Boot Dividends and the Automatic Rule: Bedford Revisited

Mervyn S. Gerson
BOOT DIVIDENDS AND THE AUTOMATIC RULE: 
BEDFORD REVISITED

For a quarter of a century gain recognized in a reorganization because of the distribution of “other property” has been treated by many courts, and the Treasury, as a dividend for federal income tax purposes if sufficient earnings and profits exist. This so-called “automatic rule” was based on a Supreme Court case in which the parties were attempting to pay a lawful dividend and reorganized only to be able to pay it, and has resulted in some anomalous results. Recently, cases have begun to interpret the statute literally and accurately, looking to see the “effect” of the distribution, and the “automatic rule” may be headed for its long-overdue demise.

Mervyn S. Gerson*

The concept of a “dividend” for federal income tax purposes is frequently in dispute. As a result, a substantial body of case law has evolved and several statutes have been enacted to define what is and what is not a dividend.¹ In the area of distributions in connection with a corporate reorganization, however, such cases and statutes have generally been ignored because of adherence to the “automatic” rule


¹. Inr. Rev. Code of 1954, § 316(a) defines “dividend” as follows:

(a) General Rule—For purposes of this subtitle, the term “dividend” means any distribution of property made by a corporation to its shareholders—

   (1) out of its earnings and profits accumulated after February 28, 1913, or

   (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.
which provides that other property received in a reorganization is taxed as a dividend if there are adequate earnings and profits.

Section 356(a)(1) of the Internal Revenue Code of 1954, as amended, provides that if property other than stock or securities is received in a reorganization exchange, gain is recognized to the extent of such property. If the exchange "has the effect of the distribution of a dividend," that portion of recognized gain, the "other property or money" received by each distributee (commonly called "boot"), shall be treated as a dividend to the extent of his ratable share of accumulated earnings and profits. Any other gain so recognized is taxable as capital gain.

2. Int. Rev. Code of 1954, § 356(a) provides:
   (a) Gain on Exchanges.—
      (1) Recognition of gain.—If—
         (A) section 354 or 355 would apply to an exchange but for the fact that
         (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,
      then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.
      (2) Treatment as dividend.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.


4. Dividends are taxed under Int. Rev. Code of 1954, § 301(a), (c):
   (a) In General.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).
   (c) Amount Taxable.—In the case of a distribution to which subsection (a) applies—
      (1) Amount constituting dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.
      (3) Amount in excess of basis.—
         (A) In general.—Except as provided in subparagraph (B), that portion of the distribution
The Internal Revenue Service takes the position that the receipt of "other property or money" in connection with a reorganization exchange will always have "the effect of the distribution of a dividend" to the extent of available accumulated earnings and profits (subject to the limitation that the amount of the dividend cannot exceed the amount of gain recognized to the distributee\(^5\)). This "automatic boot dividend" concept seems both anomalous and erroneous, and its development shows the effect of interpreting tax statutes in a vacuum, the problems of applying case law to different statutory patterns, and the effect of the courts' painting with too broad a brush.

A boot dividend can arise in several ways. It most frequently occurs in statutory mergers or recapitalizations, since voting stock is the only consideration that may be received tax-free in "(B)" and most "(C)" reorganizations.\(^6\) In the normal case, the consideration received by each shareholder simply will include other property. Other examples include a shareholder who tenders some of his shares in a cash tender offer to be followed by a merger and exchanges the remainder, or, in a more severe case, who tenders all his shares but a related person\(^7\) exchanges all his shares. Instead, the acquired corporation may redeem the stock of a prospective dissenting shareholder with funds of the acquiring corporation, but the shareholder's wife is the beneficiary of a trust owning additional shares of stock of the acquired corporation. In each case, the Internal Revenue Service and, it appears, most courts regard the cash payment as having the "effect of the distribution of a dividend," even though if the cash payment were not subject to section 356(a) of the 1954 Code it could qualify for capital gain treatment.\(^8\)

---

\(^5\) Sometimes called the "dividend-within-gain" limitation.

\(^6\) Int. Rev. Code of 1954, § 368(a) (1) (B), (C).

\(^7\) As defined in Int. Rev. Code of 1954, § 318(a).

\(^8\) This occurs most frequently when there is a substantially disproportionate redemption under Int. Rev. Code of 1954, § 302(b) (2). Section 302 provides in part:

(a) General Rule.—If a corporation redeems its stock (within the
Of course, most boot distributions are made pro rata among shareholders and therefore would have "the effect of the distribution of a dividend" under any reasonable test; it is this type of distribution that has been involved in most of the cases. The discussion herein will attempt to set forth criteria that seem more appropriate than a mere tabulation of accumulated earnings and profits for determining when a boot distribution has the effect of a dividend and when it does not.

**The History of the "Boot Dividend" Statute**

The present section 356(a) of the 1954 Code is derived from section meaning of section 317(b), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges.—

(2) Substantially disproportionate redemption of stock.—

(A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.
203(d) of the Revenue Act of 1924. That statute was enacted to prevent the distribution of a dividend from escaping tax in connection with a reorganization. The Senate Finance Committee Report cites, as an example of the evil it was seeking to correct, a corporation with accumulated earnings and profits of $50,000 which organized a second corporation to which it transferred all its assets in exchange for all the stock of the second corporation and $50,000 in cash, all of which was distributed to the stockholders of the transferor corporation. Under the then existing law, the $50,000 distribution, if taxable at all, would have been taxable as a capital gain. That report stated that such a distribution was "indistinguishable from a dividend distribution" by the transferor corporation, and should be taxed in the same way. To resolve this type of tax avoidance, Congress enacted the predecessor provision to section 356(a) of the 1954 Code, taxing as a dividend those boot distributions made in the course of a reorganization which have "the effect of the distribution of a dividend."

This brief legislative history does not lead to the conclusion that the receipt of boot in a reorganization automatically has "the effect of the distribution of a dividend" if there are available accumulated earnings and profits. If anything, it leads to the opposite conclusion. If a shareholder realized no gain on the exchange, section 356(a) of the 1954 Code will not tax him, regardless of the existence of available accumulated earnings and profits; and, conversely, if there are current (but not accumulated) earnings and profits, there can be no boot dividend. Indeed, it may be that the dividend-within-gain limitation was a drafting oversight, as the statute passed in 1924 did not achieve its full purpose because of that limitation.

Further, in section 333(e) and (f) and in sections 1246 and 1248 of the 1954 Code, Congress provided that gain from certain exchanges of stock constitutes ordinary income to the extent of the exchanging shareholders' ratable share of the earnings and profits of the corporation. In none of these statutes is there room for argument about the effect of the transactions: gain is simply taxed as ordinary income.\textsuperscript{15} Section 356(a) of the 1954 Code merely \textit{limits} any possible dividend effect to the amount of gain; presumably if Congress intended to enact the automatic rule, it would have done so.\textsuperscript{16} Although it is highly unlikely that Congress ever thought about section 356(a) when the foregoing statutes were enacted, the legislative history by no means supports the automatic rule.\textsuperscript{17}

Congress did consider the taxation of boot dividends again in 1954. The House of Representatives proposed the elimination of the dividend-within-gain limitation of what is now section 356(a)(2) of the 1954 Code. It also would have substituted for "the effect of the distribution of a dividend" a test of substantially disproportionate post-reorganization ownership similar to that now applied to redemptions by section 302(b)(2).\textsuperscript{18} The proposal\textsuperscript{19} was summarily rejected by the Senate. A comparable provision applicable to divisive distributions was enacted, however, as section 356(b).\textsuperscript{20} That statute provides that boot in a distribu-

\textsuperscript{131} F.2d 200 (8th Cir. 1942), involving Int. Rev. Code of 1939, § 115(g). \textit{See} note 127 infra.


\textsuperscript{16} The interpretation of tax statutes by reference to the statutory use of different language in similar situations is illustrated by Mitchell v. Commissioner, 300 F.2d 533 (4th Cir. 1962). \textit{See} Luckman v. Commissioner, 418 F.2d 381 (7th Cir. 1969).

\textsuperscript{17} There are other differences in scope between Int. Rev. Code of 1954, § 356(a), "boot dividends" and normal dividends. \textit{See}, e.g., B. BRITZER \\& J. EUSTICE, \textit{Feder\textit{al Income Taxation of Corporations and Shareholders}, 592 (2d ed. 1966).

\textsuperscript{18} \textit{See} note 8 supra.


\textsuperscript{20} Int. Rev. Code of 1954, § 356(b) provides:

\textit{(b) Additional Consideration Received in Certain Distributions.--If--}

\textit{(1) section 355 would apply to a distribution but for the fact that}

\textit{(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,}

then an amount equal to the sum of such money and the fair market
tion to which section 355 applies is taxable as provided in section 301 to the full extent of current or accumulated earnings and profits, without regard to the distributees' basis and without consideration of the "effect" of the distribution of the boot.21

This elimination of the "dividend within gain" concept and the statutory adoption of the "automatic" rule in section 356(b) of the 1954 Code strongly negates the interpretation of section 356(a)(2) as imposing an automatic boot dividend rule.22 Nine years before the enactment of the 1954 Code, however, the Supreme Court seemingly had adopted such a rule for boot in reorganizations, and the effect of that decision merits consideration.

The Bedford Case and the "Automatic Rule"

Bedford

The leading case in this area is Commissioner v. Estate of Bedford,23 involving section 112(c)(2) of the Revenue Act of 1936,24 successor to section 203(d)(2) of the Revenue Act of 1924 and predecessor of section 356(a)(2) of the 1954 Code. In that case, cash and stock were exchanged for stock in a recapitalization designed to eliminate a book deficit in surplus and to permit the payment of dividends under applicable local law. However, there were accumulated earnings and profits.25 The Court, relying on lower court cases,26 said: "... we..."

---

22. The failure to adopt the 1954 House proposals and the enactment of section 356(b) are relevant in construing section 356(a). See United States v. Corell, 389 U.S. 299 (1967) at 305 n. 20; Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).
23. 325 U.S. 283 (1945).
24. Ch. 690, 49 Stat. 1648. References in the text to sections 112 and 115 refer to the Revenue Act of 1936, ch. 690, 49 Stat. 1678, 1687, or to the Int. Rev. Code of 1939, both of which used the same basic numbering system.
25. The book deficit had resulted from charging the capital surplus account with stock dividends.
26. Campbell v. United States, 144 F.2d (3d Cir. 1944); See Millicent Turle Roelker, 39 B.T.A. 967 (1939), acqüised in, 1939-2 Cum. Bull. 32; Love v. Commissioner, 113 F.2d 236 (3d Cir. 1940); Rose v. Little Investment Co., 86 F.2d 50 (5th Cir. 1936); Commissioner v. Forhan Realty Corp., 75 F.2d 268 (2d Cir. 1935); Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934).

In John S. Woodward, 30 B.T.A. 1216 (1934) it was held that all liquidating distributions have the effect of the distribution of a dividend. Of course, this reasoning...
hold that a distribution, pursuant to a reorganization, of earnings and profits has the effect of a distribution of a taxable dividend within § 112(c)(2).\textsuperscript{27} This leads to the conclusion that \textit{Bedford} holds that any boot distribution in a reorganization has the effect of a dividend if there are sufficient accumulated earnings and profits. Of course, on its facts, \textit{Bedford} did involve a dividend (the purpose of the entire transaction was to permit the payment of a dividend) and therefore the result is unquestionably correct.

The Court arrived at this conclusion in a strange way. Taxpayer alleged, \textit{inter alia}, that the transaction had the effect of a partial liquidation as defined in section 115(i) of the Revenue Act of 1936. The Court stated:

\begin{quote}
The definition of a "partial liquidation" in § 115 is specifically limited to use in § 115. To attempt to carry it over to § 112 would distort its purpose. That limitation is not true of § 115(a) which defines "dividend" for the purpose of the whole title. Accordingly, this definition is infused into § 112(c)(2). Under § 115(a) a distribution out of accumulated earnings and profits is a "dividend," thus confirming the conclusion that a distribution of earnings and profits has the "effect of the distribution of a taxable dividend" under § 112(c)(2).\textsuperscript{28}
\end{quote}

This language, quoted by the Service in Revenue Ruling 56-220\textsuperscript{29} as authority for the automatic rule, is curious.\textsuperscript{30} The Court appears to say that the definition of "dividend" is "infused" into the boot provisions of the Code. Yet that definition is not affected by other provisions, even in the same section 115 of the 1936 Act, which make exceptions to dividend treatment in certain cases falling squarely within the definition of a dividend and, therefore, requiring a specific statutory exception. It then concluded:

\begin{quote}
As is true of other teasing questions of construction raised by technical provisions of Revenue Acts the matter is not wholly
\end{quote}

\textsuperscript{27} 325 U.S. at 292.
\textsuperscript{28} Id. at 291-92.
\textsuperscript{29} 1956-1 CUM. BULL. 191. \textit{See} text accompanying note 48 \textit{infra}.
\textsuperscript{30} It was called "not . . . satisfactory or logical . . ." in Darrell, \textit{The Scope of Commissioner v. Bedford Estate}, 24 \textit{Taxes} 266 (1946), and "imprecise" in B. Bittker \& J. Eustice, \textit{supra} note 17, at 592.
free from doubt. But these doubts would have to be stronger than they are to displace the informed views of the Tax Court. And if the case can be reduced to its own particular circumstances rather than turn on a generalizing principle we should feel bound to apply Dobson v. Commissioner, 320 U.S. 489, and sustain the Tax Court.\(^{31}\)

The Court completely overlooked section 115(c) of the 1936 Act,\(^{32}\) which provided that partial liquidations were taxed to the extent provided in section 112 of the Act. Section 115(i) of the Act, discussed at length by the Court, merely defined the term "partial liquidation." Perhaps the Court was straining to reject the taxpayer's ingenious argument that the distribution had the effect of a partial liquidation.\(^{33}\) If it had, it would have been taxed as capital gain under section 112(c)(2) of the Act because it lacked the proscribed dividend effect, even though a partial liquidation without a reorganization was taxable as ordinary income.\(^{34}\) Such a result clearly would have frustrated the congressional intent in enacting section 203(d)(2) of the Revenue Act of 1924.

Although, on the facts, the Court in Bedford reached the result intended by Congress, if it believed that because of the slight legislative history,

\[\text{[w]e are thrown back upon the legislative language for ascertaining the meaning which will best accord with the aims of the language, the practical administration of the law and relevant judicial construction,}^{35}\]

it should have considered whether its holding not only would accom-

\(^{31}\) 325 U.S. at 292. Reliance on Dobson means that the findings of the Tax Court will not be disturbed unless clearly erroneous.

\(^{32}\) Revenue Act of 1936, ch. 690, § 115(c), 49 Stat. 1687, provided:

Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part of full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

\(^{33}\) In Morley Cypress Trust, Schedule "B", 3 T.C. 84 (1944), acquiesced in on other grounds, 1944 Cum. Bull. 20, the Tax Court had held that a liquidation can be merely incident to a reorganization and thus not viewed separately. See Helvering v. Schoellkopf, 100 F.2d 415 (2d Cir. 1938).

\(^{34}\) This treatment, provided in the Revenue Act of 1934, ch. 277, § 115(c), 48 Stat. 680, applied from 1934 to 1942. See note 92 infra.

\(^{35}\) 325 U.S. at 290.
plish the legislative purpose to prevent dividend or other ordinary income distributions constituting part of a reorganization from being taxed as capital gains, but also whether its holding would tax as ordinary income distributions that were not "indistinguishable from a dividend distribution by the acquired corporation." Perhaps the fallacy in the Bedford rationale is that it interpreted "dividend effect" by referring solely to the statutory definition of a dividend and by ignoring the numerous statutory exceptions thereto. The effect of the fragmentation in the 1954 Code of section 115 of the Revenue Act of 1936 is sadly illustrated by the Bedford progeny.

The "Automatic Rule" in the Courts

The literal application of Bedford by many courts has led to some harsh results. In Lewis v. Commissioner,38 the view of the Service resulted in dividend treatment of "boot" where the taxpayer attempted a liquidation and was held to have effected a "(D)" reorganization.39 There the corporation had three businesses which it attempted to sell. It sold two but was unable to dispose of the third, which it then transferred to a newly-formed subsidiary. The cash proceeds of the sales of the first two businesses and the stock of the subsidiary were then distributed in liquidation. The Commissioner argued, and the court held, that the cash received by the shareholders should be taxed to them as a dividend, despite the strong resemblance of the transaction to a partial liquidation which would have received short-term capital gain treatment.40 Again, the fear of creating a loophole by affording long-term

36. Bedford was cited as explicitly adopting the "net effect" test of dividend equivalence in Radnitz, Jr. v. United States, 187 F. Supp. 952 (S.D. N.Y. 1960), aff'd, 294 F.2d 577 (2d Cir. 1961), and the "strict net effect" test in Davis v. United States, 408 F.2d 1139 (6th Cir. 1969), rev'd — U.S. — (March 23, 1970). Davis upheld the strict net effect test. In re Lukens' Estate, 246 F.2d 403 (3d Cir. 1947), however, found that Bedford did not endorse the net effect test.

37. In fairness, the number of exceptions is greater today than in 1945. In addition, the House debates on the Revenue Act of 1924, ch. 234, § 203(d) (2), 43 Stat. 253 seem to support the automatic rule. See 65 Cong. Rec. 2898-9 (1924).

38. 176 F.2d 646 (1st Cir. 1949), aff'd 10 T.C. 1080 (1948).

39. Int. Rev. Code of 1954, § 368(a) (1) (D). This section is the cornerstone of the Commissioner's liquidation-reincorporation approach. See text accompanying note 55 infra.

40. Both parties in Lewis had conceded that the effect of the transaction was a partial liquidation. "The Tax Court in its opinion and the Commissioner in his brief concede that the effect of the transaction was a partial liquidation." Lewis v. Commissioner, 160 F.2d 839, 843 (1st Cir. 1947).
capital gains treatment to the boot may have unconsciously affected the result.

A similar result was reached in *Estate of Elise W. Hill*.

In that case, a personal holding company was sought to be dissolved, and the assets that could not be sold were transferred to a new corporation in exchange for its stock. The proceeds of the assets which could be readily sold and the stock of the new corporation were distributed in liquidation to the shareholders of the transferor. The taxpayer argued that the transaction was a complete liquidation, giving rise to capital gain. The court held, however, that the transaction constituted a reorganization. Finding that the taxpayer’s gain exceeded her ratable share of accumulated earnings and profits, the court ruled, on the authority of *Bedford*, that the gain was taxable as a dividend to the extent of such earnings and profits.

Some cases follow the automatic rule instinctively. In *Commissioner v. Morgan*, a rather compelling case for application of the liquidation-reincorporation theory, the court, in applying the automatic rule and treating the boot as a dividend, stated that

> [s]ubsection 112(c)(2) was enacted to reach and tax as ordinary income gain realized by a stockholder from a corporate reorganization to the extent that such gain constitutes undistributed earnings.

In *Breech, Jr. v. United States*, the court, in finding that a liquidation-reincorporation was a dividend, said “[t]herefore, there was ‘boot’ taxable . . . as a dividend . . . .” In *Commissioner v. Carman*, section 112(c)(2) was construed as meaning “[i]f in fact the money was paid from earning and profits, then it would be taxable as a dividend.” These cases, although involving pro rata boot that would have dividend effect under any reasonable test, prefer to rely on the automatic rule rather than get into a discussion of a problem the resolution of which

---

41. 10 T.C. 1090 (1948).
42. Accord, Becher v. Commissioner, 221 F.2d 252 (2d Cir. 1955).
44. Id. at 680.
47. 189 F.2d 363 (2d Cir. 1951).
48. Id. at 366. The court then found that there were no earnings and profits.
is not seriously in dispute. As a result, there is a group of cases applying
the automatic rule instead of stating that pro rata boot, absent a partial
liquidation, always has dividend effect.

If these cases are to be taken literally, then section 356(a)(2) of the
1954 Code will have been judicially rewritten along the lines of, e.g.,
section 356(b), and the only relevant inquiry would be the existence
of available accumulated earnings and profits. Fortunately, some courts
have retreated from this step, and in so doing have questioned some of
the literal teachings of Bedford. The position of the Internal Revenue
Service has not helped to clarify those teachings.

Internal Revenue Service Position: Revenue Ruling 56-220

The Service announced its approval of Bedford in Revenue Ruling
56-220.49 That ruling involved a merger with a pro rata cash payment,
and the Service relied upon Bedford for the position that boot has the
effect of the distribution of a dividend under section 356(a)(2) of the
1954 Code if it is paid out of accumulated earnings and profits. The
Service apparently regarded the Supreme Court as having adopted the
automatic rule. In addition, it relied on the pre-Bedford cases50 involving
various types of reorganizations and holdings of dividend effect on pro
rata boot distributions such as that involved in Revenue Ruling 56-220.

Despite the citation of Bedford with approval in Revenue Ruling
56-220, the Service has applied inconsistently the automatic rule and the
dividend-within-gain limitation. Further, the Service’s position seems
to vary depending on the type of reorganization and the form of the
transaction, distinctions totally devoid of any statutory or other meri-
torious basis.

Recapitalizations. The Bedford case involved a recapitalization, as
did some of the earlier cases cited with approval in Revenue Ruling
56-220.51 Yet, since 1955, the Service has taken the unequivocal posi-
tion in the regulations that boot in a recapitalization is not governed
by section 356(a)(2) of the 1954 Code but rather is a distribution to
which section 301 applies.52 This regulation seems to be applied only

50. See note 26 supra.
cross-reference to § 1.301-1(l) for “certain transactions which are not within the scope
of section 356.” Treas. Reg. § 1.331-1(c) (1955), dealing with liquidations treated as
reorganizations, contains the reference “[S]ee sections 301 and 356.”
when desired. Yet, in Revenue Ruling 56-179, section 356(a) (2) was held applicable to a recapitalization without reference to the regulation to the contrary. In Revenue Ruling 69-34, the Service held that cash separately bargained for in lieu of fractions in a recapitalization would be either boot under section 356(a) or a distribution to which section 301 applies, depending upon all the facts and circumstances involved.

This vacillation leads to several unanswered questions, aside from the obvious uncertainty as to the Service’s actual position concerning the status of boot in a recapitalization. First, if “all the facts and circumstances” result in the application of section 356 of the 1954 Code, is there an inference of nondividend effect because if the Service thought the boot had dividend effect it would have applied section 301? Second, what facts and circumstances, other than the distributee’s basis, are or should be relevant? Finally, should not section 356(a) apply to all reorganizations?

Liquidation-Reincorporation. For some time the Service has taken the view that section 301 of the 1954 Code, and not section 356(a), applies to cash retained in a corporate liquidation followed by a reincorporation of the business of the liquidated corporation when the entire transaction is treated as a reorganization. This position, which

---

53. 1956-1 CUM. BULL. 187. In Rev. Rul. 56-184, 1956-1 CUM. BULL. 190, the Service ruled that a dividend paid by the acquired corporation prior to a reorganization defined in INT. REV. CODE of 1954, § 368(a) (1)(B), was governed by § 301, thus treating it as a separate transaction. The same result applies if the dividend is declared by an acquired corporation before a merger but is paid by the survivor after the merger. Rev. Rul. 69-443, 1969 INT. REV. BULL. NO. 34, at 11.

54. 1969-1 CUM. BULL. 105.


Treas. Regs. § 1.331-1 (1968) provides in part:

(c) A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of “other property.” See sections 301 and 356.
first appeared in Revenue Ruling 61-156, \(^{56}\) has been sustained by several courts, \(^{57}\) although not universally. \(^{58}\) The distinction apparently drawn in some of the cases, presumably at the urging of the Commissioner, is between reorganizations in both form and substance (so-called “functional” reorganizations) and those that are reorganizations only in form (so-called “technical” reorganizations). \(^{59}\) In these latter cases, such as a liquidation-reincorporation, the retained cash is frequently treated as subject to section 301 apparently because it more resembles a dividend than boot.

This analysis raises the same questions that are raised by applying section 301 of the 1954 Code to recapitalizations, \(^{60}\) and although there is some logic to the reasoning it appears not to answer those questions. \(^{61}\) Certainly there is no valid reason for applying sections 368 and 354 to a liquidation-reincorporation and not applying section 356. \(^{62}\)

**Acquisitive Reorganizations.** Revenue Ruling 56-220 involved a merger, and in acquisitive reorganizations the Service has consistently applied section 356(a)(2) of the 1954 Code, including the dividend within gain limitation, and the automatic rule. \(^{63}\) In the case of cash in


[^57]: E.g., Griswold v. Commissioner, 400 F.2d 427 (5th Cir. 1968); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018. It should be noted that the taxpayer in Rev. Rul 56-220, 1956-1 Cum. Bull. 191, originally planned to have cash in lieu of fractions, but revised his plans to provide for pro rata boot. See text accompanying note 49 supra.

[^58]: E.g., Ralph C. Wilson, Sr., 46 T.C. 334 (1966); James Armour, Inc., 43 T.C. 295 (1964).

[^59]: Reef Corp. v. Commissioner, 368 F.2d 125, 135 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967). This case squarely supports the position of the Service, and appears to rewrite the statutory patterns to achieve an equitable result.


lieu of fractional shares in acquisitive reorganizations, however, if the cash is not separately bargained for the Service will fragment the transaction and treat the cash as a redemption, and usually at capital gain rates and not as essentially equivalent to a dividend.\textsuperscript{64} This, of course, permits cash in lieu of fractional shares to be paid without disqualifying those reorganizations in which the sole consideration must be voting stock of the acquiring corporation.\textsuperscript{65}

The Service applied the foregoing fractional share rule to recapitalizations in Revenue Ruling 69-34.\textsuperscript{66} As indicated above, if in an acquisitive reorganization the cash in lieu of fractions is separately bargained for, it is always boot governed by section 356(a)(2) of the 1954 Code; on the other hand, in a recapitalization the Service feels that section 301 sometimes applies.\textsuperscript{67} Perhaps the rationale for this distinction is that in a recapitalization there cannot be any bargaining about the fractions, as there is only one management involved.

In any event, it appears that only in the area of acquisitive reorganizations has the Service's interpretation of \textit{Bedford}, a recapitalization case, been consistently followed by the Service.

\textit{Summary.} The Service appears to be puzzled by the automatic rule. As will be shown below,\textsuperscript{68} it sometimes argues that there is no such rule, although in Revenue Ruling 56-220 it seems to have adopted that rule. In certain areas, it attempts to avoid the issue altogether by applying section 301 instead of section 356(a) of the 1954 Code, even though the former statute (and not the latter) begins "Except as otherwise provided in this chapter . . . ."\textsuperscript{69} Administratively, it is believed that the

\textsuperscript{64} Rev. Rul. 66-365, 1966-2 Cum. Bull. 116. Accord, Rev. Rul. 69-646, 1969 Int. Rev. Bull. No. 52, at 10. The Service thus accepts the holding of Mills v. Commissioner, 331 F.2d 221 (5th Cir. 1964). This expedient conclusion is probably accurate; yet it seems to be based on the intent of the parties, or at least the intent of an unrelated acquiring corporation. From this reasoning, it is a short jump to viewing non-pro rata boot as presumptively not having dividend effect unless the payee and the payor are related. The facts in \textit{Mills} support this interpretation.

Capital gain treatment for the gain from the "redemption" of the fractional share makes sense because the shareholders normally will own different numbers of shares of the acquired corporation, especially if it is publicly held, and thus will receive differing fractional interests.


\textsuperscript{67} See text accompanying note 54 supra.

\textsuperscript{68} See text accompanying notes 70 and 94 infra.

\textsuperscript{69} Int. Rev. Code of 1954, § 301(a). This language has led to the holding that Int. Rev. Code of 1954, § 351, providing nonrecognition, overrides § 304, treating certain
Service adheres to the automatic rule, although its published positions seem to be utterly irreconcilable. With this uncertainty, it appears appropriate to try to infuse some reason into section 356(a)(2) and to give some meaning to the word "effect" in that statute. Recently, the courts have been attempting to do this.

DIVIDEND EQUIVALENCE AND THE "AUTOMATIC RULE"

Court of Claims

In a series of cases spanning the last twelve years, the United States Court of Claims has construed section 356(a) (2) of the 1954 Code as involving "dividend equivalence" and, while not explicitly rejecting Bedford, has suggested both that Bedford did not in fact impose the automatic rule and that in any event such a rule is an erroneous interpretation of the statute.

The first of these decisions was Idaho Power Co. v. United States.70 There the taxpayer redeemed all its old preferred stock in exchange for new preferred stock and cash. The corporate taxpayer claimed a dividend-paid credit for the cash under section 26(h) of the 1939 Code, arguing that Bedford required that the cash be treated as a dividend. The Court of Claims stated that the determination whether the payment of cash has the effect of the distribution of a taxable dividend was a factual question.71 The court found that the cash payment by the taxpayer severely reduced the proportionate interest of the preferred shareholders in the corporation. From this fact the court concluded that the cash payment did not have the effect of the distribution of a taxable dividend because a dividend ordinarily does not affect the distributees' relative interests in the corporation. There was no discussion of the substantially disproportionate redemption test of section 302(b)(2), as

redemptions as subject to § 301, in a case in which both were literally applicable. Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968). The Commissioner has not acquiesced in the original decision, Henry McK. Haserot, 41 T.C. 562 (1964), not acquiesced in 1966-2 Cum. Bull. 7, remanded, 355 F.2d 200 (6th Cir. 1965), opinion on remand, 46 T.C. 864 (1966), which opinion was ultimately affirmed. As can be seen from the case history, the matter may not have been finally resolved.


71. The court was apparently of the view that the phrase "effect of the distribution of a dividend . . ." in Int. Rev. Code of 1939, § 112(c) (Int. Rev. Code of 1954, § 356(a)(2)) has the same meaning of the phrase "essentially equivalent to a dividend" under Int. Rev. Code of 1939, § 115(g) (Int. Rev. Code of 1954, § 302(b)(1)). See Cobb v. Callen Court Co., 274 F.2d 532 (5th Cir. 1960); Commissioner v. Sullivan, 210 F.2d 607 (5th Cir. 1954); Bains v. United States, 289 F.2d 644 (Ct. Cl. 1961).
the 1954 Code was inapplicable and section 302(b)(2) had no predecessor in the 1939 Code.

The Idaho Power decision is unusual because it involved a reversal of the usual positions of the parties, with the taxpayer relying on Bedford and the Government asserting in its brief that there was no sound judicial basis for automatic dividend taxation of all boot distributions. The court specifically rejected taxpayer’s attempted reliance on the automatic rule, adding that “[i]f Congress meant merely to say that any boot money at all paid out of earnings should be a taxable dividend, it used a verbose and complicated way of saying it.”

In Ross v. United States, cash distributed pro rata in an acquisitive reorganization was held to have the effect of the distribution of a dividend. The Court of Claims equated the dividend effect test under section 356(a)(2) of the 1954 Code with the “essentially equivalent” test under section 302(b)(1). Idaho Power was cited for the proposition that the Commissioner’s automatic rule was incorrect and that a question of fact is involved in each case to determine whether the distribution of boot would have the effect of the distribution of a dividend. It also was cited for the view that Bedford did not adopt the automatic rule, but rather was consistent with the dividend equivalence test used by the Court of Claims.

The most recent Court of Claims case in this area is King Enterprises, Inc. v. United States. In that case a corporate taxpayer sold its stock in T corporation to M corporation for cash, notes, and M stock. Thereafter M liquidated T. The court held that the two transactions were part of a unified plan of reorganization, and thus the cash and notes were boot. The boot was held to be a dividend, and was further held to be eligible for the eighty-five percent intercorporate dividend deduction. The court said:

73. 161 F. Supp. at 809.
75. The commentators have uniformly so concluded. See, e.g., Hoffman, Impact of Bedford Case on Reorganizations, N.Y.U. 6TH INST. ON FED. TAX, 279 (1948); Moore, supra note 14; Sapienza, Tax Consideration in Corporate Reorganizations and Mergers, 60 NW. U.L. REV. 765 (1966); Shoulson, Boot Taxation: The Blunt Toe of the Automatic Rule, 20 TAX L. REV. 573 (1965).
76. 418 F.2d 511 (Ct. Cl. 1969).
77. INT. REV. CODE of 1954, § 243. See B. Bittker & J. Eustice, supra note 17, at 592;
The operative words of section 356(a)(2) suggest a test of "dividend equivalence," rather than a conclusion of automatic dividend income merely because of the existence of earnings and profits, and the more recent cases have recognized this. Thus, despite the absence of an express statutory relationship between the two Code provisions, the principles developed under section 302 have been used with increased frequency in applying the standard contained in section 356(a)(2).78

The court then stated that the absence of a "substantially disproportionate change in the continuing equity interests" of the former T shareholders constituted "a classic example of a transaction having the effect of the distribution of a dividend."79

Presumably, therefore, if a substantially disproportionate cash redemption occurred as part of a reorganization, such as by a premerger tender offer, the Court of Claims would treat the boot as capital gain. It is submitted that this result is dictated by the purpose and language of the boot statute and forms the basis for a realistic approach to the problem of boot dividends.

Other Decisions

The Court of Claims is not the only court to cast doubt upon the automatic rule. In Hawkinson v. Commissioner,80 a debt of a shareholder was cancelled as part of a consolidation. The equity interest of the shareholder was reduced to reflect the effect of that cancellation on the assets of the corporation. The Commissioner argued that Bedford established the automatic rule as a matter of law. The court noted that the Bedford line of cases all dealt with pro rata distributions,81 as did the

---


78. 418 F.2d at 520-21.

79. Id. at 521. The result appears to be a strange quirk, as the taxpayer wanted the boot to be taxed as a dividend (i.e., at an effective rate of 7.2 percent) rather than as long term capital gain (effective rate, 25 percent). Thus, the Government was again arguing against the automatic rule and it prevailed. The result in this case must have been especially unpalatable to the Service as it had issued a private ruling letter to M wherein M was afforded a stepped-up basis under Int. Rev. Code of 1954, § 334(b)(2), for the assets of T acquired in the merger.

80. 235 F.2d 747 (2d Cir. 1956).

81. In Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955), the court regarded Bedford as having "suggested" the automatic rule, but that later partial liquidation and stock redemption cases showed the automatic rule to have been unworkable. Bedford
early cases cited with approval by the Supreme Court. The court noted (as subsequently did the Court of Claims82) that the purpose of the transaction involved in Bedford was to pay a cash dividend, but backed away from rejecting the automatic rule by finding that the transaction before it was a pro rata distribution and thus had a dividend effect under any test. The court added: “[W]ere we faced with a case where the distribution did not have the effect of a taxable dividend we should find it difficult to reconcile the Commissioner’s present interpretation of Bedford with the clear language of § 112(c)(2) [of the 1939 Code].” 83

The automatic rule has been rejected by the Tax Court by dictum. In Ralph C. Wilson, Sr.,84 a corporation sold its operating assets to a related corporation for cash, sold its remaining assets to third parties, and then liquidated, distributing the cash to its stockholders. Because the shareholders also owned the related corporation, the transaction was held to constitute a “(D)” reorganization. The Tax Court agreed with the approach of the Court of Claims in Idaho Power and Ross that whether a distribution has the effect of a dividend is a factual question. It held, however, that because the distribution was pro rata, the boot was taxable as a dividend.85 Taxpayers argued that one of them planned to withdraw from the business shortly; but they failed to prove that the reorganization was part of that plan, although the court indicated that such proof might have negated the dividend effect. In a footnote,
the Tax Court indicated that the “essentially equivalent to a dividend” test of section 302(b)(1) of the 1954 Code was relevant.\(^86\)

In *William H. Bateman*,\(^87\) the Commissioner attempted to tax the receipt of stock warrants received in a statutory merger as a dividend. He argued that the stock warrants were not securities for purposes of section 354 of the 1954 Code,\(^88\) constituted boot under section 356(a)(1), and had the effect of a distribution of a dividend under section 356(a)(2). The Tax Court agreed with the first two arguments, but rejected the third on the grounds that, because no corporate assets were transferred to the shareholders, the issuance of the stock warrants did not reduce earnings and profits. Thus, since earnings and profits were unaffected, the distribution did not have the effect of a dividend.\(^89\) The Tax Court construed *Bedford* as rejecting the applicability of the partial liquidation rules in reorganizations, an analysis that is literally correct.

An interesting discussion of the automatic rule arises in other areas. In *Central & South West Corp. v. Brown*\(^90\) the question presented was whether premiums on certain stock redemptions were dividends under... etc.
section 115(a) of the 1939 Code, entitling the taxpayer to a dividend paid credit. The taxpayer argued that section 115(i) was inapplicable, but the court rejected this claim. Thus, the court concluded that not all distributions by a corporation to its shareholders of earnings and profits are dividends, and distinguished dividends in partial liquidation from ordinary dividends. *Bedford* was not even cited. In *Pennsylvania Power & Light Co. v. United States* the same issue was presented, and the court held that the specific exception in section 115(c) controlled the general definition of dividend set forth in section 115(a), an approach rather at odds with the statutory construction technique of the Supreme Court in *Bedford*.

In *Associated Telephone & Telegraph Co. v. United States*, the question of the allowance of a foreign tax credit for foreign taxes paid on a liquidating distribution was involved. The taxpayer argued that *Bedford* held that there is no qualification on the word "dividend" whenever it is used in the Code without further clarification. The Government argued that *Bedford* merely held the terms "dividend" and "partial liquidation" to be mutually exclusive. The court then held that the scope of the word "dividend" depended on the context in which it was found in the statute and held that for foreign tax credit purposes it excluded liquidating dividends because of the congressional intent in allowing the foreign tax credit. Since the liquidation distribution was entitled to capital gain treatment, the court concluded that Congress did not intend to allow a foreign tax credit in respect of a liquidating distribution unless it was taxed under the Code as a dividend.

This is the type of reasoning that the Court in *Bedford* appears to have applied, without so stating, in rejecting the taxpayer's argument that the distribution lacked dividend effect. If the Court had so stated, there would be no basis for applying the automatic rule to boot dividends. It appears, however, that there is a trend toward construing *Bedford* as not standing for the automatic rule. The relatively recent cases blindly

---

91. See text accompanying note 70 supra.
92. Full capital gain treatment was restored to distributions in liquidation in 1942, and thereafter Treas. Reg. § 29.115-1 (Cum. Supp. 1944) provided that the term dividend did not apply to distributions under Int. Rev. Code of 1939, § 115(c), relating to liquidations.
95. But see Int. Rev. Code of 1954, § 1248 with respect to the treatment of gain recognized upon liquidation of certain foreign corporations as ordinary income.
applying the automatic rule all involved pro rata boot, and thus no
cogent argument for a different result was available. As a result, the
import of Bedford is now questionable and in need of resolution.

SECTION 306 REGULATIONS

The meaning of "the effect of the distribution of a dividend" may
be related to the use of similar language in other statutes. Section
306(c)(1)(B) of the 1954 Code defines "section 306 stock" to include
certain stock received in a tax-free reorganization or a spinoff if,
inter alia, "the effect of the transaction was substantially the same as
the receipt of a stock dividend . . . ." In applying this test, the regula-
tions interpret substantially a stock dividend effect to mean "if cash
received in lieu of such stock would have been treated as a dividend
under section 356(a)(2) or would have been treated as a distribution
to which section 301 applied by virtue of section 356(b) or section
302(d)." Thus, the hypothetical cash distribution in the tax-free
transaction could be a dividend either if the boot dividend statute ap-
p lied or if it were a redemption and section 302(a) did not apply. This
regulation, therefore, recognized that whether or not a corporate cash
distribution has the effect of the distribution of a dividend may, at least
in some cases, depend on whether section 302(a) applies.

The principles of this regulation were involved in Revenue Ruling
59-84, which involved a recapitalization of new common stock and
preferred stock for old common stock. The principal shareholder re-
ceived only preferred stock, five of the other shareholders received both,
and the remainder received only new common. The principal sharehold-
er's exchange did not have the effect of the distribution of a stock divi-
dend because he surrendered all his common stock. Each of the five
shareholders receiving both classes of stock, however, owned a greater, or

---

99. Also included is any other transaction to which Int. Rev. Code of 1954, § 355,
   applies.
100. Treas. Reg. § 1.306-3(d) (1955). This concept of the regulations is known as
    the "cash substitution" test.
101. When this will occur is unclear.
103. The Service will rule in certain cases that such preferred stock, even if con-
    The Impact of Section 306 Upon Convertible Preferred Stock Issued in a Corporate
not "substantially lesser," percentage equity interest in the issuer. As to them, the transaction was ruled to be substantially the same as the receipt of a stock dividend and the preferred stock was deemed to be "section 306 stock." Presumably, if their percentage ownership were substantially less, a contrary result would have been reached. What "substantially less" would mean is unclear. In Revenue Ruling 59-84, one shareholder's percentage interest was ninety percent of what it had been prior to the recapitalization and that was not regarded as a "substantially lesser" percentage. It is submitted that by analogy to section 302(b)(2) of the 1954 Code less than eighty percent of pre-reorganization ownership should suffice.

In Revenue Ruling 60-1,\(^{104}\) a merger and recapitalization involved the issuance of redeemable preferred stock of the survivor corporation in exchange for nonredeemable preferred stock. A small number (about 15 percent) of the holders of the nonredeemable preferred stock also owned common stock. After the merger, their aggregate voting power fell from about 23.2 percent to 18.7 percent.\(^{105}\) The effect of that exchange was held not to be substantially the same as the receipt of a stock dividend, and the redeemable preferred stock was not "section 306 stock." No mention was made of the existence or extent of earnings and profits or of the distributees' basis for their nonredeemable preferred stock. It seemed to be important, however, that the exchange of preferred stock was not pro rata, involved holders of small numbers of shares of a publicly held corporation, and affected a small number of holders of common stock.\(^{106}\)

The Service appears to construe section 306(c)(1)(B) of the 1954 Code somewhat differently in recapitalizations. In Revenue Ruling 66-332,\(^{107}\) each share of existing common stock could be exchanged for

---

\(^{104}\) 1960-1 CUM. BULL. 143.

\(^{105}\) The post-merger percentage was thus more than eighty percent of the pre-merger percentage. Note that the merger and the recapitalization were treated as one transaction.

\(^{106}\) The reasons given are those usually relevant in determining when a redemption is essentially equivalent to a dividend under INT. REV. CODE of 1954, § 302(b)(1). See note 36 supra; Blount v. Commissioner, — F.2d. — (2d Cir. 1969). It may be that the publicly-held aspect is significant, especially if the management does not own significant amounts of stock. This may be one of the "facts and circumstances" considered by the Service in deciding whether boot is governed by section 301 or 356. See Rev. Rul. 69-34, 1969-1 CUM. BULL. 105. See also Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, where the fact that certain stock is "widely-held" affects the question of whether it is "section 306 stock" or, if so, whether a section 306(b)(4) ruling will issue.

\(^{107}\) 1966-2 CUM. BULL. 108.
one share of new common stock and one share of nonvoting preferred stock. The old common stock became a junior preferred stock. The Service held that preferred stock received by shareholders who exchanged all their old common was section 306 stock because the transaction had the effect of a common-for-common exchange followed by a stock dividend of preferred stock. Both the old common stock retained and the preferred stock received by shareholders who exchanged only part of their old common were section 306 stock, because the transaction was viewed as an exchange of old common stock for new common stock followed by a stock dividend of old common stock and preferred stock. Shareholders who retained all their old common stock, however, did not have section 306 stock because cash in lieu of that stock would not have been a dividend. There could be no effect on voting power, as each shareholder owned the same number of voting shares after the transaction, but this was not noted by the Service. Thus, the Service seemed to assume that cash in lieu of preferred stock received by each exchanging shareholder would have been a dividend.\textsuperscript{108}

Finally, in Rev. Rul. 70-199,\textsuperscript{109} the Service expressly looked to "dividend equivalence" in applying the cash substitution test to a preferred stock dividend. It discussed the facts at length in order to support the conclusion that the recapitalization in that situation involved no "meaningful loss of control or equity interest," because "a meaningful change in position is the indispensable first step in order to avoid dividend equivalency."\textsuperscript{110} A clearer rejection of the automatic rule could hardly be imagined.

It appears that the automatic rule is not applied by the Service in determining whether cash in lieu of stock would have been a dividend for purposes of section 306 of the 1954 Code. Certainly, the availability of earnings and profits is not determinative, and the effect on proportionate interest appears significant. It is significant that the purpose of section 306 was to prevent disguised dividends from qualifying as capital

\textsuperscript{108} Accord, Rev. Rul. 57-132, 1957-1 CUM. BULL. 115. In Rev. Rul. 59-197, 1959-1 CUM. BULL. 77, preferred stock issued in a split-off was held to be "section 306 stock" because cash in lieu thereof would "clearly" have been a boot dividend. The preferred stock was voting, and although the shareholder receiving preferred stock had a greater direct ownership interest in the transferee corporation than he had in the transferor, there was no discussion of the "dividend effect" issue. The par value of the preferred stock, however, represented the holder's ratable share of the pre-"split-off" earnings and profits.

\textsuperscript{109} 1970 INT. REV. BULL. NO. 17, at 7.

\textsuperscript{110} Id. at 8.
BOOT DIVIDENDS AND THE AUTOMATIC RULE

1970] 865

gain\textsuperscript{111} (usually as a redemption), a purpose \textit{in pari materia} with that of section 356(a) (2).\textsuperscript{112}

**PROPOSED STANDARD FOR DETERMINING DIVIDEND EFFECT**

\textbf{What is "Dividend Effect"?}

It is submitted that section 356(a) (2) of the 1954 Code means that other property distributed in a reorganization has the effect of the distribution of a dividend if the distribution would have been taxable as a dividend in a transaction in which gain or loss was fully recognized. If it would not have been so taxed, then its distribution should not have the effect of the distribution of a dividend under section 356(a) (2). Thus, if the stock or securities received were fully taxable, and if that gain were taxable under, e.g., section 302(b) (2) as a substantially disproportionate redemption or under section 346 as a partial liquidation, boot received should qualify for capital gain.\textsuperscript{113} Thus, the standard for classifying boot would depend on the Congressional intent with respect to the type of transaction, a standard less precise, yet fairer in operation, than the automatic rule.

**Bedford and the Standard**

In proposing any standard for construing section 356(a) (2) of the 1954 Code, the meaning of \textit{Bedford} must be examined carefully. It would appear that the Supreme Court stated that the distribution of boot in a reorganization can never have the effect of a partial liquidation.\textsuperscript{114} It actually held that the boot distributed in that particular trans-


\textsuperscript{112} The problems involved in the "cash substitution" test of Treas. Reg. § 1.306-3(d) (1955) are beyond the scope of this article. \textit{See} B. Bitteker \& J. Eustice, \textit{supra} note 17, at 595-601; \textit{Note}, \textit{Exclusion From Section 306 Treatment in Unifying Reorganizations}, 76 Harv. L. Rev. 1927 (1963).


\textsuperscript{114} Some courts have regarded this as the holding of \textit{Bedford}, and it may have been so intended because the Second Circuit had held the cash paid to have had the effect of a partial liquidation, apparently because there was a reduction in par value. \textit{Bedford's Estate v. Commissioner}, 144 F.2d 272, 274 (2d Cir. 1944), \textit{rev'd} 325 U.S. 283. This interpretation of \textit{Bedford} has been expressed in William H. Bateman, 40 T.C. 408 (1963), \textit{not acquiesced in on another issue}, 1965-2 \textit{Cum. Bull.} 7; \textit{Associated Telephone \& Telegraph Co. v. United States}, 306 F.2d 824 (2d Cir. 1962), \textit{cert. denied}, 371 U.S. 950 (1963).
action had the effect of the distribution of a dividend. The *Bedford* case did not involve a partial liquidation in either form, substance, or effect.116 All that *Bedford* said was that under then applicable law, which taxed partial liquidations in full, the purpose of Congress in enacting the boot dividend statute could not be frustrated by arguing that a boot distribution had the effect of a partial liquidation. To have held otherwise would have allowed ordinary income to be converted into capital gain if connected with a reorganization. Indeed, after liquidations were again afforded capital gain treatment the regulations116 under section 115 provided that the term "dividend" excluded distributions in liquidations under section 115(c). This section of the Revenue Act of 1936 was not mentioned in *Bedford*.117

Thus, it is submitted that *Bedford* did not establish the automatic rule.118 That case held that a distribution of boot has dividend effect when it would have been a dividend if there were no reorganization, a view consistent with the standard proposed above. To the extent that the Court said that boot could never have the effect of a distribution in partial liquidation, such statement was dictum119 and in light of the


117. This omission is rather remarkable. See Wittenstein, *Boot Distributions and Section 112(c) (2): A Re-examination*, 8 Tax L. Rev. 63 (1952).


119. Shoulson, *supra* note 75, suggests that when Congress inserted the words "Except as otherwise provided in this subchapter . . .," before § 346 it subconsciously overruled the *Bedford* reasoning with respect to the interrelationship of Int. Rev. Code of 1939, § 115(a) and (i) (now Int. Rev. Code of 1954, §§ 316(a), 331, 346). Int. Rev. Code of 1954, § 316(a) contains a broader phrase, "[e]xcept as provided in this subtitle . . .." *See note 1 supra.* Indeed, all relevant sections of the 1954 Code, except § 356 (and other provisions in Part III of Subchapter C, have such a provision, supporting the conclusion in Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968), that the reorganization sections control other sections when both literally apply. In general, this type of analysis is not persuasive without fortification in the legislative history or by the existence of a specific evil sought to be corrected. Thus, Shoulson's suggestion
changes in statutory language and subsequent cases, that dictum has little, if any, remaining vitality. 120

Justification for the Standard

The justification for such an interpretation seems clear. Congress, in enacting section 203 (d) (2) of the Revenue Act of 1924, was attempting to prevent disguised dividends distributed in connection with reorganizations from receiving capital gain treatment. Therefore, if the distribution would not have been taxed as a dividend absent a reorganization, the avoidance technique sought to be closed in 1924 did not exist, and there is no evidence that Congress ever intended the boot dividend statute to operate to convert capital gain into dividends. 121 This construction is reinforced by the Associated Telephone & Telegraph Co. 122 reasoning and by the comment of the Court of Appeals for the Fifth Circuit that

[i]n order to effectuate the intent of Congress the dividend, liquidation, redemption and reorganization sections of the Code must be examined and viewed as a functional whole. 123

Finally, the fact that section 356(a) (2) of the 1954 Code contains a subjective test, taken together with its legislative history, compels rejection of the automatic rule.

Application of the Standard

The adoption of the standard would provide capital gain treatment for boot received by a shareholder of an acquired corporation or a corporation undergoing a nonacquisitive reorganization if his interest in the resultant corporation is substantially disproportionate to that of the other pre-reorganization shareholders. It should not matter whether that disproportion results from a pre-acquisition tender of stock for cash, a redemption (regardless of the source of the funds) 124 or a liqui-

---

120. This view was unequivocally expressed in Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949), a redemption case.
121. INT. REV. CODE of 1954, § 341 has precisely such an effect, although it has been amended from time to time to ameliorate that result.
122. See text accompanying note 94 supra.
123. Davant v. Commissioner, 366 F.2d 874, 879 (5th Cir. 1965), cert. denied, 386 U.S. 1022. The Fifth Circuit then decided that liquidation-reincorporations transcended that functional whole, and selected §§ 301, 354, and 368(a) (1) (D), (F) as applicable.
124. The Service apparently takes the view that a redemption can qualify for capital
liquidation-reincorporation. To be sure, liquidation-reincorporation situations may provide problems. In those cases, however, the standard would treat pro rata retained boot as a dividend. Logically, boot can never have the effect of a complete liquidation, and thus liquidation-reincorporation cases, if viewed as fully taxable, would be either redemptions or ordinary dividends.

The interpretation suggested above would not, however, permit disguised dividends to qualify for capital gain treatment under section 356(a)(2) of the 1954 Code, and would apply dividend effect to pro rata distributions not having the effect of a partial liquidation. Further, it would not have affected the result of any of the cases heretofore discussed, except for the Lewis case.\textsuperscript{125} It would assure flexibility, in that the treatment of boot would always correspond to the treatment of corporate distributions generally. Finally, it would give the statute the interpretation intended by Congress.

CONCLUSION

There appears to be no legal or policy reason why the Service could not adopt the interpretation of section 356(a)(2) of the 1954 Code set forth above. There appears to be no commentator whose view is contrary, although some would go further and would substantially vitiate boot dividends.\textsuperscript{126} The problems that apparently disturb the Service relate primarily to the dividend-within-gain limitation, and if that provision is undesirable (as it may well be\textsuperscript{127}) legislative relief is appropriate.

\textsuperscript{125} 176 F.2d 646. The partial liquidation provisions of § 346 probably would not apply to Estate of Elise W. Hill, 10 T.C. 1090 (1948) because of the failure of the corporation involved therein, being a holding company, to satisfy the active conduct of a trade or business requirement of § 346(b).

\textsuperscript{126} In theory, the individual shareholders' pre-reorganization versus post-reorganization percentage ownership could be compared, although almost all boot would qualify for capital gain treatment under such a test. Moore, supra note 14, would determine "substantially disproportionate" by use of post-reorganization ownership.

\textsuperscript{127} The provision may be especially undesirable in nonacquisitive reorganizations, as a controlling shareholder with high-basis stock could obtain tax-free dividends by
appropriate. The statutory language, the legislative history, the trend of the cases, and the section 306 regulations, however, all lead to the conclusion that "the effect of the distribution of a dividend" requires an inquiry into the generic tax consequences of the distribution and to the rejection of the automatic rule.

Recapitalizing. Fear of such a result probably underlies Treas. Reg. § 1.301-1(l) (1955) and Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, and may explain the distinctions drawn by the Service between acquisitive and other reorganizations.