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The Outer Limits of Realization: Weiss v. Stearn and Corporate Dilution

Jeffrey L. Kwall
Loyola University Chicago School of Law

Katherine K. Wilbur

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THE OUTER LIMITS OF REALIZATION: *WEISS V. STEARN* AND CORPORATE DILUTION

Jeffrey L. Kwall[*] *and Katherine K. Wilbur*[**]

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*Kathleen and Bernard Beazley Professor of Law, Loyola University Chicago School of Law.

**Associate, Varnum LLP, Grand Rapids, Michigan.

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ABSTRACT

The United States Supreme Court's 1924 Weiss v. Stearn decision involved a classic case of corporate dilution. In that case, a corporation ("Oldco") transferred its business to a new corporation ("Newco") in a transaction in which the Oldco shareholders surrendered all their stock for 50 percent of the stock of Newco (and cash). The transaction diluted the proprietary interest of the Oldco shareholders from 100 percent to 50 percent. Because the Oldco shareholders surrendered control of the enterprise, the 50 percent interest they received in Newco was fundamentally different from the 100 percent interest they had owned in Oldco. Nevertheless, the Court held that the receipt of the Newco shares was not a taxable event (a "realization event") to the Oldco shareholders. The Court reached this result by ignoring the dilution that occurred in the case.

In 1991, the Supreme Court resurrected the Weiss v. Stearn decision in the Cottage Savings case. There, the Court relied on Weiss v. Stearn to establish that the exchange of property triggers a realization event only if the property received is "materially different" from the property surrendered. Once again, the Court ignored the dilution that occurred in Weiss v. Stearn. As a result, Supreme Court jurisprudence sheds no light on the question of whether corporate dilution can trigger realization.

Corporate dilution is a common phenomenon. It can result from an actual exchange of proprietary interests, like the transaction in Weiss v.

Stearn. It can also occur when a shareholder does not physically transfer shares. For example, if a sole shareholder of a corporation sells 50 percent of her stock to a third party, the diluted 50 percent interest she retains is as different from the 100 percent interest she previously owned, as were the interests in Weiss v. Stearn. Notwithstanding the pervasiveness of dilutive transactions, no significant scholarship addresses the impact of dilution on realization.

This Article explores the fundamental question of when corporate dilution should trigger realization. By virtue of the "material difference" standard that emerged from Cottage Savings, the transaction in Weiss v. Stearn should be treated as a realization event. Specifically, the loss of control that resulted from the Stearn transaction left the original shareholders with a materially different interest in the enterprise. More significantly, the material difference standard should be extended to treat realization as occurring in an equally dilutive transaction that does not entail a physical transfer of the diluted interest. As long as a material difference exists, the shareholder should be treated as engaging in a "deemed exchange" of the 100 percent interest for the 50 percent interest, thereby triggering a realization event. Now that nine decades have passed since the Stearn decision was rendered, it is high time for the impact of dilution on realization to be clarified.

> "Since the [Eisner v.] Macomber decision in 1920, the Supreme Court has found an absence of realization to be significant in only one case."[1]

I. INTRODUCTION

One of the most fundamental principles of federal income taxation is the realization requirement, enunciated by the Supreme Court as a constitutional mandate in *Eisner v. Macomber*.[2] By virtue of this requirement, an increase in the value of property is not taxed at the time the appreciation occurs. Rather, a "realization event" (normally thought of as a

1. Mark L. Louie, Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857, 857 n.1 (1982) (citing Weiss v. Stearn, 265 U.S. 242 (1924)). The statement in the text remains true in 2015.

2. Eisner v. Macomber, 252 U.S. 189 (1920). The Court has since retreated from its original view and now regards the realization requirement as primarily an administrative rule of convenience. *See infra* Part III (discussing the evolution of the realization requirement).

sale or exchange of property) is required before an increase in the value of property is included in the income tax base.[3]

From an economic perspective, an income tax should tax any increase in a taxpayer's wealth when it occurs.[4] Imposing the additional requirement of a realization event, therefore, distorts the timing of income. This distortion is justified on administrative grounds—measuring changes in asset values in the absence of a sale or exchange of property is a process that is believed to be too inexact and cumbersome to incorporate in an income tax system.[5] Commentators have frequently challenged this conclusion,[6] but the realization requirement remains a well-ensconced feature of the U.S. income tax.[7]

In light of the artificial deferral conferred by the realization requirement, one would expect the tax system to impose an extremely low hurdle for realization to occur. Surprisingly, the hurdle is higher than one might think. One of us has previously examined the omission of certain

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3. Although no statutory definition of a realization event exists, the requirement is inferred from I.R.C. § 61(a)(3) (gains from "dealings" in property) and I.R.C. § 1001(a) (gain from the "sale or other disposition" of property). I.R.C. §§ 61(a)(3); 1001(a).

4. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (5th prtg. 1965) ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."); ROSWELL MAGILL, TAXABLE INCOME 17 (1936) ("Income is the money value of the net accretion to economic power between two points in time.").

5. *See generally* Victor Thuronyi, *The Taxation of Corporate Income–A Proposal for Reform*, 2 AM. J. TAX POL'Y 109, 126 (1983) [hereinafter Thuronyi, *Corporate Income*] (explaining that the failure to tax unrealized income is defended on the basis that annual asset valuations would be impractical).

6. Various proposals have been advanced to adopt a "mark-to-market" tax system that would tax asset appreciation as it accrues. *See generally* David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (discussing a proposal for an accrual income tax system); David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967) (advancing a proposal to tax the stock of publicly held corporations as such stock appreciates); Thuronyi, *Corporate Income, supra* note 5, at 109 (discussing the repeal of the corporate income tax on publicly held corporations and taxing shareholders on the annual increase in the value of their shares).

7. *See* Marjorie E. Kornhauser, *The Story of Macomber: The Continuing Legacy of Realization*, *in* TAX STORIES 93, 134 (Paul L. Caron ed., Foundation Press 2nd ed. 2009) ("[B]roader proposals to switch to an accretion system have not met—and most likely will not meet—with success.").

dispositions of property from the scope of a realization event.[8] Specifically, under current law, a disposition of property does not result in realization unless a quantifiable benefit is received by the transferor.[9] For this reason, inter vivos and testamentary gratuitous transfers of property are generally not realization events.

In contrast to a gratuitous transfer, realization normally occurs when property is exchanged for a quantifiable benefit. In 1924, however, the Supreme Court determined that realization did *not* occur in *Weiss v. Stearn*, a case involving a transfer of corporate stock in exchange for stock in a successor corporation.[10] The Court viewed the successor corporation as substantively equivalent to its predecessor because the contents of the two corporations were the same and both were incorporated in the same state.[11] The Court concluded that the mere substitution of a new corporate entity for the old entity where the owners *retained the same proportionate interest* did not trigger realization.[12] In arriving at this conclusion, the Court ignored the fact that shareholders owning 100 percent of the predecessor received only 50 percent of the stock of the successor (and cash), i.e., the transaction "diluted" the original shareholder group's proprietary interest from 100 percent to 50 percent.[13] As a result, the Court failed to consider whether the dramatic change that resulted from the dilution (i.e., a loss of control of the enterprise by the original shareholders) should have triggered realization with respect to the original shareholders' entire proprietary interest. Because the *Stearn* Court ignored the dilution issue, the decision sheds no light on the question of whether a dilutive transaction should trigger realization of gain or loss with respect to the diluted interest.

In the nine decades since the *Stearn* decision, the common law of realization has evolved in a manner that facilitates the taxation of transactions resulting in significant dilution. *Stearn* was decided a few years after *Macomber*, where the Court treated realization as a constitutional mandate.[14] The Court retreated from this view in the 1940s when it acknowledged that realization was principally an administrative mechanism.[15] In 1991, the Court revisited the realization requirement in

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8. *See generally* Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for a Disposition Standard of Realization*, 86 IND. L.J. 77 (2011) (proposing the adoption of a "disposition" standard of realization).

9. *Id.* at 85-86.

10. Weiss v. Stearn, 265 U.S. 242 (1924). *See also infra* Part II.A (explaining the mechanics of the Stearn transaction).

11. Stearn, 265 U.S. at 252-53.

12. *Id.* at 253.

13. *Infra* Parts II.B., II.C.

14. *Infra* Part III.A.

15. *Infra* Part III.B.

Cottage Savings v. Commissioner.[16] There, the Court relied on *Stearn* and a trilogy of other early Supreme Court cases to articulate an additional "material difference" requirement for realization.[17] Specifically, when properties are exchanged, realization occurs only if the property received is materially different from the property surrendered.[18] To be materially different, the properties must embody "legal entitlements that are different in kind or extent."[19] The *Cottage Savings* Court endorsed the *Stearn* Court's holding but continued to ignore the impact on realization of the significant dilution that occurred in that case. Thus, Supreme Court jurisprudence to date has not taken a position on the question of whether a dilutive transaction should trigger realization with respect to the diluted interest.

This Article explores the fundamental question of when corporate dilution should trigger realization.[20] By virtue of the "material difference" standard that emerged from *Cottage Savings*, the transaction in *Stearn* should be treated as a realization event. Specifically, the loss of control that resulted from the *Stearn* transaction left the original shareholders with a materially different interest in the enterprise.[21] More significantly, the material difference standard should be extended to treat realization as occurring in an equally dilutive transaction that does not entail a physical transfer of the diluted interest. For example, if a sole shareholder sells 50 percent of her stock to a third party, the diluted 50 percent interest she retains is as different from the 100 percent interest she previously owned, as were the diluted and undiluted interests in *Stearn*. In our view, the absence of a physical transfer of the diluted interest should not preclude realization from occurring. Rather, as long as a material difference exists, the shareholder should be regarded as engaging in a "deemed exchange" of the 100 percent interest for the 50 percent interest thereby triggering a realization event.[22]

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16. Cottage Sav. Ass'n. v. Commissioner., 499 U.S. 554 (1991). *See also infra* Part III.C. (discussing the impact of the *Cottage Savings* case on the realization requirement).

17. *Cottage Savings*, 499 U.S. at 562 (citing United States v. Phellis, 257 U.S. 156 (1921); Weiss v. Stearn, 265 U.S. 242 (1924); Marr v. United States, 268 U.S. 536 (1925); Eisner v. Macomber, 252 U.S. 189 (1920)).

18. *Id.* at 561-562.

19. *Id.* at 565.

20. Surprisingly, no significant scholarship explores this question. For an article raising related issues in a narrower context, see Herwig J. Schlunk, *Rationalizing the Taxation of Reorganizations and Other Corporate Acquisitions*, 27 VA. TAX REV. 23 (2007) [hereinafter Schlunk, *Rationalizing*].

21. *Infra* Part IV.A.

22. The Treasury has promulgated regulations delineating a "deemed exchange" analysis in the context of the modification of a debt instrument. *Infra* Part III.D. That analysis can be readily extended to those dilutive transactions where a

Unfortunately, realization is a crude mechanism for differentiating taxable and nontaxable dilutive transactions and, if relied upon to do so, will impose a heavy administrative burden on the tax system.[23] This problem stems from the need to undertake a fact intensive inquiry to determine whether a material difference exists in any particular case. To remedy this problem, Congress should presume that realization is triggered when significant dilution occurs and enact appropriate nonrecognition rules to defer taxation when such treatment is desirable from a tax policy standpoint.[24]

Part II examines *Weiss v. Stearn*, a case that offered the Court an ideal opportunity to clarify the impact of dilution on realization. It will show that the Court ignored the dilution that resulted in that case by artificially dividing the transaction into two sequential events.[25] Bifurcating the transaction in this manner did not comport with its substance. In substance, the shareholders of the old entity engaged in a single unified transaction that resulted in the dilution of their 100 percent proprietary interest to a 50 percent proprietary interest in the new entity. This dramatic change in the nature of the original shareholders' proprietary interest should have triggered realization with respect to the diluted interest.[26]

Part III explores the evolution of the realization requirement subsequent to *Stearn*. It will delineate the progression from constitutional mandate to administrative mechanism to a substantive concept when the Court, in *Cottage Savings*, articulated the material difference standard. It will also examine Treasury Regulations that formalize the notion of a "deemed exchange." These developments create a pathway for treating certain dilutive transactions as realization events under current law.

Part IV identifies the circumstances in which a dilutive transaction should be treated as a realization event; namely, when a material difference

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material difference exists but the retained interest is not physically transferred. *Infra* Part IV.B.

23. *Infra* Part IV.D.

24. These nonrecognition rules would also presumably apply when a loss is realized (i.e., when the diluted interest has a basis in excess of value).

25. *Infra* Part II.C. First, the original shareholders were treated as selling 50 percent of the stock of the old corporate entity. Second, the original shareholders were treated as exchanging the remaining 50 percent of the old entity's stock for 50 percent of the new entity's stock in a non-dilutive transaction (i.e., the original shareholders owned 50 percent of the enterprise both before and after this isolated step).

26. As one of the earliest commentators on the Weiss v. Stearn case remarked, "the Court . . . found no realization of income in *Weiss v. Stearn* in which, taking the stockholder's entire interest in the old company as a unit, the economic changes were the most pronounced." Henry Rottschaefer, *Concept of Income in Federal Taxation*, 13 MINN. L. REV. 637, 652 (1929).

exists between a pre-dilution and a post-dilution proprietary interest. It will also examine when a dilutive transaction in which the diluted interest is not physically transferred should trigger a realization event. Finally, it will discuss the role that Congress should play in creating an administrable system for distinguishing between taxable and nontaxable dilutive transactions.

II. *WEISS V. STEARN:* SUPREME COURT IGNORES CORPORATE DILUTION

Weiss v. Stearn involved the transfer, in 1916, of all the stock of a corporation in exchange for half the stock of a successor corporation and cash. The transaction occurred during the infancy of the tax law, a few years after enactment of the 16th Amendment in 1913.[27] The primitive 1916 statute imposed a tax on "gains . . . derived from . . . sales, or dealings in property . . . ."[28] The government claimed the stock exchange in *Stearn* was a "dealing in property" that triggered tax on the entire gain in the stock of the predecessor corporation.[29] The two corporations, however, were substantively similar; each owned the same assets and was governed by the laws of the same state. As a result, the taxpayers convinced the courts that the physical exchange of share certificates should be ignored and the taxpayers should be treated as selling only half of their proprietary interest; namely, the 50 percent interest they surrendered for cash.[30]

The transaction in *Stearn* substantially diluted the taxpayers' interests. Before the transaction, the taxpayers' owned 100 percent of the enterprise; after the transaction, the taxpayers' only owned 50 percent of the enterprise. The Supreme Court held that the taxpayers did not realize gain with respect to their 50 percent retained interest.[31] In reaching this result, the Court ignored the dramatic change in the nature of the taxpayers' property resulting from their surrender of control of the enterprise.

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27. U.S. . amend. XVI. Shortly after the 16th amendment was ratified, Congress passed the Tariff Act of 1913 which imposed a tax on "net income" which included "gains, profits, and income derived from . . . sales, or dealings in property . . . ." Revenue Act of 1913, ch. 16, § II(B), 38 Stat. 114, 167. Earlier versions of the income tax date to the Civil War years. *See, e.g*., Act of Aug. 5, 1861, ch. 45, § 49, 12 Stat. 292, 309.

28. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757 ("[T]he net income of a taxable person shall include gains, profits, and income derived from . . . sales, or dealings in property . . . .").

29. *See infra* Part II.B.1.

30. *See infra* Parts II.B.2−3.

31. *Stearn*, 265 U.S. at 254.

A. *The 1916 Transaction*

The *Stearn* transaction involved a series of steps in which the shareholders of a predecessor corporation ultimately received a 50 percent interest in a successor corporation and cash. The shares and cash were not transferred directly between the parties. Instead, a financial intermediary ("Depositary") collected the shares of both corporations and the cash, then subsequently disbursed the shares of the successor corporation and the cash to the designated parties.[32] The contract delineates the following five steps:

1. Shareholders of Old Acme Transfer Old Acme Shares (Valued at $15 Million) to Depositary

On November 8, 1916, Louis Stearn and certain other shareholders ("Vendors") of The National Acme Manufacturing Company ("Old Acme") contracted to sell all of their stock to Eastman, Dillon & Company ("Purchasers") via The Cleveland Trust Company ("Depositary"). Old Acme was an Ohio corporation with 50,000 shares outstanding with a value, based on the contract, of $15 million ($300 per share).[33] The contract became operative only if at least 80 percent of the stock of Old Acme was deposited with Depositary.[34] The shareholders of Old Acme ultimately deposited all 50,000 outstanding shares with Depositary.[35]

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32. The shares of the predecessor corporation were presumably retired.

33. 50,000 shares x $300/share = $15,000,000. The contract provided as follows:

> First−The Vendors agree to and will sell all their said shares of common capital stock to, and the Purchasers agree to and will purchase the same from them, as well as any and all shares of the common capital stock of [Old Acme], the holders of which deposit the same with the depositary . . subject to the terms of this agreement, at and for the price of Three Hundred Dollars ($300) per share, payable one half in cash and one half in securities . . . .

Statement of Agreed Facts at Exhibit A, p. 1, ¶ 1, Stearn v. Weiss, No. 10126 (N.D. Ohio, 1922) [hereinafter Statement of Agreed Facts].

34. The contract specifically provided, "[T]his contract is made upon the express condition, that it shall not become operative unless, on or before December 1st, A.D. 1916, at least eighty per centum (80%) of the entire outstanding common capital stock of said company is deposited hereunder, for sale in accordance with the terms hereof, with said depositary." *Id.*, para. First (Apr. 9, 1920).

35. *Stearn*, 265 U.S. at 251 ("Respondents and other owners delivered duly indorsed certificates representing the entire capital stock ($5,000,000) of the National Acme Manufacturing Company . . . to the Cleveland Trust Company, as depositary.").

2. Purchasers Transfer $7,500,000 to Depositary

After the shareholders of Old Acme deposited at least 80 percent of the outstanding stock with Depositary, the Purchasers were required to deliver $7,500,000 in cash to Depositary.[36]

3. Shareholders of Old Acme and Purchasers Form New Acme

The contract required the Vendors and Purchasers to incorporate a new Ohio corporation with powers that were similar to those of Old Acme, under the name of The National Acme Company ("New Acme"). New Acme was authorized to issue 500,000 shares of stock.[37]

4. Old Acme Transfers All Assets and Liabilities (Valued at $15 Million Net) to New Acme, and New Acme Issues All of Its Stock (Valued at $15 Million) to Depositary

After New Acme was incorporated, it purchased all the assets and assumed all the liabilities of Old Acme.[38] In consideration, New Acme issued all of its authorized shares but it did not transfer those shares to Old Acme. Instead, the contract instructed New Acme to issue all the shares to Depositary.[39] The fact that the New Acme stock was issued to Depositary

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36. Once the 80 percent threshold of deposited stock was reached, the contract required the Purchasers to deposit the sum of $7,500,000 in two lump sums with Depositary. Statement of Agreed Facts, *supra* note 33, at Exhibit A, pp. 2-3, ¶ 3.

37. *Id.* at Exhibit A, p. 3. The new company had no value as a shell corporation. When it acquired $15 million of net assets from Old Acme, the shares of New Acme had a value of $30 per share ($15,000,000/500,000 shares = $30).

38. *Id.* at Exhibit A, p. 1. The contract provided as follows: "Purchasers and Vendors will cause such proceedings to be had by its stockholders and directors as will cause [New Acme] to purchase all the property and assets . . . of [Old Acme] . . . subject to all its outstanding contracts and liabilities . . . which are to be assumed by [New Acme] . . . in consideration of . . . its entire authorized issue of stock, and to issue such stock in payment therefore." Order on Findings of Fact at p. 3, Stearn v. Weiss, No. 10126 (N.D. Ohio, 1922) [hereinafter Order on Findings of Fact] (quoting Contract at ¶ 4).

39. The contract provided as follows: "The Purchasers and Vendors will cause all the stock of [New Acme] to be issued to . . . Depositary . . . to be held and distributed by it as hereafter provided." Order on Findings of Fact, *supra* note 38, at p. 3 (quoting Contract at ¶4). *See also* Statement of Agreed Facts, *supra* note 33, at Exhibit A, p. 3. The Agreement references consideration of $25 million which is the par value of New Acme stock, not the fair market value. New Acme's fair market value was a function of the assets it acquired which was $15 million, assuming the

rather than Old Acme makes it impossible to determine whether Purchasers acquired 50 percent of the New Acme stock from New Acme, or whether the Purchasers acquired 50 percent of the Old Acme stock from the shareholders of Old Acme (and received their 50 percent of New Acme when Old Acme liquidated). The implications of this uncertainty on the tax consequences of the transaction will be discussed below.[40]

5. Depositary Transfers:

(a) 250,000 Shares of New Acme (Valued at $7.5 Million) to Purchasers, and
(b) 250,000 Shares of New Acme (Valued at $7.5 Million) and $7.5 Million Cash to Original Shareholders of Old Acme

Once New Acme became the owner of Old Acme's business, Depositary was instructed to transfer one-half (250,000 shares) of the 500,000 New Acme shares to Purchasers.[41] Assuming the stock of New Acme had a market value equivalent to the $15 million market value of the Old Acme shares (50,000 shares at $300 per share), Purchasers received $7.5 million of stock (50 percent of the $15 million value of New Acme) for the $7.5 million Purchasers had deposited with Depositary (see 2., above).

In addition, Depositary was instructed to pay the shareholders of Old Acme $150 for each Old Acme share deposited with it. Because all 50,000 outstanding shares of Old Acme were deposited with Depositary, Depositary paid out the entire $7.5 million deposited by Purchasers to the original Old Acme shareholders.[42]

Finally, Depositary was instructed to retain the remaining 250,000 shares of New Acme (with a value of $7.5 million), along with the corresponding voting rights, until May 31, 1917, when it was to be released to the depositing Old Acme shareholders by distributing five New Acme shares (at a value of $30 per share; $150 for five shares) for each of the 50,000 Old Acme shares (which had a value of $300 per share).[43] Thus, the Old Acme shareholders transferred Old Acme stock with a value of $15 million and ultimately received $7.5 million in cash and 50 percent of the stock of New Acme with a value of $7.5 million.

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value of Old Acme's net assets was equivalent to the value of Old Acme's stock (stipulated to be $15 million).

40. *See infra* Part II.C.

41. Order on Findings of Fact, *supra* note 38, at pp. 3-4 (quoting Contract at ¶ 5(a)).

42. 50,000 shares x $150/share = $7.5 million. Statement of Agreed Facts, *supra* note 33, at Exhibit A, p. 4, ¶ 5(a).

43. *Id.*

B. *Neither the Parties Nor the Courts Focus on the Dilution Issue*

Not surprisingly, the parties adopted dramatically different views of the transaction. The government argued realization occurred with respect to the sellers' entire proprietary interest because all of the shares of one corporation (Old Acme) were exchanged for other property (New Acme shares and cash). By contrast, the taxpayers argued that the two corporations were substantively equivalent and, therefore, the transaction should be treated as a sale of half of the sellers' proprietary interest in the corporate enterprise. Neither party focused on the fact that the dilution resulting from the transaction fundamentally changed the nature of the taxpayers' continued investment in the enterprise—i.e. they no longer owned a controlling interest—The lower courts and the Supreme Court also ignored the dilution issue.

1. *Government: Shareholders Realized Entire Gain Because They Transferred All Their Shares*

The government argued that the transaction resulted in a sale by each Old Acme shareholder of his or her holding in Old Acme in exchange for cash and New Acme stock.[44] Thus, each taxpayer realized gain equal to the amount by which the cash and the value of the New Acme stock received exceeded the original cost of the Old Acme stock.[45] In the government's view, the exchange of shares of one corporation for another triggered realization no matter how similar the two corporations might have been.[46] In

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44. At the district court, the government characterized the facts stating, "Stockholders and Officers of [Old Acme] . . . agreed to sell to [the Purchasers] . . . their stock in [Old Acme] at and for the price of $300.00 per share, payable one-half in cash and one-half in Common Stock of [New Acme], a new corporation." Brief for Defendant at p. 1, ¶ 1, Weiss v. Stearn, No. 10126 (N.D. Ohio, 1922) [hereinafter Brief for Defendant]. At the Sixth Circuit, the government continued to characterize the transaction in this manner, stating "There is nothing in the record in this case other than the interpretation of the District Court to controvert the clear and unqualified statement contained in the agreement that all and not one-half of the stock in the old company was being sold to [the Purchasers]." Brief on behalf of Plaintiff in Error at p. 8, Weiss v. Stearn 285 F. 689 (6th Cir. 1923) (No. 10126) [hereinafter Brief on behalf of Plaintiff in Error].

45. Brief on behalf of Plaintiff in Error, *supra* note 44, at p. 6 ("[The Old Acme stockholder] realized upon his original investment and the amount by which the cash and securities so received exceeded the original cost of his [Old Acme] stock was income to him and properly taxable as such.").

46. *Id.* at pp. 4-12. The government also focused on the fact that the agreement stated a "sale" had occurred: "The Vendors agree to and will sell all their

other words, the government apparently believed that the exchange of shares in different legal entities was sufficient for realization to occur.[47] Although the government acknowledged that the 50 percent ownership interest in New Acme received by the Old Acme shareholders was different from their 100 percent interest in Old Acme,[48] it did not focus on the dilution issue.[49]

2. *Taxpayers: Shareholders Realized Only Half of The Gain Because They Retained Half of Their Proprietary Interest*

The taxpayers argued that the exchange of Old Acme stock for New Acme stock did not result in taxable gain for the Old Acme stockholders by analogizing the case to *Eisner v. Macomber*.[50] In *Macomber*, the Supreme Court determined that a pro rata stock dividend was not taxable as income under the 16th Amendment.[51] The taxpayers applied *Macomber* to *Stearn* by arguing that if the new corporate entity, New Acme, was ignored, then the exchange of stock should be treated as a stock dividend followed by a sale of

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said shares of common capital stock to, and the Purchasers agree to and will purchase the same from them." *Id.* at pp. 7-8 (quoting language from Contract). *See also* Statement of Agreed Facts, *supra* note 33, at Exhibit A, p. 1.

47. Because the stock received in the exchange represented an interest in a different legal entity, the Government argued this necessarily led to the conclusion that a "sale" occurred. Brief on behalf of Plaintiff in Error, *supra* note 44, at p. 6.

48. "The transaction was a sale of all of the stock in the old company and while the corporate assets may have been the same upon its completion as they were at its inception, it is certainly not true that stockholding interests were identical. As far as it appears from the record the old stockholders prior to November 8, 1916, owned an undivided interest in all of the property and assets of [Old Acme]. Subsequent to that date they owned only an undivided one-half interest in the same property and assets, while an entirely new set of stockholders had become owners of fifty (50) percent of the stock in the new company." Brief on behalf of Plaintiff in Error, *supra* note 44, at pp. 8-9. This point fell by the wayside because the courts rejected the government's version of the facts (namely, that the taxpayers exchanged a 100 percent interest in Old Acme for New Acme stock and cash in a single unified transaction). *See infra* Part II.C.

49. The government potentially approached the dilution issue in its District Court brief when it mentioned an early Committee on Appeals and Review decision 26-20-1024, and noted that, "the facts in [the Committee on Appeals and Review decision] were very similar to those under discussion here, with the exception that no cash was received by the stockholders making it, therefore, a weaker case than the present one." Brief for Defendant, *supra* note 44, at p. 10, ¶1.

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

51. *Id.* at 204-05. For further discussion of *Eisner v. Macomber*, *see infra* Part III.A.

a 50 percent interest in the *same* corporation.[52] The taxpayers effectively ignored the changes that occurred at the shareholder level in favor of focusing on how, at the corporate level, Old Acme and New Acme owned the same assets.[53] Thus, the taxpayers' narrow argument was that the exchange of stocks should not be taxable because New Acme's status as a different corporate entity should be ignored.

In effect, therefore, the arguments set forth by the parties' briefs were essentially whether the transfer of the stock of the predecessor corporation triggered realization of the entire gain (government), or whether the new corporation could be ignored and the transaction could be viewed as a sale of 50 percent of the stock in a single corporation (taxpayers). Neither party focused on how the dilution of the Old Acme shareholders' 100 percent interest in Old Acme to a 50 percent ownership interest in New Acme impacted realization.

3. Courts: Taxpayers Prevail Because Substance Trumps Form

The courts rejected the government's argument that the exchange of shares in one corporation for shares in another necessarily results in realization by focusing on the similarity of the two corporate enterprises. In effect, the two corporate enterprises were treated as one because no meaningful change had occurred at the corporate level. As the Sixth Circuit stated,

> The same ends might have been achieved by an amendment of the articles of incorporation providing for the increase of the capital stock, the reduction of the face value of its shares, and the change of name . . . . Therefore, if the

52. Brief on Behalf of Plaintiff, Stearn v. Weiss, No. 10126, at p. 5 (N.D. Ohio, 1922). Specifically, the taxpayer argued that the transaction should be treated as if Old Acme had changed its corporate name, increased its capital stock from $5,000,000 to $25,000,000, declared a stock dividend of four hundred percent, and then the Old Acme shareholders had sold one-half of their Old Acme stock to the Purchasers.

53. *Id.* at pp. 8-9. The taxpayer also made this point in the appellate brief; i.e., that no new money or property went into New Acme apart from the very same assets and liabilities that made up the business of Old Acme. Brief in Behalf of Defendant in Error at p. 2, Weiss v. Stearn 285 F. 689 (6th Cir. 1923) (No. 3790) ("The National Acme Company had come into existence, an Ohio corporation, having the same corporate powers and purposes as The National Acme Manufacturing Company, with a capital of $25,000,000, divided into shares of the par value of $50.00 each. It had exactly the same property and the same liabilities, neither more nor less than The National Acme Manufacturing Company, which property was devoted to the same purposes as it had been when it was the property of The National Acme Manufacturing Company.").

> transaction be taxable, it must be because of the giving up of the old and the taking on of the new charter. It is true that a new corporate being has intervened; but where a corporate entity has been found to be a mere matter of form, it has been disregarded in similar transactions in respect of income taxation.[54]

The opinion of the Sixth Circuit laid the groundwork for the Supreme Court to focus on whether the exchange of stock in two similar corporations results in realization. Like its predecessors, the Supreme Court paid little attention to the form of the transaction and focused on substance.[55] Moreover, the Supreme Court rejected the significance of the new corporation at least in circumstances where no other changes occurred.

> Applying the general principles of *Eisner v. Macomber*, it seems clear that if [Old Acme] had increased its capital stock to $25,000,000, and then declared a stock dividend of 400 per cent, the stockholders would have received no gain—*their proportionate interest would have remained the same as before*. . . . We cannot conclude that mere change for purposes of reorganization in the technical ownership of an enterprise, under circumstances like those here disclosed, followed by issuance of new certificates constitutes gain separated from the original capital.[56]

Thus, the Supreme Court rejected the government's view that a change in corporate entity per se causes realization to occur.[57]

As one might expect, the *Stearn* courts focused on the two views presented by the parties. After observing that the predecessor and the successor corporations were substantively equivalent, the courts rejected the government's argument that realization occurs in every exchange. The courts did not focus on the fundamental change that had in fact occurred at the shareholder level, namely, the dilution of historic ownership from 100

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54. Weiss v. Stearn, 285 F. 689, 692 (6th Cir. 1923) (citations omitted). The District Court also acknowledged that its decision would not be guided by the form of the transaction, but by its substance. Stearn v. Weiss, No. 10126, p. 2 (N.D. Ohio, 1922), J. Westenhaver ("All counsel agree that the substance and not the form of the transaction is controlling, and that the Court will and must look through the machinery and verbiage in order to ascertain the true substance and nature of the transaction.").

55. *Stearn*, 265 U.S. at 254 ("[W]e must regard matters of substance and not mere form.").

56. *Id.* at 253-54 (emphasis added).

57. The Court's language ("technical ownership of an enterprise") suggests that a mere change in the legal entity that owns the enterprise, in the absence of other meaningful changes, is insufficient for realization.

percent to 50 percent. Instead of confronting this issue, the courts adopted a fiction that camouflaged the resulting dilution.

C. *Courts Bypass Dilution Issue by Treating Sale of Half of Proprietary Interest as Occurring Before Exchange of the Other Half*

Notwithstanding that all three of the *Stearn* courts rejected the government's argument that the substitution of one corporation for another is sufficient for realization, the courts concurred that the Old Acme shareholders realized gain with respect to the half interest they sold for cash. The courts also agreed that gain was not realized with respect to the New Acme stock received by the Old Acme shareholders. The courts reached the latter conclusion without confronting the fact that the New Acme shares represented a significantly diluted ownership interest in the original enterprise. The courts bypassed the dilution issue by bifurcating the *Stearn* transaction into two *sequential* events: (1) a sale of 50 percent of the Old Acme stock, followed by (2) the exchange of a 50 percent interest in Old Acme for a 50 percent interest in New Acme.[58] By severing the sale from the subsequent exchange, the courts viewed the subsequent exchange as a non-dilutive transaction, i.e., one in which no change in the proportionate interest of the Old Acme shareholders occurred.

1. *The Fiction Employed by the Courts*

The District Court articulated the two-step fiction as follows:

> The real transaction was a sale by the stockholders of the old company to . . . Eastman, Dillon & Company of a one-half interest in their shares of stock and a reorganization by the old stockholders and Eastman, Dillon & Company of the corporation, the substance and legal effect of which was to leave *all stockholding interests* and all the corporate assets *in precisely the same situation after the transaction was fully carried out as it was when it was begun*.[59]

This view enabled the District Court to avoid the question of whether the dilution of a 100 percent ownership interest to a 50 percent interest triggers realization. Instead of confronting the dilution issue, the court treated the

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58. *See* Richard H. Tye, *Reciprocal Mortgage Sales: A Question of Realization*, 41 BAYLOR L. REV. 135, 148 (1989) ("The Court bifurcated this transaction, however, treating it in part as a sale of one share of the stock for cash, and in part as an exchange of the other share for the same proportionate interest in the new corporation.").

59. Dist. Ct. Opinion, Stearn v. Weiss, No. 10126, p. 2 (N.D. Ohio 1922) (emphasis added).

cash as consideration for 50 percent of the Old Acme stock and severed that cash purchase from a subsequent exchange of the remaining 50 percent of the Old Acme stock for 50 percent of the New Acme stock.[60]

The Sixth Circuit affirmed the District Court in an opinion that more clearly treated the cash as consideration received for 50 percent of the Old Acme stock in a purchase occurring *before* the exchange of the remaining 50 percent of the Old Acme stock for New Acme stock. The court stated,

> Except for the change of corporate entity, there was here a continuance of the same concern. The assets were the same, and the stockholders *(assuming the sale of the other half to have been consummated) were* the same, and *in the same proportions* . . . ").[61]

By "assuming" the sale of half of the Old Acme stock was consummated before the subsequent exchange of shares, the court avoided the question of whether the dilution of a 100 percent ownership interest to a 50 percent interest triggers realization. As a result, the court concluded that the subsequent exchange of the selling shareholders' remaining 50 percent of Old Acme stock for New Acme stock resulted "in the same proportions" (a 50 percent interest in the enterprise both before and after the exchange).

The Supreme Court followed the Sixth Circuit's lead and articulated the view that a sale of a 50 percent interest in Old Acme occurred *before* an exchange of the remaining 50 percent interest in Old Acme for a 50 percent interest in New Acme. In the words of the Court,

> [T]he Collector ruled that each old stockholder sold his entire holding, and assessed respondent accordingly for resulting profits. Adopting a different view, the courts below held that he really *sold half for cash and exchanged the remainder*, without gain, *for the same proportionate interest* in the transferred corporate assets and business. We agree with the conclusion reached below. The practical result of the things done was [1] a transfer of the old assets and business . . . to the new corporation, [2] a disposal for cash by each stockholder of half his interest therein, and [3] an

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60. This conclusion follows from the court's statement that all stockholding interests were left "in precisely the same situation after the transaction was fully carried out as it was when it was begun." For that statement to be true, the court must have viewed the transaction as beginning *after* 50 percent of the Old Acme stock was sold to the Purchasers. In that event, the Old Acme shareholders and the Purchasers each owned 50 percent of the enterprise both before and after the transaction. By contrast, if the transaction had been treated as beginning *before* the sale of 50 percent of the Old Acme shares to the Purchasers, the transaction would have reduced the Old Acme shareholders' interest from 100 percent to 50 percent.

61. *Stearn*, 285 F. at 691 (emphasis added).

exchange of the remainder for new stock *representing the same proportionate interest in the enterprise*."[62]

The Supreme Court, like the lower courts, treated a sale of 50 percent of the New Acme stock as occurring independently of, and prior to, a subsequent exchange of the remaining 50 percent. This treatment enabled the Court to conclude that the exchange results in no change in proportionate interest.[63] Therefore, no realization occurred with respect to the 50 percent of the Old Acme stock exchanged for 50 percent of the New Acme stock. As the next section will demonstrate, the courts' fiction is inconsistent with the substance of the transaction and an equally viable alternative fiction would have exposed the dilution.

2. *Critique of the Courts' Fiction*

As demonstrated above, all three of the *Stearn* courts avoided the corporate dilution issue by bifurcating the transaction into a sale of 50 percent of the Old Acme shares followed by an exchange of the remaining 50 percent of the Old Acme shares for 50 percent of the New Acme shares. By isolating the second leg of the transaction, the courts concluded that the Old Acme shareholders had the same proportionate interest before and after the exchange. This two-step fiction, however, does not comport with the substance of the transaction.

The substance of the transaction can be divined from the agreement between the parties. Pursuant to the agreement, unless 80 percent of the Old Acme shares were tendered, the proposed transaction was null and void.[64] Thus, the essence of the transaction was a single, unified exchange of all the Old Acme stock for New Acme stock and cash.[65] In substance, therefore, the

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62. *Stearn*, 265 U.S. at 252 (emphasis added).

63. As precedent for its holding, the Supreme Court cited *Eisner v. Macomber* and other early cases in which assets were rearranged among wholly-owned entities, but there were no changes with respect to the proportionate ownership interests of the stockholders. *See id.* at 253-54, *citing* Towne v. Eisner, 245 U. S. 418 (1918); Southern Pacific Company v. Lowe, 247 U. S. 330 (1918); Gulf Oil Corporation v. Lewellyn, 248 U. S. 71 (1918). Based on these cases, the Court determined that precedent existed for ignoring the separate nature of two distinct legal corporate entities where the two corporations are substantially identical.

64. Statement of Agreed Facts, *supra* note 33, at Exhibit A, p. 1, ¶ 1 ("This contract is made upon the express condition, that it shall not become operative unless, on or before December 1, A.D. 1916, at least eighty per centum (80%) of the entire outstanding common capital stock of said Company is deposited hereunder for sale, in accordance with the terms hereof, with said depositary.").

65. The fact that delivery of the New Acme shares to the sellers was delayed several months does not undermine the view that 100 percent of the stock of

transaction resulted in the dilution of a 100 percent equity interest to a 50 percent equity interest—a dramatic change in the nature of the property that should not have been ignored. Nothing in the agreement implies that the shareholders of Old Acme intended to sell 50 percent of their Old Acme shares and that the transaction could have ended at that point.

Even if one entertained the idea of bifurcating the transaction into two distinct parts, that approach need not have camouflaged the significant dilution that resulted from the transaction. The courts could have adopted an equally viable fiction that would have exposed the dilution that resulted from the transaction. Neither one of these two fictional approaches is superior to the other nor can either approach be validated because the financial intermediary gathered all the consideration and distributed it to the relevant parties after the assets were transferred.[66] Use of the intermediary makes it impossible to discern whether the buyers acquired an initial stake in Old Acme (under the Court's fiction) or New Acme (under the alternative fiction). Thus, no justification exists for choosing the particular fiction that the courts adopted.

The two alternative fictions are summarized as follows:

> I. The Courts' Fiction: Purchasers Buy 50 Percent of *Old Acme* Before Old Acme Shareholders Exchange Remaining 50 Percent of Old Acme for 50 Percent of New Acme.

All three *Stearn* courts bifurcated the transaction in a manner that treated the Old Acme shareholders as selling 50 percent of the Old Acme stock *before* the subsequent asset sale and liquidation of Old Acme. If the transaction had actually been structured in this manner, the following three consecutive steps would have occurred:

1. Purchasers buy 50 percent of Old Acme stock from Old Acme shareholders for $7.5 million;
2. Old Acme transfers all its assets to New Acme for 100 percent of New Acme stock;
3. Old Acme liquidates distributing 50 percent of New Acme stock to original Old Acme shareholders and 50 percent of New Acme stock to Purchasers.

As discussed above, the substance of the transaction does not support treating each of the steps as independent events. If, however, the steps were regarded as independent, the shareholders of Old Acme would have owned

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Old Acme had been transferred to Depositary before the reorganization was effectuated. Order on Findings of Fact, *supra* note 38, at, p. 5 (noting that Cleveland was to hold on to one-half of the New Acme stock until May 31, 1917, unless the Purchasers consented to an earlier disbursement, at which time the stock would then be transferred to the Old Acme shareholders).

66. *See supra* Part II.A.

50 percent of Old Acme immediately before their interest was converted to a 50 percent interest in New Acme as a result of the liquidation. Hence, no dilution would have occurred.

<u>II. An Equally Viable Fiction</u>: Purchasers Buy 50 percent of *New Acme* Before Old Acme Shareholders Exchange 100 percent of Old Acme for 50 percent of New Acme and Cash.

In lieu of the courts' approach, the transaction could have been bifurcated by treating the Purchasers as buying a 50 percent interest in *New Acme* before Old Acme's subsequent asset sale and liquidation. If the transaction had been structured in this manner, the following three consecutive steps would have occurred:

1. Purchasers buy 50 percent of New Acme stock from New Acme for $7.5 million;
2. Old Acme transfers all its assets to New Acme for $7.5 million and 50 percent of New Acme stock;
3. Old Acme liquidates distributing $7.5 million and 50 percent of New Acme stock to Old Acme shareholders in exchange for 100 percent of Old Acme stock.

Commentators and the IRS have actually adopted this alternative fiction.[67] Even the Supreme Court in *Stearn* lapsed into the view that the Purchasers bought into New Acme before the asset sale and liquidation. The Court stated, "The sale of part of the new stock and *distribution of the proceeds* did not affect the nature of the unsold portion; when distributed this did not in truth represent any gain."[68] By stating that the "proceeds" from the sale of part of the New Acme stock were "distributed," the Court implies the following: (1) the Purchasers bought New Acme shares *before* New Acme

67. *See, e.g.*, David F. Shores, *Reexamining Continuity of Shareholder Interest in Corporate Reorganizations*, 17 VA. TAX REV. 419, 434 (1998) ("In [Stearn], all of the assets of Old Corporation (a manufacturing company), were transferred to New Corporation. New Corporation also received an infusion of cash from an investment company, in exchange for half of its common stock. The *remaining half of the new corporation stock plus the cash received from the investment company were distributed to the shareholders of Old Corporation*, and Old Corporation was dissolved.") (emphasis added); Jasper L. Cummings, Jr., *A General Theory of F Reorganizations*, 137 TAX NOTES 1193, 1205 (2012) [hereinafter Cummings, *A General Theory*] ("In *Weiss*, the Supreme Court held that no realization occurred when one corporation actually transferred its assets to a new corporation with a different name for its stock and cash contributed to it by new investors and liquidated, giving the original shareholders half the new corporation's stock and the cash."); T.A.M. 1995-15-003 (April 14,1995) ("Weiss v. Stearn involved a corporate reorganization where a corporation sold its assets to new corporation in exchange for 50% of the stock in the new corporation and cash.").

68. *Stearn*, 265 U.S. at 254 (emphasis added).

purchased the Old Acme assets; (2) New Acme used the cash and the other half of the New Acme stock to fund the asset purchase; and (3) half of the New Acme stock and the cash were *distributed* to the Old Acme shareholders in liquidation of Old Acme. By contrast, if the Court had been true to the fiction it adopted, no "distribution" of the cash by Old Acme could have occurred because the cash would never have entered corporate solution. Rather, the cash would have been paid directly to the Old Acme shareholders. Thus, even the Supreme Court in *Stearn* was complicit in conceptualizing the transaction in a way that makes it impossible to ignore the dilution.[69]

In sum, the *Stearn* transaction substantially diluted the taxpayers' interests. The Supreme Court held that the gain with respect to the 50 percent retained interest was not realized. The Court did not address the question of whether the significant change in the nature of the retained interest should have triggered a realization event. Because the Court ignored the dilution issue, the *Stearn* jurisprudence sheds no light on the question of whether dilution can trigger realization.

III. EVOLUTION OF THE REALIZATION REQUIREMENT: A PATHWAY TO TAXING DILUTIVE TRANSACTIONS

Although significant dilution resulted from the transaction in *Weiss v. Stearn*, the courts refrained from confronting the question of whether dilution should trigger realization. During the past century, the common law of realization evolved significantly from its primitive state when the *Stearn* transaction occurred in 1916. That evolution facilitates treating the *Stearn* transaction and certain other dilutive transactions as realization events under

69. A third alternative fiction would have been to bifurcate the transaction by treating Old Acme's sale of assets and liquidation as occurring before the Purchasers purchased an interest in New Acme. Under this fiction, the following consecutive three steps would have occurred: (1) Old Acme transfers all of its assets to New Acme for 100 percent of the New Acme stock; (2) Old Acme liquidates distributing all the New Acme stock to the Old Acme shareholders; and (3) Purchasers buy 50 percent of the New Acme stock from the Old Acme shareholders. In this situation, the shareholders of Old Acme would have owned 100 percent of Old Acme immediately before their interest was converted to a 100 percent interest in New Acme as a result of the liquidation, and no dilution would have occurred. The fact that both sellers and buyers were to incorporate New Acme undermines the view that Purchasers bought half of the New Acme stock before Old Acme transferred its assets to New Acme. *See* Order on Findings of Fact, *supra* note 38, at pp. 3-4, ¶ 4 ("Purchasers and Vendors will cause to be incorporated under the laws of the state of Ohio a manufacturing corporation."); *Id.* ("Purchasers and Vendors . . . will cause . . . [New Acme] to purchase all the property and assets . . . of [Old Acme] . . . .").

current law. Part III examines the evolution of the realization requirement during the past century.

A. *1920: Eisner v. Macomber—Realization as a Constitutional Mandate*

Between the time of the *Stearn* transaction and the time the courts rendered their decisions, the Supreme Court decided the seminal case of *Eisner v. Macomber*.[70] The *Macomber* Court determined that a pro rata stock dividend was not taxable as income under the 16th Amendment.[71] According to the Court, a stock dividend is not taxable as income when it does not increase the proportionate interests of the shareholders, takes nothing from the corporation, and adds nothing to the interests of the stockholders.[72] Because the new stock is simply different evidence of the accumulation of profits and increase in capital, the Court held that the stockholder "has not realized or received any income in the transaction."[73]

The *Macomber* Court treated realization as a constitutional requirement. As the Court stated, the "essential matter" for determining whether there is income is to ask whether there is a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived'*—that is, *received or drawn by* the recipient (the taxpayer) for his *separate* use, benefit, and disposal—*that* is income derived from property.[74]

Therefore, because the stock dividend in *Macomber* was simply a representation of the shareholder's portion of accumulated profits and was capital, not income, the stock dividend was not properly taxable under the 16th Amendment.[75] Two decades later, the Court departed from its view that a severance from capital was a prerequisite to realization and acknowledged that realization was essentially an administrative mechanism.

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70. 252 U.S. 189 (1920).
71. *Id.* at 219.
72. *Id.* at 212.
73. *Id.*
74. *Id.* at 207. In defining income, the Court emphasized the necessity that gain be severed from capital but did not tie severance to an actual sale or exchange of property.
75. The *Stearn* Court focused on this language and found that the requisite separation of income from capital had not occurred in *Stearn*. "We cannot conclude that mere change for purposes of reorganization in the technical ownership of an enterprise, under circumstances like those here disclosed, followed by issuance of new certificates constitutes gain separated from the original capital interest." Weiss v. Stearn, 265 U.S. 242, 254 (1924).

B. 1940: Bruun and Horst—Realization as an Administrative Mechanism

In *Helvering v. Bruun,* a landlord and a tenant entered into a 99-year lease of land and a building.[76] The tenant demolished the original building and constructed a new building on the property that increased the value of the leased property.[77] The tenant eventually defaulted on the lease, and the landlord recovered the land and the new building.[78] The Government argued that the recovery of the leased premises was a realization event, and thus, the landlord was taxed on the increase in the value of the property resulting from the construction of the building.[79] The Supreme Court agreed that a realization event occurred, stating as follows:

> While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset . . . . The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization . . . . It is not necessary to recognition of taxable gain that [the taxpayer] should be able to sever the improvement . . . from his original capital.[80]

The *Bruun* decision significantly relaxed the realization requirement. As two respected commentators have noted, "Although the *Bruun* opinion did not reject the famous definition promulgated by *Eisner v. Macomber*, it watered down the requirement of a realization by suggesting that any definite event – here the forfeiture of a leasehold – could properly be employed as the occasion for taking account of the taxpayer's gain."[81]

Shortly after the *Bruun* decision, the Supreme Court explicitly stated that realization was based on administrative convenience. In *Helvering v. Horst*, a taxpayer who owned a coupon bond gratuitously transferred one of the interest coupons to a child shortly before the due date of the interest payment.[82] The child collected the interest and it was reported on the child's tax return.[83] The government claimed the interest income was attributable to

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76. Helvering v. Bruun, 309 U.S. 461, 464 (1940).

77. *Id.* at 464.

78. *Id*.

79. *Id.* at 464-65.

80. *Id.* at 469. The holding of *Helvering v. Bruun* was subsequently overruled by Congress. *See* I.R.C. § 109 (excluding from the lessor's income improvements made by the lessee on the lessor's property).

81. BORRIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶5.1 (3d ed. 2005) [hereinafter BITTKER & LOKKEN].

82. Helvering v. Horst, 311 U.S. 112, 114 (1940).

83. *Id.* at 131.

the parent who presumably paid tax at a higher rate than the child.[84] The Supreme Court agreed with the government that the taxpayer could not escape taxation on the interest that accrued while he owned the underlying bond and stated that the realization rule was "founded on administrative convenience."[85] The Court subsequently reaffirmed this view of the realization requirement.[86]

Bruun and *Horst* treated realization essentially as an administrative mechanism that facilitates terminating the artificial deferral it confers at the earliest convenient time.[87] The movement away from treating realization as a

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84. *Id.* at 114.

85. *Id*. at 116.

86. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 559 (1991) ("[T]he concept of realization is 'founded on administrative convenience.'").

87. *See* MARVIN A. CHIRELSTEIN & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION ¶ 5.01 (12th ed. 2012) ("[R]ealization is strictly an administrative rule and not a constitutional, much less an economic requirement, of 'income."); Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. NW. U. 779, 791 (1941) ("[T]he formalistic doctrine of realization proclaimed by [Eisner v. Macomber] is not a constitutional mandate."). *But see* Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 VA. TAX REV. 1, 58 (1993) ("'[T]he reports of [the constitutional realization requirement's] death have been greatly exaggerated.' Although undermined by commentary and the dicta of decisions like *Cottage Savings Association v. Commissioner,* realization as a constitutional principle, while perhaps lethargic, subsists."). It remains debatable as to whether Congress could mandate a mark-to-market tax system that brings asset appreciation into the tax base merely because of such appreciation. But even those who maintain a constitutional prohibition on a mark-to-market tax system exists concede that the presence of some meaningful event other than a sale or exchange is sufficient to trigger realization. *See, e.g.*, David P. Hariton, *Should Share Repurchases Be Dividends to Remaining Holders?*, 144 TAX NOTES 175, 179 (2014) [hereinafter Hariton, *Should Share Repurchases*] ("[T]he majority's opinion in *Eisner v. Macomber* . . . did not forbid Congress to recast the form of a transaction that has real economic consequences in a manner that gives rise to taxable receipts. It merely held that Congress cannot tax receipts – deemed or otherwise– arising from a transaction that does nothing at all as an economic matter . . . . But clearly, the Constitution *does* allow Congress to recast the form of a transaction that has economic consequences for a taxpayer and tax the resulting deemed receipts as income."); Gene Magidenko, *Is a Broadly Based Mark-to-Market Tax Unconstitutional?*, 143 TAX NOTES 952, 954 (2014) [hereinafter Magidenko, *Is a Broadly Based*] ("The Supreme Court's precedent suggests that a property tax is direct [and subject to apportionment] only if it is a levy on property purely because of its ownership. If the tax attaches *because of some action, exchange or change in circumstance*, then it is an excise and indirect, subject only to the geographical uniformity requirement of the Constitution.") (emphasis added); Erik M. Jensen, *The Constitutionality of a Mark-to-Market Taxing System*, 43 TAX NOTES 1299, 1299 n.

constitutional requirement accommodates the view that events other than an actual sale or exchange can trigger realization. As Professor Stone stated, "It appears that the Court now considers the realization requirement satisfied by *any tangible, identifiable event* that marks an occasion for acknowledging that the taxpayer's property has increased in value, even if the taxpayer has not extracted his gain from his original investment."[88]

Now that realization is no longer the workhorse that it was when *Stearn* was decided,[89] the Supreme Court has paved the way for treating dilutive transactions as realization events. Moreover, two subsequent developments further facilitate that result.

C. 1991: Cottage Savings—Realization as a Substantive Concept

The Supreme Court revisited its *Stearn* decision in 1991 when it confronted the essence of realization in *Cottage Savings v. Commissioner.*[90] The *Cottage Savings* Court blithely followed its predecessor by parroting the view that the transaction in *Stearn* did not result in a change in the shareholders' proportionate interests.[91] Thus, the *Cottage Savings* Court showed no greater awareness of the significant shareholder dilution that occurred in the *Stearn* transaction. However, the *Cottage Savings* Court clarified the essence of realization and, in doing so, further set the stage for treating certain dilutive transactions as realization events.

Cottage Savings addressed the question of whether a savings association realized a loss after engaging in an "R-49 transaction" sanctioned by the Federal Home Loan Bank Board (FHLBB). Specifically, the savings association swapped its portfolio of mortgage interests in single family homes for a new portfolio of "substantially similar" (according to the FHLBB) mortgage interests in other single family homes located in the same municipal area.[92] The value of the original mortgages had dramatically

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6 (2014) [hereinafter Jensen, *The Constitutionality of Mark-to-Market*] ("What rises to the level of a realization event can be an issue in some circumstances, but, by anyone's definition, a mark-to-market system does not require realization.").

88. Richard B. Stone, *Back to Fundamentals: Another Version of the Stock Dividend Saga*, 79 COLUM. L REV. 898, 919 (1979) (emphasis added) [hereinafter Stone, *Back to Fundamentals*].

89. *See* Richard L. Bacon & Harold L. Adrion, *Taxable Events: The Aftermath of Cottage Savings (Part I),* 59 TAX NOTES 1227, 1245 (1993) [hereinafter Bacon, *Taxable Events, Part I*] ("[C]ommon law principles . . . made it increasingly easy to find a realization event.").

90. Cottage Sav. Ass'n. v. Commissioner., 499 U.S. 554 (1991).

91. *Id.* at 564 ("In each case [including Weiss v. Stearn], . . . the stockholders of the old corporation received shares in the new corporation equal to their proportional interests in the old corporation.").

92. *Id.* at 557-58.

declined due to an interest rate surge and the savings association hoped to claim a tax loss without recording an economic loss on its books.[93] The Commissioner argued that a loss was not realized because the properties exchanged, namely the mortgage participation interests, were not "materially different" and, therefore, disallowed the deduction of the loss.[94] The Supreme Court agreed with the Commissioner's argument that an exchange of property triggers a realization "event" only if the exchanged properties are "materially different."[95] But the Court held that the material difference requirement was met in this case (and the losses were realized for tax purposes) because the mortgages at issue were made to different obligors and secured by different homes.[96]

The threshold question faced by the *Cottage Savings* Court was whether realization requires that the properties exchanged be "materially different" from one another.[97] Although the Code had never delineated a material difference requirement for realization, the regulations had imposed that requirement since 1934.[98] In addition, the Court determined that such a requirement could be inferred from its early corporate reorganization jurisprudence that included *Stearn*.[99] According to the Court, *Weiss v. Stearn*,[100] *United States v. Phellis*,[101] *Marr v. United States*,[102] and *Eisner v. Macomber*[103] made up the "contemporary legal context" in which Congress enacted the statutory rules governing realization that originated in 1924.[104] These cases acknowledged a "'materially' or 'essentially' different

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93. *Id.* at 556-57.

94. *Id.* at 559-60.

95. *Cottage Savings*, 499 U.S. at 560.

96. *Id.* at 566.

97. *Id.* at 560.

98. *Id.* at 560-61 ("The Commissioner himself has by regulation construed § 1001(a) to embody a material difference requirement . . . ."). *See* Treas. Reg. 86, Art. 111-1 (Revenue Act of 1934) ("[T]he Act regards as income or loss sustained, the gain or loss realized from . . . the exchange of property for other property differing materially either in kind or extent."). The current regulation reads as follows: "[T]he gain or loss *realized* from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*, is treated as income or as loss sustained." Reg. § 1.1001-1(a) (emphasis added).

99. *Id.* at 561-62.

100. 265 U.S. 242 (1924).

101. 257 U.S. 156 (1921).

102. 268 U.S. 536 (1925).

103. 252 U.S. 189 (1920).

104. Cottage Sav. Ass'n v. Commissioner., 499 U.S. at 562. The Revenue Act of 1924 was enacted on June 2, 1924, a few days after the Court decided *Stearn* (May 26, 1924) and before the Court decided *Marr* (June 1, 1925). Thus, these decisions could not have influenced the 1924 Act.

requirement" for realization.[105] In addition, Congress left the "principles of realization" from these cases untouched throughout subsequent enactments of the Code.[106] Thus, the Supreme Court reasoned that Congress presumably intended to codify the cases' principles in the Code.[107]

After confirming the existence of a material difference requirement, the *Cottage Savings* Court proceeded to the question of what constitutes a "material difference." The Court acknowledged the dearth of guidance on this question and opted to rely on its early corporate restructuring decisions.[108] Once again, the Court focused on *Macomber, Phellis, Marr,* and *Stearn.*[109] The Court found that the latter three cases "refined Macomber's conception of realization in the context of property exchanges."[110] The Court initially identified the similarities in the three cases. Specifically, "in each case, the corporation in which the taxpayer held stock had reorganized into a new corporation, with the new corporation assuming the business of the old corporation."[111] More significantly, the Court stated as follows.

> In each case, following the reorganization, the stockholders of the old corporation received shares in the new corporation *equal to their proportional interest in the old corporation.* The question in these cases was whether the taxpayers realized the accumulated gain in their shares in the old corporation *when they received in return for those shares stock representing an equivalent proportional interest in the new corporation.*[112]

As a result of these purported similarities, the Court ultimately differentiated *Phellis* and *Marr*, which held that realization occurred, from *Stearn*, which held that no realization occurred. Specifically, in *Phellis* and *Marr*, the old and new corporations were incorporated in different states, but in *Stearn,* the old and new corporations were incorporated in the same state.[113]

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105. *Id.* at 561-62.
106. *Id.* at 562.
107. *Id.* at 561-62.
108. *Id.* at 563 ("To give meaning to the material difference test, we must look to the case law from which the test derives and which we believe Congress intended to codify in enacting and reenacting the language that now comprises § 1001(a).").
109. *Cottage Savings*, *499 U.S.* at 563-65.
110. *Id.* at 563.
111. *Id.* at 564.
112. *Id.* (emphasis added).
113. *Id.* ("As we explained in *Marr,* our determination that the reorganized company in *Weiss* was not 'really different' from its predecessor turned on the fact that both companies were incorporated in the same State.").

Quite clearly, the requirement that an identical proportionate interest be received to escape realization represented a fundamental element of the *Cottage Savings* Court's test for not finding a material difference. The Court summed up its analysis as follows:

> Taken together, *Phellis*, *Marr*, and *Weiss* stand for the principle that properties are "different" in the sense that is "material" to the Internal Revenue Code *so long as their respective possessors enjoy legal entitlements that are different in kind or extent*. Thus, separate groups of stock are not materially different if they confer *"the same proportional interests* of the same character in the same corporation." However, they are materially different if they are issued by different corporations or if they confer "different rights and powers" in the same corporation.[114]

The *Cottage Savings* Court might be criticized for erroneously stating that the shareholders' proportional interests did not change in *Stearn*. But the *Cottage Savings* Court apparently never reexamined the facts of *Stearn*. Instead, it simply restated that Court's conclusion that the transaction did not change the proportional interests of the shareholders. Because the *Cottage Savings* Court failed to acknowledge the reduction in proportionate interest in *Stearn*, *Cottage Savings* fails to offer any additional insight into how a shift in proprietary interest impacts realization. To date, the Supreme Court has bypassed the question of whether corporate dilution should trigger realization.

After *Cottage Savings*, the principal prerequisite to realization is satisfaction of the material difference requirement. The *Cottage Savings* Court made it clear that no material difference exists when the proportional interests of the shareholders remain the same before and after a corporate transaction. Part IV explores how much of a change in proportionate interest must occur to satisfy the material difference standard. But first, the final element on the path to taxing dilutive transactions will be addressed.

D. 1996: "Deemed Exchange" Regulations—A Substance Over Form Element of Realization

Stearn and *Cottage Savings* both involved an actual exchange of property. In *Stearn*, the shareholders of Old Acme transferred all their shares for shares of New Acme and cash. The Supreme Court held that no realization event occurred because the properties exchanged were not materially different (based on the faulty premise that the original shareholders retained the same proportionate interest in the enterprise).[115] In

114. *Id.* at 564-65 (emphasis added, citations omitted).
115. *See supra* Part II.

Cottage Savings, the savings and loan institutions transferred a basket of mortgages in exchange for a basket of different mortgages. The Supreme Court held that a realization event occurred because the property received in the exchange was materially different from the property surrendered.[116]

Stearn illustrates that dilution can result from an actual exchange of property. In many if not most cases, however, dilution results from a transaction that does not entail a physical transfer of the diluted interest. For example, a sole shareholder might sell 99 percent of her stock to a third party thereby diluting her interest to one percent. In this situation, the powers associated with the one percent retained interest differ dramatically from those of the original 100 percent interest. Owning 100 percent of an enterprise gives the owner complete control over every business decision. By contrast, the ownership of a one percent interest in the same enterprise provides the owner with basic rights and obligations under corporate law but rarely enables the owner to influence any significant business decision. Thus, although the shareholder did not physically transfer the retained one percent interest, the sale can be regarded as effectuating a "deemed exchange" of the "old" 100 percent interest for the "new" one percent interest.[117]

Prior to *Cottage Savings*, the IRS ruled in a different context that a significant change in one's property rights can result in a deemed exchange that triggers a realization event. In a 1987 revenue ruling, the holder of a bond who was entitled to a higher rate of interest under an interest adjustment clause waived its right to receive the higher rate of interest.[118] The IRS ruled that the holder's action "represents a material change in the terms of the bonds and results in a taxable exchange under section 1001 of the Code and a *deemed issuance* of new bonds." Similarly, a 1989 ruling involved two situations; one in which a debtor and a creditor agreed to reduce the interest rate on a sovereign debt and the other in which a debtor and a creditor agreed to reduce the stated principal amount.[119] In both situations, the IRS ruled that "the modification [of the obligation] results in a *deemed exchange* of the original obligation for the modified obligation under section 1001 of the Code. [The creditor] may realize and recognize a gain or loss on each exchange . . . . The modified obligation is treated as a newly issued debt instrument for federal income tax purposes."[120] In both rulings,

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116. *See supra* Part III.C.

117. The sale of 99 percent of the stock potentially triggers two realization events. The first realization event is the actual sale of a 99 percent interest. The second realization event is the "deemed exchange" of a 100 percent ownership interest for a one percent interest. Both realization events are triggered by the sale of 99 percent of the stock; hence, they occur simultaneously.

118. Rev. Rul. 87-19, 1987-1 C.B. 249.

119. Rev. Rul. 89-122, 1989-2 C.B. 200.

120. *Id.* at 201.

the holder of the debt instrument did not physically transfer the original debt instrument. Rather, the terms of an obligation were modified and the resulting change in the nature of the obligation triggered a realization event, notwithstanding the absence of an actual transfer of the old obligation.

The *Cottage Savings* decision potentially expanded this deemed exchange concept beyond the modification of a debt instrument.[121] As two commentators remarked:

> [T]he question . . . is what principle Cottage Savings stands for – whether . . . it creates a "new" tax threshold for realization events lower than many believe exists under current law. The special concern is with the tax test for determining when changes in the terms of bonds, other debt instruments, and similar contract and *property rights*, without execution of an entirely new agreement, are realization events.[122]

Congress and the courts have yet to address the extent to which a change in "property rights" is sufficient to trigger realization in the absence of a physical surrender of property. However, the *Cottage Savings* decision served as a springboard for the Treasury Department to formalize and expand its position with respect to this issue in the context of modified debt instruments.

In 1996, the Treasury Department invoked the *Cottage Savings* decision when it promulgated regulations delineating when the modification of the terms of a debt instrument results in a deemed exchange that triggers a

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121. The common law prior to *Cottage Savings* neither supports nor undermines the view that modifying the legal rights associated with a property interest can result in a deemed exchange and trigger a realization event. A plethora of case law addresses the converse situation; namely, whether an *actual* exchange of substantively similar property might *not* trigger a realization event. *See, e.g.,* Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948) (holding that an exchange of bonds with different interest rates, maturity dates and call periods constituted a realization event); W. Mo. Power Co. v. Commissioner, 18 T.C. 105 (1952) (holding that exchange of defaulted bonds for refunding bonds did not trigger a realization event); Mutual Loan & Savings Co. v. Commssioner, 184 F.2d 161 (5th Cir. 1950) (holding that exchange of refunded bonds for original bonds did not trigger realization event); Girard Trust Co. v. United States, 166 F.2d 773 (3d Cir. 1948) (holding that surrender of old bonds not in default for new bonds with modified terms triggered realization event). The courts, however, have not addressed the question of whether a significant modification to retained property might result in a *deemed* exchange that triggers a realization event.

122. Bacon, *Taxable Events, Part I*, *supra* note 89, at 1229 (1993) (Emphasis added.). *See* Gregory E. Stearn, *Tax Aspects Of Restructuring Financially Troubled Businesses*, 541-4th TAX MGMT. PORT. (BNA) A-34 (2009) ("The Supreme Court may have lowered the judicial threshold at which a disposition was deemed to occur in Cottage Savings . . . .").

realization event.[123] Under the regulations, if a debt instrument is "significantly modified," the holder is treated as exchanging the original debt instrument "for a modified instrument that differs materially either in kind or extent."[124] In these circumstances, a realization event occurs. Much criticism has been directed at these regulations but no indication exists that the regulations exceed the Treasury's authority to promulgate interpretive regulations.[125]

The current state of the law on deemed exchanges is undeveloped. Based on the evolution of the realization requirement and the *Cottage Savings* decision, however, a physical transfer of property should not always be necessary for realization to occur. If a "tangible, identifiable event"[126] changes the nature of a property interest and the modified interest is materially different from its predecessor, the holder should be treated as exchanging the original property for new property. Under these circumstances, a realization event would occur, notwithstanding the absence of a physical transfer of property.

As Part III demonstrates, subsequent to the *Stearn* transaction, the common law of realization has evolved in a manner that significantly liberalized the realization requirement. These developments accommodate the view that certain dilutive transactions are realization events. Part IV explores when dilution should trigger realization under current law and how Congress should rationalize the treatment of this issue.

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123. Treas. Reg. § 1.1001-3. *See also* Prop. Reg. § 1.1001-3, 57 Fed. Reg. 57034-1 (1992) ("*Cottage* [*Savings*] did not involve the modification of an instrument, but an actual exchange between holders. Questions have arisen, however, concerning the Court's interpretation of the material difference standard and its possible application to modifications of debt instruments by issuers and holders . . . . In response to the issues raised by the *Cottage* [*Savings*] decision, and in an effort to provide certainty, the Service proposes to expand the regulations under section 1001 of the Code to deal explicitly with the modification of debt instruments.").

124. Treas. Reg. § 1.1001-3(b). *See also* Treas. Reg. §§ 1.1001–3(c) (definition of "modification"), –3(e) (definition of "significant modification").

125. *See* I.R.C. § 7805(a). *See also* Richard L. Bacon & Harold L. Adrion, *Taxable Events: The Aftermath of Cottage Savings (Part II),* 59 TAX NOTES 1385, 1386 (1993) [hereinafter Bacon, *Taxable Events, Part II*] ("Virtually all the comments focus on the collateral effects of finding that a realization event has occurred rather than on the soundness of treating specific events as 'triggers' for realization events in the first instance.").

126. Stone, *Back to Fundamentals*, *supra* note 88, at 919.

IV. WHEN SHOULD CORPORATE DILUTION TRIGGER REALIZATION?

In *Weiss v. Stearn*, the Supreme Court should have addressed whether an exchange that dilutes a shareholder's proprietary interest constitutes a realization event. As demonstrated in Part II, the Court bypassed the dilution issue by artificially dividing the transaction into two discrete parts that effectively eliminated the dilution. As discussed in Part III, the realization requirement was significantly liberalized subsequent to *Stearn*. Thus, a fresh look at the question of whether dilution should trigger realization is desirable. Part IV explores the circumstances in which a dilutive transaction should trigger realization under current law.

A. An Exchange That Dilutes a Majority Interest to a Minority Interest Should Normally Trigger Realization

In *Stearn*, the shareholders of Old Acme transferred all the stock of Old Acme for shares of New Acme and cash.[127] The fact that the shareholders transferred all their shares would normally have been sufficient to trigger realization of each shareholder's gain or loss. But two elements of the transaction raised doubts about whether realization occurred. First, although a new corporate entity replaced the old one, the corporate enterprise remained substantively the same because the contents of Old Acme and New Acme were identical. Second, the legal rights and obligations associated with the stock issued by New Acme were the same as those associated with the stock of Old Acme because both entities were incorporated in the same state. The only change that occurred with respect to the Old Acme shareholders was the dilution of their proprietary interests from 100 percent to 50 percent, an effect that the courts ignored by bifurcating the transaction. The question, therefore, is whether the dilution that resulted from the *Stearn* exchange is sufficient to trigger realization under current law.

According to the *Cottage Savings* Court, an exchange of property does not automatically trigger realization because the common law dictates that the property received in the exchange must be "materially different" from the property surrendered for a realization event to occur.[128] Under this standard, "properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent."[129] As an example, the Court stated,

> [S]eparate groups of stock are not materially different if they confer "the same proportional interest of the same character

127. Weiss v. Stearn, 265 U.S. 242, 251-52 (1924).
128. Cottage Sav. Ass'n v. Commissioner., 499 U.S. 554, 561-62 (1991).
129. *Id.* at 565.

> in the same corporation." However, they are materially different if they are issued by different corporations, or if they confer "differen[t] rights and powers" in the same corporation.[130]

As two commentators have remarked, "Under this formalistic interpretation, the vast majority of exchanges trigger realization when anything other than identical properties are transferred."[131]

In *Stearn*, the owners of Old Acme surrendered 100 percent ownership for 50 percent of the stock of New Acme and cash.[132] The resulting change in ownership is significant because it entailed a shift from complete control by the Old Acme shareholders to shared ownership with the purchasers of the 50 percent interest. The legal entitlements associated with 100 percent of the stock of Old Acme may not have differed in "kind" from those associated with the 50 percent of New Acme stock issued to the Old Acme shareholders in light of the corporate level equivalence of the two enterprises and the fact that both corporations were incorporated in the same state. But the Old Acme shareholders' ownership of 50 percent of New Acme relative to their ownership of 100 percent of Old Acme clearly represents a difference in the "extent" of the legal entitlements they enjoyed. Even a layperson would likely conclude that a 50 percent interest in a business enterprise is dramatically different from 100 percent ownership of a substantively equivalent enterprise.

To demonstrate that the dilution of a 100 percent equity interest to a 50 percent interest constitutes a material difference in a same state, reincorporation transaction under current law, it is instructive to begin the analysis with a more extreme example. Assume that Stearn was the sole shareholder of Old Acme and that he exchanged 100 percent of the stock of Old Acme for one percent of the stock of New Acme and cash. Quite clearly, stock representing ownership of 100 percent of a business is dramatically different from stock representing one percent of the same business. Owning 100 percent of an enterprise gives the owner complete control over every business decision. By contrast, the ownership of a one percent interest in the same enterprise rarely enables the owner to influence any significant business decision. In rare cases, facts may exist where a sole shareholder whose interest is diluted to one percent can continue to exert significant influence and the question of whether a material difference exists might be a

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130. *Id.* (Citations omitted).

131. Rodney P. Mock & Jeffrey Tolin, *Realization and Its Evil Twin Deemed Realization*, 31 VA. TAX REV. 573, 603-04 (2012) [hereinafter Mock & Tolin, *Realization*].

132. Weiss v. Stearn, 265 U.S. 242, 251-52 (1924).

close one.[133] But in all other cases, the dramatic differences that exist between a one percent interest and a 100 percent interest should satisfy the material difference standard delineated in *Cottage Savings*.

An equally compelling case can be made that the Old Acme stock and the New Acme stock are materially different even if less than 99 percent dilution had occurred in the previous example. If Stearn had been the sole shareholder of Old Acme and he exchanged all of his Old Acme stock for ten percent of the stock of New Acme and cash, Stearn would likely have sacrificed as much control by surrendering a 90 percent interest as when he surrendered a 99 percent interest. The same is true if Stearn emerged with a 20 percent interest in New Acme or even as much as a 49.9 percent interest in New Acme. In all cases where a 100 percent ownership interest in a corporation is converted to a minority interest, the consequent loss of control is likely to render the New Acme interest materially different from the Old Acme interest.[134] Exceptional cases will likely exist.[135] Nevertheless, in the typical situation where majority ownership is surrendered, the loss of control should satisfy the material difference standard and thereby trigger realization with respect to the shareholder's entire interest in Old Acme.[136]

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133. For example, if two unrelated parties each own 49.5 percent of the stock of a corporation, the one percent shareholder might exercise considerable influence on any issue with respect to which the two principal shareholders disagree.

134. *See* Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 936 n. 188 (2010) ("In a closely held corporation, a large minority shareholder can have absolutely no control if there is a majority shareholder."). In the case of a publicly traded corporation, however, a large minority interest might be able to exercise control influencing the election of the directors. The main focus of this Article is on closely held corporations.

135. For example, a shareholder who owns 49.9 percent of the stock might exercise significant control if the other 50.1 percent of the stock is divided among a large group of shareholders. In that situation, the 49.9 percent shareholder could align with one of the minority shareholders and the two together could control most business decisions.

136. *See* Gwendolyn Griffith, *Realization and Recognition of Losses on Stock Surrenders: A Frolic Through Subchapter C*, 17 FLA. ST. U. L. REV. 49, 68 (1989) [hereinafter Griffith, *Realization and Recognition*] ("In the close corporation context, . . . control through stock ownership may be crucial to continued employment, compensation packages and other benefits arrangements."); Alan R. Plamiter, EXAMPLES & EXPLANATIONS: CORPORATIONS, 125-126 (7th ed., 2012) ("Shareholders who own a majority of the shares can exercise their voting power to elect the board, giving these owners virtually unfettered control of the business . . . . For minority shareholders in a close corporation, voting rights are normally not a meaningful protection."); Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 703 (1993) ("The majority may even be able to deny the minority shareholder any return in the long run by siphoning off corporate assets in the form of high salaries or rents, insulated from judicial review by the

Unlike the prior discussion, the transaction in *Stearn* did not involve *more than* 50 percent dilution, it involved *exactly* 50 percent dilution. To approach the fact pattern in that case, assume that Stearn was the sole shareholder of Old Acme and that he exchanged 100 percent of the stock of Old Acme for 50 percent of the stock of New Acme and cash. If Stearn retained a 50 percent interest, he would likely have been in a stronger position than if he had only retained a minority interest. Unlike a minority owner, a 50 percent owner can normally block any action of the others. Nevertheless, when a 50 percent interest is compared to a 100 percent interest, fundamental differences still exist. In contrast to a sole shareholder, the holder of a 50 percent interest cannot take any unilateral action. Therefore, even 50 percent dilution should normally render the 50 percent interest in New Acme to be materially different from the 100 percent interest in Old Acme and, therefore, trigger realization with respect to the entire interest in Old Acme.[137]

The foregoing hypothetical differs from *Weiss v. Stearn* because Stearn was not the sole shareholder of Old Acme. Rather, a shareholder group owned 100 percent of Old Acme and that group received 50 percent of the stock of New Acme in the exchange. The existence of group ownership of Old Acme diminishes the potential control that these shareholders could exercise. As a practical matter, if different views existed within the group, the group may not have been capable of exercising control either before or after the dilution. Here again, the facts of each case will determine whether the Old Acme shareholders could exercise control at any point in time. Nevertheless, in light of the low threshold for finding a material difference with respect to exchanged property,[138] the surrender of control by a group of shareholders should still normally trigger realization.

This section demonstrates that when a majority interest is surrendered in a transaction in which a corporation is reincorporated in the same jurisdiction, the requisite material difference for realization will normally exist. Although this conclusion deviates from conventional thought,[139] it may appear to be insignificant because of its narrow scope. But

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business judgment rule. Alternatively, the majority may seek to force the minority shareholder out of the enterprise on terms which the minority shareholder believes are unfair.").

137. Situations will of course exist where a 50 percent owner can exercise control. For example, if other shares are owned by family members under the influence of the 50 percent owner, he may effectively control a majority of the stock. Moreover, control could be exercised if a shareholders' agreement creating a voting block exists.

138. *See supra* Part III.C.

139. *See* Cummings, *A General Theory*, *supra* note 67, at 1195 ("[A] same-state reincorporation is not inherently a realization event, even if it involves an actual property exchange from one corporation to another (as in *Weiss*).").

stripping away this potential exception to realization has significant implications for dilutive transactions that, unlike *Weiss v. Stearn*, do not involve a physical transfer of the diluted interest.[140]

B. *Other Transactions That Dilute a Majority Interest to a Minority Interest Should Normally Trigger Realization Even When the Diluted Interest is not Physically Transferred*

Realization under current law is normally thought to require both an actual exchange of properties and a material difference between the property surrendered and the property received. The *Weiss v. Stearn* transaction satisfied the exchange requirement because the shareholders of Old Acme transferred *all* the Old Acme stock for 50% of the New Acme stock and cash. As demonstrated above, the *Weiss v. Stearn* transaction also likely satisfied *Cottage Savings*' material difference requirement because it entailed the surrender of majority ownership of the enterprise.

In contrast to *Weiss v. Stearn*, many highly dilutive transactions do not involve a physical transfer of all the shareholder's shares. For example, if April, the sole shareholder of Oldco, owns 10,000 shares of stock and Oldco engages in a public offering in which it issues 990,000 additional shares to new shareholders, April's proprietary interest will be diluted from 100 percent to one percent notwithstanding that she refrained from transferring any of her shares. Alternatively, if April sold 9,900 of her 10,000 shares to a third party, her proprietary interest will likewise be diluted to one percent even though she did not physically transfer all of her shares. As discussed above, a one percent proprietary interest is almost always materially different from a 100 percent interest because the power associated with a one percent interest is miniscule relative to the power associated with a 100 percent interest.[141] When dilution results from a transaction in which the shareholder does not transfer her entire proprietary interest, does the fact that the retained, diluted interest was not physically transferred preclude realization? In our view, realization should not depend on such a formalistic distinction.[142]

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140. Corporate level transactions that change the asset content of a corporation can also be seen as materially changing the shareholders' proprietary interests, even when their percentage interests remain the same. *See* Schlunk, *Rationalizing*, *supra* note 20, at 73-74. Because this Article is focused on shareholder level dilution, the impact of corporate level changes in non-dilutive transactions is beyond the scope of the Article.

141. *See supra* Part IV.A.

142. *See* Schlunk, *Rationalizing*, *supra* note 20, at 29-32 (demonstrating the substantive equivalence of dilution resulting from an exchange of the entire interest and the exchange of a partial interest).

As discussed in Part III, by virtue of Supreme Court jurisprudence subsequent to *Stearn*, "it appears that the Court now considers the realization requirement satisfied by *any tangible, identifiable event* that marks an occasion for acknowledging that the taxpayer's property has increased in value . . . ."[143] Moreover, "any *definite event* . . . could properly be employed as the occasion for taking account of the taxpayer's gain."[144] A dilutive transaction in which the diluted shareholder does not physically transfer her entire interest is an event that can mark the moment of realization. Although the diluted shareholder does not physically transfer the retained interest, the dilution does not occur by mere happenstance. Rather, a discrete transaction must occur to trigger the dilution. The requisite transaction must either increase the corporation's outstanding shares (e.g., a public offering) or reduce the diluted shareholder's stock ownership (e.g., a sale of some of the shareholder's stock). Hence, a specific event, the transaction that triggers the dilution, marks the moment of change. If that specific event leads to a dramatic enough change in the nature of the diluted shareholder's interest, the dilutive transaction will effectively transform one property into another. In that situation, even if no physical transfer occurs, in substance a "deemed exchange" has occurred. The question under current law, therefore, is whether such a "deemed exchange" of property is sufficient to satisfy the realization requirement.[145]

The Code neither endorses nor rejects the notion that a deemed exchange can trigger a realization event. In fact, the Code does not even define a realization event. Among the examples of gross income included in the statute is "[g]ains derived from dealings in property."[146] This language dates back to the first modern income tax law in 1913.[147] The term

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143. Stone, *Back to Fundamentals*, *supra* note 88, at 919 (emphasis added).

144. BITTKER & LOKKEN, *supra* note 81, at ¶ 5.1 (emphasis added).

145. Note that we are not arguing for mark-to-market taxation where mere increases in the value of stock would trigger income without any corresponding "event." Our argument is that the dilutive transaction can represent the requisite "event" to trigger realization. Although a constitutional impediment to a mark-to-market tax system might exist, that barrier does not apply to defining a realization event. *See, e.g.*, Jensen, *The Constitutionality of Mark-to-Market*, *supra* note 87, at 1299 n. 6 ("*What rises to the level of a realization event can be an issue in some circumstances*, but, by anyone's definition, a mark-to-market system does not require realization." (emphasis added)); Magidenko, *Is a Broadly Based*, *supra* note 87, at 954 ("If the tax attaches because of some *action, exchange, or change in circumstance,* then it is an excise and indirect, subject only to the geographical uniformity requirement of the Constitution." (emphasis added)).

146. I.R.C. § 61(a)(3).

147. The Revenue Act of 1913 imposed a tax on "net income" which included "gains, profits, and income derived from . . . sales, or dealings in property . . . ." Revenue Act of 1913, ch. 16, §II(B), 38 Stat. 114, 167.

"dealing," however, has yet to be defined and it could certainly encompass a deemed exchange of property. The Code also provides a formula for measuring gross income when a "sale or other disposition of property" occurs.[148] But that provision merely quantifies gain or loss after a realization event occurs; it does not undermine the possibility that a deemed exchange is sufficient for realization.[149] Congress has enacted specific rules that sanction realization in the absence of a physical transfer of property.[150] These rules deal principally with technical issues created by artificial tax regimes applied to domestic and foreign business enterprises to curtail tax deferral. Congress has refrained from delineating the contours of realization in more fundamental, conceptual contexts like the deemed exchange that might result from a dilutive transaction. Thus, the Code neither sanctions deemed exchange treatment of a dilutive transaction nor does it impede such treatment.

Unlike Congress, the Treasury Department has acknowledged that realization can result from a deemed exchange. The Treasury has developed this view in a single context, namely, the modification of a debt instrument.[151] As discussed above,[152] the Treasury Department, relying on *Cottage Savings*, promulgated regulations delineating the circumstances in which the modification of a debt instrument results in a "deemed exchange" and, therefore, a realization event.[153] These regulations provide that a

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148. I.R.C. § 1001(a). This provision dates from 1924. Revenue Act of 1924, ch. 234, §202(a), 43 Stat. 253, 255.

149. See 1 STANLEY S. SURREY, WILLIAM C. WARREN, PAUL R. MCDANIEL & HUGH J. AULT, FEDERAL INCOME TAXATION: CASES AND MATERIALS 818 (Foundation Press 1972) ("Section 1001(a) governs the computation of the amount of *gain or loss* from the *sale or other disposition* of property. This section does not determine the inclusion of gains or the amount allowance of losses. Rather, it relates to gains which have qualified for inclusion under section 61(a) as a result of the construction of that section . . . .") (emphasis omitted); Bacon, *Taxable Events, Part I*, *supra* note 89, at 1248 ("Section 1001(a) assumes that gain or loss has been found elsewhere in the code to have been realized and then comes into play to declare how gain or loss is to be computed.").

150. *See, e.g.*, I.R.C. §§ 301(c)(3), 475(a), 731(a), 877A, 951, 1256, 1293(a); Mock & Tolin, *Realization*, *supra* note, 131, at 591 ("[P]resumably the Supreme Court's retreat in Bruun and Horst . . . from its strict interpretation of realization suggests the various deemed realization events in the Code are constitutional.").

151. The Treasury has also acknowledged that realization can occur in the absence of an actual transfer of property. *See* Reg. § 1.1001-1(c)(1) ("Even though property is not sold or otherwise disposed of, gain is realized if the sum of the amounts received which are required by section 1016 . . . to be applied against the basis of the property exceeds such basis.").

152. *See supra* notes 123-126 and accompanying text.

153. *See* Reg. § 1.1001-3.

"deemed exchange" occurs when the terms of a debt instrument are significantly modified even if the original debt instrument is not surrendered.[154] Thus, the owner of the original property need not physically transfer that property for realization to occur. Rather, if the negotiated terms are sufficient to change the fundamental nature of the underlying property, realization is deemed to occur. In other words, the debt modification regulations, like *Cottage Savings*, focus on the change in the nature of the underlying property. Under the regulations, if a sufficient change in the nature of the property results, it is as if the owner transferred the old property for the new property even if no physical exchange has occurred.

Like the modification of a debt instrument, non-exchange dilutive transactions should be treated as deemed exchanges in cases where a material difference exists between a taxpayer's pre-transaction proprietary interest and the diluted interest retained by the taxpayer.[155] As discussed above, a dilutive transaction that converts a majority interest to a minority interest generally effectuates a material difference in the nature of the property.[156] Thus, realization normally should occur in these circumstances, even if the owner of the diluted interest does not physically transfer the entire proprietary interest in the dilutive transaction.[157] Congress could certainly mandate this result.[158] But even in the absence of Congressional action, a court could rely on *Cottage Savings* to find that a dilutive transaction

154. *See* Reg. § 1.1001-3(a) ("[T]his section applies to . . . an amendment of an existing debt instrument.").

155. *See* Bacon, *Taxable Events, Part I*, *supra* note 89, at 1232 ("The potential reach of Cottage Savings extends far beyond debt workouts to many actual exchanges of property in kind and *modifications the of terms of* stocks, bonds, and contract and *property rights* of all kinds.") (emphasis added).

156. *See supra* Part IV.A.

157. *See* Schlunk, *Rationalizing*, *supra* note 20, at 67 ("[I]t is theoretically possible to say that a shareholder's investment represented by his shares of a corporation's stock has been altered by z%. If the alteration is sufficiently great, it is proper for the tax law to treat the shareholder as now owning shares in a new and different corporation, and thus having engaged in an exchange of the original shares for new shares.").

158. *See, e.g.*, Hariton, *Should Share Repurchases*, *supra* note 87, at 179 ("[T]he majority's opinion in *Eisner v. Macomber* . . . did not forbid Congress to recast the form of a transaction that has real economic consequences in a manner that gives rise to taxable receipts . . . . It merely held that Congress cannot tax receipts–deemed or otherwise–arising from a transaction that does nothing at all as an economic matter . . . . But clearly, the Constitution *does* allow Congress to recast the form of a transaction that has economic consequences for a taxpayer and tax the resulting deemed receipts as income.").

resulting in a material change in the shareholder's interest represents a deemed exchange of that interest and thereby results in a realization event.[159]

It should be emphasized that the view advanced in this section represents a significant departure from current perceptions. Case in point: Sole shareholder owns stock with a value of $1,000,000 and a basis of $10,000. Sole shareholder sells 50 percent of the stock for $500,000. If the circumstances are such that the retained 50 percent interest is materially different from the previously owned 100 percent interest, our view is that the entire $990,000 gain should be realized; i.e., both the $495,000 gain in the shares that are sold and the $495,000 gain in the shares that are retained. Critics will likely assert that taxing the gain on the retained shares is "unfair" in these circumstances.[160] They will claim that the taxpayer does not have the liquidity to pay the tax and it will be administratively difficult to detect these transactions when they are not self-reported.

These criticisms miss the point of our argument. Our point is that in a realization based system where the requisite event for triggering realization is a material change in the underlying property, realization should occur as a matter of law regardless of whether the event that effectuates the change involves an actual transfer of the underlying property. Realization is a legal standard that is not based on equity. When the requisite change in the underlying property occurs, the deferred gain (or loss) from past appreciation (or depreciation) should be realized, regardless of whether the property is physically transferred.[161]

Although realization should occur in certain non-exchange, dilutive transactions, we are not arguing that these transactions should necessarily be taxed. We are simply stating that the realization requirement should not be

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159. This is a mere possibility because it effectively requires a court to reach a result representing the converse of the *Cottage Savings* decision. *Cottage Savings* establishes that an actual exchange does not result in realization unless the property received is materially different from the property surrendered. In the dilution context, the court must find that when the diluted interest is materially different from the non-diluted interest, a deemed exchange occurs that results in realization. As such, it is difficult to predict if a court would treat a non-exchange dilutive transaction as a realization event but such treatment is possible in appropriate circumstances.

160. *See* Schlunk, *Rationalizing*, *supra* note 20, at p. 57 ("[M]ost taxpayers think it is grossly unfair to be taxed on gain from an investment prior to their disposition of such investment.").

161. *See* Schlunk, *Rationalizing*, *supra* note 20, at 76 (expressing criticism of a proposal that provided for different consequences when the same substantive effect results from a transfer of shares and a retention of shares, and arguing for a rule where "any shareholder of a corporation involved in a reorganization-like transaction is deemed to experience a realization event, whether or not he continues to own his original shares.").

relied on to preclude gain (or loss) from being triggered. The substance of realization under current law is a material change in the nature of the underlying property. The presence or absence of a physical transfer of property is solely a matter of form and should not be dispositive of whether realization has occurred.[162] Rather than relying on realization to differentiate taxable and nontaxable dilutive transactions, realization should be seen as the norm when a majority interest is converted to a minority interest and Congress should enact nonrecognition rules to implement policy in this area. Before exploring Congress's role, however, it is desirable to consider whether those dilutive transactions that do not convert a majority interest to a minority interest should ever trigger realization.

C. Dilutive Transactions That Do Not Convert a Majority Interest to a Minority Interest Should Sometimes Trigger Realization

The foregoing discussion demonstrates that a dilutive transaction resulting in the surrender of a controlling interest normally represents a fundamental change in the owner's interest and therefore should generally constitute a realization event, regardless of whether the dilution results from a physical transfer of the diluted interest. Most dilutive transactions, however, do not have the effect of converting a majority interest to a minority interest. Rather, many shareholders will own a minority interest both before and after a dilutive transaction. In addition, a majority shareholder might still hold a (smaller) majority interest after a dilutive transaction. Thus, an effort should be made to identify the line that separates those dilutive transactions that result in a materially different interest, from those dilutive transactions that do not reach the material difference threshold.

Unfortunately, it is impossible to devise an objective standard for distinguishing those dilutive transactions that satisfy the material difference requirement from those that do not. The issue will almost always turn on the facts and circumstances of the particular case. Nevertheless, just as the previous sections identified those classes of dilutive transactions that were likely to effectuate a material difference, it is useful to identify the opposite end of the continuum; namely, those dilutive transactions that are unlikely to effectuate a material difference between the pre-transaction and post-transaction proprietary interests.

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162. The view that a material change in the nature of retained property should trigger realization has implications beyond the corporate dilution context. For example, the disposition of a partial interest in real property or the improvement of a parcel of real property could potentially result in a material change in the taxpayer's investment and arguably trigger a realization event. Whether our view should be applied in contexts other than corporate dilution is beyond the scope of this Article.

Dilution is a common event in practice and can occur in tiny increments to a wide swath of shareholders in everyday transactions. For example, the issuance of option shares to employees of a public corporation dilutes every shareholder's interest to some degree. Although the number of shares held by existing shareholders remains the same, the augmented amount of outstanding shares reduces the relative interest of each of the existing shareholders, thereby diluting their interests. A secondary offering by a publicly held corporation has the same effect: by increasing the outstanding shares of the corporation, each existing shareholder who does not acquire shares in the offering suffers a reduction in the shareholder's relative ownership of the corporation.

A slightly diminished proprietary interest that results from a dilutive transaction will not normally be materially different from the owner's former interest. For example, the decline in a public shareholder's proportionate interest from .0012 percent to .0011 percent represents a change in interest, but one would be hard pressed to regard the change as material. From a practical standpoint, the power of the public shareholder associated with the retained interest is not altered by the dilution, so the retained interest should not be regarded as materially different from the original interest.

What factors might be considered in evaluating when a dilutive transaction results in a materially different interest in cases where a controlling interest is not surrendered? One obvious factor is the magnitude of the shareholder's interest before the dilutive transaction. A shareholder whose interest is diluted arguably should own an interest of some significant magnitude before the dilution occurs to make it possible for the diluted interest to be materially different from the original interest. For example, it seems unlikely that a shareholder who owns less than a five percent or ten percent interest in a corporation before a dilutive transaction would own a materially different interest after the transaction occurs.[163] Unfortunately, there is no single, objectively correct, minimum interest threshold from which a potential material difference can result. In speculating about this amount, it is useful to consider whether a material difference is likely to exist if the maximum dilution of that interest were to occur. In other words, if ten percent is thought to be the minimum ownership threshold that can trigger a material difference as a result of dilution, one must be comfortable

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163. In determining a minimum ownership threshold for dilution potentially to trigger realization, consideration might be given to including stock owned by related parties in calculating whether the threshold is met. *See*, e.g., I.R.C. §§ 267(b), 318. Establishing a minimum ownership threshold would exclude the vast majority of taxable shareholders of publicly traded corporations who hold very small proprietary interests. This treatment would render the possibility of dilution triggering a realization event almost exclusively to the shareholders of closely held corporations.

concluding that the dilution of a 9.99 percent shareholder's interest to .001 percent cannot constitute a material change in interest. In effect, one must conclude that the rights and obligations of a 9.99 percent shareholder and a .001 percent shareholder are not materially different from one another. In most cases, this conclusion would seem reasonable. In any particular case, however, an ad hoc determination must be made because even if the interest of the diluted shareholder is below the minimum threshold, it is possible that the facts are such that a material difference exists.[164]

In addition to establishing a minimum ownership threshold for a dilutive transaction to normally result in a material difference, another relevant factor is the extent to which the shareholder's proportionate interest is reduced by the dilutive transaction. Thus, a material difference is unlikely to exist in the absence of some meaningful percentage reduction of a shareholder's proportionate interest. Moreover, the magnitude of the requisite contraction might differ depending on whether the diluted interest was that of a majority shareholder or a minority shareholder. In the case of a majority shareholder, the more that is surrendered, the less practical control that is retained, and passing various ownership thresholds (e.g., 75 percent, 66-2/3 percent) might significantly change the nature of the shareholder's control.[165] Thus, a somewhat smaller decline in proportionate interest might be deemed to result in realization for a majority shareholder than for a minority shareholder who has no control over any decision regardless of the magnitude of her interest.[166] Here again, the magnitude of dilution that must

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164. For example, if the minimum ownership threshold were ten percent and a corporation had a 41 percent shareholder, a 9.99 percent shareholder would be in a stronger position than a .0001 percent shareholder because the former could provide the 41 percent shareholder with control whereas the latter could not.

165. For example, in Illinois, a two-thirds vote is normally required to approve a merger or a sale of substantially all the assets of a corporation. 805 ILL. COMP. STAT. 5 §§11.20(a), 11.60(c) (1983). The two-thirds vote requirement can be modified by amending the articles of incorporation to provide that a larger or smaller majority is needed. 805 ILL. COMP. STAT. 5 §§11.20(b), 11.60(e) (1983). *See generally* CHARLES W. MURDOCK, 8 ILLINOIS PRACTICE SERIES, BUSINESS ORGANIZATIONS, Ch. 17 (2010).

166. For example, the relative interest of a diluted majority shareholder who retains a majority interest might be required to decline by at least 20 percent for a material difference to exist (e.g., the transaction would need to dilute a 75 percent shareholder to 60 percent (or less) for realization to occur). *See* Commissioner. v. Fink, 483 U.S. 89, 91, 99 (1987) (holding that reduction in interest of controlling shareholders from 72.5 percent to 68.5 percent did not represent a significantly different interest because the taxpayers remained in control in the corporation in a case involving a non pro rata contribution of shares to capital in which taxpayers attempted to deduct the loss.). By contrast, a more significant reduction might be required in the case of a diluted minority shareholder whose interest normally has very little power before the dilution occurs. *See* Griffith, *Realization and*

occur for realization is not clear—any guideline would be an arbitrary effort to constrain the instances in which dilution results in realization and would always be subject to the facts of the particular case.[167]

The realm of possible dilutive transactions occupies a continuum. At one extreme, the dilution that occurs almost certainly results in a material difference that triggers realization. At the other extreme, the dilution almost certainly does not result in a material difference. Between the two extremes, the outcome of a particular case is likely to be unclear. Even if all possible transactions could be located on the continuum, the line that differentiates those dilutive transactions that normally result in a material difference from those that do not is impossible to discern. Moreover, even if that line could be discerned, it would be uncertain whether any particular transaction represented the general rule or an exception to that rule until the specific

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Recognition, *supra* note 136, at 68 ("Minor reductions in shareholdings will not result in any practical difference in corporate operations if the post-surrender ownership percentage exceeds the statutory minimum required for major corporate decisions such as mergers, liquidations or the sale of assets other than in the ordinary course of business. In these cases, the shareholder remains in effective control regardless of the surrender."). Thus, a minority shareholder's interest might be required to decline by at least 40 percent before the dilution could trigger realization (e.g., the transaction would need to dilute a 30 percent shareholder to 18 percent (or less)). Requiring a significant reduction in the interest of a minority shareholder to trigger realization in a dilutive transaction is the converse of the approach taken to determine when a redemption of a minority shareholder qualifies for sale treatment under I.R.C. § 302(b)(1) where almost any reduction in a minority interest is treated as a sale for tax purposes. *See, e.g.*, Rev. Rul. 56-183, 1956-1 C.B. 161 (reduction from 11 percent to 9 percent satisfied I.R.C. § 302(b)(1)); Rev. Rul. 76-364, 1976-2 C.B. 91 (reduction from 27 percent to 22.27 percent satisfied I.R.C. § 302(b)(1)).

167. In determining how much dilution is necessary to trigger realization, it is helpful to consider the converse of a dilutive transaction; namely, a corporate transaction that results in accretion. Under I.R.C. § 305, a shareholder whose proprietary interest increases in a transaction that diminishes the interests of other shareholders can be taxed on the increase in the shareholder's proportionate interest even though the shareholder does not participate in the transaction. *See* Stone, *Back to Fundamentals*, *supra* note 88, at 928-930; James A. Hime*, The Application of Sections 305(b) and 305(c) to Redemptions, Recapitalizations and Acquisitions,* 48 TAX LAW. 375, 403-06 (1995). Not surprisingly, Congress takes a very restrictive view of the circumstances in which it is appropriate to tax a nonparticipating shareholder in these transactions. Treating dilutive transactions as realization events is arguably a less extreme action than taxing accretive transactions because of the different nature of the potential income in the two cases. In an accretive transaction, Congress is taxing the beneficiary of the accretion on a benefit derived when the accretive transaction occurs. By contrast, in the case of a dilutive transaction, a benefit was derived as the proprietary interest appreciated, not when the dilutive transaction occurs. The dilutive transaction would merely mark the time of realization.

facts of the case were considered. Thus, although dilution can result in realization, uncertainty will inevitably exist as to whether a particular dilutive transaction triggers a realization event.

D. Congress Should Enact Policy-Based Nonrecognition Rules to Differentiate Taxable and Nontaxable Dilutive Transactions

Once it is acknowledged that some level of dilution can effectuate the material change required for realization, realization ceases to operate as a convenient standard for determining whether a dilutive transaction is taxable. Although general rules governing when dilution results in realization might be formulated, some degree of uncertainty will almost always exist. This uncertainty exists because the facts of the particular case normally control whether a diluted interest is "materially different" from a previously undiluted interest.[168] For purposes of administration, therefore, it is undesirable to rely on the common law of realization to determine whether a dilutive transaction is taxable. Instead, Congress should determine when, as a policy matter, a gain should be taxed or a loss should be allowed in a dilutive transaction and enact appropriate nonrecognition rules to implement this result.[169] Since 1924, Congress has exercised its prerogative to defer gain and loss after a realization event occurs by enacting nonrecognition rules.[170] Congress should consider liquidity, valuation and fairness issues in the course of enacting appropriate nonrecognition rules to govern dilutive transactions.

An existing set of nonrecognition rules applies to many dilutive transactions. The corporate reorganization rules confer nonrecognition

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168. As two commentators have remarked, "One possibility is to do nothing and live with common law case-by-case decisions . . . ." *See* Bacon, *Taxable Events, Part II*, *supra* note 125, at 1395.

169. *See* Schlunk, *Rationalizing*, *supra* note 20, at 55 (suggesting that nonrecognition rules might have been utilized as a backstop by Congress to guard against the possibility that the courts and the Commissioner would define realization too liberally).

170. The concept of recognition was introduced in the Revenue Act of 1921 but recognition was generally the exception, rather than the rule, at this time. *See* Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 227, 230. Under the 1921 Act, when an exchange of property occurred, gain or loss was *not* recognized unless the property received by the taxpayer had a "readily realizable market value." The Revenue Act of 1924 reversed the presumption in favor of *not* taxing exchanges. Instead, the 1924 Act treated an exchange as a realization event and provided that all realized gains and losses are recognized, except when Congress carves out specific exceptions that merit deferred taxation. *See* Revenue Act of 1924, ch. 234, § 203(a), 43 Stat. 253, 257. The general rule of recognition of realized gains and losses still exists today. *See* I.R.C. § 1001(c).

treatment on specifically defined amalgamating and restructuring transactions.[171] Indeed, the transaction in *Stearn* likely would qualify as a corporate reorganization under current law.[172] Hence, even if, as we have argued, a realization event occurred in that transaction, the shareholder level gains attributable to the New Acme stock received in the exchange would not be recognized under current law.[173]

As a general matter, the corporate reorganization rules accommodate extreme dilution because these rules focus exclusively on the nature of the consideration received in the transaction.[174] A continuing proprietary interest is required by these rules, but nonrecognition treatment is not dependent upon the magnitude of that interest. As such, a small target ("housefly") can be swallowed by a large acquiring corporation ("elephant") in a transaction in which the elephant issues its stock as consideration for the acquisition and the shareholders of the housefly will be accorded nonrecognition treatment.

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171. When a corporate acquisition qualifies as a "reorganization" (as defined in I.R.C. § 368(a)(1)), the target corporation is accorded nonrecognition (I.R.C. § 361) and the target shareholders are accorded nonrecognition with respect to stock received in the acquiring corporation (I.R.C. § 354).

172. The transaction in *Weiss v. Stearn* would probably qualify as a nondivisive "D" reorganization under current law. I.R.C. § 368(a)(1)(D). This treatment would result by virtue of a 1986 amendment that reduces the necessary control threshold from 80 percent to 50 percent to satisfy the reorganization definition. Tax Reform Act of 1986, P.L. 99-514, § 1804(h)(2) (adding I.R.C. § 368(a)(2)(H)). This reduction in the ownership threshold for control was designed to support the government's effort to thrust reorganization treatment on taxpayers in certain liquidation-reincorporation transactions that were designed by taxpayers to exploit the low capital gains tax rates that applied to individuals. *See generally*, Kelley Walsh White, *The Type D Reorganization After 1986: A Case for Repeal*, 21 LOY. U. CHI. L.J. 123 (1989). The *Weiss v. Stearn* transaction might also qualify as an "F" reorganization under current law but we do not believe that form of reorganization is satisfied by the 50 percent shift in proprietary interest that occurred in the transaction. *See* Prop. Reg. §§ 1.368-2(m)(1)(i)(B) (limiting F reorganizations to transactions in which "there is no change in the ownership of the corporation in the transaction . . . ."), 1.368-2(m)(5) Ex. (1) (illustrating this limitation).

173. I.R.C. § 354.

174. The reorganization rules focus only on the nature of the consideration received and are not concerned with the amount of dilution that occurs in the transaction. *See, e.g.*, I.R.C. § 368(a)(1)(B) (consideration must be "solely voting stock"); I.R.C. § 368(a)(1)(C) (same, subject to the "boot relaxation rule" of § 368(a)(2)(B) that can allow up to 20 percent non-stock consideration in certain cases); Reg. § 1.368-1(e)(2)(v) Ex. 1 (mandating at least 40 percent stock consideration in a merger). No statutory or common law restrictions exist on the extent to which the transaction dilutes the target shareholders' proprietary interests. *See* BORRIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 7th ed., ¶¶ 12.21, 12.23[1], 12.24[1].

This treatment is conferred notwithstanding that the 100 percent ownership interest of the shareholders of the housefly is diluted to a miniscule proprietary interest in the elephant. Commentators have long criticized Congress and the Treasury for conferring tax deferral in these highly dilutive transactions but, for the most part, that criticism has fallen on deaf ears.[175]

Although the corporate reorganization rules address dilution by default in certain exchange transactions, no evidence exists that they were drafted with this issue in mind. Moreover, neither the corporate reorganization rules (nor any other existing nonrecognition rules[176]) apply to those dilutive transactions that are outside the scope of these rules. Hence, the reorganization rules do not provide a comprehensive answer to the question of when dilutive transactions should be taxed.

It would be desirable for Congress to examine the general question of when dilutive transactions should result in recognition of gain or loss and when nonrecognition should be conferred. Congress could resolve this issue by adopting an all or nothing position; i.e., allowing all dilutive transactions that constitute realization events to be immediately taxed, or enacting blanket nonrecognition rules for such dilutive transactions. Rather than adopting either of these extreme positions, Congress could take a middle ground and enact targeted nonrecognition rules that defer tax on certain dilutive

175. *See* Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11. VA. TAX REV. 349, 396 (1991) ("[T]he continuity of [proprietary] interest requirement does nothing to ensure that the nature of the transferor's investment remains substantially the same."); Jerome H. Hellerstein, *Mergers, Taxes and Realism*, 71 HARV. L REV. 254, 261 (1957) ("[M]any of the exchanges permitted by the reorganization provisions are changes 'merely in form' only as judged by highly artificial standards; that stockholders . . . obtain interests in the merged companies which cannot properly be regarded . . . as . . . 'continuing their former interest' . . . ."). For a proposal to mitigate the permissible dilution, see II ALI Fed. Income Tax Stat. § X601 (Feb. 1954 Draft) (requiring target shareholders to own at least 20 percent of combined enterprise for transaction to qualify as a reorganization); H.R. 8300, 83d Cong., 2d Sess., §354 (1954) (adopting 20 percent principle similar to the ALI recommendation). Although Congress has not addressed the dilution issue, it has taken small steps to restrict the nature of the investment that qualifies for nonrecognition treatment. *See, e.g.*, I.R.C. §§ 354(a)(2)(A) (taxing excess principal amount of securities received over securities surrendered); 354(a)(2)(C) (taxing excess of nonqualified preferred stock received over nonqualified preferred stock surrendered).

176. *See, e.g.,* I.R.C. §§ 351(a), 721(a) that confer nonrecognition to certain taxpayers who transfer property to a corporation or a partnership without regard to the magnitude of dilution that results.

transactions but allow an immediate tax to be imposed on transactions outside the scope of the targeted rules.[177]

In sum, the view that dilution of an ownership interest can never trigger realization should be rejected. Dilutive transactions should result in realization when the diluted interest is materially different from the former interest, regardless of whether the dilutive transaction entails an actual transfer of the retained interest. Realization, however, is a poor mechanism for distinguishing between taxable and non-taxable dilutive transactions because the material difference standard requires a fact intensive inquiry. As such, realization should be seen as the norm in transactions involving substantial dilution and Congress should enact nonrecognition rules to implement policy goals in this area.[178]

V. CONCLUSION

The federal income tax was a mere decade old when the Supreme Court decided *Weiss v. Stearn*. Accordingly, the common law of realization was in its infancy at that time. Thus, it is not surprising that the Court refrained from wading into the dark waters of shareholder dilution when it rendered its decision. Unfortunately, the case continues to be cited favorably by the Court and the flaw in the decision (the Court's failure to confront the dilution issue) has been deeply buried by the passage of time.

The law of realization has been significantly liberalized since *Stearn* was decided. As such, the dilution that occurred in *Stearn* would likely be

177. Commentators have delineated the implications of blanket recognition, blanket nonrecognition, and a targeted system between the two extremes. *See* Schlunk, *Rationalizing*, *supra* note 20, at 63-81 (delineating full range of nonrecognition alternatives and commentators favoring each one).

178. It is unlikely that any taxpayer who might potentially realize a gain in a dilutive transaction will report the gain since no authority mandates this result under current law. However, if Congress does not enact a rational system of nonrecognition for dilutive transactions, taxpayers with a potential loss might take the position the loss is realized in a dilutive transaction since no authority bars that result. For example, a 100 percent shareholder with an unrealized loss who sells 51 percent of her stock might claim the loss in the retained 49 percent interest if no nonrecognition rule applied. This would not be the first time that taxpayers have endeavored to accelerate losses. *See* Bacon, *Taxable Events, Part I*, *supra* note 89, at 1236-37 (acknowledging potential for whipsaw created by *Cottage Savings* decision); Griffith, *Realization and Recognition*, *supra* note 136, at 70-81 (suggesting that realized loss in non pro rata contribution to capital cases could be recognized and allowed); Schlunk, *Rationalizing*, *supra* note 20, at 65 ("[I]t is possible that such inconsistency would be exploited by taxpayers seeking to accelerate losses . . . "). Even if a realization event occurred in these circumstances, it is not clear that the realized loss would be allowed as a deduction; i.e., a loss might not be sustained in these circumstances. *See* I.R.C. § 165(a).

regarded as triggering a realization event if the same facts were put before the Court today. More significantly, the analysis leading to this conclusion suggests that realization should occur in heavily dilutive transactions even if the diluted interest is not physically transferred in the transaction.

Because the material difference standard for realization under current law requires an ad hoc inquiry to determine whether a dilutive transaction constitutes a realization event, realization should not be relied on to differentiate taxable and nontaxable dilutive transactions. Instead, Congress should regard all transactions involving substantial dilution as triggering realization and implement policy goals in this area by enacting appropriate nonrecognition rules. Now that nine decades have passed since the *Stearn* decision was rendered, it is high time for the impact of dilution on realization to be clarified.