundaries, a parent corporation may be effectively foreclosed from disposing of a subsidiary through a sale of stock.

DON B. CANNADA