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Bruce E. Gagnon

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Among the sections added to the revised version of the Internal Revenue Code of 1954 was section 306, designed to close a gaping loophole which might have permitted many taxpayers to withdraw earnings and profits from a corporation through the distribution and sale of preferred stock and to receive capital gains treatment at the shareholder level rather than the dividend treatment ordinarily applicable to such distributions. In this article, Professor Gagnon argues that, as applied to corporate reorganizations, section 306 falls far from its mark. After discussing the purpose and operation of section 306 and related sections, the author suggests a number of problem areas involved in the application of section 306 to the use of preferred stock in acquisition type corporate reorganizations.

I. INTRODUCTION

Section 306 was added to the Internal Revenue Code of 1954 primarily in response to *Chamberlain v. Commissioner*,[1] a case in which the court conferred long-term capital gains treatment to a bold, and almost classic, form of the preferred stock bail-out.[2] At the time of *Chamberlain*, the case law under section 115(g) of the 1939 Code had developed sufficiently to prevent capital gains treatment of direet redemptions by the shareholders unless the underlying equity position of the redeeming shareholders had changed substantially in the process. In *Chamberlain*, the shareholders chose a different route: a tax-free preferred stock dividend was distributed pro rata to the shareholders,

* Assistant Professor of Law, Vanderbilt Law School. A.B., LL.B., Harvard University.

1. 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954).

2. The phrase "bail-out" is a term of art which refers to the withdrawal of earnings and profits from a corporation by the shareholders by means of a transaction which, while entitling the shareholders to capital gains treatment, does not significantly alter or dilute the control or underlying investment of the shareholders.

who in turn immediately sold the preferred to two insurance companies, reporting gain on the sale at long-term capital gains rates. The preferred stock was subject to mandatory retirement over a period of less than eight years, and, in net effect, the insurance companies simply served as a delayed conduit through which the shareholders withdrew substantial amounts of accumulated earnings from the corporation without sacrificing control or altering their underlying equity position to any significant degree. Confronted by so obvious a loophole, Congress enacted section 306 to prevent a repetition of *Chamberlain*, whatever the form of the transaction. Under section 306, as it applies to a preferred stock[3] dividend distribution such as the one in *Chamberlain*, the initial distribution is still tax-free, which is as it should be, since the mere receipt of preferred stock by the shareholder, without more, is inconsequential for bail-out purposes. Any later redemption, sale or other disposition of the preferred stock (306 stock), however, will usually trigger ordinary income treatment of the amount realized, unreduced by any basis previously allocated to the preferred at the time of the original distribution.

Judging from the lack of case law developments under section 306, it would appear that section 306 has succeeded in discouraging bail-outs. Nevertheless, of some concern to the tax attorney are the potentially adverse effects of section 306 on transactions which innocently or unwittingly place a shareholder who receives preferred stock in a position to achieve a bail-out if the shareholder were so inclined. In this respect, the issuance of preferred stock in a merger, stock swap, or asset acquisition is of particular concern in view of the increasing use of preferred stock in exchange offers by acquisition-minded corporations. Apparently, Congress was only dimly aware of the complexities and problems posed in determining whether preferred stock issued in a reorganization exchange lays the foundation for a later bail-out, inasmuch as the provision in section 306 dealing with reorganizations—a term which includes the conventional methods of take-over—simply states, in effect, that preferred stock received tax-free in a reorganization will be 306 stock whenever the receipt of that stock has an effect "substantially the same as the receipt of a stock dividend." Unfortunately, no indication of the meaning of "stock dividend" is given in section 306, nor for that matter, elsewhere in the Code. This article shall examine the phrase "stoek dividend" in detail,

3. By its terms, § 306 is not limited to preferred stock, but embraces, generally, any stock which is not common stock.

but before doing so, it is perhaps appropriate to confine the focus of the problem.

II. Limitations to the General Rule

A. Excluded Transactions

If preferred stock received in an exchange transaction is not received tax-free by the shareholder, it will not be 306 stock, and there is no cause to worry about adverse tax consequences under section 306 on any later disposition of the preferred. This limitation will exclude from section 306 coverage a large number of significant transactions. For example, in many tender-offers and asset acquisitions in which preferred stock is used, the preferred stock will be non-voting stock, and accordingly, the preferred stock will not be received tax-free by the exchanging shareholder because of the "solely for voting stock" requirement contained in section 368(a)(1)(B) and section 368(a)(1)(C).[4] Moreover, even if preferred stock is voting stock, other requirements, such as the control requirement in section 368(a)(1)(B), may not be met; in which event, the exchange will be taxable and the preferred stock will not be 306 stock.

A second occasion when preferred stock received in a transaction will not be 306 stock arises when no gain is realized in the transaction, inasmuch as section 306(c)(2) provides that 306 stock does not include any stock "no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock."[5] Thus, if the basis of the stock or securities exchanged is equal to or greater than the fair market value of the stock and other property received in exchange, no gain would be realized; hence section 356(a)(2) would not impose any tax, much less a dividend tax, even if cash had been received in lieu of the preferred. Presumably the same result would follow, even when a gain is realized, whenever other boot property is received which would equal or exceed the taxable gain under section 356(a)(2), since additional cash in substitution for the preferred would not result in an increase in taxes, either at capital

4. Conceivably a thin slice of non-voting preferred, added to a package including voting stock, could be used in a tax-free § 368(a)(1)(C) reorganization, if the non-voting preferred is viewed as "additional consideration" within § 368(a)(2)(B), but the language in § 368(a)(2)(B), for no apparent reason in terms of tax policy, is hardly inviting.

5. This reading of § 306(c)(2) is somewhat confused by the inappropriate heading "EXCEPTION WHERE NO EARNINGS AND PROFITS." *But see* § 7806(b), which provides that "descriptive matter" is to be given no legal effect. Throughout this article, the existence of earnings and profits will be assumed.

gains rates or dividend rates, assuming that the entire gain is allocated to the other boot property. The Service, however, may well question the allocations necessary to arrive at this conclusion.[6]

Finally, section 306(b)(3) excludes any tax-free disposition of the 306 stock—such as in an exchange in another tax-free reorganization. Accordingly, the shareholder is free to participate in later tax-free transactions without cause for concern under section 306.

B. *The Tax Avoidance Rule of Section 306(b)(4)*

Another important, though largely subjective, limitation is section 306(b)(4), which provides that section 306 shall not apply if the Service is satisfied:

> (A) that the distribution, and the disposition or redemption, or
> (B) in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,
>
> was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[7]

This provision is hardly a model of good draftsmenship; it perhaps reflects the haste in which it was written and the rather limited appreciation Congress had of section 306 problems as they relate to reorganizations. Taken literally, the provision would arguably require the Service to rule in the taxpayer's favor in even the most flagrant bail-out, since a bail-out does not have as one of its purposes the "avoidance of Federal income tax." In fact, the purpose of a bail-out is to incur federal income taxes, but at favorable rates.

How section 306(b)(4) is to be coordinated with the section 306 reorganization provision is not readily apparent. Since it would be hard to view preferred stock received by the shareholder in an exchange transaction involving stock in another corporation as a "distribution," section 306(b)(4)(A) seems to be restricted to 306 stock received by the shareholder in a simple stock dividend distribution. Perhaps the last

6. Perhaps it goes without saying that the somewhat anamolous gain limitation of § 356(a)(2), standing alone and as it relates to § 306(c)(2), can be used for tax abuse. For example, a taxpayer can sell his stock to his wife shortly before the exchange; the stepped-up basis to the wife, if at least equal to the fair market value of all the property received in the exchange, protects against dividend treatment under § 356(a)(2). Consequently, by virtue of § 306(c)(2), preferred stock received will not be "§ 306 stock." Care must be taken, however, to assure that the purchase price to the wife is at least equal to or above market value, since even a small recognition of gain and dividend treatment under § 356(a)(2) would seem to taint the entire amount of preferred under the cash substitution test of § 306(c)(2).

7. INT. REV. CODE of 1954, § 306(b)(4).

sentence of section 306(c)(1)(B) was meant to clarify this constructional problem by providing that preferred stock within the ambit of section 306(c)(1)(B) shall be treated as a distribution of stock for purposes of section 306. This language in section 306(c)(1)(B), however, is of no assistance in squaring an exchange transaction with section 306(b)(4)(B), which seems to contemplate the issuance of preferred stock with respect to other stock already held by the shareholder.[8]

One thing is certain: for purposes of a relief provision such as section 306(b)(4), there is no reason to distinguish stock received in a reorganization from stock received in a dividend distribution. The Service very early appeared to adopt this position by glossing over such constructional difficulties by relying on section 306(b)(4) and the Regulations related thereto in holding section 306 inapplicable to certain preferred stock received in a reorganization.[9]

Nevertheless, assuming that section 306(b)(4) may be applied to preferred stock received in a reorganization, further obstacles remain. Relief under the provision depends on the "satisfaction" of the Service as to the absence of tax avoidance. From what appears in section 306, the Service would seem to have a broad range of discretion in granting or withholding its approval. To make matters more difficult, the Service has repeatedly announced its reluctance to make advance rulings under section 306(b)(4);[10] it will do so only within fairly restricted limits. In view of this, a shareholder who wishes to dispose of his preferred stock could not always be assured in advance of the tax consequences; he is likewise thwarted by the limited availability of pre-reorganizational rulings. The position taken by the Service seems to be at odds with the rather obvious design of section 306(b)(4) to invoke the advance ruling procedures. As the matter stands, there is little likelihood that a taxpayer, except in obvious cases, could safely determine whether the Service will be satisfied with the transaction until after the transaction has been completed and deficiency procedures are initiated, a move which by its very nature indicates dissatisfaction. If the taxpayer resorts to a court determination, an attempt to rely on section 306(b)(4) offers little chance of success unless

8. As will be seen, preferred stock received in a reorganization (except when received in exchange for stock which is already "§ 306 stock") will be deemed "§ 306 stock" ordinarily only when some common is received in addition to the preferred, with the preferred viewed as a stock dividend with respect to the common. Given this, the language of § 306(b)(4) is somewhat more accomodating.

9. Rev. Rul. 56-116, 1956-1 CUM. BULL. 164.

10. *See, e.g.*, Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, 1234; Rev. Proc. 64-31, 1964-2 CUM. BULL. 947, 950-51; Rev. Proc. 62-32, 1962-2 CUM. BULL. 527, 532.

the taxpayer can demonstrate a clear abuse of authority on the part of the Service in withholding its approval.

Despite the foregoing reservations, section 306(b)(4), when taken with the regulations and the Congressional Reports, still offers the taxpayer a few seeds of hope. One Regulation[11] provides that in the case of a prior or simultaneous disposition of the stock with respect to which the 306 stock was issued, it is ordinarily not necessary to establish the absence of tax avoidance. Presumably the Regulation embraces 306 stock received in a reorganization, and accordingly the taxpayer could safely dispose of the preferred so long as he retains no common stock.[12]

The Regulation goes on to provide, in somewhat more guarded language, that section 306(b)(4) may be invoked in the case of "isolated dispositions by minority shareholders." In a pre-1964 Ruling[13] the Service probably meant to indicate that the term "isolated disposition" includes any disposition by a minority shareholder where the shareholder is acting independently and the disposition is not in anticipation of a proposed redemption by the corporation. If this is so, section 306(b)(4) would appear to grant relief to just about any disposition by a minority shareholder under circumstances which indicate that the shareholder's decision to dispose of the stock is independently and privately determined. What is meant by a "minority shareholder" is a more difficult question, and as to this, the Regulation is of no assistance. The Senate Report[14] indicates, however, that section 306 is not intended to apply to an isolated disposition by minority shareholders who do not in the aggregate have control of the corporation. The Report goes on to state that it would be "inappropriate to impute to such shareholders an intention to remove corporate earnings at tax rates applicable only to capital gains." Presumably the exception for "minority shareholders" would depend on a factual determination with respect to the shareholders' ability to influence, or control, the dividend distribution policies of the

11. Treas. Reg. § 1.306-2(b)(3) (1968).

12. If the taxpayer is completely terminating his interest in the corporation, as would often be the case in a prior or simultaneous disposition, additional support for favorable tax treatment is found in § 306(b)(1), which is perhaps a more certain basis for the taxpayer's claims inasmuch as application of § 306(b)(1) does not in any respect depend on the Service's satisfaction. On the difficulties of squaring § 306(b)(1) with § 306(b)(4), see Metzer, *The Impact of Section 306 Upon Convertible Preferred Stock Issued In A Corporate Reorganization*, 116 U. PA. L. REV. 755, 788-89 (1968).

13. Rev. Rul. 56-116, 1956-1 CUM. BULL. 164.

14. S. REP. No. 1622, 83d Cong., 2d Sess. 243-44 (1954).

corporation. Accordingly, section 306 is of little concern to any shareholder who holds stock primarily in the capacity of an ordinary investor and to whom percentage of ownership is of little concern. Perhaps even a large shareholder in a management position of a publicly held corporation could qualify under the section 306(b)(4) exception, even though the shareholder is in a position to influence dividend policies, whenever it could be demonstrated that the dividend policies of the corporation were largely unaffected by considerations of tax consequences at the shareholder level.

In a very guarded fashion, the Service has also expressed willingness to grant section 306(b)(4) relief where the preferred is "widely held,"[15] though the scope and meaning of "widely held," and whether relief will be available to large as well as small shareholders in a "widely held" corporation are still open questions. It must be remembered that tax abuse through the use of a preferred stock bail-out was peculiar to closely held corporations prior to the enactment of section 306, and there would appear to be little reason to apply section 306 to a shareholder of a publicly held corporation—even though he might effectively control the corporation with less than a controlling block of common stock—under circumstances which indicate that the shareholder, if he had received no preferred, could have redeemed some common stock at capital gains rates under the rules of section 302. Again, whether the Service would be "satisfied" under section 306(b)(4) by arguments going to the policy, design, or legislative history of section 306, or whether the court would find a clear abuse of authority in the Service's failure to be satisfied by such arguments, remains to be seen. In any event, the existence of a provision such as section 306(b)(4) acknowledges that Congress was aware that, by its broad scope, section 306 might have unintended consequences. It would be desirable for the Service to seize on the opportunity offered by section 306(b)(4) to limit section 306 coverage to those situations which in fact represent bail-out threats.

In any case where the taxpayer has already disposed of the preferred, has a bona fide, and at least arguably meritorious, position for favorable tax treatment under section 306, and is not otherwise under close scrutiny by the Service, the attorney should probably advise him to file his return at capital gains rates. This approach is suggested because of the practical difficulties the Service must have in tracing stock sales with section 306 treatment in mind.[16] Taken generally,

15. *See, e.g.*, Rev. Rul. 57-212, 1957-1 CUM. BULL. 114.

16. The House bill initially dealt with the preferred stock bail-out by imposing a tax on

uncertainties in the tax law make the taxpayer's position more difficult from the standpoint of planning, and particularly so in situations where—as under section 306—the differences in tax liability can be so substantial. Nevertheless, once the disposition of preferred is completed, the tables are turned, the burden is shifted to the Service, and the uncertainties of section 306 can probably be used to the taxpayer's advantage.

III. Defining 306 Stock

A. The Cash Substitution Test

1. *Introduction.*—In determining when preferred stock received in a tax-free reorganization will initially be deemed 306 stock, the critical question under section 306(c)(1)(B)(ii) is whether receipt of the preferred has an effect "substantially the same as the receipt of a stock dividend." A major problem with this test is the meaning of "stock dividend," a matter on which section 306 gives no assistance whatsoever. Taken literally, a "stock dividend" could include all the preferred stock, less one share, received by a shareholder in a reorganization, even though the shareholder received nothing but preferred stock, inasmuch as it is possible to have a "stock dividend" of, say, 99 shares of preferred on each share of preferred outstanding in a simple distribution by a corporation to its shareholders. Nevertheless, it is hard to imagine that Congress intended this result, because a shareholder who receives nothing but preferred stock in a merger is in no position to effect a bail-out, at least in the absence of further arrangements. Looking to state law or the accounting definitions of "stock dividend" is equally unhelpful, since there the primary significance of the term "stock dividend" relates to the distinction between a "stock divided" and a "stock split" for purposes of determining the proper treatment of the stock distribution in the corporation's capital accounts. For example, accountants recommend treatment as a "stock dividend" of an issuance of new shares in ratios of less than 20 to 25 percent of the outstanding shares. Following this procedure, presumably up to 25 percent of the preferred stock received could be treated as a "stock dividend" even though the shareholder receives nothing but the preferred—again, a result hardly intended by Congress.

Quite apart from this, however, it is easy to see that Congress intended the term "stock dividend" to mean the receipt of preferred together with common stock under circumstances which enable the

the corporation, for the stated reason that "it is less complex to administer such a tax by a check on the corporate books than to attempt to trace sales of stock." H. Rep. No. 1337, 83d Cong., shareholder to retain the common and to bail-out with the preferred without dilution of voting power. If an analogy is to be found, it is probably to preferred stock distributed as a "stock dividend" on common stock in a simple dividend distribution. Thus, if the corporation undertakes a recapitalization with the end result that the former common shareholders now hold preferred as well as common, pro rata, the preferred stock is certain to be treated as 306 stock, since the effect of the transaction is substantially the same as receipt of a stock dividend of the preferred on the common. If, however, the recapitalization involves the shifting of interests in the corporation so that some of the former common shareholders now hold predominantly preferred stock, the transaction loses its pro rata characteristics and, consequently, its similarity to a preferred stock distribution with respect to common stock. A predominantly preferred shareholder, who has sacrificed his voting common stock in the process of acquiring the preferred, is not in a position, by himself, to effect a bail-out. Accordingly, such preferred stock should not be deemed 306 stock.

This view of the meaning of "stock dividend" makes it immediately apparent that the safe harbors of section 302, and the case law developments on the meaning of "essentially equivalent to a dividend" under section 302(b)(1) and its predecessor provision in the 1939 Code, offer useful guidelines to a determination of the preferred stock's section 306 status. The Treasury and the Service have in effect approved this view of stock dividend through the adoption of a somewhat unwieldy "cash substitution" test. This test provides that preferred stock received in a reorganization will be 306 stock "if cash received in lieu of such stock would have been treated as a dividend" under sections 356(a)(2), section 356(b), or section 302(d).[17] In net effect, this test provides that if cash substituted for the preferred would not have been taxed at ordinary income rates the preferred stock will not be 306 stock. Such a test, in a roundabout way, says that the "stock dividend" language in section 306(c)(1)(B) means the same thing as section 306(c)(2). If the Treasury and the Service are correct in this reading of section 306(c)(1)(B), the conclusion is unavoidable that much of the provision becomes useless surplusage.

2. *Application to acquisition transactions.*—In applying the

2d Sess. 36 (1954). The Senate, noting the "harsh consequences" of such a proposal, rejected the House Bill in this respect and adopted what is now § 306 in its stead.

17. Treas. Reg. § 1.306-3(d) (1955); Rev. Rul. 66-332, 1966-2 CUM. BULL. 108.

"cash substitution" test to acquisition transactions, the applicable Regulation refers to section 356(a)(2) and section 302(d).[18] Section 302(d) would be invoked only when the shareholder received no stock or securities other than the preferred (now deemed to be cash), because the receipt of other stock or securities in addition to the preferred (deemed cash) would bring the transaction within section 356 and not section 302. The principal issue under section 302 would simply be whether the "cash" is entitled to capital gains treatment by virtue of section 302(b)(3) which requires a complete termination of the shareholder's interest.

The more important reference is to section 356(a)(2), inasmuch as this provision would apply to the more complicated question of when preferred stock will be 306 stock with regard to a shareholder who receives both common and preferred (deemed cash).[19] Unfortunately,

18. The reference in Treas. Reg. § 1.306-3(d) (1955) to § 356(b), relating to boot received in a § 355 corporate division, will not be discussed in this article, but it sbould be noted in passing that § 356(b) provides for dividend treatment of all boot distributions in a corporate division. As applied to preferred stock under the "casb substitution" test, it would follow that all preferred stock received in a corporate division would be "306 stock," a flat rule which appears to be of questionable validity, especially in view of the seemingly liberal provision in § 355(a)(2)(A) for tax-free treatment of non-pro rata distributions. Under § 355(a)(2)(A), a common shareholder of the distributing corporation eould conceivably receive notbing but preferred in the distributee corporation, and applying the "cash substitution" test, the preferred would be "§ 306 stock," even though the transaction, standing alone, hardly suggests a "bail-out" situation. One answer to this may be that the receipt of cash alone would not be witbin § 356(b), and hence the "cash substitution" test must look elsewhere for proper treatment of tbe preferred; depending on whether an exchange is made, however, either § 301 or § 302 would apply to the hypothetical cash, with the result that dividend treatment of cash, and hence § 306 treatment of the preferred, as under § 356(b), would usually follow. Nevertheless, since the attribution rules of § 318 probably do not apply in determining § 306 status, it may be argued that a non-pro rata distribution of common and preferred to members of a family in a § 355 transaction invites such potential tax abuse that a flat rule may be necessary. However, treating the preferred as "§ 306 stock" does nothing to prevent such abuse, inasmucb as the preferred, even though "§ 306 stock," could ordinarily be redeemed at capital gains rates in complete termination of the sbareholder's interest in the distributee corporation under § 306(b)(1)(B), tbus effecting a bail-out. This is possible because the remaining common stock which the shareholder holds in the distributing corporation is not taken into account in determining whether the complete termination qualifies for capital gains treatment. *But see* § 302(c)(2)(B), which somewhat restricts the bail-out potential of a complete redemption of the preferred termination of the shareholder's interest.

19. One coneeptual difficulty, of perhaps minor importance, is that in many § 368(a)(1)(B) reorganizations, in many § 368(a)(1)(C) reorganizations, and sometimes even in § 368(a)(1)(A) reorganizations, the receipt of cash instead of the preferred would have the effect of disqualifying the transaction because of "solely for voting stock" or continuity-of-interest requirements. In which event, § 356(a)(2) could not apply to the cash to impose dividend taxation. But this problem can easily be disregarded for purposes of applying the hypothetical, since the question to which the hypothetical is addressed relates only to § 306 characterization of the preferred, and not to whether the preferred is received tax-free or to the underlying qualification of the transaction as a reorganization.

section 356(a)(2) simply states that "cash" will be treated as a dividend whenever the receipt of the "cash" has the "effect of the distribution of a dividend." At first blush, not much has been accomplished by injecting a "cash substitution" test, since it still must be determined what has the "effect of a dividend," a project hardly more inviting than the initial question under section 306 of what has the "effect of a stock dividend." But there is one significant difference: case law developments under section 356(a)(2) on the meaning of "effect of a dividend" have drawn a line between pro rata and non-pro rata distributions. If nothing else, the resort to sections 302 and 356 by the Regulation has the advantage of incorporating a body of fairly well developed case law that would not otherwise be available under section 306.

While it was once thought that the language now found in section 356(a)(2) automatically imposed dividend treatment on any boot received in a reorganization,[20] more recent cases invoke the traditional test developed by case law under the "essentially equivalent to a dividend" language in section 302: did the shareholder have substantially the same equity interest in the corporation as he had before payment.[21]

Taken generally, section 302(b) has the same function as section 356(a)(2), but with the added virtue of a good deal more precision; the courts should not hesitate to use the case law developments under these two provisions interchangeably. After all, it would make little sense to impose dividend treatment under section 356(a)(2), or to apply section 306 to preferred stock, if the shareholder could have redeemed the respective common stock at capital gains rates under section 302 in the

20. *See* Commissioner v. Estate of Bedford, 325 U.S. 283 (1945). Continued application of the "automatic rule" in *Bedford* would be hard to justify. Congress knew how to create an "automatic rule"—and did exactly that in § 356(b) on corporate divisions—and something other than an automatic rule must have been meant by the "effect of a dividend" language in § 356(a)(2).

21. *See, e.g.*, Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959); Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956). In *Ross*, the court stated that the phrase "has the effect of the distribution of a dividend" in § 356 and the phrase "essentially equivalent to a dividend" in § 302, are to be construed "in *pari materia*." For its part, the Service has with few exceptions held that nearly all preferred stock received in a reorganization is "§ 306 stock," presumably taking a *Bedford* view of § 356(a)(2) as it relates to § 306. At the same time, however, the Service has used § 306(b)(4) to introduce the disproportionate rules of § 302, apparently because it feels more comfortable in keeping the battleground within its discretionary authority in § 306(b)(4). Another reason may be that the Service feels bound, in construing § 306(c)(1)(B), by Treas. Reg. § 1.306-3(d), Example (1) (1955), which takes the flat position that preferred stock received in a merger together with common stock is § 306 stock. *But see* Rev. Rul. 60-1, 1960-1 CUM. BULL. 143.

absence of the reorganization transaction. Presumably even the safe harbors of sections 302(b)(2) and 302(b)(3) should be applied, at least as a guideline, in the construction of section 356(a)(2).

B. *The Corporate Frame of Reference*

The foregoing proposition is much easier to state than to apply, since section 302 was not designed to cover an acquisition transaction. Section 302 is concerned with changes in shareholder interests within the framework of a single corporation. This situation is readily conducive to a comparison of shareholder interests before and after a redemption to determine whether the net effect of the transaction is "essentially equivalent to a dividend." With respect to acquisition transactions under section 356(a)(2), however, an additional corporation is involved, and new shareholders are introduced. The net effect of the transaction on the shareholders of either corporation will generally be a reduction in voting power and equity interest as it relates to the combined enterprise. Stated differently, a shareholder who exchanges common stock in the acquired corporation for common and preferred in the acquiring corporation may not be altering his equity interest vis-a-vis other shareholders in the acquired corporation, but at the same time his voting power may be reduced from a high percentage in the acquired corporation to a relatively low percentage in the acquiring corporation. How such preferred should be treated under section 306 is not readily apparent. It may well be argued that the preferred was acquired only at a substantial loss in voting power, and that accordingly a bail-out situation is not presented. Nevertheless, it is not hard to imagine a situation in which the shareholders in the acquiring corporation would be willing to accommodate a bail-out by allocating all the voting power they are willing to sacrifice to the common stock, with the understanding that the preferred will later be redeemed. By this means, the acquired corporation's shareholders could obtain a substantial amount of cash without loss of voting power they otherwise would have received in the proposed acquisition (of course, additional adjustments to the equity structure of the acquiring corporation would be necessary to accomplish this). If the overall equity structure of the combined corporation is to be taken into consideration, the conclusion is well-nigh irresistible that proper application of the dividend test under section 356(a)(2) would require a comparison of this final equity structure to the overall pre-combination structure, taking the acquiring corporation's shareholders into account at both ends of the comparison; otherwise section 306 could be avoided in any acquisition transaction where the voting powers of the acquired corporation's shareholders are significantly reduced. But such a comparison could be made only at great difficulty and uncertainty, since there is no convenient means to determine how much voting power, if any, was sacrificed by the acquired corporation's shareholders by virtue of the receipt of the preferred stock.

It should be noted that the problem of defining the appropriate frame of reference is not peculiar to section 306, but is one that must be faced under section 356(a)(2) whenever boot is received in a partially tax-free acquisition transaction. One commentator advocates a comparison which looks solely to the shareholders of the acquired corporation.[22] Another would compare the voting power in fact received with the voting power the shareholder would have received but for the fact that he opted for boot instead of additional voting stock.[23] The difficulty with this latter test is that it requires a speculative and highly conjectural assessment of the voting value of the boot and disregards the fact that the shareholder may not have had any choice in the matter. The case law under section 356(a)(2), however, has not been troubled by this; the decisions and rulings have seemed to assume that the equity interests of the acquired corporation's shareholders are to be tested only vis-a-vis the other acquired corporation's shareholders, with no account taken for dilution in equity represented by voting powers held by the acquiring corporation's shareholders.[24] In terms of both practical application and tax policy, this approach certainly seems preferable to the alternative of including the acquiring corporation's shareholders in the comparison. Harsh results no doubt could follow, however, inasmuch as a substantial reduction in equity should entitle the withdrawing shareholder to capital gains without regard to whatever tests are used.

Neither approach, however, does much to distinguish the position of a shareholder in a closely held corporation from a shareholder in a publicly held corporation, since any percentage-oriented test treats both shareholders alike. A shareholder in a publicly held corporation would be justifiably surprised—and somewhat disconcerted—to learn that

22. Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573 (1965).

23. Moore, *Taxation of Distributions in Connection with a Corporate Reorganization*, 17 TAX L. REV. 129 (1961).

24. In one case where it was raised, Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959), the court rejected the taxpayer's arguments relating to the reduction in equity position in the combined enterprise on the ground that this is in the nature of any consolidation. Of course, this is hardly a very satisfactory answer.

disposition of the new preferred may generate dividend taxation, especially when sale or redemption of his previous stock would have received capital gains treatment. Insofar as the right to capital gains treatment is concerned, distinctions should obviously be drawn; and perhaps such distinctions, though unmentioned, are built into the dividend equivalence tests of sections 302(b)(1) and 356(a)(2). The same distinctions might also be drawn with respect to a shareholder who substantially reduces his equity, but on a pro rata basis with other shareholders in the acquired corporation.

An additional element of flexibility is introduced by section 306(b)(4), and the Service has expressed willingness to cooperate in this area. For example, it has ruled that the section 306(b)(4) relief provision would apply to periodic redemption of preferred stock which was received pro rata with common stock by shareholders of a publicly held corporation in an exchange offer.[25] In reaching this conclusion, the Service emphasized that the stock was "widely held by the public," which suggests that shareholders in a closely held corporation would be treated differently. Of course, a determination of when stock will be treated as "widely held" is no easy task, since many publicly held corporations have shareholders with holdings sufficiently large to deny favorable treatment as to them. Perhaps a fairly flexible and subjective test is unavoidable if proper focus is to be made on the relative degree of control exercised by the shareholder, either alone or in conjunction with others. In consequence, within a given corporation, some shareholders may qualify while others may not.

It should be emphasized that considerations under section 306 should be much broader than under section 356(a)(2), since there is a good deal of difference between an immediate cash distribution and a distribution of preferred which threatens, not a present bail-out, but a bail-out at some future date. For this reason, it was suggested earlier that relief under section 306(b)(4) should be available even to fairly large shareholders in a publicly held corporation, at least when the circumstances demonstrate that the dividend policies of the corporation are largely unaffected by tax consequences at the shareholder level. In passing, it should be noted that, as a condition to "publicly held" treatment, the Service will want assurances that the preferred will not be redeemed or sold in anticipation of redemption within a short period of time after distribution—a condition which seems reasonable enough.[26]

25. Rev. Rul. 57-212, 1957-1 CUM. BULL. 114.

26. *See, e.g.*, Rev. Rul. 56-116, 1956-1 CUM. BULL. 164.

C. *Voting Preferred and Convertible Preferred Stock*

1. *Treatment of Voting Preferred Stock.*—Another problem with the cash substitution test is whether any voting powers in the preferred stock (deemed cash) are to be disregarded. A shareholder might receive a package of voting preferred and voting common, with the voting divided between the two classes of stock in such a way that, considered as a whole, the shareholder's voting power is not reduced; but, looking only to the common, voting power is sufficiently diluted to pass muster under the cash substitution test. While the thrust of section 306, generally, is against the withdrawal of corporate earnings at capital gains rates without dilution of the shareholder's control of the corporation, section 306 by its terms treats voting preferred as 306 stock, even though any bail-out with respect to that preferred may be at great sacrifice to the shareholder's equity position in the corporation. Perhaps the reason for this is that preferred stock is ordinarily redeemable; the common shareholders could sell the preferred and later force a retirement of the preferred (and thereby complete the bail-out circuit) either with the consent of or in spite of the preferred shareholders; depending on the relative voting strength of the preferred and the common. When retirement of the preferred depends on its being in friendly hands—for example, when the holders of the preferred, as a unit, are in a position to block a redemption just by weight of their own voting strength—less reason exists to attach section 306 consequences. After all, a bail-out can be effected, with only a temporary loss of control by the inside shareholders, by a sale of regular common stock to a friendly but unrelated outsider who in turn redeems the common at some later date, if care is taken to give substance to the transaction.

Nevertheless, it may be argued that the mere fact that common stock can be used to effect a bail-out is no reason to open the door for abuse still wider by giving voting preferred similar treatment. Moreover, residual common stock is seldom subject to mandatory redemption—probably it cannot legally be made so. Consequently, if common stock is used to effect a bail-out, the inside shareholders are always faced with the possibility that the person who holds the bail-out common may become unwieldy and refuse to redeem. With voting preferred subject to redemption, however, the inside shareholders are in a better position to assure a later redemption by careful planning with respect to the voting strength transferred.

Rather than get into these problem areas, section 306 does not distinguish between voting and non-voting preferred. For this reason, relatively harsh results may follow from section 306 treatment of preferred stock which has many common stock characteristics and is the practical equivalent of common stock. Perhaps such a flat rule has much to be said for it, however, at least when it is compared with the alternative of distinguishing between voting preferred which invites the risk of permanent dilution and voting preferred which remains outstanding only at the pleasure of the inside shareholders. In addition, relief under section 306(b)(4) would be appropriate on a proper demonstration by the taxpayer of the absence of bail-out potential or motives.

Without regard to the foregoing, however, there may well be reason to make a distinction between voting and non-voting preferred in applying the stock dividend and cash substitution tests in section 306(c)(1)(B). The bail-out potential of voting preferred, though it no doubt exists, is conjectural at best. Section 306(c)(1)(A) seems to require that no distinction be made between voting and non-voting preferred—a result Congress probably did not intend—but there is little reason, other than for consistency, to carry this through to the stock dividend test in section 306(c)(1)(B). Furthermore, unlike section 306(c)(1)(A), the term "stock dividend" in section 306(c)(1)(B) necessarily invokes a test which depends on voting powers, and presumably Congress intended "stock dividend" to be construed in a manner conforming to the underlying purpose of section 306, which is to prevent the withdrawal of corporate earnings at capital gains rates without dilution of voting power. While the matter is hardly free from doubt, it would seem that any voting power in the preferred should be disregarded across the board under the cash substitution test, inasmuch as the preferred could only be disposed of at a sacrifice and a dilution in voting strength. It would then be possible that voting preferred may not be 306 stock even though the shareholders total voting is not reduced, since the cash substitution test would only look to a strict comparison of common stock voting.

2. *Treatment of Convertible Preferred.*— Much the same problem exists on the question of whether Congress properly treated convertible preferred as within section 306. Any bail-out potential through a sale followed by redemption depends on placement of the convertible preferred in friendly hands, since redemption of the preferred could be defeated through an exercise of the conversion privilege; the resulting dilution in equity militates against section 306 treatment. In this respect, the case is even stronger than with voting preferred that section 306 should not apply, since the purchaser of convertible preferred has

independent and virtually absolute control over whether he will submit to a later redemption. Again, however, even though convertible preferred and common are almost identical in relation to bail-out potential, this alone may not be sufficient reason to open a bail-out loophole even further by equating convertible preferred with common stock.

With respect to convertible preferred, the cash substitution test is virtually unworkable in identifying bail-out transactions. Applying this test, a shareholder who receives nothing but convertible preferred will be deemed not to hold 306 stock, even though a partial conversion, followed by a sale and later redemption of the remaining preferred, squarely presents a bail-out.[27] The Service has attempted to counter this by providing that convertible preferred will not be 306 stock so long as there is no later conversion pursuant to a plan which enables shareholders ultimately to hold both common and preferred.[28] A position along these lines seems sensible enough, and presumably it is within the province of the Service to tailor the "cash substitution" test in the Regulations to deal with the special problem of convertible preferred. Nevertheless, though the Regulations may be subject to modification, such a position seems difficult to reconcile with section 306(c)(2), which sets up a cash substitution test of its own, and which mandates against section 306 treatment of convertible preferred when nothing else is received by the shareholders, since such a shareholder often would otherwise have qualified for capital gains treatment under section 302(b)(3) if cash had been received in lieu of the convertible preferred. On the other hand, the partial conversion into common—which sets the stage for a bail-out—might appropriately be viewed as relating back to the initial exchange or distribution. Thus viewed, the shareholder is treated as if he had received both common and preferred at that time, and, depending on how the section 356(a)(2) issue on dividend treatment is resolved on the reconstructed set of facts, the otherwise clear mandate of section 306(c)(2) could be avoided. While this approach entails some violence to the language of section 306(c)(2) and has the disadvantage of placing an additional hypothetical on top of the hypothetical already existing in section 306(c)(2), something on this order is certainly called for and perhaps even required by the step-transaction doctrine in appropriate fact

27. This proposition assumes that convertible preferred should be treated differently than common stock, an assumption which, though apparently mandated by § 306, is hardly of unquestionable soundness.

28. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, 1234.

situations. As noted earlier, a bail-out with convertible preferred is no easier to accomplish from the shareholder's standpoint than a bail-out through the use of common stock, but it would be difficult to take this factor into account in applying the cash substitution test under section 306(c)(1)(B).

D. *Section 318 Attribution Rules*

Perhaps the most serious defect in the stock dividend language of section 306(c)(1)(B)—and consequently in the Service's cash substitution test—is the lack of any reference to the attribution rules of section 318, a fact which unquestionably invites tax abuse. For example, a controlling shareholder can transfer part of his common stock to his wife or children and, soon thereafter, effect a recapitalization under which the wife or children exchange the common stock for preferred stock. In the absence of family attribution, the preferred stock will not be 306 stock, even though a total redemption of the common by the wife or children would have been taxed at dividend rates since the attribution rules apply to redemptions.[29] Once the preferred is received free and clear of section 306, it could be sold, as was done in the *Chamberlain* case, at capital gains rates to an outsider, who in turn could later redeem the preferred and complete the bail-out circuit.[30] Perhaps the most peculiar feature of the above bail-out is that the section 306 status of the preferred is in effect tested, under the cash substitution test, by the provisions in section 302(b), stripped of the family attribution rules.

In view of the ease with which a bail-out can be accomplished in the above example, or in variations thereof, it may be expected that the Service will press for application of section 318 in construing "stock dividend" under section 306(c)(1)(B), perhaps in reliance on *Gregory v. Helvering*[31] and related cases on business purpose. Consideration of

29. INT. REV. CODE of 1954, § 302(c). Under § 302(c)(2)(B)(i), the constructive ownership rules are not waived in a § 302(b)(3) complete termination if the stock which is redeemed was acquired within 10 years from a related party (here the husband or father). It should be noted that § 356(a)(2) on dividend treatment of boot generally, is equally deficient in any reference to § 318.

30. Conversely, a direct redemption of the preferred would not result in capital gains treatment—not because of § 306, but because of § 302(c)(2)(B)(i)—unless the parties are willing to wait 10 years.

31. 293 U.S. 465 (1935). In 69-19 TAX MANAGEMENT MEMORANDUM 13 (Sept. 22, 1969) (tidbit 2), it is reported that the Service has taken the position, apparently in an unpublished ruling, that § 318 rules will apply to determine the § 306 status of preferred stock received in a reorganization (recapitalization).

family relationships and indirect application of section 318 would appear to be within the province of the Service's discretion under section 306(b)(4), but, though important, this would be of limited value. Chances of broader success are slim indeed. First, by its own terms, the section 318 attribution rules apply only when "expressly made applicable," a requirement which by its very nature calls for a strict construction. To make matters worse, the attribution rules of section 318 are invoked in section 306(b) with respect to disposition of preferred stock once it is determined to be 306 stock; this is a strong indication that Congress was concerned with the interrelationship of section 306 and section 318, and an equally strong indication that if Congress had wished section 318 rules to apply in defining 306 stock under the stock dividend test in section 306(c)(1)(B), it would have expressly said so. While the *Gregory* case and the "business purpose" doctrine are no doubt designed to overcome the tax results otherwise compelled by a technical and literal construction of the Code, the use of such authorities to trifle with the "express reference" requirement of section 318 would be hard to justify.[32]

IV. Earnings and Profits

With regard to section 368(a)(1)(B) reorganizations, another area for tax abuse is created by the reference in section 306(a)(2) to the earnings and profits of the redeeming corporation for purposes of determining the tax consequences of a redemption of section 306 stock. For example, assume that shareholders of the *A* corporation, with substantial earnings and profits, swap common stock for common and preferred stock in the *B* corporation. *B* may be a corporation created simply for the purpose of acquiring the common stock of *A*. Better yet, *B* may be a corporation with prior business activities of its own, controlled either by outside shareholders, by related parties, or by the existing shareholders in *A*. Most important is that B has little or no earnings and profits. If *B* does not liquidate *A* after the exchange, the earnings and profits of *A* will not be transferred to *B* under section 381. Consequently the preferred stock held by the former *A* shareholders can be redeemed under section 306(a)(2) and section 302 at capital gains rates. Even if the *B* corporation has earnings and profits,

32. Alternatively, the Service could press for application of the "automatic rule" of Commissioner v. Estate of Bedford, 325 U.S. 283 (1945), to the section 306 status of preferred stock under the cash substitution test. The battlefield would then be moved to § 306(b)(4), where the Service could freely look to § 318 rules.

dividend treatment of the redemption would not exceed those earnings and profits.

The above scheme is not without its difficulties, however, apart from section 306. First, care must be taken to avoid a "sham" attack and the application of the step-transaction doctrine. The use of a shell corporation would hardly be advisable. In any event, *A* must not be liquidated for a relatively safe period of time, and even then not pursuant to an original plan. Second, *B* might have practical problems in obtaining funds necessary for the redemption. If funds are obtained from *A*, in all likelihood the transaction would be treated as a dividend distribution, with the consequence that the earnings and profits of *A* would be transferred to *B* to that extent, and the later redemption would not work. A procurement of funds from outside sources may be equally dangerous unless *B* could demonstrate an independent ability to discharge the liability created without a distribution or loan from *A*. In any event, a long-term loan arrangement would probably be necessary; this would be successful only if the *A* stock is not pledged to secure the loan.

No doubt section 306(a)(2) reflects the failure of Congress to comprehend the full scope of bail-out potentials in reorganizations. Section 306(a)(2) proceeds on the assumption that the same corporation can be looked to at all relevant times. For this reason, it is unlikely that the Service—short of business purpose arguments of uncertain value—would have much success in convincing a court to view the redemption in terms of *A*'s earnings and profits, which is rather clearly the appropriate frame of reference. The courts have been receptive to this interpretation in a substantially similar problem under section 356(a)(2) with respect to "boot" received from the acquiring corporation in merger exchanges,[33] but the language in section 356(a)(2), "effect of a dividend," invites a broader look at the substance of the transaction than the language of section 306(a)(2). Furthermore, all the relevant transactions under section 356(a)(2) occur in a much shorter period of time, and it is easier to view the boot, to which section 356(a)(2) is addressed, as in substance a distribution from the *A* corporation. Of course, the same look to "substance" would be made in the initial determination that the preferred stock held by the *A* shareholders is 306 stock under the cash substitution test, but

33. *See, e.g.*, Ross v. United States, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959).

it is doubtful whether the earnings and profits remaining in the *A* corporation could again be looked to at the much more significant later date of redemption. On the other hand, it should be noted that, even though section 306 is avoided, section 302 still operates as a backstop; under section 302(b)(1), a court could well rely on the section 356(a)(2) authorities in holding that the *A* corporation's earnings and profits may be taken into account in determining whether the redemption is "essentially equivalent to a dividend." Perhaps a mere passage of time between the exchange and the later redemption would be enough to avoid this result.

V. Conclusion

As the foregoing discussion indicates, a controlling shareholder of a closely held corporation who is serious about the business of effecting a bail-out can still do so with very little risk or sacrifice. For this reason, perhaps the primary significance of section 306 is the "chilling effect" its complexity has upon taxpayers who are uncertain of its meaning. While the virtue of uncertainty should not be taken lightly in areas of tax avoidance, section 306 as a whole is a sad commentary on the workability of technical rules to separate the good from the bad.